

Emerging market debt: Darkest before dawn

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We expect the US dollar to peak in Q4 2022 and if and when this happens, it will mark a significant downgrade in the strength of headwinds affecting EMD.

- **Within the fixed income spectrum, EMD offers particularly compelling value on account of already having priced in much of the risk that other asset classes must negotiate in the year to come.**
- **Following the bruising sell-off in the first six months of the year, 20% of the EMD universe trades at over 1000bps in spread terms, and 26% of the asset class trades at distressed cash prices below 70bps.**

Markets are witnessing the first glimmers of light at the end of the tunnel for emerging market debt (EMD). For much of this year, the asset class has struggled under the weight of the strong US dollar, however, there are signs that high inflation and rising interest rates are catching up with the world's largest economy.

All signs suggest that a slowdown in US growth is inevitable in the near term. Such a scenario would stay the hand of the US Federal Reserve and put an end to the rally of interest rate rises that have choked off fixed income returns for much of the year so far. After an unprecedented run of strength, we expect the US dollar to peak in Q4 2022; if and when this happens, it will mark a significant downgrade in the strength of headwinds affecting EMD.

The problem dollar

A weakening of the US currency will be good news for EMD issuers, which service part of their debt in US dollars. In the coming months, as EM corporates and governments face fewer external vulnerabilities as a result of a potentially weaker USD, the pending global economic slowdown will begin to manifest in other areas of the market. We saw early signs of this in the third quarter when the S&P 500 lost 4.9% and the Dow Jones declined 6.6% over the period¹. As this slowdown intensifies, we expect investors to begin tentatively seeking shelter in fixed income.

EMD, having been hit hard by global headwinds earlier in the year, has long priced-in many of the issues that are now catching up with other asset classes. As a result, EMD performance in the third quarter moved in lockstep with US 10-year treasuries, indicating that the asset class has reached an inflection point.

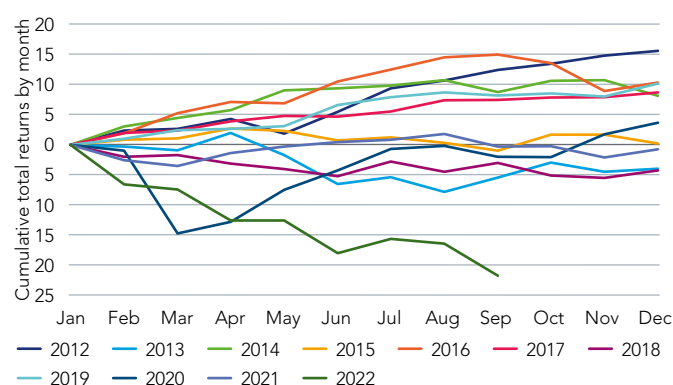
If this trend holds firm into the end of this year and next, EMD will prove fertile hunting ground for investors on account of the compelling value that can now be found across the asset class.

A weakening of the US currency will be good news for EMD issuers, which service part of their debt in US dollars.

Compelling value in EMD

Owing to the bruising sell-off in the first six months of the year, 20% of the EMD universe trades at over 1000 basis points (bps) in spread terms, and 26% of the asset class trades at distressed cash prices below 70bps². These are unprecedented valuations by historical standards, implying significant default risk and debt restructuring that simply does not reflect the actualities on the ground. We are now in a heavily mispriced marketplace, in which the headline EMD index is down 21.51% year to date³.

Figure 1: JP Morgan Emerging Market Bond Index Global Diversified Index – total returns



Source: JP Morgan, September 2022

Past performance is not a reliable indicator of future performance.

Current price action has been indiscriminate and, for much of this year, the market has treated EMD as a fundamentally high yield asset class despite a significant proportion of the investment grade names in the index exhibiting similar risk profiles to their US equivalents. More than 70% of the sovereign and corporate universe is rated BB and above. As a result, distressed pricing at the present time has created a compelling entry point for investors. We advocate tactically adding EMD exposure to exploit the current pricing anomaly and to position portfolios for the unfolding dynamics of the year ahead (namely, slower global growth and high inflation).

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How to exploit the EMD anomaly

We advocate a barbell approach when investing in EMD. This involves balancing risk and reward in a portfolio by maintaining exposure to both the highest-quality investment grade opportunities as well as select, heavily discounted high-yield names.

¹ Source: Bloomberg, October 2022.

² Source: Bloomberg, October 2022.

³ As measured by the JP Morgan Emerging Market Bond Index Global Diversified Index, September 2022

Figure 2: Barbell opportunities – EM high yield vs. EM investment grade



Source: Bloomberg, September 2022

Past performance is not a reliable indicator of future performance.

At current prices, EMD is no longer just a yield play, but an opportunity to earn a unique total return through security selection.

Distressed pricing at the present time has created a compelling entry point for investors.

Commodity price support

Hydrocarbon prices, which underpin many EM economies, remain robust. In a portfolio, commodity exposure can function as a natural hedge against inflation, particularly if it is supply-side driven. As supply constraints continue to push prices higher across the commodity spectrum, EM hydrocarbon exporters (approximately 50% of the JP Morgan Emerging Market Bond Index Global Diversified Index) have seen an upgrade in economic growth and fiscal forecasts. Many Middle Eastern oil exporters have used higher prices to build back their buffers.

In Latin America, Chile, Peru and Colombia are three examples of countries upon which we are constructive given their fiscal stance and strong balance sheets. Furthermore, high inflation may prompt a shift in voter behaviour: the pernicious and widespread effect of high inflation may prompt voters to elect more fiscally conservative candidates. Across other regions, we see more appealing opportunities among many African countries, including Angola, Gabon, and Nigeria. In Asia, we remain particularly cautious on China which is in the midst of a challenging transition away from an economic growth model driven by investment and debt.

Inflation may prompt voters to elect more fiscally conservative candidates.

Summary

Investors are likely to begin tentatively reallocating to fixed income in the coming months amid the shifting dynamics of the market. Within the fixed income spectrum, EMD offers particularly compelling value on account of already having priced in much of the risk that other asset classes must negotiate in the year to come. As a result, we advocate tactically building exposure in EMD to take advantage of the unprecedented price action that has characterised the year so far.



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