FIM Partners

Global Emerging Markets Debt

When Carry Meets Vol

Market Outlook | March 2025

Francesc Balcells
FIM Partners
CIO – Global EM Debt

- **Our outlook favours carry as the primary source of returns**
- **We identify four type of strategies that help us to realize carry and minimise volatility**

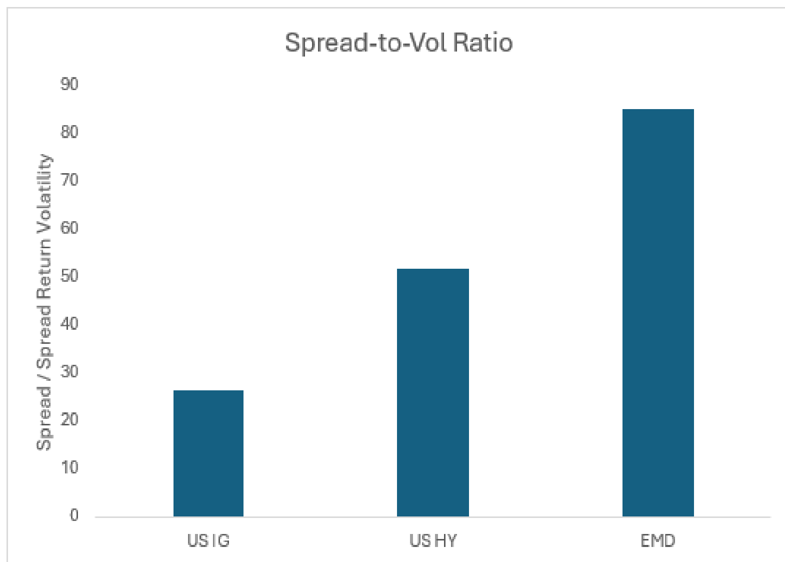
Amidst a high degree of uncertainty, we are focussing on what we consider to be the steadier and safer sources of returns at this point in the cycle.

Indeed, of the four drivers behind EM fixed income returns - spread, duration, carry and FX - we are now leaning the strategy further towards carry (more below).

Asymmetric Risk-Reward on Spreads

On spreads, we think the risk-reward is poor as EM spreads are now trading at the 20th percentile of their 10yr historical range.

Same applies to global credit in developed markets where spreads are even tighter than EMs, and more so when adjusted by quality or volatility, which speaks highly of EMD on a relative value basis.



Source: Bloomberg, as of March 2024

We do not anticipate a significant widening of spreads from here as the state of EM fundamentals is good, the rating cycle is on an upswing, and technicals are relatively healthy.

We are, however, concerned about global risk headwinds, and the general level of uncertainty, struggling to see much more spread tightening henceforth given initial levels.

There are some exceptions to this rule, particularly in the EM high-yield credit bucket, where some idiosyncratic stories are still to fully play out.

For example, we see Argentina's final rating destination as a single-B credit (vs. triple-C today, where the bonds are currently priced at), leaving some room for spread compression.

Best Duration is in Local Markets

On duration, we are somewhat neutral on US dollar rates. What's priced in the front end of the OIS curve strikes us as fair, if not marginally excessive, with almost three cuts already priced in for this year.

Likewise, the long-end of the US dollar curve is within the range of fair value in the context of expected nominal trend growth in the US, and a neutral rate more likely above 3 than below.

DOGE notwithstanding, we still see Trump's policy mix as more inflationary than not given his stance on migration and tariffs.

We see value in some pockets of EM local duration where real rates are high, curves are steep, and disinflation is accelerating.

South Africa is a case in point, where local bonds are yielding 11 percent and FX hedging costs are running in the mid 3% area, allowing us to capture duration returns in a supportive macro backdrop for rates.

EMFX is Attractive but Will Remain Volatile

We think EM currencies will be caught up between tariff risk and sticky US inflation, and the Trump administration's desire, if only covertly, of a weaker US dollar.

The reflationary winds coming from Germany, China and Japan should also support EMFX.

As a result, we are counting on EM currencies to give us returns but without betting the house on it as uncertainty and risk will weigh on the asset class.

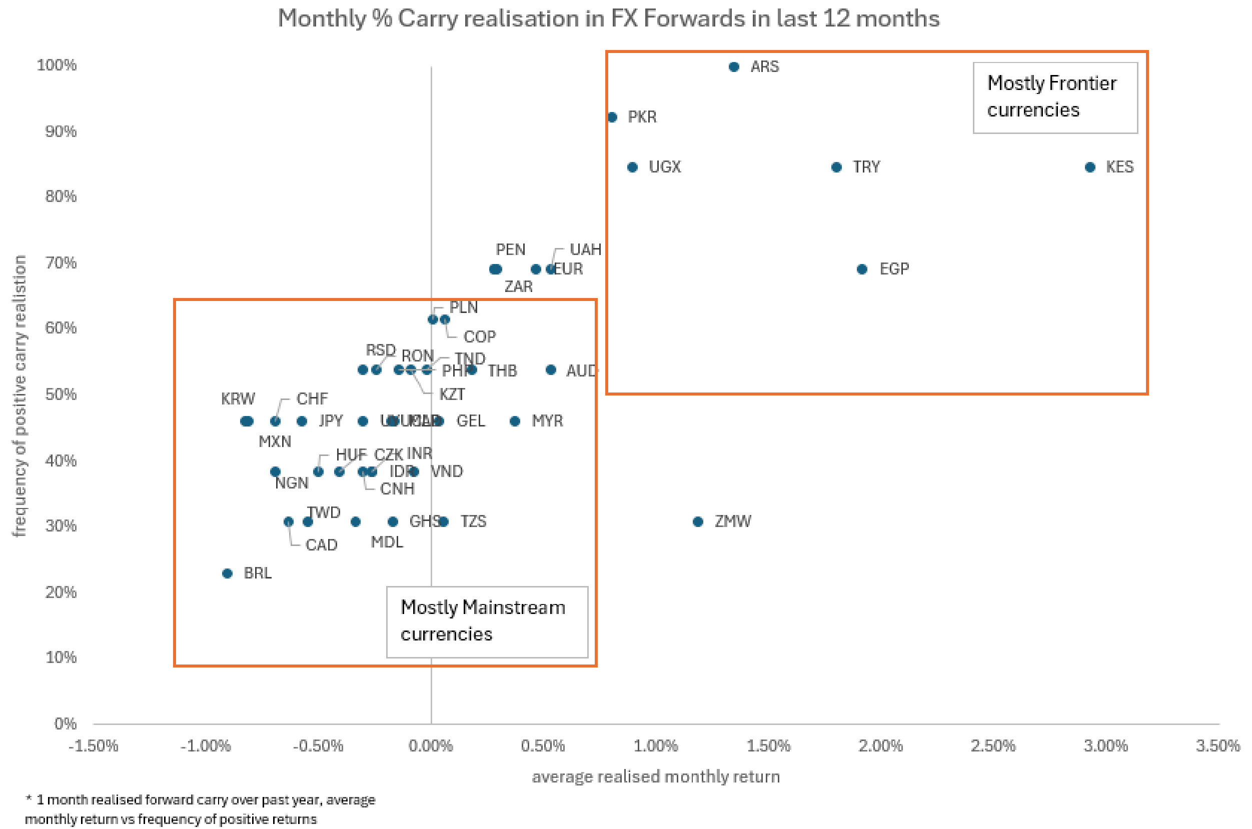
Relying on Carry we can Realise

All in, with markets buffeted by multiple cross currents, we think the most reliable source of return in the coming months will be carry.

The challenge within EM is being able to realise the carry, given the volatility associated with the uncertainty.

We see four strategies where the carry can be realised.

Firstly, local frontier, where the carry is exceedingly high, and the volatility is low.



Source: Bloomberg, FIM Partners, as of March 2024

The latter, however, is artificially suppressed by central banks, and therefore it is paramount to understand where the frontier countries are in the cycle, and whether conditions are in place for central banks to be able to maintain the suppression of volatility.

Cheap currencies, high real rates, access to external financing, and IMF support are some of the factors present now in many of the local frontier markets which permit a high degree of FX stability and, therefore, carry realisation.

The Egyptian pound meets many of these criteria.

Secondly, "safe carry" in credits where spreads are supported by lack of supply.

Many of the middle-income countries in EM rely almost exclusively on local currency debt as a source of financing.

For those countries, external debt has now become almost an extinct or residual source of funding, providing a very favourable technical backdrop to own those Eurobonds.

In Brazil, the stock of sovereign Eurobonds has barely changed over the last 10 years as the stock of public external debt has shrunk dramatically relative to GDP and relative to foreign assets.

Thirdly, front-end Eurobonds in high-yielding credits where external financing is secured and there's an explicit (or implicit) umbrella of IFI or bilateral support.

The lack of volatility in those front-end positions is anchored by the pull-to-par of the bonds, and the safety of knowing that the funding needs are covered and that there are enough external assets at hand to cover potential funding gaps.

Front-end Eurobonds in Pakistan, accounting only for a small share of the total stock of public sector external debt, carry very high whilst falling due within the timeframe of the existing IMF program.

Finally, countries that are using the FX as a nominal anchor in the context of a disinflationary policy stance.

Like frontier carry strategies, in those instances we need to make sure the conditions are in place for central banks to be able to generate (and accept) sustained real currency appreciation without incurring excessive imbalances in the process.

In Turkey, the central bank is carrying out such a policy, allowing us to capture and realise carry, understanding, however, the finite nature of the trade.

In conclusion, we think it is now the best time to lean on carry as an alpha engine for the strategy.

Carry returns are also typical of the phase of the cycle we are in: what begins as a spread trade at the start of the cycle, evolves into carry trades, and ends up with duration and FX being the main sources of returns. We are now in the middle of this process.

Contact Details:

Francesc Balcells

CIO – Global EM Debt

+44 7983 357706

fbalcells@fimpartners.com

Investor Relations

investorrelations@fimpartners.com

Website:

www.fimpartners.com

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