Investment Insights

Navigating dark clouds across emerging markets debt

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Marketing communication

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It has been an unrelenting year of negative headlines, with a war in Ukraine, inflation concerns and recession fears jolting investors into a frenzy. Capital Group Investment Director David Cheng sat down with Portfolio Manager Luis Freitas de Oliveira to discuss his thoughts on the challenging macro backdrop, the investment implications for emerging markets debt (EMD) and how, in his view, the asset class remains investable amid the growing headwinds.

How has EMD evolved as an asset class over the years?

Emerging market debt has broadened and deepened significantly in the last few decades. As a result, the asset class has become significantly more appealing to a broader investor base. Issuance has increased, thereby improving liquidity and yield curves have become more developed, allowing us to add value across different maturities.

In the early stages, emerging market debt primarily traded defaulted bonds from a few large countries, primarily in Latin America. Although returns were higher, so were the risks. Today, the investable universe has grown tremendously to become significantly more diversified, which allows us to capture a range of opportunities with different risk return profiles. Hard currency bond investors now have access to sovereign credits from 69 countries, with no single country dominating the index.[1] With greater variety comes a higher-risk credit profile. Most of the countries that raise debt exclusively in hard currency are lower-rated, export-dependent nations whose economies are at an earlier stage in their transition to becoming more developed. This is reflected in the ratings distribution. The average credit rating of sovereign emerging market dollar bonds is BB+, compared with BBB for local sovereign bonds.

Ratings distribution[2]

GBI-EM GD	BBB	EMBI GD	BB+
AA	5.0%	AA	7.5%
A	28.5%	A	16.2%
BBB	42.2%	BBB	28.3%
BB	20.7%	BB	22.3%
B	2.7%	B	20.9%
<CCC & others	1.0%	<CCC & others	4.8%

How are emerging markets coping with the current inflationary period?

Emerging markets (EM) historically have had much more experience in dealing with higher inflation rates. Many EM central banks have been better prepared and much more proactive in responding to the current pricing pressures, raising interest rates well before developed markets. As a result, inflation has already plateaued and is starting to come down in some emerging markets, having established high real rates. A couple of EM currencies have also stabilised, which has helped to support financial conditions rather than add to inflationary pressures.

1. As at 31 August 2022. Index: JPMorgan EMBI Global Diversified Index. Source: JPMorgan
2. As at 26 August 2022. GBI-EM GD: JPMorgan GBI-EM Global Diversified Index. EMBI GD: JPMorgan EMBI Global Diversified Index. Source: BlackRock Aladdin. Totals may not reconcile to 100% due to rounding.

Where do you see opportunities among EM bonds?

Hard currency EM high yield bonds offer quite a significant premium relative to US high yield bonds. Some of the higher yielding credits in countries, such as the Dominican Republic, as well as Egypt and Tunisia look attractive. We are more selective within EM corporate high yield, and remain cautious about the Chinese property sector.

Within local currency bonds, we are finding opportunities in Latin America following steep interest rate hikes. Inflation linked bonds in Brazil, Mexico, and Columbia have already priced in high real rates. Countries in Latin America were also large beneficiaries of rising commodity prices and were less exposed to the conflict in Ukraine.

Opportunities in Central Europe look to be on the horizon. The low interest rate environment that we have seen in Europe for years is coming to an end. Central banks across the region have been aggressively hiking rates to tame inflation. Starting yields are now significantly higher, presenting an attractive entry point for investors.

We remain cautious within Asia, as the region is still a few months behind Latin America in the tightening cycle. However, extensive fundamental research allows us to uncover opportunities, even in those countries that are behind the curve.

Do you expect US dollar strength to continue to weigh on local currency markets?

The US dollar will likely continue to strengthen on the back of aggressive monetary policy tightening by the US Federal Reserve, a robust US economy and weaker growth in Europe and China.

While most EM currencies appear very cheap, a strong dollar continues to be a headwind to local currency bonds. In order to target the strong real returns that valuations are suggesting, we would need to see an end to this strong US dollar cycle. However, none of the factors mentioned above seem likely to change anytime soon, so the dollar rally will likely continue.

Once these factors start to change, the dollar could weaken very quicky, given its current high valuations. If investors want to start positioning portfolios for a downturn in the dollar cycle, EM local currency might be one of the most attractive asset classes in fixed income.

EM equities have lagged US equities since the 2008 financial crisis in the magnitude of hundreds of percentage points. Why is there such a significant performance disparity, and do you see more value in EM equities or EM debt?

There is a common misperception about EM equity returns. When we compare EM equities to the S&P 500 Index the difference in total returns is huge. Likewise, when comparing to the MSCI World Index. However, it's important to remember that the world index primarily consists of US-based companies. If you compare returns to the EAFE index, which excludes the US and Canada, you find that returns are actually very similar.[2]

However, in our balanced portfolios we still see a better risk return profile in EM local currency bonds relative to EM equities.

[2] Comparison of returns between different indices is in US dollar terms

What role do EM corporate bonds play in a portfolio?

We like to hold EM corporate bonds alongside EM sovereign bonds in our portfolios. The geographic representation and risk structure of EM corporates is quite different to sovereigns, thus providing an element of diversification.

The shorter-dated investment-grade bonds inside the corporate world offer more defensive positioning. These bonds have proven to be quite resilient during times of volatility. You also benefit from some spread pick-up relative to an equivalent non-EM bond of equal duration and rating.

China is the biggest EM country and one that investors are most worried about. How are you navigating the complexities around China?

On the ground fundamental research supported by comprehensive global macro analysis is especially important when investing in China. We need to think carefully about the policy tailwinds or headwinds individual sectors or companies could face and how different industries and companies fit into China's vision of Common Prosperity.

However, it is important to remember that while EM corporate bonds as a standalone asset class are very much dominated by China, EM hard and local currency bonds as a whole are not very exposed to the region.

Given the surge in energy and food prices, a few EM countries are experiencing financial stress while others have already defaulted. How important is the International Monetary Fund (IMF) in dealing with sovereign distress?

The IMF has become significantly faster in its responses and more flexible in its plans, partly due to greater funding. The framework of the IMF has evolved over the years and, as a result, has become a lot more robust. Bond markets are now in a much better position to deal with sovereign distress relative to the past. The fact that more than 20% of the hard currency universe globally is comprised of the more vulnerable single B and below rated credits means that IMF programmes will likely play a larger role in how we arrive at our investment decisions.

Conclusion

The investable universe for emerging market debt has grown significantly in the last few decades. As active managers, we have been able to capture a range of investment opportunities with different risk return profiles.

The ongoing aggressive pace of interest rate hikes from many developed market central banks remains a key headwind for EM debt. With volatility likely to persist, we think a balanced and risk prudent approach to investing in emerging markets is crucial. However, valuations have markedly improved, and EM debt is starting to offer attractive returns potential for long-term investors. We see attractive opportunities in select higher yielding hard currency sovereign and corporate bonds, as well as in certain local currency countries that have been proactive in their monetary policy responses.

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