NCRAM Emerging Market Hard Currency 2025 Outlook

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Overview

- We expect EM hard currency bonds to deliver attractive returns in 2025
- US Trade Policy will be in focus but unlikely to cause broad based headwinds
- Corporate credit metrics remain strong and default rates look to dip even lower in 2025
- EM Credit spreads narrowed significantly in 2024, but have lagged developed markets post US elections; we expect this gap to narrow again in 2025, particularly in BB and single B rating categories

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

As we think about our 2025 outlook, we begin with first assessing our 2024 outlook. What did we get right, and where did we miss the mark?

We called for high single digit returns for the full spectrum EM Hard Currency strategies. With 2024 aggregate returns averaging 7% for the broader hard currency blended strategies and 12-13% for EM HY, we are close to where we thought we should be. In fact, had it not been for December's sharp sell-off in US interest rates, we would have seen meaningfully higher full-year returns. In short, 2024 was a good year for EM hard currency fixed income and follows an even stronger result in 2023.

While higher full-year returns across the board would have been nice, we actually like this outcome better. Why? Because the asset class not only weathered high interest rate volatility well, but it also proved to be less volatile than US Treasuries during that period. Who would have ever expected EM to be less volatile than US Government Bonds? As provocative as that question may sound, we would argue that the asset class did precisely what it was supposed to do by using its credit spread premium to function as a shock absorber and dampen the interest rate volatility.

Aside from that, our 2024 outlook ended up ticking all the right boxes. Admittedly, apart from an election heavy calendar, it was not a particularly eventful year. As we like to say, "*Boring is good in Emerging Markets!*"

The supportive sovereign storyline remained firmly in place. Resilient growth, solid credit metrics, and EM election results in line with expectations continued to be evident throughout the year.

Meanwhile, we had flagged the strength of often underappreciated corporate credit fundamentals. These factors continue to set this asset class apart from its DM peers. Not only were default rates below expectations, but they are on a path to dip even lower in 2025. A similar undertone supported the sovereign segment, where there were no defaults in 2024, upgrades outpaced downgrades, and several countries emerged from restructurings.

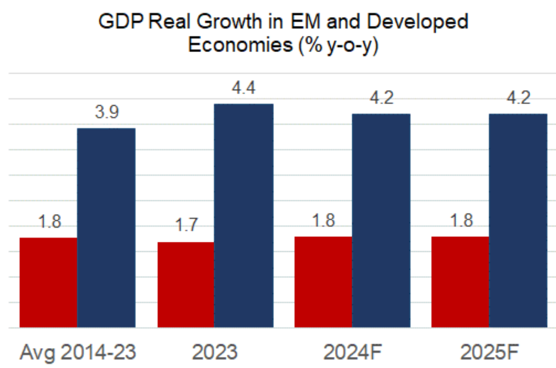
Technicals remained generally supportive despite limited evidence of direct inflows. Flow data is historically imperfect and covers only a small segment of the asset class. Hence, we attach only limited weight to the available imperfect data. Gauging by heavy primary market activity, demand for new deals, secondary market performance, and net new issuance, market technicals were strong. We remain confident that relative value and the strong performance of EM hard currency strategies will attract further investor attention in 2025.

Supportive Sovereign Storyline

EM GDP growth is expected to remain steady at around 4% in 2025, despite the China slowdown, while sovereign fiscal and primary deficits should improve marginally from 2024 levels. Sovereign debt ratios in EM economies are elevated relative to the most recent 10-years of data, but contained below 50% of GDP on average. Higher commodity prices have positively affected many EM credits, while lower oil prices impact some countries negatively, but help heavy oil importers. Uncertainly on tariffs pose potential downside risks for large US trading partners like Mexico and China, but we think FX adjustment and reasonable compromises on US demands should mitigate some of the negative effect if tariff threats materialize.

In line with our expectations, EM elections in 2024 brought no major changes in the political landscape or altered economic policies materially. The 2025 election calendar is relatively light with only a few countries in the pipeline (Philippines, Chile, Ecuador, Ivory Coast, Jamaica and Honduras among them, with legislative polls in other countries like Argentina). Probably more relevant will be the response of China, Mexico and other countries to potential new US tariff threats and the developments in the Middle East and Ukraine. Muscular trade policies towards China have enjoyed bi-partisan backing in the US on the grounds of national security issues, while in the case of Mexico and Canada, tariff threats appear more targeted to secure support from these countries on specific areas like illegal immigration and illicit trade rather than balance of trade objectives per se (the USMCA agreement is set for review in 2026).

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

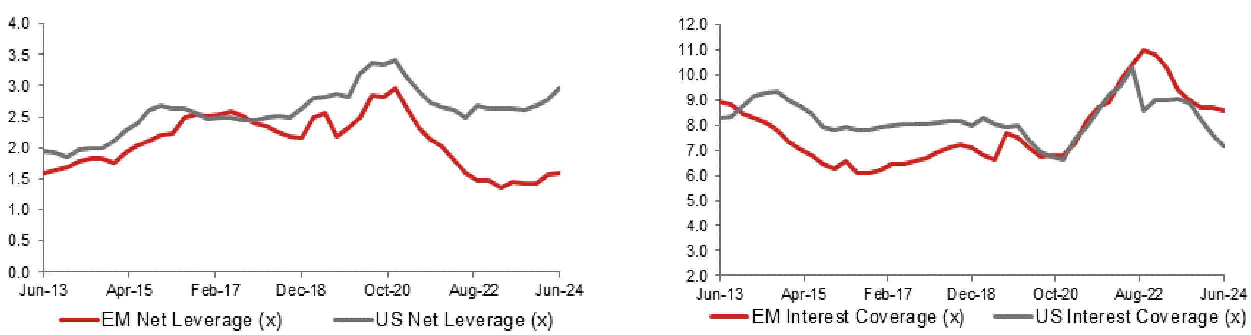


Source: IMF, World Economic Outlook, October 2024

Resilient Corporate Credit Fundamentals

EM corporates withstood any potential concern that the strong fundamental backdrop post-Covid would deteriorate again. In general, key credit metrics have proven to be stable and resilient. The main exception has been in the high-yield oil and gas sector. Despite fears of an economic growth slowdown, both nominal and real growth have remained elevated. The normalization of policy interest rates as well as a healthy demand for credit has provided for a favorable refinancing environment that many corporates have taken advantage of to refinance upcoming maturities early, further reducing near-term risks.

EM Corporates: Net Leverage and Interest Coverage



Source: ICE BofA, financials data as of June 2024

Declining Defaults

Extraordinary EM default rates remain in the rearview-mirror, with moderate defaults experienced in 2024 and a benign 2025 outlook. After elevated default rates post COVID between 2020 and 2022, driven mainly by the Chinese property sector and Russia, defaults in EM Corporates were less than 2% for the overall EM HY and EM IG universe and less than 4% within the EM high-yield bucket. Only a small number of issuers in select sectors such as telecommunications, airlines in some Latin American countries, and certain Chinese high yield companies either defaulted or conducted distressed exchanges in 2024. For 2025, the rate should be less than 1%, with main potential risks in the oil & gas sector. Any marked decline in the oil price could lead to a pick-up in credit stress for high-yield oil and gas issuers, even as the total number of affected index issuers would be benign. Anticipating potentially elevated risks, we have pared back our exposure to this sector going into next year

Meanwhile, in the sovereign space, no new sovereign defaults materialized in 2024. Countries including Ukraine, Ghana and Sri-Lanka successfully completed debt restructurings, while some other high-yield credits like Ecuador, El Salvador and Nigeria managed to conduct debt liability management in the capital markets.

EM Historical Defaults: Expect Low Default Rates to Continue in 2025

EM Corporates	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025F	10y Avg.
Asia	3.1	1.0	1.0	2.5	1.8	3.4	13.3	16.9	10.0	4.7	3.0	5.4
EM Europe	2.5	3.6	3.6	0.0	0.0	3.3	0.0	32.0	20.8	0.5	2.8	6.4
Latin America	5.7	9.2	2.0	2.1	2.3	4.4	2.5	3.7	5.4	4.6	3.4	4.4
ME & Africa	4.0	5.7	3.2	0.0	1.8	2.1	0.0	0.6	0.0	1.0	0.5	2.1
% EM HY universe (*)	3.8	5.1	2.2	1.6	1.7	3.5	7.1	14.2	8.7	3.5	2.7	5.0
% EM IG & HY bonds (*)	**1.4**	**2.0**	**0.8**	**0.7**	**0.7**	**1.4**	**2.9**	**5.7**	**3.0**	**1.2**	**0.9**	**1.9**
EM Sovereigns	**2015**	**2016**	**2017**	**2018**	**2019**	**2020**	**2021**	**2022**	**2023**	**2024**	**2025F**	**10y Avg.**
% EM IG & HY bonds (*)	**2.3**	**0.0**	**0.2**	**0.1**	**0.0**	**10.2**	**0.1**	**5.1**	**1.0**	**NA**	**NA**	**2.4**

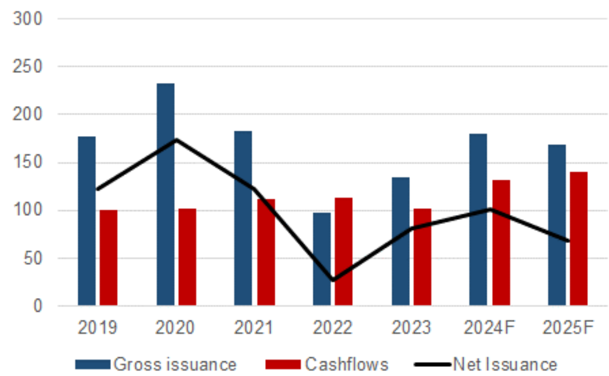
**Excludes 100% quasi-sovereigns*
Sources: NCRAM and JPMorgan, as of December 2024

Strong Market Technicals

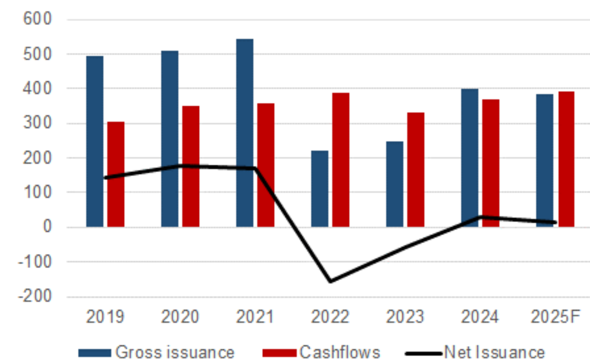
We continue to expect market technical factors to remain highly constructive in 2025. Strong balance sheets, healthy cash flows, and conservative liquidity profiles position corporate issuers to be selective and opportunistic in tapping the external debt markets, particularly as access to alternative sources of funding, such as local bond markets, have become more viable. New EM corporate debt issuance net of amortizations was negative during 2022-2023 and turned positive in 2024 to around $29bn, according to JPMorgan, who expect net issuance to decline to less than $20bn in 2025. Meanwhile, net new issuance from EM sovereigns should remain positive in 2025 at about $70bn, well below historical averages and down vs. 2024. Notably, despite a higher-for-longer interest rate environment, even some B and CCC-rated sovereigns were able to access capital markets in 2024. Finally, while inflows into dedicated EM fixed income products did not materialize in 2024, outflows from EM funds have not soured investment performance. Crossover flows became more pronounced throughout the year, and we would expect inflows into emerging markets to become evident in 2025.

Net Issuance Remains Supportive for Technicals:

EM Sovereigns



EM Corporates

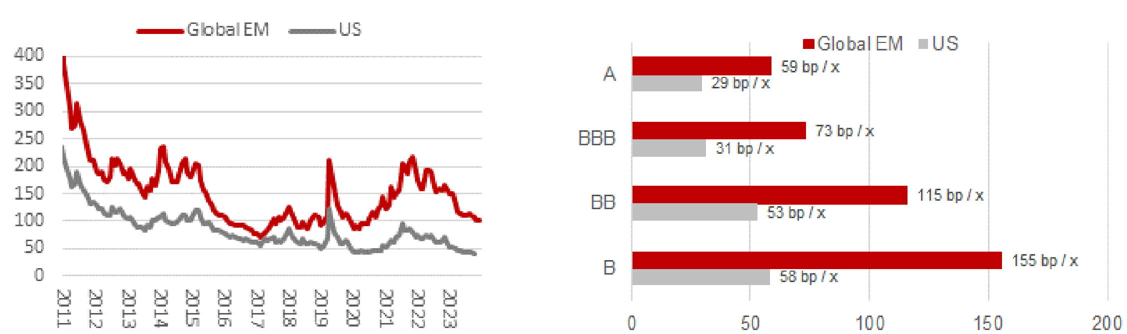


Source: JPMorgan, as of December 2024

Valuations Remain Compelling vs. Developed Markets

In line with the spread tightening in global credit markets, EM valuations also compressed meaningfully in 2024. This spread decline reflects the supportive backdrop of a soft landing economic environment, limited net issuance of EM corporate issuers, a strong fundamental backdrop, and 2024's attractive starting point in terms of yields. While the spread outlook offers significantly less potential for tightening, several positive features keep us constructive on EM debt. All aforementioned fundamental factors – a stable growth outlook, limited net issuance, strong fundamental backdrop – remain supportive. Although spreads are in the lower percentiles of their historical distribution, we note that duration is lower and credit quality higher relative to most of EM corporates' history. For example, the current duration of our index stands at 4.2, compared to as much as 5.1 at the end of 2010, and although spreads are tight, all-in yields remain elevated. We believe that this combined environment of relatively low duration, strong credit-quality with an investment-grade average rating, and high carry, remains an interesting proposition for investors. Meanwhile in the sovereign segment, investment grade spreads also remain near historically tight levels, leaving most of the spread opportunity to the high yield segment, where average yields are still in the high-single or double-digit space.

EM Corporate Valuations: Spread per Turn of Leverage



Source: BofA, Spreads data as of November 2024; financials as of June 2024

Total Return Outlook

Attractive returns over the next twelve months in both the sovereign and the corporate segments is our base case scenario, driven by current valuations and our overall market outlook (soft landing in the US). We note that higher returns are still within reach in a scenario where US inflation decelerates more rapidly and allows the Fed to cut rates further.

EM Corporates: 1-year Forward Index Return Scenarios including Carry

Overall CEMBI BD Index							
5y UST / Sprd	175	200	225	250	275	300	325
3.25	13.1	12.0	10.9	9.8	8.7	7.6	6.6
3.50	12.0	10.9	9.8	8.7	7.6	6.6	5.5
3.75	10.9	9.8	8.7	7.6	6.6	5.5	4.4
4.00	9.8	8.7	7.6	6.6	5.5	4.4	3.3
4.25	8.7	7.6	6.6	5.5	4.4	3.3	2.2
4.50	7.6	6.6	5.5	4.4	3.3	2.2	1.1
4.75	6.6	5.5	4.4	3.3	2.2	1.1	0.0

Sources: NCRAM, JPMorgan Corporate Emerging Market Bond Index Broad Diversified (CEMBI BD), as of December 31, 2024

EM Sovereigns: 1-year Forward Index Return Scenarios including Carry

Overall EMBIG Index							
10y UST / Sprd	225	250	275	300	325	350	375
3.50	18.1	16.3	14.6	12.8	11.1	9.3	7.6
3.75	16.3	14.6	12.8	11.1	9.3	7.6	5.8
4.00	14.6	12.8	11.1	9.3	7.6	5.8	4.1
4.25	12.8	11.1	9.3	7.6	5.8	4.1	2.3
4.50	11.1	9.3	7.6	5.8	4.1	2.3	0.6
4.75	9.3	7.6	5.8	4.1	2.3	0.6	-1.2
5.00	7.6	5.8	4.1	2.3	0.6	-1.2	-2.9

Sources: NCRAM, JPMorgan Emerging Markets Bond Index Global (EMBIG), as of December 31, 2024

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