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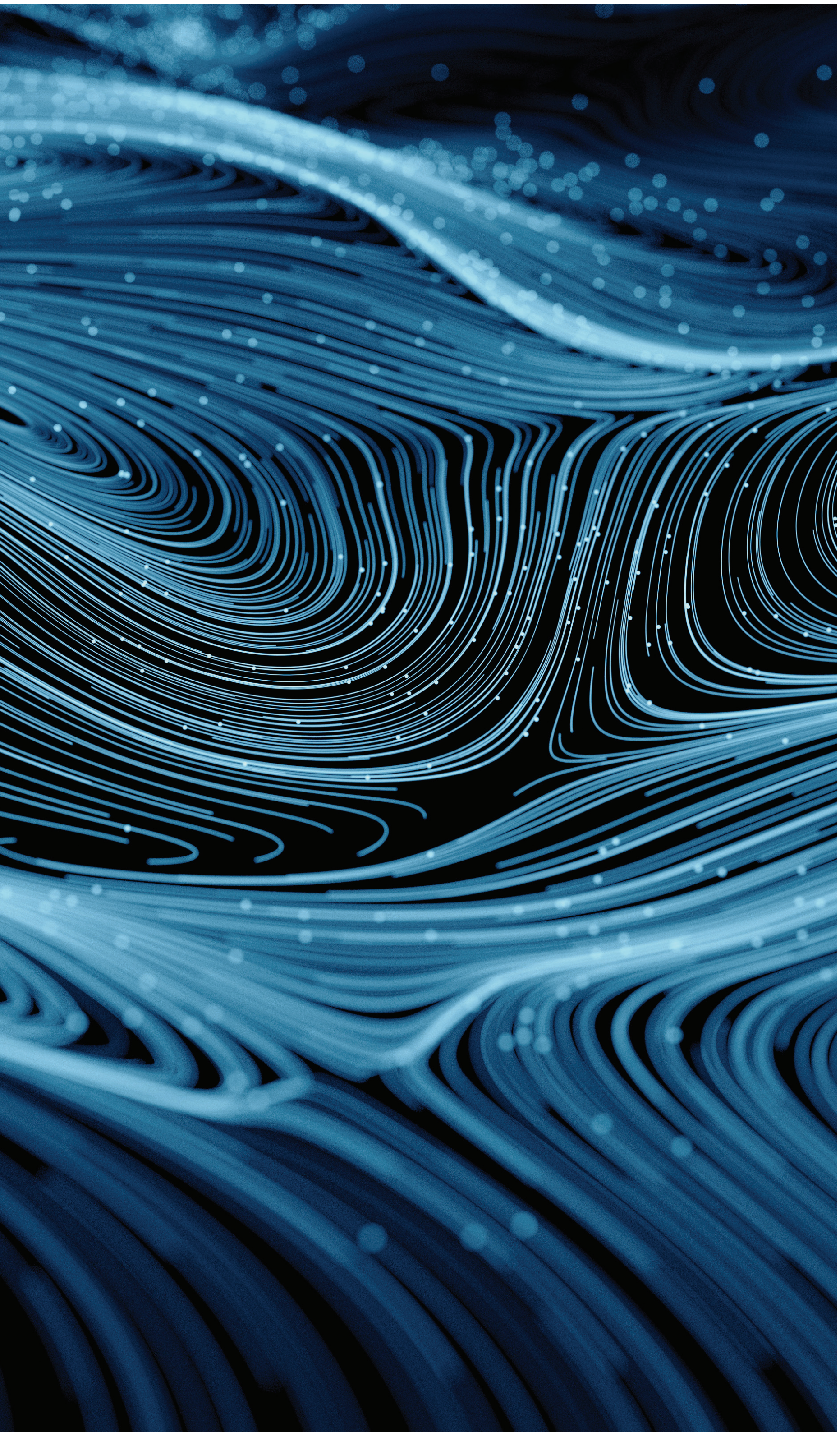
INVESTMENT MANAGEMENT



2021 Market Outlook
Favourable Winds for Emerging Market Debt

Conditions for EMD outperformance in 2021 appear to be in place. First, a global backdrop of steady, extended monetary accommodation, prospects of a large-scale deployment of COVID-19 vaccines by 1H21, and, to a lesser extent, expectations of fiscal stimulus in the U.S., should boost the growth-sensitive segments of the asset class. Therefore, HY credit, EM FX and local currency high-yielders should outperform IG, which has less of a valuation cushion, and is vulnerable to potentially steepening DM yield curves in our opinion. Moreover, the next U.S. administration may alleviate trade tensions, thus widening EM-DM growth differentials, which are a key driver of portfolio flows into emerging markets. Furthermore, the consensus weak U.S. dollar view, if accurate, would further strengthen the case for investing in EM fixed income, though we note that a weaker dollar is not a necessary condition for EMD outperformance next year.

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FIXED INCOME | GLOBAL FIXED INCOME TEAM

External Debt

In external debt, our fair-value sovereign spread model *(Display 1)* suggests that the most attractive opportunities are in HY sovereign/quasi-sovereign bonds.

Country-Specific External Debt Opportunities:

- Overweight Egypt: Offers value on the back of strong commitment to reforms, ongoing cooperation with multilateral organisations, resilient activity indicators and high real yields.
- Overweight Ukraine: Provided the government puts the IMF program back on track, following recent setbacks on key reform items.
- Overweight Turkey: If the incipient shift toward more orthodox economic policies proves sustainable.
- Underweight Sri Lanka: Despite cheap valuations, the recently released 2021 budget failed to dispel debt sustainability concerns.

Local Currency Debt

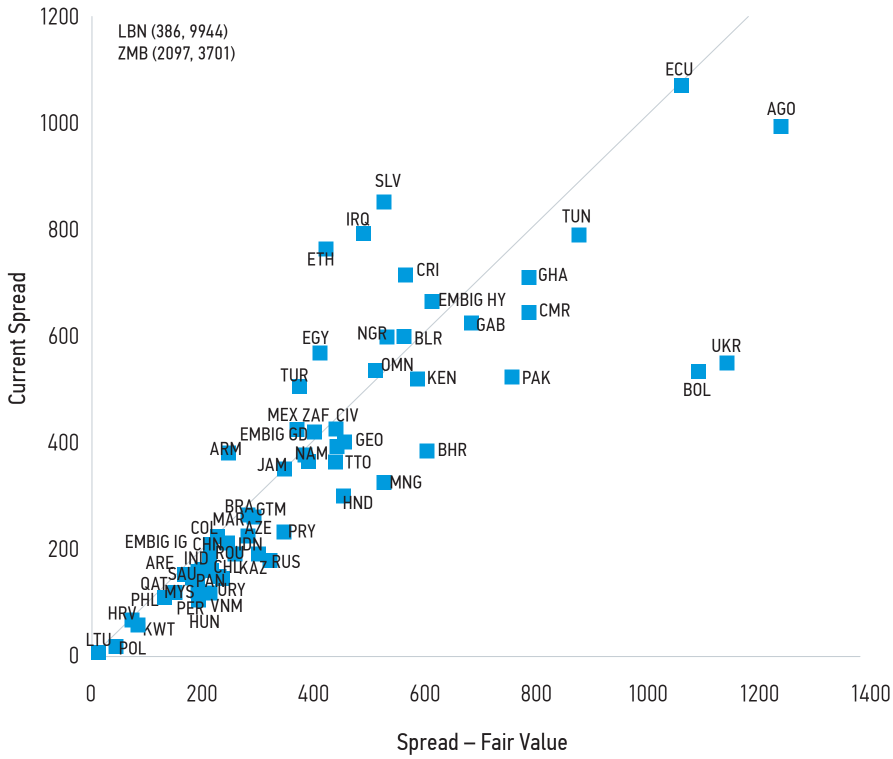
We believe opportunities in local rates can be found primarily in high yielders. These should outperform in scenarios of higher global growth via a reduction in risk premia, and their relatively high yields should help provide cushion in a DM yield curve steepening scenario.

Country-Specific Local Currency Debt Opportunities:

- Overweight duration in Russia, South Africa (the steepest curve in EM) and Indonesia, and to a lesser extent in Mexico.
- Brazil rates look attractive but we remain neutral for the time being, as we assess the government's willingness properly to address its poor public debt dynamics.
- Finally, we stay on the sidelines in low yielders such as Czech Republic and Thailand, on their vulnerability to improved global economic prospects next year.

DISPLAY 1

Fair Value Sovereign Spread Model



Forecasts/estimates are based on current market conditions, subject to change, and may not necessarily come to pass. This is for illustrative purposes only and is not meant to depict the performance of a specific investment. **Past performance is no guarantee of future results.**

Source: Bloomberg, MSIM, November 2020.

EM Corporate Debt

Overweight Asia:

- China: We remain comfortable with our overweight. We have taken advantage of the new issue market to add exposure to the new economy/consumer sector and continue to favour the real estate sector. We are encouraged in the short term by the resilience of the larger companies, which have, with few exceptions, delivered meaningful earnings growth, and in the medium term from the rollout of the government's Three Red Lines policy aimed at reducing leverage across the sector.
- Elsewhere in Asia: The outlook remains relatively benign with our overweight positioning outside China remaining predominantly across Indian (utilities) and Indonesian credit.

Mixed Positioning within the Middle East:

- The Middle East property sector remains challenging, although we believe the worst may already be over, with regional malls/hotels/offices reopening toward the end of the second quarter.
- We are more constructive on the utilities and infrastructure sectors, while the outlook for consumer staples has improved.

Underweight EM Europe:

- Our positions are driven more by individual credit views than macro-trends (particularly in countries such as Turkey).
- In our view, geopolitical risks challenge the attractiveness of valuations for Russian corporates despite the strength of their credit fundamentals.

Idiosyncratic Opportunities in Latin America:

- We favour Latin America nondiscretionary consumer and commodity sectors where demand appears to be stabilising and prices have settled into a more healthy range.
- Outside of idiosyncratic stories such as Argentina, which from a corporate perspective is not yet out of the woods, the outlook is fairly constructive.

Conclusion

We began this piece by stating the factors which we believe support the overall case for EM debt in 2021. In addition, technical factors enhance our optimistic outlook. We believe that an increasing EM-DM growth differential and a continued search for yield should drive inflows back into EM. There is ample room to recover on this front, particularly in local currency debt, which still shows outflows of $3.4bn year-to-date versus inflows of roughly $12bn last year, and record highs of over $42bn in 2017.[1]

Notwithstanding our constructive outlook for the asset class next year, we highlight potential risks. First, a delayed deployment of vaccines in EM would require extended policy support by governments, exacerbating fiscal and debt sustainability concerns, particularly in countries that entered the pandemic with fragile balance sheets. There exists the potential for debt restructurings and defaults, though in our view, they would not pose a systemic risk for the asset class. We believe that an active approach to investing in EM debt is an effective way to help ameliorate these risks.

More generally, a delayed transition to fiscal consolidation, whether it is caused by logistical hurdles in deploying vaccines in EM or by governments' reluctance to incur the political cost of fiscal austerity, may prompt the market to demand higher risk premia in EM fixed income assets. Finally, optimism about reduced trade frictions under a Biden administration (particularly, in U.S.-China relations) may prove to be faulty and could challenge our positive scenarios for global trade and growth, and thus negatively impact the performance of high-beta-to-growth EM assets.

Emerging market debt provides relatively higher yields and the potential for strong 2021 returns. While there are risks for EMD in 2021, we believe the tailwinds of strong monetary and fiscal support, coupled with the delivery of the COVID vaccine, along with a potentially weaker U.S. dollar, lay the foundation for a continuation of last quarter's strong rally.

[1] Source: JP Morgan

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