

Emerging Markets: Distressed Leads the Way

ANISHA GOODLY | 9 APRIL 2024

At the beginning of the year, the market was pricing in 158bps in rate cuts for 2024, starting in January. However, a number of macro-economic developments, including stronger-than-expected U.S. growth data and concerns about the path of disinflation, led to a subsequent unwinding of U.S. rate cuts. More recently, perceived dovishness from the March FOMC meeting and expectations of a soft – or even no – landing in the U.S. has supported risk-on sentiment.

For the first quarter of 2024, Emerging Markets (EM) sovereign hard currency debt and EM corporate hard currency debt returned 1.99% and 2.35%, respectively, whereas local currency debt underperformed (-2.26%) due to dollar strength. The high yield (HY) segment returned 4.92% outperforming the investment grade (IG) returns of -0.77% significantly. Within high yield, the lower rated and distressed credits rallied with the B rated segment returning 4.61% and the C rated segment returning 22.02% for the quarter. Spreads on the EM sovereign index tightened by approximately 50bps to close the quarter at approximately 375bps.

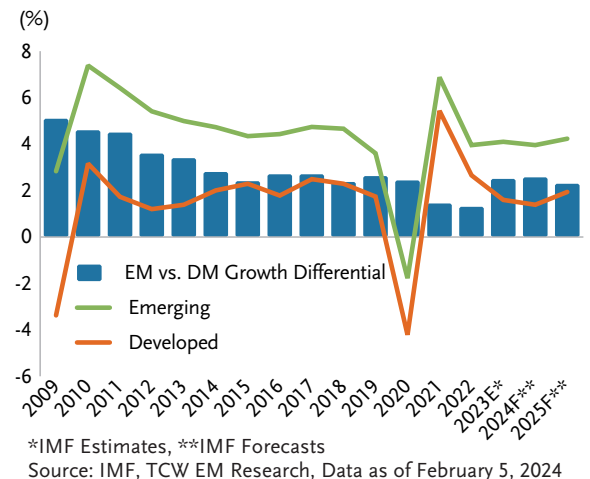
Looking ahead, we remain constructive on the outlook for Emerging Markets, based upon:



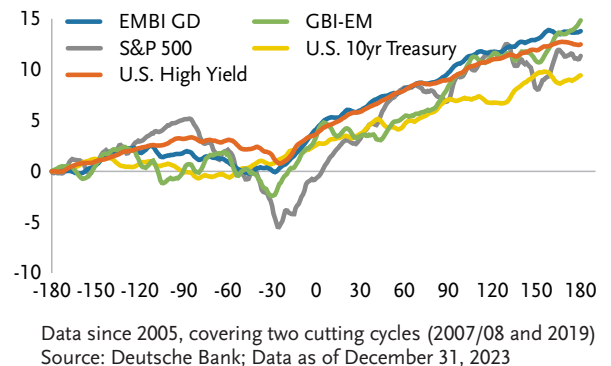
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Ms. Goodly is the Portfolio Specialist for the TCW Emerging Markets Group, serving as the primary liaison between TCW's Emerging Markets investment team and TCW's client relations and marketing professionals. As part of her role, she also leads the EM Portfolio Specialist team, whose core activities include communicating investment strategies, performance and outlook, in addition to supporting product marketing and development. Ms. Goodly is also a member of TCW's ESG Group and Diversity, Equity, and Inclusion (DEI) Taskforce. Prior to joining TCW in 2013, Ms. Goodly spent eleven years at Morgan Stanley, most recently as an EM Fixed Income institutional salesperson. Ms. Goodly is the co-chair of Diversity and Inclusion for Women in Institutional Investments Network (WIIN) and was shortlisted for "Ally of the Year" for the Women in Asset Management Awards. She is also a Founding Member of the Los Angeles chapter of Chief, a leadership network for executive women, and a member of the Los Angeles Leadership Committee for 50/50 Women on Boards. Ms. Goodly graduated with a BA in Economics from Stanford University.

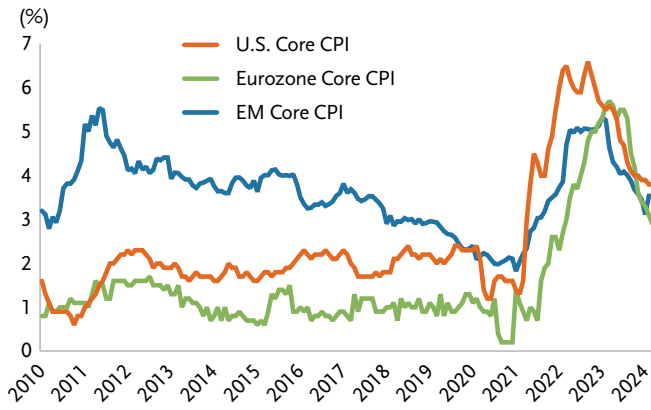
EM-DM growth differential is forecast to reach its widest level in almost a decade. This is in the context of a conservative estimate for growth in China (4.5% versus the 5.0% government target)¹. Further, Emerging Markets represent 80% of global growth.



Global financial conditions are forecast to be looser in the second half of the year, which has historically benefited Emerging Markets fixed income. In fact, EM fixed income has generally returned an average of 14% in the 12 months around the start of past cutting cycles, outperforming both the S&P and U.S. High Yield.

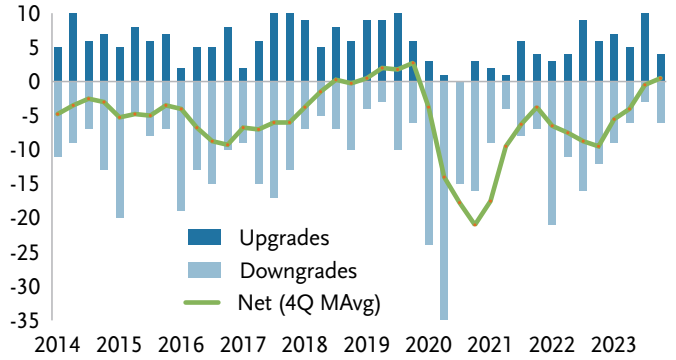


¹ Forecast based on TCW Emerging Markets group research and IMF data



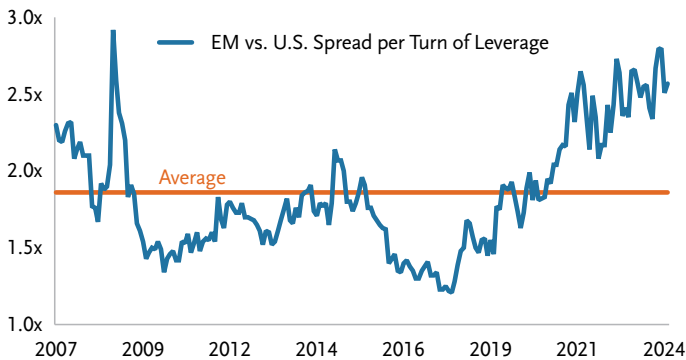
Source: Refinitiv Datastream, Bloomberg, HSBC; Data as of March 31, 2024

EM economies posted more rapid declines in inflation than Developed Market peers in 2023, owing to proactive central bank policy. A decline in global inflation should be beneficial for EM.



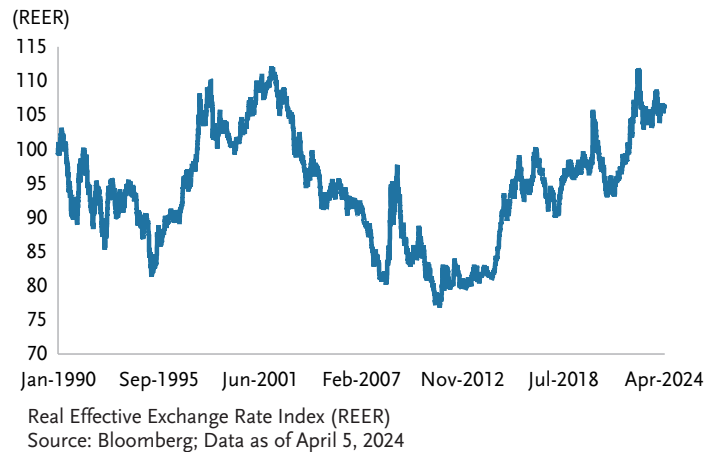
Source: Deutsche Bank; Quarterly data as of December 31, 2023

EM fundamentals are reasonably sound, with no sovereign defaults forecast for 2024. In addition, ratings upgrades are forecast to outpace downgrades for the first time in a decade. Further, debt/GDP for Developed Economies exceeds 100%, versus 67% for Emerging Markets.



Source: BofA Securities; Leverage data as of 2Q23
Spreads as of March 31, 2024

Attractive Emerging Markets valuations relative to Developed Markets, particularly in high yield.



Real Effective Exchange Rate Index (REER)
Source: Bloomberg; Data as of April 5, 2024

Potential for a weaker US Dollar, benefiting EM local currency, on the back of a slowdown in U.S. growth and a decline in U.S. rates.

In the near term, the market is likely to be driven by expectations for U.S. monetary policy and global growth expectations. We anticipate that returns for hard currency will be driven largely by carry, with some support from lower U.S. rates. Given the extent to which spreads have rallied, we anticipate spread compression to be a minimal driver of returns from here, outside of idiosyncratic situations in high yield.

In our view, the USD, which has been largely directionless year-to-date, should begin to weaken once the markets are confident that the Fed is on a path to easing. Another important factor for dollar performance going forward will be growth in the rest of the world. While very early in the cycle, global PMIs are starting to turn and demand for commodities is increasing. The European outlook appears to be improving after high rates and lower Chinese demand weighed on growth in 2023. In addition, Chinese demand is starting to improve at the margin.

We are actively monitoring growth, geopolitical and election risks:

- **Hard Landing:** One significant risk, in our view, is a hard landing in the U.S., particularly if higher rates for longer send the U.S. economy into a downward spiral. A soft landing in the U.S., in the context of slower global inflation, should be supportive for EM fixed income.
- **Israel/Hamas Conflict:** Our base case is that the Israeli/Hamas conflict remains relatively contained within the region. Although fighting could continue for the next several months, Hamas allies in the region are trying to demonstrate support without triggering a broader response from Israel or the United States. The international community has stepped up efforts to ease the humanitarian crisis in Gaza and diplomatic channels have focused on brokering a cease-fire agreement that would free hostages. Negotiations for de-escalation have continued through Ramadan, but the gap between demands from both sides still seems wide. Of course, the risk of miscalculations from any of the parties involved could contribute to further escalation which, in turn, could drive spikes in oil and, potentially, inflation.
- **Chinese growth downside:** While the recovery in parts of China's economy appear to be gaining strength, the property sector remains weak, particularly purchases of new homes and housing starts. There remains a risk of a more disorderly downturn, as households' fear of developer bankruptcies and declining home prices makes them less willing to pre-pay for uncompleted new homes. This would worsen liquidity pressures for developers, leading to more bankruptcies and housing price declines, which would have a negative impact on construction, jobs, household consumption and wealth, banks non-performing loans (and their ability to finance new lending), and local government finances (which remain dependent on revenues from land sales).
- **Election Risk:** The three biggest remaining elections in Emerging Markets are in India, Mexico and South Africa. We believe India and Mexico will result in a continuation of current policies with minimal market impact. Elections in South Africa could present more volatility if the ANC loses support and is forced to look for a more populist coalition partner. We believe the ANC will get between 45% and 50% of the vote enabling them to seek coalition partners to advance their reform agenda. The U.S. election could be a bigger source of volatility as we head into the second half of the year, as concerns around tariffs and foreign policy become front and center. ■

Glossary

BPS: Basis points; FOMC: Federal Open Market Committee is the branch of the Federal Reserve System that determines the direction of monetary policy in the U.S. by directing open market operations; IMF: International Monetary Fund; DM: Developed Markets; S&P: Index that tracks the stock performance of 500 of the largest companies listed on stock exchanges in the U.S.; GDP: Gross Domestic Product; USD: US Dollar; PMI: Purchasing Managers Index is a measure of the prevailing direction of economic trends in manufacturing; ANC: African National Congress is a political party in South Africa

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