2025 Investment Outlook – Asia Fixed Income: Emerging Markets

November 2024

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We have had major shifts in the US recently as the US Federal Reserve started cutting rates in September 2024 and the presidential election was held in early November. We are set to have the second Trump administration with an easing bias in terms of monetary policy going into 2025. Some of the policies Trump proposed during his campaign look negative for emerging markets, particularly export-oriented emerging market countries. While we wait for the details to pan out in the coming months, we take comfort in the fact that Asia emerging market (EM) countries continue to have robust economic fundamentals compared to the rest of the world.

As growth slows down globally, healthy growth and robust government balance sheets among Asian emerging market economies may provide better downside protection for asset performance in the coming quarters. We are also encouraged by recent policy shifts in China as the government has started to emphasize the growth target more frequently. At the same time, the market is still waiting for more details and the impact of China's recent stimulus package as well as clarity on potential headwinds coming from US policies. We believe that if US policies against China and other emerging markets became more aggressive, the Chinese government may potentially push through more measures to support domestic growth. If this occurs, our base case is that these two sets of policies are likely going to offset each other in terms of the overall impact on Asian EM countries' fundamentals.

Figure 1 – Global manufacturing PMIs

Manufacturing PMI		Jan-24	Feb-24	Mar-24	Apr-24	May-24	Jun-24	Jul-24	Aug-24	Sep-24
Major Economies	USA	49.1	47.8	50.3	49.2	48.7	48.5	46.8	47.2	47.2
	China	49.2	49.1	50.8	50.4	49.5	49.5	49.4	49.1	49.8
	Japan	48	47.2	48.2	49.6	50.4	50	49.1	49.8	49.7
	Eurozone	46.6	46.5	46.1	45.7	47.3	45.8	45.8	45.8	45
	UK	47	47.5	50.3	49.1	51.2	50.9	52.1	52.5	51.5
	Switzerland	43.1	44	45.2	41.4	46.4	43.9	43.5	49	49.9
Scandinavian	Sweden	47.1	49.7	50.2	51.6	54	53.1	49.3	52.8	51.6
	Norway	50.97	51.87	50.3	52.46	52.39	47.97	57.21	52.04	51.7
Eurozone	Germany	45.5	42.5	41.9	42.5	45.4	43.5	43.2	42.4	40.6
	France	43.1	47.1	46.2	45.3	46.4	45.4	44	43.9	44.6
	Italy	48.5	48.7	50.4	47.3	45.6	45.7	47.4	49.4	48.3
	Austria	43	43	42.2	43.5	46.3	43.6	43.1	44.4	42.8
	Greece	54.7	55.7	56.9	55.2	54.9	54	53.2	52.9	50.3
	Ireland	49.5	52.2	49.6	47.6	49.8	47.4	50.1	50.4	49.4
	Spain	49.2	51.5	51.4	52.2	54	52.3	51	50.5	53
Asia	Korea	51.2	50.7	49.8	49.4	51.6	52	51.4	51.9	48.3
	Taiwan	48.8	48.6	49.3	50.2	50.9	53.2	52.9	51.5	50.8
	Malaysia	49	49.5	48.4	49	50.2	49.9	49.7	49.7	49.5
	Indonesia	52.9	52.7	54.2	52.9	52.1	50.7	49.3	48.9	49.2
	India	56.5	56.9	59.1	58.8	57.5	58.3	58.1	57.5	56.5
	Thailand	46.7	45.3	49.1	48.6	50.3	51.7	52.8	52	50.4
Eastern Europe	Poland	47.1	47.9	48	45.9	45	45	47.3	47.8	48.6
	Hungary	50.1	52.3	52.2	51.8	51.3	49.1	48.8	47.7	49.4
	Czech Republic	43	44.3	46.2	44.7	46.1	45.3	43.8	46.7	46
Latin America	Mexico	50.2	52.3	52.2	51	51.2	51.1	49.6	48.5	47.3
	Brazil	52.8	54.1	53.6	55.9	52.1	52.5	54	50.4	53.2
Africa	South Africa	44.3	50.2	48.9	53.5	44.7	46.2	51.9	44.2	53.3

> 3rd quartile | between median and 3rd quartile | between 1st quartile and median | < 1st quartile

Source: Bloomberg, Invesco. Data as of 8 Nov 2024.
Note: Quartiles generated based on data from November 2020 to September 2024.

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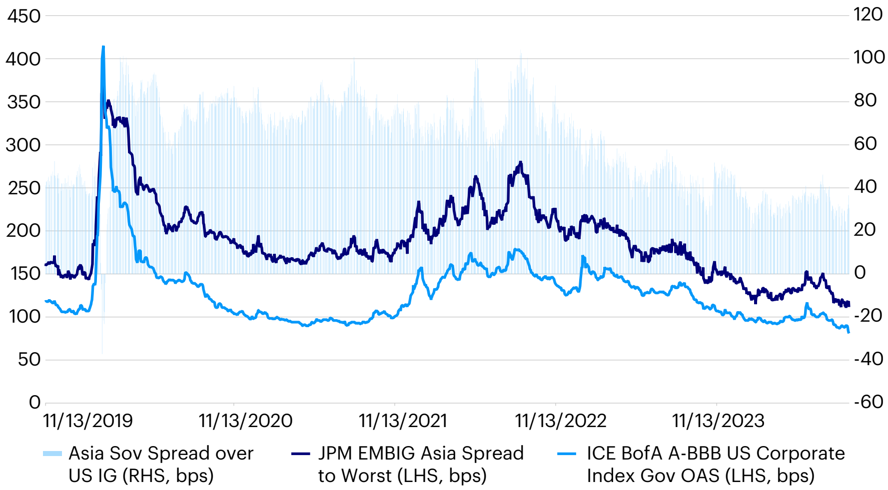
Although we think robust fundamentals could provide better protection for Asian EM sovereign and quasi-sovereign bonds in a sell-off environment, we still feel the valuations of these bonds are currently trading at very expensive levels, particularly investment grade (IG) bonds. In earlier years we observed Asian IG bonds trading at much higher yield levels compared to similarly rated US investment grade bonds (Figure 2). However, the yield pickup has since shrunk from approximately 80 to around 30 basis points.

Figure 2 – Asia sovereign spreads over US investment grade bonds

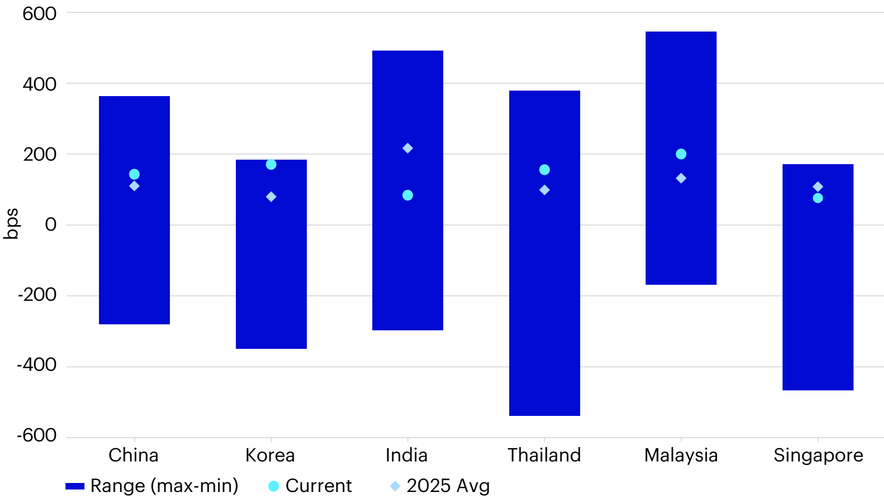


Source: Bloomberg, Invesco. Data as of 8 November 2024. **Past performance does not guarantee future results.** An investment cannot be made in an index.

Given these unfavourable valuations it is difficult to be bullish towards hard currency Asia EM sovereign bonds. The overall US treasury yield curve is likely to move tighter as the US Federal Reserve begins its easing cycle. The potential spread widening may put tight Asia sovereign bonds at risk. Our base case is that Asia hard currency sovereign and quasi-sovereign bond spreads may widen in the coming quarters and likely underperform other emerging market regions due to lower carry and expensive valuations. We are however still positive on Asia EM local currency bonds accounting for our outlook for bond prices and exchange rates in these markets.

With the US Federal Reserve entering a rate cutting cycle in September 2024, Asian central banks now have more room to ease as capital outflow pressures subside. Current real rates in Asia have been hovering above historical average levels. As global economic growth momentum slows, we expect local central banks to become more accommodative by cutting domestic policy rates. This is likely to lead to upside opportunities in bond prices for investing into local currency government bonds.

Figure 3 – Emerging market Asia 10-year real rates



Source: Citi Research, Bloomberg, Citi Research Forecasts. Date range spans from 1 January 2016 to 7 November 2024. 2025 average real rates are calculated by taking a simple 12-month average, where inflation forecasts are taken from Citi's economic forecasts.

We expect Asian EM local exchange rates against the US dollar to generally have balanced risk profiles in 2025. On the one hand, as the US Federal Reserve cuts interest rates more aggressively than Asian central banks, interest rate differentials will work in favour of local currencies. At the same time, the US president-elect Donald Trump's planned trade policies would hamper local currency performance for economies that are more export driven. We believe Trump's election is likely to cause more volatility in Asian exchange rates. However, we do not think this cause a persistent depreciation trend of Asian currencies against the US dollar, as the market will mainly focus on fundamental factors such as rate differentials and economic performance.

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