March 2023

Emerging Market Debt Indicator

The fast view

Market background

The collapse of Silicon Valley Bank and events surrounding the UBS takeover of Credit Suisse made for a volatile month as investors digested the potential implications of both. Against this backdrop, EM fixed income and currency markets held up well, with all sub-asset classes posting positive returns.

Africa

The IMF executive board approved a new US$5 billion flexible credit line for Morocco. Ghana's government passed the key tax bills required to get its IMF deal finalised. Elsewhere, Angola's economy finally put its five-year long recession behind it – growing by 3.0% in 2022.

Asia

The theme of strong service sector activity (boosted by China reopening) and a more subdued manufacturing sector continued. Positive surprises included lower-than-expected inflation in the region and improving data on China's property market - new home sales returned to pre-COVID levels.

Latin America

Inflation continued to fall in much of the region. In Brazil, President Lula's fiscal framework was more conservative than expected, allaying market fears. Political risk continued to abate in Peru, but increased uncertainty sparked a sell-off in Ecuador, as a greater possibility of impeachment increased the likelihood of President Lasso calling early elections, dissolving Congress and ruling by decree.

Central and Eastern Europe

While hard economic growth data across the region has generally disappointed, soft data (e.g., consumer and business confidence) continued to recover. Inflation has generally fallen, albeit not always in-line with expectations. Markets welcomed news that Montenegro's president (incumbent for 30 years) lost the election to a pro-EU former investment banker.

Rest of Europe, Middle East and Africa (EMEA)

Ahead of the May election and facing a stronger opposition, Turkey's President Erdogan gave more fiscal handouts. Turkey's external position remains fragile given the large current account deficit and falling usable foreign exchange reserves. In Ukraine, the IMF reached a staff-level agreement for a US$16 billion credit facility. Governance and political risk continued to weigh on Israeli assets.

EM corporate debt highlights

Global macro headlines overshadowed EM corporate developments and drove market moves, but against this backdrop the asset class held up well. While the risk-off shift in sentiment and fears of banking sector contagion caused spreads to widen meaningfully across both high-yield and investment-grade issuers, the rally in US Treasuries helped to offset this.

Werner Gey van Pittius
Co-head of Fixed Income

Market background

March was an eventful month for global financial assets. The collapse of Silicon Valley Bank (SVB) in the US shook markets globally, with market participants fearing contagion across the banking sector. This led to a flight to quality, as investors flocked to lower-risk investments. Combined with a sharp downward revision of forecasts for the terminal US interest rate, the result was a drop in US Treasury yields across the curve. Other contributors to heightened market volatility included stronger-than-expected US labour market data (non-farm payroll numbers), amid an increasingly uncertain macroeconomic backdrop.

News out of Switzerland subsequently dominated global financial headlines given the UBS takeover of troubled competitor Credit Suisse. This caught the market by surprise, not least given the Swiss regulator's controversial decision to pay equity holders ahead of investors in Credit Suisse's bank capital debt (specifically, Additional Tier 1 bonds - AT1s). Market turmoil ensued, prompting central banks and other authorities around the world to reassure investors that they would not adopt the same approach as the Swiss regulator.

Although the SVB and Credit Suisse headlines stoked concerns around banking sector health across the globe, the biggest impact was felt in developed market indices. This seems a fair reflection of the limited fundamental impact on the EM financial sector, where major banks typically have a large and diverse depositor base and adopt relatively prudent investment strategies that leave them less exposed to interest-rate risk.

Against this backdrop, EM fixed income and currencies held up well, with the local index (JPM GBI-EM) returning +4.1%, driven by both bonds and currencies. Hard currency debt markets also managed to deliver positive returns over the month: the EM corporate index (JPM CEMBI) ended the month 0.8% higher, led by investment-grade bonds, while in the sovereign bond space, the index (JPM EMBI) returned +1.0%.

In Asia, service sector activity growth remained strong, with the manufacturing sector continuing to be subdued. In China, house prices increased month on month for the first time in 18 months, while the People's Bank of China loosened monetary policy by cutting the reserve requirement ratio by 25bps, effectively increasing liquidity in the financial system. Turning to Latin America, the much-anticipated fiscal framework was announced in Brazil towards month end – this was more conservative than many market participants had feared.

Top-down views and outlook

Although we expect EM bond markets to remain volatile given ongoing uncertainty around global economic growth, inflation, the war in Ukraine and recent developments in the banking sector, we are constructive on the medium-term outlook for returns from the EM debt asset class. Many EM economies have solid fundamental foundations, and 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 re lative 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 and the financial tightening caused by recent events in the banking sector begins to bite, growth will slow and with it, the risk of recession is likely to rise across markets. However, the relaxation of China's COVID policy stance is likely to counteract this somewhat by spurring an economic recovery.

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 further trimmed our overweight risk target across our EM debt strategies and are now only slightly overweight. This was driven by a reduction in our hard currency debt target, which we cut to neutral. As a US recession appears closer, hard currency debt is vulnerable to slowing growth, and although in our view valuations remain attractive, we felt it was prudent to reduce risk. As for EM local debt, we remain at a neutral target, 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 given good underlying fundamentals of higher carry and healthy external balances against positive valuations.

Top-down positioning at end March 2023

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

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EM Perspectives: takeaways from our annual seminar

Over two days in early March, our emerging market (EM) experts joined some of our institutional investor clients from across the globe in our London office to reflect on a shifting global backdrop and share insights on how to navigate an uncertain future. Here are some of the key themes that were discussed.

The shift to a multi-polar world

Geopolitical risk has returned as a key consideration for asset allocators, with the war in Ukraine accelerating the move to a multi-polar world, while also speeding up energy policy shifts. This does not herald an end to global growth, but it does signify that regional trading patterns are becoming more entrenched.

Latin America is benefiting from the shifting global backdrop, especially Mexico given its proximity to the US. Across the region, we're seeing bilateral deals and strategic relationship building.

Cyclical divergence between China and the US/rest of the world and between regional groupings is likely to continue.

Weighing the EM investment case and fundamentals

The structural investment case for EMs remains intact. Global economic momentum is still shifting away from advanced Western economies, and revenue growth remains correlated to GDP growth. Structural foundations in EMs are robust as evidenced by credible central banks and current account surpluses, among other factors. In EM sovereign debt, overall credit quality has improved significantly over the last 30 years, even with the entry of new frontier markets. Frontier markets are a highly diverse part of the opportunity set and a rich source of potential alpha.

In the sweet spot, with buffers

Thanks to proactive central banks, EM economies are now in a sweet spot – they do not face the same labour supply issues as developed markets, inflation is anchored, and rate-hiking cycles are almost complete. Once the Federal Reserve finishes the US rate hiking cycle, central banks in many EMs should be able to cut rates fast.

China's policy is shifting gear but requires careful navigation

China's regulatory environment has eased in terms of implementation, but broader social goals remain central to policymaking in the country. Policy considerations are key to effective stock selection.

At current valuations, fixed income investors are really being compensated for risk, while also gaining ongoing diversification benefits stemming from China's economic divergence.

Backward-looking scores do not provide a robust analysis of sustainability risks and opportunities

An over reliance on backward-looking ESG scores is a flawed way to manage risks and capture opportunities. A forward-looking, qualitative approach is vital to gain a true picture of progress and potential, and a proprietary toolkit is essential, especially in EMs. A case in point is Brazil – third-party ESG scores are not reflecting the positive shift on environmental policy under the new administration.

The global energy transition will be complex and non-linear and investment approaches should reflect this

Energy security concerns are acting as an accelerant for energy policy shifts and change is happening surprisingly fast; some industries have already reoriented away from Russian hydrocarbons.

Investors should be wary of jumping to simple conclusions on the investment implications of climate change and the global transition to net zero. A technological shift is taking place and it's too early to say who will win. There will be divergent and idiosyncratic outcomes that countries and regions need to prepare for and hedge their bets around. China dominates in solar, wind and electric vehicles but is also building huge capacity in coal; expect a messy and long transition.

To profitably participate in the transition, focus on real-world decarbonisation and target EM investments

Decarbonising a portfolio will not generate a real-world impact for the energy transition. Rather than divesting from heavy emitters, investors can mitigate carbon emissions by supporting companies with credible transition plans while also providing capital for climate solution providers which offer the products and services that drive decarbonisation. EM corporates are at the heart of this.

This is not a free pass for investors to own high-emitting sectors. Instead, responsible investors must distinguish between companies that have practical and implementable transition plans and those that cannot or will not change sufficiently. Investors need the assurance that these 'transition investments' have the capacity to reduce emissions in the long run.

For transition investing to work, both carbon impact and commercial investment returns are essential.

Regional highlights

Africa

GDP growth eased in Angola to 2.6% over the fourth quarter, but for 2022 overall it was confirmed at 3.0% - signifying a break from the five-year recessionary trend in the country. In domestic oil markets, output has continued to drop, which raises some external risks, but production and investment from TotalEnergies are expected to increase in 2023.

There was disappointment in Egypt, with an ongoing lack of clarity on the government's sale of state-owned enterprises – initial progress stalled due to uncertainty over the exchange rate outlook. Separately, a larger-than-expected World Bank partnership agreement was announced - double the amount of support initially expected to be provided over 2023-2027. The budget was also announced, confirming the government's commitment to tighter fiscal policy by increasing the primary surplus target to 2.5% of GDP.

In Ghana, the government passed the key tax bills required to get the country's IMF deal finalised. This, along with initial signs of progress on reaching an agreement with China on its loans, suggests that an IMF deal could be reached soon. Other positives over the month included trade and external data, which continued to surprise on the upside. The current account registered a 2% deficit overall for 2022 and a surplus in the fourth quarter.

The IMF executive board approved a new US$5 billion flexible credit line for Morocco, which significantly reduces external risks for the country. In addition, S&P affirmed Morocco's credit rating at BB+ with a stable outlook, as high debt levels were offset by positive reforms and strong liquidity metrics.

Inflation in Uganda continued to slow, coming in at 9.0% from 9.2%; core inflation moved from 7.8% to 7.6%. This should allow the central bank to keep rates on hold for now. Fitch revised its outlook to negative from stable, citing concerns about the country's external debt being accumulated to invest in a new oil industry. Although this is a risk, we believe it is likely to be offset by an improvement in external balances as oil production increases.

In Zambia, trade data remained positive but weaker than the previous numbers as the recent drought has weighed on power production and exports, while elevated fuel prices have kept import costs higher. All eyes are on the first review of the IMF programme, which will be completed at the beginning of April. If successful, this would allow the disbursement of US$183 million and would set the stage for re-starting negotiations with creditors.

Asia

Across the region, there is a clear trend around economic activity: purchasing managers index (PMI) readings point to the manufacturing sector remaining subdued while services sectors fuel the rebound – boosted by China reopening from COVID. In addition, inflation has been lower than expected in much of the region.

In China, the annual National People's Congress – the key policy event of the year – took place at the start of the month. There were no major surprises and key developments included confirmation of the GDP growth target for 2023 – at "around 5%" – and a fiscal deficit target of 3% of GDP. Separately, the People's Bank of China cut the reserve requirement ratio (RRR) by 25bps, helping to provide liquidity to the financial system to support growth. Housing sector data was better than expected, with home prices increasing month-on-month for the first time in 18 months. New home sales are also back to pre-COVID levels. Meanwhile, the trade balance data remains elevated, with the current account looking in better health since imports have yet to recover and the terms-of-trade have improved given the lower oil price. However, the likely rise in outflows from tourism – as locals begin to resume overseas travel in greater numbers – may add some pressure to the current account later in the year.

Fiscal revenue in Indonesia was very strong over the first two months of the year, with oil spending lower and tax revenue higher. This, along with stable economic growth and inflation, and a healthy strong current account, allowed the central bank to signal that it has completed its rate hikes.

In the Philippines, the central bank hiked rates by 25bps, which was in line with expectations. The trade deficit began to widen again, while inflation is still high, putting pressure on the central bank to continue hiking rates.

Tourist arrivals have continued to increase in Thailand as the country benefits from China's ongoing re-opening from COVID. The central bank hiked rates and signalled that there is still a risk that inflation may surprise on the upside, leaving room for further hikes if needed. The country is also gearing up for elections in May, which the markets could start paying more attention to as we get closer to the date.

Activity data in South Korea was more sluggish than expected and inflation surprised on the downside. In a boost to the local bond market, the central bank governor was slightly dovish, suggesting that the bank doesn't need to see inflation fall to 2% before it starts cutting rates.

In Taiwan, the central bank hiked rates by 12.5bps; although this is a small amount, the market expected rates to be left unchanged. The hike was on the back of the central bank's upside revision to its inflation forecast, although at the same time, it revised its growth expectations down.

Turning to Sri Lanka, the country achieved an IMF programme after the IMF's executive board signed off on the staff-level agreement. The deal is for US$3 billion over four years. The market is now eagerly waiting for the government to confirm what its debt restructuring will look like, which we expect should be resolved by the end of September 2023.

Latin America

The main development out of Brazil was the much-anticipated announcement of the Lula administration's fiscal framework towards the end of the month. This served to allay market participants' fears, setting limits on the primary fiscal deficit while also capping the country's expenditure growth. Overall, it was more fiscally conservative than expected and the government is estimating a primary fiscal surplus in a couple of years. In other developments, the central bank kept rates on hold, but with an accompanying hawkish message suggesting it could hike rates if needed. However, inflation was in line with consensus, remaining on a downward trend.

In Peru, protests and general political risk continued to abate. Although a new impeachment proceeding against President Boluarte was announced over the month, it has already been put on hold. Inflation in February also eased, coming in lower than expected, while the central bank kept rates on hold with its statement left unchanged.

The Lower House in Chile rejected President Boric's tax reform, which was set to raise 3% of GDP in government revenues. Under local law, this means Boric cannot submit a similar proposal for another year, which is a big political defeat for him. Away from politics, fiscal revenue is still performing well overall given strong lithium export revenues. The government also announced a new stimulus programme to help low-income households deal with high inflation. The trade surplus was also strong at US$2 billion given weaker imports driven by lower domestic demand.

In Mexico, President Amlo's controversial electoral reform – which sparked large protests given the threat it posed to the independence of electoral authorities – has been temporarily suspended by the Supreme Court while it considers a challenge to the proposal. The central bank hiked rates by 25 basis points, with the accompanying statement suggesting that the hiking cycle is complete. On the trade front, the deficit was worse than expected given resilient imports, while auto exports weakened. In addition, Elon Musk announced that Tesla is building a factory in the country, which confirms that Mexico continues to benefit from nearshoring (a topic we touched on in a recent article on our website).

The main news in Argentina revolved around the government's decision to force state entities that hold US dollar government bonds to swap them for Argentine peso bonds in a bid to stabilise the FX market. While the bond swap gives the government some ammunition to sell into the local FX market, investors in dollar bonds face the worrying prospect of a supply glut. More positively, ex-president Mauricio Macri has announced that he will not be running in the October 2023 presidential elections. This gives the opposition a chance to rally behind a much more popular candidate.

In Colombia, the government moderated its pension reform proposal which had rattled markets in February and its health system reform is encountering strong opposition in Congress. The Council of State also blocked President Petro's decree to take control of setting utility prices. Separately, inflation was in line with expectations at 13.3% year-on-year.

The Constitutional Court in Ecuador approved the impeachment process of President Lasso. By increasing the likelihood of Congress moving ahead with the impeachment, this also raised the prospect of Lasso calling early elections to dissolve Congress and then use the subsequent six-month window to rule by decree. The increased political uncertainty has led to a sharp sell-off in government bonds.

Both Panama and Costa Rica issued US dollar-denominated bonds over the month, with both issues being very well received by the market. Also in Panama, there was positive news regarding the stand-off between the government and First Quantum, the company that runs a large copper mine. The resumption of mining activities will greatly help Panama's economy.

Central and Eastern Europe (CEE)

While hard economic growth data (industrial production, retails sales) has generally surprised to the downside across the region, there has been a continued recovery in soft data (e.g., consumer and business confidence), tentatively suggesting that the outlook may be improving at the margin.

In a welcome development, inflation has generally been falling across CEE, but relative to market expectations it has been more of a mixed picture. The Czech Republic continues to look like the standout disinflationary story, while inflation in Hungary is finally moderating from a very high level. In Poland, the latest data for March surprised to the upside, with somewhat concerning core inflation dynamics. Overall, central banks in the region have been more hawkish in their guidance, particularly in the Czech Republic and Hungary. Despite the inflation outlook, the National Bank of Poland remains the most dovish in the region, although even here, market participants expect a longer delay before rate cuts begin.

Staying with Poland, the incumbent party, PIS, is gearing up for the upcoming elections at the end of the year and announced some extra fiscal measures to boost its popularity.

In Hungary, the government has been calling for interest rate cuts. However, at the latest meeting, the central bank remained hawkish, suggesting that it will not succumb to pressure and change direction anytime soon.

In Montenegro, there was a significant political development, as the incumbent president Milo Djukanovic, who has been in power for 30 years, lost in the elections at month end. The new president, Jakov Milatovic, who is a former investment banker, won by a significant margin and has a strong pro-EU agenda, all of which should prove positive for the county's economic outlook.

The normalisation of relations between Serbia and Kosovo has moved forward under the EU framework, and while challenges remain (e.g., Serbia is still not ready to recognise Kosovo as an independent country) we think the direction of travel is clear with Serbia increasingly falling into the orbit of the EU at the expense of Moscow.

Rest of Europe, Middle East and Africa (EMEA)

Turkey continues to gear up for the presidential election on 14 May. After some initial wobbles, the opposition has now unified around a candidate, with early polling suggesting they have the potential to win. However, we are mindful of the limited reliability of the polling data and the benefits that Erdogan enjoys as incumbent. With the opposition's chances improving, Erdogan has been giving more fiscal handouts to boost his popularity. The election is also putting pressure on the lira. Turkey's external position is fragile given the large current account deficit and falling usable foreign exchange reserves. The prospect of opposition victory is putting pressure on the lira and leading to significant stress in the illiquid forward market as market participants anticipate the need for devaluation of the currency post-election. In a bid to stem this, the central bank continued to introduce macroprudential measures to reduce the demand for foreign currencies. Further Eurobond issuance and Saudi Arabian central bank deposit have helped to shore up reserves at the margin.

Turning to Russia and Ukraine, the conflict carries on, although an increasing number of experts believe that the Russian offensive has ground to a halt and that Ukrainian forces will soon be back on the offensive. Staying with Ukraine, a staff level agreement was agreed with the IMF. The deal is for a US$16 billion credit facility and is the first of its kind for a country at war. In addition, the Ukrainian central bank announced that only coupons (not principal) can be repatriated for foreign-owned local bonds – this

was a well flagged reversal of previous communication earlier in the year suggesting that amortisations would also be subject to the repatriation window.

In **Israel**, the domestic situation remains fragile given the controversial judicial reforms. These proposed reforms seek to increase the control politicians wield over justice-sector appointments and limit the power of the Supreme Court to overturn government decisions and laws. However, the reforms have been postponed to after the parliament recess, giving some potential for a negotiated solution in the meantime. All-in-all, this political and governance risk makes for an uncertain outlook on the medium term for the country. Meanwhile, inflation continues to be stickier than expected, while just after month end, the Bank of Israel raised interest rates by 25bps, which was in line with expectations.

Growth data has been holding up relatively well in **South Africa**, with retail sales, manufacturing and mining data all surprising on upside. However, this January data was released before the worst of the load shedding issues, so it remains to be seen how resilient the growth outlook is to the challenging energy picture. Inflation surprised slightly to the upside, with core accelerating to 5.2% year-on-year, driven by components of the services basket. At the headline level, stubborn food prices were the main cause of the sticky data. Turning to monetary policy, the South African Reserve Bank (SARB) hiked rates above expectations to 7.75%. While this partly reflected the more challenging inflation picture, it also reflected the SARBs concern for the weakening backdrop for the rand.

In the **Middle East**, just after month end, OPEC+ announced that it will be cutting its oil production by 1.1 million barrels per day. This came a surprise to the market, helping to put a floor in global oil prices which had been under pressure given the deteriorating global demand outlook.

EM corporate debt highlights

Global macro headlines dominated corporate sector developments to drive EM corporate credit market moves, but against this backdrop the asset class held up well. While the risk-off shift in sentiment and fears of contagion (following the collapse of SVB and events at Credit Suisse) caused spreads to widen meaningfully across both high yield and investment-grade (IG) issuers, the rally in US Treasuries helped to offset this. The result was the JP Morgan CEMBI BD gaining 0.8% over the month, with the high-market segment returning 0.2%, while IG posted a 1.3% gain.

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