CAN EMERGING MARKET DEBT MAINTAIN ITS POSITIVE MOMENTUM IN 2020?

January 2020

They say a rising tide lifts all boats. This certainly appeared to be the case for emerging market debt in 2019. Central banks around the world, provided the liquidity and easy monetary conditions required to boost sentiment and support valuations.

How's the 'big picture' likely to affect emerging market debt this year?

It seems likely that the US Federal Reserve will leave policy settings unchanged for the foreseeable future, keeping the US Treasury curve flat for a while. The underlying assumption is for a 'soft landing' in the US and Europe in the year ahead, as well as a pickup in activity levels in emerging economies. That said, contrary to the consensus view that markets will enjoy a cheerful start to 2020, we are a little more cautious – particularly for January and February.

The Fed is due to withdraw some liquidity from the US financial system from mid-January onwards. Remember, this is the same liquidity that fuelled the pre-Christmas rally in risk assets and a reversal could provide a headwind for risk assets in the first quarter of the year.

What about the outlook for emerging economies more specifically in the remainder of the year?

Once we get past this potential early bump, we think investors will start to refocus on market fundamentals. The ceasefire in the US/China trade dispute – the 'phase one' deal as markets are calling it – appears likely to hold for the time being; both parties have an incentive to limit the damage that's already been done.

With that in mind, emerging markets appear to be in reasonable shape for 2020. Growth differentials between emerging and developed markets are expected to increase again after shrinking slightly in 2019, which should result in improved capital flows towards emerging markets. Lower sovereign bond issuance should also reinforce the market from a technical perspective. Looking at current funding requirements, new issuance this year looks set to be around US$120 billion, versus US$169 billion in 2019. If that's the case, 2020 will see the lowest level of net supply since 2008.

Countries in the Middle East and Latin America are likely to see a particularly strong growth impulse. Sentiment towards Latin America as a whole has been eroded by recent economic challenges in Argentina, as well as various other interruptions and protests against governments. But we believe countries like Mexico, Peru and Brazil can pick up the slack.

The *~~elephant~~ giant panda* in the room remains China, which continues to contribute much of the growth in the EM universe and greatly influences the prevailing business cycle. Averting the risk of further tariffs being introduced on goods exported to the US should help ease economic policy uncertainty and, in our view, result in a slightly stronger Chinese economy in the second half of the year.

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Are there any other geopolitical risks to be wary of?

At this stage, we believe investors might have to grapple with two additional geopolitical issues during 2020. The first is by no means a new one – there is a reasonable chance that North Korea resumes missile testing and, perhaps, even underground nuclear testing program. Moreover, recent rhetoric suggests the country has moved closer to both Russia and China. Investors must consider the potential consequences of this development, including how ensuing instability could affect fragile relations between the US and China.

The second is Taiwan, which is due to hold elections in January. It appears likely that the incumbent President Tsai Ing-wen of the China-sceptic Democratic Progressive Party will be re-elected. She has repeatedly pushed back against Beijing's effort to unify Taiwan under the banner of '*one country, two systems*'. Consequently, China could harden its approach towards Taiwan; perhaps to such a degree to provoke a hard-line response from the US, pushing back on Beijing.

As we have seen before, issues like these can be concerning for investors and can result in pockets of volatility as the latest developments are digested.

How are valuations looking following the 2019 rally?

Looking at the performance drivers of the asset class in 2019, falling US Treasury yields, spread tightening and positive carry were contributors at different times of the year. The overall risk premium of emerging market sovereign bonds was relatively stable throughout most of the year, but we believe there is room for it to grind even lower in 2020. This reflects our anticipation of a broad-based pickup in growth rates in most emerging regions, a generally supportive technical backdrop and a relatively benign outlook for growth in the developed world.

Specifically we expect spreads to move gradually tighter over the year, perhaps by between 20 and 25 basis points. At the same time, we're not expecting US Treasury yields to rise significantly – removing an important potential headwind for the asset class. Overall, notwithstanding some potential volatility along the way, expected returns of between 5% and 9% from the asset class in 2020 appear reasonable if our central scenario plays out as anticipated but of course, this cannot be guaranteed.

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