EMD: Carry on, but mind the bumps

Outlook and Strategy

A very strong global backdrop — resilient growth, global disinflation, and dovish central bank talk — supports risk taking, we still believe. Lately, strong activity and inflation in the US led the market to reprice the size and speed of potential rate cuts by the US Federal Reserve.[1] We take these setbacks as bumps on an otherwise constructive road for Emerging Markets Debt (EMD), conditional to the window for rate cuts in the develop markets (DM) to stay open. In fact, 'pure EM risk' has done very well since last October 27th (the recent peak for US 10-year Treasury yield): EM sovereign spreads tightened by more than 100 basis points (bps), the long-end of EM local debt (ex-Asia) has outperformed the US 10-year by 62 bps, and EM FX has rallied 1.8% vs. the US Dollar, despite US rates having sold off by 62 bps year-to-date (as of April 10th).[2]*

We remain constructive on EM debt for Q2 and find comfort in the fact that: 1. Global growth is broadening to sectors and geographies to which EM growth is more sensitive;[3] 2. disinflationary dynamics, even if recently disappointing, are still progressing;[4] 3. Central bankers in DM continue to indicate that rates cuts are coming, even if at a slower pace, and despite some higher inflation prints.[5]

EMD valuations have become quite stretched; however, this does not mean the avenues to EM performance have closed. Therefore, we focus on: 1. *The EM carry*, which we believe continues to provide juicy levels of income to investors, with enough (even if reduced) pickup from risk free rates;[6] 2. *Credit quality compression*: we believe the current macro environment to be one in which investors feel comfortable reaching down the capital stack, thus expect further flattening of the EM credit curve (yield vs. rating), suggesting HY should outperform IG; 3. *Improving idiosyncratic stories*: which we see many of in EM today (e.g. Argentina, Ecuador, Kenya, Pakistan, Turkey, Egypt, Nigeria) and require a dedicated bottom-up research effort.

We see three potential challenges to our constructive view: 1. a more profound revisiting of the room to cut rates by the Fed; 2. geopolitical risks; 3. risk aversion shocks in the run up to the US presidential elections, should worries about the fiscal soundness of the US intensify or trade wars restart.

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Highlights

- We remain bullish into Q2, as EMD retains solid fundamentals, and we find attractive pockets of value.
- There could be bumps in the road as resilient inflation challenges how much room there is for central banks in developed markets to start cutting rates.
- Valuations are tight, thus market pullbacks of a technical nature, or geopolitical risks, could be used as entry points.
- EM credit quality continues to improve, 2024 could see the return of positive net credit rating upgrades in the sovereign space.
- From a risk/reward point of view, we carry a tilt that favors the high yield segment of EM hard currency -corporates and sovereigns- over local currency debt.
- We find significant opportunities in idiosyncratic stories that are turning the corner.

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Average years of experience: 21 (Directors & MDs)
Assets under management USD 35 billion – as of April 2024

Source: BlackRock, JP Morgan EMBI, CEMBI, GBI-EM; Bloomberg; Goldman Sachs; IBOXX; MSCI, as of 10 April 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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Resilient global growth supports EMD

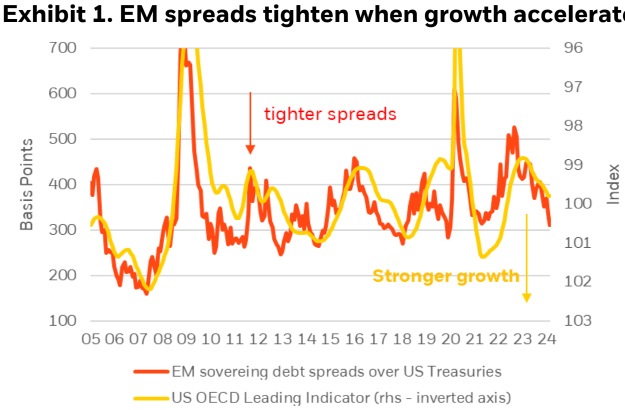
Emerging markets debt remains supported by a global environment mostly characterized by trend-like growth and easing inflation. These conditions tend to be conducive to stronger appetite for risk, as investors feel comfortable to reach away from risk free assets and go down the capital stack, and EMD is no exception. The spread on EM sovereign debt over US Treasuries has historically tighten when the global economy accelerates (see Exhibit 1). In this sense, EM remains mostly a *long-growth* asset class.

Recent data suggests economic growth appears to be broadening geographically and across sectors. The latest Purchasing Managers Index survey (PMIs) reveals that while the economic expansion continues to be led by the US and the services sector, there is a notable catch up happening by the rest of the world and the manufacturing sector. This is good news given that emerging economies are quite sensitive to improving trade flows and the pull from more open economic blocks like China and Europe.[3]

Bloomberg consensus forecasts sees the global economy expanding at 2.2% in 2024, in line with potential. The US is expected to grow at 2.2% marginally lower than last year but still above potential, the EU to upshift to 0.9%, and China to meet its around 5% GDP growth target, despite stimulus that continues to be targeted and the property sector remaining on its back foot.

Importantly, fears of a global recession, quite prevalent at the beginning of 2023, have significantly eased. This is quite a remarkable achievement given more than 500 bps of hikes in policy rates in DM. Resilient job markets, cleaner private sector balance sheets, and supply side positive shocks have extended the life of the global economic expansion. The Bloomberg recession probability one-year ahead forecast dropped from over 60% to under 35% over the last twelve months.

Exhibit 1. EM spreads tighten when growth accelerates



Source: BlackRock EMD Team, as of 10 April 2024 .

DM central bank are still likely to cut rates this year

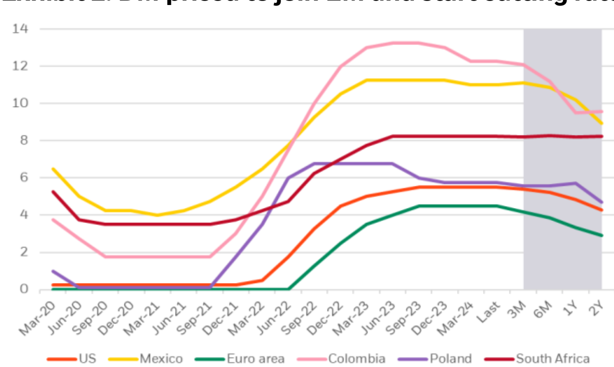
For two years EM investors had to bear the headwinds of tightening interest rates by the largest providers of global liquidity: DM central banks. Following a global shock to inflation because of supply side bottlenecks during COVID and the aftermath of strong fiscal and monetary stimulus, central banks in the core markets embarked on an aggressive monetary tightening cycle. Higher front-end risk-free rates became a strong competitor to EMD, which resulted in outflows from the asset class of the tune of $125bn from local and hard currency funds since the beginning of 2022, according to EPFR.

With inflation in decline DM central banks have manifested intentions to prevent further rises in real rates by cutting rates in the second half of the year. However, the strength of inflation and growth data in the US is challenging how fast and by how much the Fed would be able to cut rates. Our baseline remains a 2024 start, yet this requires a resumption of the disinflation path. The room for cuts is clearer for the European Central Bank, the Bank of England, and the Swiss National Bank (which has already cut once), as inflation data in these regions remains benign.

An eventual DM easing cycle would benefit EMD, via different channels. First, fundamentally, lower funding rates should help extend the life of the global business cycle and provide EM central banks what more space for their own easing cycles. Second, from a valuation point of view, lower front-end rates should reduce the whole interest-rate term structure, which forms the base of the EM yield curve. Lastly, the combination of lower yields and resilient growth tend to anchor market volatility, bringing shine to the yield pickup offered by EMD.

In short, for the first time in two years, investors could have the Fed (and other DM central banks) on their side. 'Not fighting the Fed' would finally be a positive thing for EMD (see Exhibit 2).

Exhibit 2. DM priced to join EM and start cutting rates

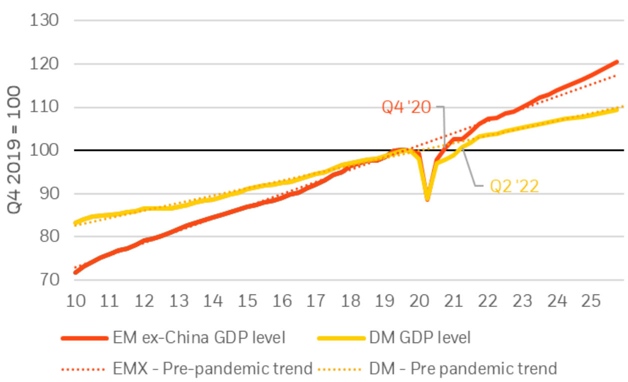


Shaded area shows future policy rates as priced in by markets. Future values might not come to pass. Source: BlackRock and Bloomberg, as of 10 April 2024. Y-axis refers to interest rate percentage.

EM fundamentals are positive

The growth picture in EM continues to be quite stellar. Emerging economies ex-China (EMX) enjoyed quite a V-shaped bounce out of the COVID-led recession, recovering its pre-pandemic GDP level in only four quarters, compared to the six quarters needed by the developed markets (DM). Furthermore, EMX real GDP level is now above its pre-pandemic point, while DM is moving along its prior path (see Exhibit 3). This means the EM share of global GDP continues to increase.

Exhibit 3. EMX growing faster than pre-pandemic

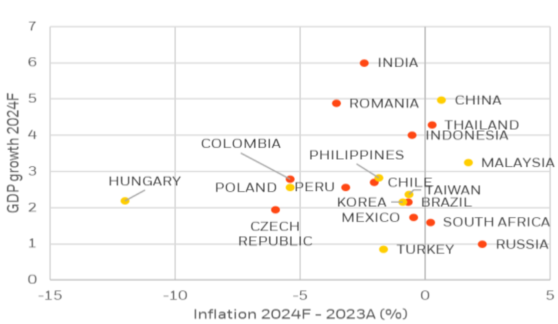


Source: BlackRock on JPMResearch data, as of 28 March 2024. Forecasts may not come to pass.

The EM cycle expansion enters its fourth year. We see EM ex-China real GDP growing at around 3.2% in 2024, keeping a similar level to that in 2023, despite developed markets that are likely to decelerate. We see China able to meet its 5% growth target this year, continuing its cyclical recovery driven by the industrial side, while consumption is likely to remain sluggish, and the property sector is stabilizing at low levels. We expect that many the largest EM countries would growth at-or-faster than its 10-year average (see Exhibit 4).

Inflation is expected to decrease across the EM universe, providing space for central banks to ease financial conditions, which should help the EM expansion to extend into 2025 as well.

Exhibit 4. Strong growth and falling inflation

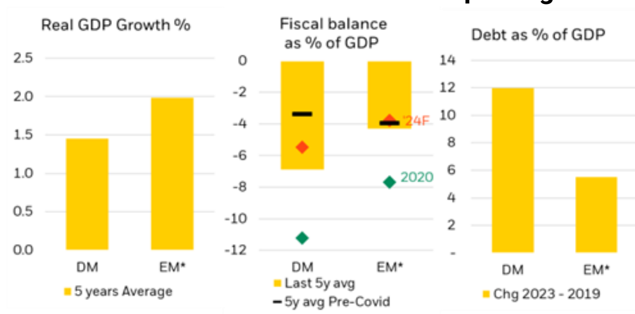


Note: orange (yellow) dots represent countries with GDP growth at around or above (below) last 10 years average. Forecasts may not come to pass. Source: BlackRock on JPMResearch data, as of 10 April 2024. "Korea" refers to South Korea.

The core of EMX looks good vs DM

Out of the pandemic, credit metrics of core EM issuers have displayed a healthier behaviour than those of DM. Not only has growth been stronger (see first chart in Exhibit 5), but also fiscal balances have been more contained. Thanks to a mixture of self discipline and that imposed by shallower funding sources, EMs were quicker to unwind the fiscal stimulus put forward during the pandemic. In fact, fiscal balances for 2024 are expected to come in line with the 5-year average pre-COVID for EM, but close to 2ppt wider in the case of DM (middle chart).

Exhibit 5. The core of EMX has been improving

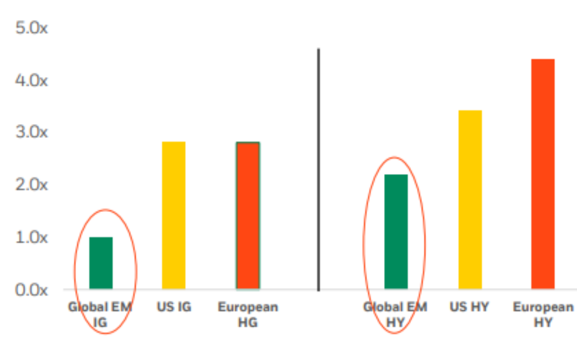


EM* is GDP-weighted average of selected large countries like Brazil, Chile, Colombia, Mexico, Peru, Indonesia, Malaysia, Thailand, Czechia, Hungary, Poland, Romania, and Saudi Arabia. Source: BlackRock EMD Team, as of 28 March 2024.

Put together, this means that the growth of public debt as a percentage of GDP for EM was half of that of DM when compared with pre-pandemic levels (right chart).

Something similar can be said about EM corporates. Global EM high grade corporates carry a x1 leverage ratio, versus close to x3 for both US and EU comparables, according to JPMorgan as of February 2024. On the high yield front, the same can be seen with leverage slighlty above 2 vs x3.5 and x4.5 in the US and EU, respectively. In terms of interest coverage, EM corporates show a x5 and x11.5 for HY and IG names, respectively, while these ratios are similar x5.5 in US and EU HY and x10 and x14 in IG, respectively (see Exhibit 6).

Exhibit 6. EM Corps' leverage lower than the DM



Source: JPM, BlackRock. Data as of 26 February,2024.

There is room to run for our EM *alpha* engines

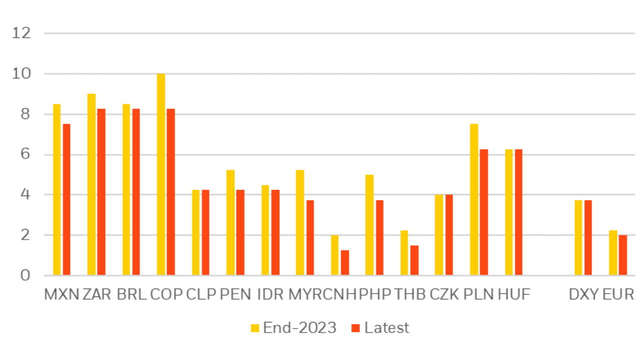
In addition to our view of a supportive macro backdrop to EMD, in our prior commentary we presented three thematic *alpha* engines that we believe could contribute to performance (see EMD: The Stars Seem Aligned, January 2024). We believe all have worked well so far and remain live in Q2.

An extended EM monetary easing cycle: as many EM central bankers hiked policy rates earlier and, in some cases, more aggressively than their DM counterparts, the turn in the global inflation cycle provides the opportunity to continue to remove restrictiveness. We acknowledge that the space for cuts is also dependent on the room available for DM easing. While a lot of rate cuts are priced by markets already, the easing cycle is broadening both geographically and in terms of speed: Mexico delivered an inaugural cut in March, while Colombia, Czechia, and Hungary accelerated the pace of easing.

Advancements in the disinflation process suggest the theme carries some momentum into the second quarter of the year. We measure the room to cut rates by combining different indicators of inflation level and expectations, inflation momentum and surprises, output gaps and growth revisions. Exhibit 7 compares the derived terminal rates (easing cycles endpoints) as measured today in comparison with those estimated by the end of 2023. The graph shows space has opened to carry rate cuts even further than previously thought, thanks to more progress than expected in the disinflation process.

A busy election calendar: countries representing around 50% of EM (ex-China) GDP and more than 60% of population go to the polls this year. We expect ample idiosyncratic market opportunities to potentially result from policies that may be implemented before or after elections, or surprising elections results themselves. The elections in Taiwan and Indonesia have already passed without turbulence, while local elections in Turkey brought an unexpected large defeat of the incumbent.

Exhibit 7. Disinflation progress adds room to cut rates



Source: BlackRock EMD Team, as of 10 April 2024

The next *big-ticket* items are the elections in South Africa (May and August) and Mexico (June). *In the former* we are looking to see whether the ruling ANC would have enough support to form a government, or if it needs to build a coalition, and whether it goes left of right of the political spectrum. More important, is to see whether the next administration is able and willing to strengthen fiscal consolidation and implement policies to bolster economic growth. In Mexico, the markets price in a victory of the incumbent party and candidate Claudia Sheinbaum, given her wide lead in the polls (60% support[4]). The 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.

Coming back from the cold. We focus on a set of countries that six months ago were deemed to be "un-investable" but have deliver corrective economic policies to tackle fiscal and external imbalances, and/or deleverage their economies. Argentina, Nigeria, Egypt, Kenya, Pakistan, Ecuador, and Turkey have put together a combination of all or some of the following policies: currency devaluations, interest rate hikes, spending cuts, new taxes, and have sought new external funding.

Results have been impressive, and the markets have rewarded the effort by repricing country risk lower. This cross-section of 'distressed' sovereign issuers has led to the significant decompression of spreads between the high yield and high grade subsegments of EM, contributing with most of the year to date return.

We believe there is further room for improvement and the macro data starts showing the benefits of the adjustment, while at the same time remain conscious of the implementation (political and social) risks that such policies carry (see Exhibit 8).

Exhibit 8. *Back-from-the-cold* theme is hot

Index	YTD Ret (bps)	Weight	YTD Contr. (bps)
EMBIGD	74	100.0	74
EM IG	-236	49.8	-117
EM HY	393	50.2	197
EM HY ex ARG/VEN	308	48.5	149
Back from the Cold		13.4	188
Argentina	3199	1.7	55
Ecuador	4847	1.0	50
Turkey	48	4.6	2
Nigeria	157	2.0	3
Egypt	2038	2.5	50
Kenya	456	0.8	4

Source: BlackRock EMD Team, as of 7 April 2024. Numbers are the JPM EMBI Global Diversified country indices. The figures shown relate to past performance. Past performance is not a reliable indicator of current or future results. Index returns are for illustrative purposes only. Index performance returns do not reflect any management fees, transaction costs or expenses. Indexes are unmanaged and one cannot invest directly in an index.

A preference for EM hard currency

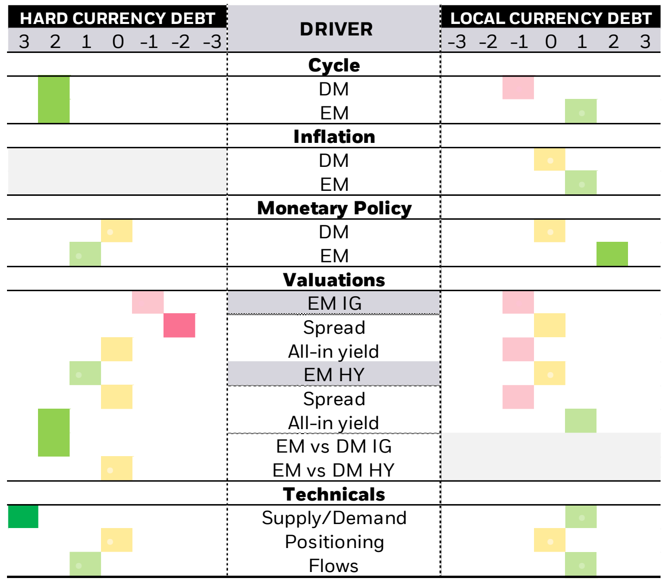
We remain bullish on EMD going into Q2 as we see the asset class being supported by solid fundamentals. We still find pockets of value in improving idiosyncratic stories and high yielding assets, and despite tight valuations. We believe the macro picture remains broadly consistent with outperformance of the higher yielding segments of the asset class despite higher rates in the core markets.

We prefer EM hard currency debt – both sovereign and corporates ––, and in particularly that of high yield, over local markets. Strong growth supports credit more than rates, and resilient inflation in the US could shorten the runway for cuts by EM central banks.

We summarize the building blocks behind our EMD view in Exhibit 9, where we subjectively score the impact of growth, inflation cycle, and the likely path of monetary policy to hard currency spreads and local markets, using a +3 (very positive impact) / -3 (very negative impact) scale. We also use market data to assess valuations and technical for each asset class.

As said, the macro remains strongly supportive for EMD, but more so for hard currency. There, EM appears 'tight' on a spread level, but remains attractive as an all-yield proposition when compared to historical levels. Technicals remain supportive overall, particularly for hard currency debt, where net supply is forecasted to be negative. Net-net, while overall bullish EMD we would slightly overweight hard currency spreads on a risk-adjusted balance.

Exhibit 9. Bullish EMD: OW on hard currency



Note: Valuations reflect 5y z-scores on the IG and HY subcomponents of the JPMorgan EMBIGD for EM hard currency, the JPMorgan GBI-EM for local currency debt, and the Bloomberg Barclay's US corporate debt for DM; Technicals are subjective values based on industry surveys (JPMorgan Research forecast for Supply/Demand), BLK calculations for positioning, and EPFR data for flows, all as of April 2024.
Source: BlackRock EMD Team.

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Notes

1/ The 2 year US Treasury bond yield moved from 4.59% on March 30th to 4.88% by April 12th.

2/ Bloomberg tickers JPGCSOSD for EM sovereign spreads, JGARY7X1 for EM ex-China local rates, JGENFXGD for EM FX

3/ Recent EU PMIs has risen to 46.1 in March from 42.7 last July, while China PMI is now at 50.8 from 49.3 last July

4/ Global CPI is down to 3.22% in March from 4.28% in September

5/ Fed Chairman Jerome Powell said "If the economy evolves broadly as we expect, most FOMC participants see it as likely to be appropriate to begin lowering the policy rate at some point this year", on April 3, 2024, and ECB Governor Lagarde said that "if disinflation continues, the rate path will reflect that" on April 11th.

6/ EM index yields are at 8% for the hard currency sovereign EMBIGD index, and at 6.44% for the local markets GBI-EM

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