September 2021

Emerging Market Debt Indicator

The fast view

Market background

– The paring back of monetary policy support, coupled with inflation concerns, weighed on sentiment.

– Most EM currencies weakened vs. the US dollar, given the risk-off sentiment shift.

Africa

– Zambia's new president is making various market-friendly moves; an IMF deal is back on the radar.

– A rebound in exports in Egypt, but the US is holding back military support on human rights concerns.

Asia

– More positive COVID-19 dynamics as vaccine programmes take off.

– Concerns over implications of credit events in China real estate weigh on Asia's bond markets.

Latin America

– Higher inflation, interest rate hikes and more hawkish central banks.

– China property market turmoil weighing on commodity exporters.

Central and Eastern Europe

– Further escalation in rule-of-law clash between Poland and the EU.

– Rate hikes in Romania, Hungary and Czech Republic.

Rest of Europe, Middle East and Africa (EMEA)

– Rate cut and more dovish rhetoric from Turkish central bank leads to lira sell-off.

– Ukraine continues to progress towards an IMF disbursement.

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Market background

It was a weaker month for emerging market bond and currency markets, as higher US Treasury yields, the prospect of slower paced central bank stimulus, and events in China all weighed on investor sentiment. The JP Morgan GBI-EM fell by 3.4%, while the JP Morgan EMBI and CEMBI fell by 2.1% and 0.7% respectively.

In the US, the Federal Reserve hinted towards scaling back ('tapering') its asset purchase programme if the US economy's progress "continues broadly as expected." Despite the disappointing non-farm payroll data in August, which saw only 235,000 jobs created versus 720,000 expected, Fed chair Jerome Powell said he thinks conditions are "likely where they need to be" for the paring back of support in the next few months. The Fed's 'dot plots' were also slightly more hawkish, with half of the central bank's members now forecasting an interest rate hike in 2022. This led to a rise in US Treasury yields.

In China, there were more negative headlines relating to China's property sector, notably surrounding industry bellwether Evergrande and concerns over the increased likelihood of a default or restructure of the company's debt and the potential for this to create more widespread damage to China's financial system. While we do not believe the risk associated with some high-profile credit events in China is systemic, the headlines weighed on bond markets across Asia.

Among FX markets, most EM currencies fell against the US dollar, as risk-off sentiment drove investors into the safe-haven currency. In more idiosyncratic news, the Turkish lira fell significantly after the central bank cut interest rates by an unexpectedly large amount, despite inflation continuing to climb.

The oil price rose sharply over the period as Brent crude hit US$80 per barrel for the first time in three years, driven by increased demand as COVID restrictions continue to ease around the world. Concerns surrounding the global oil supply also impacted the price of the commodity.

Top-down views and outlook

Peter Eerdmans

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

Inflation concerns remain front of mind for investors, dampening optimism around the growth recovery story. With various data prints still pointing to rising headline inflation, the view that this is a largely temporary phenomenon is being challenged globally.

By purely focussing on the effects of higher inflation, investors risk missing the broader cyclical picture, which remains attractive across EMs, especially against the backdrop of a global energy transition and the associated infrastructure spending that it will entail. While there will certainly be supply bottlenecks with accompanying surges in inflation as economies recover, most of these should prove transitory, if history is any guide. The recent reinflationary pressure should be viewed against the much longer disinflationary trend of the last 25 years. Investors should also note that the scaling back of support measures – likely to start in the coming months – will take place before the Fed considers raising rates.

The revival in goods demand and impact on global manufacturing continues to be supportive for EM. The US$1.9 trillion stimulus package and improvements in how governments, firms and society deal with COVID will also have a positive impact on demand. While the reintroduction of lockdown measures in parts of the world could weigh on the services sector, particularly travel, higher immunity levels (natural and vaccination-derived) should ensure the effect is modest. We expect the recovery in activity from the low levels recorded last year to push EM growth rates ex-China higher in the latter part of the year, despite some fiscal drag as spending normalises after the pandemic-related surge.

We continue to believe global central banks, and particularly those in DM, will generally remain supportive of economic growth and that the risk of an abrupt shift away from loose monetary policy that threatens the global recovery remains low. The more predictable policy backdrop of the US administration under President Biden is also expected to be modestly supportive for EMs. 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 start of the crisis (which may have been exacerbated by the pandemic), how well governments have handled the crisis, and - crucially - how they will finance and reduce their deficits.

With a significant proportion of DM sovereign debt still in negative real yield, we expect investors to reassess allocations to EM debt, as its yield and relative-value attractions remain intact. As well as the allure of relatively attractive yields, supportive tailwinds include strong commodity prices and historically high terms of trade, with EM (ex-China) growth projected to accelerate in the second half of the year, despite the modest fiscal drag.

We remain moderately constructive on prospects for the EM debt asset class and through recent months have kept a small risk-on top-down target across our strategies. While we continue to see longer-term value in EM FX, we are more cautious on a tactical basis, given the more mixed short-term dynamics. On local currency bonds we are more constructive and modestly overweight some of the markets with steep yield curves, especially when considering the relatively high amount of central bank tightening priced in across many emerging markets. While we continue to see value in EM hard currency high-yield bonds with spreads still wide to pre-COVID levels, we have modestly reduced our overall overweight in hard currency debt.

Top-down positioning at end September 2021

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

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Roger Mark
Analyst
Fixed Income

Ukraine inches towards IMF disbursements

Ukraine perfectly encapsulates the challenges and rewards of frontier market investing. With fragile politics, underdeveloped institutions and capital markets, and entrenched corruption networks, the country's participation in IMF programmes since the 2014 Maidan revolution has been crucial to investor confidence. Reforms tend to progress in a 'two steps forward, one step back' manner – another common trait among frontier markets.

The announcement of a US$5 billion IMF programme last year was a key driver of Ukrainian eurobond outperformance. However, in the second half of the year a reversal in reform momentum threatened to derail the programme. Since then, stronger leadership from President Zelensky and a change at the top in the White House seems to have nudged things back in the right direction. In this piece we examine the recent trends in Ukraine, where that leaves the country's participation in the IMF programme, and what it means for investors.

How the IMF programme seemed in jeopardy

In the second half of 2020, the country's participation in the IMF programme seemed increasingly in jeopardy. Concerns arose about central bank independence following the resignation of the governor under (in his words) "systematic political pressure". Elsewhere, politically motivated judicial rulings threatened to undo much of the country's judicial reforms and undermine the country's nascent anti-corruption architecture. Furthermore, concerns continued around the reform credentials of both Zelensky's government and the parliament (Rada) – where, on paper, Zelensky's party held a majority, but in reality, many MPs' allegiances lie with oligarchs rather than the party/government.

Each of these factors was negative from a governance perspective. However, the threat they posed to the IMF programme was even more acute as without an IMF deal, the country's financing requirements were seriously challenged. The absence of an IMF disbursement raised doubts over Ukraine's ability to secure funding from other international financial institutions; increased the likelihood of international flows to the country's local debt markets drying up; and threatened to drive up the cost of funding in the eurobond market.

Politics have turned more conducive

It's been a rollercoaster presidency for Mr Zelensky. Initially seen as a handpicked puppet of oligarch Kolomoisky, early in his reign he surprised the world with his anti-corruption stance, only to see the corrupt judiciary push back on reforms in the second half of 2020. Sinking poll ratings dented his political capital and undermined his control of the Rada, with many in his party beholden to competing oligarch interests.

However, in 2021, Zelensky's fortunes have risen. In part this was the result of an (arguably orchestrated) ratcheting up in tensions with Moscow, with Zelensky benefiting from the 'war time leader' poll boost. More interestingly, however, was his strong tilt against the oligarchs by using the National Security Council to circumvent more traditional routes to curbing oligarch power. First, he targeted the Russian-backed oligarchy and the TV channels it controlled – with clear support from the new US administration. He has maintained this tough stance through the introduction of an anti-oligarch bill and in his general rhetoric. Both of these developments have seen his poll ratings rise and this has helped to enhance his influence over his party's MPs in parliament.

The new US administration has taken a closer role in Ukrainian politics and helped to shore up support for reforms. US Secretary of State Antony Blinken visited Kyiv in May and has continued to push for anti-corruption reforms behind the scenes, and during Zelensky's recent visit to Washington, reforms and Russia were the key talking points.

Positive momentum has brought the IMF programme back on track

In quick succession in June, a number of important pieces of legislation were passed by parliament – steps that improve the oversight of the judiciary and enhance the country's anti-corruption credentials. The Rada has returned from its summer recess, and with two further pieces of legislation in focus (one on anti-corruption, which has now been passed, and the other on central bank corporate governance, which is in progress), Provided this legislation is all passed in the spirit of the IMF's requirements, it should be sufficient for the IMF to reach a staff-level agreement on disbursement.

Over the longer-term, we also think it is important that Zelensky is signalling that he wants to sign a new IMF programme (the current one expires in December), and in the meantime the finance ministry has signalled its willingness to extend the current programme by six months.

Challenges remain

While there has undoubtedly been strong progress on the above reforms, Ukraine remains a work in progress. Further structural reforms are needed to unlock the country's growth potential so that it can catch up to the income levels of regional peers.

The judiciary will remain a roadblock. Oligarch-controlled corporations and media still dominate the country's economy and control a large portion of the country's parliament. Moreover, Zelensky himself can be viewed as ambivalent to the rule of law at times. For instance, in attacking Viktor Medvedchuk (the Russian-backed oligarch) he used legally dubious security laws, and his anti-corruption stance seems selective – largely targeting those oligarchs that politically oppose him as he starts to lay the groundwork for a re-election bid in 2024.

The challenges can also be exemplified by the central bank, where there are clear tensions within the institution. Governor Shevchenko, interviewed in the Financial Times, blamed oligarchs for undermining his authority at the central bank by organising mass resignations. However, a respected insider who is close to the Monetary Policy Committee refuted such allegations and said it was Mr Shevchenko himself who was undermining the institutional capacity of the central bank. This would certainly seem to chime more with what the IMF has said in the past – part of the reason it is requiring a fresh piece of legislation to strengthen corporate governance at the institution.

The authorities' attitude to the IMF is also at times ambivalent. Recent comments from the economy minister – suggesting that the central bank needs to coordinate policy more closely with the government – will not go down well with the IMF. Ultimately, however, we think a constraints-based analysis suggests that Ukraine will continue to participate in the IMF programme for three reasons:

- Geopolitics: increased tensions with Russia this year have reinforced the need for closer integration with the West, and ongoing participation in an IMF programme is an important component of that.
- Market discipline: in the absence of an IMF programme, far from being able to pursue heterodox monetary policy/loose fiscal policy etc., without an IMF anchor, Ukraine's authorities would need to be more conservative to retain market access at current funding costs.
- Elections: continued IMF programme participation should help to secure a robust post-pandemic recovery ahead of the 2024 elections.

What does it all mean for investors?

Ukraine's ongoing participation in an IMF programme would be a clear positive for the credit strength of the country, both directly (facilitating important ESG improvements, providing a credible fiscal anchor, etc.) and indirectly (in terms of financing – helping to reduce the amount and cost of market borrowing). The country's progress may also start to support credit rating migration – of note, Fitch recently upgraded its outlook to positive.

We continue to find Ukrainian assets compelling. A premium remains in the country's sovereign spreads, while the GDP warrants offer upside potential, particularly if the country re-engages with structural reforms designed to improve growth potential. In the local currency bond space, unhedged yields have widened on the back of the central bank's hiking cycle, presenting an attractive and diversifying source of frontier market return potential, in our view.

While there is the potential for further mis-steps, there is cause for optimism that the balance is shifting more firmly in favour of a positive structural story.

Regional highlights

Africa

External dynamics in **Egypt** remain supported by strong remittances and a stable trade deficit, helped by a rebound in exports. Less positively, the US has said it will withhold US$130 million of the US$300 million it pledged in military support until certain human rights conditions are met. Inflation in the country has risen but by less than expected, increasing to 5.7% from 5.5% on back of higher food and utility prices, while core inflation remains muted at 4.5%, down from 4.6%.

In **Ghana**, the central bank continues to balance inflation and growth risks. It kept rates on hold at 13.5%, despite an increase in inflation (largely from food), a weak pick-up in domestic credit growth and continued risk aversion related to the pandemic. Inflation pressure stemming from the food sector should ease with the start of the harvest season. GDP growth for Q2 was rather weak at 3.9% year on year, as the extractive sector continues to weigh on performance. However, a loan from the cocoa regulator to cover purchases of the 2021/22 crop, together with the IMF SDR allocation, provides significant space from a US dollar liquidity perspective over the short term.

Hakainde Hichilema (HH), the new president of **Zambia**, has been progressing with various market-friendly moves. The Drug Enforcement Commission arrested the provisional liquidator of Konkola Copper Mines and charged him with theft and money laundering. HH also re-appointed Denny Kalyalya as central bank governor and provided greater clarity on the extent of Chinese lending to the country. An IMF staff visit is expected in the coming weeks, and the new finance minister aims to have outline for a deal by the end of November and to announce a new budget in October.

COVID restrictions continued to weigh on growth in **Uganda**, although President Museveni has announced a further easing of these. The removal of some restrictions had already helped the Stanbic Bank Uganda PMI return to positive territory in August, jumping to 50.2 from 34.6 in July. Inflation continues to be low, with headline inflation edging down to 1.9% year on year in August from 2.1% in July, while core inflation decelerated further to 2.2% year on year in August from 2.5% July and 2.7% in June. The central bank has kept rates on hold at 6.5% after cutting in May.

Asia

Cases of COVID-19 have been falling in the region and the trend is looking more positive. However, Singapore announced another four-week lockdown and case numbers in South Korea hit new highs, albeit with low associated death rates. China, Singapore, Malaysia and South Korea all ramped up their respective vaccine programmes; the rest of Asia is moving more slowly, but efforts are beginning to pick up.

The main headlines across Asia were focussed on **China**, which announced generally weak economic data for the month of August. However, this was somewhat expected given the recent COVID outbreak, which resulted in further temporary lockdowns, although we have since seen these pressures ease. There were also more negative developments relating to the property sector, notably surrounding industry bellwether Evergrande, while property data in general has slowed sharply over the last couple of months. More positively, the chief financial officer of Huawei was released after being prosecuted by the US, and China released two Canadians. This news has been deemed to be a step in the right direction for Sino-US relations.

In **South Korea**, net equity flows were positive over September, which is a reversal of the trend seen in recent months when persistent outflows weighed on the currency. However, weakness in the won continued, caused by a combination of negative sentiment in China spilling over, the stronger US dollar, and a resumption of North Korean missiles testing. Other Korean data has also been strong, with GDP for the second quarter printing at 5% versus 3.9% expected. Exports remain robust, and the central bank remains hawkish, pointing towards further interest rate hikes. In other central bank news, monetary policymakers in Taiwan kept rates on hold as expected, as did their counterparts in **Thailand**. However, the latter represented a slightly hawkish move as the decision was unanimous across the monetary policy committee, compared to the previous meeting in which two board members voted for a rate cut.

In **Sri Lanka**, the rumours in recent months surrounding the increased likelihood of the country approaching the IMF for help proved to be false, as the central bank governor has ruled out seeking an IMF bailout – sentiments which were echoed by the president's secretary.

Trade balance data in **Indonesia** significantly beat expectations, showing a surplus of US$4.7 billion thanks to particularly strong export data. Trade numbers were also impressive in **Taiwan**, mostly due to the iPhone cycle, reflecting Taiwan's large share of semiconductor manufacturing production.

Latin America

Inflation is rising higher than expectations across the board in Latin America, with Brazil and Mexico experiencing particularly high upside surprises. This has forced the region's central banks to adjust policy rates faster than expected. The region is also sensitive to the ongoing events in China's property sector, as demand for many of Latin America's key commodity exports has slumped. More positively, the COVID-19 picture across the region is improving.

The central bank in **Chile** hiked interest rates by 75bps to 1.5%, which was a lot higher than expected. The messaging communicated with the hike was also particularly hawkish. Throughout the month, rumours and headlines around a potential fourth pension fund withdrawal bill weighed on sentiment, and at month end, congress marginally passed a 10% withdrawal bill. However, this still needs to be approved by the senate. Being a heavy copper exporter, Chile is also sensitive to the ongoing turmoil in the Chinese property sector.

In **Argentina**, the primary elections were held for the lower house and congress. The upshot was lower levels of support than expected for the ruling coalition. Although the market initially took the news well, the government reaction since has hurt sentiment. It has increased its spending via more fiscal stimulus, and is planning to use the IMF SDR allocation twice, to both repay an IMF payment and to create fiscal revenues to allow for more spending. There was also a cabinet reshuffle, and tensions have since erupted between President Alberto Fernández and Vice President Cristina Fernández de Kirchner. More positively, the government didn't change its economic team, so the market is still confident it will continue to progress towards an IMF deal early next year.

The 2022 budget was presented in **Mexico**, which showed encouraging fiscal consolidation and that the country maintains its prudent fiscal stance. In addition, President Andres Manuel Lopez Obrador also announced that the profit sharing tax on Pemex will be reduced from 54% to 40%, which will reduce government revenues. On the data front, retail sales were lower than expected, while inflation surprised on the upside.

Inflation continues to rise in **Brazil**, with the latest data for August coming in at 10% year on year. This prompted the central bank to raise rates by 100bps to 6.25%, with another hike of the same magnitude expected in October. Despite the rate hike and hawkish central bank, the real suffered over the month due to the high inflation print, with a government discussion on extending its fiscal stimulus into next year also weighing on the currency. The large fall in the iron ore price further hurt the real as it weighed on the country's terms of trade.

Central and Eastern Europe

The rule-of-law clash between **Poland** and the EU looks set to escalate further following a ruling by the Constitutional Tribunal that some rulings by the Court of Justice of the EU (CJEU) related to the Polish judicial system violated the rule of law and the primacy of the Polish constitution. This development implies a further holdup of EU recovery funds as well as more fines levied in the various infringement procedures. Poland's Monetary Policy Council delivered a surprising hike of its key short-term rate by 40bps to 0.50% following a further acceleration in inflation well above the central bank's tolerance band.

In **Romania**, a political crisis erupted as the government, headed by Florin Cîțu, was dismissed following a successful motion of no confidence submitted by the major opposition party (PSD) against the PNL-led government with support from MPs of the former ruling partner. The National Bank of Romania defied expectations and hiked the policy rate to 1.50% in an attempt to anchor long-term inflation expectations as global prices for commodities, food and construction materials kept rising, coupled with bottlenecks in production and supply chains.

In **Hungary**, the central bank (MNB) continued with its tightening cycle but at a slower pace, raising the base rate by 15bps to 1.65% and signalling further tightening ahead. Headline inflation accelerated in September, matching expectations, but the strengthening trend in underlying inflation points to a more persistent nature of inflation pressures.

In the **Czech Republic**, the CNB board raised its policy rate by 75bps, taking it to 1.50% and exceeding market expectations. The board is particularly concerned about acceleration of core inflation, primarily due to imputed rents, which the board expects to remain high, given rising property prices and construction costs, as well as a tight labour market.

Rest of EMEA

Headlines coming out of **Turkey** were dominated by more unorthodox monetary policy action. The central bank cut interest rates by 100bps, despite inflation printing above the policy rate and the inflation trajectory remaining challenging. The statement accompanying the hike was also much more dovish than in previous meetings, paving the way for further cuts in Q4 2021. This surprised the market, resulting in the lira selling off significantly.

The pace of interest rate hikes slowed in **Russia**, with the central bank increasing rates by 25bps. However, the message to the market was still hawkish, suggesting there is at least one further hike to come. September and weekly inflation data suggest there is still material pressure over the near term, although the central bank will welcome the moderation in inflation expectations. Russia continues to see soft data prints on growth after a strong first half of the year, but the recent spike in gas prices could add an extra US$100 billion in export revenue if maintained, and this is supporting the ruble. On the political front, Putin's party, United Russia, maintained control of the Duma in legislative elections that were largely a foregone conclusion.

The progress towards an IMF disbursement continues in **Ukraine**, as the required legislation is currently in the process of being voted on in the Rada. Meanwhile, President Zelensky's campaign against the oligarchs continues, with a new law passed which limits the ability of oligarchs to fund political parties. Growth indicators in the country remain mixed, while inflation continues to creep higher. Turning to monetary policy, the central bank raised interest rates to 8.5%, in-line with its previous guidance. It has suggested that this marks the end of the hiking cycle, unless there are further upside inflation surprises.

Leading indicators suggest that the economy in **South Africa** has bounced back after the riots in July. Inflation has started to tick higher, but it remains mostly benign, allowing the central bank to keep rates on hold.

In the **Middle East**, Bahrain has re-engaged with fiscal reforms by proposing a rise in VAT from 5% to 10%, while in Lebanon, the 12-month stalemate in forming a government has ended, with the appointment of a new 'technocratic' government. This could facilitate an unlocking of structural reforms and an IMF deal, but we remain sceptical given the same political elite remains in control behind the scenes.

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