June 2022

Emerging Market Debt Indicator

The fast view

Market background

June proved to be another challenging month for fixed income markets, as the combination of higher US interest rates, persistent inflation and risk-off sentiment all took their toll. In the US, the Federal Reserve hiked rates by 75bps, while inflation data showed that consumer prices rose further in May. As a result, the yield on the 10-year Treasury rose, peaking at 3.4%, but it fell back sharply into month end to around 3.0%, as fears of a global recession became forefront of investors' minds.

Africa

Inflationary pressures eased in both Angola and Egypt, thanks to lower food prices, while in Kenya, the central bank hiked rates by 50bps for the first time since 2015, as inflation breached the upper part of the target band. Weaker copper prices weighed on Zambia's trade balance but it still has a healthy surplus.

Asia

Inflation is still surprising to the upside, and momentum has been picking up. China continued to gradually reopen from COVID lockdowns, helping growth to improve, but the country's 'zero COVID' policy remains in place.

Latin America

After outperforming year-to-date, currencies weakened in June as commodities sold off on global recession fears. Leftist candidate Gustavo Petro won Colombia's presidential election and his foreign minister appointment was well received. Protests continued in several countries.

Central and Eastern Europe

Inflation continued to surprise to the upside. Hawkish monetary policy kept the pressure on local bonds across the region over much of the month, while currencies came under renewed pressure from weakness in the euro and continued high energy prices.

Rest of Europe, Middle East and Africa (EMEA)

While there has been increased attention on finding a way for Ukraine to export its agriculture products, a deal seems unlikely, near term. Ukraine is struggling to finance itself but foreign budget support is finally stepping up. It was a volatile month for assets in Turkey and the authorities introduced further unorthodox measures to stem lira weakness.

EM corporate debt highlights

In a similar vein to EM hard currency sovereign debt markets, concerns over the economic outlook combined with higher US rates weighed on EM corporate bonds, with the JP Morgan CEMBI falling 3.1%. Given the market's increased fears of a US and global recession, high-yield debt underperformed investment grade (IG).

Peter Eerdmans

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

Market background

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In the US, the Federal Reserve hiked rates by 75bps, while inflation data showed that consumer prices rose further in May. As a result, the yield on the 10-year Treasury rose, peaking at 3.4%, but it fell back sharply into month end to around 3.0%, as fears of a global recession became forefront of investors' minds after several softer-than-expected economic data prints, suggesting that the Fed may not raise rates as aggressively as previously thought.

Growing fears over the economic outlook combined with higher US rates weighed on EM bond markets. The EM local bond market (JP Morgan GBI-EM) fell 4.4%, driven by both FX and bonds. The hard currency index (JP Morgan EMBI) also weakened, falling 6.2%, with a clear divergence between high-yield and investment-grade (IG) markets – the former fell 9.2% and the latter fell 3.3%. This was a similar picture in the EM corporate debt market (JP Morgan CEMBI), which ended the month down 3.1%.

In Asia, inflation momentum has been picking up, driven by both food and fuel prices, while China continued to gradually reopen after the COVID lockdowns. This is likely to continue, although the country's 'zero COVID' policy remains in place.

In Latin America, many of the region's currencies experienced a sharp sell-off given the fall in commodity prices on the back of increased global recession fears.

Top-down views and outlook

With both war in Ukraine and the economic impact of COVID lockdowns in China continuing, investors face ongoing uncertainty. Sources of uncertainty include the disruption to exports of soft commodities and energy, and continuing supply-chain disruption. Against this global backdrop, global growth is falling and recession risk is rising.

While the threat of inflation remains the dominant focus of central banks – with the US Federal Reserve firmly on the rate-hiking path – recession risk is tempering what markets are pricing. We continue to believe that, in general, emerging market bond valuations are more fairly reflective of current inflationary pressures. That said, inflation remains high and is a key risk facing investors. While our analysis of various projections leads us to expect some headline relief by the end of the year, the economic impact will be diverse and requires careful navigation, especially as the conflict in Ukraine is pushing the point at which inflation is expected to peak further into the future. The surge in commodity prices has widened the gap between commodity exporters and importers, with several emerging markets benefitting significantly.

In aggregate, the fundamentals of emerging markets remain sound and valuations – that were already attractive before the war – remain a significant support for the asset class. While uncertainties are likely to continue to impact these markets, we remain optimistic on the medium-term outlook for the asset class.

From a top-down positioning perspective, we continue to be neutrally positioned across our EM debt strategies. Regarding EM FX, we continue to have a neutral top-down target; while commodity price strength, market positioning and the interest rate differential vs. developed markets are all helping the asset class, there has been a deterioration in EMs' terms of trade, particularly for oil importers, and the growth outlook for EMs is weakening. In hard currency debt our positioning is also neutral, as rising US rates and thinning liquidity are keeping us cautious. As for local currency bond markets (local rates), we remain neutrally positioned as although the weak growth outlook is favourable for bond prices, inflation remains elevated across our investment universe. Bottom-up selection is key in this environment, in our view.

Top-down positioning at end June 2022

	- -	-	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.

Three questions top of mind for EM Debt investors

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Portfolio Manager

Peter Kent

Portfolio Manager and Co-Head of SA & Africa Fixed Income

On a recent visit to North America, Grant Webster, Werner Gey van Pittius and Peter Kent, spent time with allocators and consultants discussing the challenges and opportunities in the asset class. The conversations highlighted three questions that are top of mind for EM Debt investors.

1. How vulnerable are EMs to current macro challenges?

Resilience in evidence during bond bear market

Since the start of the year, we have been in a bond bear market with yields rising and credit spreads widening. While quantitative tightening and rate hikes have been key drivers, the war in Ukraine has exacerbated matters, not least by increasing inflationary pressure via food and energy prices.

Despite all this, EM assets – excluding Russia, Ukraine and the underlying US asset price effects – have held up really well, with EM currencies outperforming G10 currencies. This reflects fundamental strength in many EM economies and the conservative approach of EM central banks, which moved decisively to tackle high inflation.

Ahead of the curve in tackling inflation

Rather than let real policy rates fall as inflation advanced, over the past year central banks across emerging markets have acted much more prudently than their developed market peers by swiftly hiking. In aggregate, emerging markets are now running real policy rates well above their pre-COVID levels. In contrast to the US and other developed market economies, much of the pain of rate hiking is already behind many emerging markets. Coupled with the fact that we believe food and fuel inflation should moderate into year-end 2022 as the base effects of pre-crisis commodity price increases come through, we think this puts most EM economies on more favourable footing than developed markets. Historically, EM currency performance has been closely tied in with commodity cycles.

Sizable buffers are in place

Widespread weakness in current account balances was a key factor in the 2013 taper tantrum; today's situation stands in stark contrast. Terms of trade (average export prices minus import prices) across the EM universe have been very strong, allowing emerging markets to run large current account surpluses for some time. This proved to be helpful for monetary policymakers as they responded to COVID, allowing them to cut interest rates without worrying too much about the negative impact on exchange rates. As developed markets began to reopen in 2020/2021, the surge in demand for EM exports gave further support to current account balances, with sluggish imports helping drive trade surpluses higher. The result is that emerging markets are now net lenders of US dollars to the rest of the world, making them more resilient to the negative effect on their exchange rates of US interest rate hikes. In effect, emerging markets in the main have built sizeable buffers.

Benefiting from strong commodity prices

The surge in commodity prices is widening the gap between commodity exporters and importers, with some emerging markets benefitting significantly.

An increased focus on energy security is likely to further boost a range of EM energy exporters, as well as exporters of materials needed for renewable energy, for example. As for energy importers and other less fiscally robust economies, the allocation of special drawing rights from the IMF has substantially alleviated funding requirements in many markets. Furthermore, some energy importers (e.g., in Central and Eastern Europe and Asia) have very strong long term productivity gains, balance sheets and external positions and, therefore, should see their assets remain resilient, despite the higher import costs.

2. Does the long-term investment case for EM debt still stack up?

Compelling yields

Despite recent moves higher in US yields, the EM yield differential is still sizable, making the EM debt market a rich hunting ground for active investors, particularly given its inherent inefficiency. In the major EM bond indices, nominal yields range from 6.4% (corporate) to 7.5% (sovereign), which compares with a 3.0% yield on US sovereign debt, as at the end of May 2022. The difference in real yields is also stark, with a negative reading (-0.09%) in the US compared with 2.41% for the main EM local bond index.

Just one part of the overall investment universe, EM corporate external debt, has grown to over US$2.7 trillion*, making it a larger market than US high yield. Consequently, it is getting much more attention from global asset allocators, who recognize the spread premium for comparable credit quality, among other attributes.

EM vs. DM growth differential

While the backdrop of war in Ukraine and rising inflationary pressure saw the IMF revise down its growth forecasts for this year and next as we noted here, growth in emerging markets continues to outpace that of developed economies – with the gap expected to widen significantly in favour of emerging markets next year. The IMF's latest World Economic Outlook forecasts growth of 3.7% for the US this year and 2.3% for 2023. This compares with 3.8% in 2022 and 4.4% in 2023 for emerging market and developing economies, though with significant dispersion within them. Excluding Russia, the IMF's EM growth forecasts for 2022 range from 0.8% for Brazil to 8.2% for India.

Furthermore, cyclical dynamics are set to favour emerging markets relative to their developed peers. As the US withdraws the exceptional fiscal and monetary policy stimulus/support measures and its economic growth outlook weakens, we expect to see EM growth assets outperforming their developed counterparts. However, in bottom-up selection decisions, it is important to distinguish between structural and cyclical drivers. For example, the consistent productivity gains seen in Asia and Central & Eastern Europe fall into the structural category, while current commodity price-related fiscal strength seen in Latin America and the Middle East & Africa is likely more cyclical in nature. That said, energy and commodity market trends may well be moving into the realm of structural shifts when you consider the global transition to a net-zero world.

3. Is now a good entry point for EM debt?

Considering the EM debt asset class overall, whether you look at local, EMFX or hard currency, EM assets are cheap relative to history and to their developed market peers. Current valuations suggest that mild recession is already priced and that a hard recession (although not our base case) is not far off being priced. This suggests we could be close to an attractive entry point already; a turn in the inflation tide or another 100bps of spread widening are the triggers we are currently watching for.

However, the war in Ukraine and its implications for inflation and growth have complicated the landscape for the US Federal Reserve and, consequently, for emerging markets. The peak in inflation has been pushed higher and further out, and the downside risks to global growth have been exacerbated. Our in-depth work on inflation and hiking cycles has made us relatively cautious from a top-down perspective. We are neutrally positioned across local rates, EMFX and hard currency debt, preferring bottom-up selection in a complex global environment, which we see as having distinct winners and losers.

*Source: JP Morgan, as at 31 March 2022.

Regional highlights

Africa

In Angola, growth continued to rebound, with the figure for Q1 2022 coming in at 2.6% from 2.4%, largely on the back of more supportive oil prices. Inflation also started to slow (24.4% and down from 25.8%), reflecting an easing of food price pressure.

Inflation in Egypt surprised to the downside, printing at 13.1% versus 13.2% in May as food price pressure started to slow down. Even though this decline could be a temporary lack of core price pressures, it points to a lower need for tightening from the central bank than initially expected. The trade balance also continued to improve, thanks to higher exports, largely supported by the surge in gas prices; the trade deficit is now close to its lowest level in 10 years.

The government in Ghana approached the IMF for a new program, with discussions likely to take place over the upcoming months. There will also be a new midterm budget update in July, which will shed light on any changes to the country's fiscal path.

In Kenya, the central bank hiked rates by 50bps for first time since 2015, as inflation breached the upper part of the target band, driven by higher food and utility prices. With Eurobond markets shut, the government is now looking towards the syndicated loan market, but funding plans have been negatively influenced by leading presidential candidate Raila Odinga talking about debt restructuring post-election.

Inflation eased further in Zambia, printing at 9.7% in June. The trade balance has started to weaken as copper prices have fallen; but Zambia is still running a hefty surplus. There has been some progress with regards to the official creditor committee, as China has decided to chair the meetings. With the first of these meetings occurring in June, there is hope that the restructuring process can now kick off in earnest.

Asia

Inflation in Asia continued to surprise to the upside, with momentum picking up broadly across the region. The predominant driver is the rise in food prices, given food's high weighting in the inflation baskets, as well as high fuel prices. Asia has lagged other regions in re-opening after COVID, which has delayed the reopening reflation theme; inflation is still not as high as it is in other emerging market regions, but it is above targets throughout the region.

China continued to gradually open-up from the COVID lockdowns. The authorities loosened the inbound visitor quarantine rules, which is a welcome step, although there has been no deviation from the 'zero COVID' policy. The easing of restrictions has resulted in growth data improving, giving optimism to the market as reflected in gains across equities and the renminbi and higher bond yields. Activity data was good overall relative to consensus, including retail sales and industrial production.

The central bank in India hiked rates by 50bps, in line with expectations, but bonds continued to sell off as the oil price remains high. Despite inflation being well above the target range, the central bank has only just started hiking, so there is likely to be a long way to go in the cycle. In the FX market, the central bank intervened to help curb the sell-off in the rupee. Although the central bank is not overly concerned about a weaker rupee from an inflation perspective - given the low pass through to inflation and the boost it provides to exports – it is averse to sharp moves.

In the Philippines, the peso continues to underperform other currencies in the region, as the incoming central bank governor has said he is happy to allow it to weaken. The authorities in Korea have voiced their concerns on the Korean won weakness, however the won continues to trade poorly as portfolio outflows continue to overwhelm. In addition, the Bank of Korea bought KRW3 trillion (c. US$2.3 billion) of bonds; although not a large amount relatively, it indicates the intent of stabilising bond prices.

Latin America

Currencies across Latin America are still performing well compared to other regions on a year-to-date basis, but they gave up a large amount of the year-to-date returns over June. The high carry and commodity trade that has supported Latin American currencies came under pressure as commodities

sold off on global recession fears. Although the carry is still prevalent, the market is quick to punish any let-up in central banks' hawkish messaging.

Election results in Colombia were relatively close, with leftist candidate Gustavo Petro the victor, but the margin was large enough for it not to be contested. The result weighed on domestic assets given the concerns around market unfriendly policies. However, comments from Petro have been constructive so far, and there has been encouraging dialogue with the centre and centre right parties. Petro has picked his foreign minister who is pro peace, which was well received. The market eagerly awaits news of the appointment of the finance minister, although the names in circulation are market friendly.

In Brazil, the central bank hiked rates by 50bps to 13.25%, in line with consensus, however it also signalled another hike at the next meeting and suggested that it will keep rates high for an extended period. The government's fiscal surplus was lower than expectations, bucking the improving trend seen recently, due to the increased spending social programmes outside of the spending cap. State-owned utility, Petrobras, saw another (very recently appointed) CEO being forced to step down, just as his predecessor was in May, caused by political pressure related to the fight against inflation.

The central bank in Chile hiked rates by 75bps to 9%, roughly in line with the market's expectations. It is expected to make two more 50bps hikes, as inflation continues to rise at 1.2% month-on-month, although this was lower than expected. Strikes in the country are hurting the economy and the peso, with the latter coming under pressure from lower copper prices. To help stem this weakness, the Treasury announced that it will start selling US dollars again for the next two months, totalling US$5 billion, as the weaker peso has a significant pass-through rate to inflation.

May trade data in Mexico printed at a larger deficit than expected, driven by strong imports. The central bank voted unanimously to hike rates by 75bps, in line with Fed, and revised its inflation forecast higher again. In the quasi-sovereign space, state-owned oil company Pemex surprised the market with new bond issuance to repay debts owed to some suppliers.

Rates in Peru were hiked 50bps to 5.5%, in line with expectations, while trucker strikes and farmer protests – relating to higher fuel and fertiliser prices, respectively – continued to weigh on sentiment. In government, tensions continued between congress and President Castillo.

Protests were also prevalent in Ecuador and continued despite President Lasso announcing increases in cash transfers and subsidies for fertilisers. Lasso subsequently announced a state of emergency in several states to try to quell the more violent protests, but is now accepting offers to enter talks, so hopefully this is the start of de-escalation.

Central and Eastern Europe (CEE)

Inflation across CEE continued to surprise to the upside, forcing central banks to remain hawkish, particularly in Hungary and the Czech Republic, with Poland and Serbia also seeing rate hikes. Hawkish monetary policy kept the pressure on local bonds across the region over much of the month, while currencies came under renewed pressure from weakness in the euro and continued high energy prices. The rise in natural gas prices in particular, on the back of Russia's supply curbs, is weighing on current accounts across the region.

While Poland reached a deal with the EU on the Recovery Fund Flows, recent newsflow has been more negative, given the measures Polish authorities will have to implement to access all the funds.

The rule of law dispute with the EU commission and Hungary continued. Although we think that, ultimately, a Hungarian compromise is the most probable outcome, it will likely take several months of negotiations. Meanwhile, the authorities looked to fill the potential funding gap with further external issuance in June and announced budget consolidation measures, concentrated in windfall taxes across several sectors, as well as some cuts to capital expenditure.

In the Czech Republic, new appointments in the central bank were somewhat more encouraging than expected, meaning the institution will retain credibility, albeit with the new members likely to show a more dovish stance. The authorities also continued to intervene to stem the weakness in the koruna. In the energy market, a report co-authored by the government and the energy regulator, pointed to large increases in energy tariffs, weighing on the inflation outlook.

Rest of Europe, Middle East and Africa (EMEA)

The war in Ukraine continues, and while there has been increased attention on finding a way for Ukraine to export its agriculture products, a deal seems unlikely over the near term. Despite the central bank hiking interest rates sharply to protect the currency and to make domestic assets more attractive, the Ukrainian government is struggling to finance itself domestically. With the government continuing to try to issue bonds at or around the previous policy rate of 10%, there has been a significant reduction in local bank funding as the central bank rate is now 25%. However, foreign budget support is now finally stepping up, with nearly US$5 billion due in June.

It was a volatile month for assets in Turkey. President Erdogan increased the nationalistic rhetoric and once again committed to keeping interest rates suppressed, despite inflation continuing to accelerate, now at 73% year-on-year. There was considerable stress in the local banking sector, with thin liquidity in the FX market prompting the authorities to introduce further unorthodox measures to stem lira weakness.

Inflation momentum picked up the pace in South Africa, while growth indicators were generally a bit weaker; load shedding is weighing on the economic outlook, as is the deteriorating terms of trade.

In the Middle East, there have been diplomatic improvements between Saudi Arabia and Turkey, and potentially the US, with President Biden due to meet Crown Prince Mohammed bin Salman Al Saud. However, geopolitical tensions are arguably rising, with Iran nuclear talks in Qatar ending without any sign of progress.

EM corporate debt highlights

In a similar vein to EM hard currency sovereign debt markets, concerns over the economic outlook combined with higher US rates also weighed on EM corporate bonds, with the JP Morgan CEMBI falling 3.1%. Given the market's increased fears of a US and global recession, there was a clear divergence between high-yield and investment-grade (IG) bonds, with the former falling 4.7% and the latter falling 1.8%, reflecting the former's higher sensitivity to the global backdrop. In the CEMBI, Macao and Colombia were the weakest performing markets on a weighted basis, with the former continuing to come under pressure from negative newsflow around travel restrictions and the COVID situation in China.

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