2023 Investment Outlook: Emerging Markets

Moderating global factors may help to alleviate pressures on emerging market economies in 2023.

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Key Points

- Pressures from exogenous shocks are abating, while years of monetary and fiscal policy reforms have helped to support emerging market (EM) economies.
- As the U.S. Federal Reserve (Fed) moves closer to the end of its hiking cycle, a lower U.S. dollar may be a potential tailwind for EM economies.
- Elevated dispersion among EM markets may create attractive relative-value opportunities for active management in 2023.

Three factors contributed to spread widening in emerging markets in 2022: 1) a tightening of financial conditions from central bank policy hikes across emerging markets, as well as the Fed's fastest hiking campaign since the 1980s; 2) a dramatic slowdown in global growth ascribed to China's Zero-COVID-19 policy that dominated most of the year; and 3) energy and food inflationary pressures, largely a result of the Russian invasion of Ukraine, restricting growth and consumer spending. As we look to 2023, the bright side is that we see pressures in each of these areas moderating, if not completely dissipating.

Despite these difficult exogenous factors, we did not see a “systemic EM crisis” or contagion due to years of reforms to strengthen monetary and fiscal buffers including local market financing, inflation targeting monetary policy, and relatively prudent fiscal stances across a number of large EM countries. At the same time, investor sentiment is pessimistic and could bode well as a contrarian indicator. Fortunately for an active manager, dispersion across the EM space remains high (see Figure 1); the J.P Morgan EMBIG Investment Grade Index spread was actually modestly tighter on the year, while high yield ended approximately 185 basis points (bps) wider, ending with a yield to worst (YTW) of 12.2%, or about 3.2% higher than that of U.S. high yield.

Portfolio Positioning and Outlook

The potential for the Fed to be nearing the end of its hiking cycle in early 2023 would be a positive development for EM, as the dollar starts to weaken versus global currencies and shifts from a headwind to tailwind for EM economies. Given relative-value considerations, we are adding higher-quality EM sovereign bonds across global and other mandates, favoring those countries that may benefit from positive terms of trade and prudent fiscal and monetary policies, as well as select high yield issuers that have alternative access to financing and stand to benefit directly from China reopening as it steps back from its zero-COVID policy.
Figure 1. Plenty of Dispersion in EM Sovereigns; Higher Than Normal Defaults Already in the Price

Default probabilities derived from valuations for five-year term credit default swaps (CDS) of sovereign issuers

Source: Bloomberg. Data as of December 31, 2022. A credit default swap (CDS) is a contract between two parties in which one party purchases protection from another party against losses from the default of a borrower for a defined period of time. Past performance is not a reliable indicator or guarantee of future results. For illustrative purposes only and does not represent any specific portfolio managed by Lord Abbett or any particular investment. Indexes are unmanaged, do not reflect the deduction of fees or expenses, and are not available for direct investment.
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