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Our 2023 Emerging Markets Debt Market Outlook Update

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The macro environment in 2023 is likely to remain volatile for emerging market debt, until global disinflation trends gather momentum and central banks shift to an accommodative stance. Yet the headwinds to the asset class from 2022 – inflation, monetary tightening, zero Covid Chinese policies and soft growth – are likely to stabilize and subside as the year advances. The decline in global macro risks from inflation as well as China's re-opening will eventually create a supportive environment for the performance of fixed income assets, including emerging market debt.

Headwinds are well priced

The headwinds to EMD are well priced and if / when the Fed does eventually pivot to a focus on supporting the US economy through a slowdown, emerging markets should perform well. We think however that through the first half of the year, the Fed will remain focused on combatting inflation and only shift to growth accommodative policies in the second half of 2023, or even 2024.

There are clear indications that the US economy is slowing down yet labor market strength and sticky inflation cloud the outlook. Markets are awaiting resolution on whether the US economy undergoes a soft or hard landing with consensus still supporting a benign scenario of gentle slowdown and gradual deflation to target by 2024. Europe has narrowly avoided recession as gas prices collapsed on an uncharacteristically warmer winter and realized energy savings. The Chinese authorities executed a complete turnaround on zero-covid policies in November 2022 and relaxed quarantine rules and mobility restrictions. This led to swift upgrades of China's 2023 growth outlook and energy demand in January 2023. Global economic resilience and lower core rates typically bode well for emerging market debt performance and asset class allocations.

EM growth will likely also be under pressure in 2023 but should outperform that of developed markets. EM inflation is likely to peak early next year and has already in several economies with rates markets in EM similarly sensitive to DM of any sign of a rolling over of inflation providing ample opportunity for differentiating among countries in local rates markets. We retain a constructive commodities outlook for 2023 although we expect declines from the unprecedented highs of 2022.

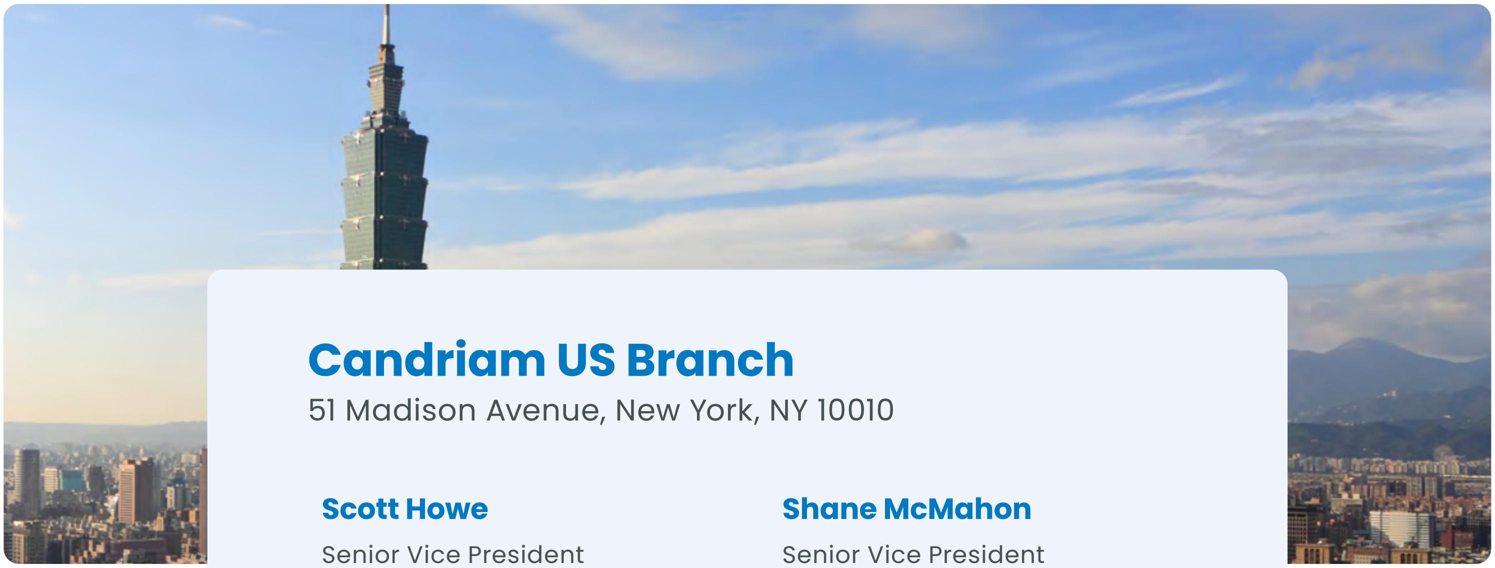
Sovereign defaults are likely to persist in 2023, but the market is pricing more defaults than we think are likely to occur and most of the countries with elevated credit risk are already trading at extremely distressed levels.

Valuations offer good entry points

Global bond markets were hit hard in 2022 and EM was no exception with the largest drawdown on record. That was in large part due to the selloff in US rates, which also experienced its largest drawdown on record. That has left an asset class that, while with risks, is now offering attractive valuations and a buffer against rising yields. Outside of the depths of the 2008 financial crisis and the Treasury correction in 2022, carry for EM sovereign credit is at its highest levels in two decades.

What's next?

The main risks and opportunities for each EMD sub-asset class will be driven by the evolution of US Treasuries, the Chinese economy, the level of defaults for EMD Hard Currency; and by EM disinflation, the trajectory of the US Dollar, and by the EM versus DM growth differential for EMD Local Currency. We will continue to follow and assess them, and keep you informed on a regular basis.



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