NCRAM Emerging Market Hard Currency Market and Tariff Impact Review

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Market Recap and Tariff Impact on EM Hard Currency Debt

The announcement of new US tariff policy on “Liberation Day” (April 2) trigged significant volatility in the global credit markets. EM hard currency bonds were unable to avoid the resulting market turmoil, particularly at the beginning of the month. However, after the early overreaction, EM credit managed to recover most of the losses by month-end. After the initial uncertainty, the market quickly began to focus on identifying the likely winners and losers of the announced trade policies. In addition, some tangible signs of tariff policy de-escalation, along with a recovery of US Treasuries and continuing supportive technical factors, drove the strong recovery into month-end. Ultimately, resilient EM credit fundamentals positioned the market favorably to weather the risks of tariff policy uncertainty.

EM corporate bonds, as measured by the JPMorgan Corporate Emerging Market Bond Index Broad Diversified (CEMBI BD) ended April with a negative return of -0.43% m/m and a YTD positive return of +1.98%. CEMBI credit spreads ended the month at 258 bps, which is 52 bps wider YTD but 20 bps tighter than the peak during April. Meanwhile, EM sovereign bonds, as measured by the JPMorgan Emerging Markets Bond Index Global (EMBIG) ended with a close to flat -0.08% return in April, bringing the YTD return to 2.26% and spreads 38 bps wider to 335, also about 20 bps tighter from the peak in April.

Aside from the broader credit spread decompression between the investment grade and high yield market segments, credit differentiation in terms of tariff impact was a key performance driver. We note that while the new trade policies are global in nature, only a few EM countries that we define as being representative of our investment universe are meaningfully impacted, such as Mexico, China, and South Korea.

In the EM corporate debt segment, exposure to China is mostly concentrated in technology or financials, while industrial names represent only a negligible share of the investment universe. Latin America ex-Mexico was almost entirely spared higher reciprocal tariff rates, and on a sector basis we believe that only a small share of issuers in CEEMEA are fundamentally affected by the immediate tariffs, notwithstanding possible longer-term economic and inflationary effects on the global economy. We hold very little exposure to the export-oriented manufacturing sectors most directly affected by the tariffs. For EM sovereigns as a whole, the countries that underperformed the most in April were high yield oil producer credits (mainly in Africa) or other low-rated commodity producers in Central Asia like Sri Lanka or Pakistan, confirming the point that the tariff shock was more indirect via lower commodity prices.

In sectoral terms, the key underperformer was oil and gas, down -1.88% in April according to the CEMBI BD index. Oil-focused exploration and production companies were particularly impacted. This underperformance was driven by the double threat stemming from fears around loosening OPEC production discipline as well as possible disruption in global trade and transport. Although the gaming sector in Macau initially widened significantly, we believe this underperformance was driven by technical rather than fundamental factors, and accordingly we have seen spreads tighten back to March levels. Beyond these more idiosyncratic underperformers, we found less cyclical industries that constitute a substantial part of our investment universe and portfolio, including telecommunications, infrastructure, and utilities, to be more resilient, widening less initially and retracing most (if not all) of their widening in spreads.

In terms of sovereigns, not surprisingly, high yield credits underperformed in April overall with a -0.42% decline vs. a +0.17% gain in investment grade sovereigns. At the same time, we saw several positive idiosyncratic credit developments such as Ecuador (elections) and Argentina (conclusion of new IMF program and easing of capital controls) that resulted in strong performance that was captured by our investment strategies.

Overall, we took advantage of a comparatively light exposure to the lower-rated energy sector. Our high yield overweight generated some performance headwinds in early April. However, many of these positions reflected high conviction credit calls that benefitted from strong price recovery into month-end. We also selectively took advantage of several larger price dislocations driven by market illiquidity rather than credit fundamentals.

Tactically, we also invested in some high yield sovereign credits like Angola, Nigeria, and Mexico that allowed us to capture the market bounce efficiently.

EM Outlook

We believe that credit spreads have room to recover further from current levels. Our base case is that the US economy will avoid a hard recession but instead will hover between soft landing (NCRAM's previous base case scenario) and a mild recession, a scenario likely to be accompanied by lower interest rates. In this environment, we continue to see conditions for the EM hard currency and EM sovereign debt markets to deliver solid returns at the index level, with potentially more upside for sovereigns in the event of more aggressive rate cuts, but more defensive performance in corporates overall.

We see elevated risks in the lower credit quality oil and gas sector, where we remain particularly selective about our exposure. In the more cyclical commodity space, we continue to prefer metals and mining as a sector with a more stable supply/demand outlook supported by strong balance sheets. We remain constructive on higher quality, shorter duration, non-cyclical high yield issuers with strong fundamental profiles. Following the recent credit spread widening, we increased our exposure to non-cyclical investment grade issuers across regions. While slower growth may introduce some headwinds, the robust fundamental quality of the investment universe should be able to absorb the effects of slowing economic growth.

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