For Professional Investors Only

Global Asset Management
BlueBay Asset Management

EM Debt: Our 2022 view

December 2021

Polina Kurdyavko
Head of Emerging Markets

"We are likely to see interesting developments in terms of new ESG trends, while stable carry continues to play its part, combined with a benign default rate scenario with Chinese real estate being the wild card."

Foreword

2021 has been a volatile and challenging year and in many ways, transitional. We have been focused on US inflation dynamics, but are yet to see the Federal Reserve (Fed) raising rates and starting to taper. In 2022, these expectations will be tested to their full merit. In China, a new geopolitical landscape is being formed. The withdrawal of troops from Afghanistan and a military alliance between the US, Australia and UK are all part of a long-term strategic focus on countering China's regional influence, in our view. While these tectonic shifts in geopolitics are underway, we could start to see the European inflation debate heating, with higher energy prices and supply chain issues filtering through, with inflation expectations strengthening enough to become unignorable.

Against these top-down thematic factors, we expect a number of countries to experience significant domestic developments – policy shifts in Argentina and Tunisia come to mind, as well as elections in Colombia and Brazil. Indeed, Turkey could have an early election and we will be watching the Ukraine/Russia situation extremely carefully. In China, further clarity on the policy framework around the real estate sector is likely to be one of the key performance drivers for emerging market (EM) corporate credit.

That said, like in 2021, aggregate default rates are expected to stay relatively low and contained, allowing investors to earn carry in credit. Finally, the benefits of vaccination rollout will be more broadly felt across the world, putting the global growth bounce-back on a stronger footing. Whether or not Omicron challenges this view remains to be seen.

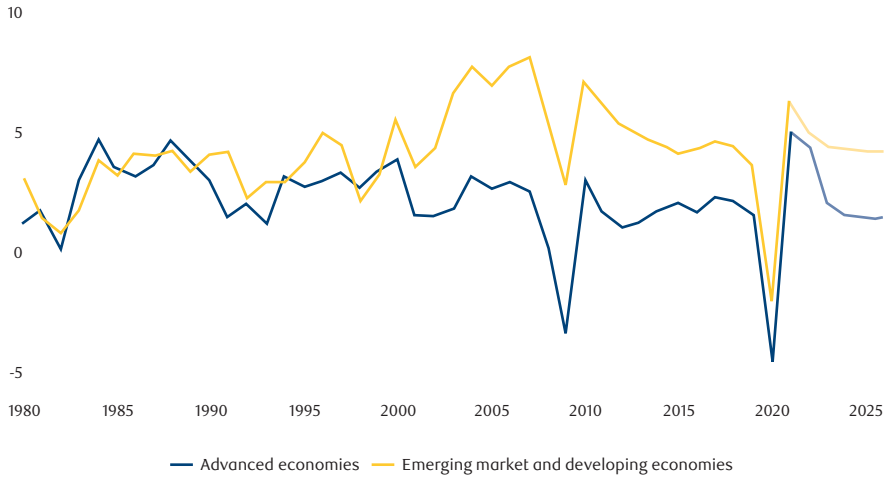
Against this backdrop, we expect EM hard currency assets to have a muted beta return next year, driven primarily by carry. However, we think there will be plenty of opportunities to generate alpha by taking differentiated views on liquid names from a bottom-up perspective. EM local currency debt remains in our focus, as this is an asset class that could potentially outperform if the timing is right. The EM corporate asset class should continue to offer attractive diversification. We are likely to see interesting developments there in terms of new ESG trends while stable carry continues to play its part, combined with a benign default rate scenario with Chinese real estate being the wild card.

Graham Stock
EM Senior Sovereign Strategist

> "Some countries are recovering faster than others, but the vast majority of EMs will have completed their rebound from Covid-19 early in 2022."

Will EMs bounce back from the Covid-19 pandemic?

Real GDP growth (annual percentage change)



Source: IMF, World Economic Outlook, October 2021

As we enter 2022, it is fair to say that, in aggregate, EMs have already witnessed the bulk of the short-term whiplash caused by Covid-19. As in developed markets (DMs), the initial impact was a sharp decline in activity as lockdowns and other restrictive measures were imposed, followed by a rebound as they were gradually lifted. Annual IMF data shows that EMs contracted less in 2020 and grew faster in 2021 than advanced economies.

But it is also clear that the trend pace of growth in EMs has been slowing since China's turbo-charged integration with the global economy earlier this century, and that the differential between EM and DM growth has been narrowing.

In 2022, the IMF forecasts that this differential will narrow even further, with EM growth slowing to 5.1% and advanced economy growth remaining well above trend at 4.5%. This relative performance reflects the contrast between the continued policy support lined up (for the US economy in particular) and the need for EMs such as China to turn their focus to stabilisation.

Some countries are recovering faster than others, but the vast majority of EMs will have completed their rebound from Covid-19 early in 2022. If the subsequent stabilisation is successful, EMs should be able to graduate to a trend growth rate of around 4.5%.

Brent David
Senior Portfolio Manager

Christian Libralato
Portfolio Manager

Inflation profiles vary across the EM universe – when's the right time to go long local rates?

Inflation profiles across the broad EM universe have seen significant upside pressure in 2021, particularly in Latin America and Central and Eastern European markets. Asia has been somewhat more sheltered, largely due to lower mobility. The positive is that, on average, the majority of central banks across the region that are facing significant upside pressure regarding inflation (which then challenges their inflation targeting mandates), have reacted and tightened monetary policy across the board.

This contrasts with their DM peers, which have opted to look through these inflationary pressures. This should bode well for those markets heading into Q1 and Q2 2022, as they continue to tighten policy rates.

We broadly look for the cooling-off in the pace of inflation to take place during this period, which should create an opportunity to go long local duration as we expect to see incremental positive growth dynamics and improving fiscal deficits, combined with the peaking in inflation and high nominal policy rates.

Frontier local markets should continue to offer some idiosyncratic diversification from more liquid local EMs in 2022. While enjoying positive returns in 2021, we note that heavy positioning in frontier markets, as well as rising yields in credit and liquid EMs, may limit some of the positive technical drivers evidenced during the year, despite impending index inclusion for Egypt and Ukraine.

Amongst frontier credits, from a fundamental perspective, the importance of inflation will vary case by case and will be only one of the drivers of duration returns in 2022 – with policy credibility, access to external funding and offshore flows remaining key factors. Aside from Zambia, which is expected to see material decline in inflation in 2022, we do not see an immediate need to be long frontier duration at the outset of 2022, preferring to take a wait-and-see approach into the second half of the year.

We generally favour nations that have evidenced relatively sound policies, have external buffers and likely access to external funding, such as Egypt. While inflation in Egypt is contained and real rates are elevated, high foreign positioning will likely limit any material move lower in nominal yields. We believe shorter-dated bills offer attractive risk-adjusted return potential as we eye developments in the external accounts and a still uncertain broader macro environment, which may result in pressure on the currency.

> **"We broadly look for the cooling-off in the pace of inflation to take place during H1 2022, which should create an opportunity to go long local duration."**

Sven Scholze
Senior Corporate Analyst

"China represents close to 25% of our investible EM high yield universe, which means it drives our overall EM corporate default forecast to 2.8% in 2022."

What implications will defaults in the Chinese property sector have on the overall default outlook for the EM corporate asset class?

When looking at defaults in 2022, we need to divide the market into China and the rest of EM to get a clear view. The economic environment next year should generally be supportive for EM high yield corporates, namely attractive commodity prices, a continued recovery following Covid and historically low interest rates. Despite political uncertainties in several countries, this should still result in a very low default rate of 1.3% outside China.

Looking specifically at China, the property sector has come under significant stress from tightening liquidity conditions. At first, these only affected idiosyncratically challenged players, but have now spiralled to create a crisis of confidence that is pulling companies into it that would ordinarily have not been considered to carry default risk. This makes predicting defaults more difficult – the strength and timeliness of policy response will ultimately decide the outcome.

In our base case, we predict a default rate of 8% for China, but it could rise as high as 31%. China represents close to 25% of our investible EM high yield universe, which means it drives our overall EM corporate default forecast to 2.8% in 2022 in the base case. Assuming a worst-case scenario for China, this could increase to up to 10%.

Vishal Iyer
Corporate Analyst

"In most EM countries, the last two quarters of results suggest that asset quality is holding up well as relief programmes end."

What is the post-pandemic outlook for the financial sector?

EM banks entered the pandemic with large capital buffers and more robust profitability than their DM peers and have managed to weather the worst of the pandemic via short-term payment holidays, a build-up of precautionary provisions and regulatory forbearance. In most EM countries, the last two quarters of results suggest that asset quality is holding up well as relief programmes end. For example, this is evident for Israeli, Mexican and Indian banks, which have reported pre-pandemic levels of asset quality and profitability while maintaining healthy capital ratios.

However, without the level of fiscal support seen in DM, some banking sectors will feel the effects of long Covid. Within Latin America, Panama is an example where a stringent and extended lockdown has led to a material amount of restructuring. Additionally, in Mexico, some issuers in the non-bank financial sectors have been structurally impaired by the pandemic given their exposure to low-income borrowers.

In Asia, the Thai banking sector has felt the effects of several Covid waves, high household indebtedness and a sluggish recovery in GDP growth with banks reporting persistently high levels of provisioning and the regulator asking banks to implement long-term sustainable restructuring.

In Turkey, despite the resilience to Covid, banks remain at the mercy of policymakers. Conversely, Chinese regulators have recognised that the small banks are the weakest link in the banking system and are trying to help recapitalise them.

Timothy Ash
EM Senior Sovereign Strategist

"It seems that emerging European central banks are going to have to hike policy rates a lot more aggressively."

What are the key geopolitical issues impacting Central & Eastern Europe, the Middle East & Africa?

In terms of potential headline risks, we are closely monitoring the Republic of Srpska's push for independence and the possibility of disintegration in Bosnia and Herzegovina triggering a wider Balkan crisis.

Elsewhere, the crisis in Belarus could see Poland and Russia both move troops to secure the NATO/Russia border, potentially even escalating to include another Russian military intervention in Ukraine.

In terms of what's happening right now, emerging Europe has a clear inflation problem. Central banks are behind the curve as policy rates remain negative in real terms while on the back of difficult electoral calendars, fiscal policy remains loose and reflationary. It seems that emerging European central banks are going to have to hike policy rates a lot more aggressively.

As well as risks, Turkey presents interesting potential opportunities. Should there be an early election that Erdogan loses, we could see robust re-engagement by the market in Turkish assets, with the Turkish lira, rates and credit all rallying.

Anthony Kettle
Senior Portfolio Manager

Alex Collins
Corporate Analyst

Oil and gas prices surged in H2 2021 – what's your view on the sector and how should EM fixed income investors position around the industry as we move into 2022?

We think energy prices are well supported. We're seeing robust demand (growing activity since lockdowns) relative to a tight supply side, with careful hiking from OPEC, falling global inventories and a slow pace of US drilling when compared with previous oil price recoveries.

As credit investors, we are primarily focused on avoiding oil price downside, as opposed to benefiting from further price upside. We advocate being long oil via robust high yield names that still have clear de-leveraging potential at USD60 a barrel and avoiding the lowest-rated names that need oil prices to remain at elevated levels.

We also remain conscious of the risk factors here, which include the resumption of lockdowns due to new Covid variants and a more hawkish OPEC. Despite the potential for noise in the short term, we think structural factors will ultimately prevail and investors need to look through any short-term volatility.

Gautam Kalani
EM FX Strategist/Portfolio Manager

"Individual countries are exiting the pandemic at differing speeds. These divergent growth rates should also prove a source of FX volatility."

Given the Fed is expected to raise rates and conduct tapering in 2022, do you expect to see more or less volatility in EM currency markets next year?

In 2022, the Fed is expected to raise rates while a number of other DM central banks, such as Canada and the UK, are expected to tighten policy. Meanwhile, most EM central banks are already hiking rates and will continue to do so over the coming months at different speeds – Brazil and Chile have been hiking at a pace above 100bps per meeting, while Russia, Colombia, South Africa, Central Europe and South Korea are also in various stages of tightening policy. As such, we expect to see significant divergences and moves in rate differentials between currencies in 2022, which should lead to greater FX volatility. Further, individual countries are exiting the pandemic at differing speeds. These divergent growth rates should also prove a source of FX volatility – for example, the US has a more robust growth outlook while Chinese growth has been more muted.

On the back of these factors, we expect the Chilean peso, South Korean won and Canadian dollar to be among the outperformers in Q1 2022, while the Turkish lira, Philippine peso and British pound are expected to be among the underperformers.

Andrius Isciukas
Portfolio Manager

Mark Agaiby
Corporate Analyst

With the ESG agenda continuing to grow, are you finding effective ways to engage with issuers?

Engaging with issuers is an essential part of our ESG strategy. In EMs in particular, it is vital that we work with our issuers – many of whom are starting from a lower base – to aid their transition to becoming stronger, more transparent and sustainable companies and we have had some success in that respect.

In Brazil, we are co-chairs of the Investor Policy Dialogue on Deforestation (IPDD), which now has 56 members managing USD7.2 trillion in AUM. We have seen tangible evidence that the debate on the ground has moved away from Bolsonaro's neglect of environmental concerns and towards real action at the federal and sub-national level to reduce deforestation.

This work is complemented by our engagements on the corporate side where, alongside bilateral engagements, we have joined soft commodity and protein working groups with the UN PRI and EM Investor Alliance (EMIA). These engagements are focused on finding solutions for traceability in supply chains and alignment in deforestation policies, bringing together investors, issuers and NGOs in roundtable discussions, providing opportunities to gain insight and influence companies, as well as increase transparency.

Generally speaking, the focus on ESG engagement has been growing, and with that, issuers are becoming more responsive, but more so when engaging for insight rather than influence. In 2021, 23% of our engagements included engaging for influence and 77% for insight. In our efforts to influence, we have found collaboration (much like the IPDD initiative) to be one of the most powerful mechanisms for achieving tangible results.

Jana Velebova
Senior Portfolio Manager

"We expect investors to increasingly demand higher standards across all ESG-labelled products, building on the ICMA principles to alleviate greenwashing concerns."

ESG issuance is on the rise. How do you expect this theme to develop in EMs?

We expect ESG themes to remain on top of issuers', investors' and asset owners' agendas in 2022.

The EM ESG-labelled bond market now stands at around USD500 billion, based on HSBC and Bloomberg data, having expanded by over 40% year-on-year. We expect this rapid growth to continue. We also expect investors to increasingly demand higher standards across all ESG-labelled products, building on the ICMA principles to alleviate greenwashing concerns and improve the quality and ambitiousness of future issuances.

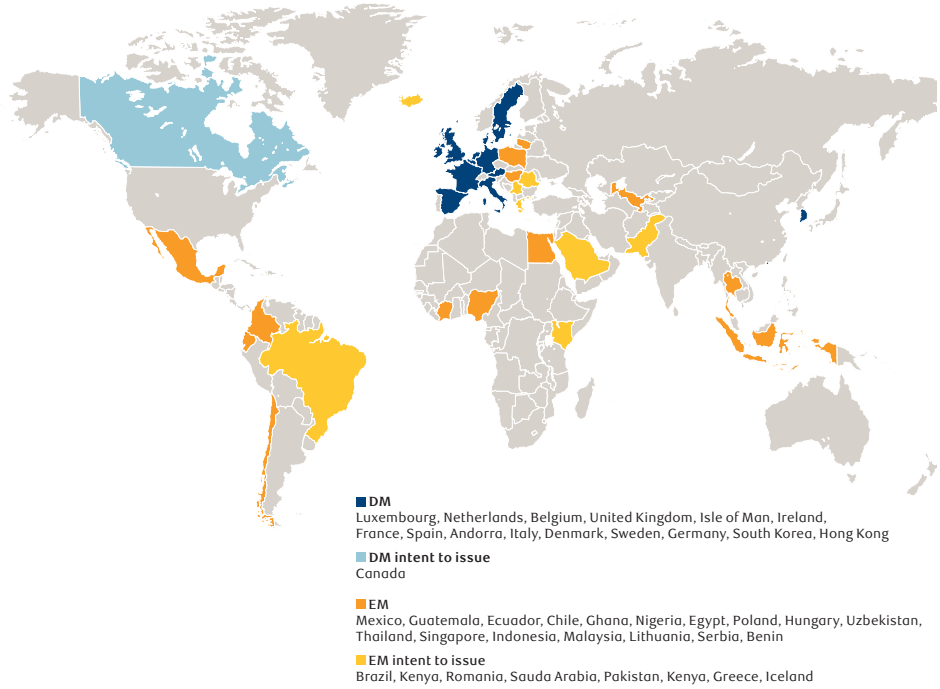
Given the large financing needs for green and social projects among developing countries, many EM countries are expected to launch their inaugural ESG labelled (green and social) bonds in hard and local currencies to fund projects much needed to achieve a range of sustainable development goals.

To name a few, Saudi Arabia, Ghana, Kenya and Namibia have all signalled their preparedness to do so, while Uruguay and Chile are both edging closer to issuing their first sovereign sustainability-linked bond next year with interest rates linked to environmental objectives.

Whilst 2021 saw a range of EM countries update their NCD targets (China, Saudi Arabia, South Africa, Argentina and others), unfortunately, the vast majority remain insufficient to limit global warming to 1.5 degrees Celsius. We expect more of these pledges to be turned into policies in 2022.

Finally, we expect regulatory forces and investor demand to contribute to greater and better quality ESG-related disclosure. EM investors have their part to play in all of these efforts through ongoing engagement.

The sovereign green, social & sustainability bond landscape as at end Q3 2021



Source: Climate Bonds Inititiative, 2021

Matias Vammalle
Senior Corporate Analyst

How will energy supply impact the utility space?

The recent moves in fuel prices shocked utility companies both in terms of the size and speed of the moves, but the ultimate impact on company fundamentals depends on several factors. The potential effect will vary depending on the fuel mix of generators, the amount of contracted capacity and the structure of sourcing and selling contracts, as well as natural resource availability and country policies. This combination of aspects makes blanket statements on the sector potentially misleading.

For example, pure-play renewable generators with fixed-price contracts in India are largely insulated, while Chilean companies that are still transitioning to renewables saw a sharp impact on EBITDA and profitability. This should be reversed over time as cost pass-through mechanisms in client contracts kick in. Other countries with high exposure to thermal generation like China or South Africa might see the impact mitigated by having large coal reserves and mining operations, or like Indonesia, where local prices are capped at USD70 per ton and miners must destine 25% of their production to local markets.

In addition to the credit-specific factors, the duration of the disruption will be key in determining the impact and resulting response. A short-lasting shock could be absorbed as a one-off event, while a longer-term change in prices might require a change in corporate strategy or public policy.

The good news is that the situation reinforces the importance of accelerating the transition towards renewable power sources.

One silver lining is that coming into this, utility companies had sound financial profiles and were benefitting from healthy power demand as economic activity recovered. We believe this will likely continue to be the case and that discerning investors should be able to identify opportunities if and when valuation dislocations arise.

“The good news is that the situation reinforces the importance of accelerating the transition towards renewable power sources.”

Som Bhattacharya
Portfolio Manager

> **"2022 could test investors' agility; active and nimble portfolio construction will be essential."**

Which investment strategies do you think will perform best in 2022 and why?

From an asset class perspective, our views on projected returns across the various EM sub-asset classes are as follows. Warning: forecasting the future is an inexact art and a quasi-educated exercise at best!

Based on the range of outcomes set out in the table, EM hard currency sovereigns are likely to provide the leading return stream, but with a wide projected outcome range (-0.6% to +9%). Conversely, the EM corporate sector is likely to provide a still-attractive 4.2% return opportunity with a narrower outcome range (+1.7% to 5.5%). EM local currency is a high-risk, high-return asset class – it could potentially generate +13% or enter negative territory. Based on this analysis, our asset class view remains firmly skewed towards EM hard currency, ideally a combination (or aggregate) version of the two.

2022 could test investors' agility; active and nimble portfolio construction will be essential. There are four strategies we think could benefit from this confluence of factors to generate positive total returns at the benchmark or fund level.

1. Earn high carry with the lower duration theme:
a. Liquid vehicles – EM short duration aggregate bond strategies: in an environment where US rates could go up, a short-dated strategy looks particularly attractive, especially one that capitalises on higher carry assets offered at the short end. We would highlight that EM short duration aggregate is one of the few EM hard currency indices to have posted a positive return in 2021 and which can potentially do so again in 2022.

b. Illiquid vehicles: Investors able to take illiquid positions should consider EM illiquid credit strategies. These approaches allow the investors to capitalise on the illiquidity premium in EM loans. This asset class can generate robust returns without being too exposed to the rates curve.

		Current	Scenario 1: US economy recovers at moderate pace, Fed hikes 1-2 times in 2022, inflation plateaus	Scenario 2: US economy overheats, inflation accelerates, Fed hikes rates >2 times, global economy stutters towards stagflation	Scenario 3: US inflation proves transitory, growth moderately slows, EM growth paces ahead
		Probability	**50%**	**25%**	**25%**
	US Treasuries	1.61%	1.80%	2.25%	1.00%
Hard currency sovereigns	EMBIGD spread	350	325	425	300
	Spread duration	7.6	1.90%	-5.70%	3.80%
	IR duration	7.97	-0.02%	-0.05%	0.05%
	Carry	5.11%	5.11%	5.11%	5.11%
	Total return		**6.99%**	**-0.64%**	**8.96%**
Hard currency corporates	CEMBI BD spread	300	290	350	275
	Spread duration	5.68	0.57%	-2.84%	1.42%
	IR duration	4.93	-0.34%	0.03%	-0.44%
	Carry	4.54%	4.54%	4.54%	4.54%
	Total return		**4.76%**	**1.73%**	**5.52%**
Local currency sovereigns	EM local rates	5.60%	5.50%	6.00%	5%
	IR dutation	5.15	0.52%	-2.06%	3.09%
	EM FX		2.50%	-5%	10%
	Total return		**3.02%**	**-7.06%**	**13.09%**

Probability-weight J.P. Morgan Emerging Market Bond Index Global Diversified Index (EMBIGD) 5.6%
Probability-weight J.P. Morgan Corporate Emerging Market Broad Diversified Index (CEMBI BD) 4.2%
Probability-weight J.P. Morgan Government Bond Index-Emerging Markets Global Diversified Index (GBI-EM GD) 3.0%

Source: BlueBay Asset Management, November 2021

> **"We believe EM unconstrained is particularly suitable for investors who want to generate positive returns in a volatile environment."**

2. EM unconstrained: This approach is particularly suitable for investors who want to generate positive returns in a volatile environment. Our strategy is flexible enough to generate returns through robust rallying cycles but has a proven track record of protecting on the downside. Current market dislocations, such as in Chinese real estate or the oil and gas sector, allow the strategy to take positions that could prove accretive in the future.

3. Specialised client solutions:
a. ESG: While many of our UCITS strategies are being reclassified as Article 8 SFDR, we believe new thematic ESG strategies can come to have more traction in EM. A carbon-conscious strategy designed to reduce investors' carbon footprint in EM credit, or an impact-orientated strategy could be a suitable vehicle for investors to potentially benefit from EM credit.

b. Buy and maintain: Our buy and maintain solutions are suitable for investors looking for a low turnover, hard currency strategy to either match their liability or capitalise on the prevailing attractive yields. In a changing regulatory environment, this offering could allow investors to achieve financial objectives in a customised manner.

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