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EMERGING MARKETS DEBT | INTERNATIONAL/GLOBAL

Outlook for EM Debt Shining Brighter at Second Quarter's Start

By: Emerging Markets Debt | April 25, 2023

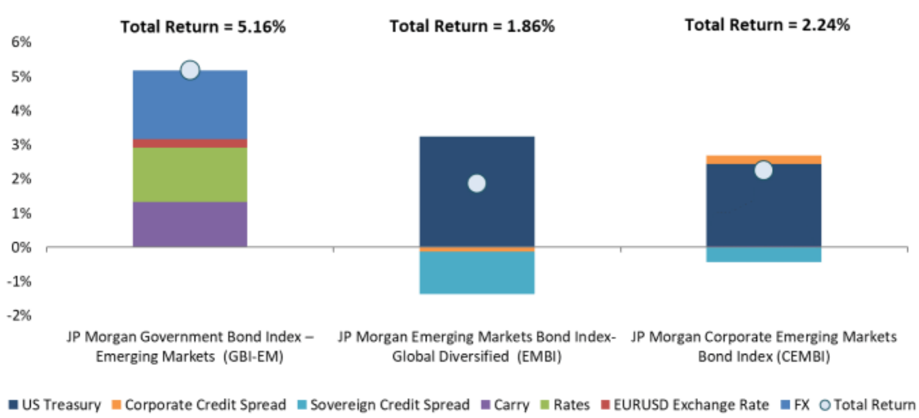
Boston - Emerging markets (EM) debt produced positive performance during the first quarter of the year despite a mixed backdrop for global capital markets. Optimism around China's reopening and expectations that the U.S. Federal Reserve's (the Fed) tightening cycle was nearing an end provided a strong start to the year, but the rally turned on high U.S. inflation readings, which led Fed officials to maintain their hawkish stance.

Banking stress in some developed markets acted as another headwind, fueling global volatility and leading performance across EM debt segments to diverge. Local markets (FX and rates) rallied strongly, while the USD-denominated hard currency segments (sovereign and corporate) were impacted by the broad widening in credit spreads globally.

All three segments in the EM sector posted positive returns in the first quarter:

- EM local-currency debt registered the strongest gains, at 5.16%, given strengthening currencies and falling local interest rates.
- Dollar-denominated, hard-currency debt gained 1.86% as returns from the rally in U.S. Treasurys more than offset the detraction from sovereign spreads.
- Corporate EM debt, the other hard-currency EM debt segment, also benefited from the strong performance of U.S. Treasurys, returning 24%.

Local currency led EM debt performance in 1Q23



Sources: JP Morgan, Morgan Stanley Investment Management, March 31, 2023. **Past performance is no guarantee of future results.** Data provided for informational purposes only. It is not possible to invest directly in an index. The vertical axis reflects the amount contributed by each factor to total return - adding the bars above 0% and below 0% (negative numbers) results in the total return. **FX** is the gain or loss in the GBI-EM from currency changes relative to the U.S. dollar. **EURUSD** reflects the portion of currency movement in the GBI-EM that is explained by the change of the euro versus the U.S. dollar. **Rates** refers to the contribution of change in local-currency interest rates in the GBI-EM. **Carry** refers to the risk-free returns in each GBI-EM country that cannot be attributed to FX, EURUSD or rates. **Sovereign credit spread** refers to the spread above U.S. Treasurys in the EMBI paid by a country. **Corporate credit spread** is the spread above the sovereign spread paid by an EM corporate issuer. **U.S. Treasury** refers to the contribution to return in the EMBI and CEMBI (both dollar-denominated indexes) due to interest-rate changes on the U.S. Treasury.

Looking ahead

We see a number of reasons to be upbeat on the outlook for EM debt ahead. For starters, the Fed's tightening cycle is likely to end in the near term, which could blunt the persistent strength of the U.S. dollar while also providing central banks in the emerging world greater maneuverability to begin easing.

As many EM central banks have tightened policy more than their DM counterparts amid last year's strong inflation surge, they are also near the end of their tightening cycles with price pressures beginning to dissipate. As a result, real interest rates in emerging markets remain significantly higher than in developed markets, sitting at their widest levels of the past two decades.

At the same time, commodity prices have come off recent highs and the falls seen should feed through to lower CPI readings. That said, on a 10-year basis prices for raw materials still remain elevated compared to longer term trends, which should support export receipts for commodity producing countries.

In terms of growth, looser monetary policy would be a boon. Already, economies in the EM world are forecast to outpace developed market peers, with upward revisions for projected GDP pointing to a rising gap in EM-DM growth differentials.

Not all economies are performing well, as the challenges of the past three years have left many countries with large-scale fiscal deficits. However, an increasing number appear to recognize the need to consolidate public accounts. Should a recovery in emerging markets further materialize in 2023, we will be looking for prudent, counter-cyclical fiscal policies to be implemented where appropriate.

With the outlook broadly improving, we believe that opportunities remain compelling across the EM debt universe and appear to offer particularly attractive compensation to investors at present.

Bottom line: We believe opportunities abound for EM debt investors today. However, growth, inflation and fiscal policy are quite divergent across the heterogeneous universe of countries that investors collectively refer to as *emerging markets*. Accordingly, we expect markets to place an emphasis on differentiation amongst countries and credits. That creates opportunities for investors with the research prowess and investment reach to access attractive credits across this wide and diverse asset class.

Emerging Markets Debt

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