

### Invesco Fixed Income

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#### Overview

- We believe the outlook for EM local rates is favorable as inflation worries subside and global rates decline.
- Currency carry in EM is attractive, in our view, and a stronger than expected Fed rate cutting cycle could allow upside appreciation in EM currencies versus the US dollar.
- A recent trip to Brazil left us more constructive on the 2024 outlook in terms of monetary and fiscal policy and prospects for growth and the currency.

## EM central banks: A measured approach to monetary policy

Looking back at 2023, the emerging market (EM) local asset class delivered on the performance we expected at the start of the year: As inflation declined, the early hikers – primarily in Latin America – began cutting interest rates while maintaining a healthy real rate differential with developed markets, particularly the US. In the late summer, when the US market narrative changed to a “higher-for-longer” rate environment, EM central banks maintained a conservative approach by either pushing out rate cuts or slowing their pace.

Despite the US Federal Reserve’s (Fed) dovish pivot in December, we continue to expect EM central banks to take a conservative approach to monetary policy until we see formal easing by the Fed. This dynamic highlights why most of the asset class’s year-to-date return came from income and lower EM rates, especially in Latin America, followed by Central and Eastern Europe, the Middle East and Africa (CEEMEA). Regarding currency performance, Latin America dominated as well, with the Colombian peso, the Mexican peso and Brazilian real gaining 26%, 15% and 9%, respectively, in terms of spot returns.<sup>1</sup>

#### 2024 outlook

Looking ahead, we believe the outlook for EM local rates is favorable. We expect global rates to decline as inflation worries subside. A Fed rate cutting cycle would likely allow Asian central banks to start easing as well. Currency carry in EM remains attractive, so even without a decline in the US dollar, we believe EM

currencies can produce positive returns. Additionally, we believe a stronger than expected Fed rate cutting cycle could lead to a decline in US dollar strength that could allow upside appreciation in EM currencies.

Given the current under-owned nature of EM local debt, we believe the growth and interest rate differentials between EM and developed market countries may be a catalyst for interest to return to the EM asset class. Idiosyncratic country developments are reasserting themselves as various growth and inflation dynamics emerge, offering greater diversity and opportunity. We remain focused on extracting alpha as these dynamics unfold.

From a monetary policy perspective, Asian central banks remained on hold in December, for the second month in a row, while CEE and Latin America continued to lower rates. The Czech central bank initiated its cutting cycle with a 25 basis point cut, while Hungary maintained its 75 basis point pace. Brazil cut by 50 basis points and Peru cut by 25 basis points, in line with previous cuts, while Colombia initiated its cutting cycle with a 25 basis point cut from 13.25 to 13%. Turkey, which has been normalizing its monetary policy, raised interest rates from 40% to 42.5% and we expect a final rate hike to 45% in January.

1. Source: Bloomberg L.P. Data as of Jan. 15, 2024.

## Notes from the ground | Brazil highlights

### Pre-trip baseline view

Ahead of our recent country visit, we were constructive on Brazil. It had good balance of payment dynamics, better growth, and faster disinflation than anticipated during the year, with an orderly economic slowdown in the second half and a decent outlook for recovery this year. We believed the fiscal side remained challenging, as the current administration will likely rely on higher revenue to finance higher spending, without stabilizing debt-to-GDP in the near term. At the same time, we expected the government to tackle structural problems and reforms. Debt levels are not comfortable, but debt is mostly local and financed largely domestically. We believed fiscal news would likely disappoint, and local investors already appeared to be taking that into account. In sum, we believed Brazil's problems were more medium-term than short-term in nature.

### Post-trip view

After a week of meetings, we remain constructive and more comfortable with Brazil's outlook for 2024, and even more so under a benign global macroeconomic backdrop. The central bank will likely continue to ease and is likely to cut more than what is currently priced into markets. Fiscal policy will likely remain noisy, but we do not see it spiraling out of control. Some local investors argue that Brazil is the only country whose support from commodities and high leverage supersedes politics. In keeping with this, many observers expect bad economic performance to lead to bad policy, such as excessive fiscal spending, as the government is seen as pragmatic. Overall, Brazilian assets are likely to perform well under the benign global macroeconomic scenario described above. Additionally, we believe the currency is well supported cyclically, given a benign macro backdrop, and structurally, given an improved trade balance, improved commodities performance and fiscal reforms. Below is a summary of our takeaways:

- **Asset prices:** We believe Brazil could present a tactical opportunity in rates and currency, given its strong agriculture sector and exports, as well as the structural story of the improvement in its trade balance and oil sector developments. Brazilian equities are also interesting, in our view, given an unlevered corporate sector and the potential for

shareholder-friendly activities, such as share buybacks, dividends, etc.

- **Politics:** President Lula's popularity has been waning, with crime and security deteriorating in the major capitals. He has prioritized more spending to reduce poverty. On foreign affairs, Lula will likely remain balanced and even-handed in his approach when engaging with major powers like the US, China, and the Middle East.
- **Agriculture:** The agricultural sector has been a standout performer, with significant wealth being created. Risks from El Nino appear more moderate this year, given that the bulk of the country's agricultural output is produced in the middle of the country, leaving it more sheltered from the extreme weather expected in the north and south.
- **Growth:** Low growth is also a risk topic, especially from the perspective of raising the fiscal pressure to spend. It is also a key structural issue and so the cyclical picture is important. Below we share our thoughts on the cyclical backdrop:

### Fiscal policy

The fiscal target is expected to be changed after the first bi-weekly revenue-expenditure report around March. Congress has two key tasks ahead of its summer recess: 1) approve the 2024 budget, and 2) approve the ICMS tax credit bill which is the larger issue in terms of generating new revenue for next year and increasing the chances of limiting the deficit shortfall next year.<sup>2</sup>

### Monetary policy

The terminal rate is expected to be single-digit next year, but this depends on the Fed, as the only constraint for the Brazilian central bank at this point is the external environment. Market bets on whether the terminal rate will be above or below 10% will likely not subside until there is clarity on Fed policy in the first half of 2024, although some believe that Brazil's central bank faces a lower limit of 9.5% with a stable Fed. We believe domestic factors are benign with moderate growth and slowing inflation. In terms of the final term of the central bank governor, most observers believe he wants to leave on a high note and will only bring rates down substantially if a clear scenario supports such a move. We believe a slow pace of cuts of 50 basis points per meeting would best manage the interplay between the currency and the terminal rate.

2. ICMS is Imposto sobre Operações relativas à Circulação de Mercadorias e Prestação de Serviços de Transporte Interestadual e Intermunicipal e de Comunicação.

### External balance

We believe the Brazilian real is structurally strong for two reasons. First, oil production has increased and will likely remain high for some time. Petrobras has revised up its estimates and the pre-salt

fields where it invests should allow for a substantial increase in production. Second, the agriculture sector, with strong expected productivity growth, should be supportive of the currency as well.

### Investment risks

The value of investments and any income will fluctuate (this may partly be the result of exchange rate fluctuations) and investors may not get back the full amount invested.

Fixed-income investments are subject to credit risk of the issuer and the effects of changing interest rates. Interest rate risk refers to the risk that bond prices generally fall as interest rates rise and vice versa. An issuer may be unable to meet interest and/or principal payments, thereby causing its instruments to decrease in value and lowering the issuer's credit rating.

The risks of investing in securities of foreign issuers, including emerging market issuers, can include fluctuations in foreign currencies, political and economic instability, and foreign taxation issues.

The performance of an investment concentrated in issuers of a certain region or country is expected to be closely tied to conditions within that region and to be more volatile than more geographically diversified investments.

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