EMERGING MARKETS DEBT – MONTHLY MARKET MUSINGS

Pushing frontiers beyond aid

FEBRUARY 2025

As the new US administration settles into the White House, some uncertainty persists over its policy agenda. This has challenged the consensus view of "US exceptionalism" with which investors began 2025. With the stockmarket and the US dollar lower, and questions around the extent of any US fiscal savings, the latest confidence surveys have made markets fear a turn to softer US growth. In this context, higher yielding opportunities in less correlated frontier markets can be appealing for investors equipped with local knowledge and a disciplined approach to risk management. We highlight these amid a new challenge – the cut in US aid and other potential developments on the horizon.

The past month has been nothing short of a whirlwind for markets. It kicked off with significant uncertainty around what the new US administration would prioritise, but with the broadly held conviction that any new policies would lead to robust US growth, a US stockmarket rally, the rise of cryptocurrencies and a strong US dollar. "US exceptionalism" was the consensus view at the start of the year.

Since President Donald Trump took power on 20 January, volatility has been high, as investors have been weighing up declarations regarding duties and tariffs. But the US stockmarket is down (fig. 1) and so is Bitcoin. The pricing-out of interest rate cuts by the US Federal Reserve has largely run its course, while key areas of fiscal policy are being worked out. Investor focus is switching to whether efforts by the Department of Government Efficiency (DOGE) to cut federal spending, a lag in tax cuts, and the oversized responsibility bestowed on the American "middle class" to keep spending will, in fact, usher in an economic slowdown. Polls such as the Conference Board and University of Michigan surveys suggest markets believe growth may soften, going forward.

In the meantime, the J.P.Morgan EMBI Global Diversified index has returned 3% year-to-date, despite some modest spread widening. Emerging market foreign currencies (EMFX) have outperformed the US dollar (fig. 1), despite new US tariffs being announced on China and Mexico.

J.P.Morgan's Next Generation Market Index (NEXGEM), meanwhile, has returned 3.4% year-to-date. Opportunities in the Dominican, Egyptian, Nigerian and Kazakh local markets have been in vogue, to name but a few. Many emerging and frontier markets fly below the White House's tariff radar. Many of these sovereigns have also delivered the largest fiscal improvements witnessed in recent years, after the pandemic. These have often been accompanied by disinflation and a commitment to stay the course on structural reforms, rendering these sovereigns some of the biggest recipients of investment flows.

Still, should US business confidence take a dive and prompt meaningful revisions in US forecasts, appetite for emerging market high-yielding opportunities could be tested. Frontier markets typically offer higher yields with lower correlation to the rest of the market, albeit with shallower liquidity. But they are also more vulnerable to the aid cuts recently announced by the US administration, and to the possibility of the US withdrawing support for multilateral development banks – see below. Approaching such less liquid investments requires local economic and market knowledge as well as effective portfolio risk management. Nevertheless, we think this approach can unlock lucrative opportunities in this component of the emerging markets asset class.

Fig. 1 US equities vs EMFX since Trump's inauguration

Source: AllianzGI, Bloomberg, as at 28 February 2025.

In focus: Sieving through executive orders

On 4 February, President Trump signed an executive order, which reads that the Secretary of State should review "all international intergovernmental organisations of which the US is a member and provides any type of funding or other support [...] to determine which organisations, conventions, and treaties can be reformed [...] and provide recommendations as to whether the US should withdraw".

The US has already withdrawn from the World Health Organisation and other UN agencies and halted aid disbursements from its own development institution, the US Agency for International Development (USAID). The impact of these decisions is being felt, especially in some of the poorer developing countries, including many frontier markets. Nigeria has added a USD 200 million (0.05% GDP) appropriation in its 2025 budget to cover health expenditure previously funded by US support, while Kenya will no longer receive USD 650 million a year (0.5% GDP), which mostly went on health. The US President's Emergency Plan for AIDS Relief, which has helped over 50 countries bring the HIV epidemic under control since it was launched by President George W. Bush in 2003, has also been halted. The lost monetary support may appear modest for the majority of countries, but the loss of technical assistance, knowledge transfer and logistical support are harder to quantify, alongside the social impact.

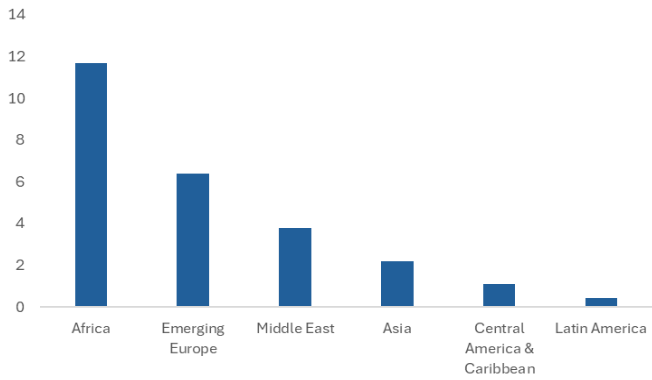
Which organisations will be considered in scope of the review is hard to say but they could include any UN body, trade organisation or multilateral development bank such as the International Monetary Fund (IMF) and the World Bank. The conservative policy plan Project 2025 recommends US withdrawal from both of these. Here, we assess the impact that any reduction or permanent stop to US aid could have on the frontier markets in which we invest.

USAID: another one bites the dust

Secretary of State Marco Rubio and presidential adviser Elon Musk have suspended all aid and terminated most employees at USAID. It remains unclear whether the agency will be folded into the State Department – a trend seen in recent years in other countries – or whether it will cease to exist. In the last decade, the USAID budget has been roughly USD 50 billion per year, with median disbursements of around USD 240 million a year for the top 50 recipients. Leaving aside Ukraine, individual country receipts have been modest in absolute terms. The top 10 recipients are Jordan, Yemen, Ethiopia, Congo, Somalia, South Sudan, Nigeria, Sudan and Kenya. This makes Africa – including both Sub-Saharan and North Africa – the largest recipient region, followed by Asia and the Middle East (fig. 2). While absolute numbers are small, they can be meaningful portions of a country's GDP or fiscal revenues. USAID support has been on average 2.4% of GDP or 9% of revenues for Jordan and 1.5% of GDP or 7% of revenues for Zambia, for example.

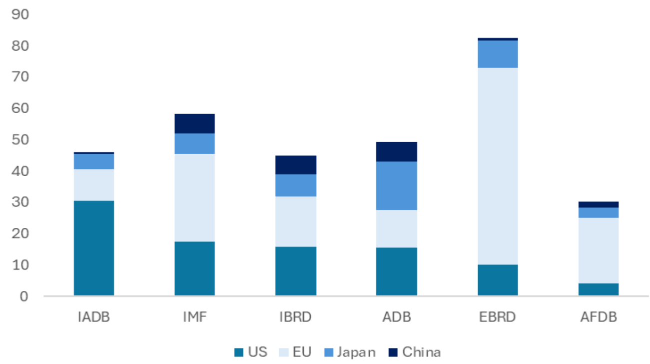
Mr Rubio says he will make exceptions to the USAID cuts, for instance in the case of Costa Rica. Overall, we do not think that the withdrawal of USAID funding would degenerate in macroeconomic instability for most frontier markets; however, the social consequences are harder to assess.

Fig. 2 USAID funding to EM sovereigns (USD bn)



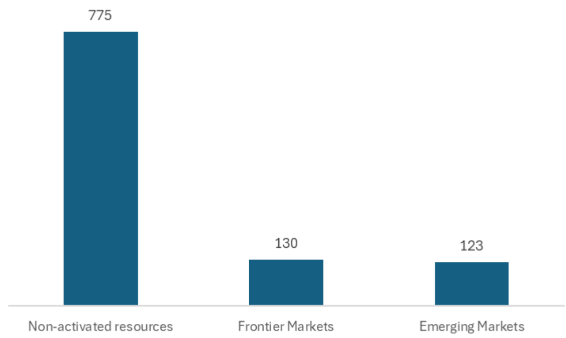
Source: AllianzGI, US Government, as at 28 February 2025.

Fig. 3 Shareholdings in major development banks (%)



Source: Inter-American Development Bank (IADB), International Monetary Fund (IMF), International Bank for Reconstruction and Development (IBRD), Asian Development Bank (ADB), European Bank for Reconstruction and Development (EBRD), African Development Bank (AFDB), AllianzGI, as at 28 February 2025.

Fig. 4 IMF lending capacity (USD bn)



Source: AllianzGI, IMF, as at 28 February 2025..

The impact on multilateral development banks

The executive order has also raised concerns that the US may withdraw from multilateral development banks, including the IMF and the World Bank. The US is the single largest shareholder in each of these and a meaningful one in many regional development banks (fig. 3). Since inception the president of the World Bank has always been an American nominated by the US government.

Fig. 5 IMF programmes in frontier markets

Country	Program	USD mn	% Quota
Ethiopia	ECF	3,400	848
Kenya	ECF/EFF	4,454	615
Costa Rica	EFF	2,389	485
Ecuador	EFF	4,000	430
Sri Lanka	EFF	2,934	380
El Salvador	EFF	1,400	360
Ghana	ECF	2,987	304
Egypt	EFF	8,134	299
Serbia	SBA	2,534	290
Pakistan	EFF	7,100	262
Jordan	EFF	1,200	262
Paraguay	PCI	403	151
Morocco	FCL	1,300	109
Zambia	ECF	1,307	100
Armenia	SBA	172	100
Georgia	SBA	280	100

Source: AllianzGI, IMF, as at 28 February 2025.

This level of ownership gives the US a unique ability to channel these organisations' priorities and project its own soft power around the world. Indeed, withdrawing from them could call into question their very role – at least for the IMF and World Bank. It is important to note that, from a funding perspective, US annual contributions to multilateral development banks are rather modest. Most of the funding for these organisations comes from borrowing from the capital markets alongside other income such as fees paid by members. In the last five years, the US contributed USD 24 billion to the World Bank, while in the same period the bank issued USD 220 billion in Eurobonds.

Should the US withdraw from the multilateral development banks, it is conceivable their lending would fall, not so much due to the loss of US direct contributions but through a decline in the ability to issue debt. The banks could see their credit ratings cut, as ratings agencies Fitch and Moody's have indicated. This would impact their borrowing costs and pool of capital, with more expensive, smaller loans passed on to their end "customers". Of course, a shareholder reducing its stake could lead to another one, such as China, increasing its own. In the past, the US has pushed back on such reallocation of quotas to China. At a time when the two largest economies in the world are competing for influence, a US withdrawal from development banks would seem counterintuitive. An exit would also mean the US would shoulder alone more of the risk associated with financing large projects in many countries, which are often financed under a multilateral umbrella. For this and other reasons, a US exit from multilateral development banks is not our base case. We find it more likely the US would change its approach to work within these organisations to tilt them in a direction more aligned with its priorities. Nevertheless, the risk of an exit has significantly risen over the past month, so it is important to highlight that, if it occurred, it would have to follow the specific prescriptions of each bank's statute.

The UK recently set a precent when it exited the European Bank for Reconstruction and Development (EBRD) following Brexit. With the EBRD's other shareholders stepping up to cover the capital, the bank's work was virtually unaffected. Of course, the potential repercussions of a US exit, not just on capital, but on confidence in these institutions, could be more severe.

In all this, the distinctiveness of the IMF makes it stand apart from the other development banks. While always headed by a European, the US is its single largest shareholder and significantly influenced its policy direction. The IMF has provided a backstop to countries in times of balance-of-payments crises. While the bulk of its lending goes to Latin America (specifically, Argentina and Ecuador), it has been most active in Africa, in terms of both the number of programmes and the growth of its lending, since Covid-19. Many African countries (fig. 5) signed onto IMF programmes as market access was curtailed in the aftermath of the pandemic. IMF financing also catalyses additional funding from other development banks. Commitments under the New Arrangements to Borrow are up for renewal at the end of this year alongside a proposal to proportionally increase IMF quotas. Both would require US Congress approval. A decision to exit would likely deliver a hit to sentiment in the near term, rather than a significant reduction in the ability of the IMF to operate. It would, however, have big implications for the international economic order.

What does this mean for frontier market investors?

In recent years, the prospect of an "IMF put" – financing and technical support from the IMF – has prompted many investors to allocate capital to frontier markets. From El Salvador to Ghana, to Egypt and Sri Lanka, the backstop provided by IMF programmes has boosted investors' confidence, re-established market access and rallied additional donor support. However, we should also highlight the number of frontier markets that have set off on homegrown reform paths. Without IMF support, they have successfully restored macroeconomic stability or strengthened their institutions, becoming recipients of sizeable investment flows. Nigeria and Uzbekistan are recent examples. Political will, not external support, remains the key driver of positive change in any country, in our view.

It will be crucial to monitor the impact of any aid cuts on countries' health and educational outcomes, social stability and climate resilience, as well as institutional and technical capacity. None of these tend to be short-term investment drivers. However, experience has taught us that they can help us avoid significant drawdown events. Examples are those that hit investors during the defaults of Ghana and Sri Lanka, whose fiscal transparency and budgetary process indicators had been worsening over time. In our experience, avoiding large drawdowns is as important as picking top performers when it comes to delivering portfolio outperformance. This year, frontier investment opportunities have been in favour. We remain confident that will remain the case.

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