EMD Outlook 2021

A year of recovery and re-risking

- Continued policy support and economic recovery projections support the overall outlook for emerging market debt in 2021
- In hard currency, we expect high yield to recover lost ground and for regional divergence to continue
- Frontier market returns should bounce back in 2021 despite vaccine sourcing and distribution challenges
- Asian debt markets will likely continue their strong rebound as the vaccine roll-out supports further normalization
- Local currency bonds could benefit from currency appreciation enhancing returns, but volatility remains
- ESG factors will play bigger role amid growing investor demand and international momentum

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Executive summary

- **The main themes for emerging market debt in 2021 will be the recovery in fundamentals and supportive technical conditions as investors re-risk rather than de-risk their investment portfolios.** Investor optimism and the continued search for yield have caused spreads to tighten close to their pre-pandemic levels after they widened sharply in early 2020. Still, the asset class should benefit from continued policy support as global growth recovers this year. Divergence in the EM-DM growth differential also bodes well for capital flows, and projections for a 2021 recovery favour emerging markets on the whole.

- **Vaccine distribution will be a pivotal factor on the road to recovery for emerging markets.** We identify three routes to vaccine access. Emerging nations may be able to develop their own vaccines. They could enter into advanced purchase agreements with pharmaceutical firms. Or they could rely on the multilateral Covax facility. Countries with the requisite knowledge, resources and production capacity to develop their own vaccines benefit from secure supply and can also strike deals to export their vaccines to other countries. Conversely, nations forced to rely on the Covax facility may face sourcing difficulties or delays.

- **In hard currency, we expect high yield to recover from its underperformance relative to investment grade.** Debt risks have risen but do not signal an impending systemic crisis. Still, credit fundamentals remain challenged. Significant external funding needs call for a selective approach. We expect continuing regional divergence in 2021. Idiosyncratic factors will shape the outlook for Latin American countries, while emerging Asia looks set to continue its strong rebound. The success of vaccine roll-outs will also be a key factor for countries still hit hard by Covid-19. Countries that have secured reliable vaccine access will be best positioned to benefit.

- **For frontier markets, the rebound could be uneven with potential hiccups.** Frontier markets were hit hard by the pandemic shockwaves and their recovery has lagged behind that of other emerging markets. Spreads are still well above pre-Covid levels. Most frontier economies will also face challenges in sourcing and distributing vaccines, as they do not have the financial resources to secure bilateral deals with producers. Nevertheless, the global rebound should help frontier markets kickstart their economies. We expect growth rates to bounce back to 3.6% in 2021 and hover around 3.9% in the medium term.

- **Asian debt markets should continue their strong rebound in 2021 as the vaccine roll-out supports further normalization.** We expect a gradual improvement in credit metrics and have a modestly positive supply-demand outlook for Asian USD bonds. A continued economic recovery should allow spreads in the region to tighten in 2021, although the challenges of Covid-19 containment and continued US-China tensions present key risks to our outlook. We see value in the Chinese property sector and the Thai banking sector at current spread levels. We take a more cautious stance on Indian investment grade, given the risk of a sovereign downgrade.

- **The ongoing recovery in corporate debt should continue gaining momentum, boosted by the vaccine roll-out and improving fundamentals.** Credit spreads are likely to tighten slightly, spurred on by the ongoing search for yield in this low-rate environment. We expect mid-single-digit total returns for 2021, owing to attractive carry, continued spread compression, and the limited impact of rising US Treasury yields. Within the corporate debt universe we see most value in Asia, which is well ahead in the recovery phase, and in Latin America, where attractive spread levels compensate for corporate fundamentals. We are also closely watching political developments that could give rise to potential tactical opportunities.

- **We forecast attractive returns for EMD local bonds, given attractive carry plus room for rate compression and FX appreciation.** The weak growth, output gaps and disinflationary environment still appear supportive for most EM local bond markets. Still, improved projections for fiscal deficits might be optimistic, and we see lingering uncertainties around vaccine distribution, the risk of continued lockdowns, and Fed policy. Overall, we expect high-single-digit returns for 2021 as a result of carry and limited rate compression and FX appreciation. We stay selective in our country approach and take a cautious stance towards more vulnerable markets with weak and deteriorating fundamentals.

- **Environmental, social and governance factors will play a bigger role in emerging market investment.** Growing investor demand and strengthening international momentum should be supportive for countries that play a pivotal role in sustainable supply chains. The pandemic has also underscored the need for action on social issues and sparked a sharp rise in social bond issuance. We expect issuance of green, social and sustainability bonds to rise apace in 2021 and beyond. EMD strategies that consistently integrate ESG factors and work to tackle still-prevalent data and transparency issues will be best placed to take advantage of this growing segment.

A year of recovery and re-risking

Macro-economic outlook

Marcin Adamczyk

Head of emerging market debt

Expectations for emerging market debt were relatively positive at the onset of 2020. The Covid-19 pandemic sent these expectations into a tailspin as soaring infections and government-imposed restrictions pushed the global economy into recession. Highly accommodative monetary policy in large developed countries brought markets back from the brink, while government borrowing and spending helped put a floor under economic activity. The IMF and other international financial institutions quickly provided loans to countries without the usual conditionalities.

Once the smoke had cleared, a cross-market recovery eventually fed demand for EM bonds, bringing 2020 full-year flows for HC EM debt back into positive territory. Resurgent investor sentiment and record-low interest rates prompted a search for yield that continued throughout the year and pushed EM bond spreads to levels not far from those at the start of 2020. Investors focused largely on expectations of a global recovery, leaving the global recession in the rear-view mirror. Positive vaccine news and US election results further lifted sentiment. Markets ended the year on an upbeat note, with positive total returns across the board for EMD sub-asset classes.

Those readers familiar with NN IP's EMD team are used to our overall approach of looking at fundamentals, technicals and valuations when taking active investment decisions. During 2020, we added a fourth lens when assessing opportunities and risks in sovereign bond spreads: bottom-up analysis of environmental, social and governance (ESG) factors. For 2021, the main themes for the EMD asset class will be the **recovery in fundamentals** and supportive technical conditions as investors searching for yield **re-risk** rather than de-risk their investment portfolios. This expected re-risking push is likely to have a strong ESG tilt, for the reasons we discuss below.

The coming year may be less extraordinary but should still offer ample investment opportunities. Policymakers are likely to be cautious in removing stimulus as global growth recovers but remains below the pre-Covid output level. This combination of economic recovery and continued dovish monetary stance signalled by DM authorities will support the EMD asset class. Divergence in the EM-DM growth differential bodes well for capital flows, which stagnated last year. East Asian economies, particularly China, were among the world's most resilient in 2020. Projections for a 2021 recovery, such as the recent growth forecasts from the IMF and World Bank, also favour emerging markets. Based on this macro outlook we expect positive overall returns for EMD for 2021, which will also be marked by dispersion between regions and countries.

ESG focus set to continue on accelerated growth path

The international backdrop for sustainability-focused investing is gaining momentum. President Joe Biden has brought the US back into the Paris Agreement and plans to "build back better" and create a modern and sustainable future focused on clean energy. Europe's Green Deal aims to make the continent climate-neutral by 2050, and the new EU Taxonomy and EU Green Bond Standard will be milestones for the green bond market's integrity and transparency. China's Xi Jinping surprised the international community with his ambitious pledge for China to become carbon-neutral by 2060.

This backdrop supports the balance-of-payments of key countries in the global supply of materials used for infrastructure (such as iron ore, concrete and copper) and green energy (such as lithium and rare earth materials). These countries include Chile, Peru, Indonesia and China. Governments that are sceptical of climate change and the Paris Agreement, such as that of Brazilian President Jair Bolsonaro, could face increased pressure from the international community and a more vocal Biden administration.

The coronavirus pandemic underscored the importance of social safety nets, adequate healthcare and working environments, and transparency and accountability for public finances because of record budget deficits. Large budget deficits and already-high government debt levels are particular points of attention in Brazil, South Africa, Oman, Sri Lanka, El Salvador and Tunisia. The pandemic sparked a sharp rise in social bond issuance in emerging markets to EUR 15 billion during 2020, mostly from corporates and partly at the expense of green and sustainability bond issuance. We expect more countries to issue green, social and sustainability (GSS) bonds in 2021, given record-high budget deficits, green recovery/transition agendas, and favourable financing levels for GSS bonds due to high investor demand.

How can investors navigate these rapidly evolving developments? We integrate ESG criteria into all our EMD strategies systematically and stringently. We have fully integrated ESG factors into all steps of our investment processes to help us proactively manage risk and identify areas of possible concern and potential opportunities. Our approach features internally and externally sourced data, and we leverage on our own expertise from NN IP's Responsible Investing team and our EM ESG analysts. This enables us to cope with still-prevalent data and transparency issues, and places us at the forefront of new developments, discussions and engagement within the industry.

The EM road to vaccination

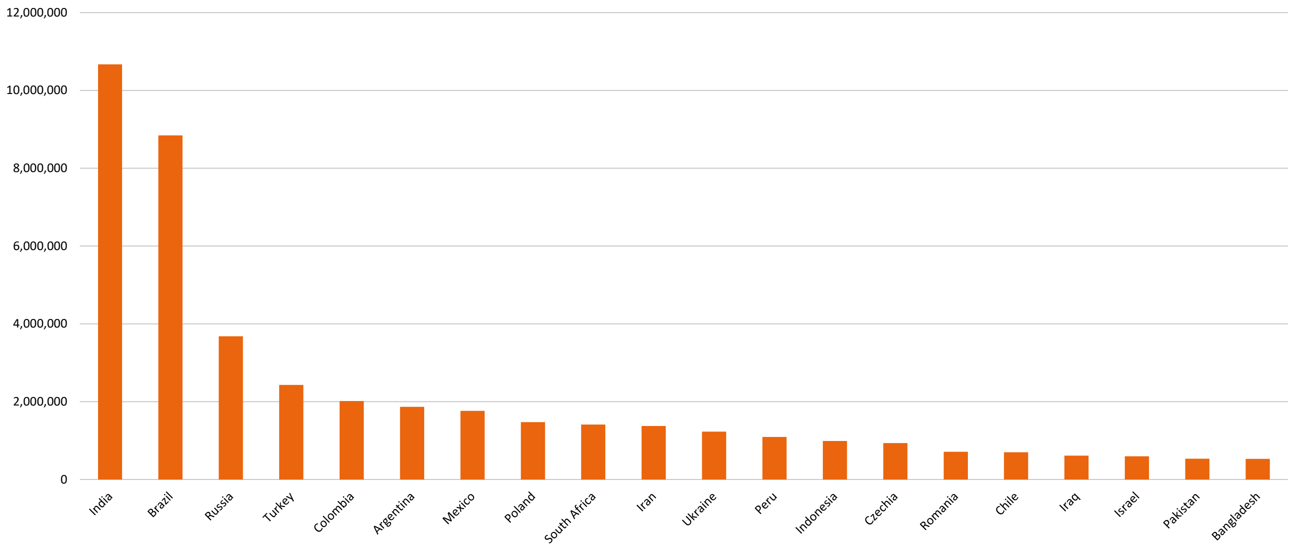
The development and distribution of several Covid-19 vaccines are on track. We can pinpoint how various emerging markets are positioned in terms of vaccine access. There are three main routes whereby markets can gain access to vaccines:

- Domestic development and production
- Bilateral advanced purchase agreements (APAs) with private pharmaceutical firms
- Multilateral Covax facility led by the World Health Organization

Developing own vaccines seems secure and can also be exported...
Domestic development and production appears to be the most secure way to gain access to a vaccine for countries with the requisite knowledge, resources and production capacity. **Russia** and **China** have a head start, having already developed national vaccines for distribution. Several countries pre-ordered and some have already received significant quantities of the vaccines developed by China. Most notably, **Chile** worked with China in developing its vaccine and testing in Phase 3 trials and pre-ordered enough to inoculate 158% of its population. **Indonesia** has pre-ordered enough of both Chinese vaccines to inoculate 35% of its population in total, and the Indonesian government expects raw material for 45 million doses of Sinovac, which its state pharmaceutical firm PT Bio Farma will process locally.

...but many EMs have opted for APAs with private firms...
According to the Duke Global Health Innovation Center (DGHIC), 24 emerging countries have pre-ordered vaccines via bilateral APAs from large pharmaceutical firms. The EMs with the biggest advantage via this route are countries with manufacturing capacity, such as **India**, **Mexico**, **Brazil** and **Argentina**, because they can strike deals with manufacturers for onshore vaccine production.

Emerging markets with the highest cumulative total of coronavirus cases as per 24 January 2021



Source: Oxford: Coronavirus Pandemic Statistics and Research (Our World in Data)

...while those left with the Covax facility stand to lose out
Countries that can't place large orders or strike production deals will have to rely on the multilateral Covax facility, the least favourable option. Covax targets 2 billion vaccine doses by end-2021, enough to vaccinate 1 billion people. It aims to distribute vaccines on a more equitable basis and ensure distribution to lower-income countries. But compared with advanced purchase agreements, the Covax facility has access to fewer doses and the roll-out will probably be slower. Covax's publications suggest that allocation decisions may not be finalized until March 2021, while EMs with APAs have already started vaccinating. Therefore, EMs that make more use of the Covax facility than the other two options stand to lose out in the race to quick vaccine access. Such countries include the poorer countries in the Middle East; most of **Africa**; Latin American countries such as **Colombia**, **Ecuador** and **Peru**; and Asian countries such as **Sri Lanka**, **Mongolia** and **Vietnam**. Countries are forming coalitions to help narrow this gap, including an effort by the African Union and the Africa CDC to pool financing for vaccine procurement and to increase manufacturing within the continent. Coalitions like this in Africa and Latin America may help low-income countries strengthen their position in the global vaccine market.

EMD Hard Currency Sovereign Bonds

High yield set to recover lost ground as regional divergence continues

- **Outlook for high yield looks promising; we recommend a selective approach to risk**
- **We forecast divergence in Latin America, continued strength in emerging Asia**
- **Vaccine distribution challenges will be determining factor**

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EMD hard currency experienced a great deal of volatility in 2020, as did financial markets in general. Markets rebounded from pessimism surrounding Covid-19 developments to subsequent optimism about vaccine developments and the policy response to the pandemic. EMD HC had further support from the rapid provision of loans from the IMF and other international financial institutions, without the usual policy conditionalities. Starting in May, the sub-asset class recovered sharply and the index ended the year with total returns of 5.26%.

Policymakers are likely to be cautious in removing stimulus as global growth recovers. This positive fundamental backdrop will support the asset class, together with the continued dovish monetary stance from DM authorities. Net new issuance of sovereign hard currency should decline significantly after record high issuance in 2020 as fiscal deficits narrow in much of the EM universe. Divergence in the EM-DM growth differential also bodes well for capital flows, which stagnated last year.

East Asian economies, particularly China, were among the most resilient in 2020. As global output collapsed, Chinese output grew. The rebounding Chinese economy also boosted other emerging economies, which contracted less than DM economies. Projections for a 2021 recovery, such as the recent growth forecasts from the IMF and World Bank, also favour emerging markets.

Valuations remain attractive relative to other credit asset classes. EMD HC exhibits the smallest retracement among global credit markets. The asset class can withstand a US Treasury yield increase of about 50 bps before returns turn negative. Close to 90% of DM bonds are currently trading at negative real yields, which boosts the case for re-risking investment portfolios and investing in EMD HC. Positive vaccine news and more predictable US policy should continue to power a cyclical upswing that strengthens demand for risk assets.

EM sovereign high yield offers attractive opportunities

In 2021 we expect high yield to recover from its underperformance versus investment grade countries. While investment grade spreads have tightened to pre-Covid levels, high yield spreads remain wider than at the start of 2020. Frontier names in particular lagged until year-end. Debt risks have risen but do not indicate an impending systemic crisis. Large EM sovereigns borrowed mainly in local markets, suggesting a worst-case scenario of higher inflation or currency devaluation, rather than external debt default in the style of Lebanon or Argentina.

Still, differentiation remains key, particularly in frontier economies that borrowed primarily in foreign currencies. Credit fundamentals remain challenged and external funding needs are significant. This leaves rating outlooks biased to the downside and underlines the need for new IMF programmes. This should keep dispersion high and will strengthen the need for a selective approach to risk in the year ahead. Our key preferences are Romania and Saudi Arabia in the investment grade space and Pemex[1], Egypt, Dominican Republic, Côte d'Ivoire, Angola and Sri Lanka in high yield.

Regional divergence will continue in 2021

The common themes among EM regions are an improving external backdrop and incomplete growth recovery. The economic recovery has been consumer-driven in parts of Latin America; manufacturing has been the main area of strength in much of emerging Asia and emerging Europe.

Latin America is the global growth laggard due to structural headwinds and limits to policy support. This region had the deepest fall globally in the second quarter of 2020, and its rebound is still slower than that of other regions. Peru and Chile will lead the Latin American recovery. A more sluggish pace is likely in Mexico, where investors distrust the president, Andrés Manuel López Obrador. Elsewhere, post-Covid frustrations will show up in street protests – we are closely watching Colombia and Argentina – and the threat of populist victories in the upcoming Ecuadorian, Peruvian and Chilean elections.

Emerging Asia came through the pandemic as the least affected region. It successfully capitalized on the shift in global demand away from services and towards goods. The goods recovery that began in the third quarter of 2020 has sufficient

1 For illustration purposes only. Company name, explanation and arguments are given as an example and do not represent any recommendation to buy, hold or sell the stock.

momentum to continue through 2021. China's strong performance looks set to continue as consumers join the recovery. The PBoC will be the only major central bank to raise interest rates in 2021, but the economy will continue to benefit from strong credit growth related to previous policy support. In EMEA we expect loose monetary policies across the region, except for Turkey, and only a partial reversal of the 2020 counter-cyclical fiscal policies to help keep the recovery on track.

Recent sharp increases in new Covid-19 cases in many EMs could detract from the growth recovery. The success of vaccination programmes will therefore be a key factor in economic performance over the next couple of years. Although major economies have approved multiple vaccines in recent months, the outlook for emerging markets is uneven in terms of the number of orders placed with manufacturers and the health infrastructure required to mass administer vaccines.

In Latin America, Mexico, Chile, Costa Rica and Argentina are leading the region's vaccine race. All four started administering doses at the end of 2020, with the first three rolling out the Pzifer/BioNTech jab while Argentina is using the Russian Sputnik V vaccine. In EMEA, Romania will be a key vaccine beneficiary. The EU has pre-ordered jabs for the Balkan state, where distribution challenges are limited and the virus is still circulating widely. By comparison, Colombia seems to be among the worst-positioned Latin American countries so far. It has secured vaccines for only 10% of its population, and these are via Covax, the WHO facility set up to supply vaccines to low- and middle-income countries. Covax itself has not placed sufficient orders, and two-thirds of the orders it has placed have been for vaccine candidates that are still at the trial stage.

Spread and total return forecast

We forecast the Emerging Markets Bond Global Diversified Index to post a total return of between 6% and 10% this year, measured in US dollar terms, assuming 10-year UST yields remain range-bound and EMD HC spreads narrow further to 300-325 basis points.

Frontier Market Debt

Frontier markets continue to rebound despite vaccine challenges

- **Frontier markets continue to rebound from pandemic shockwaves**
- **Asset class still benefits from supportive technicals, attractive relative valuation**
- **Active management and selective approach are key**

Frontier markets were hit hard by triple pandemic shocks

The Covid-19 pandemic, coupled with the profound global slowdown and collapsing commodity prices, led to pressing health, social and economic challenges in early 2020. These challenges applied worldwide; frontier economies came under particular stress given their weaker pre-pandemic fundamentals, constrained fiscal policies, less efficient monetary transmission channels and significant terms-of-trade shocks. As developed markets went into lockdown, international capital markets shut down for frontier markets almost instantly. Spreads on their external debt quickly soared to distressed levels around 1,000 bps in March/April 2020.

The IMF took swift measures to address these countries' unprecedented liquidity pressure. Furthermore, G20 finance ministers announced the Debt Service Suspension Initiative (DSSI) to help the least developed nations ease liquidity pressure via temporary suspensions of debt service payments on official bilateral debt. This enables governments to concentrate their financial resources on urgent payments stemming from the pandemic. Initially the programme covered payments due between May and December 2020, but as the pandemic endured, it was extended by another six months to end-June 2021.

Debtors have been reluctant to involve private creditors in DSSI, due to risk of credit rating downgrades and potential loss of market access. In addition, it became clear in second-half 2020 that coronavirus and its economic impacts will not vanish anytime soon. DSSI may therefore not provide enough relief for some countries. Thus, in November the G20 announced further support with their "Common Framework for Debt Treatments beyond the DSSI" to coordinate debt treatment among creditors in low-income countries, in order to effectively address the potential liquidity and solvency issues that the pandemic poses. This multilateral support will remain important for frontier countries in 2021 and beyond, and it supports the outlook for the sub-asset class.

In the meantime, developed markets' accommodative monetary policies helped to stabilize markets, sparking a demand recovery for EM bonds, including frontier market bonds. Even the primary market opened up again for frontier economies. Issuers including Guatemala, Honduras, Egypt, Belarus, El Salvador, Mongolia and Côte d'Ivoire have issued Eurobonds since the onset of the pandemic. Some issuers, including Mongolia and Côte d'Ivoire, coupled the new issuance with a liability management by tendering short-term Eurobonds with maturity of 1-5 years at the time of issuance to smoothen their repayment profile and reduce potential liquidity risk over the medium term.

By end-2020, spreads on the Next Generation Markets Index had substantially retraced from the peak of 1,062 to 595 but remained significantly above pre-Covid levels. Their rally lagged behind that of the Emerging Markets Bond Index, especially investment grade bonds.

This year's rebound could be uneven with some hiccups

Most frontier economies do not have the financial resources to secure bilateral deals with vaccine producers, and low storage temperature requirements may make certain vaccines unsuitable for frontier markets. Frontier economies will predominantly rely on Covax to source suitable coronavirus vaccines when they are available. Regions such as sub-Saharan Africa may have a less pressing need for a quick vaccine roll-out thanks to their relatively young populations. Unless the virus is brought under control, prolonged travel restrictions could dampen the outlook of economies that are reliant on tourism, like Kenya or Caribbean islands.

Nevertheless, the rebound in global growth and demand for commodities should help frontier markets kickstart their economies. Based on the IMF's latest forecast, real GDP growth in frontier economies should bounce back to 3.6% in 2021 from last year's estimated 3.6% contraction. Over the next five years growth is expected to hover around 3.9%, higher than the pre-Covid average of 3.1% during 2015-19.

Of all sub-asset classes in the EMD universe, frontier market debt offers the most spread tightening potential. We estimate that spreads will tighten by around 100 bps to around 500 bps in 2021, which would still be above their pre-Covid levels. We believe a higher risk premium will remain warranted, given increased risks relative to the pre-Covid situation. The sub-asset class faces lower interest-rate risk than the broader EMD HC universe, which decreases the impact of potential US Treasury yield rises. Still, we expect UST yields to remain range-bound and therefore to have limited impact in 2021.

Frontier market debt offers the highest yield (currently 6.9%) among EMD sub-asset classes. Given its aforementioned spread-tightening potential, we expect it to outperform other EMD sub-asset classes in 2021, with potential total returns of 8%-12%. Dispersion should remain high among issuers, as uncertainty about the recovery, a sharp deterioration in debt metrics, and diverging recovery/development paths among frontier countries warrant an active and selective approach to risks.

Strong rebound should continue amid vaccine roll-out

- **Rebound should continue as spreads tighten further**
- **At current spread levels we like Chinese property sector and Thai banking sector**
- **Risks linked to Covid-19, US-China tensions are still in play**

Joep Huntjens

Head of Asian fixed income, lead portfolio manager, Asian debt hard currency

Asian debt rebounded strongly in 2020

Pandemic-related news was the dominant driver for the Asian debt market in 2020. The initial market reaction was limited when the virus started to spread across Asia. Concerns about its rapid spread elsewhere in the world and its impact on the global economy triggered a dramatic sell-off of risky assets in March. Asian debt did not escape unscathed. Credit spreads for Asian USD bonds more than doubled over the first quarter of 2020.

The Asian debt market rebounded following this sell-off, supported by unprecedented fiscal and monetary measures by governments and central banks and successful handling of the virus situation in China and other Asian countries. Other contributing factors included a benign US election outcome and promising vaccine developments. Owing to this market recovery and a substantial fall in US Treasury rates, the JP Morgan Asian Credit Index delivered a decent positive total return of 6.33% for full-year 2020. The average spread of Asian USD-denominated bonds increased by 28 bps to a year-end level of 228 bps. The five-year US Treasury rate, which is most representative for this asset class, ended the year at 0.36%, 1.33% lower than at the start of 2020.

Spreads set to tighten amid positive technicals, fundamentals

Asian countries have generally handled the pandemic well. China will likely be the only major economy to report positive growth in 2020. Life has largely returned to normal in China, aside from continued restrictions on international travel, and the Chinese economy's V-shaped recovery has brought GDP back to pre-Covid levels. Depressed Chinese GDP levels in the first half of 2020 should enable China to grow by more than 8% in 2021 and allow for a gradual exit from the pandemic-era monetary policy support. China should be able to sustain GDP growth of 5% in the following years, with domestic demand becoming an increasingly important growth driver.

The vaccine roll-out across Asia should support further normalization of economic activity elsewhere in the region in 2021. The more developed countries with better virus containment and more room for policy support should be the first countries to join China's accelerated economic recovery path, while the recovery in India and Indonesia is likely to lag behind. The Asia ex-Japan region as a whole should remain the fastest-growing region globally this year.

Credit fundamentals for Asian companies deteriorated modestly in 2020. Covid-19 disruption led to declining profitability during the first half of the year, resulting in increased leverage multiples. Investment grade issuers also preferred to hold higher cash balances in 2020, given economic uncertainty and low overall funding levels. This also contributed to last year's increase in gross leverage. We expect Asian companies to take a cautious stance on business expansion plans this year, reducing the need for debt funding to finance capital expenditure. Overall, we expect credit metrics to improve gradually in 2021. The default rate for Asian high yield companies, which doubled in 2020 to 3.4%, is expected to decline in the coming year. Less supportive onshore funding conditions in China are likely to keep Asian high yield default rates above 2%.

We are modestly positive about the supply-demand outlook for Asian US-dollar-denominated bonds in the coming year. Although gross supply of new Asian USD bonds is expected to remain elevated in 2021, we expect the net supply (gross supply minus bond maturities and coupon payments) to end the year slightly below the average seen over the past couple of years. The expected supply level should be manageable. Asian hard currency fund flows have been positive in every month since the March 2020 sell-off. Demand should continue to benefit from relatively attractive spread levels and better control over the virus, resulting in a less uncertain growth recovery trajectory than other regions.

From a valuation perspective, Asian USD-denominated bonds are attractive compared with US corporate bonds. The average spread pickup of Asian investment grade bonds versus US investment grade bonds exceeds 50 bps, compared with an average pickup of 24 bps over the past five years. For Asian high yield bonds, the pickup versus US high yield bonds is currently 295 bps, compared with an average pickup of 101 bps over the past five years. A strong economic recovery in Asia, combined with improving credit metrics and relatively low uncertainty about the virus impact, should allow spreads in the region to tighten in 2021. We expect spread tightening of 30 bps for investment grade bonds and 100 bps for high yield bonds.

US Treasury yields increased after Democrats won control of the US Senate in January. From these increased levels, we expect little movement in the five-year US Treasury rate for the remainder of 2021. There is limited risk of a material rise in the short end of the US Treasury rate curve, as Fed officials project the policy rate to stay at zero through 2023.

We forecast 12-month total returns of 4-6% for Asian hard currency debt, based on our expectations that spreads will tighten and five-year US Treasury rates will be fairly stable. Based on our view of improving credit metrics and spread compression, we prefer high yield, for which we forecast a 12-month total return of 6-8%, over investment grade (3-4%).

Opportunities in Chinese property sector, Thai banking sector

Within the investment universe, we prefer China, and especially its property sector. The Chinese property sector provides attractive spread levels and has recovered substantially following the early-2020 lockdown. In addition, the new “three red lines” regulations, which set guidelines for developers’ equity, debt and cash ratios, will require increased financial discipline. We recommend a selective approach for Chinese high yield bonds outside the property sector, given more challenging onshore funding conditions for these issuers. Issuers with significant upcoming debt maturities face a higher risk of default in the current environment.

We also like Thai exposure. Although Thailand successfully contained the pandemic, its dependence on tourism led to a substantial correction of Thai USD-denominated bond prices in first-half 2020. While spreads have recovered most of the widening, we see room for further tightening when travel restrictions are lifted. Within Thailand we like the banking sector, which is well capitalized. Some of its bonds continue to trade at spread levels well above pre-Covid levels.

We are more cautious on Indian investment grade companies, which have rallied strongly. At current valuations, these companies do not sufficiently compensate investors for the potential downgrade of India’s sovereign rating. This rating currently stands just one notch above the high yield threshold with a negative outlook from two of the three large rating agencies. Given the relatively early stage of India’s post-Covid recovery, investors should not disregard the risk of a potential sovereign downgrade, which would probably lead to downgrades of corporate issuers.

Covid-19 risks and US-China tensions remain in play

We expect a strong global economic recovery in 2021 and decent demand for Asian debt. We do bear in mind two key risks.

The first is the challenge of Covid-19 containment. Issues with availability and distribution of vaccines could result in second waves similar to those in the US and Europe. Although Asian countries have successfully contained the spreading of the virus, new measures might be needed to combat new clusters that could hamper the global economic recovery.

The second risk is the continuing threat of US-China tensions. Although the new Biden administration is expected to adopt a less hostile and more predictable foreign policy approach, the tensions surrounding trade and technology issues are unlikely to abate. If the US becomes more willing to coordinate policy with Europe and other major trade partners, this could increase pressure on China. The fundamental impact of trade tensions should be manageable and should decline over time as China focuses on expanding its domestic economy and reducing its reliance on the US. Still, trade-related headlines might result in occasional volatility.

Tactical opportunities in EM corporate debt

- **Economic recovery should continue gathering steam**
- **Spread levels likely to tighten; we project mid- to high-single-digit returns**
- **We see tactical opportunities in Asia, Latin America and emerging Europe**

Joep Huntjens

Head of Asian fixed income, lead portfolio manager, EM corporate debt

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The pandemic's onset in early 2020 sparked a sell-off in EM corporate debt. Timely and extensive monetary easing and supportive fiscal policies swiftly restored investor sentiment, resulting in the asset class steadily gaining ground in the months that followed. The prospect of a global economic rebound, following several scientific breakthroughs, prompted a wave of exuberance in the market. Our main benchmark, the CEMBI Diversified, ended 2020 more than 7% up, driven by strong returns in investment grade and high yield debt.

Recovery should gain ground in 2021

We expect this nascent economic recovery to gain momentum in 2021, supported by the vaccination roll-out and improvement in corporate fundamentals. Continued benign financial conditions should provide a tailwind for EM corporates. Fundamentals remain sound despite upward pressure on sovereign debt/GDP ratios and the lasting scars on sectors such as airlines, hospitality and energy. Most EM corporate issuers have manageable leverage levels, low refinancing risks and acceptable liquidity buffers. Despite pressure on profitability and asset quality, banks' capital ratios have not been eroded beyond critical levels. Fundamentals should strengthen further during 2021, with default ratios remaining well below the historical trend.

In terms of technicals the asset class benefits from low financing needs, taking into account redemptions, tenders and calls. We expect the bulk of new issue proceeds to be applied to refinancing, with limited need for aggressive capital expenditure or merger and acquisition programmes.

The market's speedy recovery in recent months, spurred on by anticipation of a successful vaccine roll-out and economic recovery, is largely reflected in spread levels, which are now closer to their three-year averages. We expect credit spreads to tighten slightly this year, spurred by the ongoing search for yield in this low-rate environment and improving credit fundamentals. US Treasury rates could increase slightly in 2021, but this would likely have limited negative fallout on total returns, as EM corporate debt is fairly short-duration on average. Against this backdrop, we expect mid-single-digit total returns for 2021, owing to attractive carry, continued spread compression towards the historical average, and the limited potential impact of rising US Treasury yields.

Opportunities in Asia, LatAm; emerging Europe merits tactical stance

We see most value in the corporate debt universe in Asia, which is well ahead in the recovery phase, and in Latin America, where attractive spread levels compensate for corporate fundamentals. In Asia, we see attractive opportunities in the Chinese property sector, as we believe the market has misinterpreted the "three red line" regulations. In Latin America, we are overweight Brazil despite a potential slowdown in reform momentum. Our base case remains that the spending cap will hold and that some market-friendly policies will be implemented which should prevent a material deterioration in government debt levels, most of which is denominated in local currency. We expect Mexico's recovery to lag behind that of most other countries, given the high infection levels and President Andrés Manuel López Obrador's austerity drive. We are tactically positioned in Argentina, which may face another currency crisis if the central bank burns through its reserves.

In emerging Europe we are cautiously positioned in countries like Turkey, as we have some reservations about President Recep Tayyip Erdogan's drive to restore trust in policymakers. We are also closely watching the actions of US President Biden. Further strain in the relationships between the US and countries such as Russia and Turkey could provide opportunities to add risk on a tactical basis.

Staying selective in EM local bonds

- **We forecast attractive returns for EMD LC, given attractive carry plus room for rate compression and FX appreciation**
- **Vaccine roll-out, lockdowns and future Fed policy present continued risks**
- **We stay selective on EM FX, duration positioning**

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Portfolio manager, EMD local currency

Attractive carry and room for rate compression and FX appreciation

A strong economic recovery in China could provide continued support to EM economies with close trade links, helped by improved exports and a strong recovery in commodity prices. However, weak demand and output gaps in many EM countries should keep disinflationary pressures in place, despite some supply-side pressures that are largely viewed as temporary. Continued lockdowns might result in some additional supply-side inflationary pressures. Weak growth, output gaps and disinflationary environment still appear supportive for most EM local bond markets.

On the other hand, improved projections for fiscal deficits might be overly optimistic. If the lockdowns lead to further stimulus programmes that pressure budgets, these improvements could take longer than expected to materialize. As a result, we expect continued heavy bond issuance in 2021. This will put upward pressure on bond yields, while EM central banks will keep supporting markets by continuing their bond purchase programmes.

We expect global liquidity to support the carry trade and lead to a further pickup of flows into EM local debt markets this year. Positioning still seems relatively light following the massive outflows last spring that have only partly reversed.

Looking at valuations, many curves still look relatively steep and offer value, especially in the long-end segment. However, this generally reflects increased credit risks. To capture these premiums we will be looking for an economic recovery, reforms, and fiscal and debt stabilization.

Taking a selective approach and avoiding vulnerable markets

We still see opportunities in EM FX, despite the strong rally of the past few months. Valuations remain relatively attractive and external balances have improved in recent months. EM FX is currently being held back by a resurgence of virus cases and renewed lockdowns in many EM countries, and upside remains once economies reopen and economic activity improves. Further inflows into the asset class might also support EM currencies. We will stay selective in our country approach and take a cautious stance towards more vulnerable markets with weak and deteriorating fundamentals.

We see less support than in 2020 for duration gains from monetary policy easing by EM central banks. Most EM central banks have limited scope for further easing, and in some cases interest-rate hikes are already being priced in. We still see scope for duration gains from term premium compression in specific markets. For our duration positioning we will also stay selective and avoid countries that appear vulnerable.

Overall, we expect high-single-digit returns for 2021 as a result of carry and limited rate compression and FX appreciation. Still, we foresee substantial volatility around the probability-weighted mid-point expectation.

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