February 2023

Ninety One

Emerging Market Debt Indicator

The fast view

Market background

After the strong start to 2023, February was a weaker month for financial markets. Data on the US economy pointed to a resilient labour market – coupled with disappointingly high inflation, this caused US Treasury yields to rise. Similarly, better-than-expected economic activity data led to a sizeable sell off in other developed bond markets. Against this backdrop, EM debt and currency markets weakened.

Africa

In Nigeria's tightly contested presidential election, Bola Tinubu was declared the victor. Tinubu is expected to try to deal with the country's macro imbalances. Egypt's government unveiled its privatisation plan (it plans to sell stakes in 30 state-owned enterprises). Ghana's government finalised its domestic debt restructuring, setting the stage for external debt negotiations.

Asia

The rise in US Treasury yields and subsequent strengthening of the US dollar dominated asset price moves. As many central banks across Asia have not needed to hike rates as much as the US Federal Reserve, the interest rate differential was front of investors' minds, weighing on currencies. China's economic activity has continued to rebound, with services-oriented sectors performing particularly well.

Latin America

In Brazil, President Lula da Silva continued his criticism of the central bank's monetary policy. More positively, the government is set to resume the collection of federal taxes on fuels at the end of February, which should help improve Brazil's fiscal account. In Mexico, the central bank raised its key interest rate by 50 basis points to 11% in February, above expectations of a 25 basis point hike.

Central and Eastern Europe

While the overall economic growth picture in the region remains weak, there are some areas of surprising resilience – helped by lower European gas prices – and current account deficits appear to be reducing in size. Core inflation appears to be moderating across the region, albeit from particularly high levels. The notable exception is Hungary, where core inflation momentum is still concerningly high.

Rest of Europe, Middle East and Africa (EMEA)

Growth data in South Africa continued to be fairly downbeat, linked to the ongoing loadshedding (power outages). On the positive side, the finance minister announced quicker-than-expected support for Eskom at the recent budget. In Israel, there was bouts of volatility across domestic assets over the month (relating to political tensions), with both local bonds and the shekel selling off.

EM corporate debt highlights

Although EM corporate debt (JP Morgan CEMBI BD) fell 1.6% over the month, it held up relatively well compared to EM sovereign bonds (-2.2%, JP Morgan EMBI) and the Bloomberg Global Aggregate Bond Index (-3.3%).

Peter Eerdmans

Head of Fixed Income and Co-Head of Emerging Market Sovereign & FX

Market background

After the strong start to 2023, February was a weaker month for financial markets. The driver of this was a reset in expectations over the outlook for US monetary policy, with investors revising up forecasts of the 'terminal rate' – the maximum level that the interest rate will reach before it starts to fall again.

Data on the US economy pointed to a resilient labour market – reflected in a large upside surprise in non-farm payrolls – while inflation remained disappointingly high. As a result, yields across the US Treasury curve climbed, with the 10-year note closing the month at 3.95%. A similar theme played out beyond the US, with a run of better-than-expected economic activity data (PMIs) leading to a sizeable sell off in developed bond markets.

Against this backdrop, EM fixed income and currency markets weakened, with the local index (JP Morgan GBI-EM) falling 3.2%, driven mostly by FX market moves. In hard currency debt markets, sovereign bonds (JP Morgan EMBI) fell by 2.2%, while EM corporate debt (JP Morgan CEMBI) proved somewhat more resilient, ending the month 1.6% lower.

The disparity between interest rates in Asia and the US was at the front of investors' minds, with the unfavourable comparison causing Asian currencies to struggle against the US dollar. In China, economic activity continued to rebound strongly as the post COVID recovery forged on, with the services sector performing well.

Turning to Latin America, the central bank in Mexico surprised the market by announcing a larger-than-expected rate hike of 50 basis points, with an accompanying hawkish message. In Brazil, political noise continued to concern investors, with President Lula suggesting that he wants to raise the country's inflation target, although this is yet to materialise.

Top-down views and outlook

Although we expect bond markets to remain volatile given ongoing uncertainty around the war in Ukraine, inflation and global economic growth, we are constructive on the medium-term outlook for returns from the EM debt asset class. Many EM economies have solid fundamental foundations, while the more fragile among them are receiving plenty of support from the IMF and other multilaterals. Furthermore, with much of the painful interest-rate hiking now behind them, most EM economies are in an enviable position relative to developed markets overall. Against this backdrop, EM bond market valuations look compelling – with some markets pricing in significantly more risk than we believe is justified.

As the monetary policy action of the past 12 months begins to bite, growth will slow – even though recent data has been mixed to stronger – and the risk of recession may rise across markets. However, the relaxation of China's COVID policy stance is likely to counteract this somewhat by spurring an economic recovery. Many EM economies are on a solid footing, aided by quick central bank action that helped rein in inflation. With EM inflation generally subsiding and much of the rate hiking done, nominal GDP is rising, fiscal balances largely look healthy, and debt-to-GDP ratios are falling. While risks around inflation (particularly the speed and rate of its decline) remain, we think most EM bond markets are already pricing this to a large extent.

Looking to some of the more vulnerable emerging markets, the IMF appears intent on ensuring that liquidity risks do not spiral into solvency risks as it engages with them, enters programmes, and helps facilitate reform agendas. We believe that many of these markets have already priced risks to a great degree.

Into the end of last year and the start of this year, one of the key headwinds to EM debt – the relentlessly strong US dollar – reversed its trend, giving some cause for optimism. At the same time, markets began to consider when a 'pivot' away from the Fed's tight monetary policy might occur. While uncertainty and volatility are likely to remain a feature of global markets for some time, we believe that in the coming months the Fed will approach the end of its hiking cycle and bond yields reach their peak. There are risks to this view, which include the Fed ramping up its hawkish rhetoric if

financial conditions ease too much, and short-term rates may be more sluggish than expected in reversing course.

From a top-down perspective, we have slightly trimmed our overweight risk target across our EM debt strategies. This was driven by our EM local debt target moving back to neutral, as while we are seeing improved structural strength across EMs, spreads over US Treasuries and hedged-bond yields have both become less attractive. Regarding EMFX, we have retained our overweight target. Strong underlying fundamentals of higher carry and healthy external balances are supportive, and the risks of a moderate global recession, while still present, are less prevalent. We have also kept our overweight to hard currency debt. Although hard currency debt remains vulnerable to slowing growth and higher rates, valuations remain attractive, in our view, as forced selling pushed high-yield valuations to extreme levels, and these have only partially recovered.

Top-down positioning at end February 2023

	- -	-	0	+	+ +
Overall risk				■	
Hard currency debt				■	
Local rates			■		
FX				■	

For illustrative purposes only. For further information on the investment process, please see the important information section.

Christine Reed

Analyst – Latin America

Notes from the road: Latin America

Christine Reed's recent trip to Brazil and Mexico revealed a deep contrast in local sentiment and highly divergent outlooks.

Brazil: bearish on Lula's fiscal direction, but this is in the price

My trip confirmed that the mood on the ground in Brazil is deeply pessimistic. Since the presidential elections, President Lula da Silva (Lula) has disappointed the markets on a variety of fronts: he has been more successful than expected at increasing fiscal spending; his ministerial appointments are highly questionable; and he has attacked the central bank and its autonomy.

It is the first point, fiscal risk, that is weighing most heavily on sentiment. Lula seems intent on driving growth through fiscal spending, which ultimately means weaker fundamentals facing debt investors. For context, Brazil's debt-to-GDP ratio – already higher than regional peers' – is expected to increase by 10% over the next four years. Coupled with this, supply and demand dynamics are likely to weigh on the external hard currency debt market: the capitalisation necessary among state banks is likely to involve some US dollar issuance, while the domestic credit market is tightening, and this typically encourages offshore issuance given the relatively attractive funding costs.

However, the bond market appears to be priced for all this, and the overall fundamental picture for Brazil is not all bad news. A buoyant agricultural sector, which is enjoying a strong year, is a bright spot for growth, with the resultant currency inflows from soy exports likely to boost the Brazilian real over the next few months. Furthermore, the central bank's decisive reaction to rising inflation last year (discussed as part of a wider piece here) – together with the downturn in domestic demand, well-contained inflation and Lula-led political pressure – all point strongly towards rate cuts this year given the exceptionally high real (inflation-adjusted) rates. While the overall direction of the Lula administration is worrisome from the perspective of debt investors, these shorter-term cyclical dynamics offer opportunities for the active investor.

Mexico: creeping optimism amid signs of AMLO pragmatism

'Nearshoring' by the US (moving part of production to countries that are geographically closer) and its potential to underpin growth and boost investment was a theme that came up several times during my trip. However, underinvestment in Mexico's energy and water infrastructure – particularly in the north – means spare capacity is limited; this poses the risk of extra investment into the country potentially adding to inflationary pressures. Fortunately, President Andrés Manuel López Obrador (AMLO) is growing more pragmatic on his energy policy, recognising that the state-owned utility company CFE is not delivering on what is needed for increased investment in the north of the country. AMLO is starting to create incentives for projects such as a large solar field in Sonora, while the ministry of finance will try to facilitate access to financing for nearshoring projects and their infrastructure requirements (water and electricity) via the development banks. AMLO's pragmatism will be key here if Mexico is to reap the benefits of nearshoring from the US.

During the trip, I also met with the CFO of Pemex, the state-owned oil and gas company. It was encouraging to learn that we are not the only investors asking the company for improvements on intentions and reporting around emissions reductions. Furthermore, the message appears to be getting through, as Pemex is working to improve its budget transparency to disclose the amounts it is spending on individual ESG-related matters. Pemex has also approved the creation of an ESG committee which will start in December.

Other takeaways from my trip that point to a relatively bright outlook for Mexico's economy is that pension regulation changes appear likely to give the already strongly growing AFOREs (individual pension schemes) market further impetus, increasing the structural demand outlook for long-dated local bonds.

Against this more constructive backdrop though, I encountered a more cautious central bank. Banxico remains vigilant around high inflation in the services sector and the persistence of core inflationary pressures, as well as being concerned that a more hawkish US Federal Reserve will mean a higher US terminal rate. Further rate hikes and then a prolonged pause seem the most likely outlook for Mexico's monetary policy, but this should allow the local bond curve to flatten and the currency to trade well.

Regional highlights

Africa

In Nigeria, voting took place in the tightly contested presidential election, with the candidate for the incumbent APC party Bola Tinubu declared the victor. Although we expect some legal challenges given how tightly contested the election was, these are unlikely to be successful, in our view. The market will now look forward as Tinubu seeks to deal with the macro imbalances that have built-up over ex-president Buhari's term, with the initial focus on dealing with fuel subsidies and the exchange rate. On the fundamental side, oil production continued to rise and this should start to help external balances; in the interim period, FX reserves have continued to decline and the black market FX premia remains around 60%.

The government in Egypt successfully issued a US$1.5 billion sukuk with strong demand from the Middle East and North Africa region, although at a yield of 10.875%, the exercise could become a costly one if more issuance gets completed at these levels. The government unveiled its privatisation plan which will see it sell its stakes in 30 state-owned enterprises (SOEs) as part of the first phase of SOE sales. We are also waiting for the IMF review on 15 March, which will again be an important milestone as investors try and assess the success of the IMF program and the country's reforms.

In Ghana, the government finalised its domestic debt restructuring after several attempts, which now sets the stage for external debt negotiations. On the external debt side, a delegation from the Export-Import Bank of China visited Accra. Although China is a small holder overall in Ghana's debt, getting China on board as part of the official creditor committee is an important signal in terms of securing the IMF program, which we expect to happen in Q2 of this year.

Inflation started to increase in Zambia on the back of a weaker kwacha and higher food and fuel prices, but in a broader regional context, inflation remains reasonably low. The trade balance has also started to deteriorate, as although the overall current account is likely to remain in surplus, higher imports are starting to weigh on the size of the external surpluses. Regarding the debt restructuring, or lack thereof, visits from both Janet Yellen (US Secretary of the Treasury) and Kristalina Georgieva (Managing Director of the IMF) have started to gain global attention. We expect more traction on negotiations as we head into the first review of the IMF program in April of this year.

Asia

The main theme affecting assets in Asia over February was the rise in US Treasury yields and subsequent strengthening of the US dollar. As many central banks across Asia have not needed to hike rates as much as the US Federal Reserve (reflecting the lower inflationary pressure), the interest rate differential was front of investors' minds. This weighed on currencies generally across the region.

In China, economic activity has continued to rebound, with services-oriented sectors performing particularly well. These benefited from a sharp increase in domestic mobility, with flights and subway traffic volumes now roughly back to pre-pandemic levels. Although some weak spots remain, namely the housing market, there are early signs that property sales are beginning to grow year-on-year. Geopolitical tensions with the US were also a prominent feature, adding to the weakness in the renminbi over the month. Looking ahead to early March, the highly anticipated China's National People's Congress will begin, where we will learn more about economic policy plans for 2023.

Current account data out of Thailand was disappointing at the headline level, with imports rising much faster than expected, weighing on the Thai baht. However, we believe this is likely a one-off, as we think the current account is on an improving trend for the year ahead.

The Bank of Korea raised rates as expected, signalling that it remains open to the possibility of another hike as and when needed. The market responded positively, with local bonds rallying. However, subsequent concerns around currency weakness (relating to persistent inflation and the widening interest rate differential with the US) weighed on sentiment with heavy investor positioning leading to outsized moves; the market now believes that the central bank will have to keep hiking rates to 4.0%. We believe the market has overreacted and is pricing in too many rate hikes given the weakness of the Korean economy as result of its hiking cycle to date.

The Reserve Bank of India hiked rates by 25bps over the month, with a more hawkish statement than expected, suggesting that it is willing to increase rates further given persistent inflationary pressures, particularly core inflation. Subsequently, the consumer price index (CPI) inflation reading for January was higher than expected, lending credence to the bank's stance. The combination of this and rising US rates caused local bond yields to rise.

Similarly, the central bank in the Philippines is still hiking rates aggressively, lifting the rate by 50bps over the month, citing inflation as the cause. The current account deficit is also very wide.

However, in Indonesia the central bank paused its hiking cycle given the much-improved current account balance and already high real interest rates. The central bank also announced that it believes its policy rate is sufficiently tight to bring inflation back down to its 2-4% target. This helped Indonesian local bonds to relatively outperform over the month.

Latin America

In Brazil, President Lula da Silva continued his criticism of the central bank's monetary policy, stating that high interest rates are ruining the economy while failing to control inflation. This weighed on investor sentiment given the negative signal for central bank independence. Meanwhile, the central bank left its key rate unchanged at 13.75% in February, signalling a more cautious stance due to fiscal risks. In more positive news, the government is set to resume the collection of federal taxes on fuels at the end of February, which should help improve the country's fiscal account.

The Chinese-owned Las Bambas mine in Peru halted production following two months of blockages and protest action. However, the country's economic outlook improved towards month-end after protests showed signs of subsiding. In political news, Peru's Congress rejected a proposal to move elections forward following months of civil unrest, making it unlikely that elections will be held this year unless President Boluarte resigns – reducing the political risk somewhat. Inflation for January came below market expectations and the central bank delivered a dovish surprised by keeping rates on hold at 7.75% against market expectations for an additional hike.

Data out of Chile continued to point to softer economic activity, albeit above market expectations, making the prospect of a soft landing more likely. Chilean President Gabriel Boric announced a new package of social spending worth US$2 billion to help boost economic growth, to be partially financed from the 2023 budget. Meanwhile, forest fires continued to blaze through south-central Chile, fuelled by excessive heatwaves and drought conditions.

The Bank of Mexico raised its key interest rate by 50bps to 11% in February, above expectations of a 25bp hike. The central bank appeared more hawkish in its messaging, revising its inflation expectations higher for 2023 and 2024. Annual inflation accelerated above market expectations to 7.9% in January, while Mexico's trade deficit narrowed largely on the back of a sharp increase in exports. In other news, manufacturing PMI and retail sales both experienced positive growth, after contracting in the previous month. On the political front, thousands took to the streets to protest against President AMLO's electoral reforms, citing concerns that the changes pose a threat to the independence of electoral officials.

Argentina's grain and oilseeds export revenue fell 61% year-on-year in January, as the prolonged drought continues to weigh on the country's agricultural sector. Exports fell by 11.7% year-on-year in January, widening the country's current account deficit. On the political front, former president Mauricio Macri hinted that he would not run in the next election, ending speculation that threatened to cause divisions within the opposition party.

Colombia's economy expanded by 2.9% year-on-year in the fourth quarter, missing market expectations of a 4.0% rise. Economic activity continued to show signs of softening, with retail sales contracting for the first time since January 2021. In political news, President Petro's proposed reforms in the health and utility sectors rattled the market given the large potential fiscal cost, sparking a sharp sell-off of Colombian assets. In addition, Petro attacked the banking sector given his plans to reform the pension system.

In Ecuador, voters rejected President Lasso's referendum to reform the constitution, which had sought to improve the security situation and also included a number of political reforms. Lasso has come under increased pressure following last year's civil unrest, heightening political uncertainty in the country. In addition, the ruling party suffered from a poor local election result, which highlighted the strength of the

populist opposition and revealed just how weak Lasso's position has become. This raises the likelihood of an impeachment in the short-term.

Central and Eastern Europe (CEE)

While the overall economic growth picture in the region remains weak, there are some areas of surprising resilience – helped by lower European gas prices – and current account deficits appear to be reducing in size.

Czech Republic remains arguably the weakest in the region from a growth perspective, partly reflecting low wage growth and the effect of tighter monetary policy beginning to bite.

Seasonal price changes in January, coupled with changes to administered energy prices, made it difficult to infer inflation momentum in January. That said, core inflation does appear to be moderating across the region, albeit from particularly high levels. The notable exception is Hungary, where core inflation momentum is still concerningly high.

Overall, the guidance from central banks in CEE remains hawkish in tone. However, rather than pointing to a likelihood of further rate hikes, monetary policymakers are simply guiding for the current policy rates to be held at these high levels for longer – this resulted in some bond market repricing over the month.

Problematic inflation dynamics in Hungary saw the country's central bank remain the most hawkish among regional peers; it is likely to reduce the emergency rate only gradually from 18% back to its main policy rate of 13%.

Rest of Europe, Middle East and Africa (EMEA)

Turkey and Syria are still dealing with the fallout of the catastrophic earthquake, with the death toll tragically exceeding 50,000 people across the two countries. In Turkey, the latest estimates of the total cost inflicted by the damage are US$30-50 billion. The political implications of this have been significant anger directed towards the government, with the latest polls showing a dip in support for the ruling party. There was speculation over the month that the presidential elections would be postponed, but this is increasingly looking like it will take place as scheduled, with 14 May the most likely date. The latest news flow from the opposition has been somewhat turbulent, but it is turning more positive, with the opposition coalition promoting two popular mayors to vice presidential candidates. This is in a bid to help drive support for the less charismatic presidential candidate. On monetary policy, the central bank restarted its interest rate cuts of 50bps, while continuing to manage lira demand through increasingly tight macroprudential regulations.

In Israel, there was bouts of volatility across domestic assets over the month, with both local bonds and the shekel selling off. This reflected rising political tensions related to the government's attempt to eliminate judicial oversight (which we covered in last month's Indicator). As well as the judicial reform, Prime Minister Netanyahu was forced to publicly support the central bank's independence after a member of the government spoke out against interest rate hikes. In this vein, the Bank of Israel continued its hiking cycle by raising rates by 50bps to 4.25%, with the bank referring to the persistent inflationary backdrop and weaker currency.

Growth data in South Africa continued to be fairly downbeat, linked to the ongoing loadshedding (power outages). On the positive side, the finance minister announced quicker-than-expected support for Eskom at the recent budget. More broadly, the budget was largely in line with the policy statement made in Q4 2022, although there are risks to both revenue and government expenditure given the weak growth outlook and the looming 2024 election. In addition, South Africa was added to the Financial Action Task Force's (FATF) grey list due to its inadequate anticorruption framework. While it is too early to assess what the longer-term consequences will be, grey listings typically result in a drop in capital inflows, albeit fairly modest in size. The ministry of finance has said that it will try to address the inadequacies highlighted by the FATF.

EM corporate debt highlights

Although EM corporate debt (JP Morgan CEMBI BD) fell 1.6% over the month, it held up relatively well compared to EM sovereign bonds (-2.2%, JP Morgan EMBI) and the Bloomberg Global Aggregate Bond Index (-3.3%). The underlying move higher in US Treasury yields was a dominant driver of the negative total returns, however spreads were unchanged, with investment-grade spreads actually tightening marginally. All sectors in the JP Morgan CEMBI BD were negative over the month, while from a country perspective, issuers in Brazil and South Africa featured at the bottom of the index. In contrast, issuers in Ukraine and Jamaica delivered positive total returns.

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