RBC Global Asset Management

EM Debt: Our outlook for 2023

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"At the height of this pessimism, we are also starting to notice some early hints of potential stabilising."

After the annus horribilis of 2022, does it still pay to invest in EM?

Emerging markets have had a tough year in 2022, driven by a combination of three main factors:

- **Rising interest rates in the US** – resurgent economic activity following the depressed levels of the COVID era, and policy stimulus have led to higher CPI prints in the US, in turn causing a hawkish Fed to start an aggressively tighter monetary policy cycle. This has led to a stronger dollar and a net negative total return for many fixed income asset classes.
- **Russia's invasion of Ukraine** – the ensuing war has resulted in a significant surge in commodity prices and triggered a nearly 40 year high in non-core inflation in many parts of the world, also contributing to further upward pressure on rates.
- **Decimation of the real estate sector in China** – successive policy mistakes and strict credit tightening, as well as a stringent zero COVID policy, had a material impact on Chinese GDP growth.

As a result, we have witnessed a 2008 style sell off in the asset class, with an unprecedented amount of liquidity withdrawal (nearly $84bn as at end of October). The peak to trough drawdown in 2021-22 in Emerging Markets (EM) hard currency sovereign index has been 28%, which rivals the 29% sell-off we witnessed during the global financial crisis.

> "China appears to be more firmly seeking the path to reopen its economy and has developed a 16-point plan to support the property sector."

Yet at the height of this pessimism, we are also starting to notice some early hints of potential stabilising. In fact, the month of November provided some hope in that context. All three macro and idiosyncratic factors, described already, showed signs of turning:

- US CPI print has come in lower than expected leading to a strong rally in US treasuries. Euro CPI is also starting to surprise on the downside.
- Russia's withdrawal from Kherson, in our view, is the beginning of the end of this invasion and we now expect an end to this war, in one form or another, by the end of 2023. This has major consequence for the energy markets. In fact, most key energy and soft commodities are already materially below their peak.
- China appears to be more firmly seeking the path to reopen its economy and has developed a 16-point plan to support the property sector.

Yet, the rally is far from being secure or overdone. Given the high carry of the asset class (nearly 9% at the time of writing, the highest since 2009), we would expect the probability of a positive return from the EM hard currency sovereign index with a 12-month horizon to lie at 80%, with the mean return hovering around 9%. The outlook for long term investors holding onto this asset class for longer is even more attractive.

Equally as important, we sense that the technical factors have a strong chance of turning positive in 2023, with multiple institutional investors on the sidelines looking to allocate to this asset class. Should these inflows materialise, spread tightening could be significant. Yet we would caution investors that "catching the bottom" may prove elusive and indeed, further volatility cannot be discounted. The age-old approach of investing at attractive levels by small amounts and averaging out the overall investment should prove to be most rewarding.

In summary, we acknowledge that 2022 was a shock, driven by a confluence of major unfavourable factors. But in our view, 2023, the year of the water rabbit, according to the Chinese Zodiac, should prove to be more prosperous, with some of the major clouds on the horizon lifting gradually.

Christian Libralato
Portfolio Manager
BlueBay Fixed Income Team

> **"Idiosyncratic circumstances will play a large role in the ability of sovereigns to navigate the year and stay current on external debt."**

Won't default rates increase with higher US interest rates?

Sovereign credit

2022 evidenced that rising interest rates present a challenge to frontier credits, requiring a diversification of external funding sources away from Eurobonds that many had become accustomed to.

In 2023, as in 2022, this shouldn't mean a systemic set of defaults, because idiosyncratic circumstances will play a large role in the ability of sovereigns to navigate the year and stay current on external debt. Factors such as proactive policy, terms of trade, depth of local markets and access to IMF resources should insulate almost all issuers in 2023. That is not to say that the market will not continue to price a heightened risk of debt distress, with focus on policy and external funding needs in 2023 and beyond, especially in twin deficit countries such as Kenya, Pakistan and Egypt where orthodox policy and adhering to IMF programs will be important drivers.

Overall, for nations that regularly relied on relatively cheap Eurobond funding, fuelled by global liquidity, rising interest rates have seen many access IMF funding and begin to adjust policy to improve debt sustainability. Sovereigns such as Kenya have followed this path and have eased the burden for 2023. For issuers such as Sri Lanka and Ghana, the effect has been severe thanks to poor policy choices and proactively avoiding IMF policy prescription to access funding until it was too late. Sri Lanka defaulted, and Ghana will likely announce a debt restructure in order to belatedly secure IMF funding. In 2023, twin deficit nations will be most in focus.

Pakistan has large external funding needs relative to reserves in an election year where policy choices may falter and challenge its ability to stick to its IMF program. Egypt will similarly face large external funding needs and its ability to continue policy adjustment to secure ongoing IMF and bilateral financing will be closely watched. Kenya needs to stick to its IMF program to continue to unlock external resources and avoid a similar fate to Ghana ahead of large external debt maturities in 2024.

SSA Eurobond maturities in 2023 are relatively mild, easing the pressure somewhat on issuers who previously would look to market issuance to roll obligations. While 2023 may not see a stream of defaults, ongoing challenges will remain, and we observe that as debt maturities begin to grow in 2024-26, risks will be heightened should market issuance continue to be off the table at that time – however we note that is tail risk.

Overall, we take a case-by-case approach to rising default risk in 2023 and beyond with interest rates being one of the factors noted above. We observe that while there is a heightened risk of debt distress, much will depend on ongoing policy response and access to alternate funding, be it IFI or where bilateral relationships are key.

Sven Scholzle
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Won't default rates increase with higher US interest rates?

Corporate credit

We expect the Emerging Markets High Yield (EM HY) default rate to increase to 7.7% in 2023 but in order to understand the market impact, one must take a closer look. We expect by far the most defaults to come from China, Russia and Ukraine driven by a continuation of 2022 themes, namely the property downturn in China, the war in Ukraine and associated sanctions. Having said that, most of these bonds trade on average around 30c and so defaults are largely priced in already and would not come as a surprise. Outside these markets, our forecasted default rate is a benign 2.2%, which seems counterintuitive given higher funding costs and heightened recession risk. However, most EM corporates go into these challenges from a positive starting point, after a strong recovery post COVID and healthy aggregate leverage of 1.8x (JPMorgan).

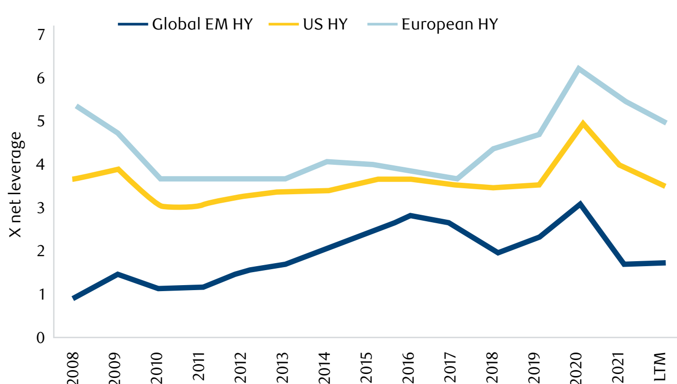
The strongest deceleration in profitability could be seen in commodity sectors, but again those benefitted from a particularly strong environment in the last 12-months and so have built buffers to withstand deterioration. And while in many major emerging markets growth is expected to slow in 2023, it will still stay positive.

As it concerns funding cost specifically, we don't believe they will be of overriding importance for defaults in 2023 yet. Despite lower issuance in 2022, High Yield (HY) maturities due in 2023 have reduced and most companies have access to domestic markets for funding if international markets are not open to them. In addition, most of the EM corporate bond universe is in fixed coupons. And lastly, highly levered and financially engineered balance sheets are far less common in EM than in Developed Markets (DM) HY. And so average funding cost will increase rather gradually and not severely impact cash flows immediately. But higher rates will eventually have a more meaningful impact in the coming years.

In any case, the above does not mean that there is no downside risk to default numbers as there remains uncertainty around the timing and severity of a recession, China's COVID policies and further geopolitical tension, to name a few, and in our downside scenarios defaults rise to 13.4% and beyond. Still, while headline defaults will likely persist at elevated levels going forward, the amount of bonds trading at distressed levels is the highest in over 10 years and negative surprise risk is reduced.

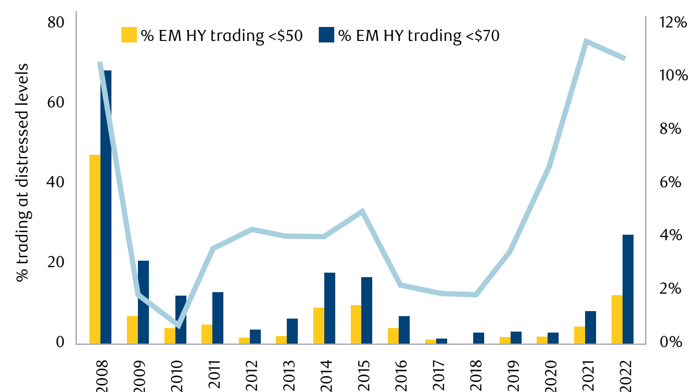
"While in many major emerging markets growth is expected to slow in 2023, it will still stay positive."

EM vs DM High Yield net leverage



Source: J.P. Morgan

Percent of EM HY at stressed/distressed levels



Source: J.P. Morgan

Graham Stock
EM Senior Sovereign Strategist
BlueBay Fixed Income Team

Anthony Kettle
Senior Portfolio Manager
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"Even a victorious Ukrainian expulsion of Russian forces is unlikely to restore Russian energy supplies to their traditional markets in Europe."

How will the moves in commodity prices in 2023 impact the market beta?

Emerging market returns are positively correlated with commodity prices (and therefore EM spreads are negatively correlated). This is because oil and gas producers account for around half of the market capitalisation of the EMBIG, led by the Persian Gulf states, Mexico, Colombia, Indonesia and Malaysia. Another 15% of the index consists of producers of other important commodities such as Chile and Peru (copper), Brazil (iron ore, soy, coffee) and South Africa (gold, platinum, coal). The correlation is volatile, and can even switch sign periodically, but we calculate that over the last twenty years a US$10 rise/fall in the price of oil is associated with 16bp of spread tightening/widening for the EMBIG as a whole.

There will be countervailing forces at play in commodity markets in 2023. On the one hand, likely recession in the US and Europe will weigh on demand and would ordinarily portend a very bleak outlook. On the other hand, even a victorious Ukrainian expulsion of Russian forces is unlikely to restore Russian energy supplies to their traditional markets in Europe, and the lifting of COVID restrictions in China should shore up demand there. Meanwhile, Saudi Arabia seems determined to use its dominance in OPEC to support oil prices even if demand does soften. For other key commodities, copper should likewise benefit from a modest Chinese recovery and ongoing energy transition demand, and soy prices are expected to remain close to historic highs.

On this basis, we continue to favour energy producers in the Persian Gulf, such as Oman and UAE, and in Latin America, including Mexico and Ecuador. Our positive view on Argentina is also boosted by the prospect of rising gas output from the Vaca Muerta shale deposits as the new Nestor Kirchner gas transport pipeline comes on stream around mid-year. Sanctions on Russia and the fallout from the Ukraine conflict will continue to complicate the energy supply picture for Europe in particular, so we are broadly underweight Central and Eastern European sovereigns.

In the absence of a significant further supply shock, global inflation pressures should continue to ease, particularly as demand slows in response to tighter monetary policy. We have already started to rotate into receiving positions in countries where central banks have moved fastest and furthest, such as Brazil and Mexico. We expect further opportunities to arise as we move into 2023.

We would also be conscious of the secondary impact of commodity price actions on corporate sectors. In particular, Turkey, which is highly exposed to energy price movements, exhibits higher pressure on financial services sectors at times of acute stress. From that perspective, we may leverage opportunities to express some of our commodity views through this sector as well, in particular in hedge fund strategies where shorting is permitted.

Vanessa Stevenson
Senior Corporate Analyst
BlueBay Fixed Income Team

"This was also a very important political year for the Chinese Communist Party which saw Xi Jinping consolidate his power."

Is China uninvestable after the policy mistakes in the real estate sector?

2022 witnessed an unprecedented shift in terms of macro policies in China with strict COVID controls leading to extensive and repeated lockdowns in a country which had been predominantly spared both in 2020 and 2021 relative to DM nations. The combination of lower economic growth because of zero COVID tolerance, continued regulatory pressure on the technology sector and the sharp downturn in the real estate sector resulted in significant dislocation in credit markets. The fact that policy makers held back any form of stimulus or support to the economy, despite mounting pressure, scared investors off with many claiming China to be un-investable.

This was also a very important political year for the Chinese Communist Party which saw Xi Jinping consolidate his power. With this big milestone event now behind us, where should we go from here? What has really changed? Over the past couple of weeks, we have seen the Chinese regulators pivot back towards ensuring more economic stability, potentially paving the way for a China-led recovery in 2023.

The first positive sign was a landmark agreement in September between the US and China allowing audit information of US listed Chinese issuers, a sign of possible economic detente between the two superpowers. Then in October, we observed a change of tone regarding COVID controls - perhaps more of a fine tuning of existing dynamic clearing policies than a broad re-opening; nevertheless a first step towards relaxation, with more expected in the year ahead.

Finally, in the middle of November the People's Bank of China (PBOC) announced a 16-point plan aimed at stabilising support for the real-estate sector within financial markets, followed by a Rmb1.3tn funding package sponsored by China's top six banks towards a mix of State-Owned and Private developers. This is too strong of a signal to ignore, and one which has contributed already to stabilising funding conditions after a rocky period. This also confirms the view that now the authority of the Chinese Communist Party (CCP) has been strengthened with the appointment of Xi's loyalist to the politburo, policy support can be implemented more forcefully. The above measures have also been supported by a steady reduction in core rates, with credit impulse expected to re-accelerate in the next 12-months, a stark contrast to the West.

Going forward, COVID policy is set to be the key driver for economic activity. Our expectation is for mixed signals to persist in the next three months with gradual improvements being made in the spring before witnessing a more tangible recovery in the second half of 2023. The recent positive market performance, especially in the real estate sector is already partially discounting the impact of these supportive measures, with more to come. China remains the second largest economy in the world and thus we anticipate a re-opening would have a significant impact on GDP growth in the second half. The central government is more conservative than what the past couple of months might have suggested and if Xi Jinping's speech at the 20th Party Congress meeting is of any guide, there is no intention to roll-back past economic reforms and return to the 60s. China is open for business.

Timothy Ash
EM Senior Sovereign Strategist
BlueBay Fixed Income Team

> "In our estimation, Russia has very low prospects of sustaining this conflict, and the longer it continues the more resources will have to be diverted from consumption to defence."

Will we see an end to the war in Ukraine in 2023? How will political developments in the US figure in the outcome?

Our base case is that the war in Ukraine comes to an early end, and very likely now ending in a defeat for Russia.

Admittedly, this is a relatively out of consensus view but, simply put, we see no path to victory for Russia in Ukraine and the longer the conflict continues, the worse the outcome for Russia.

Russia has already tried its best to conquer Ukraine, attempting a full-scale invasion in the weeks after the initial attack was launched on February 23. This all out strategy failed, confronted by a determined Ukrainian opposition, backed by Western military equipment and financing, and hindered by poor Russian tactics and equipment. Russia seems to have subsequently scaled back its objectives to annexing the four provinces of Kherson, Zaporizhiya, Luhansk and Donetsk.

However, a string of military defeats in Kharkiv and Kherson suggests that it will struggle to keep what territory it has taken in Ukraine thus far. Indeed, Ukraine will likely only receive improved training and equipment from the West as time develops, while Russia has already seen huge casualties, including around half the overall conventional force deployed to Ukraine. Sanctions will only make rebuilding lost military capability more challenging and make maintaining some kind of parity in the arms race with NATO that much more difficult. In our view, the demotivated and brutally exposed Russian troop formations face the risk of collapse over the winter months.

Recent developments suggest that Moscow is now eager to negotiate an end to the conflict, trying to retain any gains it has made and to sell this as some kind of victory at home. But with momentum on their side, there is little to suggest that the Ukrainians are willing to negotiate yet. We expect that they will be more likely to target pushing Russian forces back to positions occupied as of February 23, and only then enter negotiations over the future of Crimea and LPR and DPR.

In our estimation, Russia has very low prospects of sustaining this conflict, and the longer it continues the more resources will have to be diverted from consumption to defence. This means lower living standards, capital flight and a brain drain. There are also the rising risks of social and political unrest in Russia and, with this, a higher threat of ousting the Putin regime. This is the calculation that we think will be behind Moscow's motivation to end this conflict sooner, rather than later.

Western unity and state support, both in terms of finance and military equipment, has been critical so far in helping Ukraine counter the Russian attack. Indeed, in many ways, the threat from Russia, has created a common purpose and a rallying point/call amongst the West and NATO. Likewise, the recent US midterms have failed to change very much, as Congress remains dominated by an overwhelming majority who back Ukraine in the war with Russia. Indeed, from a US strategic perspective this war provides a great opportunity to erode the power of a global rival, at relatively little cost from the financial side, and little risk to US lives.

Jana Harvey
Senior Portfolio Manager
BlueBay Fixed Income Team

"We expect more innovative solutions this year to help Emerging Markets fund the mounting costs of climate mitigation and adaptation within their economies."

What ESG trends are we likely to see in 2023? How will this impact market behaviour?

We expect ESG topics to continue to gain importance for issuers, investors and asset owners alike in 2023. Whilst the Emerging Markets fixed income asset class experienced significant outflows this year, ESG Emerging Markets hard currency funds have actually recorded a net inflow YTD - showing that investors were happy to finance ESG aligned investments despite a difficult macroeconomic backdrop[1]. This is encouraging, although much greater sums need to be directed towards Emerging Markets to close the USD 3.7trl funding gap in annual financing needed to reach the UN Sustainable Development Goals (SGD) by 2030, according to OECD estimates. On the regulatory side, scrutiny of ESG investment processes as well as fund labels (under SFDR regulation, established to standardise sustainable product classifications) remained in full force. Whilst we expect disclosure requirements for fund managers to continue to grow in 2023 with the implementation of SFDR 2, we don't expect this to slow down the growth of AUM within this space.

Issuers meanwhile are taking note of growing investor appetite and we expect to see a continued pick-up in overall issuance as well as new entrants into the ESG labelled bond market in 2023, within both the corporate and sovereign space. From the Emerging Markets sovereign side, we anticipate ongoing issuance from the well-established names, such as Chile, whilst others are expected to make a debut issuance in the year ahead with Turkey and Israel both completing their sustainable/ green finance frameworks in preparation.

Within the High Yield space, the Maldives are expected to return to the green bond market, whilst Gabon is expected to launch its first international green bond this year to fund the construction of hydroelectric plants. A number of countries at the earlier stages of their development are eyeing Debt for Nature swap solutions after Belize completed such a swap in 2021 in meaningful size, thus reducing its debt/ GDP by 12%. Cabo Verde and Ecuador are presently in negotiations for similar arrangements and even Sri Lanka has been contemplating such a swap according to news reports. Other issuers are discussing a possible use of carbon credits in exchange for debt, creating carbon-backed bonds, but such solutions are still only in the discussion phase, given the early stages of the carbon market's development.

We expect more innovative solutions this year to help Emerging Markets fund the mounting costs of climate mitigation and adaptation within their economies, amidst what is still likely to remain a hostile market environment for high yield names. In this respect, the COP27 agreement on the new "Loss and Damage" Fund for vulnerable countries has been a positive development and we are expecting details to be ironed out in the coming year. Finally, Indonesia followed the example of South Africa by announcing yet another Just Energy Transition Partnership at the G20 summit, helping the country to mobilize USD 20bn over the next 3-5 years to accelerate a just energy transition. We expect other countries to follow.

[1] Source: Morgan Stanley Research, Where supply meets demand, as at 9 December 2022.

"Investors are also becoming more discerning about the quality of both SLB and Use of Proceed bonds, and we expect this scrutiny to intensify."

Coming back to the liquid market solutions, this year will be interesting as following the quick rise of Sustainability Linked Bonds (SLB) issuance in recent years, Enel, the first issuer of such a structure could see a coupon step-up in 2023, depending on whether it achieves its agreed KPI target. Last year was yet another milestone year for the SLB market as we saw the first sovereign SLB issuance from Chile, followed by the first sovereign SLB with a 'step-up, step-down' structure from Uruguay. This is a testament to the popularity of these instruments as well as innovation efforts from issuers to tailor them to their own needs. In this respect, investors are also becoming more discerning about the quality of both SLB and Use of Proceed bonds, and we expect this scrutiny to intensify. This should, in turn, result in higher performance differentiation amongst bonds, depending on the quality of the underlying structure.

We are already starting to see more ambitious SLBs outperforming peers and within the UoP bonds, we expect EU Green bond standard aligned securities to see increased greenium/demand as investors look to increase alignment of their portfolios to European taxonomies.

Over the last year, we have also witnessed a step-up in engagement efforts, bilateral as well as coordinated, through organisations such as the EMIA, demanding greater transparency and improved ESG related disclosures to enhance the still very poor data sets within Emerging Markets. This effort is paying off, being met with more data as well as increased focus from the issuer side. Whilst we are still a long way from having a complete, standardised set of disclosures within our universe, this is a positive trend and we expect to continue to play our part in its advancement.

Som Bhattacharya
Portfolio Manager
BlueBay Fixed Income Team

"We should start to see long term, strategic investors coming back to this asset class, albeit cautiously."

Given the outlook, which strategies would you recommend for investors looking for EMD allocations for 2023?

Our outlook for 2023 is quite constructive, but we acknowledge that there could be further volatility as some of the rebalancing factors are still in nascent stage. Furthermore, many investors have had a difficult year following a combination of steep equity market sell off, UK LDI related sell off and other policy headwinds. We should start to see long term, strategic investors coming back to this asset class, albeit cautiously.

Against this backdrop we would highlight some of the key strategies that investors may find suitable, depending on their specific requirements:

EM hard currency exposure – for investors who prefer hard currency exposure within EM, we would recommend our *Emerging Market Hard Currency Sovereign strategy*. With a duration of nearly 7yrs this sub-asset class has witnessed one of the largest drawdowns in 2022, but could benefit equally strongly should there be demand for duration in 2023. Likewise, our *Emerging Market Hard Currency Aggregate strategy*, with 5.5 yrs duration, invests in opportunities in both the EM sovereign and corporate sectors, offering exposure to a broader EM hard currency universe. For those investors who prefer lower duration exposure while still capturing the higher yields, our *Emerging Market Short Duration Aggregate strategy* could be the suitable alternative. The hard currency risk focus of these three strategies and their top decile performance should provide investors an attractive engagement within the EM space.

Blended exposure – investors looking to take advantage of all subsectors of asset classes in a volatility adjusted manner should consider our *EM Unconstrained strategy*. It has a strong credentials in protecting against the downside (nearly 50% downside protection in 2022) but equally strong in capturing the rally.

Being unbenchmarked, it is not beholden to the structural volatility of local currency asset class and can therefore make tactical asset allocation in the local space.

It also has the advantage of being tactical on the duration front – going from nearly -1yr to almost +8yr over its 12 year history. Those investors who would like to access both local and hard currency exposure, but require a benchmark, should consider our *Emerging Market Select strategy*, which focuses on the hard and local currency sovereign space with flexibility to invest in corporates on an opportunistic basis.

Absolute returns – investors looking to take advantage of the full spectrum of long-short opportunities with uncorrelated absolute returns should look at our *Emerging Market Absolute Return strategy.* Because it has the ability to execute physical shorts, this absolute return fund has generated positive returns even in periods where the market has declined, such as last year. A strong record of delivering positive returns, drawing on a rich opportunity set should make this fund attractive for investors who are able to invest in long-short vehicles. Likewise, clients that are able to allocate capital to lock-up strategies can capture the significant illiquidity premium available in the EM loan market through our *EM Illiquid strategy*.

Specialist solutions – Away from fund solutions, we also provide dedicated **specialist solutions** for institutional clients who are interested in exploring other themes including ESG requirements (such as climate or impact investing), targeted rating requirements or lower turnover portfolios that focus mainly on the IG portion of the asset class.

Portfolio Manager Perspectives

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