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PICTET WEALTH MANAGEMENT

2024 outlook - Emerging market bonds

A useful source of portfolio diversification

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FLASH NOTE

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SUMMARY

- Local-currency emerging-market (EM) sovereign bonds have posted strong returns in 2023, outperforming their developed-market (DM) peers. Hard-currency EM corporate bonds have also risen in value over the year, performing in line with DM credit.
- Headline inflation has fallen significantly over the course of the year, enabling some EM central banks, especially those in Latin America, to cut rates. This has forced down sovereign yields. Central banks in Asia (apart from China) have been more cautious with respect to rate cuts.
- We expect local-currency EM sovereign yields to fall from 6.6% (as of 24 November) to around 5.5% by the end of 2024, driven by falling inflation and additional rate cuts. Given their low correlation to developed-market bonds and their expected outperformance next year, local-currency EM sovereign bonds are an attractive source of portfolio diversification. We remain overweight in this asset class as we expect it to deliver a high-single-digit return in 2024.
- Hard-currency EM corporate bonds have been providing attractive yields (around 7.7% at 24 November), and as such represent an attractive source of carry. However, it is important to focus on high-quality issues. We expect spreads to remain close to their current levels, ending 2024 at around 330bp. We expect Asian investment-grade corporate bonds to provide a high-single-digit total return in 2024.

EM BONDS ROSE IN VALUE IN 2023

Local-currency EM sovereign bonds, as represented by the JP Morgan GBI-EM Global Diversified index, have posted strong total returns in 2023, outperforming their DM peers. As at 22 November they had returned 7.4% year to date (YTD). EM sovereign bonds are up by a more impressive 8.6% in US dollar terms thanks to the

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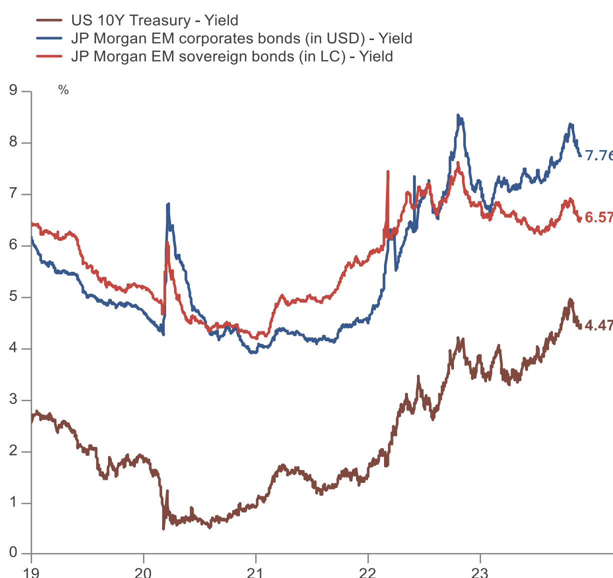
appreciation of some EM currencies (particularly those from Latin America) against the dollar, although they have only gained 6.7% in euro terms.

Latin American sovereign bonds have performed particularly well, gaining 11.5% in local-currency terms and 22.4% in US dollar terms YTD (as at 22 November). Thanks to a significant decrease in headline inflation, central banks in Brazil, Peru and Chile have been able to cut rates, resulting in Latin American sovereign yields falling. Central banks in Asia, however, have generally been more cautious, either keeping rates where they were or hiking them further. The exception is the People's Bank of China, which has implemented a number of easing measures, including cutting various key rates and further reducing banks' reserve requirement ratios. The Chinese economy's weak recovery has had a knock-on effect on economies elsewhere in Asia with the result that Asian currencies have generally dropped against the US dollar. This has caused Asian local-currency sovereign bonds to underperform those from other emerging-market regions.

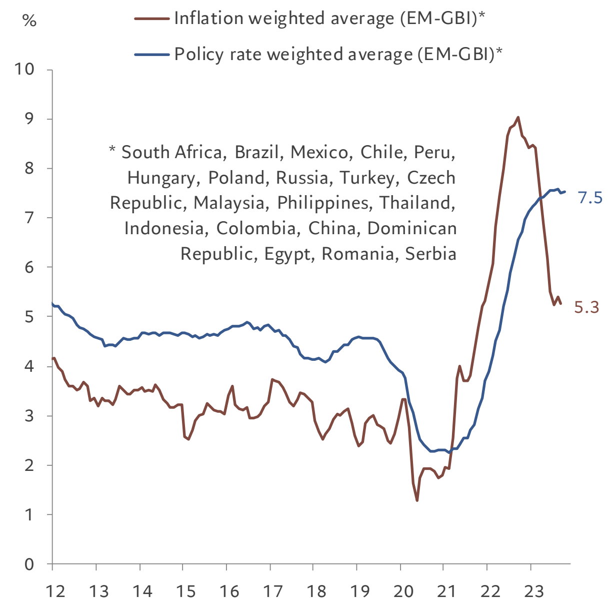
Hard-currency EM corporate bonds, as represented by the JP Morgan CEMBI Broad Diversified Index, have gained 5.0% year-to-date (as at 22 November), which is in line with DM corporate bonds' return. EEMEA (Eastern Europe, Middle East and Africa) corporate bonds have posted the strongest performance of any EM region at 10.9% YTD. Defaults in the EEMEA region rose in 2022 because of failures in Russia but the default rate for the region declined to 0% in July this year. By contrast, the corporate default rate in Asia hit 17.5% in October due to defaults among Chinese property developers.

Chart 1: US 10-year Treasury yield and EM corporate and sovereign bond yields since 2019



Source: Pictet Wealth Management, FactSet, as of 24.11.2023

Chart 2: Average inflation and policy rates in EM since 2012



Source: Pictet Wealth Management, Datastream, as of 31.10.2023

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EM SOVEREIGN BONDS: PROMISING RETURN POTENTIAL IN 2024

Local-currency EM sovereign bond yields have fallen slightly this year, but at 6.6% on 24 November *(see chart 1)* they are still slightly higher than their average level since 2010. Yields in Latin America are still high (around 10% in Colombia, Brazil and Mexico) so there is potential for them to fall further. We expect central banks in Chile, Peru and Brazil to continue cutting rates, and by more than market participants currently expect, thanks to moderating inflation. Other Latin American central banks could follow suit—especially that of Mexico, which has kept its policy rate on hold at 11.25% since March.

Market participants are pricing in further rate cuts by central banks in Latin America and Eastern Europe next year, but not yet by those in Asia. While there may be less room for yields to come down in Asia, we nevertheless believe some Asian central banks will start cutting rates in the second half of the year. Falling headline inflation in the region, possible rate cuts in the US and a potentially weaker US dollar could encourage Asian central banks to ease monetary policy. We expect the weighted-average policy rate in emerging markets to fall from 7.5% (as at 31 October, *see chart 2*) to 6.4% by the end of 2024.

We expect the US dollar to weaken against EM currencies in 2024, particularly in the second half of the year when the Fed could start to cut rates to counteract slowing growth. We believe emerging markets' growth will prove more resilient as some countries have already begun easing policy and the commodities cycle should remain supportive. EM growth, especially in Asia, could also be supported by a gradual economic recovery in China, where the authorities have stepped up policy support significantly of late.

Based on these expectations, we believe the average local-currency EM sovereign yield will fall from 6.6% at 24 November to around 5.5% by the end of next year. At these levels, this asset class remains an appealing alternative to developed-market sovereign bonds. Indeed, we expect EM sovereign bonds, which show low correlation to Bunds and US Treasuries, to outperform developed-market sovereign bonds in 2024.

Expecting local-currency EM bonds to produce total returns in the high-single-digits next year, we remain overweight this asset class. Yields could fall by more than the market expects if EM central banks cut rates more aggressively than is currently being forecast. The biggest risk to our scenario is the possibility of a sharp global slowdown. If this were to occur, the US dollar would probably strengthen due to its safe-haven status, prompting EM central banks to keep rates on hold in response to the increasing downward pressure on EM currencies.

EM CORPORATE BONDS: WE PREFER INVESTMENT GRADE TO HIGH YIELD

We also have a positive outlook on EM corporate bonds as the high coupons they are providing increase the likelihood of positive returns next year. However, EM investment-grade corporate bonds do not appear particularly cheap relative to US investment-grade credit *(see chart 3)*.

Nevertheless, our positioning in EM credit is the same as in DM credit—overweight investment grade and underweight high yield. This is because we believe

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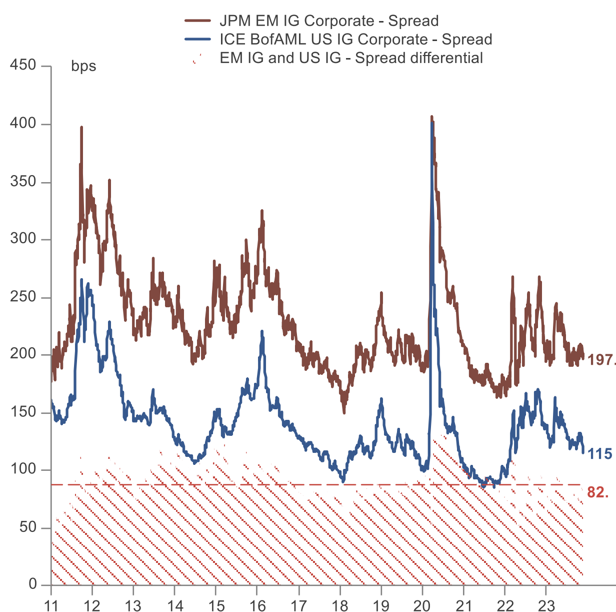
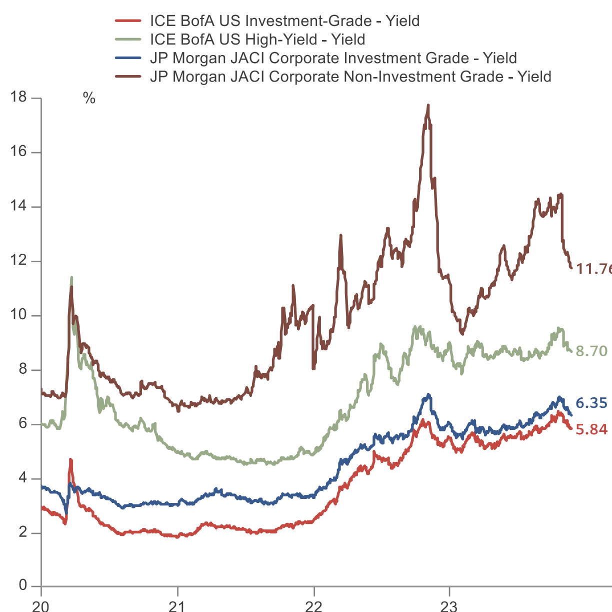
investment-grade firms will be better able to cope with higher refinancing costs than noninvestment-grade ones. We especially like Asian investment-grade bonds as their average spread differential relative to US investment-grade credit is in line with the long-term median, indicating a relatively stable and balanced risk premium in comparison to US corporate bonds.

Chart 3: EM IG and US IG spreads and the spread differential



Source: Pictet Wealth Management, FactSet, as of 23.11.2023

Chart 4: Asian and US corporate bond yields



Source: Pictet Wealth Management, FactSet, as of 23.11.2023

The spreads of USD-denominated Chinese corporate bonds have been tightening since the summer thanks to supportive policies from the Chinese government, such as increased infrastructure spending and the loosening of some rules in the property sector. These policies may lead to some investment opportunities, but we will remain cautious in terms of which companies we take exposure to.

Having declined in the twelve previous months, the default rate for EM high-yield corporate bonds rebounded to 5.9% in October, according to Bank of America, mainly due to defaults at two Chinese property sector companies. EM corporate bonds have been subject to more ratings downgrades than upgrades so far this year, although the ratio has improved relative to 2022. Meanwhile, the distress ratio (the proportion of companies with credit spreads above 1000 bp) has increased slightly recently in Latin America and in EEMEA while it has decreased in Asia. We believe the EM high-yield default rate could rise moderately next year but will probably remain below 7%.

Encouragingly, companies in emerging markets have been deleveraging in recent years, as indicated by lower net leverage ratios. What's more, investment-grade and high-yield corporate bonds still provide higher spreads per turn of net leverage (average spread over net leverage ratio) than those in the US, signalling that EM credits provide higher compensation per unit of risk involved. In Asia, spreads per turn of

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leverage for investment-grade bonds are twice as high as for US investment-grade credit and are actually close to the levels offered by US high-yield bonds. This is one of the reasons we believe Asian investment-grade bonds are attractive.

Despite the progress that EM companies have made in terms of deleveraging over the past few years, their interest coverage ratio (12-month EBITDA (earnings before interest, taxes, depreciation, and amortisation) over interest expenses) is showing signs of deteriorating as they refinance at higher rates. This reinforces our preference for investment-grade issues over their HY equivalents.

In summary, the outlook for EM corporate bonds denominated in US dollars is encouraging, and we are keen to lock in the high carry that stem from yields of around 7.7% (as at 23 November). We prefer investment grade to high yield, which leads us to maintain a neutral view on EM corporate bonds overall. We expect spreads to remain close to their current level (328 bp on 23 November), ending 2024 at around 330 bp. We expect Asian investment-grade corporate bonds, as represented by the JP Morgan JACI Corporate Investment Grade index, to provide a high-single-digit return in 2024, helped by the high carry associated with a yield of 6.4% (on 23 November, *see chart 4).* This should compensate for the limited spread compression we expect next year.

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