PICTET WEALTH MANAGEMENT

Emerging markets sovereign bonds - Update

A diversifier with attractive yields

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06 SEPTEMBER 2023, CIO OFFICE & MACRO RESEARCH

FLASH NOTE

SUMMARY

- Local-currency emerging-market (EM) sovereign bonds have posted positive total returns year-to-date, benefitting from declining yields and the appreciation of some EM currencies (particularly in Latin America).
- While falling since the beginning of the year, nominal yields on local-currency EM yields are still higher than their historic average since 2010, suggesting they could keep falling as Latin American central banks embark on a rate-cutting cycle, while most Asian central banks hold steady.
- While the weak Chinese recovery is having ripple effects on Asian economies and has led to a general depreciation of EM Asian currencies against the US dollar this year, the latter could weaken as US economic growth slows whereas EM growth proves more resilient thanks to policy easing. This environment could further support local-currency sovereign bonds, explaining our move from a neutral to overweight position on these instruments.

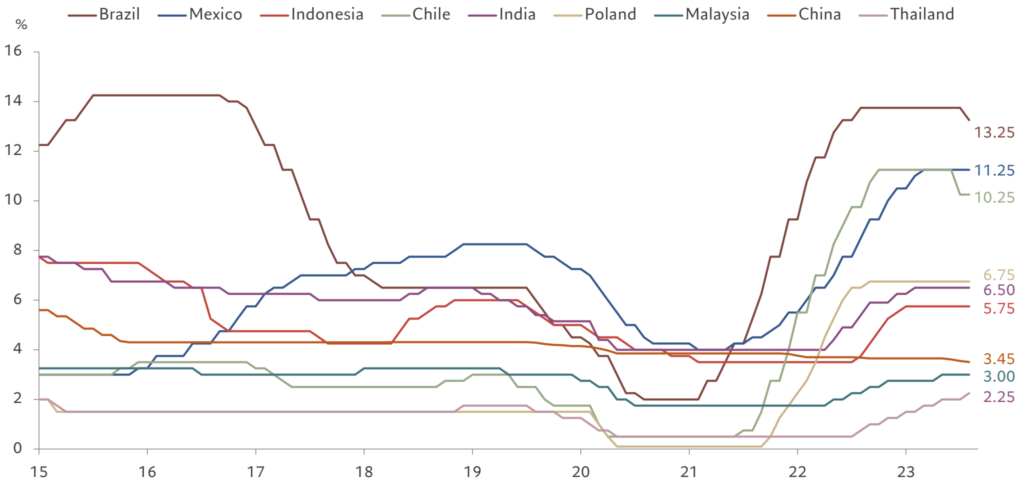
POSITIVE PERFORMANCES YEAR-TO-DATE

Local-currency EM sovereign bonds have posted positive total returns year-to-date of 6.3% (according to the JP Morgan GBI-EM Global Diversified Index on 1 September), benefitting from declining yields. This performance turns into 7.7% in USD terms thanks to the appreciation of some EM currencies (particularly in Latin America (Latam)). By contrast, there is no additional pick-up from converting performance into euros. EM local-currency bonds' positive returns stand in contrast with the negative performances posted by many developed-market sovereign bonds since the beginning of the year.

The performance of Latam sovereign bonds year-to-date has been particularly strong, at 9.7% in local currency and a whooping 20.6% once converted into US dollar (according to the JP Morgan GBI-EM Global Diversified Latin America Index on 1

September). In Latin America, where central banks started hiking rates in early 2021, headline inflation has fallen significantly, enabling central banks in Brazil and Chile to start to cut rates from elevated levels in recent weeks (*see chart 1*). Asian central banks have been much more timid about rate hikes. Indeed, many have continued to hike this year, with the exception of China.

Chart 1: EM central banks' policy rates



Source: Pictet Wealth Management, Refinitiv, as of 01.09. 2023

YIELDS ABOVE HISTORIC AVERAGES

While falling since the beginning of the year, with nominal yields of 6.4% on 4 September (according to the JP Morgan GBI-EM Global Diversified Index, *see chart 2*), local-currency EM sovereign bond yields are still higher than their historic average since 2010. Given how elevated yields in Latam are compared to their historic average (close to 10% in Colombia, Brazil and Mexico), they could keep falling as central banks embark on a rate-cutting cycle in H2 on the back of moderating inflation or, in the case of Chile or Brazil, to continue to cut rates.

By contrast, we think Asian central banks may elect to hold policy rates steady in H2, even though headline inflation has been falling in the region (to close to zero in the case of China and Thailand). The only exception is India, where economic activity has been robust and where inflation picked up again to 7.4% in July, mostly driven by food. But with core inflation continuing to trend lower, we expect the Reserve Bank of India (RBI) to hold its policy rate steady at 6.50% for the remainder of the year.

Given our expectation for a stabilisation of Asian sovereign bond yields around their historic average on the one hand, and a fall in Latam ones on the other, we project the average local-currency EM yield to fall slightly from 6.4% today towards 6% by the end of the year, with risks tilted towards a more significant fall if central banks surprise market participants with more rate cuts than are currently priced in.

For illustrative purposes. Past performance should not be taken as a guide to or guarantee of future performance. Performances and returns may increase or decrease as a result of currency fluctuations. There can be no assurance that these projections, forecasts or expected returns will be achieved. The projection is not based on simulated past performance.

Chart 2: Current EM local-currency sovereign bond yields compared to historic average

Source: Pictet Wealth Management, FactSet, as of 05.09.2023

A GOOD DIVERSIFIER

The pandemic, the war in Ukraine and growing geopolitical tensions with China have led to the weaponisation of assets from microchips to natural gas and national currencies. A period of offshoring by western firms when globalisation was at its height has given way to one where 're-shoring' or 'friend-shoring' (siting activities in friendly countries) is taking hold. A number of countries should benefit from the shift in supply chains that 'friend-shoring' implies. These include India, members of ASEAN, Mexico, and some central European countries. An influx of foreign capital could strengthen the currencies of these countries over the medium term.

Near term, while the weak Chinese recovery is having ripple effects on Asian economies and has led to a general depreciation of EM Asian currencies against the US dollar this year, the USD could weaken more broadly as US economic growth slows whereas EM growth proves more resilient thanks to policy easing (*see chart 3*).

Along with yields on average comfortably above 6%, low correlation with developed market sovereign bonds this year, and the prospect that EM currencies strengthen against the US dollar are all factors that could continue to benefit the performance of local-currency sovereign bonds (*see chart 4*). Hence, we have decided to move from a neutral to overweight position on these instruments as they are quite an attractive alternative to developed-market sovereign bonds.

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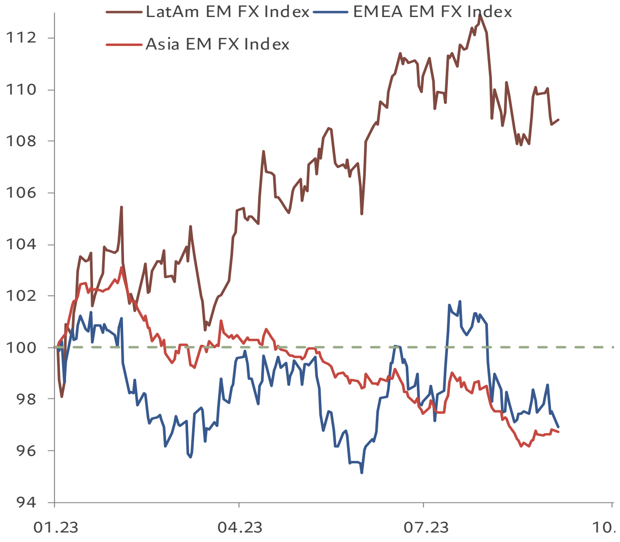
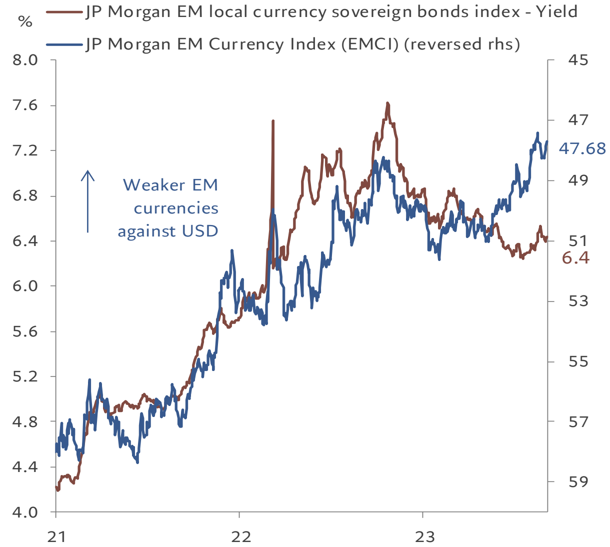
Chart 3: EM currencies' performance against USD



Source: Pictet Wealth Management, Refinitiv, as of 04.09.2023

Chart 4: EM sovereign bonds yields and currencies



Source: Pictet Wealth Management, FactSet, Bloomberg Finance, L.P., as of 04.09.2023

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