2021 Emerging Markets Fixed Income Outlook: Assessing the external drivers

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A review of 2020

Despite the devastating human and economic toll caused by the COVID-19 pandemic across the globe, and in many emerging economies in particular, emerging market debt investors were rewarded with positive returns in 2020, with local currency, external sovereign and corporate bond indices posting returns in excess of 2.5%, 5% and 7%, respectively[1]. For us, this once again exemplifies the importance of assessing the external drivers for the asset class, as well as the country-specific factors, as ultimately it was how the world responded to the pandemic that mattered to emerging market investors in 2020.

The global financial response to the pandemic was, in short, unprecedented, with an estimated USD15 trillion[2] of stimulus measures from governments and central banks combined, well in excess of what was provided in 2008. US fiscal stimulus alone has easily surpassed USD 3 trillion, while the Federal Reserve also slashed rates to close to zero and expanded its asset purchases and liquidity provisions aggressively. This abundance of liquidity allowed financial market sentiment to recover and for investors to seek out higher yields in emerging market assets, in lieu of the mostly negative real yields in developed markets.

However, we have also seen significant differentiation among emerging markets, reminding us how important it is to take a selective approach when investing in the asset class. The Turkish lira once again struggled, exacerbated by a lack of tourist revenue during the summer months. In 2020 we witnessed once again, just as in 2018, how excessively loose monetary policy ultimately caused a sharp depreciation of the lira and double-digit rates of inflation. The Brazilian real wakened significantly over the course of the year, as the fumbling of the pandemic by President Jair Bolsonaro pushed the already stretched fiscal resources of the country to their limits. Russia was also the focus of several geopolitical flashpoints, with numerous allegations targeted at the state, including the poisoning of opposition leader Alexei Navalny, bounty payments to Afghan fighters, interference in US elections and a number of high profile cyber-attacks, whilst we also witnessed protests in neighbouring Belarus and conflict between Armenia and Azerbaijan.

Fortunately, we have also seen many emerging currencies perform well. China, after locking down the city of Wuhan for 76 days, appears to have come out of the pandemic relatively unscathed, with its economy functioning almost normally. Several countries in Asia have also benefitted from the insatiable demand for technological goods during the pandemic. Finally, we have also seen a surprisingly strong flow of remittance payments despite many migrant workers suffering job losses, as direct payments from host country governments have kept the money flowing back home.

[1] J.P. Morgan GBI-EM Global Diversified Composite Unhedged USD, J.P. Morgan EMBI Global Diversified Composite, J.P. Morgan Corporate EMBI Broad Diversified Composite.
[2] Reuters (https://uk.reuters.com/article/uk-health-coronavirus-cenbank-graphic/15-trillion-and-counting-global-stimulus-so-far-idUKKBN22N2EP)

Going into 2021

It was a rollercoaster year in 2020 for emerging debt, yet the assets ultimately provided another year of positive returns. Can we expect a repeat performance for 2021? The lower starting point for US Treasury yields is, unfortunately, unlikely to bolster the asset class to the same extent as it has in recent years. Yet sovereign spreads, despite tightening sharply in recent months, are still wider than their historical average, implying potential spread tightening as a source of positive returns. Furthermore, yields for both local currency and external debt still remain significantly higher than the developed market average, implying strong demand from yield-deprived investors elsewhere. As such, should developed market yields remain low, more capital should be deployed to emerging market fixed income assets. Finally, after a number of years of underperformance, we think that emerging market currencies remain materially undervalued in aggregate and could well boost the performance of local debt going forward.

The external factors that we consider critical to the outlook for emerging market debt in 2021, aside from valuation, include global monetary policy, fiscal policy and economic growth.

We do not expect a material change in monetary policy from major central banks in 2021 with economic activity, and hence inflation pressures, likely to remain subdued until later in the year, by which time the deployment of vaccines should start to yield a level of herd immunity. Hence, we expect the benign backdrop for global interest rates to facilitate ongoing capital flow to emerging fixed income.

While the size of fiscal policy in 2021 remains somewhat uncertain, we expect it will be expanded further in developed economies, particularly as it appears that monetary policy has been exhausted for many and additional stimulus measures are likely to be required to support individuals and businesses in the coming months. We believe that this increase in the stock of debt in developed economies is yet another factor that will keep global interest rates low and see capital flow to emerging fixed income.

Finally, the economic growth outlook looks brighter for 2021 but the timing of the recovery remains deeply uncertain and is dependent on successful vaccine deployment. For many emerging economies vaccines may not be available until late in the year. As such, the economic recovery may remain subdued and intermittent as many emerging economies continue to battle fresh waves of infections. This could be decisive for many countries which are dependent on human mobility, either directly via tourism, or indirectly via demand for energy commodities. Hence, while we remain optimistic of a recovery, we expect some delays and setbacks along the way.

Finally, we need to remain cognizant of the risks to our generally constructive outlook. As always with emerging markets, idiosyncratic factors can turn would-be winners into losers overnight. Key risks on our radar for 2021 include fiscal miscalculations, geopolitical flare-ups and social unrest.

The fiscal response has varied significantly across emerging economies, with many highly rated sovereigns with low debt burdens stimulating significantly (Central and Eastern Europe, Chile, Peru etc.) while some at risk of material ratings downgrades have acted prudently (Mexico, India, Colombia etc.), while both Brazil and South Africa are in an unenviable position of accelerating debt burdens and underwhelming growth prospects. Assessing the optimal fiscal response in 2021 to balance economic growth with financial stability concerns will remain a challenge.

Geopolitical tensions persist for many emerging countries and can often erupt without warning. US-China relations remain tense regardless of the change in US presidency, with bipartisan distrust towards China having risen significantly in the US in recent years, so this remains a potential flashpoint. Russia also appears intent on antagonizing its democratic rivals, and the risk of economic sanctions against Russia remains an ever-present threat. Meanwhile, Turkey is also riling its European neighbours by staking claims in the Eastern Mediterranean.

Finally, social tensions have gained prominence in many countries in recent years and is a risk no longer confined to low income countries, as income inequality has risen significantly, even for medium-income economies. The Arab Spring of December 2010 and riots in Chile in October 2019 both illustrate how suddenly underlying tensions can boil over. We are mindful of the risk of social unrest in a number of countries, such as Thailand, Colombia and Peru, and this heightened uncertainty may reduce their appeal to investors.

How we plan to act

Last year proved to be a year of relative winners and losers and we expect this trend to continue in 2021. As such, we maintain an active and selective approach to emerging fixed income. As a rule, we will continue to avoid exposure to countries whose economies are over reliant on commodity exports and/or excessive external financing, particularly where we do not see fair compensation for bearing such risks. However, after several years of lacklustre performance, emerging market currencies are finally starting to grab investors' attention as valuations look highly compelling. With this in mind, we continue to follow an approach combining proprietary top-down asset allocation with a detailed country-level assessment which we believe is the best approach to deliver attractive returns to emerging markets investors in the coming years.

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