Strategy Insights | Fixed Income

# All growth likely to be “good” growth for reflationary assets

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**Overview**

- We expect attractive valuations in emerging market rates and currencies to attract investors seeking capital appreciation and income-generating fixed income investment opportunities amid the global reflationary backdrop.
- Emerging market central banks, generally, have looked through rising inflation, but have been hawkish in messaging and tone. South Africa has been an exception, given its weakening outlook.
- We believe the events in Chile since 2019 underline the importance of ESG factors in assessing emerging market performance and longer-term value creation.

We are cognizant of the important connections between developed markets and emerging markets. Recent US data, though improved, have underwhelmed relative to market expectations, providing some stability to US rates and causing market angst around the urgency of potential monetary tightening to ebb. Our longstanding view that the US Federal Reserve (Fed) will likely be cautious and slow to act (reinforcing its rate path dependency) has been validated by the recent economic data and subsequent market reaction. This should benefit reflationary assets, including emerging market local fixed income. We expect attractive valuations in both rates and currencies to capture the interest of investors seeking capital appreciation and income-generating fixed income investment opportunities. We believe all growth will be “good” growth for reflationary assets in the near term.

## Market Pulse

The May performance of the JPM GBI-EM Global Diversified Index was driven by stronger emerging market currencies and somewhat lower interest rates, with the balance attributed to income. The short-term portions of some yield curves (Mexico, Czech Republic, India) are attractive in our view. In addition, we see attractive carry and roll in five-year paper in various countries (Colombia, Indonesia and Brazil). However, we are generally cautious about the longer ends of emerging market rate curves as fiscal pressures continue to pose risks. At the sovereign level, we are constructive on Chinese policy bank paper on a relative value basis and view nine-month to one-year exposure to Mexico as attractive, as we believe the market is pricing in too many rate hikes this year. In currencies, the Chilean peso has seen elevated volatility caused by election uncertainty.

Central banks, generally, have looked through rising inflation and have been buttressed by the pause in the upward move in US rates and steepening in the US yield curve. A notable exception has been Brazil. After hiking 75 basis points in May, the Brazilian central bank hiked another 75 basis points in June to bring its key policy rate, the Selic rate, to 4.25%. While the central bank’s models continue to suggest that a full normalization of monetary policy (a Selic rate of 6.5% by year-end) would lead to inflation outcomes below the central bank’s target, many market participants remain skeptical and expect a policy rate closer to full normalization. While the central bank’s models continue to suggest that a full normalization of monetary policy (a Selic rate of 6.5% by year-end) would lead to inflation outcomes below the central bank’s target, many market participants remain skeptical and expect a policy rate closer to full normalization.

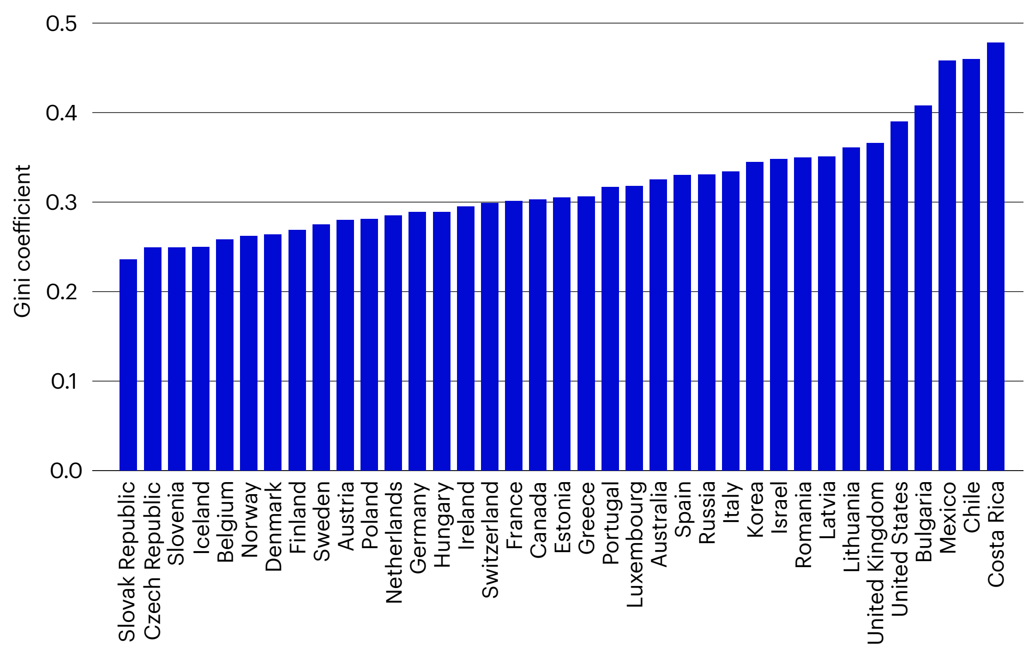
Other emerging market central banks have been on hold, though their messaging to markets has skewed hawkish. In contrast, the South African Reserve Bank bucked this trend by remaining on hold and avoiding a hawkish tone. Its forecasts now suggest that output will stay below its pre-crisis level with higher short-term growth driven by base effects. It also revised its 2021 inflation forecast lower. A third wave of infections and the slow rollout of vaccines has contributed to this outlook.

**Spotlight on ESG: Sustainable synergies in emerging market local debt**

We believe ESG is brought to life when applied to emerging markets. The organic drivers necessary for economic growth align with the environmental, social and governance (ESG) factors unique to developing nations. Because they are further behind in the level of their wealth, emerging market countries have a longer journey ahead, with the opportunity to drive faster change for sustainable and inclusive growth that supports policy stability and investors' returns.

The events in Chile since 2019 have underlined the importance of ESG factors for longer-term value creation. Chile's favorable economic position allowed it to inject monetary and fiscal stimulus into its economy during the pandemic, enabling it to outperform most emerging markets in terms of growth. However, in October 2019, 1.2 million people protested in Santiago against social inequity that had been building for years. Nearly one month later, 29 people had died, 2500 were injured, and over 2800 arrested.[1] Income inequality had moved front and center, culminating in approximately 78% of its voters voting in favor of a new constitution.[2] The new constitution will likely provide more rights focused on education, housing, and health care, while future administrations will likely seek to implement them. While there may be short-term uncertainty, we believe this process should benefit Chile in the long run. Our view is based on the potential for a modern constitution more in tune with social issues, implemented pragmatically and more inclusive of a larger swath of the population. From an investment perspective, we remain cautious on the sovereign in both rates and the currency given short-term valuations and amid political uncertainty, ahead of presidential elections later this year. As in many emerging market countries, ESG factors will likely continue to be salient contributors to Chile's future and the assessment of the sovereign.

**Figure 1: Global income inequality – Chile ranks among the most disparate**
Gini coefficient, 0=complete equality; 1=complete inequality




Source: OECD. Data as of 2019 or latest available. Gini coefficient definition: The Gini coefficient is based on the comparison of cumulative proportions of the population against cumulative proportions of income they receive. It ranges between 0 in the case of perfect equality and 1 in the case of perfect inequality..

1. Source: Reuters, One million Chileans march in Santiago, city grinds to halt, Oct. 25, 2019.
2. Source: The Guardian, A new Chile: political elite rejected in vote for constitutional assembly, May 18, 2021.

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When investing in less developed countries, you should be prepared to accept significantly large fluctuations in value.

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