Perspective from **Franklin Templeton Fixed Income**

EMD resilience to be put to the test—again

June 2022

Introduction

This paper provides an update on performance and drivers for the sovereign emerging market debt (EMD) asset class this year. The final sections lay out the main improvements and strengths that we believe will allow EMD to navigate these troubled times, proving the asset class's resilience again. These include improving balance of payments due to high commodity prices, decisive central bank policy, robust growth outlooks and better managed debt stocks. This should, in our view, combine with attractive relative valuations for sovereign EMD versus other fixed income asset classes to protect against near-term risks and enable a subsequent recovery from its current stressed state.

Inflation & balance of payments: The commodity price shock will keep EM central banks on alert

The global surge of inflation is a significant problem in EMs, but emerging markets (EM) central banks have been quick to react and should see inflation slow over the second half of 2022. Since the lows of the second quarter of 2020, global inflation has persistently surprised on the upside. Broadly speaking, the much stronger-than-expected inflation over the course of the last two years is a consequence of an unexpectedly strong rebound in global demand for goods against a backdrop of constrained supply. Across EMs, headline inflation has already reached decade highs even if their respective central banks have recently taken a decisively more hawkish stance than their developed market (DM) counterparts. The latest inflation prints from April are at record levels across all regions but have understandably spiked more in the Commonwealth of Independent States (CIS) and Central and Eastern Europe (CEE) regions, which are most exposed to the war in Ukraine (Exhibit 1 on the next page). We have excluded Turkey, Lebanon, Argentina and Sri Lanka from our EM country sample since they represent clear inflation outliers. When looking at the regional Z-scores using a four-year sample running from April 2018 to April 2022, we get a similar picture (Exhibit 2 on the next page). All EM regions, with the exception of APAC, are running inflation levels that exceed three standard deviations from their respective means. When compared to DMs, the inflation skew is more pronounced versus the United States, but the Z-scores are not that far off those in Japan or the eurozone, which even exceed those in the Middle East and North Africa (MENA), sub-Saharan Africa (SSA) and Asia Pacific (APAC).

Headline Inflation Is Running High in EMs, but the Positive Skew Is Not Too Different From DMs

Exhibit 1: Headline Inflation Is at Decade Highs Across All EMs

January 2021–April 2022

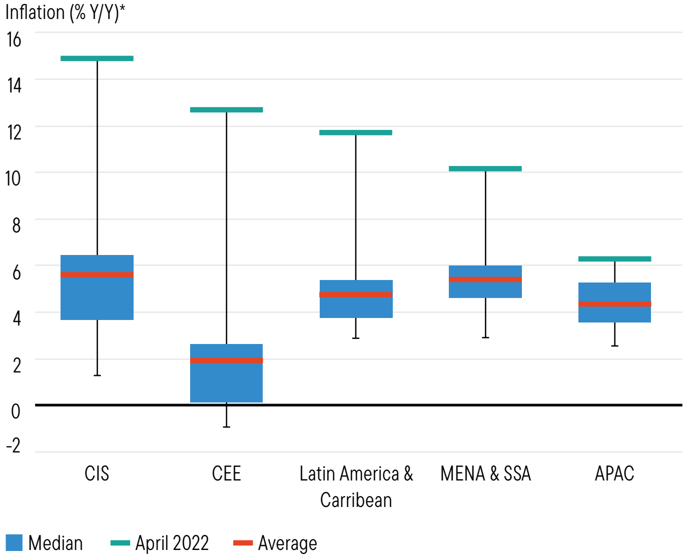
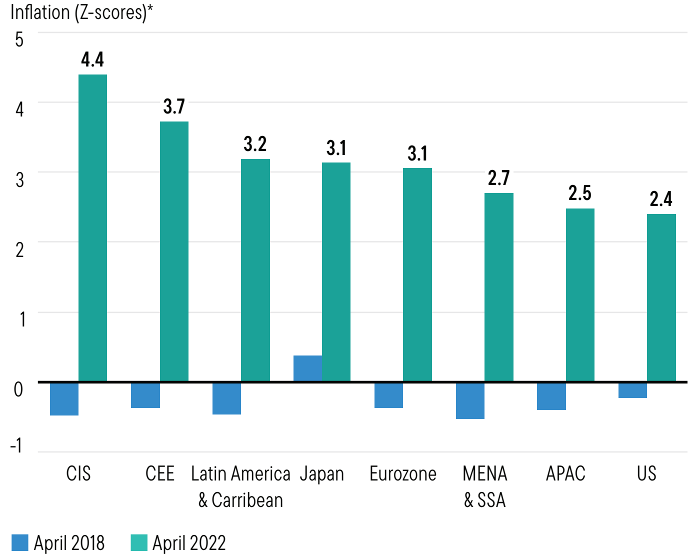


Exhibit 2: The Inflation Skew Is Largest in CIS and CEE

As of April 2022



Sources: National Statistics, Bloomberg, FT Fixed Income Research. *Note: Lebanon, Argentina, Turkey and Sri Lanka have been excluded.

Russia's invasion of Ukraine has brought a massive negative supply shock to the world economy and is affecting EMs and DMs in a similar order of magnitude. The shock is taking place against a backdrop of significant commodity shortages and already historically high prices for some key groups of commodities. The breadth of commodity price increases is striking, with most key prices rising by more than 30% so far this year. Among these, the extent of the food commodity shock is particularly worrying: the UN Food FAO price index rose 34% year-on-year (Y/Y) in March and is now around 65% higher relative to pre-pandemic levels (Exhibit 3 on the next page).

The food price shock is likely to place particular pressure on EM economies, since EM households spend a much larger share of their consumption on food goods compared to their DM counterparts. Their weight in the Consumer Price Index (CPI) basket ranges from 25% to 50% in EM economies, versus between 15–20% for DMs (Exhibit 4 on the next page). Low-income countries where wheat, corn and sorghum are a large part of the diet (especially in SSA) have seen inflation almost wholly driven by rising food prices. Some EM economies, including in the Middle East and Central Asia, have also been similarly affected by higher global food prices.

Looking ahead, commodity prices are expected to continue to be strong in 2022 before easing notably in 2023. Futures markets suggest crude oil and natural gas prices will remain elevated by end-2022 (US$103/bbl[1] and US$216/ptherm,[2] respectively), and then decline in 2023 as supply adjusts (to US$87/bbl and US$183/ptherm, respectively). Provided the overall slowdown in commodity prices materialises, headline inflation should benefit from decent negative base effects from the second half of 2023. Moreover, inflation expectations across EMs remain reasonably well anchored at longer horizons, even as they have increased in the near term. Available data suggest the tightening stance and shift in central bank communications in recent months have been viewed as enough to tame inflation over the medium term. In this context, the International Monetary Fund (IMF) expects headline inflation in EMs to moderate from the second half of 2022, averaging 8.7% Y/Y this year before slowing down to 6.5% in 2023 (versus DM inflation of 5.7% and 2.5% for 2022 and 2023, respectively).

The rise of commodity prices has had a varied impact in the terms of trade of EM economies. The overall effect is a redistribution of income from commodity consumers to commodity producers. As shown in Exhibit 5, big oil and gas exporters like Saudi Arabia and other Gulf Cooperation Council (GCC) countries are seeing enormous terms of trade gains as a result of these price moves. In its latest World Economic Outlook report in April, the IMF revised upwards its overall current account balance (CAB) projections for EMs for the entire forecast horizon (Exhibit 6). For 2022, the CAB is now projected at 1.5% of gross domestic product

High Commodity Prices Have Helped Ease Balance of Payments Pressures in Many EM Economies

Exhibit 3: Sharp Increase in Commodity Prices Since 2H21

January 1990-April 2022

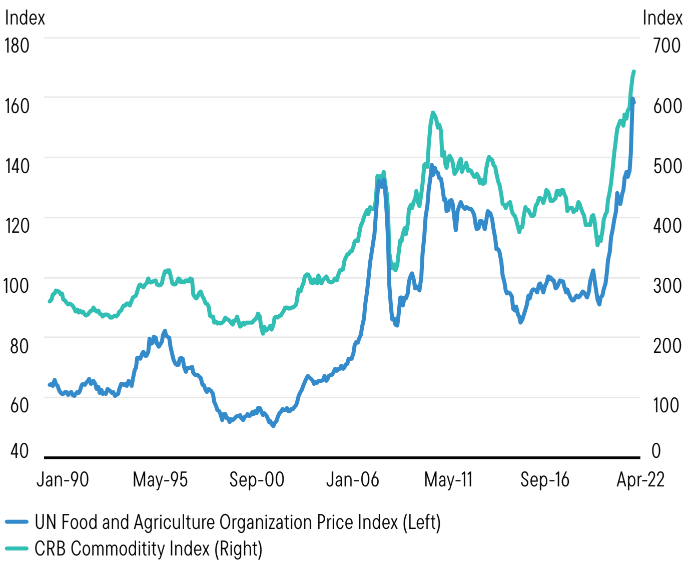


Exhibit 4: Food Represents a Big Weight in EM CPI Baskets

As of April 2022

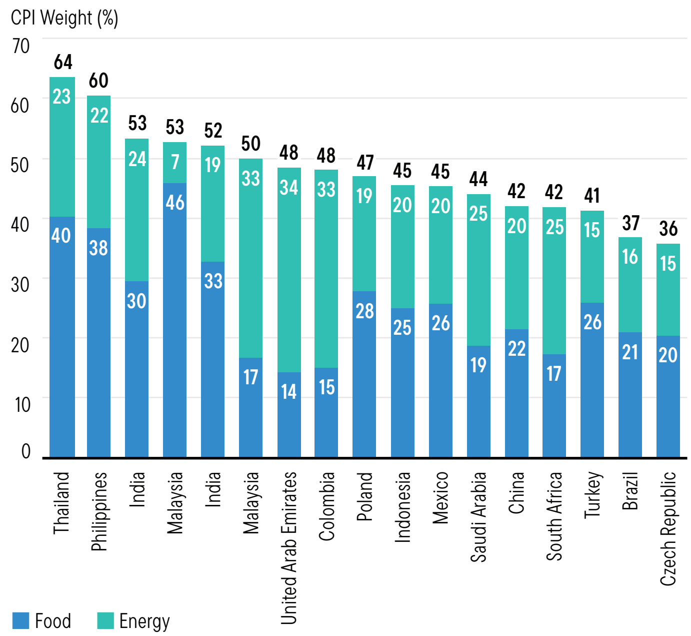


Exhibit 5: Winners and Losers of Higher Commodity Prices

As of April 2022

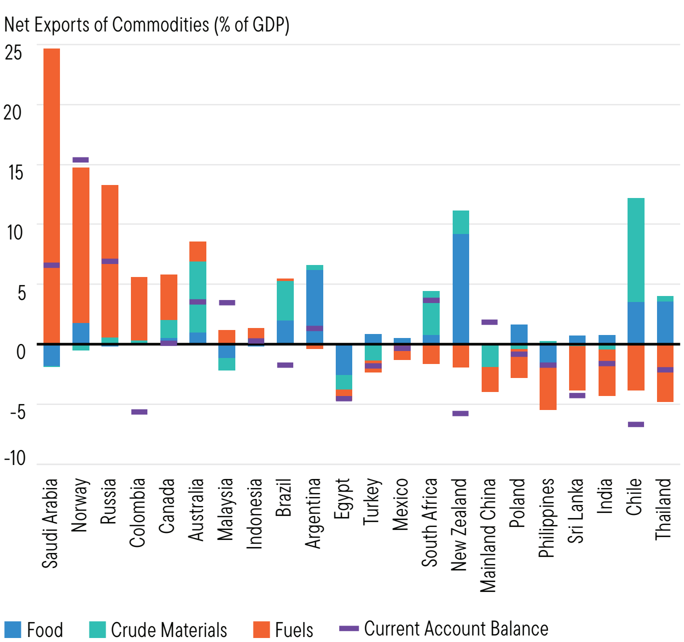
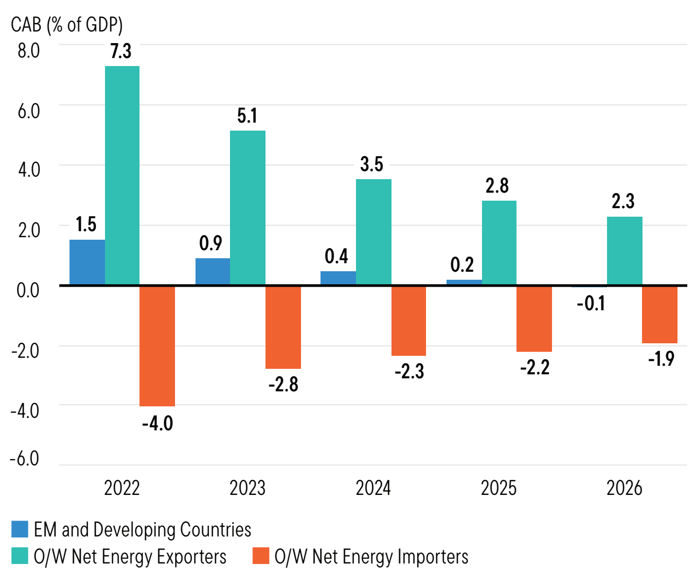


Exhibit 6: IMF World Economic Outlook (WEO) Current Account Balances

As of April 2022



Sources: National Statistics, CRB, UN Comtrade, HSBC, ILOSTAT, IMF, Bloomberg, FT Fixed Income Research.

(GDP) versus 0.6% of GDP previously, following the significant upward revision of the CABs of some net energy exporters (5.1 percentage points [pps] to 7.3% of GDP). The CAB is projected to narrow subsequently.

Basic balances remain robust for most EM economies, but importers of commodities with low foreign direct investment (FDI) inflows are exposed. While it is true that higher commodity prices are supporting CABs in many EM economies, external funding needs for some remain large and for others the volatility of financial flows remains the biggest concern. In essence, lack of funding of the balance of payments acts as restraint at the macro level that can translate into local-currency depreciation, higher inflation and interest rates, and eventually weak growth. Exhibit 7 shows the basic balances of many EM countries that have usually run CA deficits. Basic balances are defined as CAB with net FDI inflows: a positive result indicates that net FDI inflows are ample enough to cover the CAB, and vice versa. A negative basic balance also means that the remaining financing portion will have to come from portfolio capital and/or loans, which are volatile and more limited in size.

What the data show are that the largest gains in basic balances are not surprisingly seen in hydrocarbon exporters, mainly GCC economies, and they are the direct result of larger CA surpluses rather than higher FDI. More broadly, exporters of commodities show positive basic balances, while importers appear to be at risk. On this point, Kenya, Sri Lanka, Pakistan, El Salvador, and Mongolia screen as more exposed. We remain unconcerned about Asia, which saw a marked increase in FDI inflows in 2020-21 thanks to stronger investment and lending originating in China. We expect this trend to continue, or at least stabilise at current levels (around 3% of GDP), unless Chinese growth surprises significantly to the downside. By contrast, we are concerned with some African countries, such as Kenya and Angola, which have lately shown a drop in FDI from historically low levels already. As for Latin America, FDI inflows are averaging a decent 2% of GDP, in line with emerging Europe.

EM Central Banks Have Built Sizeable Real Rate Buffers

Exhibit 7: Basic Balances Have Improved, Especially in the GCC

January 2021–April 2022

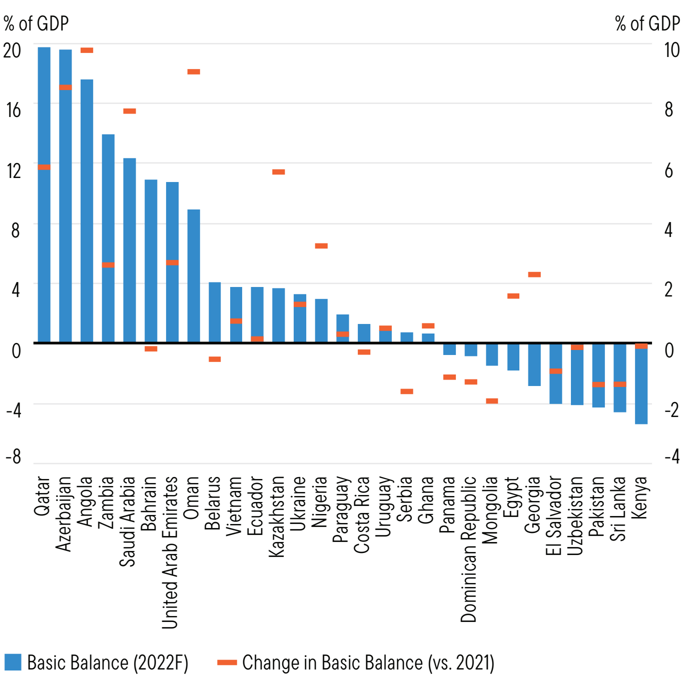
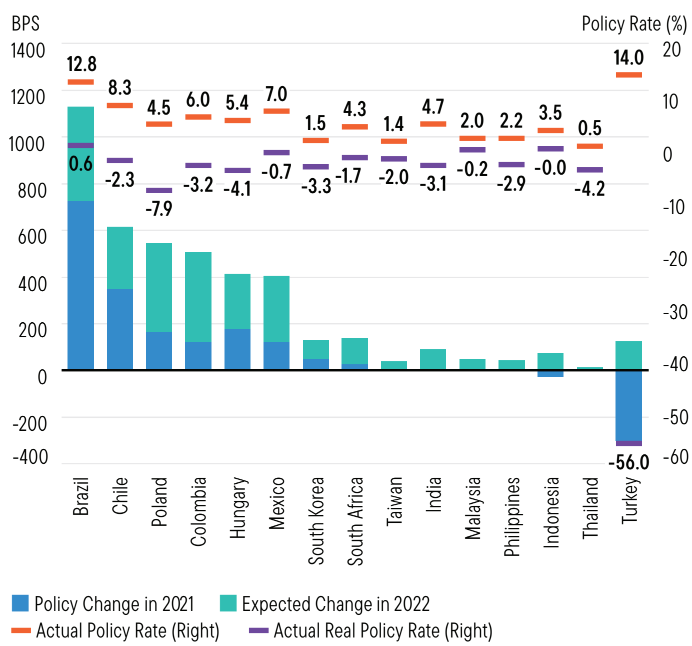


Exhibit 8: Many EM Central Banks Started Hiking in 2021

As of April 2022



Sources: National Statistics, JPM, Bloomberg, FT Fixed Income Research.

We do not expect any sizeable drop of FDI into this region ahead, unless political instability heightens, or there is a marked increase in populistic measures threatening private investments or a return to nationalisations (which for now seems unlikely).

High inflation pressures and rising US interest rates have not caught EM central banks off guard. The US Federal Reserve's (Fed's) recent hawkish tilt to catch up with inflation lags that of EM central banks, which started hiking rates already in 2021. This has allowed many EM economies to start improving real rates buffers, which are expected to strengthen further as inflation moderates over the rest of the year (Exhibit 8). Moreover, in commodity-producing EM economies that have already tightened aggressively over the past year and where real rates are higher than elsewhere, currencies have been much more resilient. The fastest pace of tightening has been in Brazil, where the policy rate has been lifted by nearly 11 percentage points in this tightening cycle, and the likely peak in rates is now being pushed higher and further in 2022. In the rest of Latin America, central banks in Chile and Colombia are already raising rates more quickly than expected and in Mexico, the Bank of Mexico (Banxico) appears set to follow a similar path to the Fed. In Asia, the story is slightly different, as weaker domestic demand has meant lower inflation and central banks have been inactive. In CEE, severe downward pressure on currencies has been met with intervention in foreign exchange markets and Hungary and Poland have already lifted interest rates by 380 basis points[3] (bps) and 440 bps, respectively. Inflation was already high across CEE and currency depreciation risks sending it higher, so we expect CEE may have to tighten further even while facing some of the biggest growth risks.

EM growth has lost steam, but is set to recover in 2023

The growth picture for 2022 in EMs remains highly uncertain, and especially diverse across regions that have been hit to a greater or lesser extent by the conflict in Ukraine, the growth slowdown in China and the lingering effects of the pandemic. All of these factors have been coupled with a strong pick-up in inflation that has forced most central banks to raise interest rates sharply. Overall, if we look at the latest indicators of industrial production

The Post-pandemic Recovery Has Lost Steam

Exhibit 9: Economic Activity Has Taken a Hit in 1Q22

March 2020–April 2022

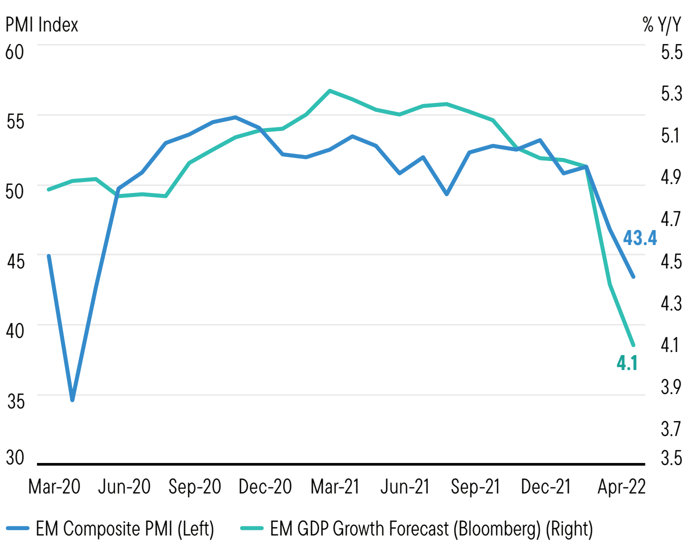
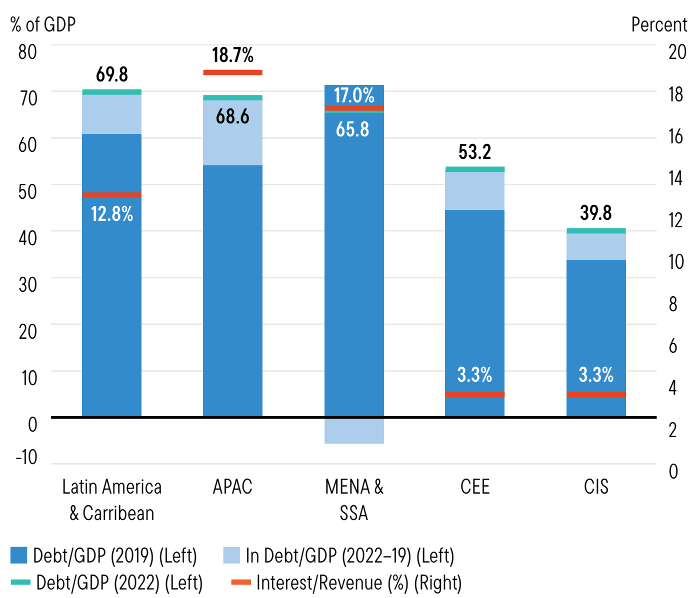


Exhibit 10: Fiscal Buffers Have Been Eroded Following COVID-19

As of April 2022



Sources: IMF, FT Fixed Income Research.

and markets' expectations of EM growth currently, the situation does not look too encouraging since the deterioration in both is evident (Exhibit 9 on the previous page). In addition, most EMs lack the fiscal space to combat this slowdown. As shown in Exhibit 10 on the previous page, during the pandemic many countries increased their public debt levels to historic highs, with the EM average now standing at around 65% of GDP. This level is almost double that seen a decade ago. As a result of this deterioration, many EM governments have been forced to implement fiscal adjustment plans already in 2022. This has reduced their ability to stimulate the economy and counteract the increasingly hawkish stances of many EM central banks.

The IMF expects EM growth this year to slow down to 3.8% Y/Y, down from 6.8% Y/Y in 2021. However, growth in EM is expected to rebound by 4.4% in 2023, clearly outpacing DM growth that is projected to fall further to just 2.4% Y/Y (Exhibit 11). Globally, growth will remain unchanged at 3.6% Y/Y during 2022–23. Understandably, the IMF's downward revision to EM growth this year (down 1.3 pps from its October forecast) is due to the adverse consequences of the war in Ukraine. In particular, growth in emerging Europe was revised down by 6.5 pps to –2.9% Y/Y in 2022 (Exhibit 12), as Ukraine's economy is projected to contract by a massive 35% Y/Y, and Russia by –8.5% Y/Y. Crucially, the forecasts assume that the conflict remains confined to Ukraine, further sanctions on Russia exempt the energy sector, and the pandemic's health and economic impacts abate over the course of 2022. These assumptions remain broadly in line with our expectations.

China's policy dilemmas

China is facing so many policy dilemmas that the "trilemma" label no longer captures the complexity of the economic, political and social challenges facing the country. We see these challenges boiling down to a need to find a balance that provides an internal and external equilibrium. In practice, this means addressing the growth slowdown with policies that do not jeopardise capital flows, risk hard won gains on the financial stability front or undermine

EM Growth Is Set to Slowdown in 2022 but Recover in 2023

Exhibit 11: EM Growth Forecast to Clearly Outpace DM Growth in 2023

As of April 2022

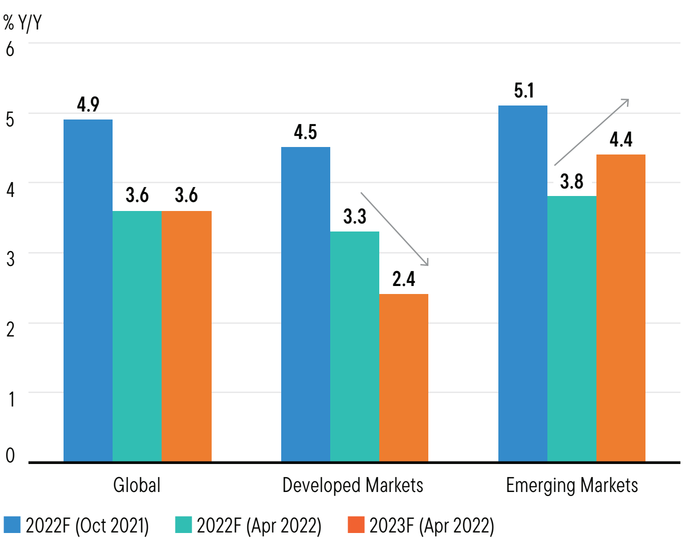
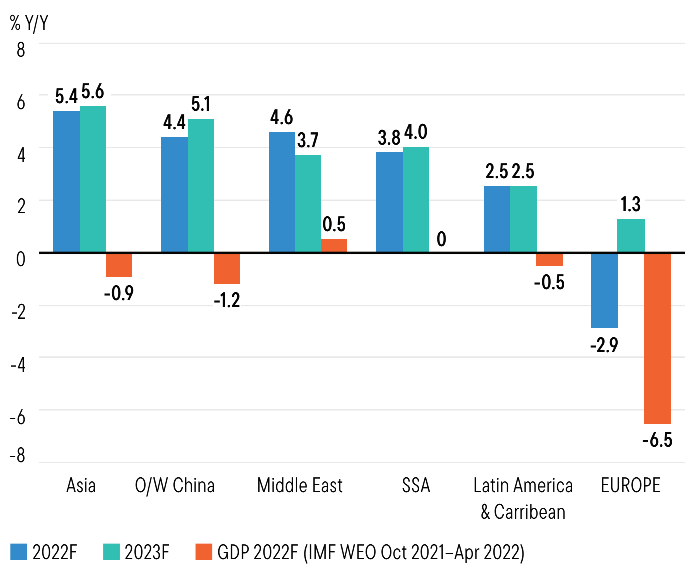


Exhibit 12: Asia Forecast to Continue to Lead EM Growth

As of April 2022



Sources: IMF, FT Fixed Income Research.

President Xi's flagship Common Prosperity agenda. The spotlight is shining particularly brightly on the country's policy response this year because of the 20th National Party Congress of the Chinese Communist Party (CCP) to be held in November. The CCP Congress will elect the country's top decision-making body, the Standing Committee, and will likely also re-elect Xi Jinping as General Secretary, or potentially even Chairman, a title not used since 1982.

Thus far, China continues to implement measured and targeted policies that help but fall short of the stimulus bazooka that is arguably called for to effect meaningful change. COVID-19 lockdowns clearly limit the effectiveness of stimulus at this time, so if dynamic zero COVID-19 is to remain the policy as seems likely, then it is vital that infection numbers are kept very low. Mass testing would appear to be the solution, but this is expensive (with estimates of 1–2% of GDP if carried out broadly and frequently). Longer term, China needs a more effective vaccination policy.

We Do Not Expect China to Meet Its 5.5% Growth Target for 2022

Exhibit 13: April Data Confirm China's Weak Momentum

As of April 2022

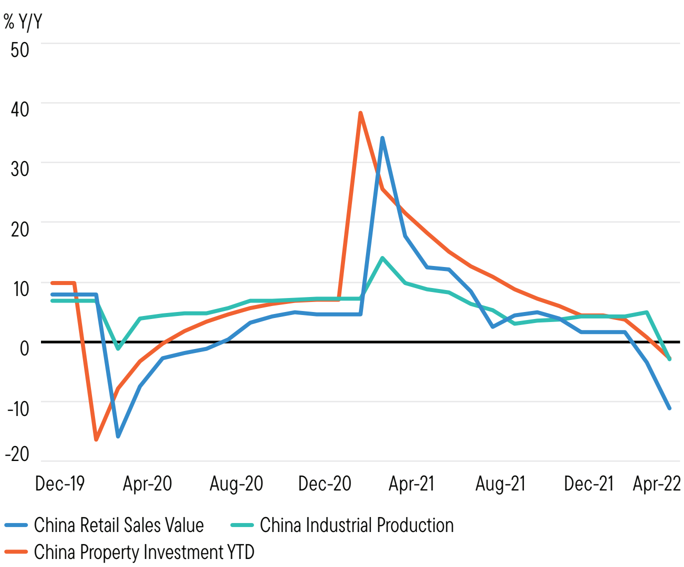
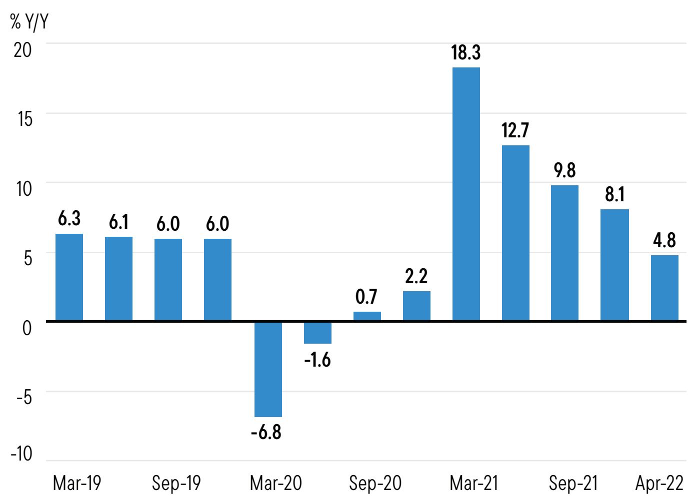


Exhibit 14: Chinese Growth Has Slowed Down Since Mid-2H21

As of April 2022



Sources: National Statistics, Bloomberg, FT Fixed Income Research.

China's April data was extremely weak, reflecting the well-publicised COVID-19 lockdowns. Industrial production was –2.9% Y/Y or –7.0% month-over-month (M/M) due to the collapse in activity in those cities and regions where movement was limited, such as Shanghai and the Yangtze River delta. Substantially weaker retail sales, which fell –11.1% Y/Y, also demonstrated the magnitude of the slowdown as a result of the Omicron wave. The surveyed urban unemployment rate increased to 6.1%, up from 5.8% and approaching the COVID-19 peak of 6.2%. Unemployment among younger people creates an additional complexity for policymakers in China. Official statistics show that the unemployment rate among the 16–24 age bracket is at a record high and that only 25% of 10 million college graduates have either a job or graduate school place. Fixed asset investment (FAI) also disappointed in April, with real estate FAI down 10% Y/Y amid a significant slowing of property market activity over the month. In response to this data the People's Bank of China (PBOC) has cut the 5-year loan prime rate (LPR) by 15 bps to 4.45%, leaving the 1-year rate unchanged at 3.7%. Clearly falling short of bazooka status, this seems to be another measured and focused boost to a specific part of the economy, namely mortgage lending. The PBOC had already reduced mortgage rates by a modest 20 bps for first time buyers (to 4.2%). This focus on mortgages appears designed to address the weakness in the property sector, although the stimulus will take time to work, not least because of COVID-19.

Can China get anywhere close to its 5.5% growth target for 2022? Based on the economic data seen so far this year and considering the potential for more COVID-19 lockdowns, not to mention the modest policy response, China's growth target seems highly aspirational. A growth rate in the 4–5% range looks more likely to us at this point. With COVID-19 lockdowns still in place, China's restrained easing is perhaps understandable and should by the same logic be temporary. Given the communications from the Politburo meeting in April and comments from Premier Li in recent days, we should see a sharp rise in infrastructure investment in the middle third of the year. We expect Beijing to continue to use fiscal stimulus more than monetary tools in the coming months.

To cut policy rates further at a time when most of the rest of the world is tightening would erode the stability of the banking system and put pressure on the currency, which has already shown signs of softness. The Chinese renminbi's move from 6.37 per US dollar to 6.78 in four weeks is double the depreciation seen in the first quarter of 2020. Indeed, the fiscal deficit widened in April to leave the 12-month rolling deficit at 7.8% of GDP. This was partially thanks to a large value-added tax (VAT) refund worth nearly 1% of GDP. This VAT refund helps to explain why April bank lending data was so weak as total social financing (TSF) was only RMB0.9 trillion, or half the previous year, while broad money growth was strong at 10.5%. With the VAT refund excluded, we could have seen TSF at the same level as the previous year.

External financing requirements

Current forward pricing of the fed funds rate points to a sharp uptick in debt financing costs for borrowers in the future, moving away from years of historically cheap interest rates for EM borrowers. EMD borrowers have taken advantage of cheap sources of financing, with the number of country constituents in the JPMorgan Emerging Markets Bond Index Global (EMBIG) universe nearly doubling over this period and eurobonds as a percentage of countries' debt stocks also growing considerably. Concerns about how EMD borrowers will handle this inflexion point in external financing costs are warranted. A full analysis of external financing needs should incorporate analysis of the current account (CA), as well as reserve assets plus other forms of short-term external debt, but for this exercise we will just focus on the public eurobond debt stock, which has historically been a primary catalyst for debt distress.

The growth in EMD sovereign and quasi-sovereign eurobonds outstanding since the end of 2008 shows a near two-and-a-half-fold increase from US$360 billion to almost US$900 billion. EM borrowers were among the first to take advantage of the long-term nature of this form of debt financing, with transactions such as the first 100-year EM eurobond in October 2010, which was followed by the likes of Peru and even Argentina. Even in Sub-Saharan Africa, out of the 13 current constituent countries, more than half of these have issued 30-year or longer debt in recent years. Therefore, EMD is not facing an imminent wave of eurobond maturities. That said, across the US dollar and euro EMBIG universes between US$90 billion and US$100 billion will need to be refinanced over the next two 12-month periods, which in a scenario where certain sections of the market currently are not able to borrow could pose a challenge. Further breaking these amounts down by rating category, roughly half of this amount is owed by investment grade-rated borrowers, who are very likely to be able to issue new debt. BB-rated borrowers have the least amount of debt coming due and although new coupons might be more than 200 bps higher than where existing average financing costs have been, this should not pose a problem for this profile of borrower when refinancing (Exhibits 15 and 16 on the next page).

Attention should therefore be paid to the two lowest rating categories, which have between US$30 billion and US$40 billion coming due in the next two 12-month periods. A large portion of this debt is already in default from sizeable borrowers such as Lebanon, Venezuela and Sri Lanka or is expected to default, in the case of Ukraine. Adjusting for these amounts the refinancing burden becomes much more manageable at about half of the annual amounts above. Turkey is the biggest component of this, representing about half of all of these maturities. These are sizeable amounts for Turkey and represent a risk but not one of a systemic nature, given the unique economic path being taken by the country (Exhibits 17 and 18).

Large Eurobond Issuance Has Not Led to a Nascent Wall of Maturities

Exhibit 15: Investment-Grade and BB Borrowers Retain Access to US Dollar Markets

As of April 2022

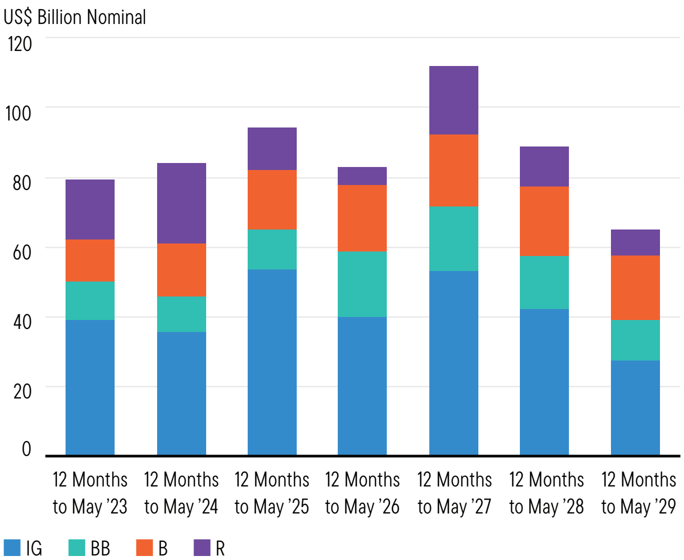
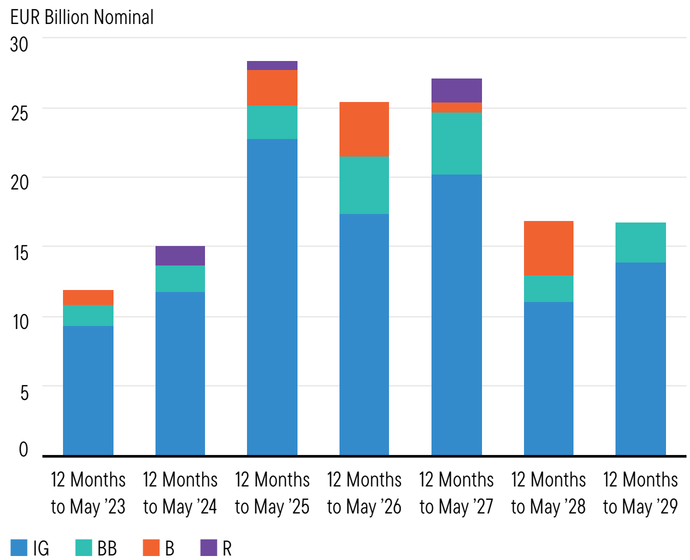


Exhibit 16: Euro Markets Are Dominated by Investment-Grade Borrowers

As of April 2022



Sources: Bloomberg, FT Fixed Income Research.

Turkey's Shift to External Financing Has Created Sizeable Annual Debt Service Needs

Exhibit 17: US$ Sovereign & Quasi-sovereign EMD Eurobond Maturities

As of April 2022

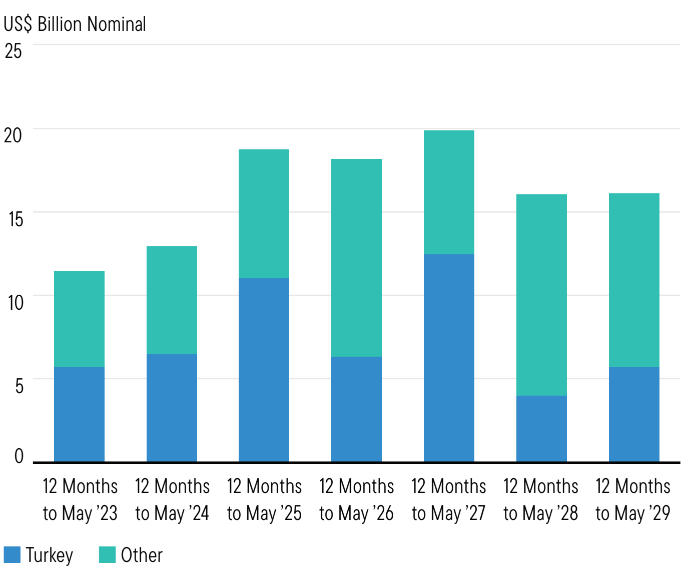
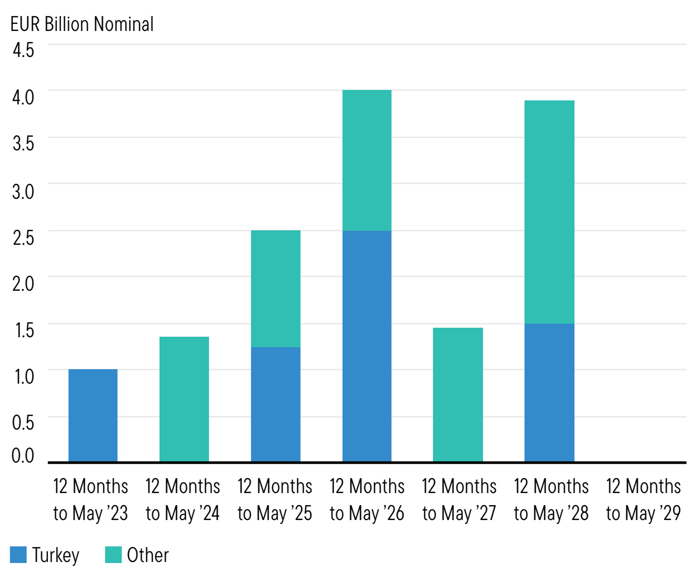


Exhibit 18: Euro Sovereign & Quasi-sovereign EMD Eurobond Maturities

As of April 2022



Sources: Bloomberg, FT Fixed Income Research.

Of the residual borrowers it is clear that Egypt faces a significant amount of maturities in the period ahead, with a debt stock that has grown swiftly over the past few years. The recent initiation of discussions with the IMF and more importantly wealthy allies from the Gulf make this a manageable task, but the next few years are likely to look very different for Egypt's external sources of financing. Pakistan's efforts to restart its own IMF programme are largely borne out of the necessity of its refinancing requirements. For Nigeria, providing oil prices remain strong, it is hard to imagine these maturities posing much of a challenge, but investors are wary of the weak fiscal framework and therefore the risks cannot be ignored, while in Ghana the market is already pricing a high risk of default with long maturity bonds in the 50 cents area (Exhibit 19). In the euro-denominated market, Tunisia stands out as a potential risk with bonds priced well into distressed territory while multilateral support remains the base case of the EMD Team (Exhibit 20). Overall, then, thanks to the proactive extending of debt maturities by EM borrowers during the low interest rate period, the asset class appears able to avoid any major systemic risk scenarios from a cascade of sovereign defaults.

Large Refinancing Risks by Single B-Rated Borrowers Have Alternative Sources of Financing Pending

Exhibit 19: US$ EMD Eurobond Maturity Profiles

As of April 2022

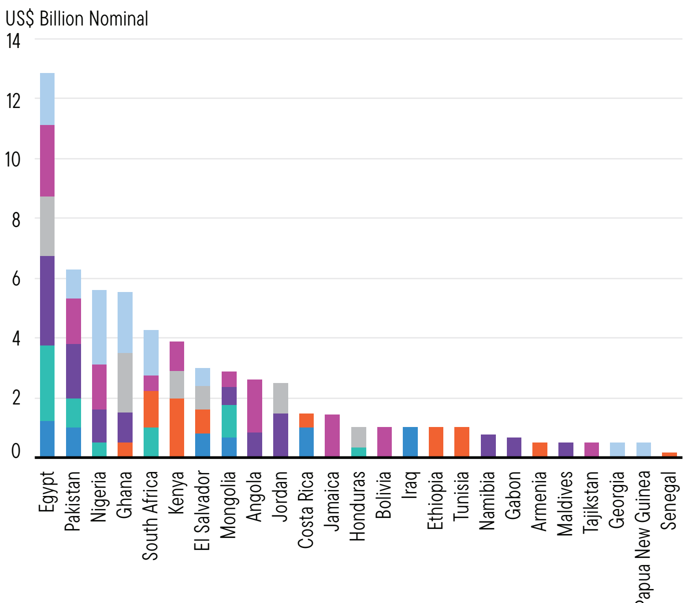
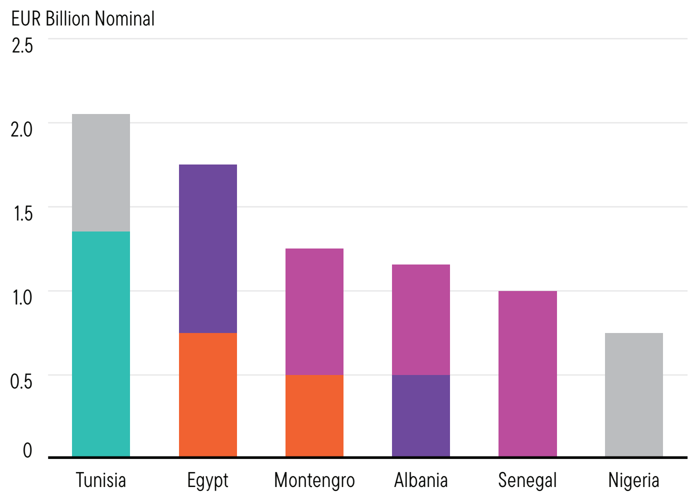


Exhibit 20: Euro Eurobond Maturity Profiles

As of April 2022



12 Months to May '23 | 12 Months to May '24 | 12 Months to May '25 | 12 Months to May '26 | 12 Months to May '27 | 12 Months to May '28 | 12 Months to May '29

Sources: Bloomberg, FT Fixed Income Research.

Conclusion

The tragic events that have taken place within the borders of Ukraine this year have undoubtedly taken a toll on EMD as an asset class. As the conflict moves into its fourth month, under our base case scenario of a long and drawn-out battle for territory around the south-east and southern borders of Ukraine, the negative feedback to the broader EMD asset class will diminish, considering the already large write-down in portfolio valuations and allocations to these countries. Given the unpredictable nature of the conflict, tail-risk scenarios cannot be discounted fully, and these would have significant consequences for EMD, although they currently appear low-probability at best, in our view. The uncertainty about the trade-off between high inflation and economic growth is the key question facing EMD over the next few months. The manner of response that this draws from DM central banks, in particular the Fed, presents an equally broad range of possible scenarios for fixed income assets in general. Once this uncertainty diminishes, we believe the resilience of today's EMD asset class will help fears of widespread debt distress and default recede, as the orthodox policy that has been implemented by the majority of EM policymakers over the past decade takes hold. However, the risks in the current global backdrop need to be acknowledged and countries that have not implemented strong reform measures are likely to be overwhelmed by tightening external financial conditions.

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Endnotes

1. The abbreviation bbl refers to a barrel of crude oil.
2. ptherm (or price per therm) is the convention measure used for UK natural gas.
3. One basis point is equal to 0.01%.

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