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NAVIGATING EMERGING MARKET DEBT

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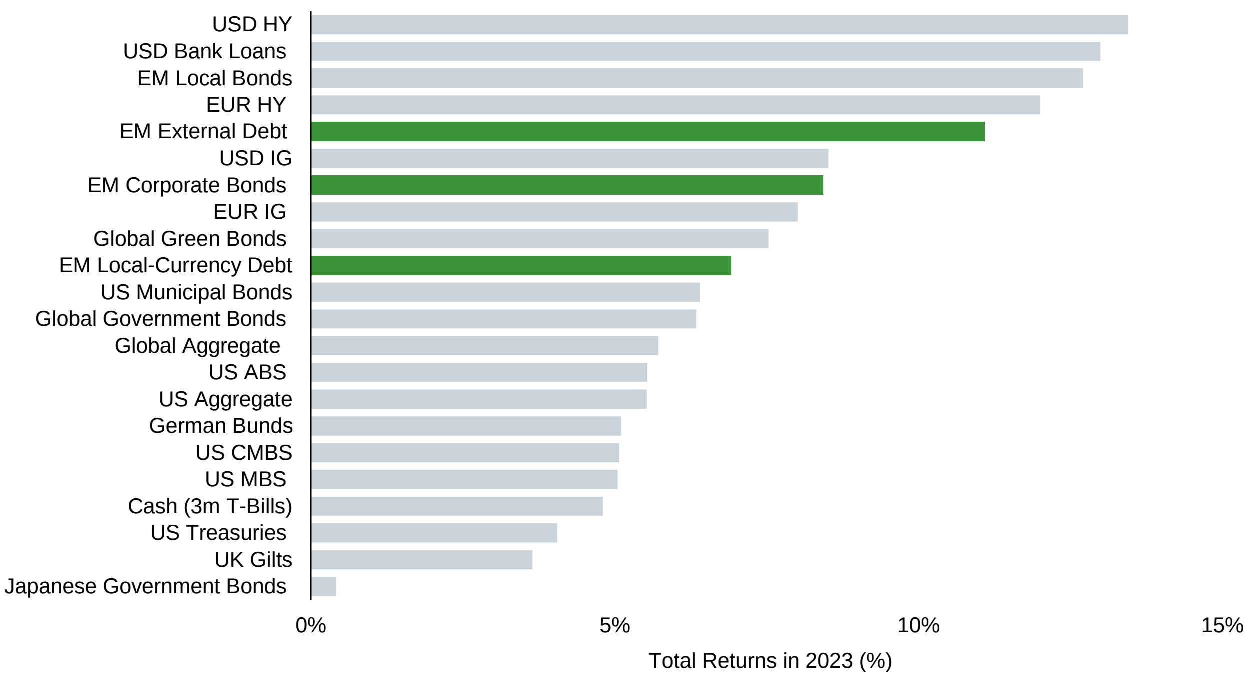
In the latest edition of our Navigating Fixed Income insight, Anupam Damani, Co-Head of Emerging Market Debt, and Maral Shamloo, Head of Emerging Market Sovereign Research, answer questions from Gurpreet Garewal, Macro Strategist & Head of Fixed Income Insights, about their outlook for emerging-market debt (EMD).

Gurpreet: Emerging market (EM) economies have been in the headlines over the past couple of years, with particular attention being paid to the slowing Chinese economy and countries in distress. How does this compare to the reality?

Anupam: The reality is quite different from many observers' negative perception of EMs. It's crucial to look beyond the headlines and analyze the underlying drivers of risk and return. In 2023, EM economies and assets showed remarkable resilience despite the challenging external environment. EM economies grew by an estimated 4.3%, which was in excess of estimates of their potential growth rate (which range from 3.5-4.0%), and significantly faster than developed market (DM) economies' growth of 1.6%.[1] This led to strong gains in EM fixed income assets.

Exhibit 1: EM bonds were among the best-performing fixed income categories in 2023



Source: Goldman Sachs Asset Management, Macrobond, Bloomberg, J.P.Morgan, ICE BofAML, Markit iBoxx. Annual total returns as of 2023. Local currency. **Past performance does not guarantee future results, which may vary.**

[1] Source: Goldman Sachs Global Investment Research EM Macro Navigator (19 January 2024).

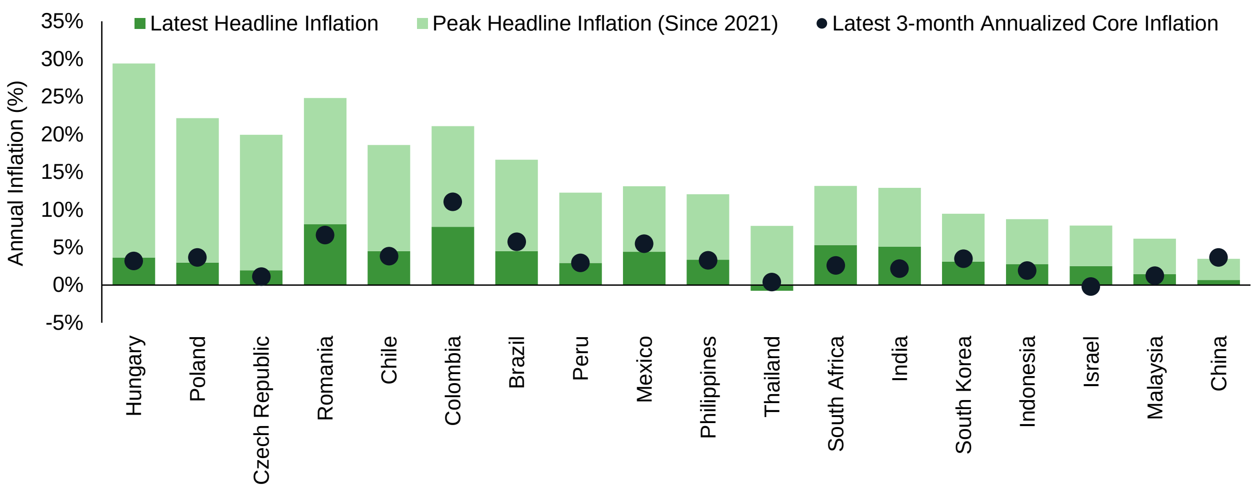
Gurpreet: How do you expect the economic and policy environment across EMs to evolve in the coming months?

Anupam: We're encouraged that the growth momentum we saw in 2023 has continued into 2024. For instance, our EM current activity indicator (CAI), which provides a timelier view of economic activity than traditional growth data, suggests that EMs are currently growing at an annual rate of 5.8%, well above the 1.6% growth rate of developed markets (DMs).[2] EM economies' solid growth is a result of several factors, such as the easing of financial conditions especially in Latin America (LatAm), the recovery from the energy shock in Central and Eastern Europe (CEE) and the boost from higher energy production and the resultant increase in revenues in some Gulf Cooperation Council countries, such as Saudi Arabia, the UAE and Qatar. Looking ahead, a potential improvement in the global inventory cycle may provide a boost to export-oriented economies in Asia, such as South Korea, Vietnam, and Taiwan. Thailand is also benefitting from a revival of tourism and looser fiscal policy.

Meanwhile, EM inflation is declining rapidly, with the steepest falls in CEE and LatAm, where inflation was previously highest. While this is partly due to the base effects of lower commodity prices, monthly price rises are slowing and domestic inflationary pressures are easing, which suggests that inflation will continue to fall as we go through 2024.

On the policy front, EM central banks have been proactive in cutting rates. By the third quarter of 2023, more EM central banks were easing policy than tightening for the first time since 2020. We expect this trend to continue in 2024 as falling inflation and rate cuts by major DM central banks, such as the Fed and the ECB, will make it easier for EM central banks to cut rates further without fear of experiencing currency weakness.

Exhibit 2: EM inflation fell sharply in 2023 and has scope to fall further in 2024



Source: Goldman Sachs Asset Management, Macrobond. As of February 2024.

More broadly, we are encouraged by commitment to price stability, as well as greater fiscal discipline and progress on structural reforms across various countries. In addition, some economies are also benefiting from significant foreign direct investment which bodes well for long-term growth potential. Combined, these developments lead us to anticipate more sovereign credit rating upgrades than downgrades this year, a positive turn of events compared to recent trends.

Economists often say that there are four types of economies in the world: developed, developing, Japan, and Argentina. Japan has recently abandoned unconventional monetary policies, while Argentina is adopting more conventional macro policies. Weak fiscal fundamentals have been a major macroeconomic issue for Argentina, but the Milei Administration's efforts to achieve swift fiscal adjustment in 2024 are reigniting investor interest. Policy discipline, such as hawkish monetary actions, is also benefiting Turkey, another EM sovereign that had lost investor favour in recent years.

[2] Source: Goldman Sachs Asset Management. Based on data released as of March 15, 2024. For more details on our CAI, see Innovation-Driven Investing (January 2020).

Gurpreet: You mentioned that some of the negative sentiment towards EMs stems from the challenges faced by China. How do you assess the situation in China and the implications for the financial markets?

Maral: We expect the Chinese economy to continue its gradual and targeted deceleration as the country adapts its growth model to reduce its dependence on the property sector and related industries, while increasing the shares of consumption, services and innovation. This growth transition will also involve major investments in strategic areas such as renewable energy, semiconductors, and biotechnology. All this is necessary to counteract the imbalances and vulnerabilities that have built up over the years, especially in the property sector.

We don't expect a hard landing or systemic crisis in China as policymakers have tools available to them to cushion the effects of the slowdown and prevent contagion to other parts of the economy. Over the past year they have already announced a series of fiscal and monetary measures including tax cuts, infrastructure spending, reserve requirement ratio cuts and targeted lending. We estimate that the cumulative stimulus that China has delivered since October is equivalent to around 2% of GDP. This is a modest amount relative to the 14% of GDP of policy support provided in 2008 and reflects the government's preference for gradual, targeted easing rather than large-scale, broad-based measures. From an investment standpoint, we think that the defaults among Chinese property developers have peaked. While we believe that the stimulus provided to date will stabilize the economy, we do not expect a sharp rebound or return to high growth, and we believe much more stimulus is needed for recovery to take hold. Our forecast is for the Chinese economy to grow by around 4.5% this year, below the government's "around 5%" real GDP growth target.

While China faces headwinds from debt, demographic aging and geopolitical tensions, investors should not lose sight of the opportunities that exist in other EMs, especially in Asia. Many Asian economies have recovered strongly from the pandemic and are growing robustly, driven by favorable demographics, rising consumption, and increasing integration into the global economy. India and Indonesia are good examples: they have large, young populations, growing middle classes and dynamic private sectors. They also have reform-minded governments that are pursuing structural improvements and fiscal prudence. Other Asian countries, such as South Korea, Taiwan, Vietnam, and Thailand, stand to benefit from a recovery in global trade, shifts in supply chains and tourism.

In short, China's growth reorientation will be a multi-year process that will require patience, but it should not overshadow the diversity and dynamism of the broader EM universe.

Gurpreet: With that in mind, where do you see the best opportunities in the EM sovereign bond universe?

Anupam: Several macro headwinds that have clouded the outlook for EM sovereign bonds in recent years are fading. The combination of lower funding costs, falling inflation and resilient growth lead us to believe that the asset class will produce a positive total return for the second year in a row in 2024, mainly due to the carry it provides. Valuations improved modestly early in the year, which we believe has created an attractive entry point.

For instance, we see value in US dollar-denominated debt issued by Mexico, acknowledging the strides made towards fiscal discipline in recent years. We also see potential for progress to be made on resolving of issues among quasi-sovereign entities. Additionally, Mexico stands to gain from the reorientation of global supply chains, including 'nearshoring' benefits. That said, our perspective is nimble, and we maintain a dynamic approach to our positioning, keeping a close watch on the potential ramifications of a fiscal deficit that exceeds expectations for the current year. Our confidence in Mexico's monetary policy framework reinforces our belief that it will effectively safeguard against external vulnerabilities. We also maintain a positive stance on Central and Eastern European (CEE) economies, notably Poland and Hungary, as both sovereigns are reaping the benefits of enhanced Foreign Direct Investment (FDI) prospects. Specifically, we believe Poland's structural growth prospects are poised to improve due to its increasing integration with the European Union (EU), while Hungary exhibits an upward trend in fiscal health.

In addition, we anticipate that the yield on high-yield bonds will narrow compared to investment-grade bonds as US rates fall. This, along with our positive forward-looking assessment, informs our favorable view of US dollar-denominated bonds in several countries, including Serbia, Ivory Coast, and Oman.

We also see potential for strong returns in certain distressed issuers where the premium reflected in bond valuations in the event of a near-term default or restructuring is high relative to our assessment. This includes sovereigns that have recently regained market access and have been able to overcome upcoming maturity walls, as well as markets with improved policy frameworks such as Kenya, Angola, Nigeria, Ecuador, and Pakistan.

Gurpreet: Do you anticipate further gains for local-currency EM bonds following their strong 2023?

Maral: EM local bonds delivered impressive returns in 2023, supported by falling inflation, currency appreciation and monetary easing in many EM economies. And even though the rise in US rates in recent years have reduced the spread between DM and EM local bond yields, there is still room for EM policy rates and EM local bond yields to decline. Importantly, disinflation and impending Fed rate cuts will make possible more monetary easing across more EM economies, which should ultimately extend local-currency bonds' strong performance.

We see the most potential for further rate cuts and yield compression in markets where inflation has decreased significantly, such as the Czech Republic, Mexico, and South Korea. We also anticipate continued monetary easing across Latin America. And we believe intermediate-maturity bonds in Central and Eastern Europe and Brazil offer value, as weak economic activity may prompt central banks to lower rates below estimates of neutral rates.

Gurpreet: Many of our clients are familiar with our belief that EM corporate bonds represent an attractive complement to existing DM corporate or EM sovereign exposures. What's your latest assessment of the EM corporate bond market?

Anupam: The EM corporate bond market remains a favourable, and yet underappreciated, area of the fixed income universe. It currently provides a yield of over 7%, which is an attractive source of income for an asset class that is high quality.

EM corporates can offer attractive returns relative to risk and provide diversification for existing sovereign exposure. Private sector corporates also tend to exhibit lower sensitivity to political events, making them attractive in a heavy electoral year like 2024. And they demonstrate greater resilience to domestic macro volatility, partly due to their exposure to global demand and, in many instances, US dollar-denominated revenue streams, which can protect them against currency volatility.

It's important to recognize that the spike in EM corporate bond defaults over the past three years was primarily linked to the challenges in China's property sector and the Russia-Ukraine conflict. Beyond this, default activity has been muted. With weaker companies leaving the market, the remaining firms have demonstrated that they can withstand macro headwinds, so we expect a lower default rate in 2024 than in 2023. We think the positive fundamental backdrop means credit ratings should remain stable. The technical backdrop is also supportive. We expect limited new bond supply due to conservative capital management and access to other funding sources like bank loans and local bond markets, where interest rates are going down.

Gurpreet: Where do you see the best opportunities in EM corporate bonds?

Maral: The EM corporate bond market is broad and diverse, including bonds from diverse entities such as quasi-government utilities, telecom giants, search engines and electric car makers. This means we can invest in companies that are key to both near-term economic growth and long-term transitions. For example, we see value in an Indian renewable energy company that's helping India reach its goal of 45% renewable energy generation by 2030. The company has a long-term fixed pricing model, which means its revenues are predictable, and it's generating stable free cash flow.

We also like a Mexican cement company that has a presence around the world, is focused on reducing carbon emissions and is generating consistent cash flow through economic ups and downs. We gained confidence in this company after talking to its management.

Gurpreet: Lastly, what risks or potential catalysts are you closely monitoring?

Anupam: We're watching three things particularly closely. First, the technical environment. EM sovereign bond issuance has been robust so far in 2024. We view this positively, as it indicates that EM sovereigns, particularly B-rated high-yield issuers and distressed countries—are able to access global financing. On the demand side, we have seen portfolios benchmarked to the global aggregate index return to EMD, after being mostly absent for several years. Although these flows can exhibit volatility, they can provide a good anchor in the near to medium term and we see several reasons for dedicated inflows to EMD to also resume in 2024. These include the widening growth differential between EM and DM economies, the strong performance of EMD in 2023 and a global backdrop of moderate inflation and accommodative monetary policy. These factors should increase EMD's attractiveness and boost investor demand. Although the pace of the Fed's cutting cycle is uncertain, Fed Chair Powell has hinted that the central bank will begin to dial back restrictive territory this year, provided there are no significant upside surprises in inflation. This will also provide a tailwind for risk sentiment and assets like EMD, as long as it occurs against a backdrop of still-resilient US and global growth.

The second thing we're closely watching is the economic implications of the busy global election calendar, with a record number of people set to vote in 2024. Goldman Sachs Global Investment Research analysis of over 1,100 elections in 152 developed and emerging markets shows that governments tend to loosen fiscal policy in election years, increasing spending and reducing taxes to win votes. This effect is stronger in lower-income and less democratic EM countries, where fiscal discipline can be weaker. Elections also create uncertainty, which can hamper efficient capital allocation, deter investment and weigh on growth. The outcome of the US election will have significant implications for emerging economies as it is likely to impact future trade policy and global relations. Given the difficulty of forecasting and positioning ahead of elections, we think the best investment strategy is to build resilient portfolios that are well diversified and actively managed, with careful bond selection based on fundamental and technical factors.

Lastly, we continue to assess how sovereign fundamentals are affected by the new realities of higher rates relative to the last cycle, geopolitical instability, shifting trade patterns, digitization and decarbonization. These factors create both opportunities and challenges for different countries in the EMD universe, which is diverse and volatile. We believe fundamental research and engagement with policymakers can help us identify sovereigns that are resilient and those that are vulnerable, and distinguish short-term volatility from long-term opportunity.

Overall, we think that EMD remains an attractive investment opportunity for investors seeking high yields, total return potential and diversification, but it also requires disciplined risk management, diversified exposures and an active approach to country and security selection with a focus on liquidity.

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