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Emerging Markets Debt

2022 Outlook: Unearthing Opportunities in an Altered Landscape

Boston - In 2022, we expect emerging markets (EM) may embark upon a road to recovery, albeit with potential bumps along the way. While slower but ongoing recoveries in economic growth and global trade combined with reasonably attractive valuations for EM debt should act as tailwinds.

That said, continued headwinds from higher inflation, tightening monetary conditions, developments in China and uncertainty linked to the evolution of COVID-19 will likely remain challenges.

Ultimately, the broad and diverse nature of the EM universe means that these trends will play out differently at the individual country level.

Global growth supportive despite vulnerabilities

After a brisk expansion in global economic activity in 2021, growth is set to moderate to slightly less supportive levels this year. Global demand conditions remain relatively strong, with business activity still recovering from the pandemic-induced lockdowns. Less positively, however, the economic jolt of re-openings has been met by capacity constraints in developed and emerging economies, which are whipping up price pressures.

In response, the world's central banks are gradually abandoning pandemic-era stimulus in a move to normalize monetary policy. The U.S. Federal Reserve has already started tapering its asset purchases and is expected to hike rates three times in 2022. Here it is important to highlight that despite increases, rates will remain at extremely accommodative levels. Furthermore, with three hikes anticipated, it is unlikely that the Fed will surprise with more aggressive policy action, in our view.

In terms of other areas of risk, China — the world's second largest economy and a key trade and investment partner with other emerging markets — is showing signs of additional slowing. The government has stepped up regulatory crackdowns in sectors such as real estate, technology, private education and gaming — moves that have caused Chinese stocks to gyrate.

We are now seeing defaults by property developers, which we are continuing to monitor closely — not least because real estate is the largest sector in the Chinese economy. In terms of other policy, the government signaled a recommitment to "common prosperity," a term that many interpret as wealth redistribution, which has given markets reason for pause.

Lastly, no country is out of the woods as far as COVID-19 is concerned, particularly in light of the Omicron variant's fast global spread. Public health risks differ by country



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—with varying levels of vaccination rates and medical capacity across EMs — but most remain susceptible to the broader macro risks that further pandemic restrictions on cross-border trade and investment would entail.

Valuations particularly attractive in local rates

Notwithstanding the importance of growth, economic activity alone is not the key determinant for the performance of emerging-markets debt, as we saw in 2021 — a year of economic renewal and underwhelming performance on EM debt indexes.

On balance, we remain neutral to slightly positive on the main performance drivers for the asset class, as outlined below:

Rates. Relative rates between emerging and developed markets remain attractive, with a wide and positive differential. We believe rates will be a key return driver for EM local debt in 2022 (Exhibit A).

Currencies. Foreign exchange is an area where we see pockets of value, but broadly currencies appear fairly priced relative to the risk. On a nominal and real effective exchange rate basis (REER), EM currencies experienced a broad weakening over 2021 but we continue to see attractive opportunities on a selective basis

For every country like Turkey, where heterodox policy is cause for concern, there are lesser known and overlooked EM success stories, such as Egypt and Ukraine.

As a case in point, Egypt is set to relist on the J.P. Morgan Government Bond Index - EM (GBI-EM) Global Diversified at the end of January in recognition of the country's efforts to simplify access to its local bond market.

Ukraine is another candidate for GBI-EM inclusion later in the year. While the country's leadership has done much to strengthen the economy and public finances, it must be noted that external risks emanating from a retaliatory Russia complicate the picture.

Bottom line: We remain cautiously optimistic in our outlook for 2022, given the still favorable backdrop for global growth as well as EM debt valuations, which are particularly attractive in the local rates segment. That said, several macro risks remain and should be monitored closely. As ever, we believe that the best opportunities are to be found at the country level, where broader macro risks can be mitigated by tapping into unique and differentiated performance drivers.

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