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Investment Institute Asset Class Views

Emerging market debt outlook: Something old, something new

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Key points

- Following an agitated but constructive summer, US election jitters are starting to impact emerging markets
- A Trump win is generally seen as bad for emerging market debt, as it would likely bring about trade protectionism, leading to US dollar appreciation, a potential currency war with Asia and higher US rates that would hurt frontier markets. A Harris win would be better as it would help avoid such challenges
- However, Trump presidency is not a new outcome for markets and Vice President Harris also offers a relevant playbook given her position in the current administration
- Does the first Trump presidency offer a useful guide as to what to expect from Emerging Market Debt (EMD) should he win another term?

When we look at the emerging markets' (EM) environment today, the similarities with the period just prior to the 2016 US presidential election are striking.

In November 2015, Ukraine had just completed its debt restructuring following Russia's invasion in the previous year and the subsequent sovereign default. In August 2024, Ukraine once again restructured its sovereign debt, after a two-year moratorium on external debt payments.

In 2016, Argentina was having a moment with the Mauricio Macri reformist government which was promising a break from the past. Today we are witnessing another attempt at a turnaround, with Javier Milei's administration having embarked in an aggressive fiscal stabilisation programme.

Similarly to nowadays, China was struggling with low growth, overcapacity and deflation fears, with the property market in the doldrums.

In addition, Brazil was experiencing both a fiscal and political crisis. Dilma Roussef's administration pushed the budget deficit to double digits (it peaked at -10.2% of GDP in 2015) and she eventually faced impeachment. Today Lula da Silva's honeymoon with markets (after his re-election in October 2022) seems to be over, with the 2024 projected budget deficit at -10% of GDP again.

EMD during Trump 1.0: More fear than harm

Overall, during the first Donald Trump presidency, emerging market debt (EMD) enjoyed buoyant returns, with hard currency and local currency debt rising by around +23% between January 2017 (Trump inauguration) and January 2021, when Joe Biden took over as US president.[1]

In the run up to the election, in September 2016, EMD hard currency spreads[2] stood at 340 basis points (bps) for sovereigns and 330bp for corporates. When Trump's unexpected victory was announced, there was an immediate 40bps widening of spreads for sovereigns, while EM corporates - a more illiquid and less reactive asset class - did not move.

EM spreads consequently proceeded to rally, to 268bps for sovereigns and 247bps for corporates, until the end of 2017. In all, EMD returned +9% for the combined sovereign and corporates asset classes in the first year of the US administration.

Argentina, a darling of the market by then (after re-accessing debt markets following Macri's election in 2015 and the clearance of the conflict with bond holdouts), outperformed and delivered +15%. Ukraine, still riding on post-restructuring enthusiasm, was up 17%.

2018 saw the start of tentative policy tightening from the Federal Reserve (Fed). This led to a widening of EM spreads, with the countries most exposed to external financing risks (Turkey and Argentina) cracking under the pressure of tighter financial conditions. Argentina eventually defaulted on its debt in October 2019, after Macri lost his re-election bid, while Turkey experienced a balance of payments crisis with the lira (TRY) losing 30% in one day in August 2018.

In summary, in Trump's first year the stars aligned as EMs benefitted from a few idiosyncratic stories (Ukraine, Argentina), easy US monetary and fiscal policies, as well as a synchronised growth rebound.

Starting in 2018, Trump's reflationary policies led to a tightening of monetary policy, which hit the most fragile EMs (Turkey, who ran a high current account deficit (CAD), and some frontier markets such as Argentina and Ecuador).

Are we going to (trade) war again?

The start of the China/US trade war can probably be traced back to March 2018, when Trump tweeted about his intention to impose tariffs - with steel and aluminium targeted first. In all, four rounds of levies ensued, alongside sanctions on China's technology industry (Huawei and ZTE) and military companies, which were followed by export controls on a number of key products and sectors.

China's yuan (CNY) had been under pressure going into US elections, depreciating 6% in the 12 months preceding Trump's inauguration. However, between the start and the end of Trump's Presidency, the CNY slightly appreciated, by around 4%. A 14% depreciation occurred after March 2018, and was consequently reversed.

Despite being a popular short[3] with investors, as witnessed by various surveys, the CNY has remained eerily stable this year. An imminent CNY devaluation seems to be preceded by a widening of the Chinese Yuan Renminbi Offshore (CNH)/CNY spread, reflecting short speculative positions on the CNH from offshore investors. This occurred for instance in August 2015, when a steep devaluation of 2.7% of CNY followed. This spread has remained wide this year, as CNY shorts have become a consensus trade. However, in the recent bout of currency volatility, the CNY followed Japan's yen (JPY) and appreciated swiftly, and the CNY/CNH spreads converged to 0 - a sign that speculative shorts have been cleared in the episode.

Betting on CNY depreciation and buying the US dollar (USD) has not been proprietary to foreign investors only. If we measure the difference between the cumulative Chinese trade balances (showing large surpluses) and conversions of USD into CNY by exporters, one can notice that much of China's surpluses have been stored in USD (some estimates put holdings of USD by corporates and households at $300bn-$600bn).

Dollarization increased in recent years across Asia, given the high interest rate differential between the US and the region. Chinese 10-year government bond yields trade around 1.7% inside 10-year US Treasury (UST) yields (the spread went as high as 2.4%).

Hedging Asian currencies into USD is carry positive[4], due to negative interest rate differentials versus the US: three-month annualized hedging costs via forwards[5] stand at -2.6% for the Thai Baht (THB), -2.5% for the South Korean won (KRW) and -2% for the Malaysian ringgit (MYR).

This means that Asian FX is already oversold and the risk of a re-conversion of USD into local currencies, should CNY weakness fail to materialise, especially as US rates head lower (making the shorting less attractive from a carry point of view), is worth noting. This could limit CNY depreciation pressure, even as tariff fears mount.

What could happen to Ukraine?

As mentioned, when Trump first took office, Ukraine had completed its restructuring of external debt in August 2015, issuing new bonds in November 2015.

In August 2024, Ukraine reached an agreement with bondholders and sent out a restructuring proposal of those very obligations, and new instruments have been trading since the end of August.

The 2015 restructuring was relatively straightforward: it contained a 20% haircut[6] on principal, no payments until 2019 and a four-year maturity extension. The 2024 restructuring proposal is slightly more complex, encompassing the exchange of old instruments for two types of bonds, a classic bond A with step up coupons and a bond B with a contingent payment schedule, whereby the principal can be increased depending on certain conditions being met on the level and the growth rate of Ukraine GDP by 2029.

The principal haircut is slightly higher than in the first restructuring, between 37% and 25% (depending on whether the optionality of Bond B is met). External debt payments over the next four years are, in International Monetary Fund (IMF) terms, “token”, allowing significant cash flow relief for Ukraine.

At the time of the first restructuring, the economic and political situation of Ukraine was dire, but not dis-similar to today’s. Part of Ukraine’s territory was occupied, and despite the Minsk agreements of 2014/2015, a complete cease fire had not been achieved. The conflict appeared frozen although flare ups would be recurrent. Ukraine’s GDP had fallen dramatically following the invasion, registering a 50% year-on-year contraction in USD terms in 2015, partially explained by the local currency’s debasement (Ukraine’s hryvnia - UAH - lost half of its value from 10UAH/USD in 2014 to 22UAH/USD in 2015). At the exit, Ukraine had a debt-to-GDP ratio of 90% and had secured an IMF support package of US$17.5bn.

Today, Ukraine has secured a similar amount of IMF support, with a four-year EFF (Extended Fund Facility) totalling USD15.6bn, of which the latest US$2.2bn tranche was released in May 2024. GDP seems to have fallen by less than during 2014/2015, (-20% in USD terms) especially thanks to the relative stability of the UAH, which “only” lost 45% since the start of the invasion.

The most important parameter in determining the value of the Ukraine bonds going forward is the exit yield - i.e. the yield at which the new instruments will trade once issued. After the 2015 restructuring, the new bonds, carrying coupons of 7.75%, traded relatively well after being issued and settled at a yield of around 8%, hovering between 8% and 10% between November 2015 until February 2022, when Russia invaded Ukraine and yields skyrocketed to the 40%-60% area.

How will bond prices vary in a Trump versus Harris scenario?

Trump has repeatedly said he would end the Ukraine war in “days” and threatened to cut support not only for the Ukraine conflict but for NATO in general. Since the 2014 invasion of Ukraine, the US have provided US$58.2bn in military support, of which the vast majority (US$55.4bn) since February 2022[7]. Should support be cut completely, one would assume Ukraine would find itself in a very similar situation to the one of the first invasion, which had been fought off with much less Western military assistance. This would be without counting on Europe increasing its aid as the gap between committed and allocated aid to Ukraine is high.

With a similar debt-to-GDP ratio as in 2015, a similar amount of IMF assistance, and committed assistance from Europe still in place, Ukraine bonds could follow a similar pattern to the first restructuring outcome i.e., trade with spreads between 800-1000bp, resulting in yields in the 12-14% area.

We admit there is significant uncertainty as to how the market would react in case support was dramatically reduced - with an initial hit on sentiment probable. However, we believe servicing of the bonds is secure under the IMF programme and another restructuring, barring an unforeseen worsening of the war in the next four years, is unlikely.

Argentina: Milei vs. Macri – Is this time different?

Back in November 2015, outsider businessman turned politician, Mauricio Macri was elected on a platform vowing economic and political change after a decade of ‘Kirchnerismo’ rule. Within one year of his presidency and by the time Trump got elected, Macri had lifted capital controls, floated the currency, and issued a record bond deal after inking a multibillion settlement with hold-out creditors from the previous restructuring.

Today, the beleaguered South American nation is grappling with another episode of high inflation, economic recession, and risk of debt default. Profligate government spending, financed by money creation, is the root cause of Argentina’s economic malaise according to President Javier Milei. An economist political outsider turned senator in 2022 and president in 2023, Milei was elected on a mandate to stabilise the economy, which was at the brink of hyperinflation, with rising poverty levels amid a web of price and capital controls. To reverse the secular economic decline and avoid another debt default, Milei has pledged to undertake a massive fiscal adjustment – and is already doing so – unlike his predecessors.

Both Macri in 2015 and Milei in 2023 inherited challenging situations. Arguably, Milie's inheritance was even worse than Macri's – triple digit versus double digit inflation, double digit (in billions) versus single digit negative international reserves, double digit versus single digit twin deficits (including central bank deficit). Despite optimism, worldwide interest, and initial success, the Macri experiment failed as fiscal dominance prevailed leading to renewed imposition of capital controls, higher levels of inflation than inherited, and an eventual debt restructuring.

Milei and his team, which includes some key Macri officials, are pursuing a different strategy this time around. The new administration has achieved a remarkable 0.3% of GDP fiscal surplus year-to-date and is well on track to achieve the first full-year primary surplus since 2008. Banking on a fiscal anchor, bolstered by closing the 'faucets' of monetary emission, Milei is hopeful his strategy leads to sustainable disinflation, improved fiscal solvency, and a return to economic growth. Voters and investors alike will judge the programme by its outcome, as the Macri experiment showed.

As bond investors, we find more comfort in Milei's than Macri's approach. Budget and external surpluses, reserve accumulation and a fall in inflation are tangible successes of this administration's strategy. We continue to like the story and, as we monitor progress, maintain a positive view on Argentine government bonds.

Is history likely to repeat itself?

Despite certain challenges the asset class and certain EM countries were facing in 2016, post the US presidential election EMD performed well. Buoyant equity markets, decent global growth and some idiosyncratic turnaround stories helped returns in the year following Trump's inauguration.

This time around, we think EMD can repeat this pattern, regardless of the US election result. We still see upside in EM high yield, particularly in frontier markets, with Ukraine and Argentina being favourites in our view. Trade wars and protectionism could potentially bring about a strong USD, but de-dollarisation as US interest rates are cut can act as a powerful counterbalance.

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[1] Source: Bloomberg, JPM Indices. It also applies to other market data in this article, unless otherwise stated.
[2] The *difference between yields on differing bonds* of varying maturities, credit ratings, issuers etc.
[3] Aiming to profit from a falling asset price
[4] Where the return from an investment exceeds the cost of financing the investment
[5] Forward contract - an agreement between two parties to sell or buy an asset at a specified future date at an agreed price
[6] A lowering of outstanding interest payments / a portion of the *bond* which will not be repaid
[7] Source: US department of state website- https://www.state.gov/u-s-security-cooperation-with-ukraine/, August 2024.