Invesco

Emerging Market Macro Insights

Monthly report

Invesco Fixed Income

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Overview

- The EM local debt asset class is in good shape, in our view, thanks to solid macro fundamentals, attractive valuations and favorable interest rate differentials versus developed markets.
- EM central banks have continued to lower interest rates but are carefully watching Fed moves for their future policy direction.
- After South Africa's recent election, we expect general macroeconomic stability and see potential opportunities in South African assets.
- Sizeable capital inflows continue to help improve Egypt's financing conditions. Adherence to a recently expanded IMF program should help stabilize the country's economy and promote external confidence and investment flows.

EM central banks stay on rate cutting path, with eyes on the Fed

Market commentary

Emerging market (EM) central banks lowered interest rates over the past month, but with a more cautious approach, as expectations for US monetary policy softened. In Latin America, Peru proceeded with another 25 basis point rate cut, while indicating possible further reductions in its policy rate below the Fed's rate. Chile and Brazil reduced the pace of their cuts to 50 basis points and 25 basis points, respectively. The Czech Republic and Hungary each cut rates by 50 basis points, maintaining their current pace of rate reductions, but suggesting that the next cuts might be smaller.

South African election

In South Africa, the African National Congress (ANC) secured a majority of seats in Parliament, but fell short of expectations, causing speculation about the formation of a coalition government. Pre-election polls had suggested the ANC would secure close to 45% of the vote, paving the way for a coalition government and allowing President Ramaphosa to push forward with his reform plans. However, the ANC managed to secure only 40% of the vote, surprising market participants. We expect this outcome to cause volatility in South African asset prices over the next few weeks, but we expect the ANC to eventually form a government and Ramaphosa should proceed with his reform agenda. We expect policy to remain stable going forward and currently see potential investment opportunities in South Africa.

Fed policy

We believe we are slowly approaching the beginning of the US Federal Reserve (Fed) cutting cycle. US second quarter growth was in line with or below expectations, and revisions have come in consistently lower. These factors, along with an ongoing disinflation process, provide us with cautious confidence that EM central banks will likely shift their focus to domestic cycles after dealing with external shocks in the early part of the year. As we enter this phase of the cycle, we expect rates markets to display greater differentiation based on domestic policies, compared to currency markets, which will likely be more influenced by US dollar strength or weakness.

Overall, we believe the EM local debt asset class is in very good shape. Attractive carry, healthy economic growth, and favorable interest rate differentials versus developed markets present a favorable outlook for EM local debt performance in the second half of the year, in our view. Additionally, we believe the unique local narratives within EM contribute to a diverse and lucrative opportunity set.

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Notes from the ground | Egypt update

Egypt's financing conditions have improved. The recent Ras El-Hekma land investment deal is a positive economic development with the potential for sizable capital inflows: The USD24 billion in new financing from Abu Dhabi Development Holding Company (ADQ) to develop Egypt's Ras El-Hekma region should allow Egypt to improve the level and composition of its reserves and reduce government debt.[1] At the same time, Egypt's recent policy initiatives and the IMF's new policy package should help preserve the country's macroeconomic stability, restore confidence, and allow Egypt to manage the challenges associated with recent external shocks. Egypt's key policy commitments include the move to a flexible exchange rate system, tighter monetary and fiscal policies and a slowdown in large national infrastructure projects to reduce inflation and preserve debt sustainability, while fostering an environment that supports and enables private sector activity.

Importantly, the new monetary and fiscal regimes are subject to ongoing monitoring and certification by the IMF. The fiscal authorities and the Prime Minister's Office have committed to greater fiscal transparency, including several concrete measures highlighted below. The central bank has committed to a flexible currency regime.

IMF program back on track

The initial Extended Fund Facility (EFF) loan agreement between the IMF and Egypt received approval in December 2022, but external shocks and postponed policy implementation led to delays. Egypt opted to maintain its pound at a closely monitored rate, while the conflicts in Ukraine, Gaza, and Israel further complicated the macroeconomic challenges. These circumstances necessitated new monetary and fiscal regimes in Egypt, backed by a stronger external funding package from the IMF. In early March, an agreement was reached between the IMF staff and Egyptian authorities regarding the terms of the loan, which was announced alongside the currency devaluation and regime change. Later that month, the IMF Executive Board gave its approval for the first and second reviews of Egypt's program. These initial reviews represent the first step out of a total of eight reviews by the IMF to assess Egypt's progress in meeting the organization's terms. This month, the IMF staff and Egyptian authorities reached a staff level agreement on a comprehensive set of policies and reforms to complete the third review under the EFF arrangement.

Pending approval by the IMF's Executive Board, Egypt is set to have immediate access to approximately USD820 million of the expanded 46-month USD8 billion loan.[1] Egypt's original program was augmented by an additional USD5 billion to total USD8 billion. The remaining five reviews will take place every six months, with each disbursement programmed to be around USD1.3 billion.[1]

Why was the program increased?

According to the IMF, Egypt's program was calibrated to meet its actual financial needs, and the IMF saw the need for more firepower to put the right external financial buffers in place. The expected financing gaps for this year and next are large, and reserve accumulation is required to build these buffers.

Program implementation moves ahead

Egypt's failure to implement the initial program's policies as planned caused the IMF to postpone its initial reviews for over a year. However, given the significant geopolitical and international pressures, the Egyptian authorities and IMF are actively seeking a permanent solution to Egypt's economic challenges. Moving forward requires meeting structural benchmarks and repeated certification. The IMF aims to have quick program reviews and establish a regular cadence, without causing undue market focus or stress with each review. The Egyptian authorities have implemented a long overdue shift in their currency regime, significantly tightened monetary policy, and are delivering strong fiscal performance. The IMF staff also highlighted other important macroeconomic risks, such as imposing limits on nominal investments and creating fair competition between the public and private sectors.

The recent efforts made by the Egyptian authorities have contributed to improved economic conditions and fostered macroeconomic stability. In May, the core inflation rate fell for the third month in a row to 27.1%, down from 31.8% in the prior month.[2] However, addressing current regional challenges and domestic obstacles demands committed program implementation. In the short term, it is crucial for Egypt to maintain strict monetary policies to address inflation. Additionally, upholding a flexible exchange rate system is a key component

1. Source: IMF Communications Department. Data as of June 6, 2024.
2. Source: Bloomberg L.P. Data as of June 10, 2024.

of the authorities' overall economic strategy. The ongoing efforts are showing promising results, including a brighter economic forecast, increased currency circulation, a slowdown in inflation and indications of improved confidence in the private sector.

Egypt's fiscal year 2024/25 budget

The Egyptian government announced a new budget for fiscal year 2024/25, prioritizing economic growth, social support and investment in key sectors. A substantial portion of the budget is allocated to stimulate economic expansion, specifically targeting industrial and export industries. Structural reforms are expected to drive consistent private sector-led growth, with measures aimed at improving the business environment by removing barriers to private sector activities and ensuring fair competition with state-owned entities. The budget also addresses the debt ceiling, which is one of the IMF's key priorities. The ceiling for the new fiscal year has been set at 88.2% of Egypt's GDP, marking a significant decrease from the previous year's level of 96%.[3]

Egypt investment view

The influx of capital from the IMF's policy package, along with the proactive implementation of new fiscal and monetary measures by the Egyptian authorities, gives us a more optimistic outlook for Egypt's immediate future. The IMF program is vital to the recovery of Egypt's economy, but there are certain risks, both internal and external, that could threaten the success of the program. Egypt's medium and long-term economic stability relies heavily on its commitment to effectively implement and follow through on the new policies put in place. Considering Egypt's history of corruption and failure to implement policies successfully over the long term, we remain cautious on Egypt's medium and long-term situation.

3. Source: Daily News Egypt. Data as of June 4, 2024.

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.

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