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Global Insights

2021 Investment Outlook: Emerging-Market Debt

Lord Abbett's outlook for emerging-market debt in 2021 considers optimism over vaccines, supportive global monetary policy, record levels of negative-yielding debt, and the prospect for a worldwide recovery in economic activity.

Against the backdrop of a pandemic that has affected every aspect of life around the world, we find ourselves focusing our outlook for emerging-market (EM) debt primarily on two pillars of support: 1) external factors influencing inflows to EM debt markets and, 2) supportive EM-specific factors that contribute to a constructive fundamental outlook.

Exogenous Forces at Work

Global Liquidity Expansion

We believe certain external factors that are setting the stage for a positive environment for emerging markets in 2021 include the extraordinary liquidity measures provided by both the U.S. Federal Reserve (Fed) and central banks across developed and emerging markets. Regardless of the COVID-19 vaccine announcement, these institutions have committed to providing continued, stimulative monetary policy in order to support the global economy through the crisis and perhaps beyond 2021. Massive global liquidity measures designed to keep economies afloat and maintain low interest rates and low volatility have also contributed to the record levels of negative-yielding debt in 2020 (see Figure 1). Although the increase does signal demand for low-risk assets, we believe it will also intensify investors' search for yield within the EM debt markets.

Easing Global Financial Conditions and Emerging Markets

The current environment of global liquidity expansion mirrors the situation that followed the Global Financial Crisis (GFC) when central banks were injecting liquidity less consistently in order to save financial institutions that had reached tipping points. What followed between 2009 and 2013 were substantial inflows into EM debt and EM local, foreign exchange (FX)-markets, as interest rates declined, and yield-seeking behavior surged. Global inflows into EM bond funds following the COVID-induced rush of outflows in March 2020 have been impressive, posting 20 consecutive weeks of positive inflows through mid-November.[1] We believe this trend should continue in 2021, as investors search for attractive positive yields.

Emerging markets have remained on a positive fundamental path over the last 15 years, and we believe EM debt markets have become a bona fide asset class worthy of a long-term investment allocation. However, EM assets remain under-owned, accounting for approximately 5% and 7% of global bond and equity allocations, respectively, according to J.P. Morgan data as of November 2020. Room for expansion within allocation targets could provide additional support, as investors reach for yield available within the high-yielding and expansive opportunity set provided by EM debt.

COVID-19 Recovery Within Emerging Markets

Although there will be challenges to delivering the COVID-19 vaccines to emerging economies with underdeveloped health-care infrastructures, outcomes regarding virus cases have been better than expected across several large regions, such as Northern Asia and Sub-Saharan Africa. Certain frontier markets have also benefited from younger populations and are no longer imposing lockdown restrictions. There are also potential opportunities within select Latin American countries that have low debt-to-GDP (gross domestic product) levels, providing space for additional fiscal and monetary stimulus.

Shift in Foreign Policy Initiatives

The resolution of the U.S. election cycle eased the uncertainty that was impacting the U.S. financial markets. Similarly, the outcome of those elections shifted foreign policy expectations with the arrival of a new administration in the White House. We believe a more predictable foreign policy initiative will develop in the coming months that will provide a multilateral approach to foreign trade and separate issues of national security. A foreseeable approach to foreign trade could potentially alleviate uncertainty and decrease risk premiums in EM assets, enhancing the pull of global capital inflows.

[1] J.P. Morgan Emerging Markets Outlook and Strategy for 2021, November 24, 2020, p.26.

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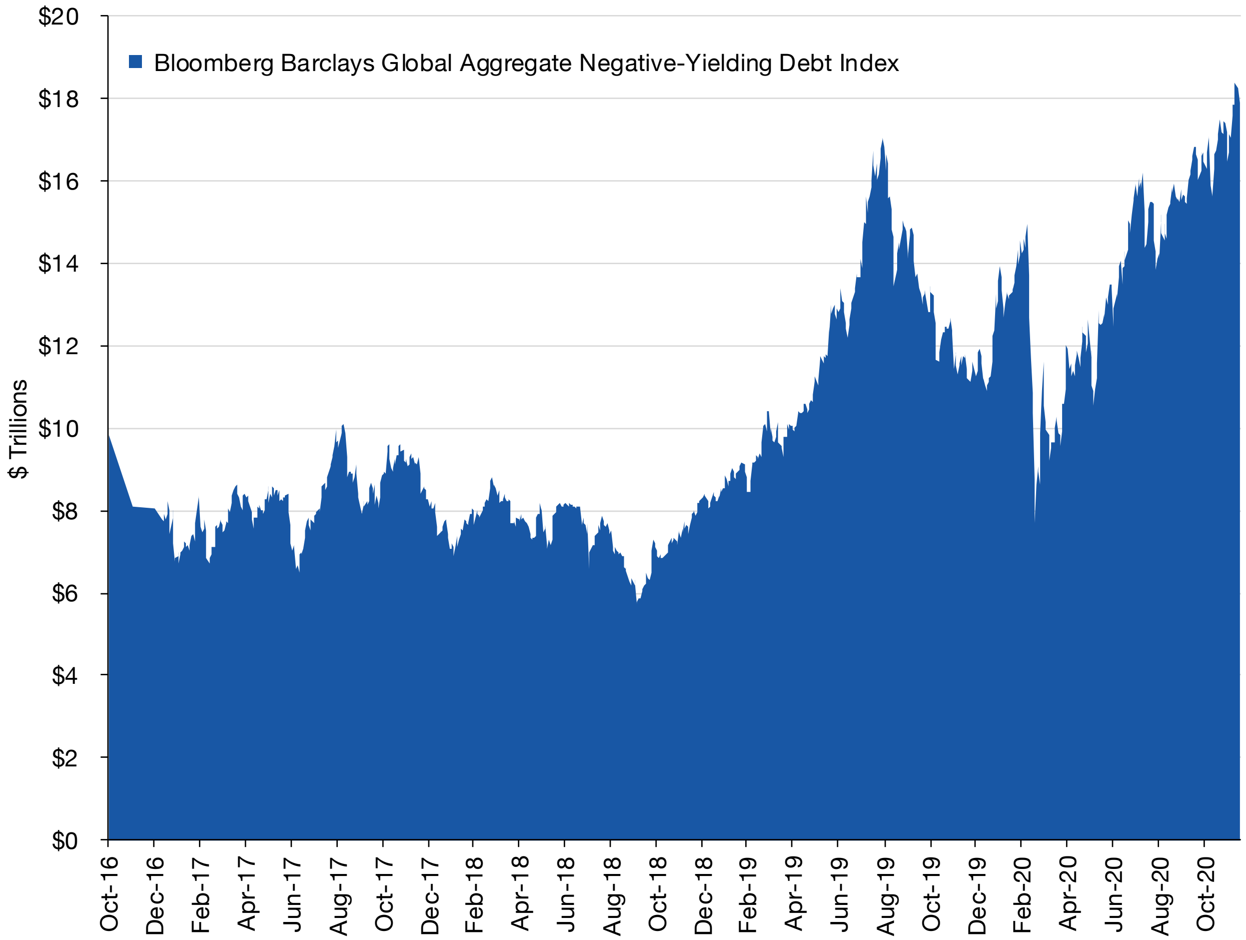
Figure 1. Total Negative-Yielding Debt

Negative-yielding securities are on the rise.



Source: Bloomberg. Data as of 12/18/20. For illustrative purposes only and does not represent any specific portfolio managed by Lord Abbett or any particular investment. Bloomberg Barclays Global Negative-Yielding Debt Index represents negative-yielding, global, investment-grade debt and includes treasury, government-related, securitized, and corporate bonds from emerging- and developed-markets issuers.

Fundamental Factors Specific to EM Debt

International Monetary Fund Provides Swift Support

Central banks have evolved their policies and support following lessons learned from previous global financial events, such as the GFC. The International Monetary Fund (IMF) has as well. The IMF's funding response to the COVID-19 pandemic was immediate, distributing close to $300 billion in funding facilities to emerging economies in 2020 alone. Through direct funding, the IMF helped to bridge the gap between the effects of lockdowns and economic deterioration and eventual recovery expected in 2021.

Attractive EM Debt Fundamentals

The exceptional policy response by the IMF and central banks enabled certain EM companies to sustain the blows of the pandemic. Surprising to most is that default rates following the March disruption have been much lower than expected among EM corporate debt (see Figure 2). Default rates are also expected to remain below 3% in 2021. We view low current and expected EM corporate debt default levels as favorable.

Sovereign EM debt fundamentals have been improving over a long period of time. Local currency markets have evolved, allowing for natural market forces to determine prices instead of pegged currency exchange rates. Stable currency exchange rates have significantly improved inflationary

Figure 2. Default Rates in 2020 Have Been Below Expectations

EM Corporate Bonds Default Rates and Comparisons									
	2013	2014	2015	2016	2017	2018	2019	2020 YTD	2021F
Asia	1.2%	1.5%	3.1%	1.0%	1.0%	2.5%	1.6%	2.7%	2.6%
EM Europe	2.3%	4.0%	2.5%	3.6%	3.6%	0.0%	0.0%	3.3%	1.1%
Latin America	10.6%	6.5%	5.7%	9.2%	2.0%	2.1%	2.3%	4.4%	3.6%
Middle East & Africa	0.0%	4.6%	4.0%	5.7%	3.2%	0.0%	1.6%	2.2%	3.4%
EM Corp HY (ex. 100% quasis)	4.3%	3.8%	3.8%	5.1%	2.2%	1.6%	1.5%	3.5%	2.8%
Index Level Default Rates									
CEMBI HY	2.8%	3.7%	2.5%	4.0%	1.4%	1.2%	0.8%	3.2%	2.8%
Developed Market Default Rates									
U.S. High Yield	0.7%	3.0%	2.6%	4.3%	1.5%	1.9%	2.9%	6.7%	3.5%
European High Yield	1.7%	0.9%	1.2%	2.5%	1.1%	1.4%	1.8%	2.9%	2.0%

Source: J.P. Morgan. Data as of November 24, 2020. J.P. Morgan Corporate Emerging Markets Bond Index (CEMBI) is a market capitalization weighted index that tracks total returns of U.S. dollar-denominated debt instruments issued by corporate entities in emerging market countries. CEMBI High Yield (HY) is the below-investment-grade subset of the CEMBI. Quasi-sovereign bonds are corporate bonds in which the government owns a partial stake in the issuing company. Asia = CEMBI Asia. EM Europe = CEMBI Europe. Latin America = CEMBI Latin America. Middle East & Africa = CEMBI Middle East & Africa. For illustrative purposes only and does not represent any specific portfolio managed by Lord Abbett or any particular investment. Forecasted default rates are not guaranteed, and 2021 defaults may be higher depending on general market conditions and other factors that may affect particular countries, industries, or companies

pressures in emerging economies, while promoting stability and growth. As mentioned earlier, central banks have also learned from previous financial crises and have adapted the use of their complete monetary policy tool kits, which further support EM Sovereigns and provide access to capital previously limited during times of stress.

China

One of the most important factors influencing our outlook for EM debt in 2021 is the recovery in China. China has become the second largest economy in the world and is now more important to emerging-market growth than developed markets. China's capacity to adapt economic activity during the pandemic has had a very positive impact on emerging-market economies that are dependent upon commodity exports to China. North Asian countries, such as China, South Korea, and Taiwan, have led the world in measures taken to reduce the spread of the virus and have also shown exceptional economic resilience. We believe the improved recovery profile in this region will provide a boost to fundamentals.

A Final Thought

Our overall positive view toward EM debt is focused on external forces and EM debt-specific factors that we believe provide support to the asset class in 2021. These positive implications, however, are not uniformly anticipated across countries or regions. Challenges to vaccine penetration, significant debt burdens, and changing political landscapes are only a few reasons why we believe country, region, and security selection remain key to investing in the EM debt markets.

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A Note about Risk: The value of investments in equity securities will fluctuate in response to general economic conditions and to changes in the prospects of particular companies and/or sectors in the economy. The value of investments in fixed-income securities will change as interest rates fluctuate and in response to market movements. Generally, when interest rates rise, the prices of debt securities fall, and when interest rates fall, prices generally rise. High-yield securities, sometimes called junk bonds, carry increased risks of price volatility, illiquidity, and the possibility of default in the timely payment of interest and principal. Bonds may also be subject to other types of risk, such as call, credit, liquidity, interest-rate, and general market risks. Bonds issued or guaranteed by non-U.S. governments and governmental entities (commonly referred to as "sovereign debt") present risks not associated with investments in other types of bonds. The sovereign government or governmental entity issuing or guaranteeing the debt may be unable or unwilling to make interest payments and/or repay the principal owed. Non-U.S. investments generally pose greater risks than U.S. investments. The securities markets of emerging-market countries tend to be less liquid, to be especially subject to greater price volatility, to have a smaller market capitalization, and to have less government regulation. Investing in non-U.S. denominated and/or domiciled securities may involve heightened risk due to currency fluctuations, and economic and political risks, which may be increased in emerging markets.

No investing strategy can overcome all market volatility or guarantee future results.

Forecasts and projections are based on current market conditions and are subject to change without notice. Projections should not be considered a guarantee.

This article may contain assumptions that are "forward-looking statements," which are based on certain assumptions of future events. Actual events are difficult to predict and may differ from those assumed. There can be no assurance that forward-looking statements will materialize, or that actual returns or results will not be materially different from those described here.

Statements concerning financial market trends are based on current market conditions, which will fluctuate. There is no guarantee that markets will perform in a similar manner under similar conditions in the future.

Glossary and Index Definitions

Foreign Exchange (forex or FX): The trading of one currency for another. For example, one can swap the U.S. dollar for the euro. Foreign exchange transactions can take place on the foreign exchange market.

Gross Domestic Product (GDP): The monetary value of all the finished goods and services produced within a country's borders in a specific time period, though GDP is usually calculated on an annual basis. It includes all of private and public consumption, government outlays, investments, and exports less imports that occur within a defined territory.

Debt-to-GDP: A measure of a country's federal debt in relation to its gross domestic product (GDP). By comparing what a country owes to what it produces, the debt-to-GDP ratio indicates the country's ability to pay back its debt.

International Monetary Fund (IMF) is an international organization created for the purpose of promoting global monetary and exchange stability; facilitating the expansion and balanced growth of international trade and assisting in the establishment of a multilateral system of payments for current transactions.

Indexes are unmanaged, do not reflect the deduction of fees or expenses, and are not available for direct investment.

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Lord, Abbett & Co. LLC | 90 Hudson Street | Jersey City, NJ 07302-3973 | T 1.888.522.2388 | lordabbett.com

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