September 2023

Emerging Market Debt Indicator

The fast view

Market background

It was a challenging month for financial markets, with EM fixed income no exception. The risk-off tone was fuelled largely by market participants pricing in a 'higher for longer' interest rate outlook in the US, which drove a sharp rise in US Treasury yields. The bond market sell-off extended beyond the US.

Africa

Egypt continued to make progress on its privatisation programme, and the current-account balance returned to surplus. Kenya's current-account balance also continued to improve (a smaller deficit) as tighter monetary and fiscal policy have tempered imports.

Asia

Inflation was generally higher than expected, although mainly on a headline basis (driven by volatile items like food and fuel) rather than a reflection of core inflation dynamics. China's economic data was more encouraging overall, with recent piecemeal policy easing starting to bear some fruit.

Latin America

Brazil cut its policy rate by 50bps, as expected. Chile's central bank also continued with its rate cutting cycle, cutting by 75bps. In contrast, Mexico's central bank remained rather hawkish, with the governor saying that rate cuts are not yet on the table.

Central and Eastern Europe (CEE)

In Poland, the central bank forced through a rate cut of 75bps, which was much bigger than expected. In contrast, monetary policymakers in both the Czech Republic and Hungary sounded hawkish. Overall, inflation prints in the region remained relatively benign, but rising fuel prices are adding some pressure.

Rest of Europe, Middle East and Africa (EMEA)

Continued orthodox policymaking in Turkey prompted Fitch to upgrade its outlook to 'stable'. In South Africa, GDP growth in Q2 was higher than expected, but high-frequency indicators remain mixed. Oil prices remained supported by OPEC and Saudi Arabia's production-cut announcements, leading to credit-rating upgrades for the likes of Oman.

EM corporate debt highlights

EM corporate debt succumbed to the broader bond market sell-off over September. High-yield issuers outperformed investment grade (IG), given the longer duration of the latter. From a spread perspective, both segments saw spreads tighten, especially in the high-yield segment.

Werner Gey van Pittius
Co-head of Fixed Income

Market background

September proved to be a challenging month for financial markets, with EM fixed income no exception. The risk-off tone was fuelled largely by market participants pricing in a 'higher for longer' interest rate outlook in the US. The drivers behind this revision in expectations included somewhat more persistent inflation and surprisingly resilient economic data. Furthermore, although the US Federal Reserve kept interest rates on hold at its September meeting, it increased its 'dot plot' forecasts for interest rates next year by 50 basis points (bps). This drove a sharp rise in US Treasury yields, with the 10-year closing the month at 4.57% (46bps higher than the end of August), causing a sell-off in bond markets.

The bond market sell-off extended beyond the US, as sovereign rates in Europe also rose, notably in Germany, France and Italy. The European Central Bank (ECB) raised its key interest rate to a record high of 4%, although it signalled that the hike was likely to be its last. The ECB also indicated that it expects inflation to reach its 2% target over the next two years – which is slower than expected – with economic growth likely to slow further.

A further headwind to financial markets came in the form of the continued rise in the oil price, which also fed fresh inflation concerns across emerging and developed markets.

Turning to EMs, inflation across Asia generally printed higher than expected, although this was mainly driven by volatile items such as food and fuel rather than a reflection of core inflation dynamics. Economic data releases in China were more encouraging overall and the People's Bank of China cut the reserve requirement ratio by 25bps. In Latin America, the central bank in Brazil cut its policy rate by 50bps, in line with the market's expectations, and Chile's central bank also continued with its rate cutting cycle, this time cutting by 75bps. In contrast, Mexico's central bank continued to be on the hawkish side, with the governor saying that rate cuts are not yet on the table.

Top-down views and outlook

Although some recent inflation prints have been higher than expected, with higher oil prices also posing a risk to inflation, the global inflation picture continues to be one of moderation overall. Furthermore, recent data releases have led markets to become more confident of a soft landing (rather than recession) for economies, especially in the US. While markets are likely to remain volatile, we continue to be constructive on the medium-term outlook for returns from the EM debt asset class.

Many EM economies have solid fundamental foundations. The more fragile EMs are receiving plenty of support from the IMF and other multilaterals. Furthermore, with much of the painful interest-rate hiking now behind them, most EM economies are in an enviable position relative to developed markets overall, with most EM central banks either having completed their hiking cycle or beginning to cut rates. EM bond market valuations look attractive – with some markets still pricing in significantly more risk than we believe is justified.

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 – initially reversed its trend, however, in recent months the dollar index has been stronger, reversing part of this weakness. At the same time, markets began to consider when peak global monetary policy rates 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 reach the end of its hiking cycle and bond yield curves will reflect this. There are risks to this view, which include the Fed ramping up its hawkish rhetoric if financial conditions ease too much, or if inflation proves stickier than the Fed expects, resulting in short-term rates being more sluggish in reversing course than is currently priced by markets.

From a top-down risk perspective, we have kept our neutral target. While the overall risk target is unchanged, we moved from a modest overweight to neutral in EM local debt, while closing our small underweight in EMFX to a neutral target. Hard currency debt targets have remained neutral. In EM local debt, although we are seeing improved structural strength and spreads over US Treasuries have begun to widen again, the risk for upside surprises in headline inflation from higher oil prices lead us to

be more cautious. EMFX offers solid underlying fundamentals and high carry in select markets, while the recent sell-off has improved valuations. Turning to the hard currency market, despite spreads remaining above their long-run averages (particularly in the high-yield space), we see increasing risks to the downside. The asset class is currently pricing in a soft landing - rather than recession - for the US economy, against a global backdrop of heightened geopolitical tension.

Top-down positioning at end September 2023

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

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

Regional highlights

Africa

The government in **Egypt** continued to make progress on its privatisation asset sales, after what has been a slow start; the UAE Global Investment Holding Company agreed to buy a 30% stake in Egypt's main tobacco company, Eastern Company, for US$625 million. In addition, the current account returned to a surplus in Q2. This helped increase net foreign currency reserves and marginally reduced the negative net foreign asset position of domestic banks. The government also announced a date for presidential elections, which will be held on 10-12 December 2023, after which we would expect a re-engagement with the IMF to complete the delayed country review.

In **Nigeria**, the president announced Yemi Cardoso as the new central bank governor, who called for greater coordination between the monetary and fiscal authorities, as well as a reduction of monetary supply to reduce the pressure on the exchange rate. Cardoso will need to deliver results quickly, as after an inspiring start, we have seen further pressure on the black-market exchange rate, while fuel subsidies have started returning given domestic social pressures.

The monetary policy committee in **Kenya** kept interest rates on hold at 10.5%, noting that inflation remained within range and generally in-line with expectations. To re-iterate its tight fiscal stance, the government called for 10% cuts across ministerial budgets in an attempt to assuage investor concerns regarding a recent budget document, which showed a planned deficit of 5.4% of GDP (up from 4.4% previously). Current-account data showed a continued improvement (to a deficit of 3.7% of GDP) as tighter monetary and fiscal policy have tempered imports.

In **Zambia**, after some delays, it seems likely that official creditors will sign a memorandum of understanding soon, which should also accelerate discussions around debt restructuring. In a positive surprise, copper production increased to a 19-month high in July, even before the government had started to see the benefits from a large investment, which has since been announced.

Asia

Inflation across Asia has generally been surprising on the upside, although this is largely on a headline basis (driven by food and fuel price rises) rather than a core inflation issue – the latter has generally been trending lower. Food prices are facing upward pressure from bad weather as a result of the El Niño weather pattern, while the rise in the oil price adds to inflationary pressure since most Asian economies are oil importers.

Economic data releases in **China** were more encouraging overall relative to the previous months. The piecemeal policy easing of the last few months has started to bear some fruit, providing some stability to various growth and activity data points. Retail sales, credit growth and industrial production all surprised positively for August, while manufacturing activity continued to show signs of stabilisation. We also see some signs of stabilisation in property data as property policies have shifted notably looser, although we are not seeing much sign of recovery yet. Trade data was slightly better than expected. The People's Bank of China cut the reserve requirement ratio (RRR) by 25 basis points (bps), left the loan prime rate unchanged, and implemented a large real intervention in the renminbi to stabilise the currency. We expect that the drip feed of policy measures to continue until the authorities get the growth results they want; data following the upcoming Golden Week holiday will be hotly anticipated given its usefulness is gauging the level of demand recovery.

In **India**, El Niño and lower-than-usual rainfall during the monsoon season continued to support high food inflation forecasts, while the higher oil price is putting upward pressure on the trade deficit via higher import costs. However, economic activity data remains good overall and India's growth rate is outperforming that of many other economies. While this puts pressure on the trade balance via strong imports, exports are still holding up well, particularly services. As a result, the rupee has been outperforming peers, helped also by continued strong equity flows and the Reserve Bank of India actively intervening to curb currency depreciation.

Turning to **Thailand**, the debt management office announced a larger-than-expected local debt issuance programme (with longer-than-expected maturities), weighing on bond prices and the Thai baht. The Bank of Thailand also hiked rates by 25bps with a hawkish outlook and raised its GDP forecast, all of which further exacerbated the bond market sell-off. Tourism data was a disappointment, with August typically being a seasonally high period, but arrivals from both Europe and China were lower than usual.

In **South Korea**, export numbers for September were better than expected, with broad-based improvement across sectors. The country's unemployment rate was also better than expected. Headline inflation rose as a result of the higher oil price, while bad weather pushed up food prices, much like the rest of the region.

The IMF completed its programme review in **Sri Lanka**; it disappointed the market by not agreeing to the disbursement of the next tranche of the programme. However, signs that the country is getting closer to a resolution with bond holders on its external debt supported Sri Lanka's hard currency bonds.

Latin America

The central bank in **Brazil** cut its policy rate by 50bps in September, in line with the market's expectations. Current-account data for August showed a strong improvement, with a US$700 million deficit much smaller than expected, thanks to a strong trade balance on the back of soy and oil exports. In addition, the 2024 budget presented by the government was largely in line with the government's fiscal target for next year, although authorities need to find an additional BRL160 billion (c.US$32 billion) of revenues.

Chile's central bank also continued with its rate cutting cycle, this time cutting by 75bps. This was on the lower side of expectations (the market was split between 75bps and 100bps) but still resulted in the peso weakening. Inflation was much better than expected, falling to 5.3%. The decline was broad based across the underlying components.

In contrast, **Mexico's** central bank remained relatively hawkish, with the governor saying that rate cuts are not yet on the table. This is despite headline inflation falling to 4.4% year-on-year, with core inflation also dropping. In other developments, the Foreign Exchange Commission surprised the market by announcing it would only roll over half of its non-deliverable forward (NDF) book. Combined with heavy

market positioning, this caused the peso to weaken. Exacerbating this was the announcement of a worse-than-expected budget, which contained an array of pre-election spending plans, as well as more support for Pemex. Increased issuance is also a concern on the hard currency debt side as over US$10 billion of external issuance next year seems plausible after the 2024 budget raised the external issuance ceiling to US$18 billion.

In **Colombia**, there was a bout of weak economic data releases, with both industrial production and retail sales coming in below expectations. Inflation remains elevated, with both headline and core inflation at around 11% and food prices still causing upside surprises. The government also increased gasoline prices to reflect the rising oil price, adding further pressure to inflation. President Petro's health reform made some progress in Congress by passing the first debate, but we still expect the bill to be watered down throughout the rest of the process.

In **Argentina**, Economy Minister Sergio Massa gave more handouts, including cutting income tax, in an effort to gather support for the upcoming election on 22 October. These fiscal handouts now total a significant 1.5% of GDP.

In **Ecuador** the first polls for the second round of the presidential election showed Daniel Noboa (of the National Democratic Alliance) to have a lead of 6-10%. Noboa, who is perceived as the more market-friendly candidate, has made populist comments, suggesting that he would use some of the central bank's reserves for fiscal spending purposes – this weighed on market sentiment towards the country.

There was a large issuance of local currency debt from the **Dominican Republic** in September, a market which has historically relied on external US dollar issuance. This is encouraging as it means the country relies less on foreign currency debt, while the hard currency bonds benefitted given the lower issuance levels in US dollars.

Peru started its rate cutting cycle with a small 25bps cut. The government also announced a fiscal stimulus package related to El Niño, which totalled 1% of GDP.

Central and Eastern Europe (CEE)

In **Poland**, the central bank forced through a rate cut of 75bps, which was much bigger than expected. This appeared to be at odds with domestic macroeconomic fundamentals and regional peers, as well as the European Central Bank. In contrast, monetary policymakers in both the **Czech Republic** and **Hungary** sounded hawkish over the month. While Hungary's central bank cut rates by 100bps, it signalled that further rate cuts will be data dependent and it is clearly concerned about forint weakness. In the Czech Republic, the central bank kept rates on hold and signalled that cuts this year are far from inevitable – despite the market pricing in various cuts – highlighting inflationary risks.

Overall, inflation prints in the region continued to be relatively benign, however, there is slight upside pressure from rising fuel prices. This is not likely to be transmitted into Polish CPI inflation though due to politically motivated fuel price cuts from the state-owned petrol company.

Central banks will also be monitoring the worsening growth picture in the region. Purchasing Managers' Indexes (PMIs) remain firmly in contractionary territory, and this is largely backed up by hard data and increasing signs of a recession in the EU, notably Germany. Trade balances for the region continued to be in surplus or falling deficits, but the higher oil prices likely cap further improvements.

National elections in **Poland** will be key to watch in the coming months. The latest polls suggest that the ruling PiS party will be the largest party, but it may struggle to form a coalition. This is providing a window of opportunity for the pro-EU opposition to form a coalition of their own. As a result, the overall outlook is uncertain.

Political tensions with **Kosovo** weighed on Serbian credit spreads, although we expect strong US and EU pressure to prevent risks from spilling over.

Rest of Europe, Middle East and Africa (EMEA)

Oil prices continued to be supported by OPEC and **Saudi Arabia's** announcements of production cuts. The strong oil price is supportive of credit fundamentals in the Gulf, with the likes of Oman being upgraded to BB+ by S&P and Fitch.

Elsewhere, **Turkey** received an upgrade to its outlook from Fitch (from negative to stable) given continued momentum in the country's orthodox policymaking. Interest rates were hiked by 5% in September to 30%, and the authorities continued to unwind some of the unorthodox banking regulations which had been trying to support the lira, but at a large fiscal cost. However, further rate hikes will be needed as inflation is still rising in year-on-year terms and is currently above 60%.

The Bank of **Israel** kept rates on hold, although there was an upside surprise in August inflation, which if sustained, may change the interest rate outlook. With parliament in recess and the supreme court still debating the proposed controversial judicial reforms behind closed doors, news flow was quiet over September. This all changed post month-end, following an unprecedented attack by Hamas, leading to a highly uncertain outlook for geopolitics in region.

GDP growth in Q2 was higher than expected in **South Africa**, but high-frequency growth indicators remain mixed, with weak manufacturing and mining production in July, as well as lower retail sales. Inflation was broadly in line with expectations, with the South African Reserve Bank keeping rates unchanged but maintaining its hawkish bias as the monetary policy committee vote was split between keeping rates on hold and a hike.

EM corporate debt highlights

Along with other fixed income markets, EM corporate debt succumbed to the broader bond market sell-off over September. However, the asset class outperformed EM hard currency sovereign debt, as well as US high-yield and US investment-grade corporate debt markets. Within the JP Morgan CEMBI, high-yield issuers outperformed investment-grade (IG), with the longer duration of the latter weighing on bond prices. From a spread perspective, both segments saw spreads tighten, especially the high-yield segment.

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