NCRAM Emerging Market Hard Currency 2024 Outlook – Midyear Update

Connecting Markets East & West

MAY 2024

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Overview

- We expect EM hard currency bonds to deliver attractive returns over the next twelve months given the relatively high all-in yields and coupons.
- EM economic growth remains supportive with a more resilient than anticipated US economy and China taking some measures to boost growth
- Key corporate credit metrics remain solid near decade-peak levels, while default rates continue to normalize and technical factors are favorable
- Valuations remain compelling, particularly in EM high yield credits, while strong market technicals continue to favor the credit spread tightening narrative in the EM corporate segment

A brief foreword along with a critical assessment of our 2024 Outlook published in December 2023

Emerging markets hard currency strategies have posted strong returns year-to-date despite a higher US interest rate environment as inflation pressures have proven to be more resilient than expected. Emerging markets hard currency sovereigns have generated a total return of +2.05% year-to-date (JP Morgan EM Bond Index Global as of May 16, 2024), while broad spectrum emerging market corporates have posted a return of +2.95% (JP Morgan Corporate EM Bond Index Broad Diversified). More notably, the high yield buckets of these sovereign and corporate indices have outperformed with returns of +6.06% and +5.30%, respectively.

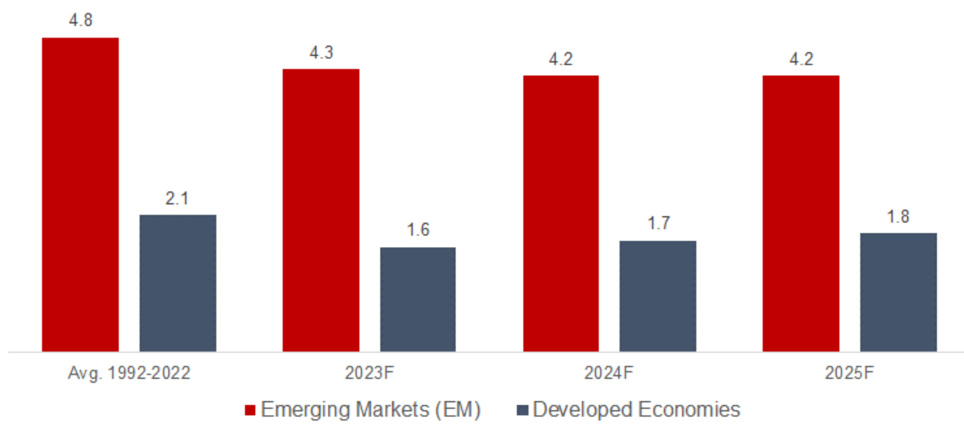
As we update our outlook, we think it is important to begin by grading our last outlook – asking ourselves what did we get right, and where did we miss the mark. Thankfully, the report card is a good one. The supportive sovereign storyline has played out as we expected, anchored by resilient growth, solid credit metrics, and benign election results so far in an election heavy year. Meanwhile, corporate credit fundamentals remain constructive, as evidenced by a default rate trend below the long-term average. We had also flagged that market technicals would remain highly supportive, and we continue to see evidence of that as well, particularly for the corporate segment. However, this is also where we didn't get it quite right so far, as we had hoped positive market momentum would open the door for inflows into the asset class. That prediction has not materialized yet, which we attribute in part to the broader challenges in fixed income assets given inflation headwinds. Still, we remain confident that the relative valuations and outperformance of emerging market hard currency strategies versus other fixed income asset classes will ultimately attract the investor attention it deserves. As such, we are optimistic that inflows will materialize. Finally, our total return outlook has remained largely unchanged as credit spreads have tightened more than expected, comfortably absorbing higher US interest rates.

Supportive Sovereign Storyline

EM GDP growth is expected to remain at around 4.2% in 2024-25, while sovereign fiscal and primary deficits should stay in line with 2023 levels at around 5.6% and 3.4% of GDP, respectively. In net terms, sovereign debt-to-GDP ratios in EM economies remain above the past ten-year average (as a result of the pandemic), but contained below 50%. US economic resilience in the face of higher interest rates, reversal of monetary tightening in many large EM countries, and measures aimed at stabilizing economic growth and property in China bode well for the EM growth outlook. Elevated commodity prices have also positively impacted many EM credits.

In line with our expectations at the beginning of this year, EM elections so far have not brought major changes in the political landscape or altered economic policy meaningfully. While some important elections remain in the 2024 pipeline (Mexico, South Africa, final stages in India), it does not appear that results will shift the trajectories of the major EM economies. Probably more relevant for EM will be the US presidential elections in November. However, surprises should be limited, as we note that major trade policies have found bi-partisan backing from Democrats and Republicans, including momentum for tariffs on Chinese imports and a constructive approach to renegotiation of the USMCA with Mexico and Canada, which is up for review in 2026.

Real GDP Growth in EM and Developed Economies (YoY%)

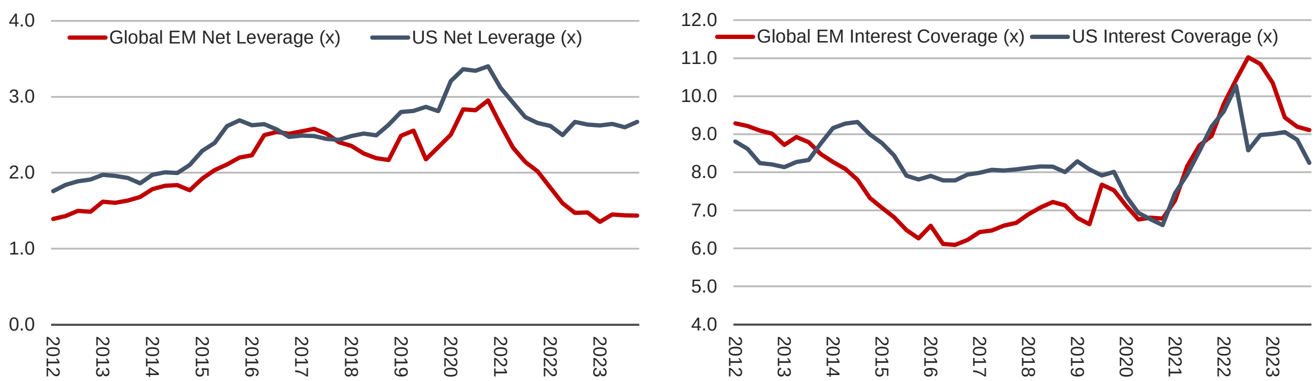


Source: IMF, World Economic Outlook, April 2024

Resilient Corporate Credit Fundamentals

The fundamental backdrop for EM corporates remains favorable. Key credit metrics such as net leverage, interest coverage, and liquidity remain near a decade peak in terms of quality. From a macroeconomic perspective, the ongoing high nominal growth environment in EM remains a supportive factor for credit.

EM Corporates: Net Leverage and Interest Coverage



Source: ICE BofA, as of December 2023

Declining Defaults

After two years of elevated default rates, driven mainly by the Chinese property sector and Russia, we have continued to see evidence of default rates normalizing, in line with longer-term averages. We now expect a 1.4% default rate for EM corporates and no more than 1.0% for EM sovereigns in 2024. Only a small number of issuers in select sectors such as telecommunications, airlines in some Latin American countries, and certain Chinese high yield companies have either defaulted or conducted distressed exchanges so far in 2024, for an overall default rate of 0.7% among EM high yield issuers and only 0.2% for the broad corporate market. Meanwhile, in the sovereign space, we now anticipate a lower default rate as compared to six months ago as Egypt managed to secure large investments and avert the risk of defaulting.

EM Historical Defaults: Expect Low Default Rates in 2024, In-line with Long-term Averages

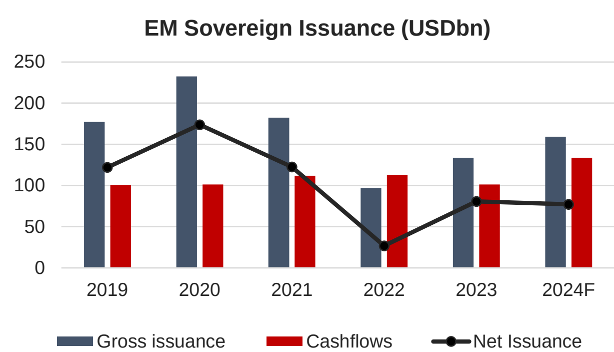
EM Corporates	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024F	2024YTD	10y Avg.
Asia	1.5	3.1	1.0	1.0	2.5	1.8	3.4	13.3	16.8	10.0	4.5	0.9	5.1
EM Europe	4.0	2.5	3.6	3.6	0.0	0.0	3.3	0.0	31.4	20.8	3.0	0.0	6.5
Latin America	6.5	5.7	9.2	2.0	2.1	2.3	4.4	2.5	3.7	5.4	5.6	1.1	4.9
ME & Africa	4.6	4.0	5.7	3.2	0.0	1.8	2.1	0.0	0.6	0.0	0.5	0.0	2.0
% EM IG & HY bonds (*)	**1.2**	**1.4**	**2.0**	**0.8**	**0.7**	**0.7**	**1.4**	**2.9**	**5.7**	**3.0**	**1.4**	**0.2**	**1.9**
EM Sovereigns	**2014**	**2015**	**2016**	**2017**	**2018**	**2019**	**2020**	**2021**	**2022**	**2023**	**2024F**	**2024YTD**	**10y Avg.**
% EM IG & HY bonds (*)	**5.5**	**2.3**	**0.0**	**0.2**	**0.1**	**0.0**	**10.2**	**0.1**	**5.1**	**0.9**	**1.0**	**0.0**	**2.3**

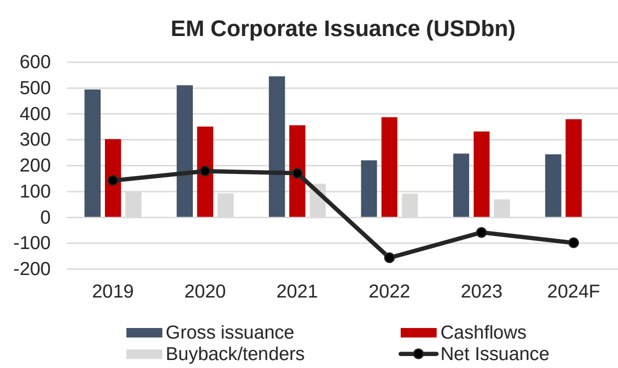
**Excludes 100% quasi-sovereigns*
Sources: NCRAM and JPMorgan, as of April 2024

Strong Market Technicals

As we noted in our last outlook, we continue to expect market technical factors to remain highly constructive in 2024. Strong balance sheets, healthy cash flows, and conservative liquidity profiles position corporate issuers to stay selective and opportunistic in tapping the external debt markets, particularly as access to alternative sources of funding, such as local bond markets, have become more viable. Net new external debt issuance from EM corporates has been negative for the past two years, a trend expected to continue for the remainder of 2024. Meanwhile, net new issuance from EM sovereigns should remain positive this year, but well below historical averages. Notably, despite a higher-for-longer interest rate environment, even some B and CCC-rated sovereigns have been able to access capital markets in 2024. Finally, while inflows into EM fixed income have not yet materialized this year as we had expected, moderate realized outflows from EM dedicated funds have not soured investment performance. Some crossover flows have been deployed to our asset class, and we would expect inflows into emerging markets to resume once disinflation makes more progress in the US, allowing the Fed to cut interest rates.

EM Net Issuance is Supportive for Technicals:





Source: JPMorgan, as of May 2024

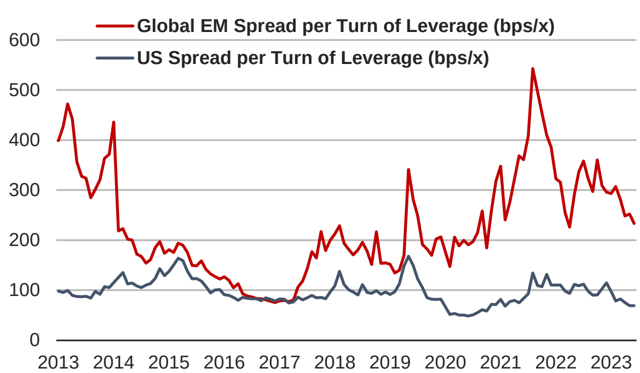
New Themes Offer Alpha Opportunities

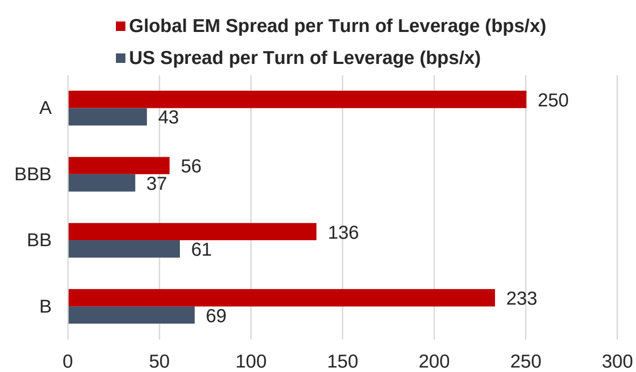
We continue to see a range of interesting themes developing in the EM credit markets. More companies are proactively pursuing "self-help" initiatives to improve credit profiles. Specifically, we have seen a number of issuers receive support from development financial institutions providing funding on concessionary terms, a trend we believe will continue. Other companies have tendered for outstanding debt, and extended maturities through a combination of cash and longer dated new bonds. As for sovereign credits, markets have remained open even for some small CCC-rated issuers, and countries with limited or no market access have been able to obtain financing from multilaterals and other official creditors for specifically earmarked projects. Debt restructuring proposals are taking shape for some small countries that defaulted in 2022, and certain large EM countries with mature capital markets began easing rates in late 2023 (Brazil, Chile, Peru, Poland) or 2024 (Mexico), which has reduced local market financing costs.

Valuations Remain Compelling

Against a strong fundamental backdrop, we expect attractive returns relative to other credit asset classes on a through-the-cycle basis. For corporate credit, spread per turn of leverage, a metric helpful to understand the risk premium relative to financial risk assumed, remains elevated in both absolute terms and relative to the US corporate bond market. For example, investors receive a spread of 233 bps per turn of leverage for B-rated emerging market corporates, versus only 69 bps in US credits. A return to historical levels offers the potential for significant spread tightening. Meanwhile in the sovereign segment, all-in yields in the investment grade space look attractive at around 5.5%, but spreads remain near historically tight levels, leaving most of the spread opportunity to the high yield segment, where average yields are still available in the double-digit space and there are some alpha opportunities in CCCs. From a simple carry perspective, even before potential capital appreciation, average coupons around 5% in both emerging market corporate and sovereign credits provide investors with a steady source of income.

EM Corporate Valuations: Spread per Turn of Leverage





Source: BofA, as of April 2024

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