CANDRIAM
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Our 2024 Emerging Markets Debt Market Outlook

FEBRUARY 2024

Marketing communication

Benign global macro backdrop

- We expect a benign economic environment, with moderating inflation and slowing GDP growth in the US and Eurozone, but no deep recessions globally. Developed Market central banks should launch easing cycles during the second half of 2024. EM growth and differential versus DM growth recovers and opens the space for EMD asset class performance.
- The US economy remains resilient relative to those of the Eurozone and China, driving a stronger US Dollar over the near term.

Valuation and expected returns*

- **In-depth analysis remains key to performance.** Across EMD asset segments, valuations are concentrated in the higher-yielding segments, so differentiation and due diligence of emerging opportunities remains critical to extracting alpha.
- For EMD Hard Currency Sovereigns and Corporates, we expect total returns of 4 to 8%, assuming of seven and ten year Treasury yields between 3.5 to 4% and EM Sovereign and Corporate spreads 10 to 70 bps wider than they were at the end of 2023.
- For EMD Local Currency bonds, we expect around 8% returns, based on positive carry and duration, and some small negative currency effects.
- For EM corporates, we expect defaults to be contained at 3-5% in 2024 as underlying fundamentals of EM Corporate issuers remain solid and we see limited short-term maturities outside of China.
- We do not foresee any defaults in EM HC or LC sovereign space although funding risks for a number of credits remain elevated. Lower core rates lead to broader market access for EM HY sovereign issuers.

Technicals

- **Inflows?** – Investment inflows have been modest. Across segments within the EM Debt class, yields are above historical levels, which traditionally attracts inflows.
- **Balanced supply/demand?** –For EM sovereign and corporates, gross and net expected supply issuance dynamics should be beneficial, balancing the inflows weakness to generate a generally neutral technical picture overall.

Lively geopolitics

- The major risks are geopolitical -- rising tensions in Middle East, unexpected EM election outcomes, worsening of the economic situation in China, and the US presidential election. The possibility of a negative surprise concerning a US soft landing offers another risk to our scenario.

* The scenarios presented are an estimate of future performance based on evidence from the past on how the value of this investment varies, and/or current market conditions and are not an exact indicator.

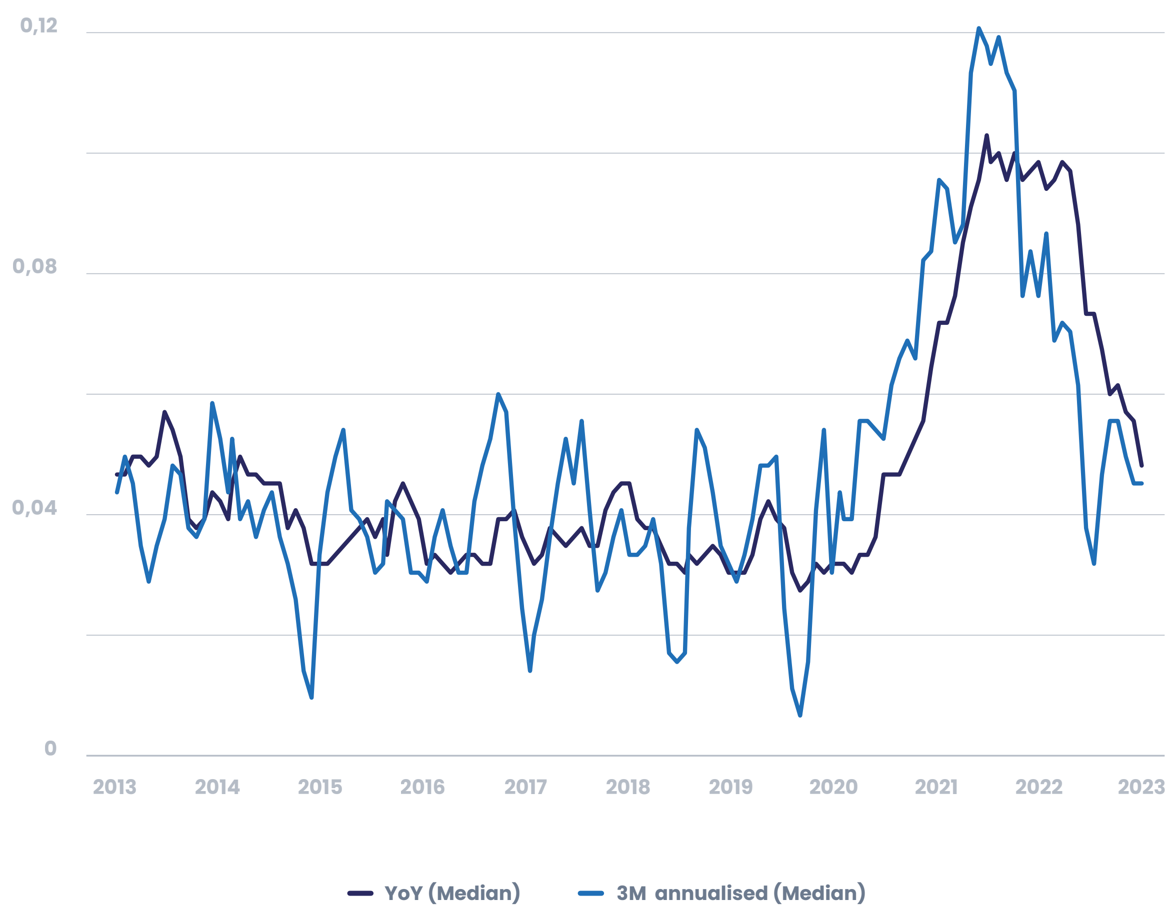
Global Macro View: Benign, but *Complicated*.

Inflation has moderated drastically across most of the world, and in many countries, it is now at or even below target. In emerging markets, inflation on a three-month annualised basis is not far from pre-Covid levels, with the strongest inflation readings from 2021 and 2022 now almost entirely out of the year-over-year comparisons.

Given this background, developed market central banks remain notably more hesitant to begin rate-cutting cycles than do central banks in the emerging markets. Emerging market central banks began to hike sooner, but have in many cases already began their rate-cutting cycles in 2023, as they enjoyed sharp declines in sequential inflation. Developed markets are likely to begin doing the same in 2024.

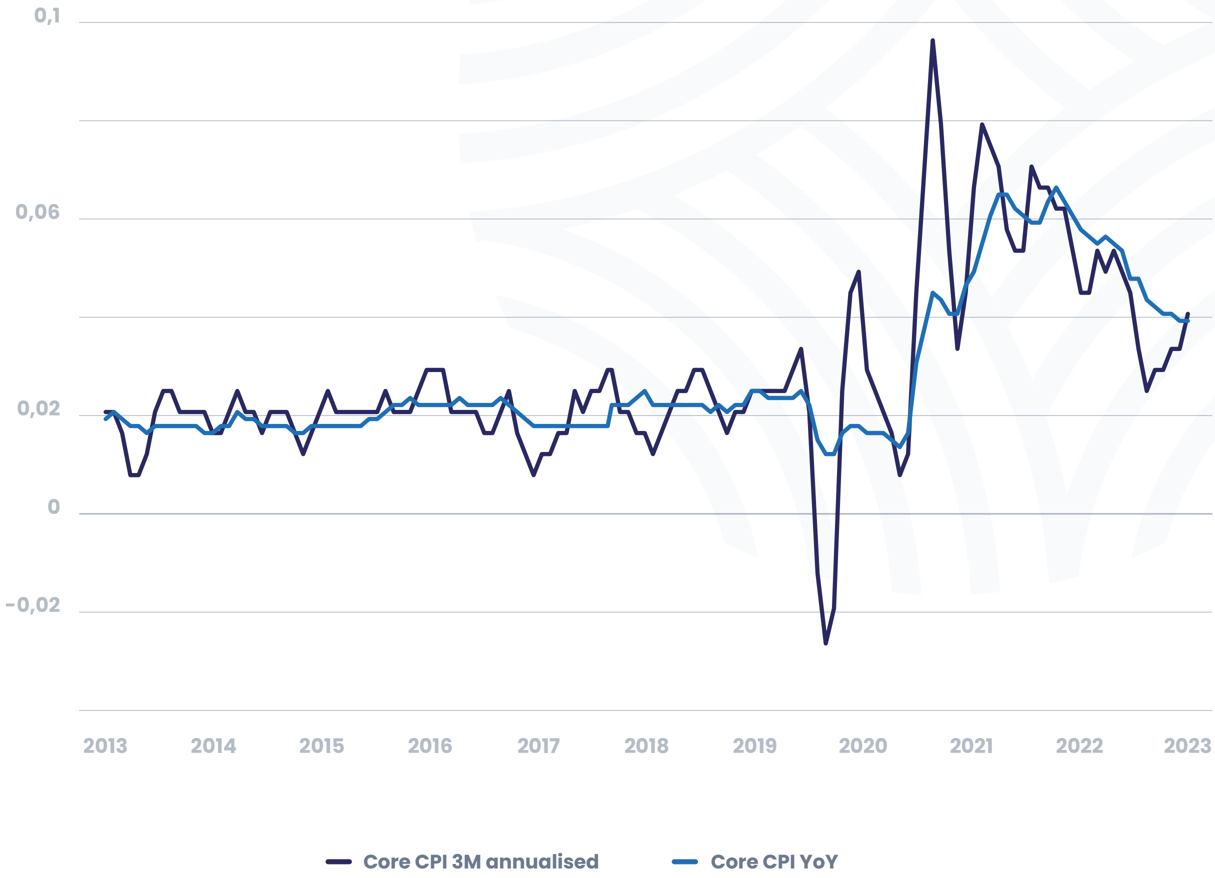
Therefore, while benign in many ways, 2024 is likely to remain volatile as the global financial markets continue to adjust to the forceful response to the elevated inflation that occurred after the Covid pandemic and the disruption to commodities due to Russia's invasion of Ukraine.

Figure 1:
EM inflation – median of 29 countries



Source: Bloomberg, Haver, Candriam

Figure 2:
US core CPI



Source: Bloomberg, Haver, Candriam

US inflation may not be quite at target, but it is not far off. Core inflation is running below 3% on a 3m annualised basis, and monthly readings have been notably more muted since mid-2023. Implied break-evens on 5Y inflation-linked Treasury securities traded between 2 to 2.5% during most of 2023, in stark contrast to their 3.7% of early 2022. In effect, the market now expects the Fed to be able to keep a handle on long-term inflation expectations, even if they do remain moderately elevated relative to the years prior to the pandemic (when market inflation expectations were 1.5% to 2%). Real rates remain notably higher than during most of the pre-Covid, post-2008 financial crisis years, of 2008-2019. The Fed has already voiced its belief that it could cut rates without causing a recession (providing inflation is under control), to avoid excessively tight real policy rates.

Unless otherwise noted, data is sourced from Bloomberg, asset class performances refer to the indices mentioned in the accompanying graphs, and calculations are made by the Candriam EMD research team.

With inflation apparently broadly under control, the focus turns to growth. We see a notable divergence in the growth outlook for the three main engines of the global economy.

- **The US economy remains resilient.** There are signs of weakness, with depressed PMI's, falling loan growth, weaker residential investment, and a falling quits rate to name a few. But overall, the US economy still remains robust, and while the unemployment rate has nudged a smidgen higher, a soft landing is still very much in sight.
- **The Euro area remains weaker,** following a stagnant 2023. PMIs continue to point to weakness, particularly in Germany. Consumption remains weak and lending growth is slow, with tight financial conditions weighing on residential investment. Yet the labour market remains very tight. The ECB is caught between a tight labour market and signs of weakness elsewhere in the economy, as well as still stubborn inflation.
- **China, too, remains subdued** and deflationary, in stark contrast to most of the rest of the world. Prices (PMIs) remain below their pre-Covid levels, the real estate sector remains depressed, and signs of stimulus are modest at best. Expectations for China are weak, but weak expectations should continue to be met at those low levels.

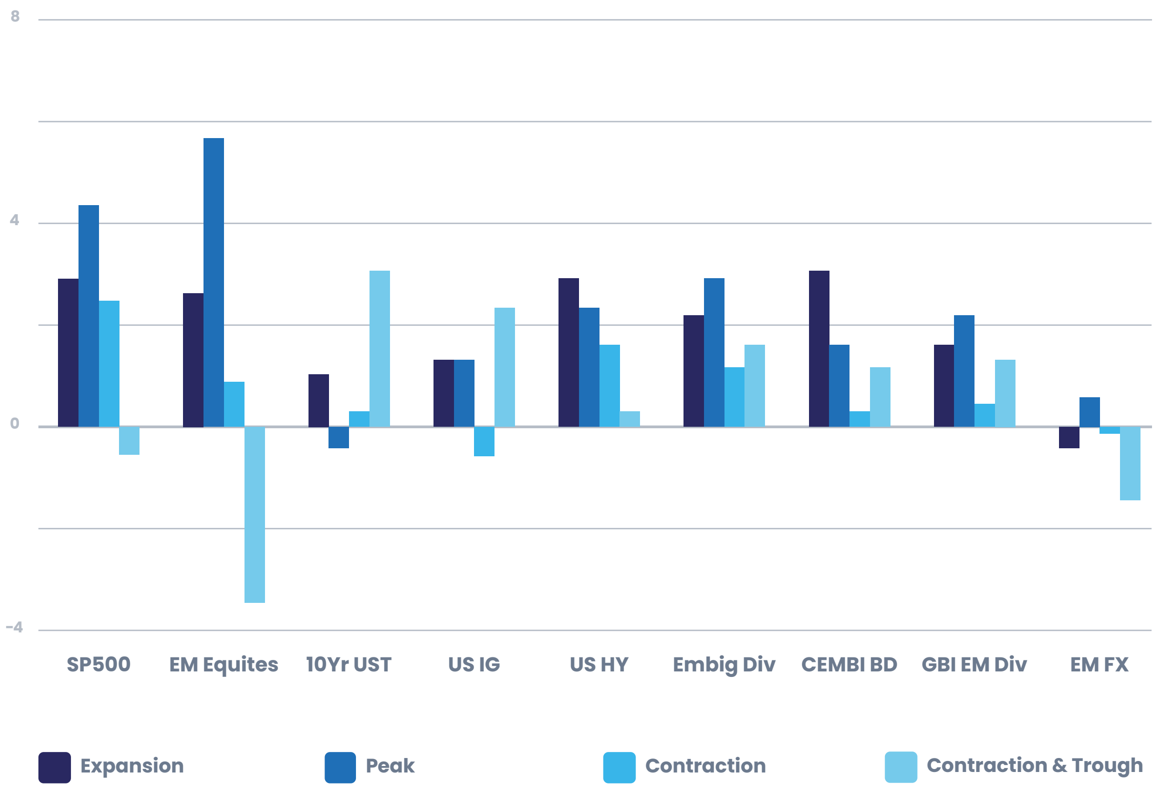
These factors combined should drive **a stronger US dollar in the near term,** particularly versus the Euro area and CEE economies (Central and Eastern Europe), where the market could increasingly anticipate a more proactive response to the slowdown. The outlook is more convoluted for credit, with strong US growth likely to support global credit through the positive impact on US credit spreads, but EMD spreads remain tight. In sum, returns from spread tightening are likely to be limited. At the same time, carry for most economies globally and the attractiveness of core yields in both developed and emerging markets are back to pre-QE highs. . Government bonds continue to look particularly attractive given limited risks of a new inflation upturn in the period ahead, and a tight policy environment (despite some revisions of expectations in late 2023).

Hard Currency Sovereign Outlook.

In 2023, the sovereign EMD HC category reversed more than 60% of its 2022 drawdown. Funding risks for distressed issuers declined sharply, and interest carry contributed strongly to returns, compensating for rising US Treasury yields. The asset class produced a 11.1% total return, in line with our 10-15% forecast,[1] with distressed or CCC-rated issuers posting an impressive +43% outcome. In a reversal of 2022, EM HY spread compression (-122bps) dwarfed EM IG tightening (-18bps), which resulted in a respectable 68bps overall index spread decline. The asset class return was in line with historical trends. EMD tends to perform well during the contraction stages of the US business cycle, which also usually coincide with the period between the end of a monetary tightening and the launch of a new monetary easing cycle. The correlation between US real yields and EM sovereign spreads is thus positive, and lower real yields should benefit EM spread compression during 2024. The risk would be if growth slows more quickly than expected, causing a broad-based balance sheet deterioration and limiting risk-taking.

Figure 3:
Performance through the business cycle

Nine asset classes, % return (Dec 2002-Dec 2023)



Past performance is no guarantee of future results and is not constant over time.
Source: JP Morgan, Bloomberg, Candriam. Indicative data which may change over time

1 Our 2023 forecasts were published on 20 December, 2022, in 'Our 2023 Emerging Markets Debt Market Outlook' on Candriam.com
[Our 2023 Emerging Markets Debt Market Outlook | Candriam]

Yet now, in early 2024, HC sovereign valuations are decidedly mixed. EM sovereign index spreads of roughly 400bps suggest fair value versus five-year averages. If we exclude distressed or CCC-rated countries, the EM sovereign spread is close to 2 standard deviations rich. In our view, EM IG barely offers any value versus US IG. And while EM HY continues to appear attractive versus US HY on screens, a lot of performance was already realized in 2023, and the apparent upside remains concentrated in distressed single-B and CCC-rated credits. This would not be an issue if the 2023 trend (of EM countries avoiding defaults) continues, or in a soft landing growth scenario. But expecting performance from these types of securities would pose serious headwinds to asset class performance in a 'high for longer' core rates environment, or if deeper than expected recessions in the US and the Eurozone trigger corrections across risky asset markets.

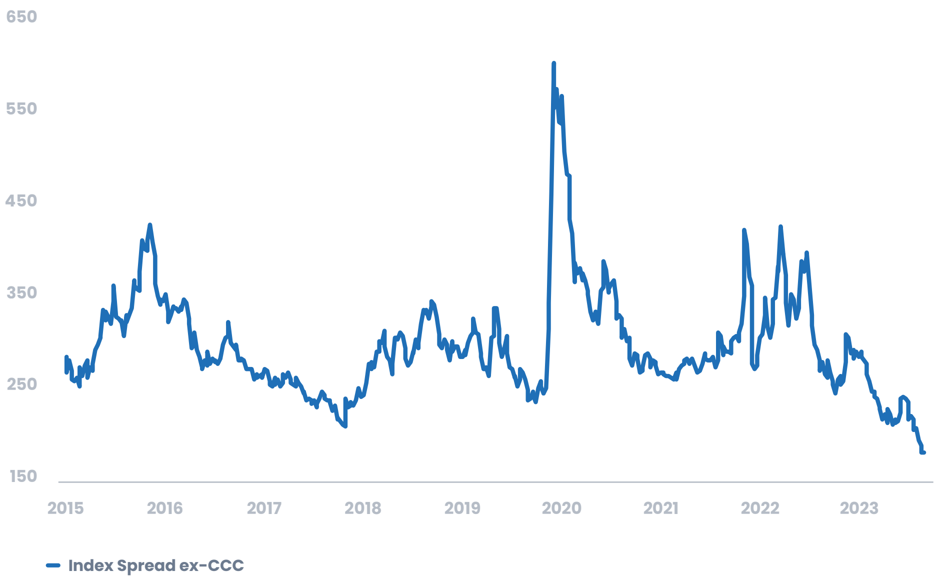
We therefore expect that **active asset selection,** with a focus on **optimizing carry** but also **minimizing downside risks,** should continue to pay off in 2024, as it did in 2023.

Figure 4a:
EMD HC Sovereign Valuation

EMBI GD Spread, all ratings, bps

Figure 4b:
EMD HC Sovereign Valuation

EMGI GD Spread, ex CCCs, bps



Past performance is no guarantee of future results and is not constant over time.
Source: JP Morgan, Bloomberg, Candriam. Indicative data which may change over time

One year ago,[2] we were concerned about potential defaults in a number of EM countries in 2023 – Egypt, El Salvador, Kenya, Pakistan – yet none of these countries defaulted. They were ultimately able to source combinations of market, concessional, and bilateral funding to service their debt last year.

Egypt, Kenya, and Pakistan are not out of the woods yet, although external funding options have expanded and debt restructurings may have been pushed out to 2025 or later. Negotiations on the ongoing debt restructurings of Ghana, Sri Lanka, and Zambia progressed materially in 2023. Suriname successfully completed its debt restructurings, while Ethiopia defaulted, but neither country had a material index weight or asset class impact. Sri Lanka and Zambia are expected to finalize their debt restructurings in the first half of 2024 while in Ghana, mid-year parliamentary elections complicate the outlook. Argentina and Ecuador remain special situations as serial defaulters, with risk premiums being driven by reform progress, fiscal consolidation, and considerations over the timing of the next debt restructuring (potentially 2025 for both).

In August 2022, Ukraine and its creditors agreed on a two year debt moratorium dating from the start of the Russian invasion in February, 2022. The government has expressed its interest in proactively addressing the August 2024 deadline by either completing an agreement on debt restructuring, or through an extension of the debt moratorium. The country is at war, recovery values are next to impossible to assess, and EU and US funding are of existential consequence. We do not attempt to predict how the Russia-Ukraine war evolves but base our scenario on a status quo of the conflict and external funding for 2024.

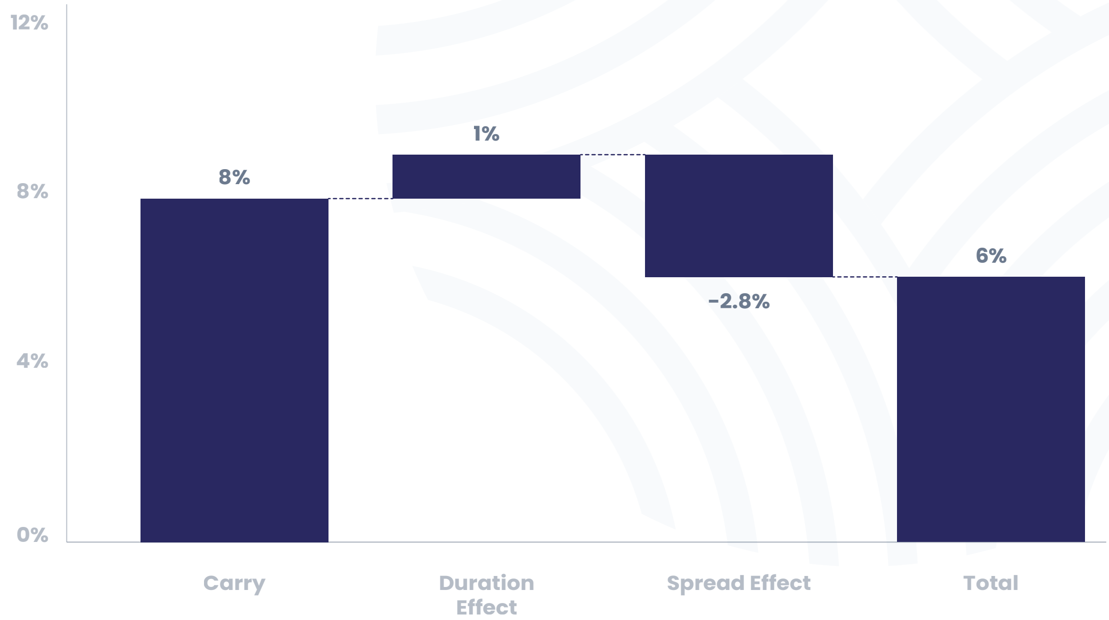
Geopolitical risks, already high, continued to rise during 2023, but so far have had a little impact on EM risk premiums. A potential Trump win in the US in 2024, with a likely return of US isolationist trade and foreign policies, would have an adverse impact on EM risk premiums. Yet, if “a week is a long time in politics”, the November election in the US is too distant to forecast with any confidence, given the Trump’s looming legal cases. We believe that China, Mexico, and Ukraine would be the worst-affected countries in the case of a Trump presidency. The EM political calendar is heavy with India, Indonesia, Mexico, South Africa, and Pakistan along with a number of smaller countries including Ghana, the Dominican Republic, Panama, and Senegal. Yet with the exception of South Africa and Pakistan, where candidates offer differing futures, we do not expect material shifts from orthodox policies – and therefore do not anticipate increased risk premiums.

Considering the extended 2024 starting point for EM sovereign spreads of 384bps, we conservatively expect EM spreads to widen anywhere between 10 to 70bps during 2024, conditional on the realized EM-DM growth differential and the depth of the global growth slowdown. On a one-year horizon, we expect risk premiums to rise, but anticipate that carry and duration effect will support positive total returns. Higher-quality credits with decent carry across rating categories should perform well. On an assumption of 10Y US Treasury yields between 3.5 and 4% and EM spreads between 400 to 450bps, EMD HC sovereigns returns should be around 3-9%.

2 Ibid. Our 2023 forecasts were published on 20 December, 2022, in ‘Our 2023 Emerging Markets Debt Market Outlook’ on Candriam.com
Our 2023 Emerging Markets Debt Market Outlook | Candriam

Figure 5:
EMG Sovereigns

One year ahead expected returns, %



Central assumption: 10Y UST of 3.75%, EM Sovereign Spreads at 425 bps

PThe scenarios presented are an estimate of future performance based on evidence from the past on how the value of this investment varies, and/or current market conditions and are not an exact indicator.
Source: JP Morgan, Bloomberg, Candriam

The EM sovereign technical picture – gross and net investor flows, and potential asset class interest – is clearly supportive of our expectation for high single digit returns. For 2024, JP Morgan forecasts $136.5bn of gross and a negative $14bn of net sovereign supply, and $244bn of gross and negative $190bn of net corporate supply. As in 2023, yields for a long list of single-B and CCC-rated issuers declined below the 10% distressed threshold,[3] which means that we may expect supply from more EM HY issuers in 2024.

After two years of EMD investor outflows (combined $128bn in 2022 and 2023), inflows should return to the asset class, especially as front-end US rates rally towards 3% and the value in DM IG and HY is exhausted. We foresee modest investment inflows of around $10-20bn in 2024 for EMD sovereigns, roughly equally split between HC and LC, as expected returns across EMD asset segments are similar.

3 That is, at yields below 10%, many issuers will be comfortable returning to the market. When above 10%, the market may ask for an additional premium.

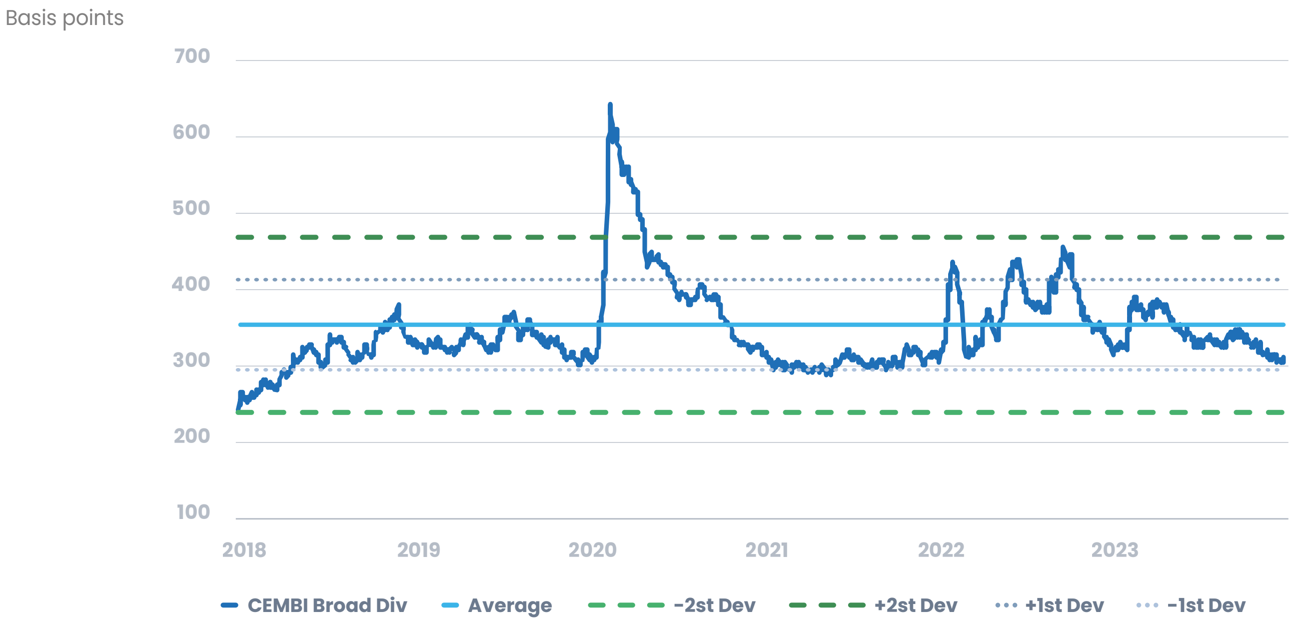
Hard Currency Corporate Outlook.

The asset class produced historically strong returns of +9.1% in 2023, in line with our forecast for 2023 and only slightly underperforming EM HC Sovereigns. Most of the return was driven by high yield EM corporates -- they generated a 2023 return of +11.17%, with single-Bs and CCCs contributing the most at +12% and +24%, respectively.

We remain constructive on the asset class, expecting low defaults, strong credit fundamentals and supportive technicals, but we do note relatively expensive valuations.

- We expect gross return of 4 to 8% during 2024, subject to Treasury moves and spread changes.
- Current EM Corporate spreads are relatively rich, trading close to one standard deviation inside their 5-year average. In spite of that, they continue to offer historically attractive carry of 7%.
- We expect defaults to be contained at 3% to 5% in 2024, as underlying fundamentals of EM Corporate issuers remain solid and we see limited short-term maturities outside of China.
- Technicals are expected to remain supportive as we expect to enter a third consecutive year of negative net supply of EM Corporate paper.
- Major risks to our outlook are geopolitics (e.g. rising tensions in Middle East or surprises in EM elections), a worsening of the economic situation in China, and potential negative surprises to our forecast for a US soft landing.

Figure 6:
EM Corporate Debt Spreads



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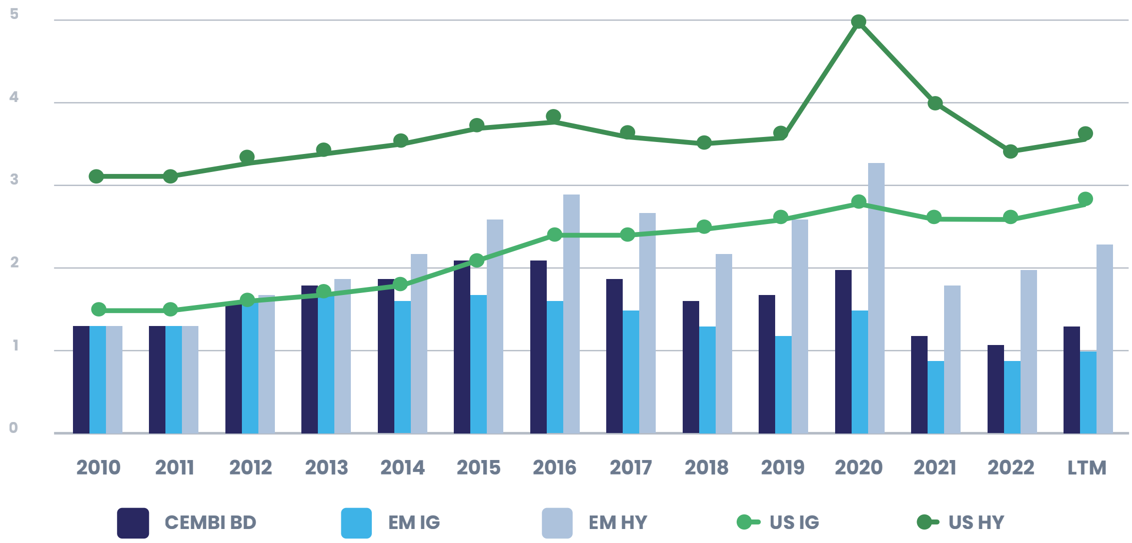
Source: Candriam, Bloomberg

Fundamentally, EM Corporates continue to have strong balance sheets relative to US IG and HY companies. At index level, EM Corporates average net leverage of 1.3x, compared to US IG corporates at 2.8x and US HY corporates at 3.6x.

Figure 7:
EM Corporates

Net leverage
vs US IG/US HY

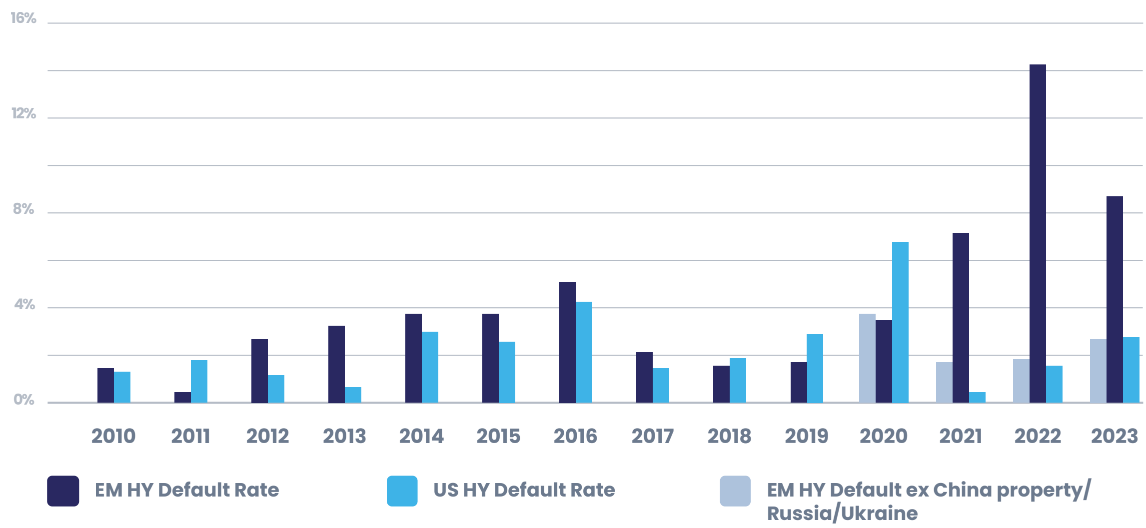


Source: JP Morgan, Bloomberg, Candriam. Indicative data which may change over time

Whilst the headline default rate in 2023 was elevated (9%), corporate defaults were mainly concentrated in Russia, Ukraine, and the Chinese property segment. Excluding these particular cases, we calculate a normalized default rate for 2023 at 2.7%, which is in line with historical levels for EM Corporates and in line with US HY. Going forward, we expect defaults to remain contained as we don't see sizeable maturities coming up in 2024 -- except for China, where HY corporates are likely to remain vulnerable. Globally, most of the maturities are concentrated in the investment grade space with limited refinancing needs for HY, another supportive indication.

Figure 8:
EM Corporate Default rates

Vs US HY



Source: Candriam, Bloomberg

Figure 9a:
EM Corporate Maturities

By rating

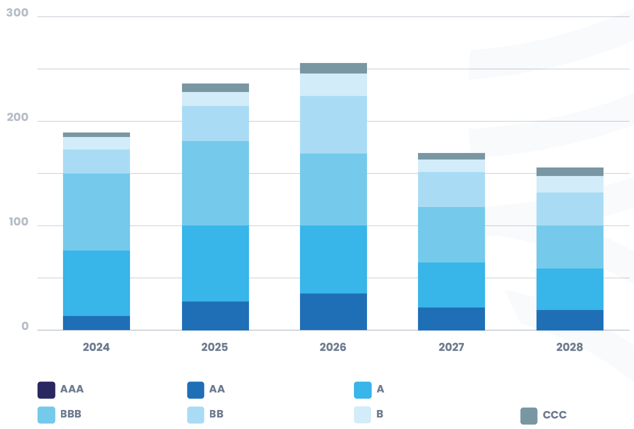
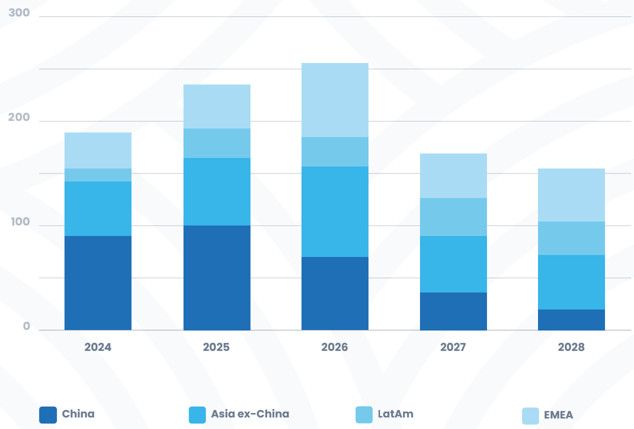


Figure 9b:
EM Corporate Maturities

By region

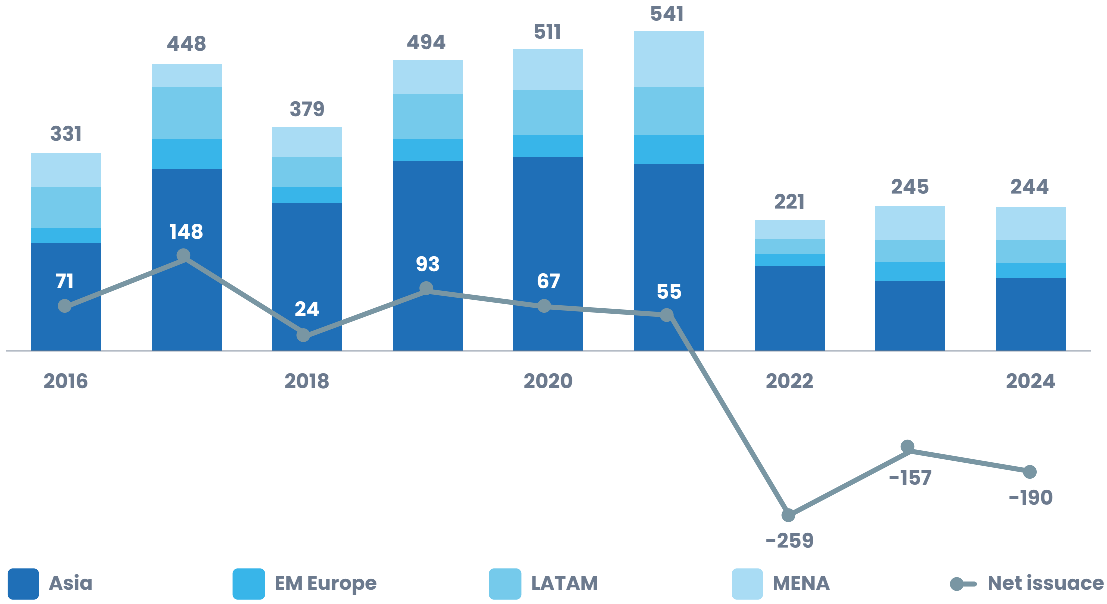


Source: JP Morgan, BAML, Bloomberg, Candriam. Indicative data which may change over time

EM Corporate technicals remain supportive as the segment experienced negative net supply in 2022 and 2023, totaling $416bn. Issuance by EM corporates has been restrained by high absolute yields, strong balance sheets, low refinancing needs as well as growing availability of attractive funding options in local markets. We do not foresee significant changes in these trends, hence we anticipate another year of negative net supply in 2024.

Figure 10 :
EM Corporate gross issuance

$ billions

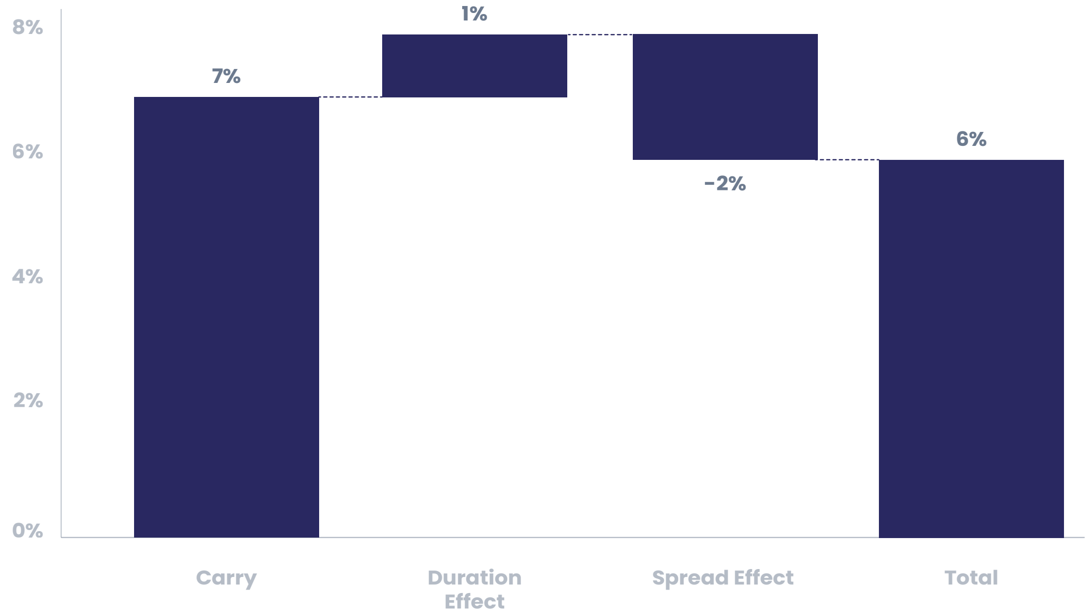


Source: JP Morgan, Bloomberg, Candriam. Indicative data which may change over time

We expect EM corporate returns to be similarly supported by carry and duration effects, while EM corporate spreads may widen by 10 to 70bps. On an assumption of 7Y US Treasury yields between 3.5% and 4% and EM spreads between 325 to 375bps, EMD HC Corporate returns may be around 4% to 8%.

Figure 11 :
EM HC Corporate

One year ahead expected returns, %



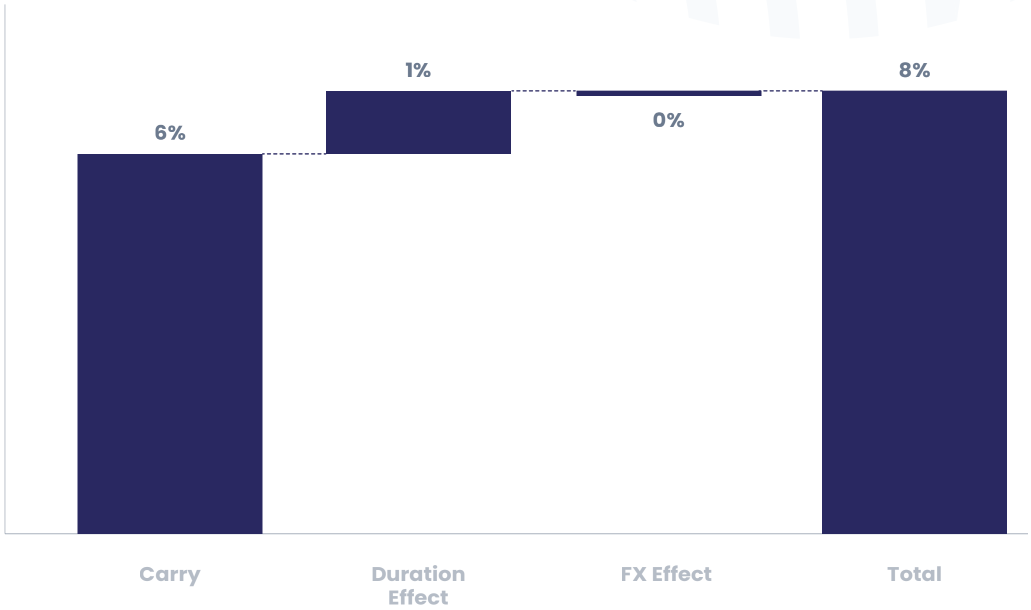
Source: JP Morgan, Bloomberg, Candriam. Indicative data which may change over time

Local Market Outlook.

Local markets will likely remain volatile in 2024, but high carry, along with continued slowing of inflation rates and associated expected policy adjustments, suggest that local bond returns should outweigh weaker FX returns.

Figure 12 :
LC Sovereigns

One year ahead expected returns, %



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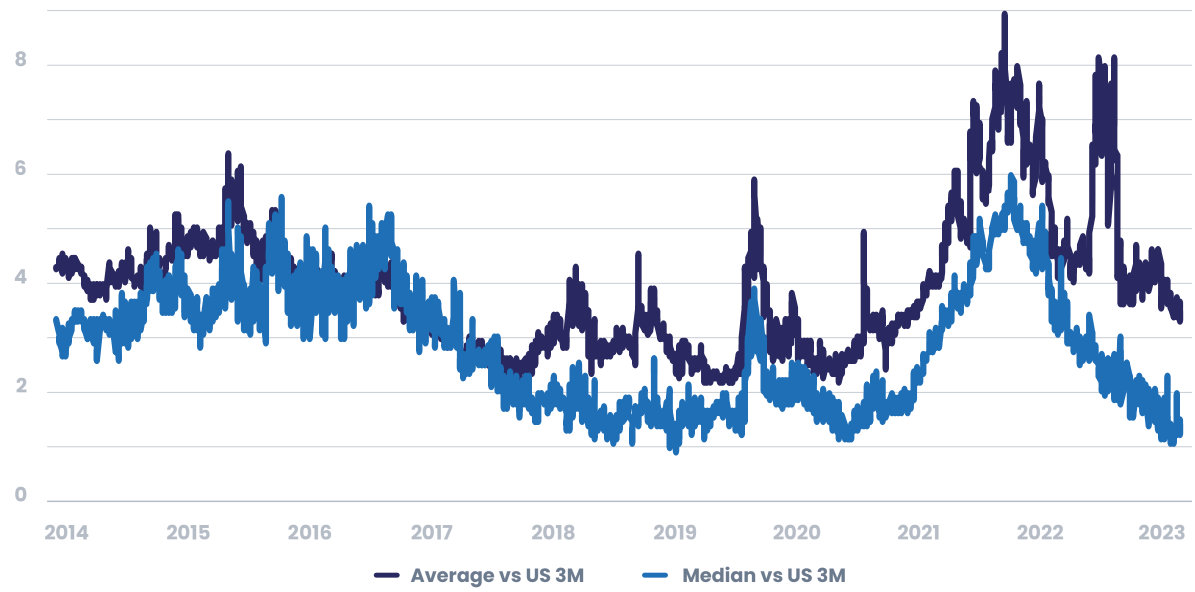
Source: JP Morgan, Bloomberg, Candriam

Pockets of value remain in EM FX, particularly in Latin America where carry is still ample. For most currencies, front-end carry (relative to dollar front-end yields) is now back to where it stood for most of the period between 2019-2021. (We exclude the high volatility of the early months of Covid-19.) That should somewhat limit the potential for ongoing strong FX returns in countries where FX carry has been particularly high versus the dollar, as local rates are coming down faster and sooner than in the US.

Figure 13 :
Three-month forward foreign exchange yields



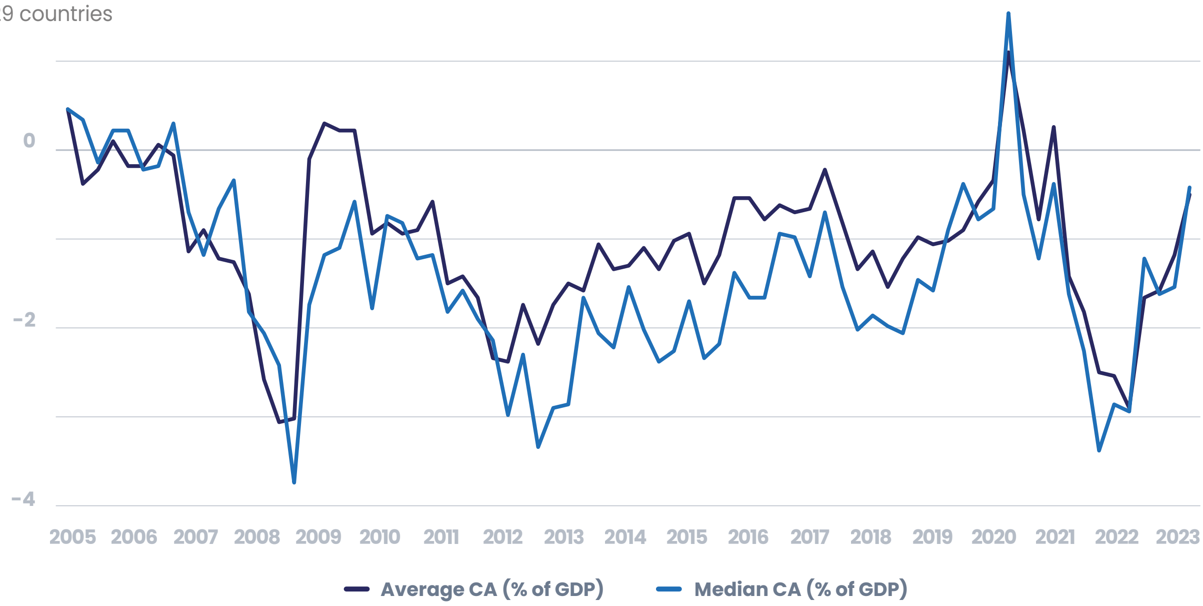
Source: Bloomberg

The longer-term story for the dollar remains intact. The dollar is very strong on a long-term basis. While it should eventually adjust, the question is -- ***When?***. The near-term story (3-6 months) continues to be one of US exceptionalism, which, should it persist, would be dollar supportive.

Nonetheless, FX fundamentals for emerging markets continue to appear supportive. Terms of trade remain elevated for most liquid local markets in the JP Morgan benchmark, current account deficits are approaching their lowest levels in almost a decade, foreign ownership of local bonds in local markets remains very low, and EM equities have been experiencing stronger inflows. That should mean that while EM FX could soften as carry erodes, a sharp downturn in FX is unlikely for most core markets and local returns should remain high.

Figure 14 :
EM current account balances

For 29 countries



Source: Haver, Candriam

Local bond returns should be a bright spot, given our outlook for continued disinflation in emerging markets. Carry, too, while constrained at the median versus the US, remains high in some local markets. This is particularly the case in Latin America, where in many cases local yields remain in or close to double digits.

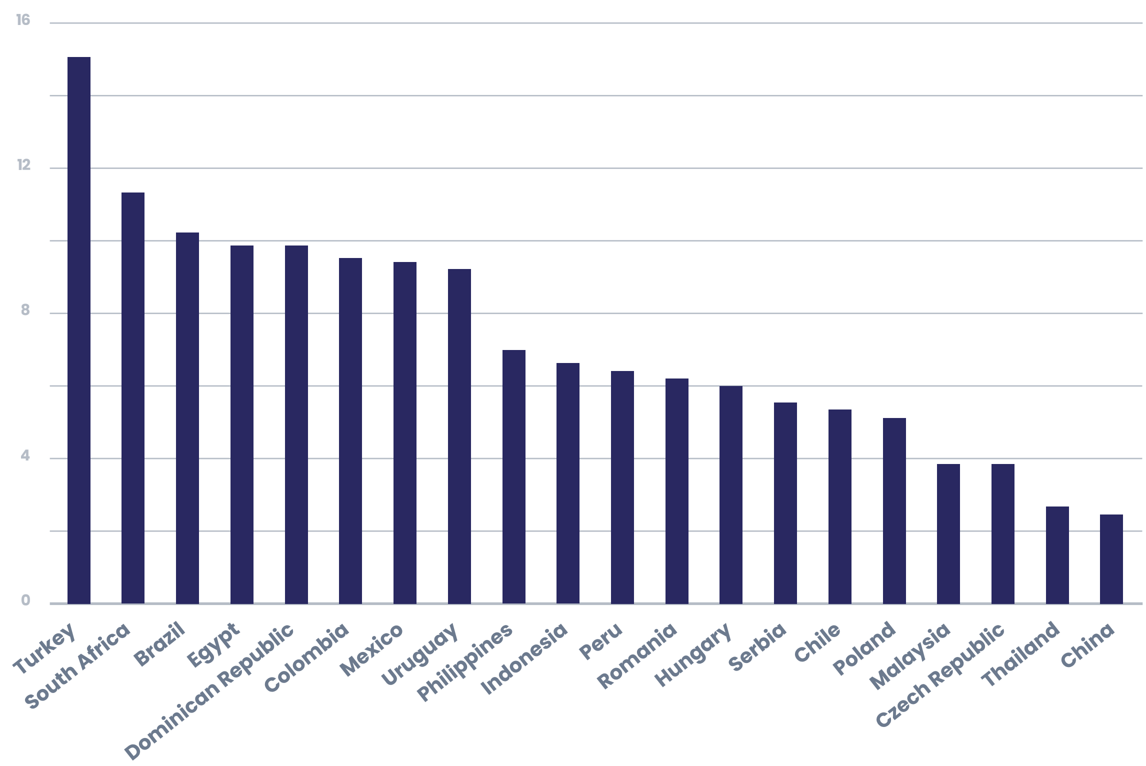
That said, the GBI-EM benchmark remains very bifurcated with yields in Asia significantly below yields in the US, particularly in China given deflation. Disinflation too now looks stronger in CEE than in Latin America, which should drive stronger duration returns in CEE this year, even if carry remains higher in Latam.

Overall, we expect continued strong local returns during 2024, from carry and duration. Active management should allow ample room to generate excess returns in local rates markets, given differing expectations for the policy environments and disinflation going forward.

On a one-year horizon, we expect 2024 returns in the 6-10% area.

Figure 15 :
GBI yields

Government Bond Index yields



Source: JP Morgan Index Data

Risks.

The main risk we see as specific to this year, 2024, is the very active Geopolitical situation. Our scenario assumes a soft landing in the DM economies; a DM recession would be a risk.

As always, risks for our Emerging Market Debt strategies include the risk of capital loss, interest rate risk, credit risk, currency risk, emerging market risk, high yield risk, derivative risk, and in some cases, counterparty risk.

€144 B

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