



Emerging market debt: Looking beyond China

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- China is fast becoming a dominant theme in risk markets
- If the situation worsens further, a sizable flight to safety trades is likely
- Other markets, large and smaller, can offer attractive alternatives

It wasn't supposed to be like this

Many hoped that the opening of the economy following the end of zero-Covid curbs would fuel an economic surge, as when China rebounded from the 2008-09 global financial crisis, lifting the rest of the world. This view failed to account for the fact that China's myriad issues pre-date Covid, and its heavy-handed handling of the Covid-19 pandemic only made things worse, psychologically scarring the population. While some of the high frequency economic data has turned slightly more positive (a cyclical bounce?), the medium-to-long terms issues remain.

Consumer confidence remains shot, despite high levels of savings. Many people's wealth is tied up in wealth management products, Chinese equities and real estate – which have been battered. Youth unemployment is at record highs of more than 20%.¹ Meanwhile, trade tensions with the U.S. and slowing growth in Europe have cut exports, and companies have been restructuring supply chains away from China.

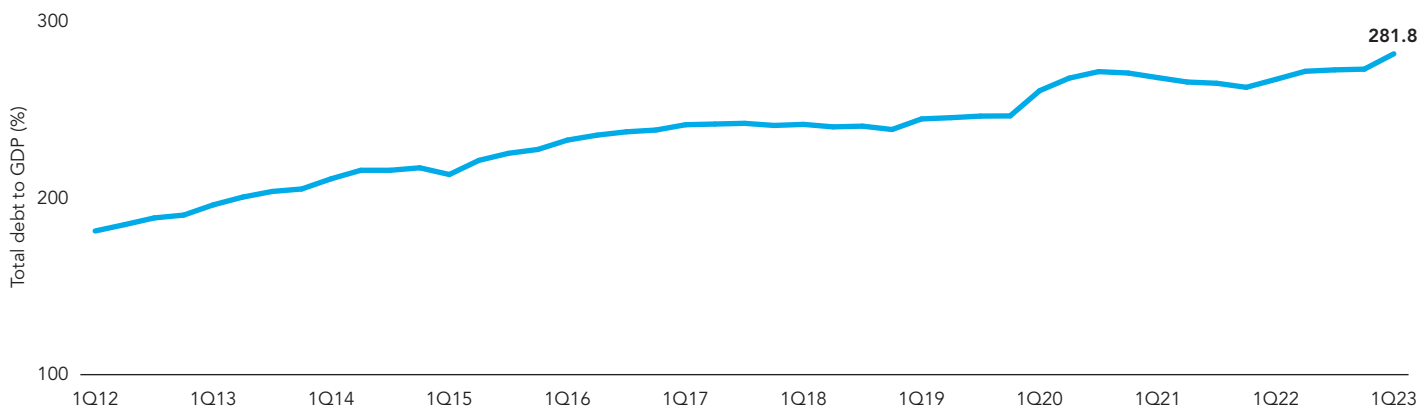
China isn't improving

Unlike his direct predecessors, President Xi Jinping has been antagonistic to the private sector and has consolidated power from all centers of government. This has discouraged entrepreneurship and weighed on the economy despite the fact that Chinese growth has long relied on sizable fixed investment and ongoing debt expansion.

One misconception about China is that everything is highly centralised. Regional governments actually do a lot of the heavy lifting in terms of investment and economic growth delivery. And they've already borrowed heavily, using land sales as a major source of revenue. With real estate in the doldrums, that door is largely closed. For bondholders, the whole sector is uninvestable.

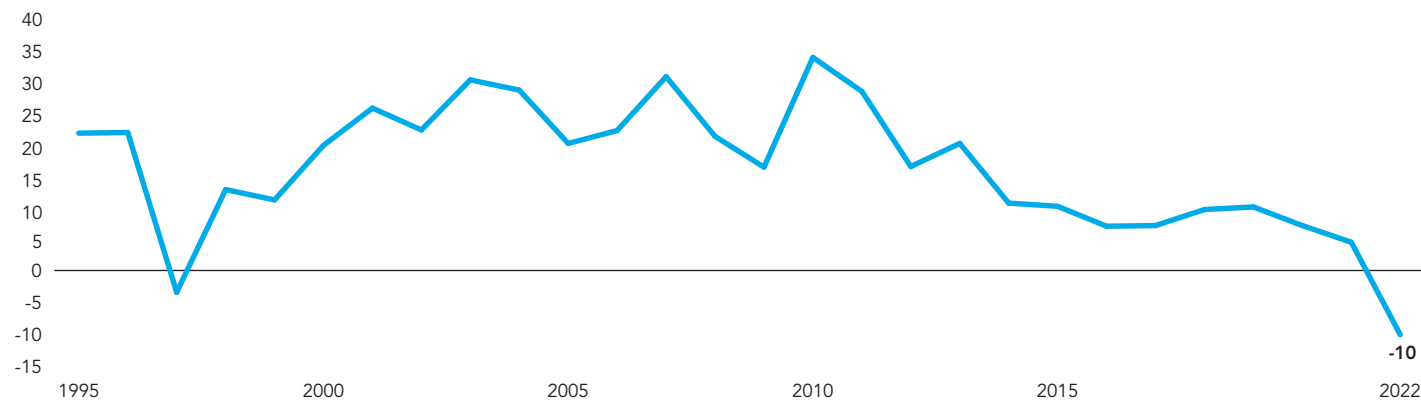
The Beijing government has been left with limited options. Tax cuts are possible, but they would have to be broad based and funded. The monetary policy moves we have seen so far are not enough. But central government has thus far been hesitant to bail out local governments and embark on a large-scale fiscal stimulus package. The Politburo and State Council have at least acknowledged the problem, and could still embark on meaningful stimulus, but the clock is ticking and the longer they leave it the bigger the costs.

Chinese total debt problem



Source: Haver Analytics

Annual investment in China real estate development %



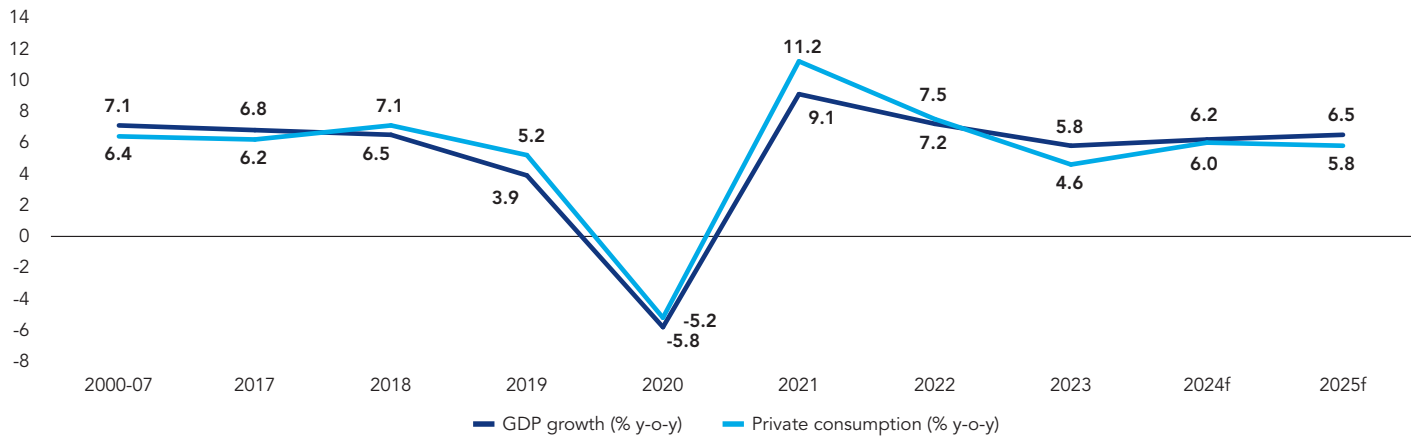
Source: Haver Analytics

¹China youth unemployment hits high as recovery falters - BBC News

India comes into focus

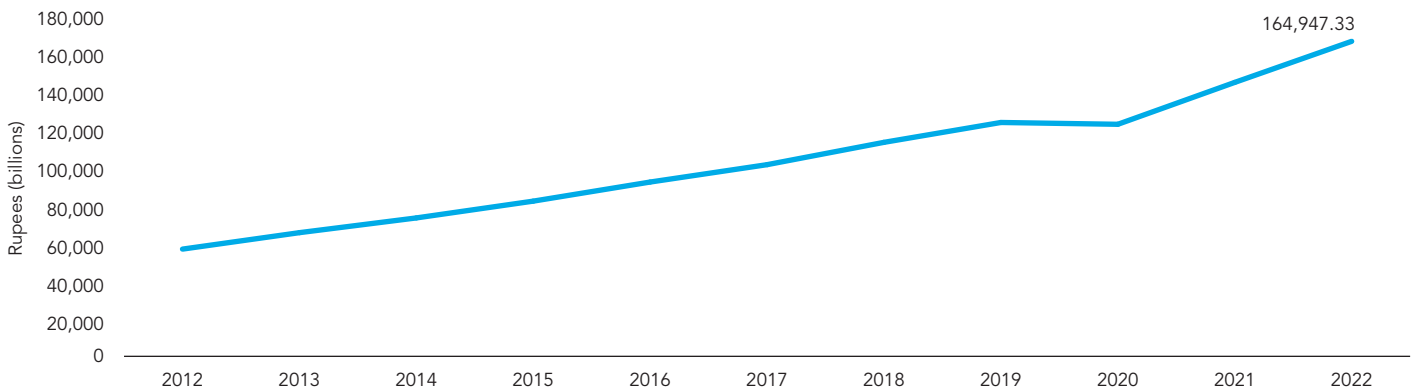
India's finance minister, Nirmala Sitharaman reminds us that India continues to be the fastest growing large economy.² Speaking at a meeting of the International Monetary Fund (IMF) Board of Governors on the theme of "Dialogue on Policy Challenges" in Marrakesh, Morocco, in October, Sitharaman emphasized that a coordinated response of the global community will foster multilateralism in the spirit of 'One Earth, One Family, One Future'. Sitharaman had earlier said that domestic consumption and investment demand will drive economic growth, but inflationary pressures may remain elevated, warranting greater vigilance by the government and the Reserve Bank of India (RBI). The finance ministry and the RBI have projected India's economic growth to be around 6.5% in FY25 compared with 7.2% in FY22. The IMF has raised its economic growth forecast for India from 6.1% to 6.3% for the current financial year. This compares to projected global growth expected to slow from 3.5% in 2022 to 3% this year, well below the historical average.

India GDP and private consumption



Sources: Central Statistical Organization, Reserve Bank of India

India private consumption expenditure



Sources: Central Statistical Organization, Reserve Bank of India

²India continues to be fastest growing large economy - FEX



Fundamental analysis for Indian corporates reveals a range of positives

Steel companies consider excess supply from China to be absorbable because infrastructure planned expenditures are still very high in India. While the level of steel and concrete per unit of industry in India pales other large emerging economies, the government is committed to large infrastructure spending.

India's power and fuel supplies are diverse, which can partially offset what has traditionally been an import reliance on hydrocarbons, helping slowly move the dial as the country increases its commitment to green energy while still benefitting from discounted oil supplies from Russia.

India's sovereign balance sheet metrics are robust, and debt is not significant to GDP. The Indian consumer is still relatively robust and still spending, and GDP projections are 6+%. The recent inclusion of India in the JP Morgan GBI EM Index, although focused on local debt issuance, still may be a positive attention grabbing catalyst for dollar bonds.

Mexico and others may also help fill the void

There are many reasons to like Mexico. Many of its public companies are doing well, with solid balance sheets, robust earnings and strong cash flows. There is a diversity of sectors with well-established, well-managed, low-leveraged corporates in which to invest.

Mexico GDP grew for a seventh straight quarter in Q2 at a 3.6% year-over-year pace, and its unemployment rate is just off record lows 3.0% as of August. Manufacturing, machinery capex and especially services have driven the improvement, with exports hitting a record high. Consumer spending has been robust, abetted by a cheap peso vs. the dollar and by solid job growth. While a potential slowdown in the U.S. would be a headwind, Mexico's underlying strengths should give its economy staying power.

As the United States' primary trading partner and, along with Canada, a signatory to the new NAFTA pact (USMCA), Mexico has been a major beneficiary of this onshore/nearshore movement. Its labor and construction costs not only tend to be the lowest of the three member countries but also are competitive with other emerging markets. Mexico's public debt to GDP is less than half that of the U.S., and in the past few years, the government under President Andres Manuel Lopez Obrador has moved to aggressively refinance and extend its debt. Its central bank began tightening a year before the Fed, helping protect the peso and put it in a good position to benefit as the Fed pauses and at some point starts to ease.

Cautious optimism remains warranted

The importance of looking beyond China has been born out recently by outperformance in countries such as Mexico, Brazil, Peru, and Turkey. Ghana and even Ukraine have improved on the prospects of bondholder-friendly debt restructuring. Global macro risks remain centered around central banks' responses to inflation, with the path of the U.S. Federal Reserve and strength of the U.S. dollar particularly important due to the wide range of potential impacts. Recent events in the Middle East add to a range of existing geopolitical risks. All of these factors underline the importance of being flexible and vigorous in identifying and assessing opportunities across emerging markets.

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