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EMD: The Stars Seem Aligned

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Outlook and Strategy

Entering 2024, the global macro environment appears decisively supportive for emerging markets fixed income (EMD), we believe. Last year, investors feared a global recession, stubborn inflation, and aggressive hiking cycles in the developed markets (DM). This year, the paradigm looks to have shifted almost 180 degrees. Our baseline is for a not-too-hot/not-too-cold global economy in which inflation converges toward target and global central bankers embark over time on an easing cycle.

EMD have proved fundamentally resilient and, as a result, have already rallied sharply, particularly in the last quarter last year. We expect that resilience to persist given that: 1. we believe EM economic growth could outperform DM this year despite we expect some slowdown versus last year, and 2. crucially, for the first time in two years, EM investors may likely have the Fed "on their side." Not only could lower DM rates be a tailwind for bonds, but it could also provide space for EM central bankers to ease monetary policy in support of the local cyclical picture.

We see thematically interesting alpha opportunities in 2024. First, the scale of the EM easing cycle may likely generate investment opportunities in local markets. Second, the busy EM elections calendar could create idiosyncratic opportunities. Finally, we see scope for "repricing" stories in multiple sovereigns and corporates either from advanced debt workouts or from market-friendly policies.

Our preferred asset allocation currently focuses on 1) local markets (where history suggests easing cycles tend to extend for longer than initially expected) and 2) monetizing EM's historically high yields especially in names with strong idiosyncratic stories behind them.

Clearly, our positive view is not risk-less and there may likely be "bumps along the way." First, the current global slowdown may morph into a hard landing. Second, a "higher for longer" paradigm could keep core rates higher than expected and moderate anticipated easing. Third, tight EM valuations may encourage outflows from the asset class. Finally, geostrategic tensions can escalate. We don't underestimate any of those risks and we keep watching them carefully; however, we believe investors are currently being well paid to take those risks.

Highlights

- We are bullish on EMD for 2024, as we see global macro tailwinds, solid fundamentals, attractive yields and strong momentum.
- The stars seem aligned: we believe the global economy is neither too hot, nor too cold; inflation is slowing; DM central banks have pivoted; and EM balances are in a good shape.
- Beyond the positive market backdrop, we identify themes that we believe could generate excess returns, including opportunities related to the slew of EM elections.
- Our asset allocation focuses on unhedged local bonds and seeks to capitalize on EM's historically high yields
- Risks are temporary selloffs spurred by technical pullbacks or geopolitical risks – and, more importantly, a potential shift in the growth outlook

BlackRock Emerging Markets Fixed Income
Investment professionals: 35
Average years of experience: 21 (Directors & MDs)
Assets under management USD 36 billion – as of December 2023

Source: BlackRock, JP Morgan EMBI, CEMBI, GBI-EM; Bloomberg; Goldman Sachs; IBOXX; MSCI, as of 6 January 2024. Any opinions and/or forecasts represent an assessment of the market environment at a specific time and is not intended to be a forecast of future events or a guarantee of future results and should not be deemed a recommendation or advice to take any particular investment action. There is no guarantee that any forecasts made will come to pass.

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A Goldilockish environment

The global economy appears to have already soft landed. We see a healthy downshift in global growth, toward a not-too-hot/not-too-cold environment enough to preclude overheating/inflationary fears but not so fast as to reawaken recessionary worries.

We expect global inflation to trend lower and end the year close to DM central bank targets. Post-pandemic red-hot demand seems to be cooling, labor market and supply bottlenecks have eased and fears of a spike in energy prices seem to have receded despite supply cuts by OPEC. While inflation may take time to fully converge to targets, we believe inflationary risks have subsided.

This backdrop has opened a window for DM central banks to signal an easing cycle. We believe there has been enough progress on the fight against inflation for central banks to feel comfortable that real rates are restrictive enough and to consider the possibility of 'maintenance cuts' (reducing rates to keep up with disinflation), as reflected in the US Federal Reserve 'dots'. The market is pricing in an even more aggressive easing cycle which could lead to some volatility, as data might, at times, validate (or not) market expectations. However, the direction of travel in favor of easing seems clearer now.

We view a scenario in which DM central bankers ease with no recession in sight as quite "goldilockish." First, it may validate the easing of financial conditions that we've already seen in the second half of 2023. Second, it could give investors confidence that DM central bankers are no longer a threat to the cycle and can, to a degree, support growth if needed. We believe EM is a huge beneficiary of this favorable macro environment. As detailed in Exhibit 1, EM countries are likely to benefit from healthy DM and Chinese growth and from the easing of monetary policy, which serves as a tailwind.

Exhibit 1. 2024 initial conditions are EMD supportive

	2023 start	vs actual	2024 start
DM growth	Recession fears	Strong US Weak EU	Soft-landing
China growth	Reopening hopes	Growth volatility	Trend-like growth
Inflation	Fears of stickiness	Disinflation	Converging to target
Central banks	DM hiking	DM hiking++ EM easing	DM & EM easing
Geopolitics	Frozen conflict	Israel-Gaza	Cease-fires?

Source: BlackRock EMD Team, as of 6 January 2024

EM's Fundamental Resilience

Emerging economies proved quite resilient to the material negative shocks of the past two years. Despite 525 bps of Fed tightening, a US banking crisis, volatile and weak Chinese and European growth profiles, and a worsening geopolitical backdrop EM ex-China (EMX) still grew at a trend-like real pace of 3.1% in '23 (Exhibit 2).

Our view is that EM's resilience is likely to be sustained in 2024. First, the growth in the big economic blocks to which EM exports (including from China) could still be a tail wind. Second, EM's disinflation should help demand. Third, the Fed pivot could open the door for a more aggressive easing by EM central banks to support their own economic cycle. While we see a slight slowdown, EMX growth is forecasted at a still healthy 2.9% in 2024, Equally important, we believe EM growth may outperform DM's growth by 180 bps in real terms (see Exhibit 2).

Moreover, EM macro balances are broadly sustainable. Public finances is an issue for many EM countries. However, a combination of higher nominal GDP and lower borrowing costs may well contain the deterioration. On the external side, we see improvements in countries that have, in recent years, experienced worsening current account deficits (e.g., Chile, Colombia, and Poland). External funding needs in 2024 seem manageable and largely covered by a combination of foreign direct investment and other portfolio flows, resulting in a net external funding need of around $200 billion USD, according to JPMorgan calculation (as of 11/15/23).

The credit rating/default cycle also appears to be turning more positive. Notably, after a flurry of EM defaults since COVID, we think we could finally see some successful debt workouts (eg. Ukraine, Sri Lanka, Zambia, Ghana), and the first year since a few of net sovereign credit upgrades. We are also cautiously optimistic on some large EMs where macro/ policy developments have been more positive (See next section).

Exhibit 2. Resilient EM ex-China growth in 2024 (%)

Region	2023 by Dec'22	2023 by Dec'23	2024 Est
Global	**1.8**	**2.7**	**2.2**
DM	0.9	1.6	1.1
US	1.1	2.5	1.6
China	4.3	5.2	4.9
EM-x China	**1.9**	**3.1**	**2.9**
EM-x China - DM	1.0	1.5	1.8

Table shows GDP growth forecasts for 2023 and 2024 at different time periods. Forward-looking estimates may not come to pass.
Source: BlackRock and JPMorgan Research, as of 6 January 2024

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Engines of EM alpha in 2024

In addition to the supportive macro backdrop, we also believe there are important thematic alpha drivers for EM this year. We identify three such drivers:

1. An extended EM monetary easing cycle: EM central bankers hiked earlier and, in some cases, more aggressively than their DM counterparts. We think there is space for more aggressive removal of restrictiveness. The Czech, Polish, Hungarian, Chinese, Brazilian, Chilean, Peruvian and Colombian central bankers are already easing. Among the major EM economies where inflation became a big problem, only Mexico and South Africa have yet to cut. Now that we see the Fed could be easing in 2024, even those EM central bankers may likely to cut rates too. Admittedly, the markets have already priced in a significant amount of EM rate cuts, however, we believe the cycle could be longer and sharper than priced. In a prior commentary ("EMD: Resilient macro widens EM runway", from September 2023), we showed a pattern of markets under-estimating the extent of the cycle. We think the same is occurring in this cycle too.

2. A busy election calendar: countries representing around 50% of EM (ex-China) GDP and more than 60% of its population will go to the polls this year. We expect ample idiosyncratic market opportunities because of policies that may be implemented before or after elections, or surprising elections results. We highlight:

- *Taiwan (January - presidential and legislative)*: all three remaining candidates have expressed a similar position of maintaining peaceful and stable cross-strait relations, thus we believe domestic issues are likely to play a more significant role than in previous elections. [1]

- *Indonesia (February – presidential):* we feel confident elections will not disrupt the good policies implemented under President Joko Widodo. Presidential candidate Prabowo Subianto leads in opinion polls ahead of the election, yet a runoff cannot be ruled out. [2]

- *India (May and June):* Prime Minister Narendra Modi seems likely to retain the position for a third term, which would be key to sustaining the current strong growth process and investors' confidence. [2]

- *South Africa (May and August):* we are looking to see whether the next administration is able and willing to strengthen fiscal consolidation and implement policies to bolster economic growth. Polls point to a tighter contest than in previous years, suggesting the African National Congress (ANC) face their biggest electoral challenge in the 30 years they have governed the country. [3]

- *Mexico (June – President and Congress):* with no reelection possible for President Andres Manuel Lopez Obrador, his Morena-led coalition candidate Claudia Sheinbaum leads the polls with 60% support.[4] Focal point for us is whether she will maintain the stringent fiscal policy of the president of Mexico AMLO, how would she eventually deal with a slower impulse from the US, and the future of PEMEX.

- *Turkey (March – municipality elections):* President Erdogan's orthodox shift that helped repair some of the investors' confidence lost over the last years could come into question if he perceives this to be damaging his chance of recovering most of the major cities for his party, which have moved into opposition's hands.

- *El Salvador, Senegal, Pakistan and the Dominican Republic*. In Senegal and the DR, re-election of the ruling party is market's expectation and preferred outcome. In El Salvador seems that Bukele will be re-elected [5], and we will be watching for any shift in fiscal priorities and progress toward an IMF program. Pakistan's election, if it takes place, will likely result in Nawaz Sharif becoming PM which should pave the way for an IMF EFF program.

3. Coming back from the cold. By coincidence or otherwise, the past five years or so have seen a number of important EMs becoming increasingly "un-investable." We believe this trend may be reversing.

- *Argentina:* Libertarian President Milei announced a set of policies to drastically adjust the fiscal, a large devaluation of the FX, and an extensive agenda of economic deregulation. This is likely to result in a period of even higher inflation and recession until the macro variables fall into place. While the right course of action, success requires people's patience to bear the bitter pill. The market reacted positively to the initial good news, and further upside would require a move forward with the agenda, like a renewal of the failed IMF agreement.

- *Nigeria*: President Tinubu initially surprised market with reforms in 2023, removing fuel subsidies and devaluing the Naira. The President's appointment of technocratic CB Governor & MinFin is creating a window of optimism.

- *Egypt*: the country over-borrowed in USDs and over-invested in negative NPV projects failing to generate enough USDs to repay. We believe the IMF could top up its program and shore up confidence given the country's renewed geopolitical importance.

- *Turkey:* we are marginally positive that Economy Minister Simsek's return could be a structural break from years of monetary policy / FX mismanagement if he retains the support from President Erdogan despite some of economic slowdown the new policies could bring.

Intra EM asset allocations for 2024

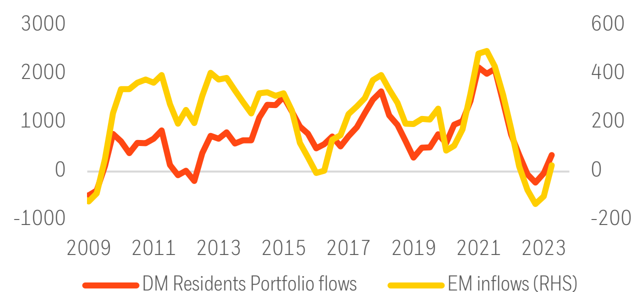
We reiterate our strong conviction on EM local rates. We have been positive on local EM markets since inflation peaked in the third quarter of 2022 (see "EMD: A Fed pause may bode well for EM debt", May 2023). Real rates in EM are high and the Fed's pivot opens the door for aggressive EM easing. We believe EM rates could potentially be a good diversifier for global fixed income at a time when outflows seen over the last quarter suggest the market may be under owned. A key question, of course, is whether to FX hedge those bonds? Our view is that the answer is no: hedging is extremely expensive and more than erodes EM local's potential attractive carry. Admittedly, EMFX is highly correlated to the USD; however, our view is that the USD may not be a tailwind to EMFX but is unlikely to be a headwind either.

We also like EM hard currency debt. Within that we favor income and selective repricing stories. While EM's spreads screen historically tight, we believe EM's all-in yield as quite attractive. On average, we think money in 2024 will be made "clipping coupons" rather than playing for aggressive spread moves. Moreover, there are ample idiosyncratic stories that could reprice higher. We also like EM corporates as an asset class and believe it screens cheap to its DM counterparties and should benefit from a strong growth tailwind. While EM corporates' fundamental strength appears to have peaked, they are still strong.

Key to the performance of EMD is whether flows return to the asset class. We believe the combination of healthy growth, widening EMX-DM growth differentials, monetary policy easing; attractive yields, all support the idea of a return of flows to the asset class. Exhibit 4 shows that that DM residential portfolio outflows tends to show quite a cyclical and to correlate well with inflows to EM. Note how 2023 lows appear to be turning: good news for EM.

Exhibit 4. Good chances for inflows to EMD in 2024

(4Q Rolling sum, USDbn)



Note: DM residents portfolio flows corresponds to foreign portfolio purshcases by US, EU, Japan and UK residents. EM corresponds to the sum of portfolio inflows in the balance of payments. Source: BlackRock on JPMorgan data, as of 6 January 2024

Illustrative 2024 return scenarios

Exhibit 5 shows potential 12-months forward EMD returns under different scenarios. In no way are these intended to be forecasts. They are just arithmetic calculations that imbed no subjective probabilities. In this sense, there are no guarantees that any of these scenarios may come to pass (methodology of calculation is included in the footnote of the Exhibit 5).

We examine three different macro scenarios. First, a soft-landing/goldilocks scenario that assumes a not too hot-not too cold global economy, with more balanced distribution between US/EU/China than in 2023, inflation converging toward the target, and DM central bankers implementing "maintenance" cuts in line with falling inflation (green box). Second, a hard landing scenario, which sees the global economy decelerating sharply to below trend, likely led by the US, and DM central bankers implementing reactively large rate cuts (purple box). Finally, we also look at a re-inflation scenario that assumes a "too strong" global economy that leads DM central bankers to walk back the priced-in rate cuts (red box).

Three observations emerge from that analysis:

- EM's high all-in yields provide (via carry) a decent protection and protects EM from even the bad scenarios.
- EM does not seem to require a rally in core rates, or a broad dollar weakness, to deliver decent returns that beat cash.
- The soft-landing scenario in EMD could conceivably lead to a repeat of 2023's strong returns.

Exhibit 5 – 12-months total return hypothetical scenarios

USD Sovs 12 months		Spread change (bps)							
		+124	+93	+62	+31	Last: 403	-31	-62	-93
UST10 yield change (bps)	+90	-5.1	-3.8	-2.5	-1.1	0.5	2.2	3.9	5.8
	+50	-3.3	-1.9	-0.4	1.2	2.8	4.6	6.5	8.5
	+25	-2.1	-0.6	1.0	2.6	4.4	6.3	8.3	10.4
	Last:3.98	-0.8	0.8	2.4	4.2	6.0	8.0	10.1	12.2
	-25	0.6	2.2	3.9	5.8	7.7	9.8	11.9	14.2
	-50	2.0	3.7	5.5	7.5	9.5	11.6	13.9	16.2
	-90	4.4	6.3	8.2	10.3	12.4	14.7	17.1	19.6

Local Mkts 12 months		Yield change (bps)							
		+76	+57	+38	+19	Last: 6.28	-19	-38	-57
EM FX Change (%)	-7.5	-5.3	-4.4	-3.5	-2.6	-1.7	-0.8	0.0	0.9
	-5.0	-2.8	-1.8	-0.9	0.1	1.0	1.9	2.7	3.6
	-2.5	-0.2	0.8	1.7	2.7	3.6	4.5	5.4	6.3
	0.0	2.3	3.4	4.3	5.3	6.3	7.2	8.1	9.1
	2.5	4.9	5.9	7.0	8.0	8.9	9.9	10.8	11.8
	5.0	7.5	8.5	9.6	10.6	11.6	12.6	13.6	14.5
	7.5	10.0	11.1	12.2	13.2	14.3	15.3	16.3	17.2

Methodology: returns are calculated using the formulas below

USD SOVS: 31bps is the one-year standard deviation spread change

*Total return = current yield + duration *(Δ EMD spreads +Δ UST 10yr)*

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LOCAL MKTS: 19bps is one-year standard deviation GBI-EM yield change

*Total return = current yield + duration *Δ LBYield +Δ EM FX vs USD*

Source: BlackRock on JPMorgan EMBI Global Diversified and GBI-EM indices , as of 6 January 2024. The hypothetical outcomes are provided for illustrative purposes only and demonstrated index and are not meant to be representative of actual performance returns of, or to project or predict outcomes for, any particular investment and does not exist and therefore does not reflect the deduction of any fees or expenses, including advisory, management and performance fees, as well as brokerage fees, commissions and other expenses that might normally apply. In addition, decisions reflected in the hypothetical were not made under actual market conditions and cannot completely account for the impact of financial risk. This is hypothetical and does not represent the investment performance or actual accounts. Hypothetical results are not indicative of future results. There are frequently sharp differences between a hypothetical and the actual record subsequently achieved. Therefore, hypothetical records invariably show positive outcomes. Another inherent limitation of these results is that the decisions reflected in the record were not made under actual market conditions and, therefore, cannot completely account for the impact of financial risk in actual portfolio management. Indices are unmanaged and one cannot invest directly in an Index.

Downside risks to our favorable EM view

Our favorable view on EMD for 2024 is, of course, not without risk. The experience of the past few years clearly illustrates the value of humility and flexibility. Moreover, investing in EM is never linear and there are often “air pockets” that can be quite material if not heeded. We highlight three risks that we’re closely watching.

- **Valuations & technicals:** after a relentless rally in 2023, in which valuation support has eroded, chances of periodic market reversals and drawdowns are never low. This would be more the case if our expectations that inflows will come back to the asset class disappoint.
- **Macro:** There is always the risk of the “healthy” slowdown the global economy is now experiencing morphing into a hard landing. EM assets tend to underperform in recessions.
- **Geopolitics:** Finally, lest one forget, there are two important regional wars currently taking place in EM countries. Escalation of geopolitical tensions (there or elsewhere) is always a risk.

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Notes

1/ https://www.brookings.edu/articles/what-are-the-key-issues-in-taiwans-2024-presidential-election/

2/ HSBC Research, "A guide to 2024 elections", 4 December 2023

3/ Ipsos October 2023

4/ https://oraculus.mx/presidente2024/

5/ IUDOP-UCA 11-29 November shows President Bukelele with 62% support

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