PICTET WEALTH MANAGEMENT

Emerging market bonds 2023 outlook

Another year of divergence?

AUTHOR

LAURÉLINE RENAUD-CHATELAIN
lchatelain@pictet.com

12 JANUARY 2023, CIO OFFICE & MACRO RESEARCH

FLASH NOTE

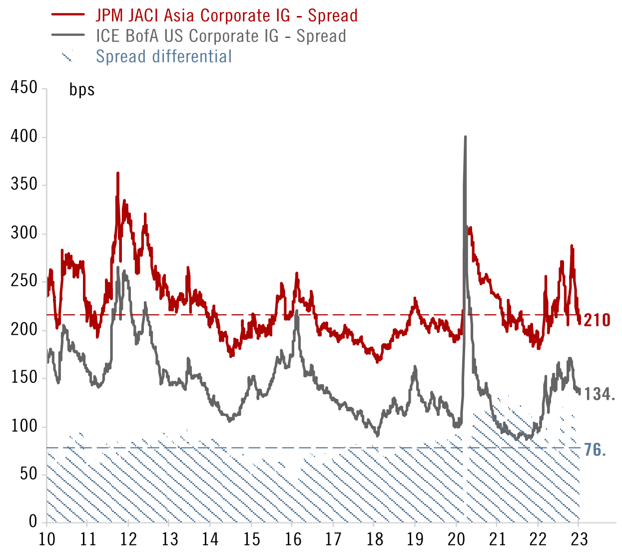
SUMMARY

- Like their developed-market counterparts, emerging-markets (EM) bonds generally posted negative total returns in 2022 due to the rise in yields, which hit EM corporate bonds in US dollars especially hard. Between missed interest payments from Russian companies and the defaults of Chinese real-estate developers, the default rate was elevated in 2022 (averaging 12.7%) for EM high-yield (HY) bonds, with a peak at 40.4% for Asian HY in October.
- We still like clipping the high carries offered by EM investment-grade (IG) corporate bonds in US dollars, particularly Asian ones, which could benefit from China's reopening. We expect Asian IG corporate bonds to post a positive single-digit total return this year, helped by strong carry. We also see Asian credits being less exposed to contamination than other EM credits if credit spreads widen in developed markets.
- Despite EM currencies' recent rally against the US dollar, we believe it is still too early to call an end to US dollar strength. As such, we remain neutral and selective when it comes to local-currency EM sovereign bonds, but we reckon that many EM central banks could pause their hiking cycle soon.
- We expect EM local-currency sovereign bond yields to end the year slightly lower (from 6.6% to 6.5% according to the JP Morgan GBI-EM Global Diversified index on 11 January), not excluding stronger rallies in the first half of 2023. In line with our overall position on EM local-currency bonds, we maintain a neutral stance on Chinese sovereign bonds in renminbi as we monitor signs that the Chinese economy is indeed recovering.

Chart 1: US 10-year Treasury yield versus EM corporate and sovereign bond yields

Source: Pictet Wealth Management, FactSet, 11 January 2023. JPM EM Corporate uses the JP Morgan CEMBI Broad Diversified index and JPM EM sovereign uses the JP Morgan GBI-EM Global Diversified index

Chart 2: Asian and US investment-grade corporate spreads



Source: Pictet Wealth Management, FactSet, 11 January 2023.

2022, A YEAR MARKED BY DIVERGENCE

Like their developed-market (DM) counterparts, emerging-markets (EM) bonds generally posted negative total returns in 2022. Corporate bonds in US dollars were hit especially hard (-12.9%), suffering also from the exclusion of Russian bonds (priced to zero) from major indexes following Russia's invasion of Ukraine in February. **Latin American (Latam) corporate bonds performed better in general** (-9.5%, according to JP Morgan CEMBI diversified bond indices) **thanks to their greater exposure to commodities**, and this despite a tumultuous political year in the region.

Between Russian companies' missed interest payments and defaults among Chinese real-estate developers, the default rate among EM high-yield (HY) bonds rose to an average of 12.7% in 2022, with an October of peak of 40.4% for Asia HY (according to Bank of America's calculations). This contributed to the negative performance of the JP Morgan EM Corporate Bond index despite a year-end yield of 7% (*see chart 1*).

EM currencies' weakness has generally worsened the negative performance of local-currency (LC) EM government bonds in US dollar terms. EM sovereign bonds in LC offered elevated yields throughout the year (*see chart 1*), as many EM central banks continued to hike policy rates aggressively to counter inflationary pressures. But only Latam sovereign bonds offered a positive return in US dollars—thanks in part to the strengthening of regional currencies against the US dollar.

CHINA'S REOPENING IS A GAME CHANGER

While commodity-producing countries and companies generally benefitted from the rise in commodity prices in 2022, it could be Asia's turn to shine this

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year thanks to the rapid unwinding of China's 'zero-covid' policy. A reopening boom in China could also boost economic growth throughout emerging markets thanks to higher levels of trade and tourism.

As seen already in the last months of 2022, **a relatively more favourable outlook for EM economies could mean tighter EM corporate spreads and a strengthening of EM currencies against the US dollar, potentially leading to positive performances for EM bonds in the coming months**. We expect investment-grade bonds, in particular in Asia, to post a positive single-digit performance in 2023, **whereas contagion from DM markets hit by recession could mean that spreads on EM corporate bonds in US dollars widen from 339 to 470 bp by year-end** (according to the JP Morgan CEMB Broad Diversified index on 11 January).

In the case of China, a weak renminbi led to a negative total return performance for Chinese sovereign bonds (-5.5% in USD) **in 2022. But they performed positively in renminbi** (+3.07%), mostly thanks to their coupon, whereas US Treasuries fell by almost 15% (according to the JP Morgan GBI United States index). Although a messy post-covid reopening could mean the Chinese currency remains volatile for a while, we expect a clearer trend towards renminbi appreciation later this year as the Chinese economy benefits from a reopening boom whereas the US economy languishes.

With domestic inflation subdued and monetary policy accommodative, the Chinese 10-year sovereign bond yield in renminbi remained broadly stable in 2022, in stark opposition with the rapid rise in sovereign bond yields elsewhere, including the US (*see chart 3*). **This led the usually positive spread between the Chinese 10-year yield and its US counterpart to dip into negative territory in early 2022, where it remains, reducing the attractiveness of the former for foreign investors**. Indeed, data show that foreigner investors' holdings of Chinese bonds declined by 12% from a year earlier in the first nine months of 2022. Overall, despite the recent inclusion of Chinese renminbi bonds in global benchmark indices, foreign investors remain wary of a number of issues linked to investing in China. These range from the preference accorded to repaying local investors in the case of defaults to US investment restrictions on Chinese securities.

While we expect the spread between the 10-year Chinese and US government bond yield to remain negative, it should narrow as a rebound in economic growth pushes Chinese yields higher while a US recession and an easing of monetary tightening leads to a decline in US yields by year's end. Our central forecast is for the Chinese 10-year yield to end 2023 at 3.0%, compared with 3.5% for the US equivalent.

USD-denominated Chinese corporate bonds have been early beneficiaries of China reopening in recent weeks (*see chart 4*). Spreads have tightened strongly since early November when rumours about a potential reopening first emerged, with investment-grade bonds posting a total return of 6.8% between 4 November 2022 and 11 January 2023, while their high-yield counterparts returned an exceptional 75.4% over the same period, according to ICE Bank of America indices. The latter have also benefited from new measures to help the property sector, where many developers have HY debt ratings. Nevertheless, **we prefer gaining exposure to China's reopening through investment-grade (IG) corporate bonds in Asia at large.**

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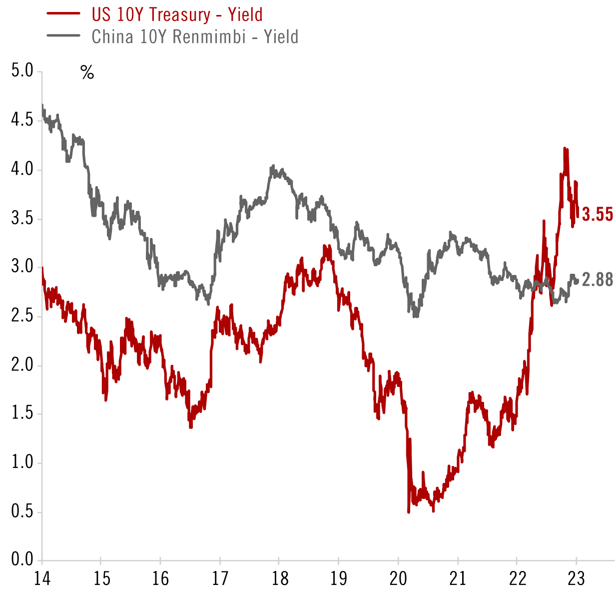
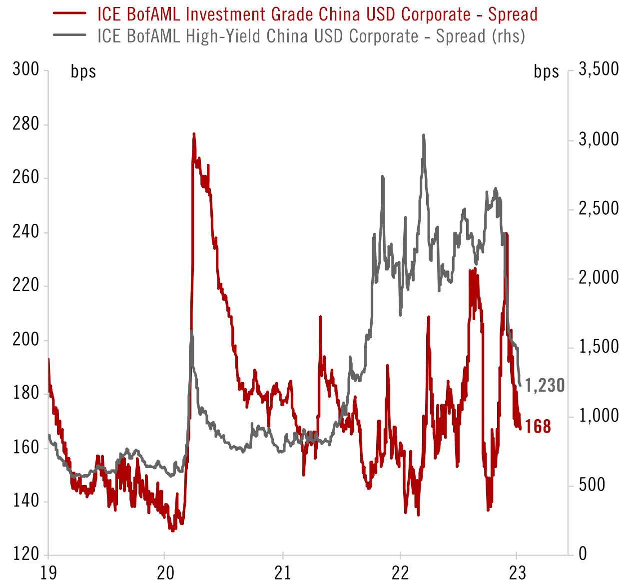
Chart 3: 10-year Chinese and US government bonds yields



Source: Pictet Wealth Management FactSet, 11 January 2023

Chart 4: Chinese US dollar-denominated corporate bond spreads



Source: Pictet Wealth Management - FactSet, 11 January 2023

FAVOURING ASIAN CREDIT

Despite EM currencies' recent rally against the US dollar, we believe it is too early to call a definite end to US dollar strength as we see the Fed continuing to hike rates in the early months of 2023. Moreover, there is a risk that some EM economies suffer if a recession in the US and Europe is not as mild as we expect. We therefore **remain neutral and selective when it comes to local-currency EM sovereign bonds**. We reckon that a pause in the Fed's hiking cycle (which we expect to come after a last rate hike in March) could prompt many EM central banks to do the same—but a DM recession could lead to rate cuts. **Much will depend on the severity of a US recession, as the US dollar tends to behave as a safe-haven asset in turbulent times**.

All things considered, and while we could see strong rallies in H1, we expect EM local-currency sovereign bond yields to be slightly below their current levels by year's end (from 6.6% to 6.5% according to the JP Morgan GBI-EM Global Diversified index on 11 January). We maintain a similarly neutral stance on Chinese sovereign bonds in renminbi as we monitor signs that the Chinese economy is indeed recovering.

We still like clipping the high carries offered by EM IG corporate bonds in US dollars, particularly Asian ones, which should benefit from China's reopening. We expect Asia IG corporate bonds to post a positive single-digit total return performance this year, helped by a strong carry (the yield on the JP Morgan JACI Investment-Grade Corporate index stood at 5.74% on 11 January), which should compensate for limited spread widening from 210 to 230 by year-end (*see chart 2*). In fact, due to the boost from Chinese re-opening, we believe Asian credit in general faces less risk of being contaminated by wider DM credit spreads in H2 than EM bonds at large. **We therefore remain overweight EM IG corporate bonds and selective on EM HY due to recessionary risks in the US and Europe**.

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