Capital at risk. The value of investments and the income from them may fall as well as rise and is not guaranteed. Investors may not get back the full amount invested.

Emerging Market Corporates - Time to Reallocate?

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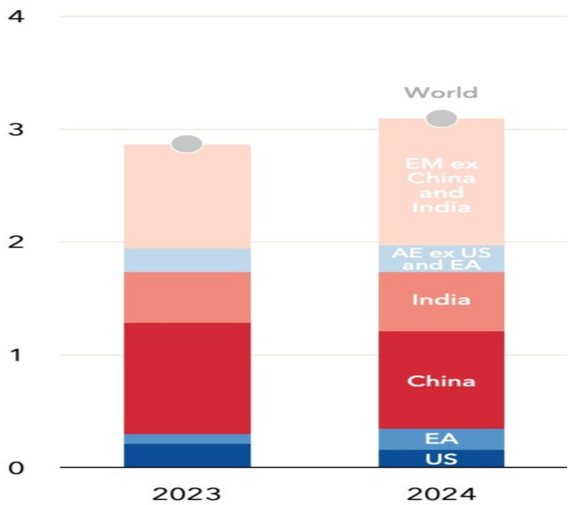
The outlook for emerging markets appears to be improving, buoyed by China's economic reopening, but it is important to focus on quality given ongoing uncertainties in the market.

Following a strong start to the year for all credit markets with the hopes of an end to the current interest rate hiking cycle, volatility has returned. Yet despite the ongoing uncertainty surrounding the direction of global economic growth, for emerging markets (EM) the outlook appears positive with the IMF predicting the main contributor to global growth in 2023 will come from EM (Fig. 1).

Fig. 1 - Contribution to Global GDP Growth (% Share of World Growth)



Source: IMF report 'Global Economy to Slow Further Amid Signs of Resilience and China Re-opening' published January 30th, 2023. Colours and countries labelled on right hand bar chart match non-labeled bars on left hand side. For illustrative purposes only.

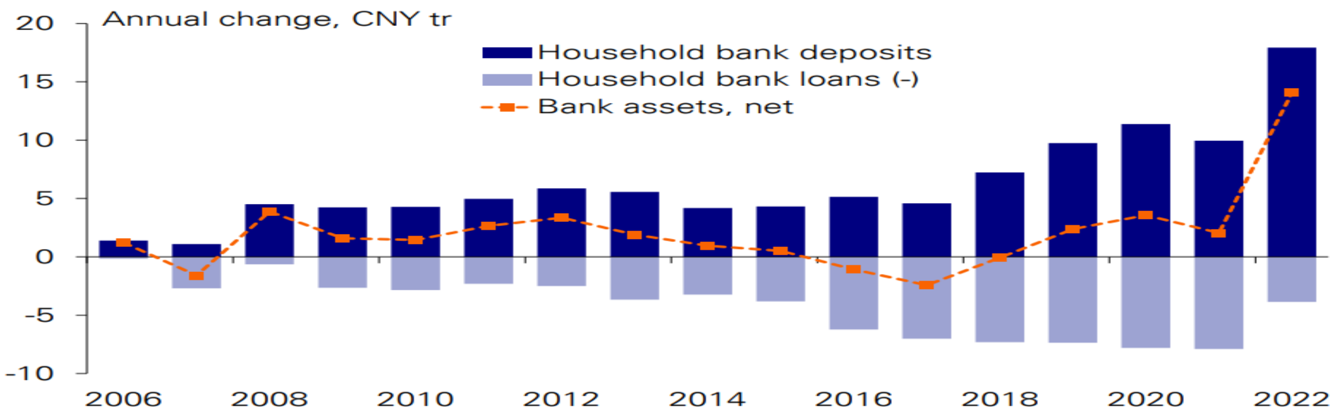
China Recovery?

Last year China suffered several headwinds including its Zero Covid Policy (ZCP), property sector turmoil and increasing geopolitical tensions all of which had a severe impact on growth. We are now seeing a resolution in these issues with a reduction in political tensions, a reversal of the ZCP and the change in governmental policy towards the property sector; China's Vice Premier Liu He said the property industry is a pillar of the Chinese economy, and new measures are being considered to improve the sector's assets. This can be measured through the opening of financial channels with an increase in government guaranteed bonds, the return of IPOs and Chinese US dollar denominated high yield property issuance.

The reopening of the economy should give a much-needed boost to economic recovery. Around CNY20trillion has built up in savings (Fig. 2), which is likely to flow back into the economy, supporting sectors such as tourism, consumer goods, services and property.

However, we believe the emerging market growth story goes beyond China; our economic analysis has indicated Philippines, Malaysia and Indonesia should grow c. 5% with a c. 4% growth rate from Thailand. The relatively mild European winter has resulted in lower-than-expected energy and gas prices, and we are expecting to see some ratings upgrades across the Middle East and Europe as well as a potential for rate cuts to be implemented in countries such as Hungary and the Czech Republic.

Fig. 2 – Household Bank Deposits and Bank Loans



Source: Deutsche Bank Research report ‘China Macro: 2023 Outlook Chartbook: Lifting the Burden’ published January 29th, 2023. For illustrative purposes only.

Finding Value while Maintaining a Quality Bias

Diversification is EM’s secret weapon. It offers investors exposure to c. 50 countries at different stages of the economic cycle and, within the corporate credit universe, a diverse range of sectors and industries. With investment grade and high yield mixed into one asset class, it also offers the opportunity to rotate from high yield (less rate sensitive) exposure into investment grade when the West’s terminal rates are reached. While last year’s trade was to choose India over China, with expectations of Chinese growth returning this year, we are starting to see opportunities in higher-quality Chinese credits within industrials and diversified financials.

In a similar vein, last year we were reducing Eastern Europe due to increasing geopolitical risk, and moving into the Middle East. With underlying valuations in the former having widened considerably, we are now seeing better relative value opportunities in Eastern Europe in areas such as banks, and transport logistics and are cautiously rotating our portfolios back into the region.

While the terrible Russia/Ukraine conflict unfortunately continues to rage, we are seeing relatively attractive opportunities in alternative energy providers in Latin America and Frontier/African markets. In Asia Pacific, there are possible opportunities due to the reopening trade in China in areas such as Macau and Thailand and sectors such as airlines.

In terms of credit risk, given ongoing volatility and tight financial conditions, we advocate an approach that favours better quality issuers and avoids frontier markets.

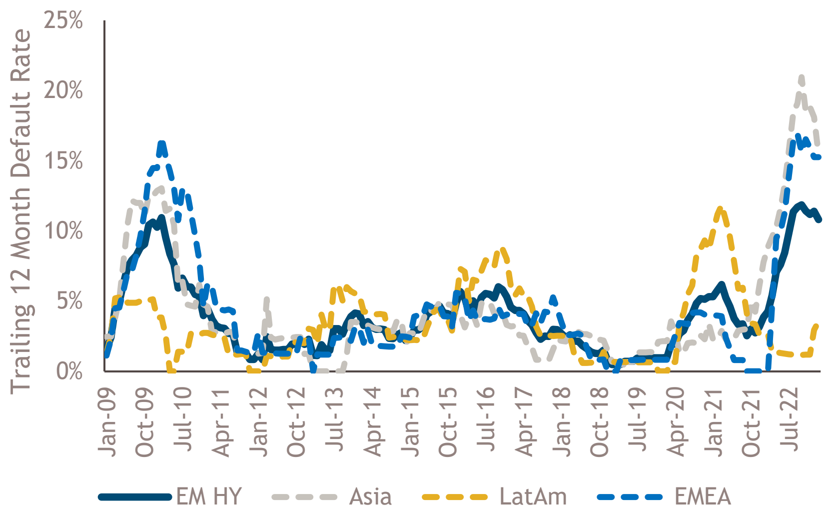
Looking ahead, the election calendar could provide some opportunities later in the year in countries such as Turkey, should incumbent president Recep Tayyip Erdoğan lose the general election, provisionally set for May 15th.

Have Defaults Peaked?

EM corporates, along with their developed market counterparts, were impacted by the global pandemic and ensuing macroeconomic turmoil. Regions likes Eastern Europe and Asia suffered the additional pain of the Russia/Ukraine conflict and the Chinese property crisis (Fig. 3).

Forecasts are for EM high yield defaults to come down in 2023 to their long-term average of 3% (Fig. 4), benefiting from some of the Chinese measures discussed earlier (reversal of ZCP, support for property sector), while regions such as a Middle East and Africa and Latin America should benefit from supportive commodity markets as investors seek Russian alternatives.

Fig. 3 – EM High Yield Defaults



Source: Bank of America Merrill Lynch Emerging Markets Monthly Chartbook data as of February 28th, 2023. Most recent data available used. For illustrative purposes only.

Fig. 4 - EM Corporate HY Default Rate Forecasted to Fall

						2023F	
	2018	2019	2020	2021	2022	Fcst.	Fcst. Ex*
Asia	2.5%	1.8%	3.4%	13.2%	16.5%	4.1%	0.7%
EM Europe	0.0%	0.0%	3.3%	0.0%	32.0%	15.7%	0.0%
LatAm	2.1%	2.3%	4.4%	2.5%	3.7%	5.0%	5.0%
ME & Africa	0.0%	1.8%	2.1%	0.0%	0.6%	0.5%	0.5%
EM Corp HY	1.2%	0.8%	2.5%	4.5%	6.0%	3.1%	2.2%

*Excluding Russia, Ukraine and China property issuers

Risk: Forecasts mentioned are not a reliable indicator of future results and should not be the sole factor of consideration when selecting a product or strategy.

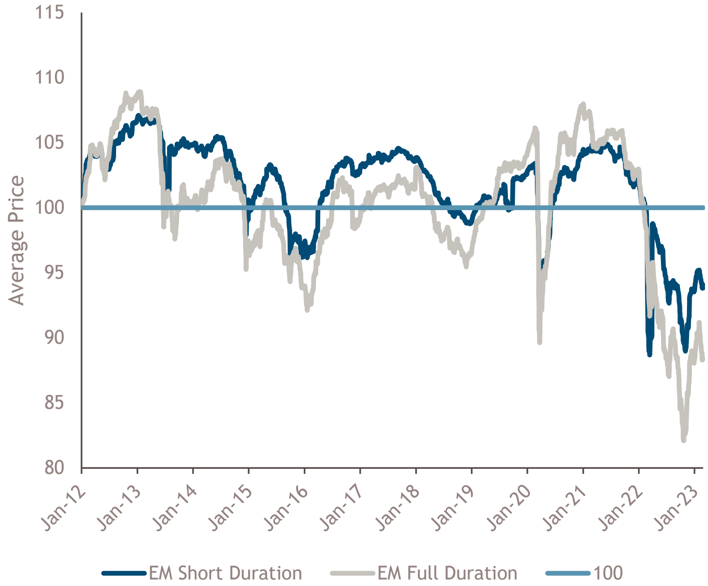
Source: JP Morgan report 'EM Corporate Default Monitor' published February 1st, 2023. For illustrative purposes only.

Opportunities in Short and Regular Duration Strategies

We saw significant outflows last year, however the tail risks that dominated 2022 are reversing and we are now seeing a robust technical backdrop with inflows resuming (given investor underweights in EM) combined with expectations of another year of net negative supply. These factors make for a strong technical backdrop.

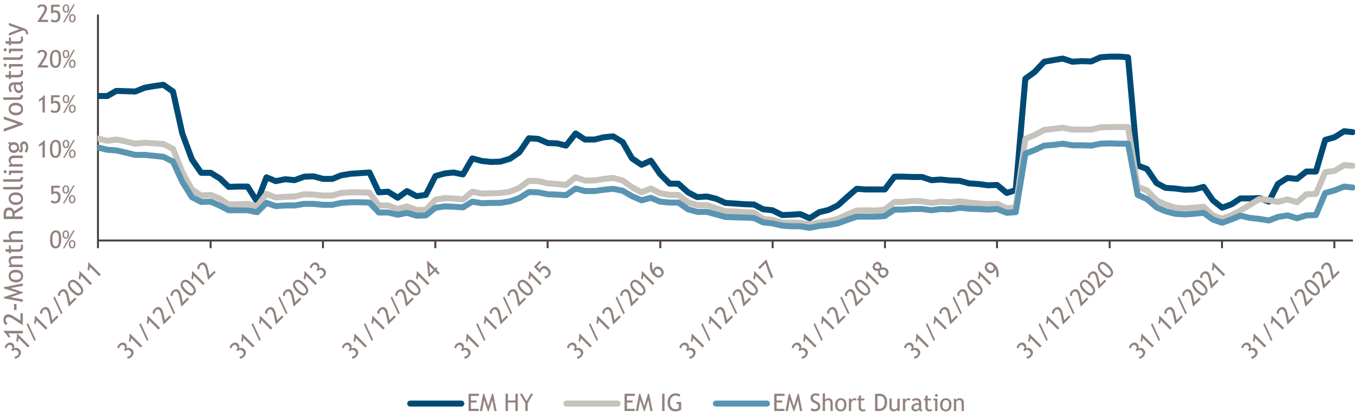
Given the price moves we have seen over the last year or so, lower prices are offering a good entry point; with many bonds priced below par, investors in short duration strategies can already seek to harvest capital gains due to the pull to par effect from the bonds as they approach maturity. Bonds in this segment also exhibit less volatility (Fig. 6).

Fig. 5 – EM Indices Priced Below Par



Source: ICE Index Platform data as of February 28th, 2023. EM Short Duration: ICE Custom Q690 Index. EM Full Duration: ICE BofA US Emerging Markets Liquid Corporate Plus Index. Indices selected as best available proxies to show average price of the respective markets. For illustrative purposes only

Fig. 6 – Lower Volatility in Short Duration



Source: ICE Index Platform. Data as of February 28th 2023. For illustrative purposes only, not to be construed as investment advice. EMHY – ICE BofA High Yield US Emerging Markets Liquid Corporate Plus Index (EMHB). EM IG – ICE BofA High Grade Emerging Markets Corporate Plus Index (EMIB). EM Short Duration - ICE BofA Custom Emerging Markets Short Duration Index (Q690). Volatility is calculated on monthly total returns excluding Russian holdings for each index. Indices selected as best available proxy to measure relative performance of asset sub-classes.

These opportunities, with appealingly high coupons, are available across the investment grade and high yield ratings segments. We believe, however, that is it important to focus on better quality credits which offer a stronger risk/reward profile than lower quality issuers. In order to better control risk, we currently favour short duration bonds which exhibit lower volatility but recognise the potential of longer-duration bonds once central banks start thinking of reducing rates.

Index Descriptions

Q690 – The ICE BofA ML Custom Emerging Markets Short Duration Index tracks the performance of short term US dollar and euro denominated emerging **markets non-sovereign debt publicly issued in the major domestic and eurobond markets.**

EMHB – The ICE BofA High Yield Emerging Markets Corporate Plus Index is a subset of the ICE BofA ML Emerging Markets Corporate Plus Index (EMCB) including all securities rated BB1 or lower.

EMIB – The ICE BofA High Grade Emerging Markets Corporate Plus Index is a subset of the ICE BofA ML Emerging Markets Corporate Plus Index (EMCB) including all securities rated AAA through BBB3, inclusive.

EMCL - The ICE BofA ML US Emerging Markets Liquid Corporate Plus Index tracks the performance of the U.S. dollar denominated emerging markets non-sovereign debt publicly issued in the major domestic and eurobond markets. Qualifying issuers must have risk exposure to countries other than members of the FX G10, all Western European countries, and territories of the U.S. and Western European countries.

Important Information