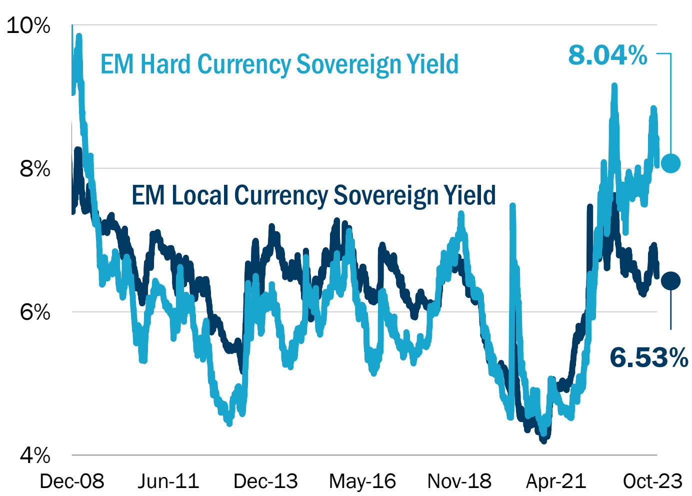
Emerging Markets Debt: 1Q2024 Outlook

Executive Summary

- *Emerging market bonds offer attractive return potential, particularly if inflation has peaked globally and interest rates stabilize or trend lower over the course of 2024.*
- *A supportive external environment where commodity prices underpin producers' economies, while not posing insurmountable challenges to importers, would provide a tailwind to the asset class overall. Manufacturing strength and a recent focus on productivity improvements in agriculture can be linked directly to improving trade balances in certain countries.*
- *Refinancing challenges remain, but many issuers are now reaping the rewards of prudent policy execution during the period of low interest rates and/or swift action in the face of rising inflation post-pandemic. We maintain that lower leverage compared with developed market peers, policy support from multilateral lenders and supportive capital flows targeting attractive real interest rates all create opportunities for investors*

The global economic outlook has clouded over the course of 2023, as central banks have made rapid progress in their quest to counter the inflationary spike caused by supply chain disruptions and the surge in pent-up demand post-COVID. However, earlier predictions of a sharp slowdown in the United States and other developed economies have failed to materialize so far, as resilient consumers and businesses have defied such predictions. For emerging markets, this resilience in developed market economies has been an important contributing factor to their growth and outperformance compared with expectations, but domestic consumers in emerging markets have also been in remarkably good health. Looking at growth differentials between emerging and developed economies, they have been moving in emerging economies' favor lately after a period of contraction during and immediately post-COVID.

FIGURE 1: EMERGING MARKET YIELDS



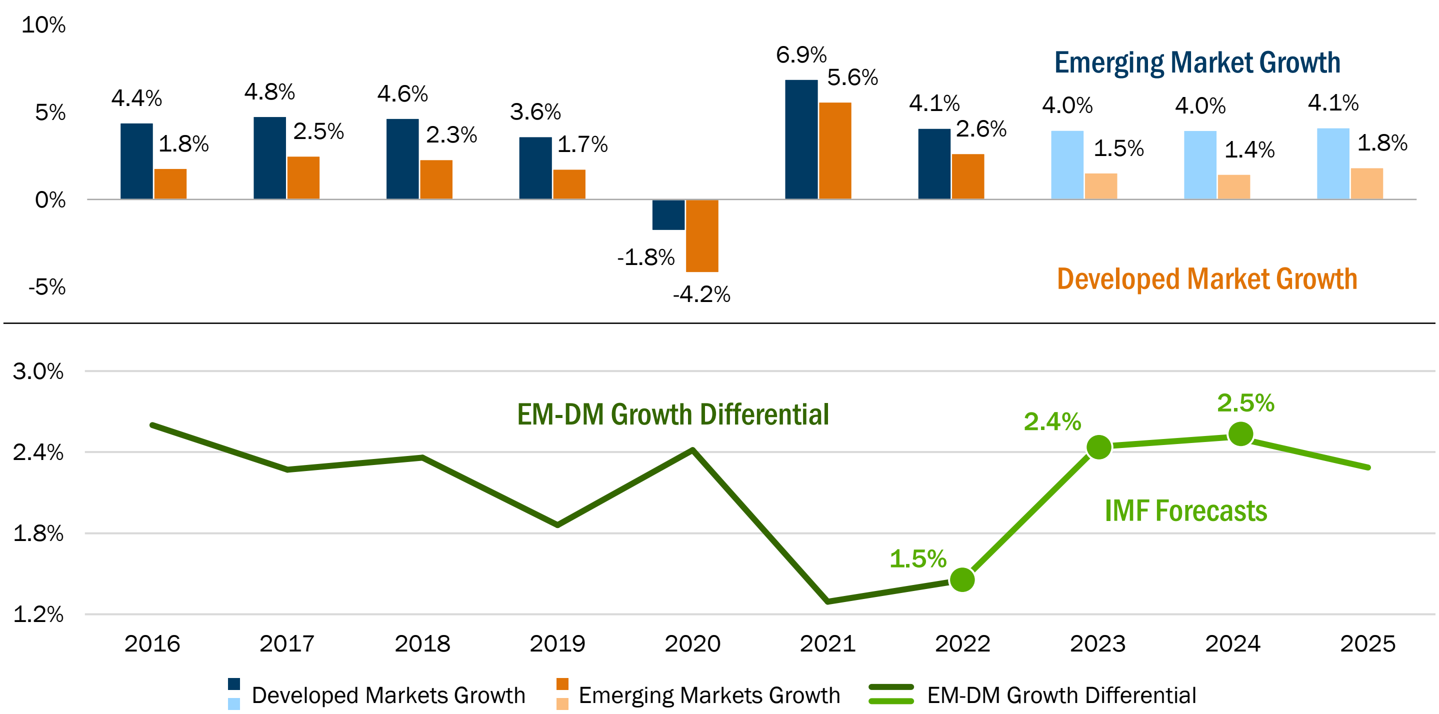
It is not possible to invest directly in an index. Please see disclosures at the end of this document. Past performance is not indicative of future results
Source: J.P. Morgan GBI-EM Global Diversified Index, J.P. Morgan EMBI Global Index

The rise in developed market interest rates and a surging US dollar leads to tightening financing conditions for emerging markets. The analysis on how countries and corporates adapt in a world of higher interest rates will be a crucial driver for returns in 2024 in our view. (See Figure 2) Over the last few quarters, we have observed many different pathways to address this new situation. Some borrowers have shifted their approach to include a higher share of local debt in their funding mix. This is particularly pertinent in Asia, where the inflationary spike has been much shallower. Compressing the interest rate differential with traditional developed market funding currencies, Asian treasurers have found that borrowing in Indian rupees, Indonesian rupiahs or Malaysian ringgits is suddenly a cheaper alternative to dollar-based loans or bonds. In Latin America, many countries also enjoy deep and liquid local markets, for example Brazil and Mexico, but the cost/benefit is smaller due to their much sharper domestic interest rate adjustments. In Europe, the Euro has been a favorite funding currency for at least the last decade as it better matches economic and trade exposures. European banking markets are comparatively deeper, reducing the need for capital market issuance and mitigating funding pressures. Many African issuers, in pre-COVID times enthusiastic users of external bond markets, have been shut out of international bond markets, due to the rise in overall borrowing costs. Particularly in Sub-Saharan Africa, the focus has now shifted to the refinancing of near-term maturities, rather than new borrowings. However, despite several sovereign defaults, for example Zambia in 2020 and Ghana in 2023, the market has taken a differentiated view across the region. For 2024, we expect further divergence in the performance of countries and corporate credits, dependent on their ability to access markets.

Political and geopolitical developments are likely to gain further in importance for markets in 2024, with the electoral calendar the heaviest in history. Globally more people will vote in 2024 than in any previous year since records began. Approximately half of the world's population (approximately 4.2 billion citizens) could potentially see a change in government, although some elections will be neither free nor fair. The US presidential election in the autumn of 2024 will likely dominate the headlines for much of next year, but important ballots in emerging markets include general elections in India, Pakistan, Indonesia and Mexico. Brazil in October and Turkey in March will hold local elections that once completed should allow for more significant economic reform policies.

The war in Ukraine in 2022 and the Israeli-Hamas conflict in 2023 have highlighted how geopolitical events can disrupt markets significantly. By nature, these events are impossible to forecast, but we don't expect significant escalations along known fault lines, for example Taiwan or the Indian/Chinese border. The war in Ukraine is unlikely to end in the near to medium term under the current Russian leadership, which is likely to win a landslide victory in heavily rigged general elections in March. If the Ukrainian election due to take place in 2024 can actually happen, the outcome is not certain. Moreover, currently imposed martial law doesn't permit them. To Volodymyr Zelenskiy, a master of political gestures, the opportunity to create a counter-narrative to the Russian sham election must be very tempting, regardless of the logistical challenges. It would seem a general election in a war-torn country where out of a total population of 38 million an estimated 5.3 million people have been internally displaced and approximately 7 million have fled abroad cannot be truly free and fair, but electoral purity would not be Ukraine's main objective.

FIGURE 2: EM-DM GROWTH: BACK TO PRE-PANDEMIC DIFFERENTIALS



Source: International Monetary Fund (IMF), Macrobound

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