Emerging Market Macro Insights

Monthly report

Invesco Fixed Income
September 2023

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Overview

- The EM disinflation story remains intact, but divergent growth dynamics could create idiosyncratic investment opportunities.
- We are cautious on Chinese rates and currencies, as more stimulus may be in the pipeline and we expect growth to pick up toward year-end.
- Three themes emerged from our recent research trip to the Andean region: slower growth, decelerating inflation and elevated political noise. We provide our key takeaways from visits to Peru, Chile and Colombia.

Diverging growth dynamics may provide idiosyncratic investment opportunities in EM local debt

The narrative around the Chinese economy took center stage this month as China's economic data disappointed and stimulus measures fell short of market expectations. While our economic team does not believe that the situation is as dire as some market commentary suggests, we consider how the market may react to headlines. Last month, we were constructive on the front end of China's interest rate curve based on our view that policy rates might be reduced. This view ultimately played out as the loan prime rate and medium-term lending facility rates were reduced by 15 basis points in August. We remain cautious on the Chinese currency and interest rates, however, as we expect more stimulus and a resumption of growth toward year-end.

The global interest rate sell-off in August created a welcome correction in some markets and a re-entry opportunity in others. But we believe the emerging market (EM) disinflation story remains intact and idiosyncratic growth dynamics could provide further differentiation. In Latin America, for example, Mexico and Brazil have performed well, while Colombia and Chile had a challenging second quarter. Peru had a challenging first half of the year. This differentiation may lead to further dispersion in EM country returns and implications for their respective currencies.

With the rate hiking cycle behind us, we expect volatility to decline in both EM and developed market (DM) sovereign bond markets. Reduced volatility should allow investors to benefit from the high levels of nominal and real interest rates currently offered by EM sovereign bonds and to lock in high levels of income. In addition, we expect the US dollar to soften as the US Federal Reserve (Fed) reaches peak rates and looks to ease policy over time.

High interest rate differentials versus DMs have benefited EM currencies this year, and a structurally lower path for the US dollar could enable EM currencies to further offer a diversified source of return. From a technical standpoint, the EM asset class appears to be under-owned by institutional investors and we believe that relative growth and interest rate differentials may be a catalyst for investor flows to return to EM.

Market pulse

EM policy divergence has begun to play out: Brazil cut its policy rate as expected by 50 basis points to 13.25% early in the month, while the Bank of Thailand hiked by 25 basis points to 2.25%, also as expected, indicating that policy has now normalized, though new inflation pressures may emerge. The market was surprised when the central bank of Turkey hiked its policy rate by 750 basis points to 25% and signaled further gradual hikes. In the bank's view, this response was needed to counter the rise in underlying inflation. While we applaud this move as a step in the right direction, we remain skeptical of the eventual path and outcome. We believe more needs to be done from a rates and currency perspective and, therefore, we remain on the sidelines for now.

Notes from the ground | The Andean states

On a recent research trip to Peru, Chile and Colombia, we noted three themes shared by the three countries: slower growth, decelerating inflation and elevated political noise. How these themes play out and their market impact will likely differ by country. Below we provide our country-specific takeaways from the trip.

Peru

While political turmoil has stabilized after a ferocious period of change at the upper echelons of government, the country is now likely in a holding pattern in terms of policy until the next election in 2026, with a low probability of implementing needed reforms. The population has expressed little interest in the political class and does not seem to mind the status quo for now. The fragmented political landscape, current and past corruption scandals and the lack of real reforms will likely hamper growth going forward. Given potentially anemic growth, and with inflation moving toward the target band, the central bank has room to cut, though, unlike other EM central banks, it will likely take a gradual approach and may be on hold for longer than the market expects. Although the market consensus is inching toward a 25 basis point cut, our impression is that the central bank is in no rush to ease.

Chile

A decade of low growth has affected local sentiment. It triggered protests in 2019 that led to an attempt to rewrite the constitution. The constitutional referendum failed and a panel of experts is now trying again. It will likely fail again and few people seem to care. Protesters seem to believe that neither government nor a new constitution is the solution. Given this situation, the experiment of the country's first left leaning administration post-dictatorship is expected to be reversed in the next election.

The central bank started its easing cycle with cuts of 100 and 75 basis points, and hopes to reach its inflation target by the middle of 2024. It does not seem concerned about the currency and we would expect it to reverse its reserve building program, as opposed to slowing the pace of cuts if the Chilean peso were to hit 910-920 versus the US dollar. The fiscal side is a bright spot and has been consolidating under the guidance of a strong finance minister, but investment is lacking. Most of the country's debt issuance will likely be in local debt markets to bring the ratio of local currency external debt back to 80% of total issuance from its current 65%, with a focus on sustainable issuance.[1]

Economic growth is currently stagnant and we expect 1.5% growth next year. The biggest issue for the economy is potential growth, which we see reaching 2% at best. We expect inflation to be between 4% and 4.5% by year-end.

Colombia

Colombia is in a somewhat more comfortable economic position than some of its neighbors, facing weak growth and sticky inflation but an improving current account deficit. The market is pricing in one rate cut in December, which seems reasonable to us. At 13.25%, Colombia's policy rate is the highest in the region, which bodes well for the continued strength of the Colombian peso. This is welcomed by the central bank since it signals no need for the building of reserves. The pace of rate cuts will likely be determined by three factors: El Nino, indexation and the pace of the diesel subsidy removal. We believe health and labor reform have a low probability of passing but expect the passage of pension reform. The impact will likely be felt by private pension plans starting in January 2025, but many uncertainties remain regarding the guidelines of a public pension fund. From a fiscal perspective, the consensus is that there is a strong commitment to the fiscal rule, helped by the independence of institutional oversight and recourse. Overall, we came away with a more optimistic outlook for the country's medium-term situation.

1. Source: Banco Central De Chile. Data as of August 31, 2023.

Investment risks

The value of investments and any income will fluctuate (this may partly be the result of exchange rate fluctuations) and investors may not get back the full amount invested.

Fixed-income investments are subject to credit risk of the issuer and the effects of changing interest rates. Interest rate risk refers to the risk that bond prices generally fall as interest rates rise and vice versa. An issuer may be unable to meet interest and/or principal payments, thereby causing its instruments to decrease in value and lowering the issuer's credit rating.

The risks of investing in securities of foreign issuers, including emerging market issuers, can include fluctuations in foreign currencies, political and economic instability, and foreign taxation issues.

The performance of an investment concentrated in issuers of a certain region or country is expected to be closely tied to conditions within that region and to be more volatile than more geographically diversified investments.

Important information