The Major bond letter

#32. Emerging victorious

Free to View
Fixed Income - Rates

Global

Steven Major, CFA
Global Head of Fixed Income Research
The Hongkong and Shanghai Banking Corporation Limited

Both developed and emerging bond markets have enjoyed a bull market for back-to-back quarters. Not that it felt like one, as for many investors this was just a clawing back of losses incurred prior to the third quarter of 2022.

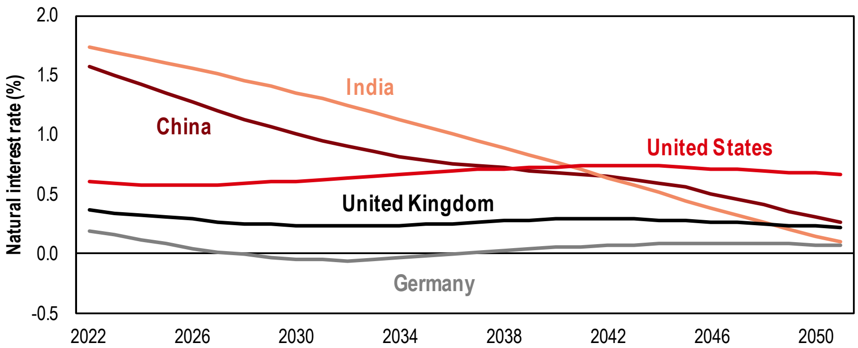
What a surprise then that, despite all the fuss over persistently high inflation and consistently hawkish central banks, EM has outperformed DM. Since the low point on 24 October 2022, the Bloomberg EM local rates index has returned 12%, whilst Treasuries are up 7% (used here to represent the biggest DM). Explanations typically range from EM central banks tightening in advance of their DM peers, to a big shift in sentiment and positioning after the turn in the dollar and peak for yields.

We think there might be a lot more to the recent EM victory over DM. It may be part of a more structural trend. Against a backdrop of excessive leverage and policy uncertainty in the developed world, there are parts of EM that can claim to be a better alternative. At a minimum, levels of risk may be no greater in EM which, if true, means the additional returns on offer are even *more attractive*. Good potential returns[1], adjusted for risk.

So it was with intrigue that we read the recent IMF report on the natural rate of interest[2]. The words "natural" and "equilibrium" are both used to describe the longer-run real rate of interest for an economy, the rate – adjusted for inflation – that neither stimulates nor contracts the economy. We discussed how today's US policy rate is approximately double the Fed's estimate of the natural rate in the *last bond letter*. Our analysis has looked at how the natural rate is determined by longer-term trends for drivers such as demographics, debt levels, productivity, and technology.

We were drawn to the chart below from the IMF report. Note how EM natural rates, represented here by China and India, are projected to fall to meet their DM equivalents, which remain close to their pre-COVID-19 levels. In about a decade's time, natural rates for India and China will be close to those in the US, and not long after, they will be below, if these projections are realised.

Falling EM natural rates whilst DM rates remain stable – the IMF's view



Source: HSBC, Platzer and Peruffo (2022), IMF World Economic Outlook April 2023

This is a Free to View version of a report with the same title published on 17-Apr-23. Please contact your HSBC representative or email AskResearch@hsbc.com for more information.

[1] Return = total return = the change in price plus coupon received.
[2] The Natural Rate of Interest: Drivers and Implications for Policy, International Monetary Fund (April 2023)

Modelling the data over the last 40 years, the IMF analysts found that the most important determinants explaining the declining natural rates were demographic forces and total factor productivity. They found that in some countries, fiscal financing needs could push up real natural rates. Whilst we found similar results on productivity and the impact of ageing populations, rising DM debt has generally been associated with lower real rates. The picture is more mixed for EM, particularly with regards to the debt impact, which in the past attracted additional risk premium.

On the outlook for natural rates, the IMF expects the adoption of more advanced technology in EM to likely result in convergence of total factor productivity onto DM. In addition, the acceleration of ageing populations in EM will require more saving, much like their DM counterparts where this is well underway.

The IMF analysis has a similar conclusion to our own on the structural backdrop for the longer-run real rate. But this does not mean it will be right. The alternative view is that something has changed – particularly with regard to debt, demographics and productivity – in the last few years, so that we do not return to the pre-pandemic trend of falling natural rates.

Below we discuss general assumptions behind the projections for natural rates and what could pull them up or down.

First, for DM, increased government spending and larger budget deficits have previously been associated with lower real yields. But what if a tipping point has been reached such that the relationship reverses? We saw what happened last September in the UK with the government's radical fiscal policy proposals; the market didn't like it. Excessive leverage could hence mitigate the relative safety of DM assets.

Second, EM debt is presumably less likely to suffer from the loss of safe asset status if it didn't have it to begin with. Indeed, while EM total debt-to-GDP ratios tend to be lower than DM, this has not resulted in lower EM bond yields in the past.

Third, demographic assumptions can be challenged. We assume that ageing populations will save more, but we cannot be certain of what the future will hold. What if circumstances and behaviour changes such that older cohorts of the population are forced to save less or even cut into their existing savings aggressively?

Fourth, recent years have seen many countries prepare to borrow more to finance the transition to net zero. Subsequent debt overhangs may continue to push down on rates, but the aggregate impacts will also depend on any productivity gains from such investments. Some argue that debt-financed defence spending could be supportive for real rates.

Fifth, globalisation is already starting to look very different, and whilst deglobalisation may be too strong a call, there are signs of regional fragmentation to both trade and finance channels. The IMF report's conclusion is that it likely pushes the natural rates up in DM and down in EM.

Overall, we find that incorporating the natural rate in our analysis helps us to look through the near-term noise of the economic and business cycles. Today's market valuations are formed by an aggregation of views from the entire universe of participants, and these tend to have a fair bit of recency bias. The most recent inflation print and employment data dominate the market today but don't give us the broader context needed for projecting bond yields.

If the IMF's projections for real natural rates prove correct, there are grounds for longer-term optimism in EM bonds. This potentially represents a structural shift, and thus a much bigger deal than the recent turn in the dollar and Treasury yields that have provided the bullish tailwind.

Previous editions of 'The Major bond letter'

#1. *Eurozone common issuance*
#2. *How to spice it up in a dull market*
#3. *New year, old narrative*
#4. *Beneath the surface*
#5. *The bond market sell-off*
#6. *Treasuries and trees*
#7. *Inflation rationality*
#8. *Lucky number*
#9. *Stuck in the middle*
#10. *Taper and the Hole*
#11. *Every basis point counts*
#12. *Push back*
#13. *Game of chicken*
#14. *Across the pond*
#15. *The most insightful question*
#16. *QT teaser*
#17. *Hikes that won't stick*
#18. *China-US divergence*
#19. *Warp speed*
#20. *Usefully wrong*
#21. *Second half narrative*
#22. *Curve cacophonia*
#23. *Breathe (in the air)*
#24. *EM reaps rewards*
#25. *The Grizzly*
#26. *Bring it on*
#27. *Funny old game*
#28. *Japan's curveball*
#29. *The penultimate hike*
#30. *Score draw*
#31. *See-saw*

Disclosure appendix

The following analyst(s), who is(are) primarily responsible for this document, certifies(y) that the opinion(s), views or forecasts expressed herein accurately reflect their personal view(s) and that no part of their compensation was, is or will be directly or indirectly related to the specific recommendation(s) or views contained in this research report: Steven Major, CFA

This document has been issued by the Research Department of HSBC.

HSBC and its affiliates will from time to time sell to and buy from customers the securities/instruments, both equity and debt (including derivatives) of companies covered in HSBC Research on a principal or agency basis or act as a market maker or liquidity provider in the securities/instruments mentioned in this report.

Analysts, economists, and strategists are paid in part by reference to the profitability of HSBC which includes investment banking, sales & trading, and principal trading revenues.

Whether, or in what time frame, an update of this analysis will be published is not determined in advance.

For disclosures in respect of any company mentioned in this report, please see the most recently published report on that company available at *www.hsbcnet.com/research*.

Additional disclosures

1. This report is dated as at 17 April 2023.
2. All market data included in this report are dated as at close 14 April 2023, unless a different date and/or a specific time of day is indicated in the report.
3. HSBC has procedures in place to identify and manage any potential conflicts of interest that arise in connection with its Research business. HSBC's analysts and its other staff who are involved in the preparation and dissemination of Research operate and have a management reporting line independent of HSBC's Investment Banking business. Information Barrier procedures are in place between the Investment Banking, Principal Trading, and Research businesses to ensure that any confidential and/or price sensitive information is handled in an appropriate manner.
4. You are not permitted to use, for reference, any data in this document for the purpose of (i) determining the interest payable, or other sums due, under loan agreements or under other financial contracts or instruments, (ii) determining the price at which a financial instrument may be bought or sold or traded or redeemed, or the value of a financial instrument, and/or (iii) measuring the performance of a financial instrument or of an investment fund.

Disclaimer

Issuer of report
The Hongkong and Shanghai Banking Corporation Limited
.

This document has been issued by The Hongkong and Shanghai Banking Corporation Limited, which has based this document on information obtained from sources it believes to be reliable but which it has not independently verified. Neither The Hongkong and Shanghai Banking Corporation Limited nor any member of its group companies ("HSBC") make any guarantee, representation or warranty nor accept any responsibility or liability as to the accuracy or completeness of this document and is not responsible for errors of transmission of factual or analytical data, nor is HSBC liable for damages arising out of any person's reliance on this information. The information and opinions contained within the report are based upon publicly available information at the time of publication, represent the present judgment of HSBC and are subject to change without notice.

This document is not and should not be construed as an offer to sell or solicitation of an offer to purchase or subscribe for any investment or other investment products mentioned in it and/or to participate in any trading strategy. It does not constitute a prospectus or other offering document. Information in this document is general and should not be construed as personal advice, given it has been prepared without taking account of the objectives, financial situation or needs of any particular investor. Accordingly, investors should, before acting on it, consider the appropriateness of the information, having regard to their objectives, financial situation and needs. If necessary, seek professional investment and tax advice.

The decision and responsibility on whether or not to purchase, subscribe or sell (as applicable) must be taken by the investor. In no event will any member of the HSBC group be liable to the recipient for any direct or indirect or any other damages of any kind arising from or in connection with reliance on any information and materials herein.

Past performance is not necessarily a guide to future performance. The value of any investment or income may go down as well as up and you may not get back the full amount invested. Where an investment is denominated in a currency other than the local currency of the recipient of the research report, changes in the exchange rates may have an adverse effect on the value, price or income of that investment. In case of investments for which there is no recognised market it may be difficult for investors to sell their investments or to obtain reliable information about its value or the extent of the risk to which it is exposed. Some of the statements contained in this document may be considered forward looking statements which provide current expectations or forecasts of future events. Such forward looking statements are not guarantees of future performance or events and involve risks and uncertainties. Actual results may differ materially from those described in such forward-looking statements as a result of various factors.

This document is for information purposes only and may not be redistributed or passed on, directly or indirectly, to any other person, in whole or in part, for any purpose. The distribution of this document in other jurisdictions may be restricted by law, and persons into whose possession this document comes should inform themselves about, and observe, any such restrictions. By accepting this report, you agree to be bound by the foregoing instructions. If this report is received by a customer of an affiliate of HSBC, its provision to the recipient is subject to the terms of business in place between the recipient and such affiliate. The document is intended to be distributed in its entirety. Unless governing law permits otherwise, you must contact a HSBC Group member in your home jurisdiction if you wish to use HSBC Group services in effecting a transaction in any investment mentioned in this document.

Certain investment products mentioned in this document may not be eligible for sale in some states or countries, and they may not be suitable for all types of investors. Investors should consult with their HSBC representative regarding the suitability of the investment products mentioned in this document.

HSBC and/or its officers, directors and employees may have positions in any securities in companies mentioned in this document. HSBC may act as market maker or may have assumed an underwriting commitment in the securities of companies discussed in this document (or in related investments), may sell or buy securities and may also perform or seek to perform investment banking or underwriting services for or relating to those companies and may also be represented on the supervisory board or any other committee of those companies.

From time to time research analysts conduct site visits of covered issuers. HSBC policies prohibit research analysts from accepting payment or reimbursement for travel expenses from the issuer for such visits.

The Hongkong and Shanghai Banking Corporation Limited is regulated by the Hong Kong Monetary Authority.

[1211595]