Allianz Global Investors

EMERGING MARKETS DEBT – MONTHLY MARKET MUSINGS

Heading into 2025 with a clean slate

OCTOBER 2024

Emerging markets' (EM) fixed income performance has proven resilient this year through geopolitical risk, market volatility, elections and changes in the US Federal Reserve's (Fed) narrative. Looking ahead, the upcoming US elections and ongoing turmoil in the Middle East are risks to watch. But heading towards 2025, US economic data continues to support the case for a soft landing, EM fundamentals are robust and investment flows appear to be returning to the asset class. In this environment, we see plenty of opportunities in local currency bonds and select hard-currency high-yield credits without trying to call the direction of the US dollar (USD) – we prefer a relative value approach to investing in EM foreign currencies (FX).

The much-anticipated start to Fed easing finally arrived in September. The Fed cut interest rates by 50 bp amid signs of a slowdown in the US labour market, although the decision was framed in the context of an expected soft landing. New data releases have also supported this thesis more recently. After a more volatile summer, the cut instilled new momentum into EM in September, particularly in high yield.

The expectation of more US monetary policy easing should help the asset class do well, going forward, if history is any indication at all. But, as always in EM, we would caution that this does not imply one can just adopt a passive approach to investing in the asset class. So far this year, EM has weathered conflict in the Middle East, multiple elections, and a wild ride with the Fed itself - going from expecting significant easing to "higher for longer" through recession fears and then "recalibrating", as Chair Jerome Powell would say, into a soft landing. Volatility has been something to contend with, although year to date returns have been solid (JPMorgan's EMBIGD Index, 7.6%; JPMorgan's GBI-EM Index, 2.2%). An active approach to investing in EM remains the best way to achieve superior returns in the asset class, in our view. Going forward, we will be looking to actively manage any volatility that could arise from the key event risk of the US elections on 5 November and from broader geopolitical risk – especially the Middle East conflict – for its implications for oil prices, global inflation and market sentiment.

What may be the impact of the US elections on EM?

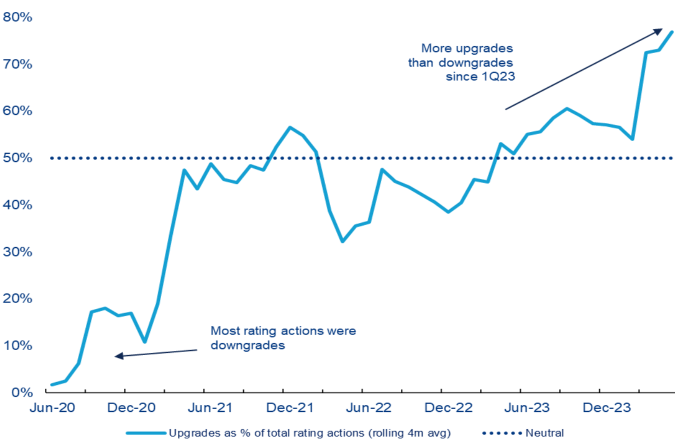
EM investors are likely to hold positive expectations for 2025 in light of robust EM fundamentals, positive reform stories, supportive Fed easing and green shoots in portfolio inflows. In the very short term, it is hard not to feel a strong sense of déjà vu though. As we head into US elections, from Latin America to Asia through Eastern Europe, some of the very same EM stories that were topical during the 2016 US election are top of mind again now. While President Luiz Inácio Lula da Silva's brief "market honeymoon" has seemingly come to an end, Brazil's current fiscal woes afford investors opportunities but bring back memories of former President Dilma Roussef's tenure roughly around the time of the 2016 US elections. In nearby Argentina, President Mauricio Macri's pro-business government had promised to turn the country around back then – not unlike current President Javier Milei's goals (albeit with very different reform priorities). In late 2015, Ukraine completed its debt restructuring following Russia's 2014 invasion and its subsequent sovereign default. In August this year, Ukraine once again restructured its sovereign debt, after a two-year moratorium requested in the wake of another Russian offensive. In 2016, China was emerging from a currency devaluation and a period of weak growth. Similarly, today we see a country pushing through significant measures to deal with industrial overcapacity, low confidence and a challenging property market. Finally, back in 2016 many frontier markets (FM) were coming out of a difficult couple of years of low commodity prices, debt accumulation and questions around market access. This year has seen the completion of many of the debt restructurings, which had been pending since Covid-19 struck (see next section). As in Q4 2016, investors are focused on the potential impact of the US elections on EM fixed income – and where opportunities may arise after 5 November.

Back in 2016, the contest was between a relatively "centrist" Democratic Party nominee, Hillary Clinton, and a more populist Republican candidate, Donald Trump. While Clinton had been the favourite in the polls, the final winner was the "unknown quantity", businessman Trump. Today, we see a Trump – who does not appear to have moved away meaningfully from what he stood for in 2016 – against a Kamala Harris who markets perceive to be as "good for bonds" as Clinton might have been. A Trump win would trigger some concerns around the outlook for EM fixed income returns, including the possible end of support for Ukraine, a trade war with China, and ensuing higher inflation that potentially alters the Fed's rates path. His stance on China could hit EM Asia and result in an overall stronger USD, while the case is not as clear under Harris. Just like in 2016, we think that it is hard to have a strong directional call on the USD, given the combination of risks around the US elections, the Fed rates path and ongoing geopolitical conflict. We prefer to express a ***relative value view in the main EMFX plays, peppered with some idiosyncratic FMFX stories where we still see value***.

Watch for any impact from Middle East conflict

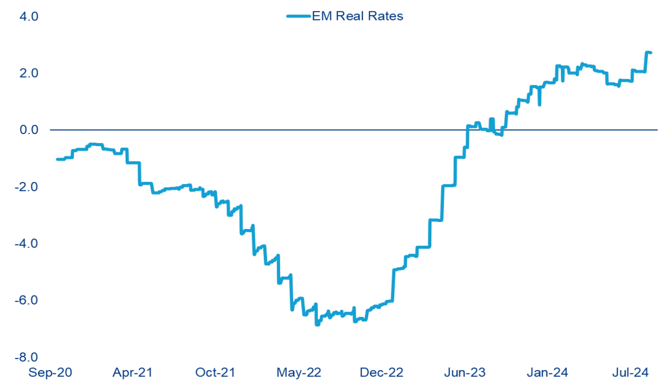
Tensions in the Middle East have been high since the 7 October 2023 attacks, with threats of escalation surfacing at different times over the past year. It is hard to predict the evolution of the conflict. But it is worth noting that although bouts of risk-off sentiment have emerged after every major incident, overall, markets have become increasingly desensitised. Crude oil was up around 9% following the most recent Iranian missile attack on 1 October – the largest increase in two years – but MENA hard currency sovereign bond spreads moved roughly in line with the high grade component of JPMorgan's EMBIGD Index (except for defaulted credit, Lebanon). Still, the potential impact of a protracted and/or broader conflict should not be underestimated, particularly if it meant higher oil prices for longer. The effects on global inflation could alter both the Fed's and local EM central banks' rates paths and hit risk appetite. It could also impact EM oil importers like Turkey,

Fig. 1 An improving credit rating trend in EM



Source: AllianzGI, Bloomberg, 4 Oct 2024.

Fig. 2 EM real rates are at multi-year highs



Source: AllianzGI, Bloomberg, 4 Oct 2024.

where FX has been a popular trade this year. As always, we also see it opening up opportunities in oil exporters, particularly those committed to economic reforms or where international support remains firm, eg, Ecuador, Egypt, Jordan and Nigeria. We still like such ***hard currency sovereign high yield opportunities where idiosyncratic stories justify valuations and prospects of further capital appreciation.***

The (EM) state of play

As we near the US elections and monitor Middle East risks, we remain convinced that opportunities abound for active EM investors. We think that it is important to remember where EM stands now, for an outlook on EM fixed income.

EM as an asset class rests on solid fundamentals. Economic growth is set to remain resilient going into 2025, with the gap between EM and developed markets' (DM) growth moving in favour of EM next year. Bloomberg consensus forecasts see EM (incl. China) growth going from 4.0% this year to 4.3% next year, with DM growth steadying at 1.7%. China's recent significant stimulus to its economy may provide upside risks to these projections. The improvement in EM fundamentals has also been mirrored by a clear trend of credit rating upgrades (Fig. 1). Importantly, EM policymakers' proactive policy actions have also allowed EM central banks to build a sizeable cushion of positive real rates, as the EM disinflationary process has moved faster than EM central banks' monetary policy easing. Despite signs of a slowdown in this process and risks from oil prices from the Middle East conflict, **real yields currently stand at multi-year highs and offer interesting opportunities to invest in local currency EM bond markets (Fig. 2).** Carry trades in local currency are likely to be appealing if US data keeps supporting the Fed easing path that markets price.

While any volatility from global geopolitical risk is key to watch, EM can also claim it has (almost) passed its busiest election year in decades with flying colours. Lower idiosyncratic political risk coupled with a soft-landing US economy, an easing Fed and a China stimulus could bring flows back into the asset class, after a long lull. This in turn is going to boost returns in EM.

In focus: frontiers - starting 2025 in good shape

The positive turnaround in several sovereign states is another reason why 2024 has been a remarkable year for EM fixed income so far. Economic reforms in Argentina, Ecuador, Egypt and Nigeria and efforts to work more closely or stay on a programme with the IMF in El Salvador and Pakistan are encouraging, as are agreements reached to restructure debt in many FMs. After false starts, delays and complications, 2024 has so far seen an impressive number of (full or near) debt resolutions that are paving the way for many FMs to become current on their debt again and return to markets in the future. We have seen debt resolutions in Ghana, Sri Lanka (agreement in principle), Ukraine, and Zambia, with Ethiopia currently in discussions with creditors. These have come on the heels of Suriname and Chad in 2023.

Most of these countries' debt defaults or moratoriums occurred in the aftermath of the Covid-19 period, though what caused them goes back further. Conflict played a key part in triggering the decisions of Ethiopia and Ukraine to stop paying creditors. Elsewhere, Covid-19 was the proverbial straw that broke the camel's back after years of poor economic management and the commodity price shock of 2014-2015 that weakened balance sheets. During the pandemic, the G20 initiative to suspend public debt payments ("DSSI") provided temporary respite, but the tightening in global liquidity conditions that followed saw some countries become insolvent. Some of them approached creditors for debt restructuring under the Common Framework (CF).

What have we learnt from recent EM debt restructurings?

Although we did not hold the debt of these countries at their time of default, we have learnt important lessons from observing their restructuring processes. There are a handful of takeaways that are worth reflecting on as they are likely to shape FM debt performance in future.

Firstly, if an investor is to embark on a debt restructuring under the CF, the experience can differ meaningfully depending on the country in question. That is mainly because, despite the name, the CF provides little in the way of a clear framework to approach a restructuring. Yet, the CF's objectives are rather ambitious: providing meaningful debt relief, in a timely fashion and in a way that is consistent with a perception of equitable burden sharing amongst creditors. Each defaulted country's Debt Sustainability Analysis (DSA) – particularly in the case of low-income countries (LICs) – provides clear guidance on the extent of relief a restructuring should provide. However, views abound on the appropriateness of the IMF's country macro assumptions and projections that form the basis of that DSA. Defining what is equitable burden sharing has also been a challenge – as Zambia's experience confirmed when official creditors rejected the first agreement it had reached with bondholders. Zambia's case, which dragged on for three years, also shows how timely debt relief is hard to deliver. Failure to do that just compounded the country's challenges. Finally, with a few countries having gone through the process, investors have also been questioning whether the current sequencing of creditors reaching an agreement is the best approach. Official creditors have tended to strike a deal first, paving the way for IMF disbursements, then for bondholders and private creditors' deals, etc.

Secondly, the last 10-15 years have seen new creditors becoming more prominent in FMs – namely, bondholders

Fig. 3 What are state-contingent debt instruments

Examples of SCDIs include:

a. Value Recovery Instruments (VRIs) issued as part of a restructuring to give creditors additional upside, if in the future the debtor's payment capacity exceeds what was assumed in the base case, e.g. Suriname's oil-linked securities;
b. Bonds that allow to reduce, defer, stop debt payments due to an event, e.g. Grenada's hurricane clause;
c. Bonds whose cash flow is linked to the issuer's attaining certain ESG-related goals, eg, Chile's and Uruguay's Sustainability-Linked Bonds (SLBs).

There are some **advantages** to SCDIs, including:

a. Facilitating a debt agreement, as creditors feel they can enjoy future upside if they are proven right that the baseline restructuring was too conservative;
b. Debtors can feel protected in case of extreme weather events outside their control that impair their ability to pay, e.g. with Climate Resilient Debt Clauses;
c. Debtors can be given incentives to reach ESG goals, which can strengthen their future capacity to pay, eg, with SLBs and Debt for Nature Swaps.

But there are also some **disadvantages** to SCDIs:

a. Identifying and defining appropriate reference variables, thresholds and payment adjustment mechanisms that cannot be manipulated, e.g. to avoid a repeat of the Argentine warrants experience;
b. The lack of a market standard for documentation, analytics and pricing of these instruments;
c. The appropriateness for inclusion in main EM indexes, though Zambia and Ukraine showed this is feasible.

SCDIs are not appropriate for all restructurings. They are better suited for cases where there is a material difference in views between a debtor, the IMF and creditors on the debtor's future capacity to pay, eg, Suriname's oil finds or Ukraine's ongoing conflict. Where no meaningful divergence is identified in how the parties think of the likely evolution of a debtor's capacity to pay (eg, Ghana) such instruments may not need to be included in the restructuring.

Source: "State-Contingent Debt Instruments: prospects for Enhancing Growth", The Bretton Woods Committee, July 2024.

and China. The CF's original intent was to bring together these different creditors. In 2023, the World Bank estimated China to hold at least 17% of Sub-Saharan Africa's (SSA) debt and warned this may be an underestimation, especially state-owned enterprises' lending. Eurobond holders have also become a prominent creditor category changing the pre-HIPC ("Highly Indebted Poor Countries" Initiative) debt stock composition of many LICs, particularly in SSA. These have brought new negotiations' dynamics and incentives systems, as well as rather different timelines, objectives and "red lines".

Thirdly, there have been a much wider deployment of state contingent debt Instruments (SCDIs), which allow for additional value recovery for creditors, if the debtor's capacity to pay exceeds that assumed at the time of the restructuring (or delay/reduce recoveries if the debtor's financial situation worsens) (fig. 3). The popularity of SCDIs has risen as private creditors bring alternative views to the restructuring country's DSA. The concept of "debt carrying capacity" has become hotly debated. In Suriname, for example, where the IMF projections did not account for the upside potential from the country's newfound oil wealth, bondholders sought to secure a claim on a better than (IMF) projected future growth path. As always, the devil is in the detail. With older SCDIs showing varying degrees of success – consider Argentina GDP warrants – we have seen a variety of such instruments coming out of recent restructurings. With sustainability now higher on the agenda, some SCDIs have also begun including financial incentives based on the creditor's success in attaining certain sustainability goals. As new SCDI structures proliferate, more work is likely to be needed to perfect both the crafting and the pricing of these new instruments.

Finally, there has been a growing recognition on the part of the IMF that the analytical tools at its disposal must be updated to handle issues that are becoming more prominent and are not as well captured in the current LIC DSA framework – namely, climate change and domestic debt. In a recent paper, the IMF provided some preliminary thinking, indicating that a full review of its analytical framework is underway. For example, in August, Grenada triggered a "deferral claim" on its debt because of Hurricane Beryl. As climate change and extreme weather events become more frequent and/or devastating, having a framework to incorporate such instances in public debt will be important. Similarly, the different treatments that domestic debt holders received in the Ghana and Zambia restructurings, respectively, confirm that a more consistent way to think of this could be beneficial to the final outcome of a debt restructuring and the fortunes of the local debt market in its aftermath. The Ghana local currency debt market has been moribund since its restructuring earlier this year.

After makeovers in 2024, entering 2025 with a clean slate

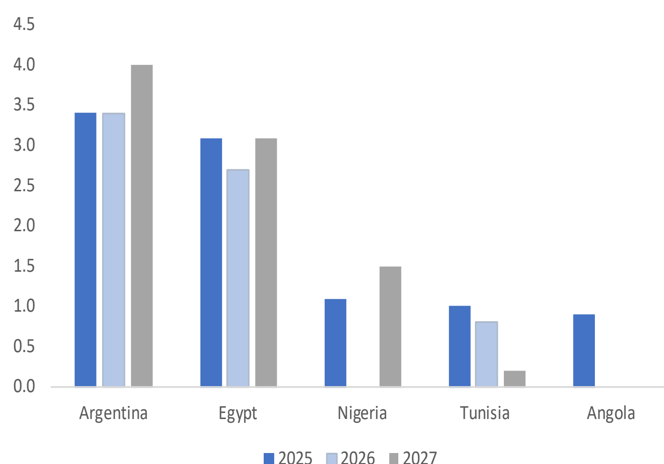
Many FMs will start 2025 with a clean slate. We do not expect any new credit events in 2025. Large maturities are concentrated in EM high-yielders that are supported in their ongoing reform efforts by IMF programmes and/or their geopolitical importance, making it likely that they will continue to enjoy donors' support – namely, Argentina and Egypt.

With stronger balance sheets and, in a Fed easing cycle, more flows, we see the return of broader support for FM. The focus may shift to security selection with new opportunities created by recent restructurings, eg, how to price the new SCDIs. With exit yields always a hot topic after every restructuring, the recent SCDIs have given rise to "blended exit yields". What we have seen thus far, as in the case of Zambia, is that plain vanilla Eurobonds have traded on the lower end of its blended exit yield range, while the "SCDI/Bond B" have traded at the higher end of that. With the new post-restructuring Ghana bonds starting to trade, it will be interesting to see whether a more "standard" restructuring leads to better price discovery. In all this, ownership structure will continue to play a part.

As some EMs return to markets post restructurings, it will be interesting to see how investors respond in terms of the amount of financing that will be made available to them. As new geopolitics-driven opportunities emerge, which countries will be able to tap additional Chinese financing? Which ones will need to rely more on donors or the growing field of blended finance?

Even in a "Fed easing" environment, we think that macroeconomic stability and reform momentum will remain key for EM fixed income opportunities. While funding should on balance be more readily forthcoming, EM sovereigns with cleaner balance sheets and on virtuous reform paths are likely to be the main beneficiaries of increased financing (see fig 4).

Fig. 4: Select frontier markets maturities (USD bn)



Source: AllianzGI, Bloomberg.

Investing involves risk. The value of an investment and the income from it will fluctuate and investors may not get back the principal invested. Past performance is not indicative of future performance. This is a marketing communication. It is for informational purposes only. This document does not constitute investment advice or a recommendation to buy, sell or hold any security and shall not be deemed an offer to sell or a solicitation of an offer to buy any security.

The views and opinions expressed herein, which are subject to change without notice, are those of the issuer or its affiliated companies at the time of publication. Certain data used are derived from various sources believed to be reliable, but the accuracy or completeness of the data is not guaranteed and no liability is assumed for any direct or consequential losses arising from their use. The duplication, publication, extraction or transmission of the contents, irrespective of the form, is not permitted. This material has not been reviewed by any regulatory authorities. In mainland China, it is for Qualified Domestic Institutional Investors scheme pursuant to applicable rules and regulations and is for information purpose only. This document does not constitute a public offer by virtue of Act Number 26.831 of the Argentine Republic and General Resolution No. 622/2013 of the NSC. This communication's sole purpose is to inform and does not under any circumstance constitute promotion or publicity of Allianz Global Investors products and/or services in Colombia or to Colombian residents pursuant to part 4 of Decree 2555 of 2010. This communication does not in any way aim to directly or indirectly initiate the purchase of a product or the provision of a service offered by Allianz Global Investors. Via reception of this document, each resident in Colombia acknowledges and accepts to have contacted Allianz Global Investors via their own initiative and that the communication under no circumstances does not arise from any promotional or marketing activities carried out by Allianz Global Investors. Colombian residents accept that accessing any type of social network page of Allianz Global Investors is done under their own responsibility and initiative and are aware that they may access specific information on the products and services of Allianz Global Investors. This communication is strictly private and confidential and may not be reproduced, except for the case of explicit permission by Allianz Global Investors. This communication does not constitute a public offer of securities in Colombia pursuant to the public offer regulation set forth in Decree 2555 of 2010. This communication and the information provided herein should not be considered a solicitation or an offer by Allianz Global Investors or its affiliates to provide any financial products in Brazil, Panama, Peru, and Uruguay. In Australia, this material is presented by Allianz Global Investors Asia Pacific Limited ("AllianzGI AP") and is intended for the use of investment consultants and other institutional /professional investors only, and is not directed to the public or individual retail investors. AllianzGI AP is not licensed to provide financial services to retail clients in Australia. AllianzGI AP is exempt from the requirement to hold an Australian Foreign Financial Service License under the Corporations Act 2001 (Cth) pursuant to ASIC Class Order (CO 03/1103) with respect to the provision of financial services to wholesale clients only. AllianzGI AP is licensed and regulated by Hong Kong Securities and Futures Commission under Hong Kong laws, which differ from Australian laws.

This document is being distributed by the following Allianz Global Investors companies: Allianz Global Investors GmbH, an investment company in Germany, authorized by the German Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin); Allianz Global Investors (Schweiz) AG; Allianz Global Investors UK Limited, authorized and regulated by the Financial Conduct Authority; in HK, by Allianz Global Investors Asia Pacific Ltd., licensed by the Hong Kong Securities and Futures Commission; in Singapore, by Allianz Global Investors Singapore Ltd., regulated by the Monetary Authority of Singapore [Company Registration No. 199907169Z]; in Japan, by Allianz Global Investors Japan Co., Ltd., registered in Japan as a Financial Instruments Business Operator [Registered No. The Director of Kanto Local Finance Bureau (Financial Instruments Business Operator), No. 424], Member of Japan Investment Advisers Association, the Investment Trust Association, Japan and Type II Financial Instruments Firms Association; in Taiwan, by Allianz Global Investors Taiwan Ltd., licensed by Financial Supervisory Commission in Taiwan; and in Indonesia, by PT. Allianz Global Investors Asset Management Indonesia licensed by Indonesia Financial Services Authority (OJK).

October 2024