EM LOCAL CURRENCY SOVEREIGN BONDS - UPDATE

LOOKING FOR CARRY

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SUMMARY

- Unlike most of their developed-market counterparts, many emerging-market central banks have already started to reverse last year's policy easing to fight inflationary pressures. Rising inflation coupled with rate hikes and expectations for more to come have pushed many EM local-currency bond yields higher and prices lower.
- Despite a relatively high carry, many real government bond yields are still low. But they are mostly positive, unlike the negative real yields prevalent in DM sovereign bond markets.
- The US dollar's appreciation against EM currencies has exacerbated the negative year-to-date performance of EM local-currency sovereign bonds. However, early policy tightening by a number EM central banks and fast-improving vaccination coverage, coupled with some EM countries' status as important energy exporters, suggest a number of EM currencies could appreciate against the US dollar, boosting the returns from their local-currency bonds.
- We expect local-currency EM sovereign bond yields to rise further by the end of the year. This is based on our belief that EM central banks will hike rates more than is being currently priced in by market participants due to accelerating inflationary pressures.
- Believing we could see their fortunes improve in the coming months, we have moved from underweight to neutral on EM local-currency sovereign bonds. We are not yet expecting particularly large positive returns, but we believe that comfortable carry and currency appreciation against the US dollar could lead to an improvement in their performance.

EM central banks are fighting inflation

Unlike most of their developed-market (DM) counterparts, **many emerging-market (EM) central banks have already started to reverse last year's policy easing to fight rising inflationary pressures**. Among the most determined rate hikers, one can mention the central banks of Brazil, Russia, Mexico and Chile. Others have started to hike more timidly, including the central banks of Colombia, the Czech Republic and Hungary, while others have yet to move but could soon do so (for example in Poland or South Africa). Taking the latest headline inflation print as a gauge of how further central banks will need to hike, we could see more rate hikes before monetary policy is restrictive enough in Brazil, Poland, Hungary, the Czech Republic, Chile and Colombia (in red in *chart 1*).

Rising inflation coupled with policy rate hikes and market participants' expectations for more to come have pushed EM local-currency bond yields higher year-to-date, with many, such as bonds issued by Brazil, Colombia, Russia, South Africa, Mexico, Chile, India, and Indonesia, displaying more attractive carry than their DM counterparts (in green in *chart 2*).

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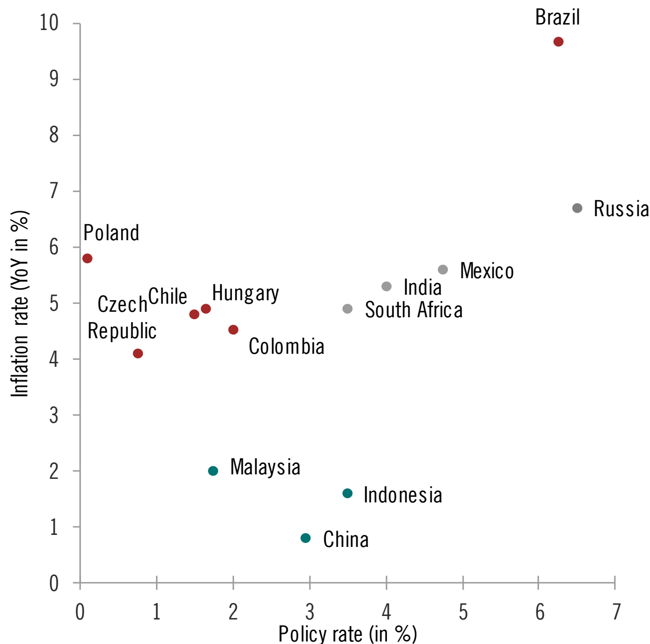
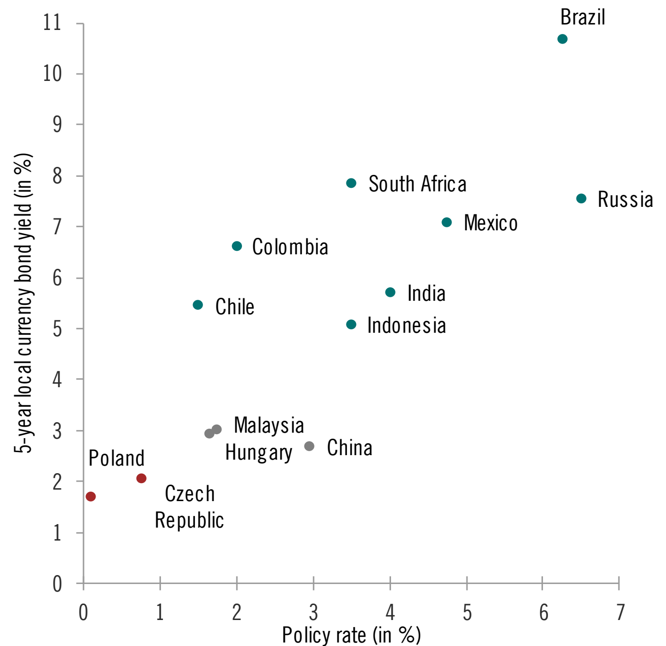
CHART 1: EM INFLATION AND POLICY RATES



Source: PWM - AA&MR, Bloomberg, 04.10.2021

CHART 2: EM LOCAL CURRENCY SOVEREIGN BOND YIELD AND POLICY RATES



Source: PWM - AA&MR, Bloomberg, 04.10.2021

Despite a relatively high carry, real EM government bond yields (i.e. nominal yields adjusted for the latest inflation rate) **are still low. Nevertheless, they are mostly positive, unlike the real yields on many DM sovereign bond markets.** More specifically, real yields remain attractive in countries like South Africa and Indonesia, and increasingly so in Mexico (*see chart 3*). However, the recent surge in energy prices is likely to translate into higher inflation globally and complicate matters for EM central banks (*see chart 4*).

Unlike their DM counterparts, **EM central banks usually target headline inflation rates**, which do not strip out energy costs. Moreover, a sudden surge in energy prices such as the one currently being experienced can lead to a reduction in industrial production. This is the case in China where factories have closed due to energy-related issues. **This complicates matters for central banks in emerging markets, potentially forcing them to quicken the pace of monetary tightening, thereby accentuating the slowdown even when the risk of overheating does not originate in the domestic economy.**

Policy makers in developed markets have been dismissing the recent rise in inflation as transient, saying it is linked to supply bottlenecks and base effects. **But their peers in emerging markets cannot take the upsurge in prices so lightly because of the risk of further depreciation of their currencies against the US dollar**, thus fuelling even more inflation through rising import prices. For example, the Polish zloty fell by 4.6% against the US dollar between 3 September and 5 October, in part because the Polish central bank has stuck with its very accommodative stance (its policy rate adjusted for inflation was -5.7% in September) and its stated conviction that higher inflation is temporary.

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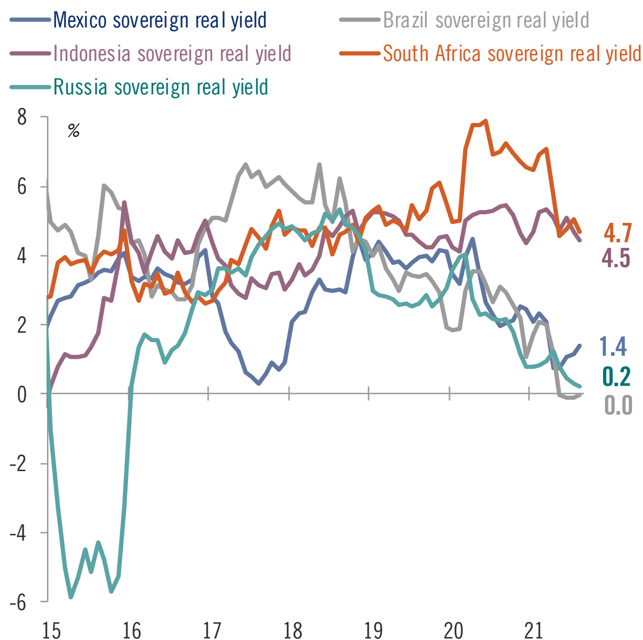
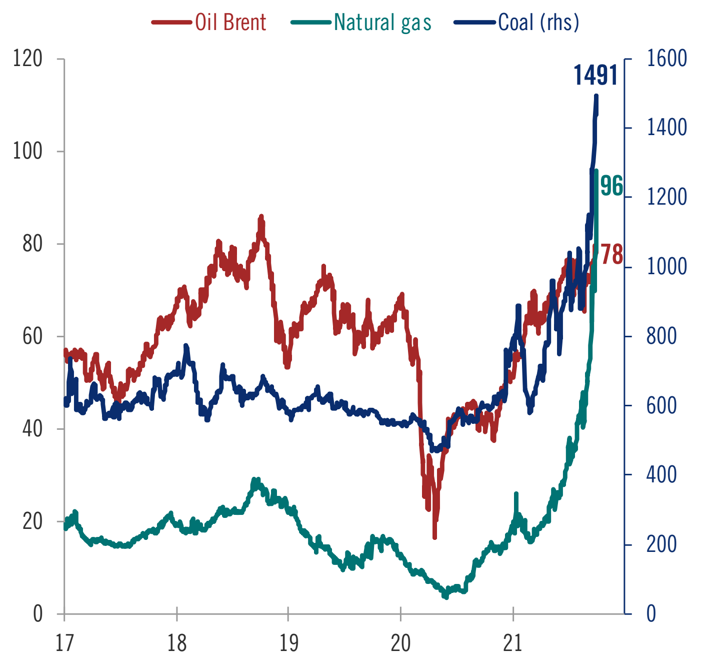
CHART 3: REAL EM SOVEREIGN BONDYIELDS



Source: PWM - AA&MR, Refintiv, August 2021

CHART 4: ENERGY PRICES



Source: PWM - AA&MR ZCE, Bloomberg, 30.09.2021

Improving growth momentum could boost EM currencies

Although EM currencies have been generally depreciating against the US dollar (by 4.4% year to date on 4 October, according to the JP Morgan EM currency index, *see chart 5*), **early rate tightening by a number of EM central banks, fast-improving vaccination rates and some EM countries' status as large energy exporters holds out the possibility of a strengthening of select EM currencies against the US dollar.**

Indonesia (which is a large net exporter of coal and natural gas), Russia (which is a large net exporter of crude oil, natural gas and coal) and, to a more limited extent, Brazil (a net exporter of crude oil), Malaysia (a net exporter of natural gas) and Colombia (a net exporter of coal and crude oil) could see their economies and currencies benefit from the recent surge in energy prices.

China, Chile and Malaysia stand out on the vaccination front, with more than 60% of their populations having already received their second dose of a covid-19 vaccine. At the other end of the spectrum, South Africa and Indonesia have vaccinated less than 20% of their populations with two doses, while Poland, Brazil and Mexico stand in the middle of the pack (with 52%, 44% and 35%, respectively). **As vaccination campaigns progress and the disruption caused by the pandemic diminishes, domestic EM economies could benefit from the same unleashing of pent-up demand as has been experienced in developed markets.**

The US dollar's appreciation against EM currencies exacerbates the negative year-to-date performance of EM local-currency sovereign bonds (which moves from -2.3% in local currency terms to -6.4% in USD, based on the JP Morgan GBI-EM Global diversified

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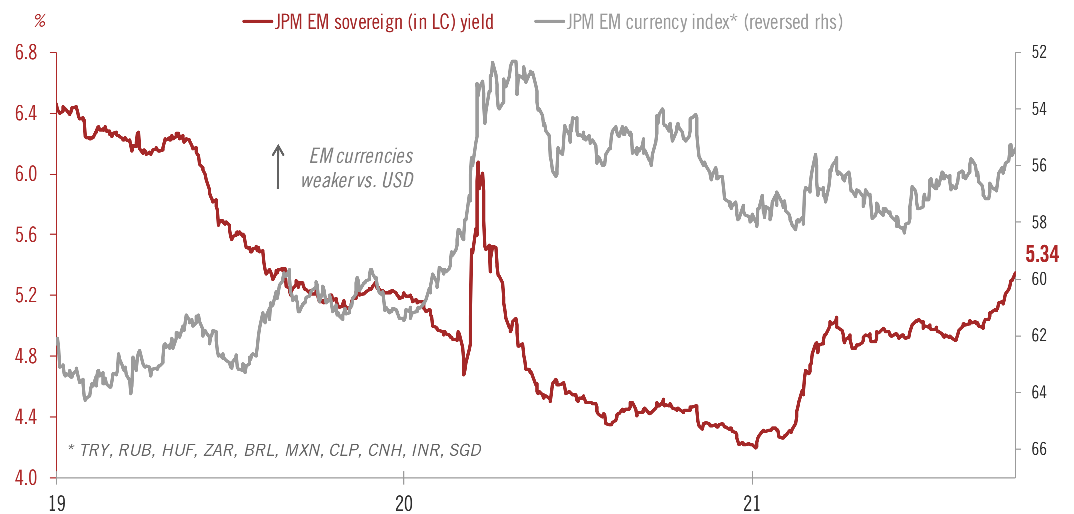
index at 4 October). However, **recent US dollar strength could abate if growth picks up in emerging markets and boosts their currencies.**

We forecast EM local currency sovereign bond yields to rise from 5.3% on 4 October to at least 5.5% by the end of the year *(see chart 5)***.** Underpinning this forecast is our expectation for more EM policy rate hikes than is being currently priced in by market participants—mostly due to the surge in energy prices and supply bottlenecks. **Nonetheless, relatively comfortable carry could compensate over time for the rise in EM bond yields and drop in bond prices.**

Timing a reversal in the performance of a financial asset is always hazardous, and even more so in the case of EM government bonds in local currency given the exchange-rate component. However, our belief that we could see a change in their fortunes has prompted us **to move from underweight to neutral on EM local-currency government bonds**. While not expecting particularly large returns, we believe their performance **could improve on the back of comfortable carry and currency appreciation against the US dollar**.

CHART 5: EM LOCAL CURRENCY SOVEREIGN BOND YIELDS AND EM CURRENCIES VS. THE US DOLLAR



Source: PWM - AA&MR; Factset, Bloomberg, 04.10.2021

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