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Why now for Emerging Market Hard Currency Debt?

Three reasons to allocate

Werner Gey van Pittius
Co-Head of Emerging Market Fixed Income

Thys Louw
Portfolio Manager

Overview

A typical question that asset allocators have posed in recent months is whether a 'US Treasury+ spread' asset class such as emerging market (EM) hard currency sovereign debt warrants a place in their portfolio, particularly in an environment of heightened economic and political uncertainty. Here are three reasons why we think it does and why now is a good entry point.

1. **Cyclical and structural tailwinds** bode well – both for the macro dynamics in many emerging markets and for the return outlook of the asset class.

2. The increasing diversity in this often under-researched, uncrowded investment universe creates **alpha-capture potential** that's hard to match.

3. Thanks to prudent policymaking, EM economies have **increased their resilience** and are leading the rest of the world when it comes to reducing debt vulnerabilities.

We also share insights into how best to navigate the asset class and pitfalls to avoid in portfolio construction.

1. Asset-class tailwinds

Spreads and the Fed

After several false dawns, the turn in the US interest cycle is finally in sight. Crucially for investors in emerging market (EM) hard currency debt, that portends well for asset-class returns. History has shown that following periods when US Treasury yields peaked, the 12-month forward return was historically higher in the EM market than in the US high-yield market.

Figure 1: Average 12-month return after 5-year US Treasury yields reach 3.5% to 4.5%

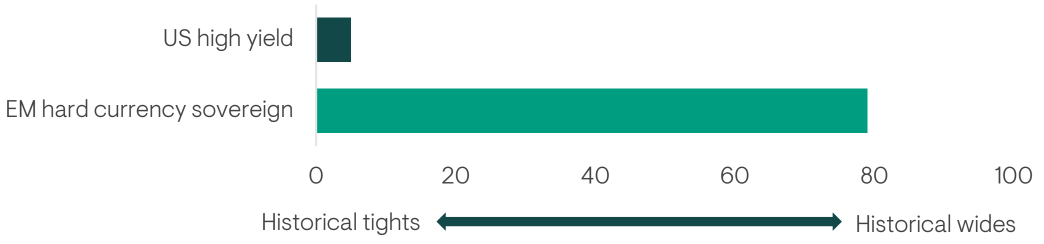
Asset class	12-month forward return potential*	Current duration	Current yield
US high yield	6.0%	3.3 years	7.9%
EM hard currency sovereign debt	8.9%	6.5 years	8.4%

Past performance does not predict future returns; losses may be made.

Source: Ninety One and Bloomberg, analysis range January 2003 – March 2024, US HY uses BofA Indices, EM Sov uses JP Morgan EMBI GD. *Historical average 12-month return after 5-year US Treasury yields reach 3.5% to 4.5%. Duration and current yield is at June 2024.

Furthermore, current spread levels are supportive of the return outlook. While spreads in the EM hard currency sovereign debt universe are still wide relative to their 10-year history, in the US high-yield market, they are close to the tightest they have been in the last decade (Fig. 2). In the context of the significant upside surprises seen in EM economic growth data in the first half of 2024 and differentiated progress on disinflation, we believe EM credit spreads should remain resilient, provided the US economy continues to avoid a hard landing (as is our base case expectation).

Figure 2: Current spreads relative to 10-year history (percentile rank)



Source: JPMorgan, Ninety One calculations, as at 28 June 2024.

Structural shifts

From a more structural perspective, many EM economies are benefitting from the changing trading relationships emanating from political change. As developed and emerging countries pursue their national interests, new spheres of influence are forming, reshaping the global landscape, with profound implications for globalisation, economic policies, currency and commodity valuations, and geopolitics. The transition to this multipolar landscape is being marked by increased geopolitical tensions, conflicts, and a more complex and fragmented global order. Simultaneously, an increasing number of countries, particularly in the so-called Global South, have chosen to remain non-aligned, unwilling to be pawns in a larger geopolitical game.

What does this mean for emerging markets? Winners will be those countries that diversify their economies, build strong regional alliances, and can navigate between different global powers. For example, countries in Central and South America, such as Mexico and Costa Rica have benefitted as US companies build manufacturing operations nearer to home. Similarly, India has benefitted as companies like Apple, following the COVID-triggered supply chain crisis, has implemented a plan to ship 40% to 45% of iPhones from India, compared to a single-digit percentage in 2022[1]. Conversely, those heavily reliant on a single economic partner or resource, or those isolated internationally, might face challenges.

This is likely to lead to further differentiation in economic prospects among the growing number of countries in the EM hard currency debt universe, a wider dispersion of returns, and greater opportunities for active managers.

[1] Wall Street Journal, November 2022.

2. Alpha-capture potential

As the EM hard currency market has evolved and matured, it has become significantly more diverse. From being dominated by Latin American markets at its inception, the flagship index (JPMorgan EMBI Global Diversified, or 'EMBI') has broadened to include an increasing number of 'frontier' markets and a number of investment-grade Middle Eastern markets. Frontier markets now account for around a quarter of the EMBI. Figure 3 illustrates the significant growth in EMBI constituent countries and the growing weight of less well researched markets; from a ratings perspective, Figure 4 shows how this dynamic has been balanced by the introduction of higher rated Middle Eastern markets.

Figure 3. EMBI number of countries and "frontier" weight in EMBI

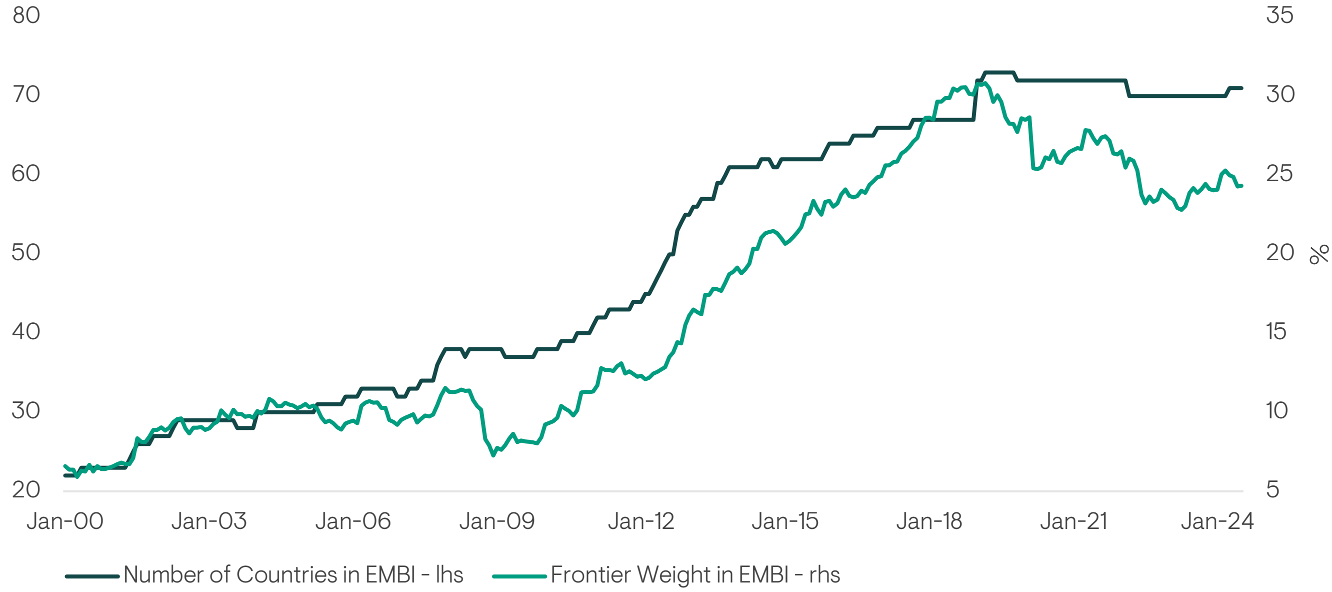
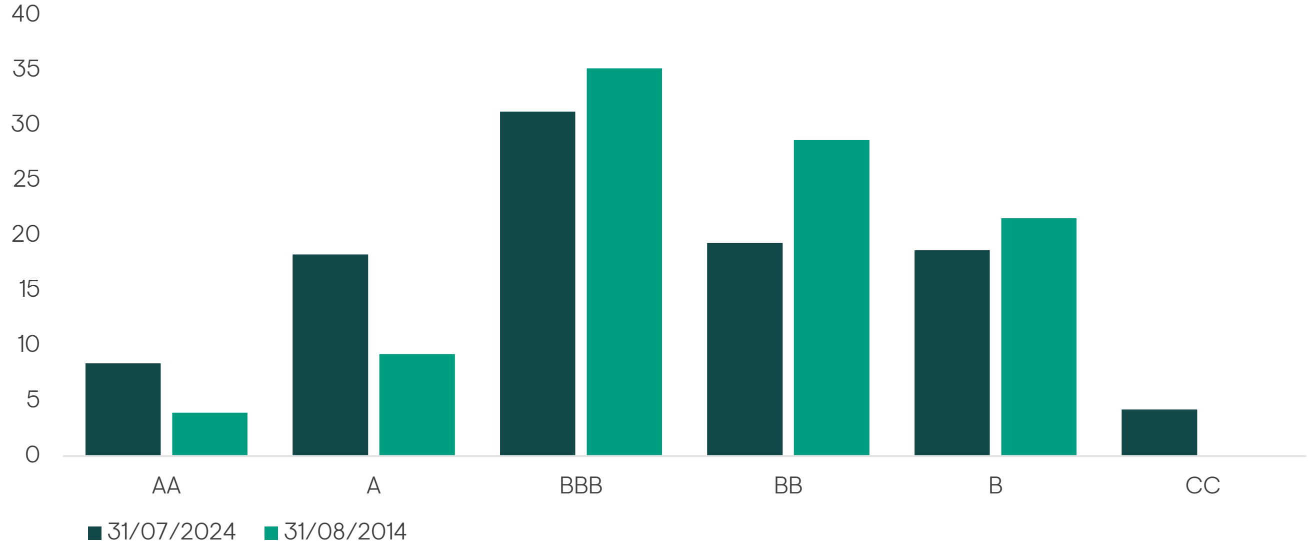


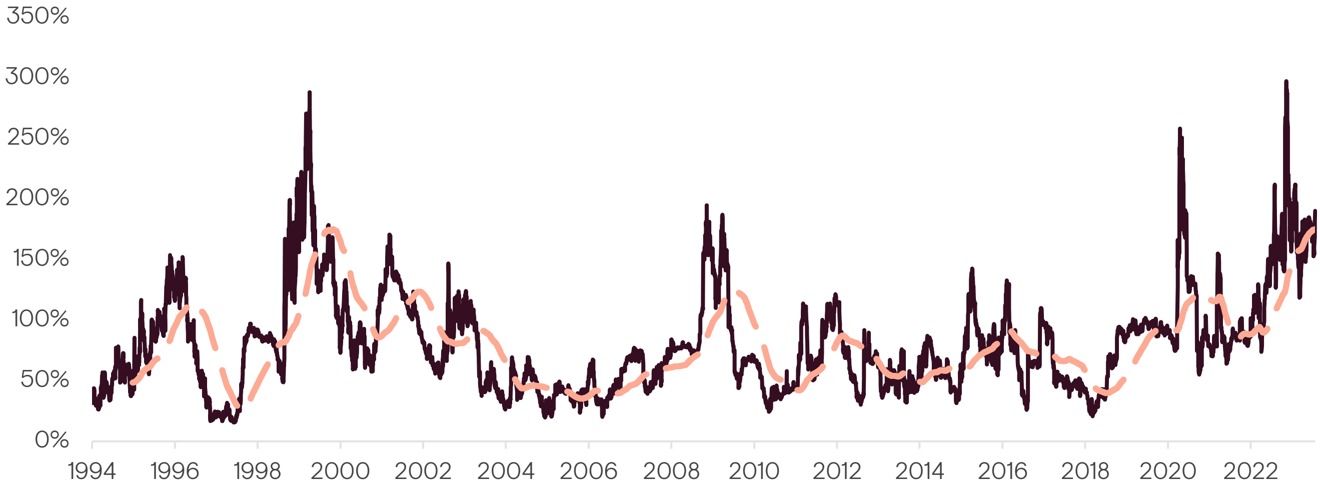
Figure 4. EMBI index composition by rating, %



Source: Bloomberg, JP Morgan, as at 31 July 2024. For further information on indices, please see Important Information section.

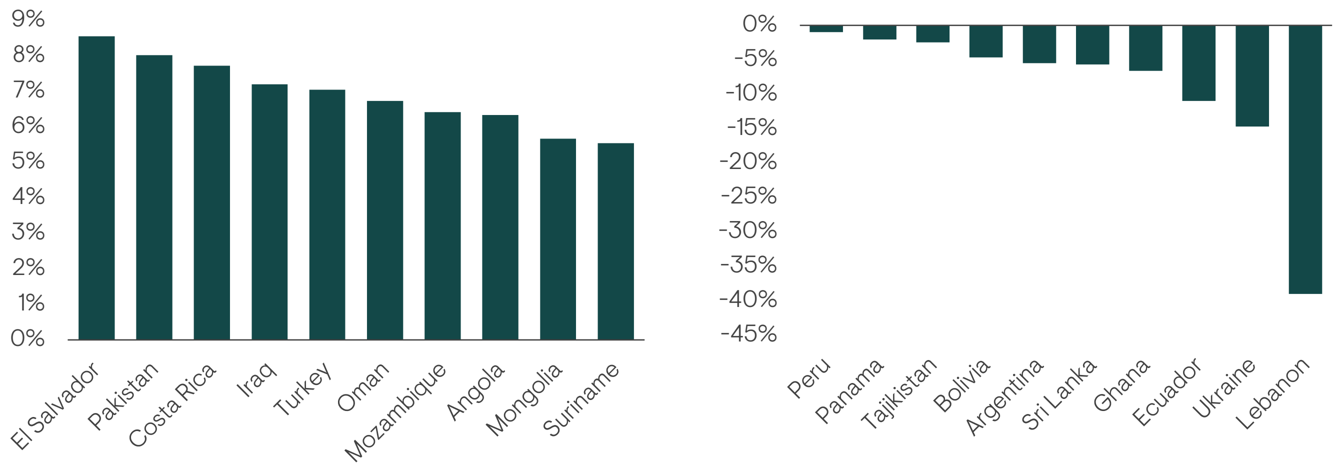
The broadening of the asset class has resulted in a high level of return dispersion within it – as evidenced in Figures 5 and 6. This is a pattern that we expect to continue, as market volatility is likely to remain more elevated than in the recent past due to lingering political and geopolitical risks, which will result in winners and losers, as noted above.

Figure 5. Dispersion between the top and bottom country year-on-year returns



Source: Bloomberg, Ninety One Calculations. Solid dark line is the top performing EMBI country minus the worst. The dashed line is a 1 year moving average. For further information on indices, please see the Important information section.

Figure 6. Top 10 EMBI Performers (return p.a.) **Bottom 10 EMBI Performers (return p.a.)**



Source: Bloomberg, Ninety One Calculations for 31 Jul 2019-31 July 2024. For further information on indices, see the Important information section.

Levels of dispersion provide significant alpha opportunities related to country and security selection as rigorous bottom-up credit analysis becomes increasingly key. For active managers with the right expertise and experience in navigating the highs and lows of the market, this is a rich alpha hunting ground.

Views from the bottom-up

Debt markets that we find offer the most compelling investment cases today include:

– **Paraguay**: strong fiscal, reform and debt dynamics should support Paraguay in achieving an investment-grade rating from all rating agencies over the next 12-18 months.

– **South Africa**: we expect continued reform progress under the government of national unity ("GNU"), which will reduce premia relative to similarly rated peers.

– **Egypt**: Egypt has a strong funding position, and its Ministry of Finance indicated at the IMF/World Bank Spring Meetings that it plans to use the opportunity to reduce fiscal and debt vulnerabilities while enhancing fiscal transparency. Egypt's hard currency debt still retains a premium relative to peers with a similar rating.

– **Serbia:** this is another investment-grade upgrade candidate, as fiscal and debt dynamics should continue to allow for spread compression relative to higher-rated peers.

Markets that warrant caution include:

- **Mexico:** reforms to be presented to the new Congress in September warrant a cautious view on this market – especially as the judiciary reform could fall foul of the United States–Mexico–Canada Agreement. In addition, there are questions over future fiscal policy direction.
- **Romania**: this is likely to remain investment-grade rated in the short term, but with very wide twin deficits (15% of GDP) we expect Romania to continue to trade at a significant premium to peers.
- **Gabon**: a lack of clarity from the interim government over economic plans significantly raises debt and fiscal risks into 2025, especially as external maturities loom in 2025 and 2026.

This is not a buy, sell or hold recommendation for any particular security.

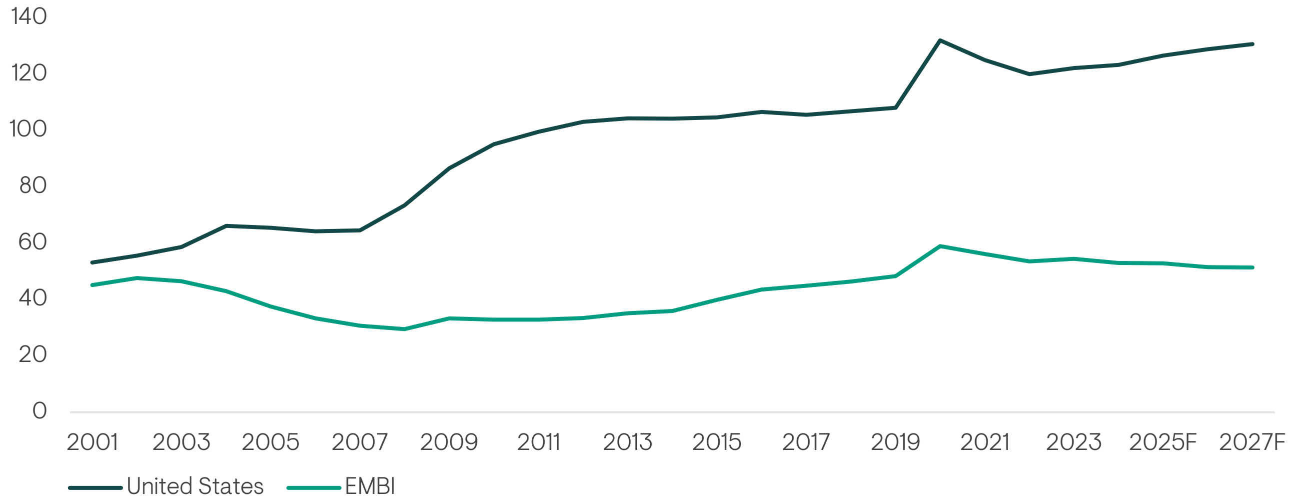
3. More resilient economies

There is no escaping the fact that COVID-related economic stress precipitated a default cycle in emerging markets – more than 10 countries have defaulted in the last few years, with three of those centred around the Russia/Ukraine war (Russia, Ukraine and Belarus). However, after a period of significantly above-trend default rates across emerging markets between 2018-2022, EM defaults have stabilised, and this has led to improved performance across 2023 and 2024 to date.

For countries still in a debt restructuring negotiation process – e.g., Ghana and Ethiopia – there is cause for optimism. Zambia recently reached a successful restructuring deal after issuing two new bonds in June – a plain vanilla 2023 bond and a State Contingent Debt instrument maturing in 2053, with financial terms dependent on certain macro thresholds. This demonstrates the evolving nature of the restructuring process and is also the first restructuring under the Common Framework.[2]

Despite all the ink spilt regarding the debt crisis in emerging markets, the defaults accounted for a small portion of the universe, and post 2022, EM economies are benefitting from prudent monetary and fiscal policy, which is further reducing debt and external vulnerabilities. Current spreads suggest the market is pricing in ample compensation for default risk, in contrast to historically expensive valuations seen in the US market (see Figure 2 earlier in this piece).

Figure 7. EM Debt to GDP EMBI Weighted scores across 79 EM Countries

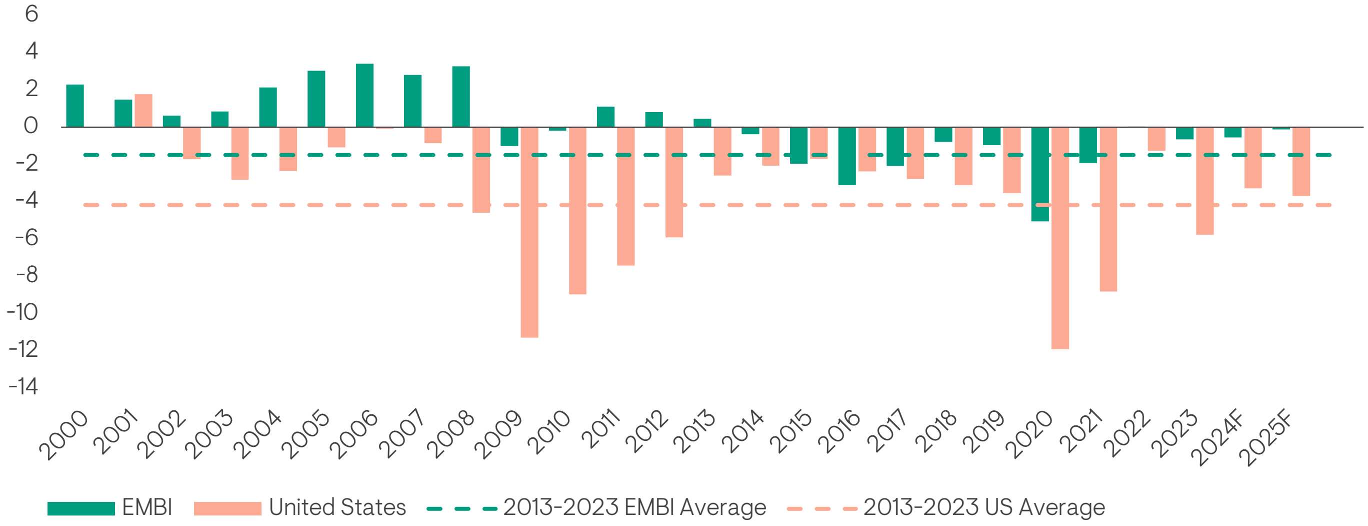


Source: IMF, Ninety One, as at April 2024.

Across EM economies, fiscal strength is seeing the biggest improvement, with increasingly healthy primary fiscal balances (Figure 8). Funding strength is better than in the pre-2012 (taper-tantrum) period, thanks to growth in local funding markets, and external resilience is improving post-COVID on stronger basic balances (current account + FDI). While the challenging global macro backdrop is a headwind to headline growth in EMs, the structural economic growth premium of EM relative to developed markets remains intact and above its long-term average. All of this points to EM economies being in a good position structurally.

[2] The G20 Common Framework for Debt Treatments was initially created to facilitate the coordination of Western lenders and China, given China's prevalence in lending to smaller emerging markets. Its broad aim is to improve the process of agreeing debt restructuring agreements.

Figure 8. EM and US primary balance (% of GDP) EMBI Weighted scores across 79 EM Countries



Source: IMF, Ninety One, as at April 2024.

Getting the most out of the asset class

While the potential rewards are significant when investing in the EM hard currency debt universe, the risks of encountering sizeable drawdowns are also high. Here are some rules of thumb for maximising alpha-capture potential while seeking to minimise the risk of costly negative surprises:

1. **Risk-aware portfolio construction** is key to ensure diversified sources of returns in a hard currency EM debt portfolio. A risk-unit approach allows managers to reduce concentration risk in this regard and can help avoid getting caught in a single theme.
2. **Harness the full opportunity set**: the resources and ability to research even the smallest frontier markets create an edge and ensure all potential alpha opportunities are pursued.
3. **Active and unconstrained**: in a universe where the return dispersion is so high, it's important to be able to take a zero weight in markets that look vulnerable or where credit events loom large. This highly inefficient investment universe warrants a high-conviction, benchmark-agnostic approach.

Why Ninety One for hard currency EM debt

Emerging market heritage

– Our EM heritage affords us a deep understanding of EM context.
– Over 20 years' experience in EMD investing helps us to look through the noise.
– Extensive corporate capability allows for a holistic sovereign risk view.

Selective, bottom-up approach

– We construct high conviction, bottom-up focused portfolios.
– Our process is designed around disciplined bottom-up analysis, resulting in a highly selective portfolio.
– We believe carefully considered portfolio construction and detailed bottom-up analysis can provide attractive risk-adjusted returns.

Continual innovation and introspection

– 15 years' worth of proprietary scoring data provides the backbone for future process innovation.
– Detailed and systematic process and performance reviews provide for critical ongoing self-review.
– We apply these same principles into areas such as ESG, which is fully integrated in approach.

Learn more

https://ninetyone.com/en/international/insights/a-role-for-em-sovereign-debt

https://ninetyone.com/en/international/insights/frontier-markets-move-to-the-fore

https://ninetyone.com/en/insights/imf-spring-meetings-aligning-perceptions-with-reality

https://ninetyone.com/en/newsroom/hidden-gems-time-to-spread-your-us-high-yield-bets-and-embrace-em-debt

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Specific Risks: Currency exchange: Changes in the relative values of different currencies may adversely affect the value of investments and any related income. **Default:** There is a risk that the issuers of fixed income investments (e.g., bonds) may not be able to meet interest payments nor repay the money they have borrowed. The worse the credit quality of the issuer, the greater the risk of default and therefore investment loss. **Derivatives:** The use of derivatives may increase overall risk by magnifying the effect of both gains and losses leading to large changes in value and potentially large financial loss. A counterparty to a derivative transaction may fail to meet its obligations which may also lead to a financial loss. Interest rate: The value of fixed income investments (e.g., bonds) tends to decrease when interest rates rise. **Emerging market (inc. China):** These markets carry a higher risk of financial loss than more developed markets as they may have less developed legal, political, economic or other system.

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