DoubleLine Emerging Markets Fixed Income Outlook

February 2021

Despite a rollercoaster year, emerging markets (EM) credit was relatively resilient, ending 2020 with positive returns for all three major EM bond indexes: The J.P. Morgan Emerging Markets Bond Index Global Diversified (U.S. dollar-denominated EM sovereigns) posted returns of 5.26%, the J.P. Morgan Corporate Emerging Markets Bond Index Broad Diversified (dollar-denominated EM corporates) generated 7.13%, and EM local currency (as measured by the J.P. Morgan Global Bond Index Emerging Markets Global Diversified) delivered 2.69%. Notably, all the stimulus and policy measures, slashed interest rates and trillions in asset purchases by governments and central banks around the world have helped the global economy rebound from the COVID-19 lockdowns. Concurrently, EM countries have made progress in combatting the public health and economic impacts of the pandemic in a variety of ways. Measures have included extending fiscal stimulus to vulnerable low-income populations via wage support and health-related expenditures, and banks and other financial institutions providing credit facilities to businesses, and forbearance on loans, leases, credit cards and mortgage payments. That said, we expect EM COVID-19 vaccinations to lag those in developed markets. There is still uncertainty regarding the efficacy and procurement of the vaccines, but emerging markets should benefit as the vaccines are rolled out, and global growth and trade improve. Furthermore, rebounding commodity prices, particularly industrial metals, should continue to benefit emerging markets.

Overall, DoubleLine remains cautiously optimistic and constructive on EM fixed income for 2021. As fiscal deficits and gross government debt rose for almost all EM countries over 2020, country fundamentals deteriorated. We will likely see improvements in fiscal balances in 2021 relative to last year, but we expect financing needs will remain elevated over the next 12 months. Overall, we see inflation pressures remaining relatively subdued in the remainder of the first quarter. In addition, while most EM central banks are near the end of their cutting cycle, we expect monetary policy to remain highly accommodative. We expect multilateral funds such as the International Monetary Fund and World Bank will continue to provide support to EM countries, and that EM governments and central banks will remain accommodative on the fiscal and monetary fronts.

We are neutral on the outlook for the near term but think 2021 will be supported by continued positive inflows into the asset class. That said, we remain concerned that markets have moved very quickly to price in the expectations for a strong economic recovery.

EM Sovereigns (EMBI GD) and Corporates (CEMBI-BD) in U.S. Dollars

	Dec 31, 2019	Mar 23, 2020	Dec 31, 2020	Jan 29, 2021	5-Yr Avg
EM Sovereign (EMBI GD)	290	721	352	352	360
EM Corporates (CEMBI BD)	311	641	328	323	344

Figure 1
Source: Bloomberg, DoubleLine

As seen in Figure 1 above, EM credit spreads for both sovereigns and corporates have retraced a significant amount of the spread widening that took place leading into March 23, ending the year at 352 basis points (bps) for sovereigns and 328 bps for corporates. As of Jan. 29, the credit spreads for EMBI GD at 352 bps and CEMBI BD at 323 bps are in line with their five-year averages.

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In our view, current valuations appear fair to tight relative to the underlying credit fundamentals of EM countries and companies. Beyond that, other potential risks include slow vaccine deployment and additional COVID-19 breakouts leading to prolonged shutdowns, new variants of the virus that could make the vaccine ineffective, falling global growth expectations, U.S.-China relations, and implications of wider debt and deficits in EM countries.

DoubleLine's base case for the EMBI GD is that 2021 will be a year of carry and slight spread compression leading to returns in the midsingle digits. We expect the same scenario for the CEMBI BD in that 2021 will be a year of carry and slight spread compression leading to returns in the midsingle digits. With that said, we expect technicals to continue to support EM fixed income as the hunt for yield continues to attract inflows. In addition, we expect net supply in 2021 to be manageable as refinancing of upcoming maturities remains the key use of proceeds while capital expenditure financing and mergers and acquisitions activity remain subdued. It is DoubleLine's expectation that fundamentals for EM corporates will continue to improve over the course of the year. With that, default rates are expected to remain low in 2021. J.P. Morgan forecasts the default rate for high yield EM corporates to fall to 2.8% from 3.5% 2020. In that light, we see opportunities in new issues; particularly those that come with a new-issue premium, or any market pullback, we view as a buying opportunity.

U.S. Dollar and EM Local Foreign Exchange

DoubleLine is neutral on the dollar in the near term but bearish in the medium term, which should benefit EM foreign exchange (FX). In the near term, we think the dollar might stabilize due to its safe-haven status and the rising risks associated with the economic shutdowns due to the latest wave of COVID-19 cases. Emerging markets are lagging their developed market peers on vaccine procurement and rollout, and virus containment, and they also have less fiscal and monetary space to address near-term headwinds. Risk assets have rallied strongly since their March 2020 lows, and we see the probability of a correction rising, which would likely bring near-term flows into the dollar.

One reason for a bearish medium-term view on the dollar is the relatively high correlation between the twin deficits and the value of the dollar. The twin deficits refer to when the government has a current account balance deficit (imports more than exports) and a budget deficit (spends more than generates). A widening current account deficit increases the need for U.S. importers to sell dollars to fund their imports, which puts downward pressure on the currency. Similarly, when the budget deficit widens, and government debt issuance increases, we see downward pressure on the currency. U.S. stimulus measures in response to the COVID-19 crisis in 2020 dramatically increased the budget deficit from under $1 trillion to an estimated $3.3 trillion as of Dec 31 according to the Congressional Budget Office's September 2020 update. The expectation is that the fiscal deficit will increase in 2021 as the Biden administration looks to address the economic impact from the pandemic. The historic relationship between the twin deficits (as a percent of GDP) and the value of the dollar (as measured by the U.S. Dollar Index) has been fairly strong, and that the changes in the twin deficit usually lead changes in the dollar by 18 to 24 months. *(Figure 2)*

U.S. Dollar and Twin Deficits

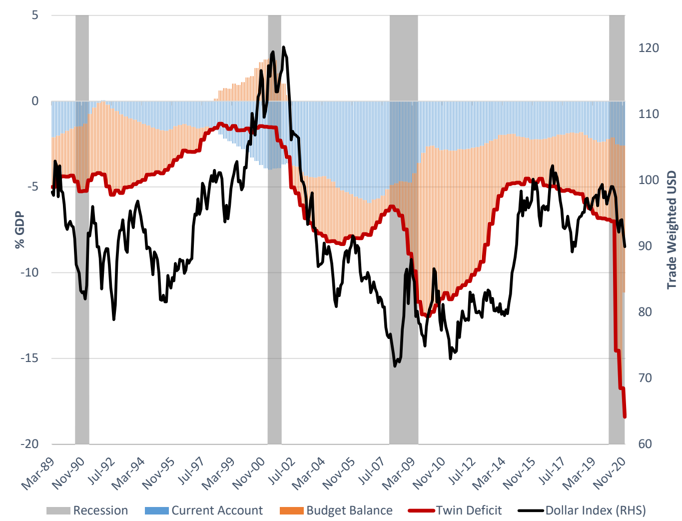

Figure 2
Source: Bloomberg, DoubleLine. Shaded areas represent recessionary periods. Twin Deficits are the U.S. Budget Balance (as of 12/30/2020) and the U.S. Current Account Balance (as of 9/30/2020).

In the medium term, we think that EM FX will present good value and should benefit when we see a broader rollout of vaccinations, likely starting in the second half of 2021. Also, the move to green energy projects from developed markets to China will help support commodities in the coming years. For these reasons, EM FX should present a good relative value trade after we get through the near-term headwinds from economic lockdowns, and concerns about vaccine rollout and COVID-19 variants. ■

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J.P. Morgan Corporate Emerging Markets Bond Index (CEMBI) Broad Diversified – This index is a uniquely weighted version of the CEMBI, which is a market capitalization-weighted index consisting of U.S. dollar-denominated emerging markets corporate bonds. It limits the weights of index countries with larger debt stocks by only including specified portions of those countries' eligible current face amounts of debt outstanding.

J.P. Morgan Emerging Markets Bond Index (EMBI) Global Diversified – This index is a uniquely weighted version of the EMBI, which tracks emerging markets (EM) bonds and comprises sovereign debt and EM corporate bonds. It limits the weights of index countries with larger debt stocks by only including specified portions of those countries' eligible current face amounts of debt outstanding.

J.P. Morgan Government Bond Index Emerging Markets (GBI-EM) – This index is the first comprehensive, global local emerging markets index and consists of regularly traded, liquid, fixed-rate, domestic currency government bonds to which international investors can gain exposure.

J.P. Morgan Government Bond Index Emerging Markets (GBI-EM) Global Diversified – This index tracks local currency bonds issued by emerging markets (EM) governments and has a broader roster of countries than the GBI-EM, which limits inclusion to countries that are readily accessible and where no impediments exist for foreign investors.

U.S. Dollar Index (DXY) – A weighted geometric mean of the U.S. dollar's value relative to a basket of six major foreign currencies: the euro, Japanese yen, British pound, Canadian dollar, Swedish krona and Swiss franc.