EMERGING MARKETS DEBT | OUTLOOK

2023 Investment Outlook: Emerging Markets Debt

By: EV Forward | December 15, 2022

Signals Indicate an Enticing Entry Point for EM Debt

KEY POINTS

1. Along with the improving macro, fundamental and technical picture, compelling valuations point to a market reset for EM debt.
2. We see a number of attractive opportunities across the universe, particularly in local interest rates and also in corporate spreads.
3. Sentiment swings may affect EM assets in 2023, although market pessimism appears to have peaked.

What We Are Seeing

Several signs indicate that emerging markets (EM) debt is poised for a turnaround in 2023. To start, valuations appear compelling on a historical basis and relative to other asset classes. In our view, market pricing in EM debt for macro uncertainty was aggressive through most of the past year — perhaps more than for any other asset class.

However, macro uncertainty is now beginning to recede in two key ways: First, the U.S. Federal Reserve's hawkish policy stance appears to have topped out, as inflationary headwinds look to be gradually dissipating. Second, while the future of China's COVID policy is not clear, it appears that authorities are starting to relax restrictions amid growth concerns and increasing social pressures.

Many EM economies are revising growth forecasts upward in line with stronger fundamentals. Monetary discipline should pay off for those countries that took early and decisive action on raising interest rates, as they will enjoy greater flexibility in managing central bank policy to stimulate growth ahead.

The technical picture is also showing nascent signs of recovery. EM debt recently saw net inflows return after record outflows of $87 billion from the asset class over the first 10 months of 2022.[1]

We believe that outflows have likely bottomed out and anticipate stronger net flows in 2023. In particular, we expect multi-sector managers, who drastically cut exposure to EM bonds in 2022, to continue increasing allocations as the outlook improves.

What We Are Doing

Based on our bullish views, we have been adding select opportunities across our EM debt portfolios. We remain particularly optimistic about EM local interest rates, as real yield differentials between emerging and developed markets appear very attractive. While slightly off their peak, those differentials remain among the highest levels seen since the global financial crisis.

Most recently, we have also been adding selectively to our positioning in EM currencies, where compensation appears comparatively attractive, given the level of risk. On the hard currency side, we maintain a slight preference for EM corporate over sovereign debt.

What We Are Watching

We continue to evaluate all opportunities on a bottom-up, country-by-country and company-by-company basis, as we believe this to be the best way to find attractive EM turnaround stories.

We recognize, however, that the broad asset class remains more sensitive to macro conditions and market sentiment at present. So we continue to monitor developments in key global markets, such as the U.S. and China, and their impact on the asset class.

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[1] J.P. Morgan, Global Emerging Markets Research: EM Flows Weekly, November 18, 2022.

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