Emerging Market Debt Indicator

The fast view

Market Background

- The JP Morgan GBI-EM Global Diversified fell during the month, delivering a total return of -1.07% in US dollars. The JP Morgan EM Bond Index dropped by 1.09%.
- The yield on the US 10-year treasury bonds rose over 1% during January, the first time this had occurred since last March. The oil price rallied above US$50 a barrel for the first time since February 2020.

Africa

- PMI prints are improving across the region, with many holding above 50.
- Egypt has begun vaccinating health care workers while remittance inflows rose by 12% in the period January-November, which have helped buffer the deterioration in the current account caused by the lack of tourists.

Asia

- The region has been performing well, with GDP growth upgraded in Singapore, China and South Korea, but there are concerns about the new strains of COVID-19 and the re-imposition of lockdowns.
- Localised consumption and imports have been more subdued, leading to strong balance of payments dynamics for much of Asia.

Latin America

- With the exception of Mexico, regional COVID infection rates appear to be stabilising. Ecuador, Panama and Brazil are the latest countries to start vaccination programmes, following Chile, Mexico, Costa Rica and Argentina, which began last month.
- On the ESG front, Chile issued US$4.3bn of a total US$19bn funding requirement in the form of green and social bonds.

CEE

- In Poland, activity data confirmed the economy's strong recovery while the National Bank of Hungary kept its policy rate unchanged at 0.60%.
- Following moderating inflation over the last couple of months, the National Bank of Romania surprised the market by cutting its policy rate to 1.25%. In the Czech Republic, the majority of the central bank's board members maintained their hawkish stance.

Rest of EMEA

- Although Turkey's central bank remained on hold in January, forward guidance messages were positive. Several negative headlines came out of Russia, mostly concerning sanctions.
- In the Middle East, vaccine programmes are being rolled out, most notably in Israel, the UAE and Bahrain, which proportionally are some of the highest vaccinating countries globally.

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Market background

The JP Morgan Government Bond Index–Emerging Market (GBI-EM) Global Diversified Index fell in January, producing a total return of -1.07% in US dollars, while the JP Morgan EM Bond Index declined by 1.09%.

Democrat wins in the Georgia runoff elections and the expectation of further stimulus and higher inflation helped push the yield on the US 10-year Treasury above 1% during January, the first time this had occurred since last March. The US Federal Reserve (Fed) Chairman indicated that the recent moderating in domestic growth prospects and higher unemployment claims, reflecting a deteriorating COVID-19 picture, would keep current monetary policy in place. The Fed forecasts an annual drop in unemployment to 5% by year-end, from 6.7% at the end of 2020, and a further decline to 4.2% by the end of 2022.

As expected, China reported annual GDP growth of 2.3% for 2020, in comparison with a global contraction of 3.5%, according to the IMF. This confirmed the country's position as the only major economy to grow during the pandemic, with some economists suggesting it will also accelerate the time by which the Chinese economy will reach parity with that of the US, now expected before the end of this decade.

The IMF reported that the roll-out of COVID vaccines in developed economies in the first half of the year, and in the second half for emerging economies, is expected to contribute to a strong recovery for global economies during 2021, although the mutating virus is causing some degree of uncertainty.

The oil price rallied above US$50 a barrel for the first time since February 2020. This was helped by Saudi Arabia's decision to cut production and prospects for the global economy later this year.

Peter Eerdmans

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

Top-down views and outlook

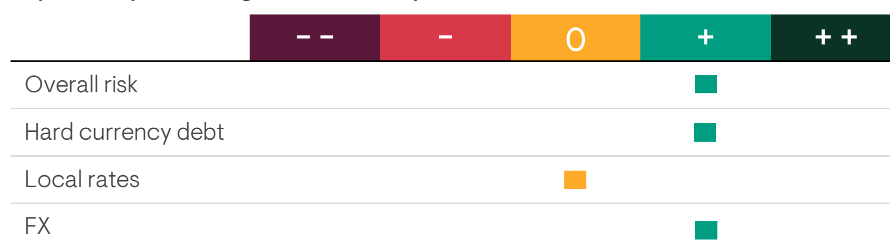
A revival in the manufacturing sector continues to be supportive for emerging markets (EMs), with demand being buoyed by US and European consumers. Although the reintroduction of lockdown measures across the world will weigh on the service sector, particularly travel, this is generally a small portion of most EM economies and so has a larger impact on developed markets. Having said that, we are seeing some weakness across EMs as a result of further lockdowns, but as vaccine programmes are rolled out and restrictions start to ease, the subsequent recovery in activity should spark positive growth during the second quarter and a return to near normality later this year.

We believe the central bank put remains firmly in play and signals ongoing central bank support as lenders of last resort. The new US administration is also expected to be supportive for EM assets, as it is likely to introduce a more predictable foreign and trade policy. We think these macro and geopolitical adjustments are likely to be accompanied by a high degree of divergence for sovereign debt, reflecting factors such as countries' vulnerabilities at the beginning of the crisis (and which may have been exacerbated by the pandemic), how well governments have been handling the crisis, and crucially how they will finance their deficits.

With a large proportion of developed market (DM) sovereign debt currently in negative real yield and c.US$15trn DM sovereign debt registering outright negative nominal yield, we expect more investors to consider EM debt, given its yield and relative value attractions remain intact. Supportive tailwinds include the allure of relatively attractive yields in a low-yield world, improving trade flows within and across EM regions and the diminishing role of the US dollar on the global stage.

We remain positive on prospects and have maintained our top-down risk exposure target across our strategies. We retain an overweight to emerging market currencies (EMFX), partly funded out of the relatively expensive euro. Improving current account balances and trade dynamics remain supportive for EMFX, which we believe is still undervalued. We also continue to see value in EM hard currency high yield bonds as spreads have not fully recovered to pre-COVID levels. We are neutral on local currency bonds (rates), and while absolute valuations are tight, selected local bonds still offer an attractive pick up compared to developed market yields.

Top-down positioning at end January 2021



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Vivienne Taberer
Portfolio Manager,
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Insights from the team

How likely is real fiscal consolidation in Costa Rica?

The staff-level agreement between Costa Rica's government and the IMF on a three year, US$1.75bn loan marks a significant change in the country's relations with multilateral agencies. It will strengthen long-standing weaknesses in public finances and provide support as Costa Rica recovers from the COVID-19 pandemic. Equivalent to 3% of GDP and 7% of estimated gross financing needs during 2021-2023[1], the Extended Fund Facility (EFF) is expected to be approved in the Costa Rican Congress by the summer. The sovereign bonds have already recovered from distressed levels and could improve further in response to the fiscal consolidation.

Following wide ranging domestic consultation, and to qualify for the EFF, the government has agreed to a range of policy adjustments amounting to 4.7% of GDP by 2023, split 75:25 between spending reduction and revenue raising measures. Expenditure adjustments centre on public employment reform as public sector wages account for half of government revenues, twice the average in the OECD. There would also be a freeze on cost-of-living increases for state pensions. Revenue measures include a tax on luxury property and lottery earnings and moving to a single rate of income tax.

Figure 1: Costa Rica IMF Programme Adjustment (% GDP)

Proposal or Policy	2021	2022	2023	2024	2025
Spending	**0.77**	**1.49**	**2.24**	**2.92**	**3.59**
2018 Fiscal Rule Enforcement	0.4	0.82	1.3	1.69	2.07
Public employment, other measures	0.37	0.66	0.95	1.23	1.52
Revenue	**0.29**	**0.7**	**1.17**	**1.16**	**1.15**
Unified Income Tax			0.43	0.43	0.43
Lottery tax	0.06	0.12	0.12	0.12	0.12
Eliminating select tax exemptions	0.11	0.35	0.34	0.33	0.32
Temporary SOE profit transfer	0.12	0.15	0.2	0.2	0.2
Luxury home tax		0.08	0.08	0.08	0.08
Total Adjustment	**1.06**	**2.19**	**3.41**	**4.08**	**4.74**

Source: IMF, Costa Rica presidency, Jefferies

[1] Source: Fitch Ratings, https://www.fitchratings.com/research/sovereigns/costa-rica-would-face-debt-challenge-even-with-imf-deal-14-12-2020

Any external financing needs to be approved by a two-thirds majority in the legislature and despite the challenges of a fragmented congress, President Carlos Alvarado Quesada is working hard to ensure sufficient support to get the IMF deal approved by mid-year and funding to commence before the next election in February 2022. Reducing salaries of the highest paid in the public sector, while freezing others is unlikely to prove contentious with the general populace, who are dealing with an unemployment rate of 22%, more than ten percentage points higher than before the pandemic, according to the national statistics agency.

The economic shock caused by the COVID pandemic has forced the government's hand regarding fiscal reform. Unlike previous attempts to solicit multilateral aid, its dialogue with the electorate on how the programme adjustment will be made (Figure 1) has meant that the EFF staff level agreement has not been accompanied by widespread public protests; the sovereign bonds have already rallied from distressed levels and spreads could continue to narrow in response to the fiscal consolidation.

Despite concerns about the country's large fiscal deficit, we remain positive on prospects, and overweight the hard currency bonds as legislative approval for the EFF will justify a confidence boost and could open the door up to further multilateral funding. With some justification, Alvarado has stated that Costa Rica has the potential to be the most developed country in Latin America. Its high ESG scores reflect a very open economy supplemented by a well-developed education system that has encouraged inward investment in the high tech sector, strong health care (the country, along with Chile, were the first in Latin America to vaccinate their citizens against COVID) and success in preserving its natural resources, supporting tourism as a major contributor to the economy. Costa Rica is also 98% powered by renewable energy, with the goal of reaching 100% during 2021, putting it among the top-ranking countries in this field.

While the road ahead for Costa Rica looks challenging, a successful combination of leveraging its good ESG score and implementing meaningful fiscal consolidation can go a long way to compressing its wide sovereign spreads further and reversing the deterioration of recent years that has seen Costa Rica's Moody's credit rating tumble from investment grade to B.

Portfolio positioning highlights

An overview of our positioning in a selection of regions, countries and currencies.

Africa

In Egypt, the health minister said the government had secured 100 million COVID-19 vaccines from a range of manufacturers and had started vaccinating health workers. The non-oil private sector contracted for the second month in a row, with January's seasonally-adjusted purchasing managers' index (PMI) at 48.7, a slight improvement on December's figure of 48.2. Remittance inflows rose by 12% in the period January-November, which helped buffer the deterioration in the current account caused by the lack of tourists. We remain long Egypt local currency through a mixture of bonds, bills and long-dated hard currency bonds.

In Angola, oil revenues declined 7% during 2020, with volumes down by 4.5%. We remain optimistic about the country's ability to slow its declining oil production, given significant regulatory reforms which has encouraged increased investment from Total and others. In a move to increase domestic market competition among telecommunications providers, the government approved a fourth license for UK-based mobile operator Africell. It also announced a new vehicle tax as it seeks to broaden the tax base. Net foreign exchange reserves declined to US$8.5bn at the end of January from US$8.7bn in December. Although the deterioration in reserves is concerning, we expect the conclusion of negotiations with the Chinese on debt restructuring, as well as higher oil prices and support from the IMF to result in the stabilisation of reserves during 2021. We remain long the hard currency bonds.

Ghana's PMI increased to 51.2 in January, from 50.3 in December, and this was attributed to the reopening of new schools and rising new orders. Public debt increased to 74% of GDP at end of November, with a fiscal deficit of 10.8% for the period January-November which was lower than the targeted 11.9% but showed that the deficit still needs to be reduced to sustainable levels over the next three years. As the economy continues to recover, the central bank decided to keep rates on hold at 14.5% as it seeks to balance the risks of a weak economic recovery with that of rising inflation from a slow reduction in the fiscal deficit. We continue to hold the World Bank guaranteed 2030 bonds, as well as hedged local currency positions.

Kenya's PMI rebounded to a three-month peak of 53.2 during January. The print was underpinned by a solid increase in output and new orders, driven by domestic demand following the reopening of schools. Siaya became the first county to approve the Building Bridges Initiative (BBI) constitutional amendment bill. Aimed at reducing tribal tensions through the introduction of a prime ministerial post as well as increasing devolution, it must be endorsed by 24 out of 47 local parliaments before proceeding to a referendum. We continue to hold Kenya infrastructure bonds as well as hard currency bonds.

There have been signs of growing dissent among the opposition in Ivory Coast regarding a strategy for the 6 March parliamentary elections, as the party of exiled former rebel leader Guillaume Soro said it would not participate. Charles Ble Goude's COJEP movement now leads the opposition coalition. This bodes well for the incumbent RDR party, which has astutely managed electoral unrest regarding a possible third term for President Alassane Ouattara. The trade surplus started to shrink as a slowdown in cocoa exports was mirrored by a pickup in imports as the economy started to normalise. After a period of strong performance, we saw limited opportunity for spreads to compress and reduced our holding in the hard currency bonds.

Asia

Key themes prevalent at the end of last year carried over into January. The region has been performing well, with GDP growth being upgraded in Singapore, China and South Korea and a broader based expansion of industrial production, but there are concerns about the new strains of COVID-19 and the re-imposition of lockdowns. As a result, localised consumption and imports have been more subdued. While global demand has been holding up, leading to strong balance of payments dynamics for much of Asia, the region faces the uncertain consequences of uncoordinated vaccine roll-outs and a reliance on the recovery in developed markets.

The rise in US Treasury yields and the resultant risk-off tone meant that bond prices retracted slightly over the month in Indonesia, Asia's highest beta market. Concerns over the heavy supply of bonds without the same support from the central bank as last year was also a factor. The central bank kept rates on hold at 3.75% as expected, and there were tighter movement restrictions imposed on the holiday island of Bali and in Jakarta. We remain overweight the rupiah and local bonds.

It was a challenging month for the South Korean won, which declined 2.8% against the dollar. Higher US Treasuries and the stronger US dollar played their part, as did domestic investors increasing investments overseas and selling won in the process. The result was a correction in the currency, which underperformed its north Asian peers. We remain long the won, however, as we believe the current account will continue to strengthen, underpinned by expected strength in exports.

China recorded a strong fourth quarter GDP of 6.5% compared with 2019 and 2.3% for 2020, making it the only major economy to grow during a pandemic ravaged year. Interest rates were kept on hold as expected. Some of our strategies closed their underweight to local bonds over the month and moved to a neutral position. China bonds underperformed over 2020, but we expect flows to continue into the market as we believe they are attractively valued versus the rest of the world, and the yield is also appealing. We remain long the renminbi.

In Malaysia, the latest COVID outbreak is severe, and in response the government has imposed a strict lockdown. Even though current infections are higher than they were last year, policy makers have estimated that the effect on economic growth will only be a quarter the comparable impact from the first wave, highlighting how the country has been able to adapt. Although the market expected a rate cut, the central bank kept them on hold. We are long the ringgit and local bonds as exports are expected to continue to perform well despite the weaker domestic demand due to the lockdowns.

Latin America

With the exception of Mexico, regional COVID infection rates appear to be stabilising. Ecuador, Panama and Brazil are the latest countries to start vaccination programmes, following Chile, Mexico, Costa Rica and Argentina, which began last month.

On the ESG front, Chile issued US$4.3bn of a total US$19bn funding requirement in the form of green and social bonds. Following active engagement with Uruguay last year, the country indicated it is exploring how to leverage its high ESG score and utilise this in a sovereign issuance programme.

In Argentina, the government imposed a ban on corn exports early in the month in a bid to prevent domestic food (meat) prices increasing. This was opposed by the farming community, which reacted by striking. The government subsequently lifted the restrictions, however its intervention affected investor confidence by suggesting a return to slightly more unorthodox policies. We are long the hard currency bonds as discussions with the IMF on debt restructuring will restart in a few weeks, the vaccination programme is well under way with some of the highest numbers vaccinated regionally, and the central bank is making progress on accumulating US dollar reserves.

With the first round of Ecuador's general election in early February, the market is largely pricing in a win for opposition candidate Andres Arauz, who has rejected the country's US$6.5bn extended fund facility deal with the IMF and this impacted bond prices. We believe that even if Arauz becomes president, it will be hard for him to backtrack completely from any IMF obligations. Domestic economic data from the country has been recovering, including the non-oil trade balance and a US$3.5bn deal has been reached with the US to pay off Chinese debt in exchange for excluding Chinese companies from its telecommunications network. We remain positive on the bonds and retain our overweight.

The central bank in Chile announced that it will build up its US dollar reserves over the next two years in line with the IMF's recommended levels, which will mean accumulating over 4% of GDP. Uncertainty around the constitutional election on 11 April is also being priced in. As a result, the peso weakened in January. In other news, retail sales rose 21% in December on the COVID induced pension withdrawals, and the central bank kept rates unchanged at a record low of 0.5%. We closed our underweight to the peso into market weakness as the central bank announced they would accumulate over 4% of GDP in reserves through weekly auctions into the middle of next year and are now neutral but remain underweight local bonds as we see better value elsewhere. On the hard currency side, we sold our position in state-owned miner Codelco into strength after spreads narrowed to recent tights against the sovereign bonds.

Colombia continued to struggle with its current account deficit, reflecting a decline in primary export volumes including coal and oil. Earlier in the month, another wave of COVID infections put further pressure on the prospects of a growth rebound, also affecting the currency. We increased our underweight to the peso, reflecting our growing concerns about the current account dynamics, because as economic growth picks up as the country recovers, imports will increase and place further pressure on the current account.

The IMF announced that it had reached a staff level agreement for a three year Extended Fund Facility (EFF) worth 0.75% of GDP with Costa Rica, which is very positive news for the country. In addition, it reported a fiscal deficit of 8.3% of GDP for 2020. Although a multi-decade high, it was still better than the market expectation of 9.2%. We retain our overweight in the hard currency bonds.

Central and Eastern Europe (CEE)

In **Poland**, activity data confirmed the economy's strong recovery. On a year-on-year basis, industrial production growth accelerated by double digits in December, much stronger than the month before and comfortably beating consensus while the manufacturing PMI recorded its best reading since July, driven by strong new export orders. Meanwhile the European Commission (EC) pushed ahead with an infringement procedure launched in April 2020 regarding potential political interference by the Disciplinary Chamber of Poland's Supreme Court. The EC gave Poland a month to comply with EU law before referring the case to the European Court of Justice. We retain an underweight position in Polish local and hard currency debt.

The National Bank of **Hungary** kept its policy rate unchanged at 0.60% at its January rate-setting meeting. This maintained a safe distance from zero while signalling that it stood ready to use appropriate instruments if the inflation outlook demanded it (i.e. if inflationary pressures persisted). Purchases of government securities will be also extended to cover those with a maturity of less than 10 years, according to the monetary policy committee. It is also worth noting the improvement in the external trade position, reflecting a favourable export performance and gains in the terms of trade. We maintain a market weight position in local currency debt, an overweight position in hard currency debt and initiated an overweight position in the forint.

In the **Czech Republic**, the majority of the central bank's (CNB) board members maintained their hawkish rhetoric over the month. Governor Jiri Rusnok said the CNB could move towards monetary policy normalisation this year, but it would be very careful to not jeopardise the economy's fragile recovery. Activity data such as retail sales and industrial production point to sustained improvements while the manufacturing PMI index remained elevated in January, better than expected. We have kept an underweight position in local currency debt and an overweight position in the koruna.

Following moderating inflation over the last couple of months, the National Bank of **Romania** surprised the market by cutting its policy rate to 1.25% at an extraordinary board meeting in January. Financial market conditions improved with money market rates and yields on RON-denominated government bonds falling significantly on a reduction in the country's credit risk premium and easier monetary policy. We maintain an overweight position in local and hard currency bonds and initiated an underweight position in the leu.

In **Serbia**, the government adopted its Economic Reform Programme for the period 2021-23 including priority structural reforms in the energy and transport markets, education, employment and labour market reforms as well as policies targeting the grey economy. The National Bank of Serbia, in line with expectations, kept its policy rate unchanged at 1% expecting inflation to remain in the lower end of the tolerance band (3% +/-150 basis points) in 2021, converging to the 3% target in 2022. We retain our overweight positioning in local currency debt and have initiated an overweight position in hard currency debt.

Rest of EMEA

Although Turkey's central bank (CB) remained on hold in January, forward guidance messages were positive, with the key theme being that the CB will do whatever is necessary to bring inflation under control, including further interest rate hikes if needed. This tone reinforced our view that more predictable and orthodox macro policies are being utilised, and encouraged us to add more credit exposure given the attractive valuations. We remain overweight the lira and hard currency debt and underweight the local bonds.

Key dissident Alexei Navalny returned to Russia after recovering from poisoning and was detained at the airport on arrival. Pro-Navalny rallies ensued with many protestors being arrested, while a widely viewed video alleged that an ostentatious mansion by the Black Sea secretly belonged to President Vladimir Putin, who denied the allegations. Further negative news flow weighed on investor sentiment, including more headlines surrounding Nord Stream 2 sanctions and suggestions the new US administration will also impose sanctions, although we believe any incremental moves will be minor. Despite this, we added exposure to the ruble, increasing our overweight as we believe valuations are compelling, while seasonality and a strong current account are supportive for the currency. We are overweight the local bonds across some of our strategies.

In South Africa, fiscal revenue surged in December, buoyed by corporate tax receipts with incremental improvements from personal income tax and VAT collections. This is encouraging ahead of the budget on 24 February, as fiscal consolidation is occurring against the backdrop of a lower primary deficit. The South African Reserve Bank's messaging was marginally hawkish, while load shedding also continued for many parts of the country. Elsewhere, studies have shown that first-wave COVID antibodies are not as effective against more recent strains and that the Novavax vaccine is 60% effective at fighting the variant. We are underweight the rand but retain exposure to hard currency Eskom debt.

In the Middle East, vaccine programmes are being rolled out, most notably in Israel, the UAE and Bahrain, which proportionally are some of the highest vaccinating countries globally. Elsewhere, the voluntary cut in oil production of 1 million barrels a day by Saudi Arabia, equivalent to 1% of global supply, begins in February and is expected to last for two months. The cut will help the oil supply and demand dynamics during exceptional times for the global economy.

In terms of positioning, in the investment grade space we have rotated out of Qatar and Abu Dhabi and moved into Saudi Arabia, after significant underperformance in the latter. Saudi Arabian spreads offer an attractive premium and could normalise due to supportive oil prices.

In high yield names, we added more exposure in Oman and Bahrain. Both states came to market during January, and we took advantage of attractive valuations versus peers. This reflects our view that the recent strength in the oil price will lower funding requirements, while additionally the Omani government is also accelerating its fiscal consolidation plans and implementing institutional reforms.

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