

October 2023

Emerging Markets Fixed Income Commentary

Overview

In October, EM credit returned -1.35% in a repeat of the theme of the prior two months. Spreads remained resilient, widening by 5bp on the month, supported by continued strong supply and demand technicals. Treasury losses of 1.46%, however, dented EM credit returns as U.S. treasuries backed up 36bps on the month. Driven by factors unlikely to be repeated, such as supply concerns and unusually strong 3Q GDP growth, the outlook for treasuries has turned more balanced following the large repricing recently.

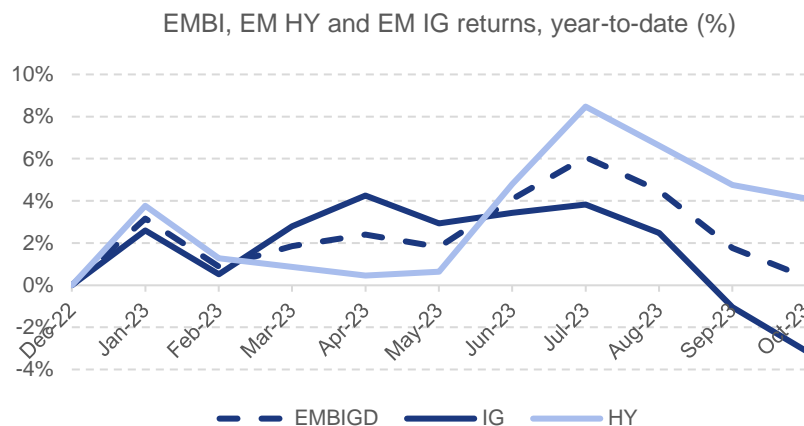
EM IG (-2.1%) again underperformed HY (-0.6%), disproportionately affected by the sell-off in treasuries on the month. The Middle East was an underperformer in October (-2.3%), driven by the flare-up in geopolitical tensions in the region. Latam also underperformed (-1.9%), owing both to the high duration sensitivity of some larger names in the region (Peru, Chile, Uruguay) and some idiosyncratic stories in Panama and Guatemala. EM high yield had positive excess returns (+0.4%) as distressed names rallied on progress over debt negotiations (Zambia, Sri Lanka). We are focused on relative value opportunities going forward, expecting return dispersion to increase as the economic cycle matures and the market punishes credits with poor fundamentals.

EM local debt returned -0.5% in October, driven by EMFX losses of 0.6% against the U.S. dollar, which rallied on the month due to rising U.S. yields and reduced risk appetite. EM rate returns were flat on the month, as carry offset price losses. In Latam, yields rose as investors paired back their expectations for near term rate cuts. In Asia, central banks in Indonesia and the Philippines even resorted to renewed interest rate hikes to counteract tightening global financial conditions and calm currency depreciation pressures. Having reduced our EM local market exposure over the summer at tight valuations, we have re-entered select positions where we feel valuations have overcorrected relative to local economic fundamentals.

Supportive technicals are the primary reason for EM spread resilience despite the crack in global risk appetite over the past three months. Outflows (-\$5.1bn in October) continue to be mitigated by negative net issuance (\$8bn in October). EM countries continue to turn to alternatives to Eurobonds, such as IFIs and local markets, restricting the supply of hard currency paper to the market. As treasury yields and thus funding costs decline, the risks to this positive technical grow, punishing countries with higher funding needs where spreads are more likely to widen versus those with lower funding needs.

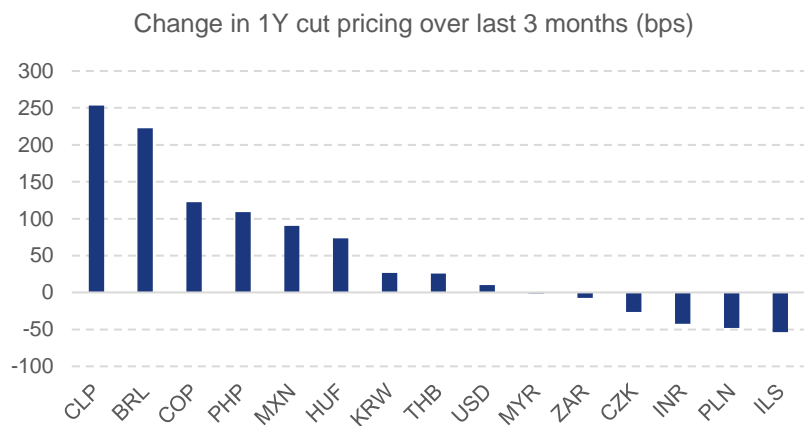
We are turning more cautious on the global growth outlook following the recent tightening of financial conditions underpinned by higher US treasury yields. We expect return dispersion across EM credit to increase, generating opportunities to add value with fundamental analysis and security selection.

Figure 1: U.S. treasury losses have dented EM IG returns over the past three months



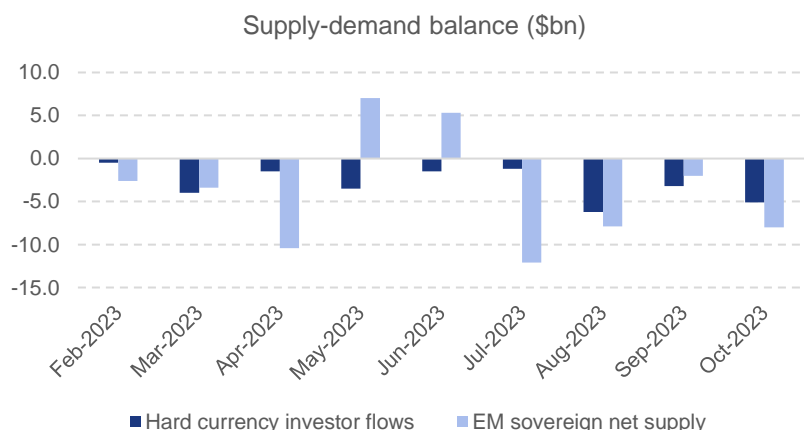
Sources: Bloomberg, JP Morgan, with Vanguard calculations

Figure 2: Some EM local markets have significantly repriced 1Y monetary policy expectations since August



Sources: Bloomberg, JP Morgan, with Vanguard calculations

Figure 3: Negative net supply continues to mitigate outflows



Sources: Bloomberg, JP Morgan

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