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BlackRock.

EMD: Are we there yet? Not yet

Outlook and Strategy

The EM macro backdrop has markedly deteriorated. Despite tighter financial conditions, global labor markets (and wage pressures) have proved resilient, wage growth is uncomfortably high, and supply disruptions have been slow to heal. Not surprisingly, global inflationary pressures are becoming stubbornly entrenched. Global central bankers have moved into overdrive signaling no pause until the inflation beast is slayed. The market now expects DM terminal rates to rise from 0% at the end 2021 to 3.30% by mid-2023. Forward markets suggest little easing thereafter. The collateral damage from tighter conditions is becoming clear and a sharp economic slowdown now seems inevitable. The probability of a hard landing has gone up.

In such an environment, the bar for owning EM assets is high. We now believe that: 1. financial conditions may stay tight for longer than initially thought; 2. global growth—which is central to EM prospects—might likely turn sour under the weight of financial conditions; 3. market volatility may remain elevated reducing the risk-adjusted attractiveness of EM carry; and, finally, 4. the strong U.S. dollar trend seems entrenched and unlikely to reverse for now.

That said, there is a light at the end of the tunnel for EMD and we are already eying the time when we get back into the asset class more aggressively. We believe the all-in yield for most EM assets are at very attractive levels and have started to seriously compete with cash as an investment proposition. Even if yields and spreads remain at current levels for the next 12 months, the hypothetical return on EM assets will be quite positive (see Exhibit 5). A rally back to historical averages would mean even better returns. Second, the asset class seems under owned, primary market issuance has been at a record low, cash levels are elevated, and our proprietary positioning indicators suggest extreme bearishness among investors. Finally, EM policy makers have been, broadly, proactive, tightening fiscal and monetary policy, and/or engaging with the IMF on both the funding and policy advice sides. In the interim, we believe the front end of high-quality EM issuers presents attractive "safe carry" and, uncharacteristically, recommend investors to retain a more tactical approach to the trading style.

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Highlights

We believe the time to add to EM debt is getting closer after a year of large losses. Global uncertainties prevent us from getting excited just yet.

We remain cautious on EM debt until we gain conviction the global monetary tightening cycle is ending.

We see growing risk of developed market central banks overtightening to rein in inflation sparking a global recession

At around 9.8%, the all-in yield of EM is becoming increasingly attractive to us, suggesting our next move would be to add risk rather than further reduce

EM debt valuations have cheapened significantly – spreads are about 2.4 standard deviation above their 5-year average - and the asset class appears under-owned due to outflows from dedicated funds, EPFR data shows

BlackRock Emerging Markets Fixed Income
Investment professionals: 32
Average years of experience: 20 (Directors & MDs)
Assets under management USD 29 billion – as of September 2022

Source: BlackRock, JP Morgan EMBI, CEMBI, GBI-EM; Bloomberg; Goldman Sachs; IBOXX; MSCI, as of 18 October 2022. Any opinions and/or forecasts represent an assessment of the market environment at a specific time and is not intended to be a forecast of future events or a guarantee of future results. There is no guarantee that any forecasts made will come to pass.

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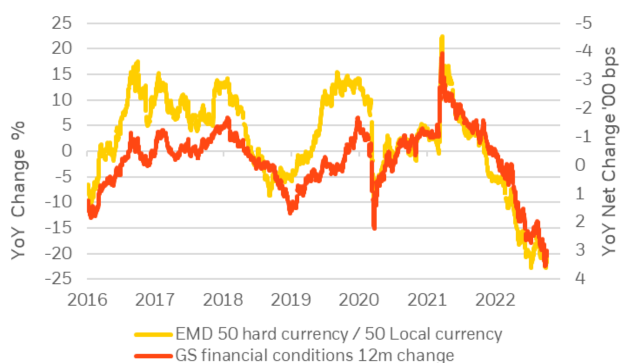
Whatever it breaks FCI tightening

In response to a surge in inflation, central banks around the world have raised interest rates by a cumulative of 210 basis points (bps) in developed (DM) and 380 bps in the emerging markets (EM), one of the sharpest tightening cycles of financial conditions (FCI) on record, as per GS Research data as of 18 October 2022. As of writing, the job does not seem done. Inflation remains elevated and labor markets unusually tight. The overall tone by central bankers is hawkish and markets are pricing in policy rates going even higher. Rate increases is one side of the action. Quantitative tightening by the Federal Reserve (Fed) and the Bank of England is also ongoing. As a result, U.S. 5-year real rates have increased by a dramatic 400 bps in less than a year, according to Bloomberg data, as of 18 October 2022—a move that in the past created collateral damage. We remain attentive to bouts of financial stability risk similar to what we recently saw in the Gilts market.

Inflation persistence and labor market resilience may pose a risk that central banks end up overdoing the tightening and the economy hits a hard landing. We do not yet see such a risk priced into risk assets. Financial conditions tend to lead economic data, thus further deterioration in economic data over the next few quarters is not impossible to see. A weaker economy could lead to even tighter financial conditions via weaker asset prices.

Emerging markets are highly sensitive to financial conditions (see Exhibit 1). EMD's large negative returns so far this year can be mapped to the rapid tightening of FCI. As of writing, hard currency sovereign bonds are down 24% (JPM EMBIGD index). Local EM bonds are down 18% (JPM GBI-EM index), explained partly by the 9% drop in EM FX vis-à-vis the U.S. Dollar, according to Bloomberg data as of 18 October 2022.

Exhibit 1. EM spreads and US financial conditions



Source: JPMorgan EMBIGD index spreads and Goldman Sachs US financial conditions index, as of 11 October 2022

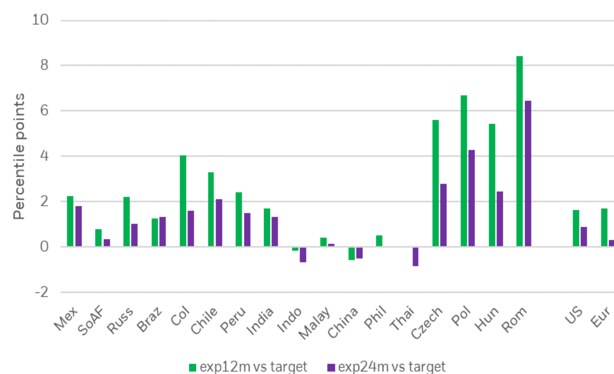
What do we need to see to turn bullish?

Ultimately, we would turn more bullish on EM assets, once we feel more comfortable that the end of the tightening cycle of financial conditions is near. In our mind, this depends on two interrelated variables: First, clear progress on the fight against inflation to allow for the end of the U.S. Fed hiking cycle, given its role as the main provider of global liquidity. Second, avoiding an economic hard landing. In this sense, we are not waiting for central banks to cut rates, but for confidence that the hawkish pursuit of global central banks is truly within reach, and that no significant damage to issuers' cashflows has taken place in the meantime.

In this regard, we have some good news. We view inflation as, at least, a product of post-pandemic supply shocks. We are comforted to see improvements in delivery times, supply backlogs, freight prices and other sentiment measures related to price formation. All those indicators are pointing to an improvement in bottlenecks formed during the Covid crisis. We believe U.S. inflation has peaked, yet disinflation appears still too slow. Separately, inflation is also a demand phenomenon; as the global economy slows down, inflation should, in theory, peak.

EM central banks, which have broadly been ahead of their developed brethren in waging the anti-inflation battle and are beginning to announce that they may be close to the end of their hiking cycles. Unlike the DM, ex-ante real rates (i.e., real rates adjusted for future inflation) are already at extremely elevated levels. This is the case for Brazil, Czech Republic, Poland, and Hungary. Others, such as Chile, Colombia and Mexico are arguably entering the last leg of tightening. Moreover, Asian central bankers, seeing more muted inflation, have had the luxury to hike less aggressively.

Exhibit 2. Inflation forecasts remains well above the respective central bank's targets



There is no guarantee that any forecasts made will come to pass.
Source: JPMorgan resesarch , as of 11 October 2022

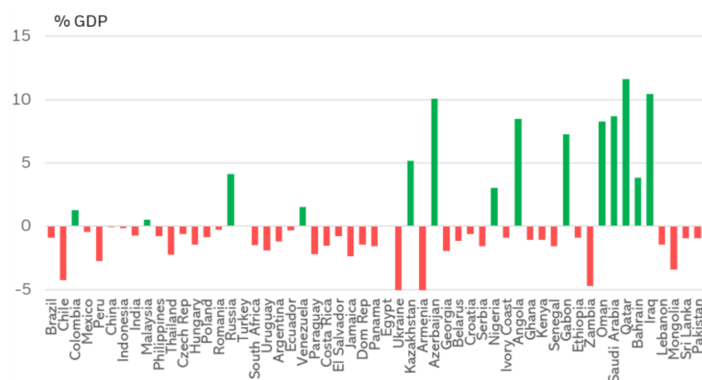
From good to mediocre growth, slowdown starts showing up in EM

After a solid start to the year, growth in EM (ex-China) is starting to slow down. The second quarter of the year saw below trend growth close to 2% driven primarily by the impact of the war in Ukraine/Russia, tighter domestic financial conditions, and negative spillovers from the Chinese COVID lockdowns. Monthly data available for 3Q confirm the slower growth momentum focused, particularly, on the manufacturing and export sectors.

The growth outlook for the next two quarters is expected to be mediocre with risks tilted to the downside. Our baseline assumes a weaker external pull to EM from developed economies in response to the rapid tightening in financial conditions. Downside risks emanate from sticky and high inflation that erodes consumers' purchasing power. China's outlook— central to the rest of EM—is uncertain. While we see its growth supported by base effects and some fiscal stimulus, the recovery could be incomplete because of the Zero Covid policy, the weakness in the property sector and by weaker external demand for Chinese exports.

We've recently been focused on the EM's external position. Following a strong improvement after the pandemic with current account balances ending 2021 in a surplus of 1.5% of GDP thanks to high commodity prices and subdued domestic demand, terms of trade have deteriorated for energy importers, leading to a large deficit in places like Colombia, Chile, CEEMEA and in some parts of Asia, according to JPMorgan data as of 18 October 2022. Higher funding needs for frontier markets are a source of concern. Most frontier markets are running sizable current account deficits that we believe might not be easy to finance given low market appetite for new issuance, and in some cases limited space to float their currencies.

Exhibit 3. Terms of trade deteriorate from most EMs



Source: Bloomberg , as of 18 October 2022

The state of EM valuations

EM valuations are cheap when viewed versus their own history. As 18 October 2022, the all-in yield of hard currency EM has reached levels not seen since 2008 (JPM EMBIGD index). Admittedly, a big part of this is due to the rise in core yields. Still, EM spreads are 1.5-to-2 standard deviations below their 1yr/3yr/5yr averages (see Exhibit 4). Importantly the "cheapness" is concentrated in lower part of the rating scale (BB and below). Spreads on high grade EM sovereigns still screens tight—within 15-20 bps of its 10yr lows. When compared against U.S. investment grade bonds, EM IG screens as uninteresting.

EM Local valuations are far more advanced and offer a significant cushion. However, major regional differences need to be kept in mind. A basket of 10yr LATAM local bonds (Brazil, Chile, Colombia and Mexico) offers a yield of 10.5%--levels rarely seen since 2000. Similarly, a basket of 10yr CEE + South Africa yield close to 11.3%, nearing highs. Asian yields, in contrast, have moved much less. EM FX valuations have been hostage to the USD performance. In nominal terms, the DXY alone is +25% since the lows of 2021, and 17% higher than where it began 2020 pre-pandemic, as per Bloomberg data as of 18 October 2022.

EM's "technicals" are favorable. We believe the asset class is under-owned, providing strong bounce back potential for when the conditions ripen. EM has experienced outflows at a historically elevated pace only seen during severe crisis periods. Year to date, we've seen around $62 billion USD in outflows, roughly equal split between hard and local currency debt, according to EPFR data. In addition, while most of the outflows have been retail driven, we've been seeing strategic outflows for the second consecutive quarter. Positioning within EM has not been this light in quite some time. Cash balances are at near local highs (+4.6%), JPMorgan data as of 18 October 2022 shows, while overall allocations to the asset class is toward the lower end of the past 1yr/3yr/5yr horizons. Finally, the primary market for EM debt has been largely closed meaning that net supply into the asset class has been significantly negative.

Exhibit 4. Hard currency spreads above past averages

	Spread	1yr std	1yr	3yr	5yr
	Basis points		z-score		
Hard currency	567	69	1.7	1.8	2.4
IG	201	24	1.1	0.5	0.6
BB	425	36	1.1	0.5	0.9
B	864	112	1.2	1.3	1.8
Local mkt yield	747	59	1.8	2.4	2.1

Indexes are unmanaged and do not account for fees. It is not possible to invest directly in an index. Source: BlackRock on JPMorgan EMBI Global Diversified and GBI-EM indices , as of 18 October 2022

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What to do?

The starting point for us is that all-in yields in EM are attractive and technicals are very supportive. That said, the fundamental backdrop (inflation, central bank hikes and likelihood of a slowdown/recession) does not justify an early jump into the asset class.

We derive four key investment implications from the current macro-market backdrop:

1. We want to stay patient and keep close to home: on duration, spreads, and USD. The value proposition in EM is clear to us but the time to engage in it is not yet.
2. That said, we see the "pain trade" as higher prices and, in the meantime, given yields, being in cash is no longer an easy option.
3. As such, we love the idea of adding carry but with a very strong preference for front end/low default probability names.
4. The bar for owning risky names is high. We are continuously underwriting those names and would need to have strong conviction that they can survive the cycle before adding.

Exhibit 5 shows potential EMD returns under different assumptions. These are not intended to be forecasts in any way, just straightforward mathematical derivations without any subjective probabilities assigned to them. In this sense, there are no guarantees that any of these scenarios may come to pass (methodology of calculation in the footnote of the Exhibit 5).

As seen, should hard currency spreads return to their average of the last year (a 1.5std ~ 100 bps reduction in spreads), the hard currency index would return around 13.2% including carry for a 12-month period assuming US 10-year Treasury yield remain unchanged at the 3.89% level it had by 11 October 2022. Any upward/downward move in U.S. yields lead to lower/higher returns. A more modest 0.5 standard-deviation downward correction in spreads would provide a yearly return of 8.6% for such given UST level.

In the case of the local markets, a similar exercise shows that 'curing' the recent cheapness through a 1.5 standard deviation drop in yields would derive a 12-month return of 11.4% for an unchanged level of EM FX vs the U.S. Dollar, including carry. Overall Exhibit 5 shows a high bar for another year of negative returns in EM, and a positive convexity in favor of positive returns that is getting increasingly harder to ignore.

Exhibit 5 – 12-months total return scenarios

Spread change (z-scores: 1 = 68bps)

UST10 yield change (bps)	+2.0	+1.5	+1.0	+0.5	Last: 566	-0.5	-1.0	-1.5
+90	-4.7	-3.4	-2.0	-0.5	1.1	2.9	4.8	6.8
+50	-3.0	-1.6	0.0	1.6	3.4	5.3	7.4	9.6
+25	-1.8	-0.3	1.3	3.1	4.9	7.0	9.1	11.4
Last:4.08	-0.6	1.0	2.7	4.5	6.5	8.6	10.9	13.2
-25	0.7	2.3	4.2	6.1	8.2	10.4	12.7	15.2
-50	2.0	3.8	5.7	7.7	9.9	12.2	14.6	17.2
-90	4.3	6.2	8.3	10.5	12.8	15.2	17.8	20.5

Methodology: Total return = current yield + duration * (Δ EMD spreads + Δ UST 10yr)

Local bond Yield changes (z-score: 1 = 59bps)

EM FX vs USD change (%)	+2.0	+1.5	+1.0	+0.5	Last: 7.48	-0.5	-1.0	-1.5
-7.5	-6.1	-4.7	-3.3	-1.9	-0.6	0.7	2.0	3.2
-5.0	-3.6	-2.1	-0.7	0.7	2.1	3.4	4.7	6.0
-2.5	-1.0	0.5	2.0	3.4	4.8	6.1	7.5	8.8
0.0	1.5	3.1	4.6	6.0	7.5	8.9	10.2	11.5
2.5	4.1	5.6	7.2	8.7	10.2	11.6	13.0	14.3
5.0	6.6	8.2	9.8	11.3	12.9	14.3	15.7	17.1
7.5	9.1	10.8	12.4	14.0	15.5	17.0	18.5	19.9

Methodology: Total return = current yield + duration * Δ LBYield + Δ EM FX vs USD

Source: BlackRock on JPMorgan EMBI Global Diversified and GBI-EM indices , as of 19 October 2022

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