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Asset Management

Emerging Market Debt Indicator

Market background

Global investor sentiment is being driven by two factors: the US election and COVID-19. Expectations of a 'blue wave' proved supportive for global and emerging market (EM) risk in the first half of the month. However, the acceleration in COVID cases across Europe and the US revived uncertainties about the rising economic and social costs of the pandemic. As such, towards the end of October, global equity and oil markets sold-off significantly. EM assets were not immune to the sell-off, with local and hard currency bond markets posting close-to-flat returns after being up around 2% earlier in the month.

While some developed markets face a difficult winter because of COVID, a differentiator this time is Asia's strategically stronger positioning, reflecting the region's more rapid move to contain the outbreak without resorting to lockdown. This has been vindicated by data showing a sharp rebound in the Chinese economy during the third quarter. The country is on track to be the only major economy to grow in 2020 and this underlines its strategic importance in global and regional supply chains, while also being supportive for other markets in north Asia. Expectations of a Joe Biden victory in the US presidential election supported currencies in China, Mexico and Taiwan, which would all benefit from smoother trade relations.

The Turkish central bank surprised investors for the second consecutive month, this time by deciding not to raise its main interest rate to support the lira. The country remains a source of regional tension, with President Recep Tayyip Erdogan's recent testing of a Russian supplied defence system worsening bilateral links with the US, in addition to its poor relations with the EU and NATO. Fighting continued between Armenia and Azerbaijan, despite an agreed ceasefire supported by their respective backers Russia and Turkey, and this also weighed on regional assets. The Russian central bank kept interest rates on hold during the month – with risks balanced between rising inflation and an uptick in COVID.

In Latin America, Brazil's central bank kept rates on hold with a dovish tilt, with macro data remaining weak and fiscal risks rising, while in Argentina a political and economic crisis of confidence is affecting all assets. A devaluation of the peso has been ruled out by President Alberto Fernandez and talks with the IMF on delaying payments on an existing bailout are expected to continue until next year.

Unfavourable oil supply dynamics and global demand weakness continue to weigh on the oil price. Libya confirmed that it is seeking to add an additional one million barrels per day onto global markets, complicating efforts by OPEC+ to increase production in the new year to compensate for relatively low prices. This weighed on oil-linked currencies and spreads into month-end.



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Top-down views and outlook

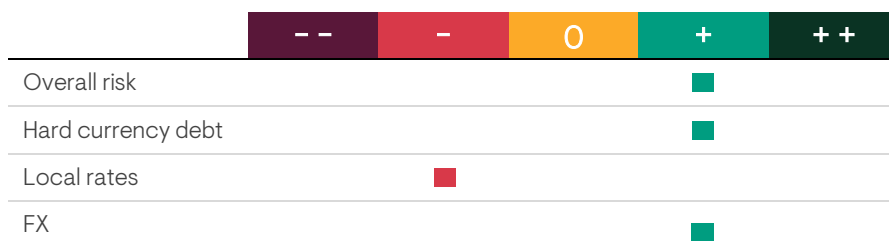
The decision to reimpose a number of country-wide lockdowns in response to a COVID surge across Europe will weigh on regional economic activity as year-end approaches. It also introduces greater uncertainty regarding the timeline for a global recovery to pre-COVID levels of output, though in sharp contrast the majority of emerging markets look unlikely to follow with such severe lockdowns.

Although some uncertainties might remain in the coming weeks as legal challenges are mounted following the outcome of the US presidential election, markets now can start to focus on the expected continued economic recovery into 2021. Given the importance of global trade to emerging market fundamentals, we see a Joe Biden presidency as supportive for EM assets, as it will bring a more predictable foreign and trade policy.

Data releases from EM economies are continuing to provide mostly positive surprises, with Asia leading the recovery. We also have a positive view on debt sustainability across emerging markets overall, although the pandemic will undoubtedly widen the gaps between the winners and the losers.

The tailwinds supporting EM debt remain intact: the allure of attractive yields in a low-yield world; improving trade flows within and across EM regions; the diminishing role of the US dollar on the global stage, to name but a few. The continuing advance to the mainstream of China's sizeable and high-quality bond market is a further long-term positive for EM debt investors, in our view. We will remain nimble on the opportunities, while keeping a firm eye on long-term positive trends.

Top-down positioning at end October 2020



For illustrative purposes only. For further information on the investment process, please see the important information section.

We have kept our top-down risk exposure target at a modest overweight across our strategies. We remain overweight hard currency debt, which we believe will benefit from investors' search for yield and expectations for the global economic recovery. We remain overweight emerging market currencies (EMFX), partly funded out of the relatively expensive euro. Improving current account balances and trade dynamics remain supportive for EMFX, which we believe is still undervalued. We remain slightly cautious on local currency bonds (rates), given current valuations and as most rate-cutting activity is now behind us. However, we still find some attractively priced local bond markets within the universe, offering compelling real yields compared with core developed market rates.



Roger Mark
Analyst, Fixed Income

Insights from the team

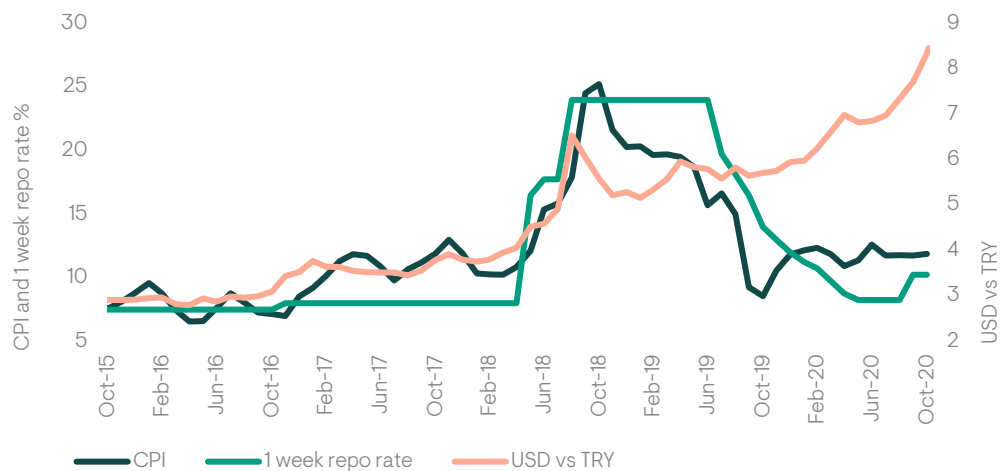
Surprise interest rate decision in Turkey

For the second month in a row, the Turkish central bank (CBRT) surprised the market. After hiking rates against expectations in September, the bank appeared to be returning to more orthodox policy. However, in October the authorities kept the weekly repo rate on hold at 10.25%, against consensus expectations for a 175 basis points (bps) increase in the CBRT’s policy rate to 12%. As such Turkish assets traded poorly, with the lira selling off by as much 2.5% and hitting record lows.

It has been clear for some time that monetary policy in President Recep Tayyip Erdogan’s Turkey is as much a political decision as an economic one. But underneath the surface the authorities did move to tighten liquidity by increasing the rate on the late liquidity window (LLW) by 150 bps to 14.75%. The LLW is supposed to be used only in times of stress but over the last few years has taken on an increasingly larger role in the CBRT’s operations. This is part of wider liquidity tightening measures aimed at increasing the effective funding rate – and in this respect they have been relatively successful, with the effective funding rate up 5.5% since July this year, while the official policy rate has only increased 2% during this period.

We think that the adjustment to the LLW will lead to a further tightening in the effective funding rate from its current 12.75%. Based on the current ratio of liquidity operations being offered, we believe that the effective funding rate will increase in the coming weeks, initially to 13.5%, but possibly higher as well. The question is whether this will be sufficient to stabilise the lira and reverse the trends in deposit dollarisation. By leaving its main policy tool unchanged it sends a less hawkish – and somewhat confused – signal when compared to September’s policy rate hike.

Pressure building on the lira as fundamentals deteriorate



Source: Bloomberg, 4 November 2020.

Ultimately, and as the above chart starkly suggests, we think the real policy rate has to move materially higher to act as an anchor on the lira and avoid a vicious cycle of lira depreciation driving further inflation. Real rates are creeping higher, for instance the 12-month lira deposit rates are up to 12.8%, versus current official inflation of 11.75% and 12-month forward inflation expectations of 10.5%. However, compared to historical episodes, real rates do not appear anywhere near high enough to stabilise the situation. Without high real interest rates to support the lira, the CBRT has fallen back on its currency reserves to prevent further depreciation amidst an increasingly concerning geopolitical outlook. Repeated FX intervention – and a widening current account deficit – has pushed the CBRT’s foreign currency reserves to multi-year lows. Yet despite the interventions, the currency has hit record lows and has been amongst the worst performing currencies globally. Thus, we think that material hikes to the main policy rate are a necessary requirement to stabilise the currency and encourage depositors back into lira accounts. But October’s decision suggests authorities are unlikely

to act swiftly and raises the possibility of further currency volatility as well as a hard landing (whereby a sharp FX move forces the CBRT into a rapid and severe rate hike).

Just before going to print, the central bank governor was fired and the finance minister (who was also Erdogan's son-in-law) resigned. The exact circumstances and reasoning for the dismissals are unclear at this point. However, the market has interpreted these moves as a signal that there will be a return to greater monetary policy orthodoxy. The key test of this will be at the next interest rate decision meeting on 19 November, when the central bank will need to make a significant hike to its key weekly repo rate to regain investor confidence. With monetary policy risks now more balanced, we have closed our underweight in the currency and moved to a neutral position.

Looking across the spectrum of Turkish assets, we still believe there is a strong degree of fundamental resilience in the corporate space, especially in select financial issuers and in technology, media and telecom. Here we remain confident in their ability to weather the challenging monetary backdrop, and they remain particularly attractive from a valuation perspective.

Portfolio positioning highlights

An overview of our positioning in a selection of regions, countries and currencies.

Africa

At month end, President Abdel Fattah al-Sisi in **Egypt** renewed the nationwide state of emergency for another three months, the 13th time since it was implemented in 2017. The move allows the armed forces to ‘take necessary measures to combat terrorism and safeguard national security’. In contrast, the government has ruled out another COVID lockdown, even in the event of a second wave outbreak in the country. Portfolio inflows of US\$ 2.5bn in August were strong, while data showed the government’s continuing fiscal discipline as it recorded a small primary surplus during the first quarter of FY 2020/21. We remain overweight the country’s currency and its hard currency debt.

During the month, the government in **Zambia** failed to achieve a quorum with the Zambia External Bondholder Committee (ZEBEC) regarding a consent solicitation to pause eurobond interest payments. A meeting with creditors has been rescheduled for mid-November to give Zambia time to provide clarity on a number of debt transparency issues, including the status of the country’s renegotiations with China, the size of the remaining pipeline loans, projects likely to get disbursed and the medium-term expenditure framework. Creditors and bondholders are concerned that any debt relief might be used to service debts owed to other parties.

We think that some progress made on deferring loans with China will put pressure on other creditors, but it is unlikely that the ZEBEC will rush into agreeing a restructuring without a clear idea of what will be done with the saved coupons. This showdown increases the possibility of a hard default during November, but we remain overweight as the bonds trade at a deep discount to what we consider to be fair value, and we see most outcomes leading to a scenario where they will settle well above current prices. We note that higher copper prices and the correction in the kwacha have contributed to a 10% of GDP trade surplus, demonstrating the extent to which the economy has already rebalanced.

Ghana’s recent budget has seen upgrades to a number of estimates following discussions with the IMF and the World Bank. On the bond issuance side, Ghana wants to remain active in the market, and so will continue to put its best foot forward. Fitch Ratings recently reaffirmed its ‘B’ rating for the country with a stable outlook, which underpins some of the government’s reform credibility won over the past three years. Fitch’s expectation is for a gradual recovery in economic performance and fiscal revenue after the COVID shock, a stabilisation of debt/GDP and the availability of financing sources, both domestic and external. Inflation finally weakened given the lower pressure on food pricing. We remain overweight the currency based on a better budget performance.

In **Kenya**, the latest public debt report from the Treasury showed the increased risk of debt distress given the temporary breaches on external debt relative to exports, but these are expected to fade into 2021. Elsewhere, the report featured the move towards concession financing as the government highlighted US\$10bn of official development assistance. The national Building Bridges Initiative (BBI) report was launched, which proposed strengthening devolution, the creation of the office of prime minister, and the reform of the electoral commission. Although BBI is expected to create some pressure on the fiscal budget, a likely benefit will be to reduce the reliance on supplementary budgets which will only be tabled in unspecified emergencies. We remain overweight the shilling and dollar debt.

Civil unrest in **Nigeria** during the month sparked by reported police brutality spread to become a broader anti-government movement. The government has struggled to deal with the fall-out from COVID, while a shortage of US dollars in part reflects the weakness in the oil price, which has accounted for nearly half of all fiscal receipts over the last three years according to Fitch Ratings. We remain underweight the country’s bonds and the naira.

Asia

Regional markets continued to adhere to a narrative similar to September, with many of them posting gains over the month, in part reflecting their strong and effective management of COVID. In addition, manufacturing data continued to improve as the global demand for goods - particularly in the technology sector - continued to recover.

Asian economies are also linked to the performance of the region's superpower, **China**, whose currency rose over the month. The Chinese authorities have not tried to drive the currency lower, believing its current levels are a fair reflection of the domestic economy's strong fundamentals, including a strong balance of payments, an improving growth outlook and a higher yield profile than its peers. Nevertheless, we used the strength in October to reduce our position in the renminbi to neutral. We improved China's environment score on our ESG matrix to reflect the recent pledge that national carbon emissions would peak in 2030, and that the country would be net carbon free by 2060. Although no plans have yet been disclosed how this will be achieved, the sentiment is encouraging and recent efforts to contain carbon emissions give us confidence that this remains a key part of its national strategy over the long term.

Indonesia passed its omnibus law during the month, which aims to improve the domestic business and investment environment by cutting red tape across business, labour and environmental legislation. This should attract foreign direct investment into the country and hence reduce the reliance on volatile portfolio flows. Against the positive market backdrop for Asian bonds, Indonesia's local bond market experienced strong foreign investor inflows, reflecting its attractive yields. We are overweight local currency bonds while we are neutral to the rupiah.

Another beneficiary of the stronger regional backdrop was **South Korea**. The country managed the COVID pandemic well and it is a large exporter in the technology space. However, corporations in the country have been slow to sell down their earned foreign currency, leading to a big build-up of foreign exchange deposits onshore. As the exchange rate strengthened, exporters began converting their dollars into won. This prompted us to close our short position to the currency during the month.

Sri Lanka came under further pressure in October, as the government continued to dismiss calls for IMF assistance. As the market believes that such aid is needed, domestic hard currency bonds weakened. In addition, the country recently amended its constitution to devolve more powers to the president, including the ability to appoint and dismiss ministers. We have downgraded the country's ESG score and remain uninvested.

Latin America

Another difficult month for Latin America. The IMF upgraded its latest regional GDP forecast for 2020 to -8.1% but compensated for this by easing its growth projections lower for 2021 to 3.6%, although the organisation's forecasts for next year are below those by the region's central banks and governments. We are somewhat more constructive, given that the selective severity of the initial COVID wave in the continent may lead to a less strong second wave resurgence, with positive economic momentum supported by the recovery in China and the US.

In **Mexico**, we are cautious on the country's sovereign debt, as the central bank has estimated it will take 6-10 years for the economy to recover from the effects of COVID and AMLO continues with policies that in our opinion are undermining business and investor confidence. We believe that hard currency exposure via Pemex is preferential to sovereign debt given it trades at much cheaper valuations, with strong government support leading us to expect spreads to sovereign debt to compress over time. Expectations of a Joe Biden victory in the US presidential election supported the peso during the month. The government remains fiscally conservative, but with inflation at the top end of the central bank's target range, there seems little opportunity to cut interest rates. We are overweight the peso, but underweight local currency debt.

In **Argentina**, risk assets continued to weaken during the month. A worsening crisis of confidence in the peso reflects the consequences of a rapid increase in the money supply and high levels of inflation, fuelling a widening gap between the official and unofficial currency exchange rate. President

Alberto Fernandez has so far ruled out a currency devaluation and talks with the IMF on delaying payments on an existing bailout are expected to continue into next year. We are overweight hard currency debt but remain uninvested in the local bonds and peso.

The **Dominican Republic** benefited from the recovery following September's broader sell-off. The new pro-reform government presented its draft 2021 budget to parliament early in October, which contained a commitment to fiscal consolidation and lower levels of COVID expenditure. Economic growth is rebounding well, and we retain our overweight on the hard currency bonds.

Colombia's economy is currently being supported by private consumption and strong inflows of remittances, while lower oil prices are balancing the COVID linked demand softening in imports. A reduction in the US election risk premium has been helpful for the peso after its recent weakness. We remain underweight the Colombian peso and overweight local bonds.

After an initially favourable investor reception to **Costa Rica's** government plans to prepare the ground for a US\$1.75bn IMF aid package, there has been a domestic political backlash led by the opposition-controlled Congress, focused on the government's fiscal consolidation proposals including privatisations, raising income and property taxes, and freezing public sector wages. We have kept our overweight exposure to the country's hard currency bonds, and we remain constructive as President Carlos Alvarado seeks a consensus on the way forward.

In **El Salvador**, the government is seeking an IMF programme to help counteract one of the sharpest slowdowns in the region, but this is not likely until legislative elections in March 2021 when the government of President Nayib Bukele is expected to consolidate its position. Until then, the domestic political situation may prove volatile and weigh on bond prices. We are overweight the country's hard currency bonds.

Central and Eastern Europe (CEE)

In **Poland**, industrial production grew strongly while the unemployment rate remained very low considering the scale of the recent economic shock. However, consumer sentiment worsened in October due to the start of the COVID second wave which led to a new set of restrictions. A further support package for companies affected will be ready in November, to be extended if necessary. We maintain a small underweight position in local and hard currency debt.

The ministry of finance in **Hungary** acknowledged that weaker than expected economic conditions will result in a more substantial contraction of the economy this year and a larger budget deficit. At the same time, the central bank retained a hawkish tone in its October rate-setting meeting statement and noted that it would react to a change in the inflation outlook with the appropriate instruments. We maintain a market weight position in the forint, and in local and hard currency debt.

In the **Czech Republic**, the government introduced a new lockdown on 22 October, closing all retailers except for grocery stores, pharmacies and household supply outlets. It also extended labour support measures until the end of 2020, helping to keep September's unemployment rate stable at 2.8%. Based on recent comments from central bank board members, the policy rate is unlikely to be adjusted until the economic impact from the second lockdown becomes clearer. We maintain an underweight position in local currency debt and an overweight position in the koruna.

In **Romania**, business confidence showed some weakness in October, mainly driven by services, with cultural activities, air transport and accommodation worst affected. Employment is projected to weaken significantly, as are selling prices. According to the country's finance minister, the government will not shut down the economy even in a worst-case pandemic scenario, and parliamentary elections will take place on 6 December as originally planned. We initiated an overweight position in local and hard currency bonds, while maintaining a market weight position in the leu.

The prime minister of **Serbia's** new government, Ana Brnabic, stated that the government has six goals: the fight against COVID and strengthening of the health system; preserving the vital interests of Serbians in Kosovo; the fight against organized crime; preserving Serbia's independence and the rule of law; accelerate reforms relating to EU accession and strengthen Serbia's economic power. Uncertainty regarding COVID and tightening restrictions will likely continue to weigh on consumption,

although the government has said it will refrain from a new lockdown. The state labour support programme has prevented major disruptions in the employment market, but the situation could deteriorate after a ban on redundancies expires at the end of the year. We maintain our overweight positioning in Serbia's local currency debt.

Rest of EMEA

Attention in **South Africa** focused on the medium term budget statement in October. Overall, while there was more realism in longer-term projections, it was slightly disappointing given less ambitious non-wage spending cuts and debt stabilisation expectations being pushed out to 2020 and at a higher level. We retain overweight exposure to the local bond market, where valuations remain compelling. However, we took profits on our overweight exposure to the rand.

Inaction by **Turkey's** central bank (CBRT) on raising interest rates is discussed more fully elsewhere in this Indicator, but for the second consecutive month investors were surprised by the CBRT's reluctance to raise interest rates. In response, the lira continued to weaken, losing more than a third of its value during the year to the end of October. The geopolitical backdrop is also unattractive, with President Recep Tayyip Erdogan's announcement during the month regarding testing of the Russian supplied S-400 defence system exacerbating tensions with the US, concurrent with deteriorating relations with the EU and NATO.

In response to the deteriorating financial situation of the country, the central bank governor was fired at the beginning of November and the finance minister (who was also Erdogan's son-in-law) resigned. The market has interpreted these moves as a signal that there will be a return to greater monetary policy orthodoxy. The key test of this will be at the next interest rate decision meeting on 19 November, when the central bank will need to make a significant hike to its key weekly repo rate to regain investor confidence. With monetary policy risks now more balanced, we closed our underweight in the currency and moved to a neutral position.

Russia experienced a spike in COVID infections, and this contributed to the central bank's decision to keep interest rates on hold. During the month, the EU responded to the poisoning of Russian opposition leader Alexei Navalny by targeted sanctions against several Russian officials; sanctions against the Nord Stream 2 gas pipeline project were not included. With the ruble registering fresh lows, we added tactically to our ruble positioning as we believe there is already a significant geopolitical premia in the price.

Reflecting a buoyant performance by in-demand high yield issuers meant **Ukraine** benefitted from a strong performance by the country's hard currency bonds. Yet the country faces large foreign debt repayments in 2020 and difficult negotiations with the IMF make us doubt that Ukraine will receive another disbursement from the IMF this year. For this reason, we have taken a more cautious stance in Ukraine's hard currency bonds and are close to neutral.

Unfavourable oil supply dynamics and global demand weakness means we retain our long standing underweight in the Persian Gulf. **Oman** issued a US\$2n eurobond which will be used to narrow its fiscal and budget deficits, but we did not participate. The country has been a laggard in implementing fiscal reforms, and we maintain a negative view of its ability to fund itself against a backdrop of softer oil prices and expect further significant issuance into 2021. Elsewhere, **Libya** could add an additional one million barrels per day onto global markets, complicating efforts by OPEC+ to increase production in the new year. We sold our exposure to the **UAE's** hard currency debt, which has outperformed, but we think has limited upside.

Lebanon's hard currency bonds registered double-digit declines during the month, with investors reacting to the reappointment of a former prime minister. The IMF is seeking far reaching reforms before it releases any external funding. We remain underweight this structurally challenged market.

General risks: The value of investments, and any income generated from them, can fall as well as rise. **Specific risks:**

Emerging market (inc. China): These markets carry a higher risk of financial loss than more developed markets as they may have less developed legal, political, economic or other systems. **Currency exchange:** Changes in the relative values of different currencies may adversely affect the value of investments and any related income. **Geographic / Sector:** Investments may be primarily concentrated in specific countries, geographical regions and/or industry sectors. This may mean that the resulting value may decrease whilst portfolios more broadly invested might grow. **Liquidity:** There may be insufficient buyers or sellers of particular investments giving rise to delays in trading and being able to make settlements, and/or large fluctuations in value. This may lead to larger financial losses than might be anticipated.

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