January 2024

Emerging Markets Fixed Income Commentary

EM credit returned -1.0% in January as large front-loaded new issue supply repriced the market and pushed spreads wider, particularly in investment grade names. Accordingly, excess returns were the driver of January's losses compared to a flat treasury component.

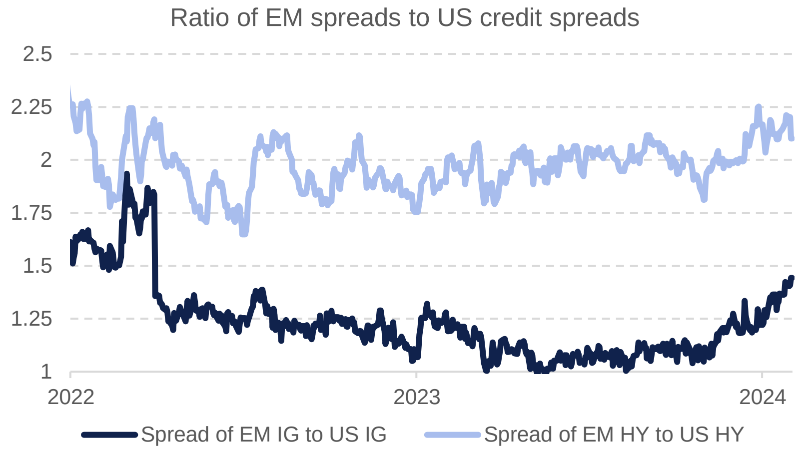
IG underperformed, returning -1.4% versus a -0.7% loss in high yield. Investment grade issuers took advantage of the re-opening of the primary market, issuing large volumes of bonds. Having tightened to extreme levels at the end of 2023, this new issue supply pushed IG spreads 17bps wider on the month. At these levels, EM spreads are near their most attractive levels versus US corporate spreads in two years and present a compelling opportunity given that EM issuance has likely been front loaded this year. As a result, demand for EM is likely to outpace supply in coming months. We used stretched valuations at the end of 2023 to rotate out of EM IG, giving us room to increase our exposure to high quality EM issuers with solid fundamentals at these attractive valuations.

EM local bonds returned -1.5% in January, in a month where positive rates performance (+0.6%) was not enough to offset EMFX losses against the U.S. dollar (-2.1%). Latam continues to be the outperformer. The region offers the most compelling valuations, owing to high but falling inflation and central banks that have ample room to cut rates before getting close to neutral. This stands in contrast to other regions where markets already price rates close to or through neutral by the end of this year. We continue to be positioned in local rates in markets where we expect inflation to fall rapidly and the central bank to follow with an accelerated pace of rate cuts. We continue to be cautious on EMFX given the erosion in carry premium as EM central banks cut rates faster than the Fed.

Coming into the year, we were expecting a normalization in supply demand dynamics in EM credit, following last year's unusually large negative net supply. Last month, countries issued $47bn in hard currency bonds, including mega deals out of Mexico ($7.5bn) and Saudi Arabia ($12bn). We estimate that issuance this year will be particularly front-loaded, meaning that future supply will be more easily absorbed by flows into the asset class. While EM hard currency bond funds saw $1.9bn of outflows in January, we expect flows to stabilize given the appeal of fixed income at this stage of the economic cycle and EM's attractive valuations versus other credit sectors where inflows have already commenced.

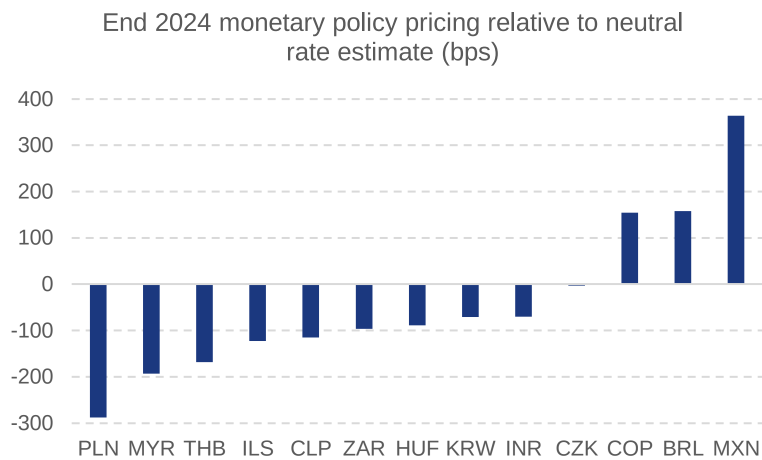
After a strong 2023, we expect another good year for EM credit in 2024. Following January's supply-driven repricing, valuations are attractive, and future supply will likely be insufficient to absorb flows into an asset class supported by strong fundamentals and a supportive economic backdrop.

Figure 1: EM credit spreads near most attractive levels vs US corporates in two years



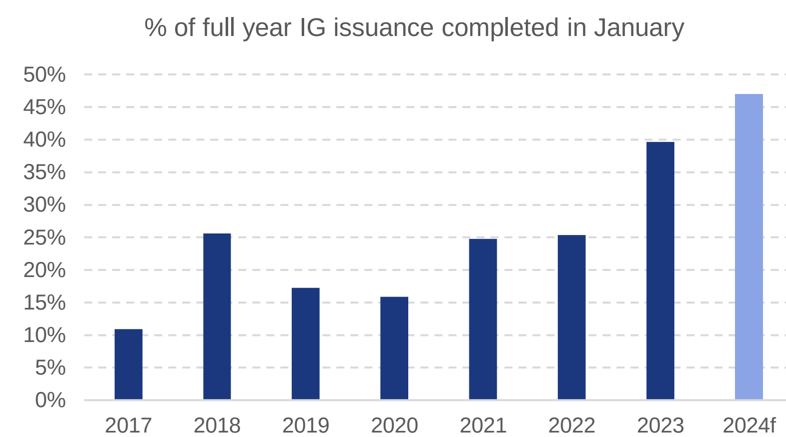
Sources: Bloomberg, JP Morgan, with Vanguard calculations

Figure 2: Latam countries still pricing policy rates above neutral



Sources: Bloomberg, with Vanguard calculations

Figure 3: New issue supply has been front-loaded this year



Sources: Bank of America, with Vanguard calculations

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