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Principal Asset Management℠

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A year of transition to a new era

2023 EMD outlook executive summary

We believe that, in aggregate, 2023 will be a fruitful year for the emerging market (EM) fixed income universe. However, properly managing an emerging markets debt (EMD) portfolio will require careful sequencing of the upcoming recovery cycle, especially in the first half of the year, before smoother sailing in the second half.

A long era of slowing inflation, met by ever-looser monetary policies, ended in 2022 when a massive surge in global inflation sent global central banks scrambling to catch up with the curve. As a result, 2023 will be a year of transition paced by the slowdown in global inflation toward a new equilibrium, which will define central banks' attitude for the years to come. The year ahead will also mark our entry into a more balanced world, where structural inflation is likely higher, global growth potential is lower, risk premia better reflect fundamentals, and distress and defaults are allowed to happen when macro or business conditions deteriorate.

For emerging markets, this will likely be a defining year, too. We expect it to be marked by:

- further deglobalization and nearshoring of investment flows away from China,
- a test of the IMF/G20-sponsored common framework and the treatment of bondholders in several upcoming EM sovereign debt restructurings, and
- a refocus on fiscal dynamics in a slowing growth environment, especially in Latin America.

The relief from earlier pressures, anticipated pricing of many of these headwinds, and a level of investor pessimism and low ownership not seen for many years in our asset class should make the coming year fruitful. We are bracing for low- to mid-double-digit returns in 2023, with income generation contributing around 7-9% on average. Yet the sequencing will matter, and the recovery will undergo several phases.

Sequencing 2023: Balanced first half, a better second half

Although the year should start on a strong note on the back of the recent inflation, China, and U.S. Federal Reserve (Fed) relief, the first part of the year (until Easter) could remain conflicted. Post-COVID-19 reopening in China will also imply a few other virus waves, which may still spook markets at times and create an impression of two steps forward, one step back. Similarly, any irrational exuberance by markets on Fed and inflation relief will run the risk of triggering some renewed hawkish Fed communication.

Peaking year-over-year inflation numbers everywhere are giving way to an intermediary period of a few months during which monetary policies will be less synchronized. This will lead to differentiation and relative value opportunities across currencies and rates markets.

The right approach remains: Emphasize income opportunities and continue to track undervalued dislocation opportunities in sovereign debt, local yields, and foreign exchange (FX), which are typical of a post-crisis environment. On Beta-sensitive assets, we intend to stay involved but remain tactical until the developed market (DM) growth slowdown is fully priced, China properly reopens, and actual Fed/European Central Bank (ECB) rate cuts are in sight. Involvement should be limited to liquid, long-dated EM hard and local sovereign bonds, FX, and occasional hedges via credit default swap (CDS) indices and bond futures.

From April to May and onward, we hope for a cleaner state of play with Europe out of winter, China being on a firmer growth and reopening path, and the U.S. economy (and equities) having properly priced their own slowdowns. This will be a better time to be more aggressive on high-yielding income opportunities, maximize exposure to liquid momentum assets, and reduce cash exposure to a minimum.

The global growth/inflation trade-off in 2023

There are some reasons to believe that the announced DM recessions in both the U.S. and European Union (EU)—on the back of recent central bank tightening—may not be as bad as initially feared. It remains, though, that a significant slowdown is on the wall for 1Q and 2Q23 across DMs. This should pressure EM growth in the first two quarters of 2023.

The fading of the post-COVID-19 recovery is leading to diminishing excess savings, as witnessed by:

- Plunging U.S. deposits and Fed reverse repurchase agreement (reverse repo) outstanding from all-time highs
- Lower wealth effect from the collapse in crypto and tech stocks and from the purchasing power hit from higher rent and housing costs (in the U.S.) and energy (in Europe).
- The abnormally high services consumption by the middle and higher classes should be expected to fade. This, in turn, should lead to a reduced excess jobs demand.

Both push and pull effects may therefore combine to lead lower-skilled workers back to the workplace, presumably at higher wage levels and for better working conditions than pre-COVID-19, helping to reduce a key source of recent inflation in the U.S.

But let's temper our expectations. We are not going back to the long-term 2% central bank sacrosanct inflation target. In a world marked by deglobalization, geopolitical rivalries leading to strategic hoarding of key technologies and materials, aversion to immigration, clamoring demands for income redistribution through fiscal channels, and surging costs of decarbonization for "corporates" and states alike, the ultimate growth/inflation trade-off should be less optimal than at any point in the past 30 years.

Inflection points, not pivot points

We are mostly talking of inflection points for now—hence better market behavior but not necessarily a V-shaped market recovery. Our best description of this new cyclical environment is one of a glass half-full.

Inflation is peaking but will be slow to recede in several countries. At the same time, growth challenges will materialize across EMs, owing to an upcoming slowdown in DM consumption and corporate earnings. This will continue to impact EM PMIs and exports negatively in the early part of the year, with its corollary in terms of slower growth and fiscal drift after two years of fiscal improvement.

However, the passing of the European winter and a fuller Chinese reopening should start to improve the EM growth picture from the middle of 2Q23. This should hopefully also be the time when the EM inflation slowdown (largely commodity-led) should start to lead central banks to signal rate cuts.

The impact on EMs of more meaningful U.S. growth (and inflation) slowdown in 2H23 could then be mitigated by better behavior from the rest of the world, leading to a further moderation in both the USD and interest rates. If, as we believe, this U.S. slowdown is not too harsh, paradoxically, this should result in a better performance of EMD assets.

This underpins our expectation that although U.S. financial conditions may remain tight during 1H23, a permutation may occur among its five key drivers.

A stabilization of expectations regarding:

1. higher Fed funds,
2. higher 10Y yields, and
3. a stronger USD,

which were all the main causes of EM stress in 2022, should give way to

4. lower equity prices, and
5. higher IG credit spreads

Indeed, the necessary pricing in DM equities of lower earnings and cash flows has not properly happened yet. We believe this process may be complete by end of 2Q23, typically ahead of the actual publication of slower earnings and U.S. growth numbers into 2H23. An early pricing of these widely expected pressures should ensure a cleaner risk appetite landscape by April–May 2023.

We believe our asset class to be much better equipped to deal with an environment of progressively slowing growth and potential fiscal slippage across EMs in 2023. We would expect a moderately weaker USD vs. EM and G10 currencies, lower U.S. long yields, and the ultimate pricing of future Fed rate cuts to prove much more powerful in supporting EMD assets' performance.

EMs: Which side of the USD smile?

We expect a moderation in USD strength in 2023 as U.S. exceptionalism in terms of growth and monetary tightening fades. Meanwhile, despite continuing growth slowdown across EMs, their growth differential with the U.S. and Europe will continue to improve. A transitional period—from a mostly hawkish Fed to a more balanced environment for U.S. growth and inflation—should keep EM currencies broadly resilient.

In currencies, we prefer those with high yields, peaking inflation, and credible central banks like the Brazilian real (BRL), the Mexican peso (MXN)—despite consensus long positioning—or the Czech koruna (CZK). We also want to be involved in those Asian currencies benefitting most from the Chinese reopening through tourism and foreign direct investment (FDI)-related flows, namely the Thai baht (THB), Malaysian ringgit (MYR), and South Korean won (KRW).

We dislike the Chilean peso (CLP) and South African rand (ZAR). Both appreciated meaningfully since mid-2022 without any commensurate improvement in fundamentals.

In domestic markets, we will focus our long domestic bond positions on those countries where central banks have been credible, real yields are elevated, and prospects of cuts exist (Mexico, Brazil, Peru, and perhaps Colombia). Alternatively, we are also attracted by higher-yielding countries where inflation may not be fully tamed but where a credible fiscal/monetary mix gives us confidence in ultimate success (Indonesia, South Africa, and the Czech Republic).

Globalization gives way to regionalization

Building on talks of reshoring or friend-shoring driven by long-lasting geopolitical tensions, we foresee a secular change in globalization dynamics and investment flows in the years to come. This leads us to adopt a more regional approach—especially in the currency space, using each regional currency as a pivot for active regional exposures.

Our late-2022 long positions in THB, MYR, and KRW are held against the Chinese yuan (CNH) rather than against the USD. Although we may tactically run our CE3 exposure versus USD, we like the great carry-to-volatility opportunity of owning the local debt of those countries versus the euro (EUR). Finally, we expect U.S. direct investment flows to increasingly favor the larger, more established Latin economies of Mexico, Chile, Brazil, and Colombia.

Sequencing and defining the Chinese recovery

Better Chinese fortunes are expected this year, but sequencing will be key for EMD assets performance. The next phase of the recovery should ultimately be yuan-negative as Chinese tourists start to spend abroad again and Chinese entrepreneurs redirect production and investments near Asia to avoid Western trade restrictions.

We prefer to play this China recovery theme through regional proxies vs. the CNH. Being long THB, MYR, and KRW vs. CNH will likely be a structural feature of our Asia positioning in early 2023. On the Asian rates side, we start the year with long positions in high carry Indonesian bonds and consider receiving some interest rate curves like South Korea, after both have sailed through the worst of their inflation cycle and retain a mostly credible policy mix.

Key country views

	Growth	Inflation	Central bank terminal rates	Fiscal policy	Our position
Mexico	1.5%	Decelerating to 5%	10.75–11.25%	Somewhat more expansionary but prudent	Long local bonds/rates and FX; tactical exposure to sovereign credit; long Pemex
Brazil	Flat	Decelerating to 5%	13.75% with cutting likely in 2H23	Expansionary and may cause volatility	Long local rates/bonds and FX; find sovereign credit rich
South Africa	0.5%	Deceleration to 5%	7.5–8%	Consolidation will continue but at a slower pace	Long bonds, FX, and sovereign credit
Turkey	Intense correction likely in 2023	Decelerating to 40–50%	Hikes likely needed 2H23	Deteriorating fiscal balance	Small long 5Y CDS position but prefer to watch from the sidelines until closer to a catalyst
China	Accelerate to 5.5–6%	2.5%	7d Repo rate stable around 2%	Supportive	Long FX in China proxies (KRW, THB); long Macau (credit); long COGARD* credit
India	Continued 6–7%	Gradual deceleration to target	6.50–6.75%	Expansionary	Small position in corporates; monitoring for opportunities in FX/rates and select corps
Indonesia	Moderate to 4.5–5%	Deceleration to target	6%	Strong fiscal accounts	Long bonds and FX

*COGARD: Country Gardens

EM growth and inflation slowdown in 1H23 to displace focus from monetary to fiscal policies

Brace for a slowdown from the very high post-COVID-19 GDP growth rates, as high 2021 base effects will play a role. But cyclical dynamics will also be less supportive, with a frontloaded slowdown in DM consumption demand not yet compensated by a backloaded Chinese rebound toward 2H23.

Slowing growth will also impact fiscal revenues, especially in the more fragile frontier EMs. In mainstream, large EM countries, the key guide to fiscal dynamics should be the evolution of interest payments/revenues. Countries with an ability to see their expected interest bills drop through credible monetary loosening—while improving or maintaining revenue collection—should be well supported (Indonesia, Mexico, South Africa, and the Czech Republic and perhaps Brazil, Romania, or Colombia).

From an external debt valuation standpoint, the 2022 repricing already largely anticipates those potential dynamics. In the more vulnerable stressed/distressed sovereign space, the potential for credit events, defaults, and low recovery is currently largely overpriced.

Such an environment will be far more bearable for EMD assets than the strong USD and violent liquidity tightening of 2022. Bear in mind that although slowing, EM growth will still exceed DM in 2023 before recovering in 2024, which should limit the scope of any sustained fiscal deterioration.

Risk considerations

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