EM local debt performance delayed, but not denied

The opportunity in EM local debt may appear delayed at the moment, but performance in the asset class won't be denied.

By *Wim Vandenhoeck*

From a monetary policy perspective, emerging market (EM) central banks continue to cut rates but have adopted a more hawkish bias driven by the change in US Federal Reserve (Fed) policy action expectations. However, domestic factors, too, played a role in monetary policy for some EM central banks.

Indonesia was the surprise hiker, upping the policy rate by 25bps to 6.25% to alleviate pressure on its currency and keep a healthy spread relative to some of its peers as it seeks to attract portfolio flows.

In Latin America, Peru re-engaged with a 25bps cut after pausing, Colombia accelerated its easing to 50bps, but from double digit absolute policy rate levels from 12.25% to 11.75%, while Chile cut 75bps to 6.5%.

The only action in Central and Eastern Europe came from Hungary, where rates were cut by an expected 50bps to 7.75%, slowing down its pace from 75bps.

Opportunity in Brazil

Brazil rates underperformed most rate markets in April. Most notably, its rates curve bear flattened, with the front end underperforming the back end of the curve after Brazil Central Bank Governor Roberto de Oliveira Campos Neto gave a speech during the IMF conference in Washington DC. He struck a hawkish tone when he linked Brazilian monetary policy not only to external factors like Fed policy, but also pointed to domestic fiscal and expected inflation dynamics.

We are still constructive on the Brazilian rates market and believe that the current

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pricing of the front end provides good risk reward. With that in mind, we used the opportunity provided from the flattening of the yield curve to sell bonds in the back end and to buy bonds in the front end to position for rate cuts in the future. Even in volatile sovereign markets, our team looks to capitalize on opportunities in curve shape to better optimize risk allocations.

EM local debt looks positive

With a flattish global growth outlook and bumpy disinflation, we expect EMs to be impacted by their own tight monetary policy and the Fed path over the next few months. At this point in the monetary policy cycle, we expect greater differentiation on the rate side, due to country-specific domestic policies rather than on the FX side, which will be dominated by US dollar strength or weakness.

The forward-looking trajectory of EM local currency is positive. The shifting narrative in markets could continue, depending on the elevated dispersion in economic data releases. Given this, the opportunity in EM initially is anchored to the high nominal and real yields that can be found in the asset class in concert with a disinflationary path that is still trending lower generally. Diversified income generation in EM is an attractive characteristic, with capital appreciation optionality linked to central banks becoming less cautious in their policy easing cycles once greater certainty with respect to the beginning of the US monetary policy easing develops.

With the US dollar close to a five-decade high and the anticipated policy rate path being lower in rates, EM currencies in the medium to longer term should provide an added source of performance alpha in concert with local interest rates.

From a regional perspective, we still favor Latin America and are neutral to underweight Asia from a relative value perspective. We believe that the front end of some EM local curves is attractive and believe that these curves could steepen upon a resumption in a more normalized policy easing environment.

Overall, we believe the asset class remains in sound shape. Robust carry, healthy growth, interest rate differentials relative to developed markets, and differentiated local stories make for a rich investment opportunity set in emerging markets in 2024. ■

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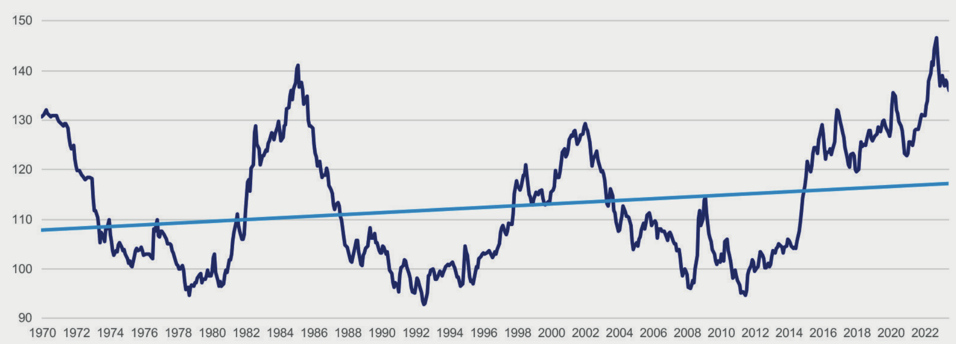
FIGURE 1: USD REACHED 52-YEAR HIGH ON TRADE-WEIGHTED BASIS LAST YEAR, REMAINS EXPENSIVE



USD real effective exchange rate.

Source: Bank of America, as of 31 July 2023. Index Level versus Trendline.

SUMMARY

EM local debt has upside potential in the medium and long term.

Increased EM central bank monetary policy divergence will create country-specific idiosyncratic opportunities to extract alpha.

Attractive diversified income generation and EM FX performance optionality are positive investment attributes for the asset class.

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