June 2023

Emerging Market Debt Indicator

The fast view

Market background

June started on a positive note, with the conclusion of the US debt ceiling deal after weeks of uncertainty. Subsequently, stubborn inflation surprises prompted rate rises across many developed markets. In contrast, inflation continued to moderate in many emerging markets. EM fixed income markets performed well, boosted by some positive country-level developments.

Africa

Ghana made further progress on its local debt restructuring. Zambia reached an agreement with the official creditor committee on its debt restructuring; this paves the way for a deal with private creditors and releases IMF funds, which had been withheld in the absence of a deal.

Asia

Inflation continued to decline, with most central banks across the region having now generally paused their rate hiking cycles. In China, economic data releases remained somewhat disappointing, prompting authorities to announce some monetary policy easing measures. Pakistan eventually agreed to a US$3 billion Stand-By Arrangement with the IMF, a positive surprise which helped the country's hard currency bonds to trade well.

Latin America

In Brazil, headline inflation continued to show signs of easing, which proved to be a common feature across Latin America. Chile's central bank kept rates on hold and signalled that it will soon start to cut rates, sparking a bond market rally. Colombian assets performed well as market participants priced in a lower chance of fiscally concerning reforms being passed through Congress.

Central and Eastern Europe

Industrial production and retail sales continued to disappoint across Poland, the Czech Republic, and Hungary, with the tightening in financial conditions starting to bite. Against this backdrop, inflation continued to print lower than expected overall, led by easing food, energy and core prices.

Rest of Europe, Middle East and Africa (EMEA)

In Israel, political headlines continued to impact local asset prices, with unrest related to the government's judicial reform agenda rumbling on. In Turkey, newly elected President Erdogan allayed market fears by appointing more orthodox policymakers. However, the central bank dashed hopes somewhat after only hiking the policy rate to 15%.

EM corporate debt highlights

The EM corporate debt market broadly kept pace with its developed market counterpart over June. Within the index, high-yield issuers materially outperformed investment-grade bonds. Although both areas of the market saw credit spreads tighten, high-yield spreads contracted more aggressively.

Werner Gey van Pittius

Co-head of Fixed Income

Market background

At the global level, the month started on a positive note, with the US debt ceiling deal being reached after weeks of uncertainty. Following this, the main theme over June was one of stubborn inflation surprises across many developed markets. The European Central Bank, Bank of England, Reserve Bank of Australia and the Bank of Canada all hiked their respective interest rates over the month. Bucking this trend was the US Federal Reserve, which kept rates on hold at its June meeting, although since then the US economy has shown continued signs of resilience, causing the market to price in a hike in July.

Turning to emerging markets (EM), in Latin America, headline inflation continued to show signs of easing across the region, with several central banks keeping rates on hold over the month. In Asia, the focus remained on China, with economic data releases somewhat disappointing. This prompted the Chinese authorities to announce some monetary policy easing measures. In Central and Eastern Europe, inflation continued to print lower than expected overall, while economic activity data across the region continued to surprise to the downside. Turning to Turkey, newly elected President Erdogan allayed the market's worst fears by appointing more orthodox policymakers to the country's finance ministry and central bank. However, the latter dashed hopes somewhat after only hiking the policy rate to 15% in June.

EM assets performed well over June, despite the headwind of rising rates across many developed economies. The local bond index (JP Morgan GBI-EM) returned 3.3%, driven by both hedged bonds and EMFX. In hard currency markets, the sovereign index (JP Morgan EMBI) returned 2.2%, driven by a sharp recovery in some distressed high-yield markets which buoyed wider risk sentiment, while in the corporate market, the JP Morgan CEMBI returned 1.1%, also driven by high-yield issuers. Spreads tightened meaningfully in the latter, helped by some improving idiosyncratic country specific developments.

Top-down views and outlook

Global inflation pressures are continuing to moderate and although recent events have led markets to price higher recession risk again, data has been less soft than expected. While risks surrounding US debt ceiling negotiations have now gone, markets are likely to remain volatile, but we remain constructive on the medium-term outlook for returns from the EM debt asset class.

Many EM economies continue to have solid fundamental foundations. The more fragile EM economies are receiving plenty of support from the IMF and other multilaterals, and recent progress on debt restructuring in some smaller markets is helping further. Furthermore, with much of the painful interest-rate hiking now behind them, most EM economies are pricing in significant cuts from the latter part of this year. EM bond market valuations still look attractive – with some markets pricing in significantly more risk than we believe is justified.

From the end of last year and into this one, 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 will reach their peak. There are risks to this view, which include the Fed remaining hawkish for longer if financial conditions ease too much, or if inflation, particularly core inflation, proves stickier than expected and does not converge back to target resulting in short-term rates being more sluggish than expected in reversing course.

From a top-down risk perspective, we have taken our overall risk target from broadly neutral to overweight. This change was driven partly by an increase in our hard currency debt targets. Hard currency spreads are still well above their long-run averages, creating attractive valuations, and we expect the asset class to benefit from an easing policy environment as well as supportive supply-side dynamics. However, we acknowledge that hard currency debt is exposed to increasing recession risk. As for EM local debt, we are also moving to a small overweight top-down risk target; we are seeing

improved structural strength across EMs and peaking inflation, and spreads over US Treasuries have begun to widen again. Regarding EMFX, we have a neutral target; while solid underlying fundamentals, high carry and the view that US dollar strength should be capped as the Fed nears the end of its hiking cycle are all supportive; the recent rally and a preference for local bonds prevent us from taking an overweight position for now.

Top-down positioning at end June 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.

Thys Louw
Portfolio Manager

A new era for Nigeria

While much remains to be done, Nigeria's new administration is beginning to lay the groundwork for a more prosperous and sustainable future. Thys Louw explores the implications for debt investors.

The new administration gets straight to work

Within his first month in office, newly elected President Bola Tinubu has moved swiftly to deal with the macroeconomic imbalances that built up over his predecessor's term. Taking aim at the two biggest challenges – a fiscally unsustainable fuel subsidy and a dysfunctional exchange rate regime – Tinubu appears to be pursuing an orthodox policy path for this struggling yet high-potential economy.

Fuel subsidy

As Africa's largest oil producer, Nigeria really should have reaped the benefits from the high oil price seen through much of 2022. But an overly generous fuel subsidy coupled with a steady decline in production volumes over recent years more than offset this. The country's fiscal position worsened in 2022, with the fiscal deficit widening to 6.2%. Furthermore, reserves fell by US$5 billion over the year, reflecting persistent financial account outflows, and constrained funding as (like many African debt markets) Nigeria saw a 'sudden stop' in foreign investment in 2022, forcing the central bank to finance a significant portion of the country's deficit.

The day after his inauguration at the end of May, President Tinubu's first move was to ditch the fuel subsidies. This is a vital first step in putting the country on a more sustainable fiscal path. And while protests have scuppered previous attempts to withdraw this long-standing financial support, the new government's transparency around the issue and moves to increase the minimum wage appear to have reduced the risk of social unrest.

Exchange rate

President Tinubu's second move was to announce the unification of Nigeria's multiple exchange-rate systems (as it was initially described). This was an equally urgent task: over recent months, uncontrolled inflation resulting from overly loose monetary policy drove the black-market exchange rate to a c.70% premium to the spot rate. The central bank hiked rates to offset some of the pressure, but real rates have remained deeply negative.

To confirm his commitment to a more orthodox path, Tinubu suspended the central bank governor, Godwin Emefiele, with immediate effect on 9 June (appointing Folashodun Adebisi Shonubi as acting

governor); Emefiele was seen as a roadblock to further liberalisation of the exchange rate.

Since we initially wrote this piece, the removal of the central bank governor has resulted in the liberalisation of the exchange rate and the black-market premium collapsing to the spot rate. This, combined with the removal of the very costly fuel subsidy, boosted investor sentiment towards the country.

Ripe for further reform

While much more needs to be done to reform an economy that has stagnated for the best part of a decade, we believe that some of the foundations are now being laid for a more prosperous future for Nigeria and its people.

Other essential areas of focus for Tinubu's government include the need to improve Nigeria's business environment and deal with high levels of corruption. The new administration also inherits some urgent social challenges. Until recently, Nigeria had the lowest possible score in our proprietary ESG scorecard, excluding it from our investable universe. Social policy and human capital in particular scores very poorly, stemming from unequal access to education (although improving), stagnation in literacy and a relatively low number of years of education on average. Access to basic education, sanitation or water services, electricity and quality transport infrastructure are also major issues.

However, positive momentum in environmental policy recently prompted us to upgrade Nigeria's ESG score. This reflected support from key figures for mitigation actions and initiatives to improve on transparency of the country's greenhouse-gas inventory system. Furthermore, with the Climate Change Act, Nigeria set into law a net-zero target, establishing a five-year and annual carbon budget process. This improves on the country's near- and long-term planning and points to a more positive forward-looking trend.

Implications for debt investors

Nigeria's credit spreads have already rallied since Tinubu has taken office. While in the shorter term investors must carefully weigh risks associated with the market's very high expectations and the significant reforms that still need to take place, we think that continued delivery on reforms could pave the way for eventual credit rating upgrades and underpin further spread compression.

Regional highlights

Africa

In **Angola**, the exchange rate came under considerable pressure from external debt servicing and lower oil prices. More positively, the government has promoted the head of central bank, José de Lima Massano, as the new Minister of Economic Co-ordination. The market welcomed this news given his views on the need for a liberalised exchange rate and a reduction in unsustainable subsidies. On the political side, some pressure persists as the government continues to try to remove fuel subsidies.

The government in **Ghana** has made further progress on restructuring local debt after an agreement was reached with banks on the restructuring of both US dollar bills and cocoa bills. China has also made positive statements regarding its participation in the restructuring deal. Investors will now be keeping an eye on the mid-year budget review on 27 July.

In **Kenya**, the new central bank governor hiked rates by 100 basis points (bps) to help combat inflation, while US dollar reserves increased to US$7.5 billion following multilateral disbursements, which will help allay external sustainability concerns. The government is also reportedly planning to buy back between US$500 million and US$1 billion of its debt that is due to mature in 2024, and considering issuing a new bond to refinance the rest.

Turning to **Nigeria**, President Tinubu continued his brisk pace of economic reforms, having suspended the central bank governor Godwin Emefiele, which eventually led to the liberalisation of the exchange rate and caused the naira to weaken substantially. This, combined with the removal of the very costly fuel subsidy, boosted investor sentiment towards the country.

President Macky Sall in **Senegal** announced that he won't be running for a third term, which should reduce investor concerns around domestic political stability. In addition, the government secured a US$1.5bn IMF deal, as well as a US$2.7 billion energy transition package from G7 partners, both of which helped the hard currency bonds to make gains over June.

Zambia reached an agreement on its debt restructuring with the official creditor committee in a deal that could increase the country's debt carrying capacity before the end of the IMF programme. This paves the way for a deal with private creditors in the near future, and also releases IMF funds which have been withheld in the absence of a deal.

Asia

Inflation continued on its downward trend, with most central banks across the region having now generally paused their rate hiking cycles.

The focus was once again on **China**, with economic data releases remaining somewhat disappointing. This prompted the Chinese authorities to announce some monetary policy easing measures, including cutting the 7-day repo rate by 10bps and both the 1-year and 5-year loan prime rates by the same margin. However, as much of the market viewed this as insufficient, local bond yields were little changed over the month. Although there is still no clear sign of the big monetary policy response that the market is looking for, the upcoming Politburo meeting is scheduled to take place post the next GDP print and the consensus view is that if growth is notably weak, the authorities may well shift their policy stance more aggressively to support growth. Against this backdrop of continued weak data and policy easing, the renminbi traded lower against the US dollar. In response to the sell-off, the authorities used their ability to be flexible on the renminbi's fixing versus the US dollar to prevent the currency from weakening too quickly.

Elsewhere, **India** released strong activity data, with services and manufacturing PMIs showing healthy expansion and GDP data pointing to robust (and better-than-expected) growth. The current account balance printed flat over the first quarter. While the May trade deficit was wider than expected, we believe this is a one-off, and it is worth highlighting that the deficit has seen a huge improvement over the last six months. Inflation has also continued to fall, although the delayed monsoon season is causing some food prices to rise and this could upward pressure on inflation going forward. Turning to the central bank, rates were kept on hold as expected, but the bank suggested it will be a long time before it thinks about cutting. As for the currency, the rupee performed well and is well insulated from China's weakness; the central bank intervened to halt further gains.

In **Indonesia**, the trade balance was much weaker than expected in May, although it is still in a surplus. The surprise was driven by imports, which were higher than expected, but we believe this is distorted by holiday seasonality and therefore do not expect a repeat in June. The central bank kept rates hold, as expected.

Export data in **Korea** was less negative than the previous month, suggesting the worst of the country's export woes may be behind it. This improvement helped the won to appreciate, even though semiconductor exports and trade with China remained weak.

In **Taiwan**, general economic data also remained weak, however, there were strong equity inflows into a market that is dominated by technology stocks. Despite this, weak exports weighed on the currency.

Pakistan eventually agreed to a US$3 billion Stand-By Arrangement with the IMF, a positive surprise which helped the hard currency bonds to trade well.

While PMIs in **Thailand** were strong, the pace of improvements in Thailand's tourism faltered slightly due to seasonal drivers (in May and June there is a gap in tourism flows). The focus has shifted to the formation of the new government – uncertainty on this front weighed on the Thai baht's performance over the month.

Latin America

In **Brazil**, headline inflation continued to show signs of easing, which proved to be a common feature across the Latin American region for the month. Brazil's Q1 growth rate surprised to the upside, although this was largely driven by the agriculture sector. The Central Bank of Brazil kept rates on hold as expected, sounding more dovish compared to the previous month and signalling the likelihood of rate cuts in the near term.

The Central Bank of **Chile** kept rates on hold in June, with two board members voting for a 50 basis point cut. In a dovish shift, it signalled that it would begin cutting rates in the short term, which led to a sharp rally in government bonds. The bank indicated that it was also looking to replenish its foreign reserves, by adding US$10 billion over the next 12 months through daily purchases of US$40 million, which should be easily absorbed by the market.

Despite May's inflation print easing below market expectations, the Bank of **Mexico** remained hawkish in its rates outlook, largely due to the strength of the underlying economy. As economic growth continues to surprise to the upside, inflation risks remain elevated and rates are likely to remain at higher levels this year. Meanwhile, May's trade data showed an improvement in exports while imports worsened. Looking forward, we expect exports to decelerate as US demand slows down, which is likely to widen the country's trade balance somewhat.

Colombian assets performed well over the month as market participants priced in a lower chance of fiscally concerning reforms being passed through Congress, particularly the health and labour reforms. President Petro was wrapped up in a scandal relating to campaign financing, with the electoral agency opening an investigation into the matter and Congress pausing further discussions around his reform plans. Inflation surprised to the downside in May, however we still expect the central bank to signal that it will keep monetary policy tight until there is more evidence that inflation is on a sustained downward trend, as seen elsewhere in the region.

Annual inflation in **Argentina** surged to 114% in May. Inflationary pressure continues to weigh on the economy and Q1 growth surprised to the downside, while May's trade balance fell to the biggest monthly deficit in five years. In political news, Economy Minister Sergio Massa continued to engage with the IMF to renegotiate the current programme, while dismissing previous reports that he would resign to go on the campaign trail. Investor sentiment is likely to improve in the near term given the confirmation of relatively market-friendly presidential candidates.

Guatemala held its general elections in June, with Sandra Torres and Bernardo Arevalo advancing to the presidential runoff in August. Although Torres was widely expected to make it through to the second round, Arevalo's progression came as a surprise to the market. Both candidates have put forward proposals that include increased government expenditure, which could pose deficit risks to the country's current account.

Central and Eastern Europe (CEE)

Industrial production and retail sales across **Poland**, the **Czech Republic**, and **Hungary** continued to surprise to the downside, with the tightening in financial conditions across the three countries starting to bite. More positively, however, soft domestic demand and lower gas prices continued to boost current account balances. Hungary, for example, which had the worst trade deficit of the three countries in 2022, posted its third consecutive monthly trade surplus in April.

Against this backdrop, inflation continued to print lower than expected, in the main. This was led by lower food, energy and core prices. **Poland** is a particularly interesting example given its stubbornly high core inflation momentum in the first few months of the year, but inflation surprised to the downside in June, and encouragingly this fall was broad-based across the inflation basket. **Romania**, by contrast, saw a higher-than-expected inflation print, with core inflation dynamics rather concerning given the country's persistently high inflation.

With inflation prints generally encouraging in Poland, the National Bank of Poland continued to sound dovish, signalling that it might cut rates ahead of the October election. In Hungary, the central bank lowered its effective interest rate by 100 basis points to 16%, signalling that it would cut rates in similar increments over the coming months. Meanwhile, the Czech National Bank continued to sound the most hawkish of the central banks across the region, despite having the most supportive inflation dynamics.

Ongoing political tensions in **Kosovo** nearly escalated into violence following attempts by the Kosovan leadership to install ethnic Albanian mayors in predominantly **Serbian** municipalities. Western governments subsequently put intense pressure on Kosovo to back down. While it is generally expected that both sides will work towards implementing the EU-brokered agreement from earlier in the year, the road is likely to remain bumpy.

Rest of Europe, Middle East and Africa (EMEA)

In **Israel**, political headlines continued to impact local asset prices, with unrest related to the government's judicial reform agenda rumbling on. During June, opposition parties walked away from negotiations, increasing the likelihood of a unilateral judicial reform from the government, which, depending on its nature could lead to fresh tensions and spook investors. In terms of economic fundamentals, inflation surprised to the downside, partly reflecting a significant slowdown in goods inflation, while services inflation remained relatively sticky. This is making it increasingly unlikely that the central bank will hike interest rates unless the political backdrop shows signs of worsening.

In **Turkey**, newly elected President Erdogan allayed the market's worst fears by appointing more orthodox policymakers to the country's finance ministry and central bank. However, the latter dashed hopes somewhat after only hiking the policy rate to 15% in June. The accompanying message reiterated the need for gradual adjustments, with the currency seemingly being allowed to depreciate sharply in the absence of central bank intervention. This made for a weak month for the lira. In contrast, hard currency bond spreads tightened due to the return to policy orthodoxy.

General growth indicators surprised to the upside in **South Africa**. Mining data held up better than expected, with gold production strong. The country's trade balance printed slightly better than forecasts, while imports and exports softened due to a slowdown in economic activity. Inflation continued to show signs of easing, with CPI and core inflation both down from the previous month. On the geopolitical front, news reports suggested Russian President Vladimir Putin would no longer attend the BRICS summit set to take place in South Africa later this year, easing some of the geopolitical pressure facing the country.

In the **Middle East**, the OPEC+ nations agreed that they would extend their production quotas, while in contrast, **Saudi Arabia** announced that it would introduce an additional voluntary cut of 1 million barrels per day, which is likely to lead to some modest pressure on Saudi's fiscal position. Meanwhile, **Bahrain** published its 2024/25 budget, which included some expenditure restraint but will still require ongoing Gulf support to meet its funding requirements.

Turning to **Russia**, the fallout from the Yevgeny Prigozhin rebellion may take some time to become apparent, with ongoing intrigue and speculation about the extent of involvement from elements of the military. Although the situation in **Ukraine** remains volatile, the instability in Russia points to an increased likelihood of the war ending more quickly than previously anticipated. This helped Ukrainian assets to outperform, and they were further supported by headlines relating to additional financial promises from Western donors to help finance the country, both through the war and reconstruction.

EM corporate debt highlights

The EM corporate debt market broadly kept pace with its developed market counterpart over June, with the JP Morgan CEMBI BD returning 1.1%. Within the index, high-yield issuers materially outperformed investment-grade bonds. Although both areas of the market saw credit spreads tighten, high-yield spreads contracted more aggressively. At the sector level, all areas of the index delivered positive returns; from a country perspective, high-yield markets that had been trading at distressed levels - such as Ukraine and Argentina - outperformed.

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