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- US Inflation Is Gradually Cooling

- The focus now shifts toward the inflation trajectory, currently a more critical factor in the Fed's reaction function. We expect the latest CPI report to show a modest slowdown in the monthly pace of core inflation to 0.3% — which is still consistent with the Fed's annual core PCE inflation target of 2.0%. Even if annual headline inflation flutters around 3.0% through year-end, persistent disinflation in the core should allow the Fed to cut rates this summer

- On a theory that reductions in the target interest rate are associated with sharp increases in dollar-denominated loan volumes in emerging markets relative to developed markets, we should expect that when the Fed lowers U.S. Rates, Emerging Market loans and debt will soar

- Roughly 80 percent of cross-border loans to emerging market economies are estimated to be denominated in U.S. dollars. Dollar-denominated credits make up 60 percent of Europe's emerging market economies' cross-border lending and over 90 percent of foreign banks' loans to emerging market economies in Africa, Asia, and the Americas.

- However, politics have much influence in the way of the dollar and ultimately, the EM debt

- Approximately 76 nations have either conducted or plan to hold elections this year, including the United States. In my view, a Biden victory would likely continue the status quo, while a Trump victory could introduce significant change, particularly more trade confrontation, which could weaken transatlantic ties, and a more aggressive posture toward China.

-Trump has suggested a 60% import tariff on Chinese products and a universal 10% import tariff if reelected. Notably, the implementation of extra tariffs could likely lead to a stronger US dollar.

-Trump's additional proposed 10% import tariff could also cause disruption beyond China and affect a broader range of developing countries. Crucially, this type of tariff could be implemented without congressional approval. Emerging economies that may be most negatively affected include those highly dependent on the United States as an export market and those where exported goods could be sourced within the United States. Asia, particularly Malaysia, South Korea, and Thailand, as well as Mexico, have high exposure to the United States with more substitutable products. However, Mexico might be exempt from the 10% import tariff due to its inclusion in the US-Mexico-Canada trade agreement. Countries with high exposure to the United States but with less replaceable products, such as commodities, including Chile, South Africa, and Indonesia, may also be spared.

-Other risks involved: China property and consumption, and Middle East Tension and Global Transit

-Diversification from US fixed Income into EM Debt

-Global investors seeking to diversify their portfolio allocations are adding EM debt to their portfolios.

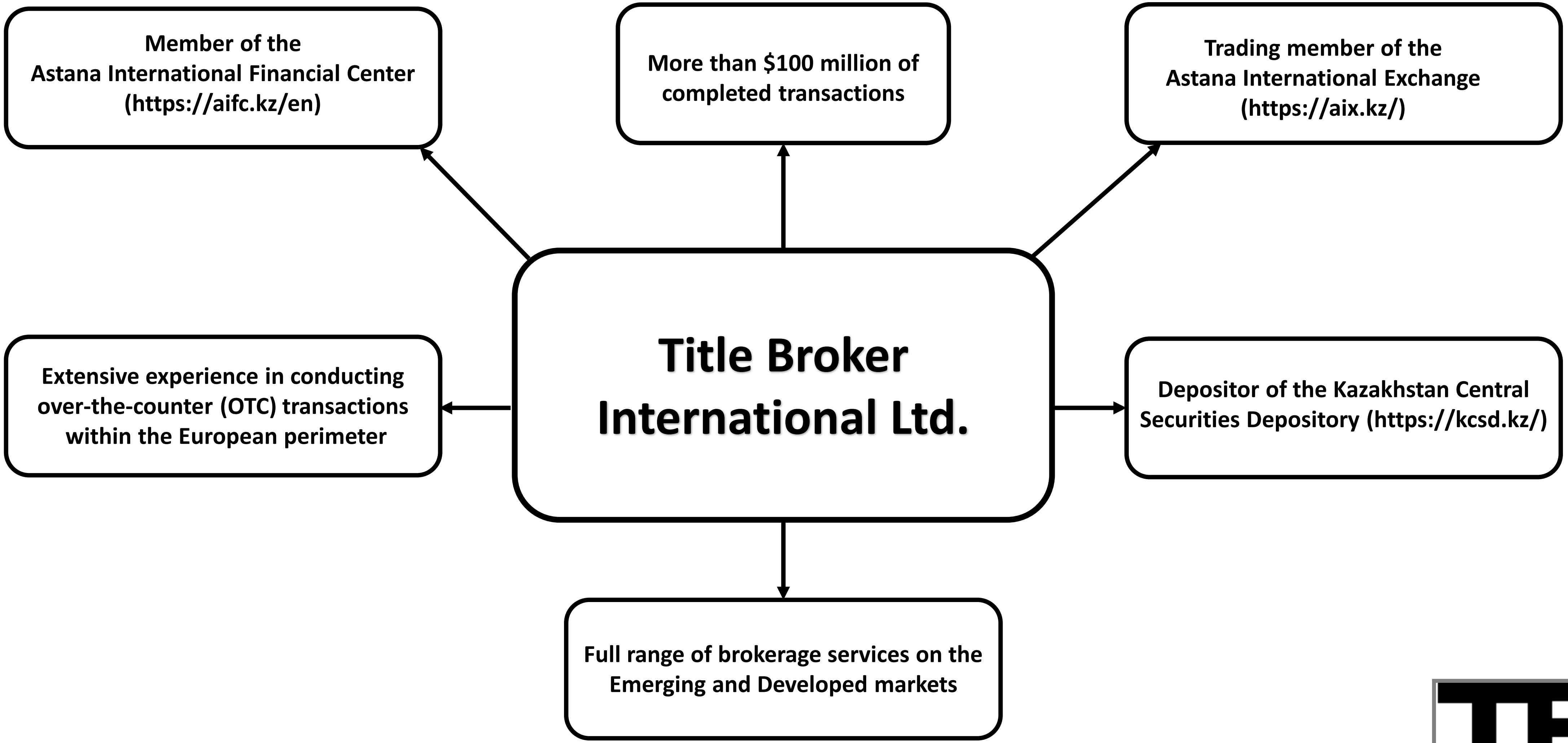
-Low investor positioning: EM remains an under-owned asset class

-Emerging markets debt (EMD) performance was mixed to start 2024. US economic exceptionalism contributed to a backdrop of broad dollar strength and higher real yields, but strong risk sentiment drove credit spread compression. Following a sharp decline in the fourth quarter of 2023, the yield on the 10-year US Treasury bond rose over 30 basis points (bps) to end the first quarter of 2024 at 4.2% as markets repriced Fed rate cuts to reflect an extended timeline and reduced magnitude. EM local debt yields fared better than core rates did but still increased roughly 10 bps during the quarter, while EM currencies fell nearly 3% in aggregate as the dollar spot index (DXY) increased around 3%. Meanwhile, EM sovereign credit spreads compressed by over 40 bps, with spread compression especially pronounced among high yield issuers.

-In local markets, EM central banks should continue to successfully combat inflation, providing room to cut interest rates and drive yields lower. We remain cautious on EM currencies in the near term as return expectations depend heavily on the performance of the US dollar. However, we believe EM local debt offers attractive opportunities over the medium term as the US dollar's long cycle appears to be overextended

-We believe we are currently in the second year of "easier" returns in EMD, following a challenging 2022 across all fixed income asset classes. Last year, EMD returned 10% to 12%, and we expect similar results in 2024. By 2025, we anticipate returns to normalize closer to the yield of the asset class. EMD portfolio management has returned to traditional bottom-up country and corporate analysis, with a focus on positive policy shifts driving spreads tighter in EM countries.

-The last positive trigger we expect for EMD is the return of investors. Over the past few years, EMD has seen outflows of around $135 billion as investors reallocated in favor of private credit, levered loans, and other less liquid asset classes. Portfolio flows typically follow performance, so we expect the inflows to return to EMD in mid-2024. If EM countries continue to improve policy, we believe this story can build upon itself and attract at least half of the money that left over the last couple of years.



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