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Transcript

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Cathy Hepworth, Head of Emerging Market Debt: Hello. I'm Cathy Hepworth, Head of Emerging Market Debt at PGIM Fixed Income. I'm joined today by Denis Cole, our EM Product Specialist, and Magdalena Polan, Head of EM Macro Research. Thank you both for joining me. In conjunction with PGIM Fixed Income's recently released paper covering the outlook for EM, we want to give you a high-level overview of the themes that we see playing out over the longer term. In the context of EM fundamentals and the changed global landscape. And as always, we want to highlight ways we believe investors can benefit from this across the various EM sectors and the current market. So Denis, what do you see as the opportunities over the longer term in EM and how might that have changed from what investors have become accustomed to?

Denis Cole, EM Product Specialist: Cathy, thanks. So there are a number of tailwinds that are either firmly in place or taking hold that will have a profound impact on EMs going forward. And because of this, I think that diversification from a country perspective is going to become more of a focus for allocators. So first, emerging market growth outperformance is back after a lull post-COVID. And that's expected to stay high for the foreseeable future. Second, competition between the US and China is changing global power dynamics. And third, demographics are likely to create differentiation between emerging market and developed market policy and that could very well have an impact on debt. Importantly, all these are interrelated and should be on everyone's radar today. Going back, the most important aspect for EM outperformance over developed markets has been growth differentials, how much emerging markets are growing over developed markets. And we have some graphics in our paper about this. So when growth differentials have been above 2%, emerging market debt has historically outperformed developed market debt. And then if we go to 2021 and 2022, when that growth differential slipped to below 1.5%, EM gave back all of its outperformance versus developed market debt. Now importantly going forward, the consensus forecast are for EM to regain that growth premium well above 2%, and with that, that EM debt outperformance should come back. So there are a number of factors that are contributing to this increased growth within EM. But from a really high level, it's the story of convergence is taking hold. So EMs are maturing. In 2007, emerging markets overtook developed markets in terms of share of GDP, and then since then, they've increased that gap, taking about 60% of global GDP, today. And then over the last few years, EMs have actually eclipsed developed markets in terms of their share of global exports. So in terms what's caused EMs to grow more than developed markets, it's been those exports combined with domestic consumption from growing middle classes within EMs. And then on the export side, it's been a focus on technology, as well as critical commodities. So copper, lithium, nickel, rare earth minerals, agribusiness, as well as hydrocarbons. EM is exporting the materials that the world needs and are likely going to need more of given the technology revolution, as well as the green energy transition. So moving to the second point, competition between the US and China. This is creating geopolitical realignment with both countries vying for influence within emerging markets, particularly the Global South. This was kicked up into high gear post

Russia's invasion of Ukraine when only a third of the global population went along with the US sanctions on Russia, right? That happened because the US has lost a lot of its influence within the Global South to China with its Belt and Road Initiative. So now to counter that, the West is using a form of economic realpolitik to compete with China on both the quantity, as well as quality of the financing that they provide to geopolitical swing states. So the first phase of this is the G7's Partnership for Global Infrastructure and Investment, right? It's over half a trillion dollars that's going to be invested within emerging markets and dispersed until 2027, right? It's no coincidence that Indonesia was the first recipient of this funding. They're one of the world's most populace states and they're a geopolitical swing state that the West is trying to court. Another really important dynamic of the competition between the West and China is shifting global supply chains. So historically, China has been the largest exporter to the United States. That changed last year. Mexico overtook China as the largest exporter to the United States. That was a combination of rising exports from Mexico, but also exports from China being down over 5% during the last five years. And EMs have taken all that market share. This is going to be a really important tailwind to EM ex China growth going forward. And now going to the third point, demographics and how that dovetails with debt. So emerging markets have less debt than developed markets and there are good reasons why developed markets have a larger debt capacity than emerging markets. However, demographic is going to be a really important dynamic going forward. And in emerging markets, working-age populations outside of China and South Korea either continue to grow or flat line. While in developed markets, it's widely expected for that working-age population to decline meaningfully over the next decade and that's going to put a lot of pressure on fiscal policy. So in the US, it's inevitably going to mean more expenditures on Social Security and Medicare and this is just not a dynamic that emerging markets will have to deal with for decades.

Cathy: Thanks, Denis. So Magda, I'm really curious to hear how EM fundamentals fit into the observations that Denis made.

Magdalena Polan, Head of Emerging Market Macroeconomic Research: Thank you, Cathy, and thank you, Denis. Denis has outlined these long-term changes affecting both the global markets and emerging markets, in particular. And before I go to the discussion of the fundamentals, let me just tell you that within this changing world, these geopolitical shifts, the one word that could describe the EM source really, resilience. These markets have faced everything you can imagine. Conflict, wide swings in commodity prices, strength of the dollar, higher funding cost, higher interest rates, and inflation shock. And yet, despite all these shocks, the number of countries in debt distress or debt default has stayed remarkably stable for the last few years. And one reason for that is what Denis has just outlined, which is maturing of EMs. And of course, they have matured in terms of their economic structure. But also, thanks to fundamental reforms, their governance standards, their policy credibility, their vulnerabilities in terms of financial vulnerabilities, external vulnerabilities. Actually quite often better than those in many developed markets. And thanks to strong growth, but also good policies, developments of the local markets, they now can benefit from very deep pools of domestic savings. And what that means is that they can borrow much more domestically and their external borrowing needs are much lower than in the past. So these are not the emerging markets of the 1980s or 1990s. The fundamentals and the degree of vulnerabilities is even lower than as recently as during the global financial crisis in 2008. So what does it mean for the outlook? Well, the combination of this structural change despite these geopolitical realignments and what's happening [inaudible] markets bodes well for emerging markets. First is the inflation cycle. The inflation and the rate cycle is turning a number of emerging markets, especially those in CEEMEA and in LatAm have already cut interest rates. And that means also lower founding costs for governance. Thanks to that, they can issue more debt domestically and that means lower external borrowing needs, which is good for hard currency bonds. And if the fed starts to cut interest rates, these central banks can also then be braver with their own interest rate cuts that should then support their local bonds. And also trigger a positive cycle with the external bonds. And then we will also see less pressure on emerging market currencies and that will be especially beneficial for those countries that have more severe external vulnerabilities. But we're not complacent to risk. With developed markets rates still being high, emerging market issuers are effectively competing with developed markets and these also offer usually lower effects risks. Then there are still growth risks, and not only from China but also from developed markets where the traditional growth drivers are under stress. Many emerging markets and developed markets alike also have to deal with fiscal risks related, for example, to energy transition or energy price caps. And we also have to be mindful that investors in developed and emerging markets alike can be affected by geopolitical risk. So while our view on EM is in general positive, we remember that this is a wide and varied asset class. So we continue to combine a fundamental bottom-up analysis looking individual countries with our top-down of analysis of global events and how they affect individual markets. This will help us identify both investment opportunities but also spot risks. And, by the way, this also helps us invest and analyze countries in debt distress because these global developments also have influence on them, and especially if we see improvement in domestic policies, but also in the external environment. So Cathy, what do you think after this view of the fundamentals of the emerging markets?

Cathy: So, thanks, Magda. So exactly how do we translate all of this into alpha-generating opportunities across the different EMD sectors where we see value? And we see value in spreads, in local bonds, as well as in FX. Our highest conviction is in spreads and that's really across the credit buckets. It's across the different sectors within spreads, and by that I mean sovereigns, quasi-sovereigns, corporates, and within the different maturity buckets, as well. So I like to have a mix of different credit exposures. Like we always talk about the credit barbell, so what do I mean by that? We're really comfortable with exposures in BBB and BB, sovereigns, corporates, and quasi-sovereigns, for all the reasons you guys mentioned. They happen to have more resilience. We're comfortable with their fundamentals. If a tail event were to materialize, some of these risks, we know that there's not going to be a credit event. They're well-funded. There's been a lot of issuance so far this year. And for some of those segments, there's actually a really nice cushion in spread. For example, EM corporates. They underperformed last year, so there's a spread of about 150 to 200 basis points relative to sovereigns. And spreads don't even have to tighten materially for this segment to do well because of where yields are. In addition to that, we like some of the distressed names. Why? Because we think that a lot of the downside risks are priced in. And by this, I mean defaulted names, as well as names that are trading at like 40 or 50 cents on the dollar. And all of these different types of exposures, this barbell actually incorporate all the themes that you talked about. The reshoring, the energy transition, the fact that the West, to put it, you know, bluntly, really needs the Global South for resources, for realpolitik, etc. So that's why we like to have a mix of different exposures across spreads. For EM local bonds, we like duration, but we're modulating our exposure to local duration. And that's in large part because of the repricing of the fed. We still think, as you well pointed out, Magda, that the EM central banks are going to cut rates. Real rates are high. Growth is at the lower end. We think it's going to increase but it's slower for a lot of these emerging market countries now so they're going to cut. But we have to -- we've taken a step back and said, you know, there could be some volatility because EM local bonds, there is a high correlation. There is a high beta to what's happening with the fed to core rates, so we've reduced some of the duration. But we think there are some really good opportunities in some Latin American countries, as well as some Asian countries. But we're, you know, much more moderate in our exposure to the CEEMEA countries. Where on the curve do we want to get exposure? Because you can generate alpha not only from duration but from curve exposure. It's really in that five to seven-year part. As you well know, a lot of these curves are inverted and we do worry that some cuts that are already priced in might not materialize if the fed goes later than we expect. And emerging market currencies, they did great last year, right? Better than everybody expected was the carry trade was full on and there's still some of that this year. But some of the greater uncertainties that we have particularly with regard to the fed, we've seen a lot more measured performance in emerging market currencies so far this year. And while we're much more neutral in our views of dollar directionality and we do think that there's opportunities in EMFX. We tend to like to use FX more tactically, right, because you can put positions on in a risk on and a risk off environment and they can be alpha generating in that context. Carry still matters but in a different way than it did last year. So thank you both for joining us. We delve deeper into the topics discussed here in the recently-published white paper which you can find at PGIMFixedIncome.com. Thank you for joining us.

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