Investment Insights

Emerging market debt outlook for 2024: a more dovish Fed in a bifurcated EM universe

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Marketing communication

EMD outlook for 2024: a more dovish Fed in a bifurcated EM universe

Robert Burgess
Portfolio Manager
Based in London

Key takeaways

- If US inflation data remains supportive, a more dovish Fed should benefit the core EM countries that are leading the way with rate cuts and the frontier economies that are facing high external financing requirements.
- **Core EM:** We look to extend local currency duration in countries with high real rates and where we expect rates and/or inflation to come down. Hard currency spreads generally already reflect strong fundamentals but select holdings can offer a spread pick-up and diversification benefits.
- **Frontier EM:** Many frontier economies are struggling with higher US rates so a more dovish Fed should benefit these economies the most in the credit space. That said, headwinds remain and holdings both in local and hard currency should be selected on a case-by-case analysis.

In this outlook, we outline the global backdrop that emerging markets (EMs) can expect in 2024, including a more dovish Fed, a more supportive backdrop for EM currencies and weak global growth. We then discuss how the higher-rated core and lower-rated frontier economies are likely to perform in this environment and how we are thinking about investing around these themes. We also have a section on EM elections in 2024.

Global backdrop

The US Federal Reserve (Fed)'s pivot

In our initial EM debt outlook for 2024, we discussed how EM debt would perform in a higher-for-longer US rate environment. This was written before the Fed made a surprise dovish shift from previous policy on 13 December. The Federal Open Market Committee (FOMC)'s statement signalled the end of the hiking cycle and opened the door to a discussion on rate cuts. In the post-meeting press conference, Fed Chair Powell said "we believe that our policy rate is at or near its peak for this tightening cycle." Meanwhile, the median dot for next year is now 50 basis points lower than the September projection, with Fed Funds futures now pricing a full cut by the March 2024 meeting.

If supported by incoming inflation data, a more dovish Fed will clearly be positive for EM debt, although it is important to note that US rates are still likely to remain significantly higher than the near-zero levels of 2021. Furthermore, if inflation were to re-accelerate or prove to be stickier than expected, we are likely to revert back to the higher-for-longer US rate environment.

The table below shows how EM currencies, hard currency and local currency debt have performed 1 year and 6 months prior to and 6 months and 1 year post Fed rate cuts in previous Fed cutting cycles. Both local and hard currency bonds have rallied the most in the run up to rate cuts, while EM currencies have performed better after the rate cuts have taken place.

How EM has performed in previous Fed rate cutting cycles
(%)

		Jan-01	Sep-07	Jul-19	Average
EM currencies	1y prior	10%	-7%	2%	2%
	6m prior	5%	-4%	2%	1%
	6m post	7%	-5%	3%	1%
	1y post	9%	2%	9%	7%
Hard currency debt	1y prior	14%	7%	11%	11%
	6m prior	7%	1%	9%	6%
	6m post	6%	4%	4%	5%
	1y post	10%	0%	3%	4%
Local currency debt	1y prior		21%	8%	14%
	6m prior		8%	4%	6%
	6m post		11%	2%	6%
	1y post		7%	-1%	3%

Past results are not a guarantee of future results.

Hard currency debt represented by JP Morgan Emerging Market Bond Index Global Diversified (EMBI). Local currency debt represented by JPMorgan Global Bond Index Emerging Markets Global Diversified (GBI-EM GD). EM currencies represented by EM currencies weighted by GBI-EM GD versus the US dollar. Exact dates are as follows: 03/01/2001, 18/09/2007 and 31/07/2019. Returns in USD. Sources: Bloomberg, JPMorgan

Support for the dollar should start to fade

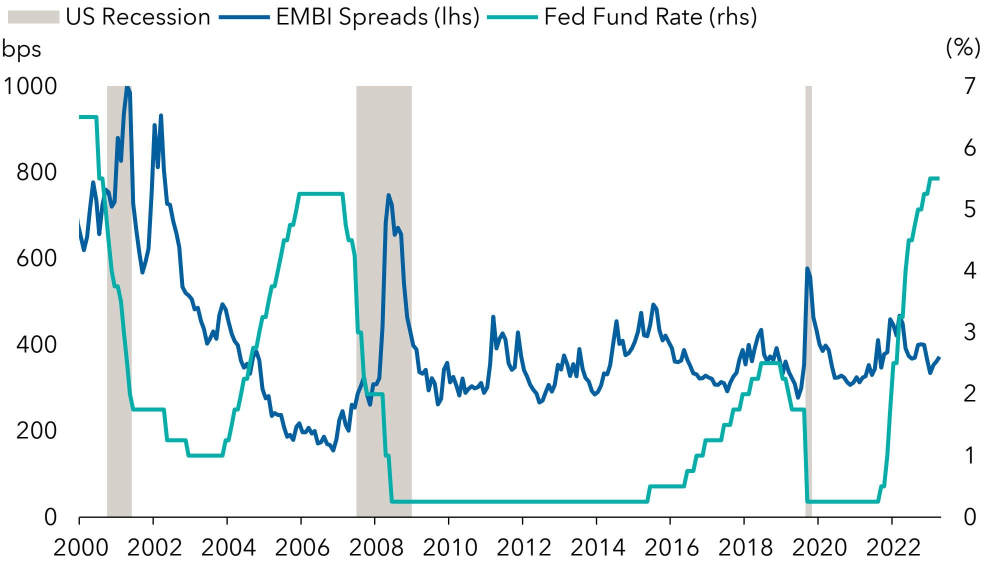
While EM currencies recovered somewhat in 2023, the strength of the US dollar and weak EM currencies have broadly been a drag on local currency bond returns over the past decade, despite the fact that the dollar looks overvalued on most fundamental metrics. This could change with lower US rates, although the process of unwinding dollar strength is likely to be a slow and gradual one given that the real rate level is still supportive of the dollar over other developed currencies and growth outside the US remains relatively weak.

The US may escape recession, but global growth is set to remain weak

While the US has so far managed to avoid a traditional recession, different sectors have been experiencing downturns at different times. The US looks set to slow further from its current pace given both the lag from a tightening in financial conditions and a lower fiscal impulse in 2024. We already see evidence of slowing labour market activity and a normalisation in some measures of consumer credit performance.

The path for EM has historically been highly correlated with US growth, as shown in the following chart, and taken very different paths depending on whether the US manages to have a soft landing or not. The fact that the US experienced the less-severe "rolling recession" in 2023, suggests that it may avoid a traditional recession in 2024 as well.

EMBI spreads during US rate cycles and recessions



Past results are not a guarantee of future results.

As at 30 November 2023. Sources: JPMorgan, Bloomberg

Left vertical axis: Emerging Market Bond Index (EMBI) spreads (bps). Right vertical axis: Fed Funds rate (%). Shaded periods are National Bureau of Economic Research (NBER) US recessions.

Outside of the US, growth is expected to remain relatively weak. Compared to the US, Europe was hit more heavily by the energy shock and the region has seen and still faces some of the most difficult policy challenges with the trade-off between inflation and growth. The latest business surveys[1] show a stabilisation in

1. Source: European Commission Business and Consumer survey for 1-22 November

eurozone economic activity at weak levels, and there remains a significant risk of contraction in some economies.

In China, the latest PMIs (Purchasing Managers' Index) were consistent with an economy continuing to expand at a very slow rate. The government has shown some willingness to use both fiscal and monetary policy to support growth, and while there might be a cyclical pick-up in growth in response to these measures, China is likely to have to adjust to a deceleration in its longer-term trend in growth over the next several years. Elsewhere in EM, we can expect an acceleration of growth in EM Asia (outside of China), a deceleration in Latin America and broadly stable growth in Europe, Middle East and Africa (EMEA).

A tale of two EMs – core (higher rated) and frontier (lower-rated) markets

The last few years have seen a truly bifurcated EM universe emerge, consisting of the higher-rated core EM countries and the lower-rated frontier economies. Both have very different attributes and will likely navigate any challenges ahead in very different ways.

Lower-rated economies generally struggled in 2022 with the rise in US rates combined with a sharp downturn in risk sentiment, both of which led to a sharp increase in the cost of financing. A number of these more frontier-type countries faced large currency adjustments, some were effectively shut out of primary markets, while sovereign debt restructurings reaching record levels – similar to 1990s. As the Fed has been raising interest rates through 2023, higher marginal rates have slowly been feeding through to aggregate debt dynamics. For those countries facing large amortisations, higher US rates combined with lower nominal GDP growth and a strong dollar is putting continued pressure on debt stock metrics. Meanwhile, many of these countries are finding it politically challenging to cut fiscal deficits, especially as interest bills have risen.

It has been a completely different story for some of the more developed EM countries, such as Brazil and Mexico. They have generally built up a large cushion of domestic private savings that have helped finance fiscal deficits and they are now starting to narrow. The borrowing characteristics of these countries have also changed, helping them to become less reliant on short-term foreign borrowing than in the past. They have lengthened the maturity of their issuance, while the foreign ownership of their local currency bonds has broadly decreased. Many of these countries have strong enough external balance sheets and access to capital to withstand any volatility and have built large foreign exchange (FX) reserve buffers, so even with any pressure on FX reserves, they remain at comfortable levels. Finally, while EM countries have traditionally struggled with inflation, many of the more developed EM countries raised interest rates earlier and more aggressively than the developed world to avoid de-anchoring inflation expectations. As a result, inflation now looks set to return to central bank comfort zones for most EM countries by the end of 2024.

The resilience of EM was thoroughly tested in 2023. As well as the aggressive US rate hiking cycle, EMs also had to contend with two separate wars, US banking stress in March and a sharp bond sell-off. The fact that the more developed EMs were able to weather this volatility without too much of an impact demonstrates how much these economies have progressed.

EM elections in 2024

Over half the world's population[2] will be asked to go to the polls in 2024 – more than in any year in history. As well as parts of the developed world, this includes many core EM countries, including India, South Africa, Indonesia and Mexico, as well as a number of countries that are potentially heading towards or already in the midst of debt restructuring such as Sri Lanka, Ukraine and Ghana. With so many economies headed into an election year, the potential for a change of direction in policy is higher.

Country	Election type	Date
Bangladesh	Presidential & Legislative	Jan-24*
Taiwan	Presidential & Legislative	13-Jan-24
El Salvador	Presidential & Legislative	04-Feb-24
Pakistan	Parliamentary election	08-Feb-24
Indonesia	Presidential & Legislative	14-Feb-24
Senegal	Presidential election	25-Feb-24
Turkey	Local elections	31-Mar-24
Ukraine	Presidential election	31-Mar-24
Korea	Legislative election	10-Apr-24
India	Parliamentary election	May-24*
South Africa	Presidential & Parliamentary	May-24*
Panama	Presidential & Legislative	05-May-24
Dominican Republic	Presidential & Legislative	19-May-24
Mexico	Presidential & Legislative	02-Jun-24
Croatia	Parliamentary election	22-Jul-24
Sri Lanka	Presidential & Legislative	Sep-24*
Romania	Local elections	Sep-24*
Brazil	Municipal 1st round	06-Oct-24
Mozambique	Presidential & Legislative	09-Oct-24
Georgia	Presidential & Parliamentary	26-Oct-24
Brazil	Municipal 2nd round	27-Oct-24
Uruguay	Presidential & Legislative	27-Oct-24
Romania	Presidential (1st & 2nd round)	Oct-Nov-24*
Uruguay	Presidential 2nd round	24-Nov-24
Romania	Parliamentary (1st & 2nd round)	Nov-Dec-24*
Venezuela	Presidential	Dec-24*
Ghana	Presidential & Legislative	07-Dec-24
Tunisia	Presidential & Legislative	2024*

Source: National Democratic Institute, IFES, National election commissions, JPMorgan.
*exact date unconfirmed

2. As at 13 November 2023. Source: The Economist

Taiwan's presidential and parliamentary elections in January are likely to have significant implications on US-China relations.

Incumbent President Widodo won't be able to run for Indonesian presidential elections in February, but his son is the running mate of presidential candidate Subianto, who is leading in the polls.

Pakistan's general elections will be key to a more stable governance and progressing with reform efforts. Former PM Imran Khan is leading in the polls, but given the court indictments against Khan, the outlook is very unclear.

Prime Minister Modi and the BJP party will be looking to be re-elected for a third term in **India** in the largest national elections in the world. Greater policy clarity following the elections should support investor flows into the country, especially ahead of the country's inclusion in the JPMorgan GBI-EM bond index.

South Africa's ANC is facing tight national elections in the summer, with polls showing support for the ruling party falling below 50%. If the ANC does not win an outright majority, they may still be able to form a coalition with smaller parties, but policy uncertainty would rise.

Mexico has a number of elections taking place including presidential, congress plus nine state elections. The incumbent President Andrés Manuel López Obrador (AMLO) won't be eligible for re-election, but Morena's candidate Sheinbaum is currently leading in the polls.

While **Türkiye** only has local elections in 2024, these should provide an indication of whether the recent adoption of a more orthodox economic management style will continue.

In October, the US announced a six-month sanction relief programme for **Venezuela** in return for holding presidential elections in 2H24, the participation of international election observers, the release of political prisoners and a process in which all candidates may participate in the elections. If the suspension of sanctions turns out to be more permanent in nature, Venezuela may be able to restructure its debt.

While **Ghana's** elections in December should be tightly contested, the country should have policy continuity given that it is currently under an International Monetary Fund (IMF) programme. The government is hoping to come to an agreement to restructure its external debt before elections, but given lengthy creditor negotiations in previous debt restructurings, this may be difficult.

Investing in the current environment

If we see earlier and faster rate cuts by the Fed, as suggested by the meeting in mid-December, then it makes for a fairly constructive backdrop for EM debt in 2024. But EMs will still likely have to navigate a fairly strong US dollar, weak global growth and a busy global election calendar. We see the largest opportunities within core local currency debt and frontier hard currency debt.

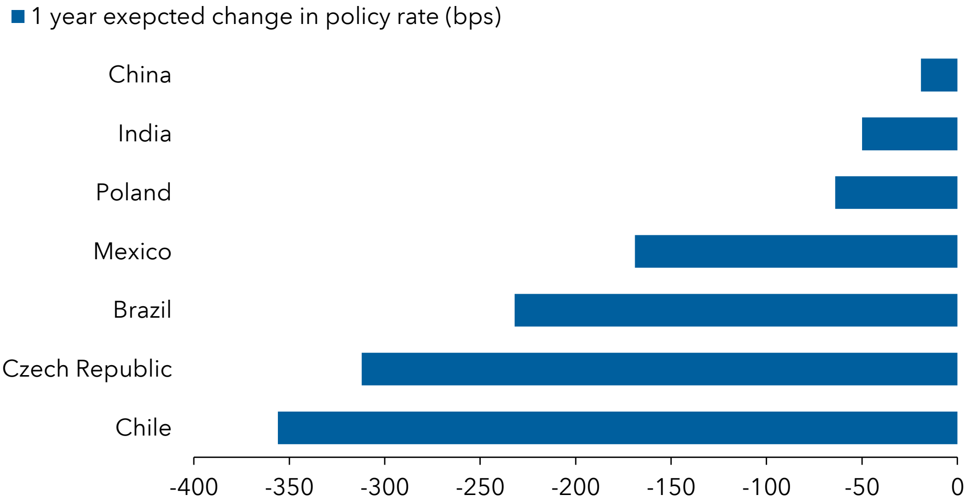
Core EM countries

The core EM countries stand to benefit significantly from a more dovish Fed. Although they are generally less affected by the Fed's actions than the lower-rated countries, they still need to balance high domestic real rates against global financial conditions and higher for longer US rates may have discouraged EM central banks from cutting rates as much or as quickly as they may have wished.

A more dovish Fed should allow the core EM central banks to move monetary policy in a direction that better reflects their domestic outlooks. In most of the core economies, inflation is expected to decline throughout 2024, allowing policy rates to come down. Falling EM interest rates should provide a duration tailwind for local currency debt holders.

Policy rates expected to come down in EM

One year expected change in policy rates



As at 16 November 2023. Source: Bloomberg

We currently favour owning some local duration in countries in which inflationary pressures continue to abate and monetary policies become more accommodative. Many of these are in Latin America, including in Brazil and Mexico, but we also like duration in South Africa where real rates are near the upper end of historical ranges and still have some cushion versus US Treasuries.

Central banks in Asia are likely to cut rates later than the rest of the EM world and Asian local currency debt tends to be more correlated with global markets, but we see duration opportunities in China, Indonesia and South Korea. In China, low yields seem justified by stubbornly low inflation and growth challenges, while monetary policy looks restrictive in both Indonesia and South Korea, especially after Indonesia's surprise rate hike in October.

We remain cautious in Central Europe. Inflation does seem to have rolled over (although it is unlikely to return to target as projected) and growth has been sluggish, but those trends are reflected in local yields with aggressive easing cycles priced into the bonds.

Within hard currency debt, spreads are fairly tight within the core EM economies, but if there is a US recession, US dollar duration should offset the impact of spread widening on returns. These holdings also provide diversification benefits. Examples of some of higher-rated credits in which we have conviction include Korea and Mexico.

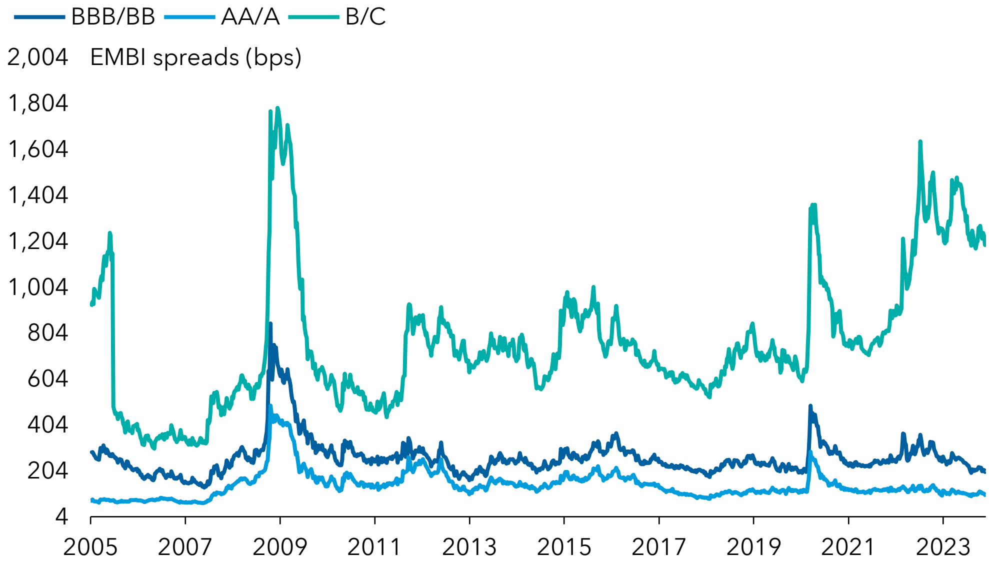
We also find value in some corporate dollar issuers. Fundamentals within EM corporates look to be in better shape as EM corporate treasurers have for the most part taken a more prudent approach to borrowing. The geographic representation and risk structure of EM corporates is quite different to sovereigns, and so provides an element of diversification. Shorter-dated investment-grade bonds inside the corporate world have proved quite resilient during times of volatility and can help with defensive positioning.

Frontier economies

The Fed's pivot should reduce external financing pressures on frontier economies and also encourage investors to look towards the lower-rated economies in the search for yield, but frontier economies will continue to face headwinds from relatively weak global growth, lingering dollar strength and higher US rates than in the past (even with the more dovish Fed).

With hard currency debt, spreads are still relatively wide, offering a significant valuation cushion in many cases. Meanwhile, recent restructuring proposals have been relatively bondholder-friendly and the IMF has continued to provide financing even where there have been sustainability concerns (e.g. in Egypt and Pakistan).

EMBI spreads by rating group



As at 1 December 2023. Source: JPMorgan Emerging Market Bond Index (EMBI)

Tunisia is an example of a credit that is pricing in a high probability of default, partly driven by some public disagreements with the IMF, but with the significant increase in FX reserves over the past year, the country should be able to service its forthcoming debt payments. Honduras is another example of a higher-yielding credit that we like. While political gridlock is currently making it difficult to get some reforms through, Honduras has the support of an IMF programme and has made good reform progress over the past few years, particularly on the fiscal side. As a result, the country's overall credit metrics are in decent shape.

EM local currency debt markets have traditionally been limited to countries further along the development path that have made progress in reducing inflation, encouraging domestic savings, and establishing local capital markets. In recent years, the number of sovereigns that have been able to issue debt in their own currencies has grown. These frontier issuers can offer attractive returns that are often uncorrelated with more mainstream EM local rates markets. However, they also come with higher risks, requiring a view on the credit as much as the rates and currency components of the investment decision. As such, currently, they face similar headwinds from a strong dollar and higher US rates to some of the more distressed hard currency issuers, and we do not see many compelling longer-term opportunities within frontier local markets in the current environment.

Robert Burgess *is a fixed income portfolio manager and research director at Capital Group. As a fixed income investment analyst, he has research responsibility for emerging market debt. He has 31 years of investment industry experience and has been with Capital Group for seven years. Prior to joining Capital, Robert worked as chief economist for emerging markets in Europe, the Middle East, and Africa at Deutsche Bank. Before that, he was an economist at the International Monetary Fund and HM Treasury. He holds a master's degree in economics from the University of London and a bachelor's degree in politics and economics from Oxford University. Robert is based in London.*

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