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Are emerging markets the next frontier in fixed income?

Claudia Calich and Charles de Quinsonas

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After another difficult year for emerging market (EM) bonds in 2022, with the asset class facing headwinds on numerous fronts, we believe easing inflation and a modest upturn in global growth should provide a more support backdrop in 2023.

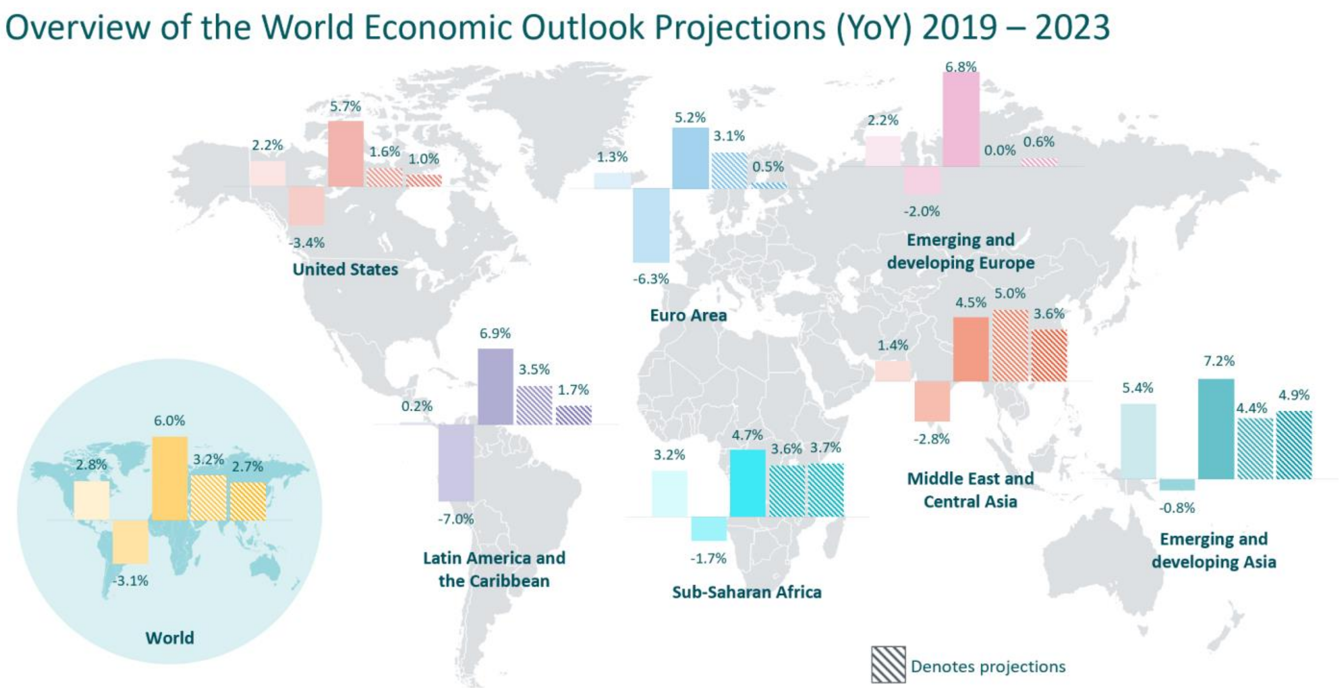
A more supportive macro backdrop

Inflation appears to have peaked in many regions and we would expect pressures to further ease due to a combination of base effects, tighter monetary conditions and lower food and energy prices. Fundamentals remain generally robust at both a corporate and a sovereign level, while the re-opening of the Chinese economy should prove supportive for global growth. The International Monetary Fund (IMF) recently upgraded its growth outlook, with EM regions seeing a relative improvement in growth prospects versus developed market (DM) economies. (Figure 1).

We also think EM bonds look compelling from a valuation perspective, with the asset class offering an elevated real yield which compares favourably with other segments of the fixed income market. While further volatility is to be expected in the near-term, it is worth noting that EM bonds have historically delivered high subsequent returns when yields have been around current levels.

Figure 1. Global growth picture

Past performance is not a guide to future performance.



Source: M&G Bloomberg Deutsche Bank 5 January 2023. Order of bars for each group indicates (left to right): 2019, 2020 and 2021 actual, 2022 and 2023 projections.

Inflation trending lower

Overall, we think the macro backdrop looks favourable for emerging market bonds. The global economy is expected to grow at a pace that is neither too hot nor too cold, while the central bank hiking cycle appears to be in its final stages. This is especially the case in many EM countries where central banks were generally ahead of the curve, with some starting to hike as early as 2021.

Perhaps most importantly, inflation has started to moderate, and this trend is expected to continue in 2023. The recent fall in food and energy prices will be a key driver here, especially in many EM countries where food makes up a large component of the inflation basket (see Figure 2). Base effects and tighter monetary conditions (which typically works with a lag of 12-18 months) should also help to drive inflation lower, providing a welcome tailwind to EM bond markets.

Figure 2. Inflation moderating across emerging markets

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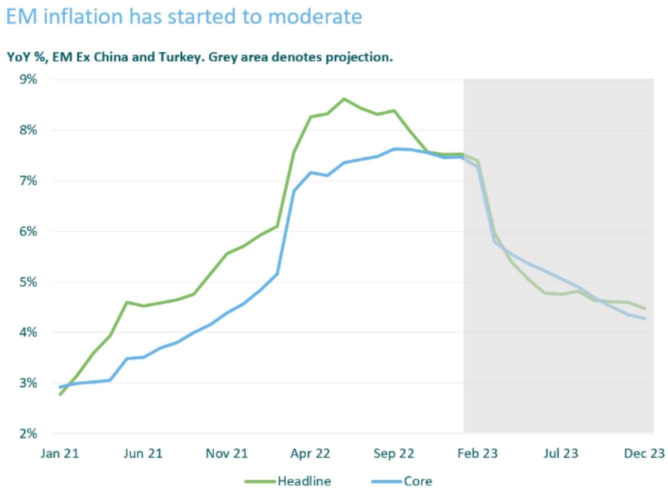

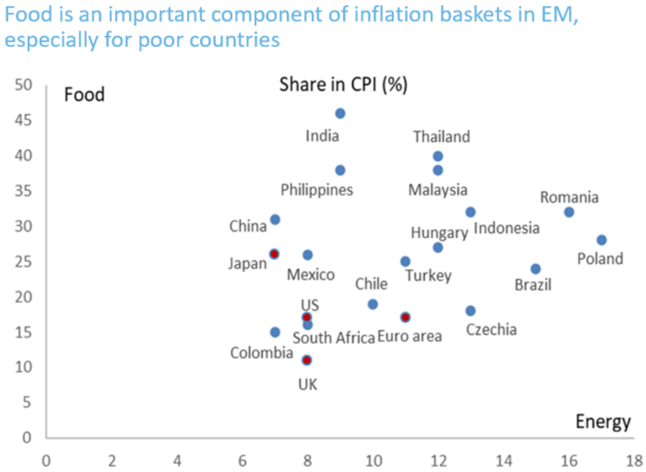

Source: JP Morgan. January 2023.

Real yields remain elevated

From a valuation perspective, we think EM bonds look attractive. Real yields remain elevated in most EM countries and compare favourably with DM yields, which in many cases are still in negative territory (see Figure 3). As inflation moderates and central banks start to slow the pace of their rate hikes, we think current yields could look especially appealing – we currently favour local currency bonds as best-placed to capture this trend.

In hard currency markets, we generally favour high yield (HY) over investment grade names, primarily on valuation grounds. While defaults are expected to rise quite sharply in the HY EM space, we believe these are likely to be concentrated in specific areas, such as Chinese property, Russia and other distressed areas. In contrast, we think fundamentals look much more solid in other regions, such as Latin America and the Middle East. It is therefore important to be selective and to ensure a detailed credit analysis, although for investors who do their homework, we believe that significant value can be found within the HY segment.

Figure 3. EM real yields remain elevated vs DM

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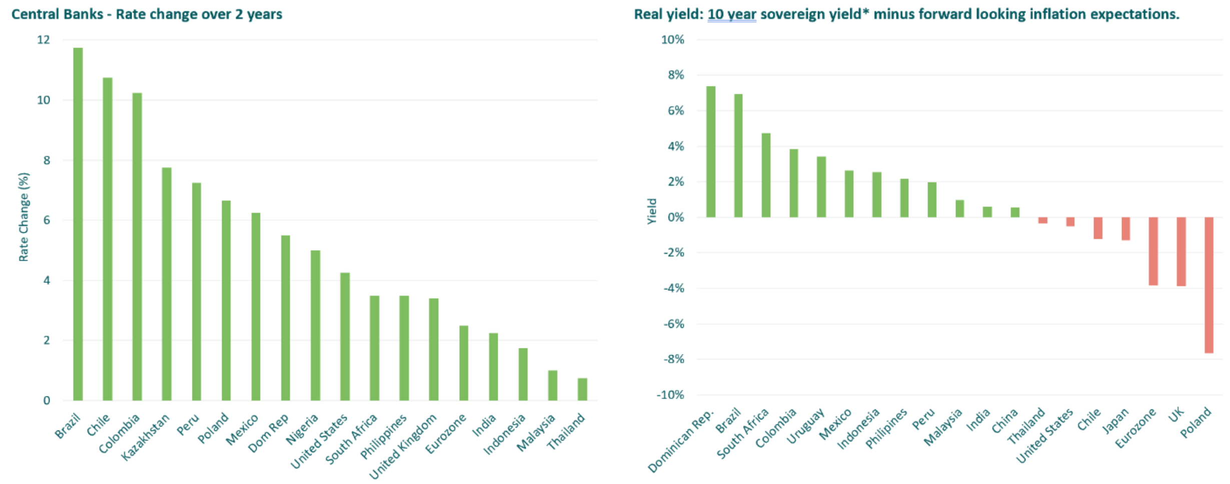

Source: Bloomberg, 11 January 2023. *10 year bonds or closest available maturity.

Headwinds expected to ease in 2023

With many of the headwinds facing EM bond markets expected to ease in 2023 we maintain a positive outlook for the asset class. An environment of modest economic growth – helped by the recent re-opening of the Chinese economy – and cooling inflation should provide a more supportive backdrop going forward. We also think EM bonds look attractive from a valuation perspective, offering elevated real yields that compare very favourably to many DM bond markets. On a medium term view, it is worth noting that EM bonds have historically delivered strong subsequent returns (over the following 24 months) when yields have been around current levels (Figure 4).

Figure 4. At current level of yields, subsequent returns have historically been high

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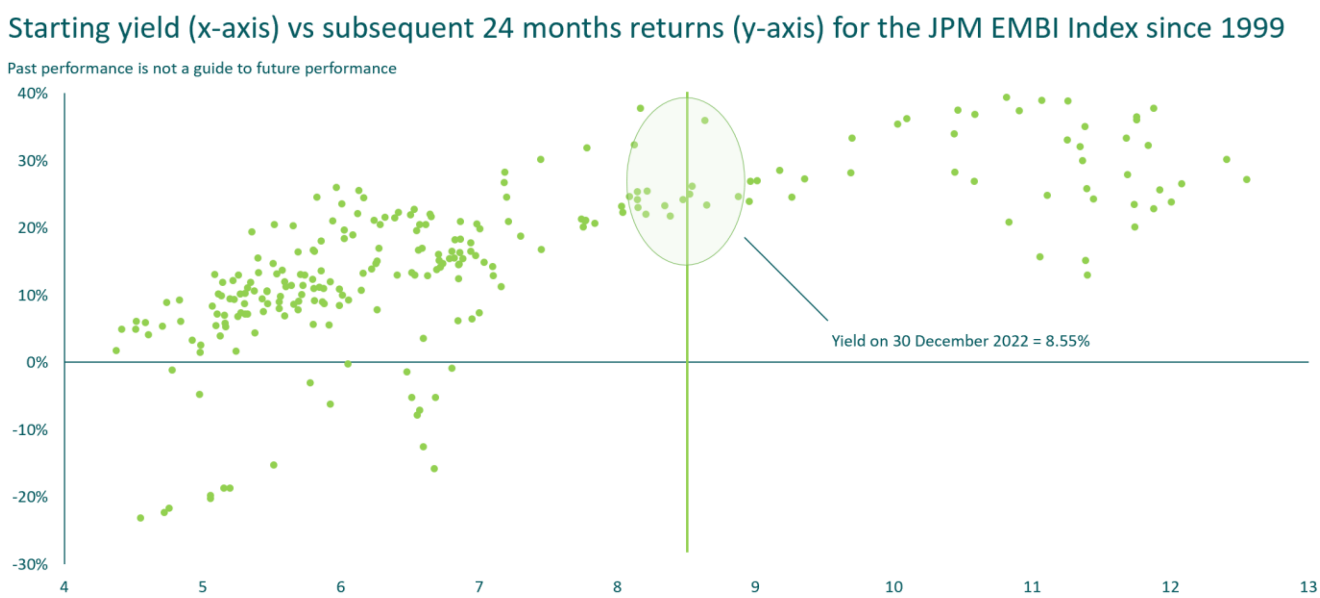

Source: M&G, 30 December 2022, JP Morgan EMBI returns from 31/12/1999.

Investments in bonds are affected by interest rates, inflation and credit ratings. It is possible that bond issuers will not pay interest or return the capital. All of these events can reduce the value of bonds held by the portfolio. High yield bonds usually carry greater risk that the bond issuers may not be able to pay interest or return the capital.

The value of investments will fluctuate, which will cause prices to fall as well as rise and you may not get back the original amount you invested. Past performance is not a guide to future performance. The views expressed in this document should not be taken as a recommendation, advice or forecast.

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