Beckoning frontiers in emerging market debt – prospecting for attractive potential

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Mohammed Elmi, CFA
Senior Portfolio Manager,
Emerging Market Debt

Jason DeVito, CFA
Senior Portfolio Manager,
Emerging Market Debt

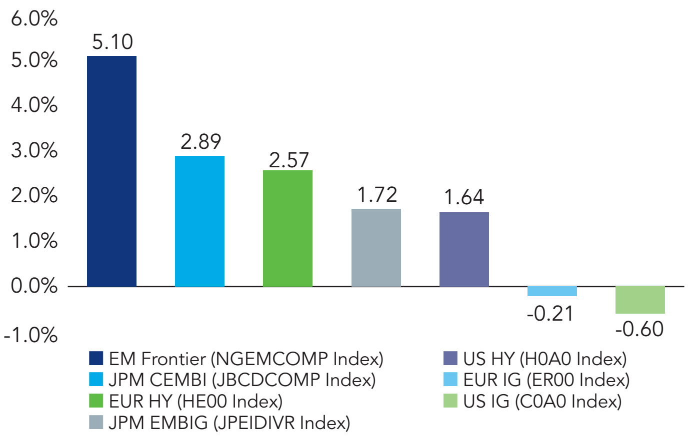
Federated Hermes

In relative terms, emerging market debt (EMD) has extended its strong 2023 performance through the first half of 2024. For the year to date, global fixed-income total returns have been stymied by re-elevated core rates following the late 2023 rally, while money market yields have remained elevated, providing clients with an attractive alternative to longer-duration assets.

Going into the year, along with many market participants, we believed that EMD returns would be largely driven by rates. However, as the potential for US Federal Reserve (Fed) rate cuts has receded significantly, EMD running yield should be a useful proxy for 2024 total returns.

We believe one way to augment and introduce total return opportunities in EMD is to embrace frontier markets, and doing so can add capital appreciation possibilities along with the higher running yields. We detail this argument in the second section below.

Emerging market frontier bonds lead performance year-to-date in 2024



Source: Bloomberg, as at 31 May 2024.

Even though EM spreads are fairly tight by historical standards at the midpoint of 2024, we remain constructive on the asset class and would recommend a move out the credit and yield curve to lock in elevated yields for the following reasons:

- Oil prices are stable and above the fiscal and external break-even prices for oil exporters.
- Other commodities such as base metals and agricultural products have also performed solidly.
- A number of EM countries have seen disinflation and are now loosening monetary policy, prompting strong economic growth.
- EM corporate fundamentals are in general good health with leverage ticking down and margins holding in.
- EM elections, a well-trailed 2024 risk, have so far passed through without too much controversy.
- Frontier countries in particular are providing total return opportunities.

One of the market risks in 2024 centers on elections, however, in the EM many risks have abated, and election results have yielded positive market outcomes in a few countries. The Indian election has seen PM Narendra Modi returned for a third term with a grand coalition (which should check the executive's power and potentially reduce ethnic and religious divisions). In South Africa the ANC polled below 50% for the first time in the post-apartheid republic. This has meant a new coalition government with the Democratic Alliance, sidelining the Marxist-leaning Economic Freedom Fighters and Jacob Zuma's MK party, which would have endangered the the South African Reserve Bank's independence and risked upside pressure on the country's fiscal deficit.

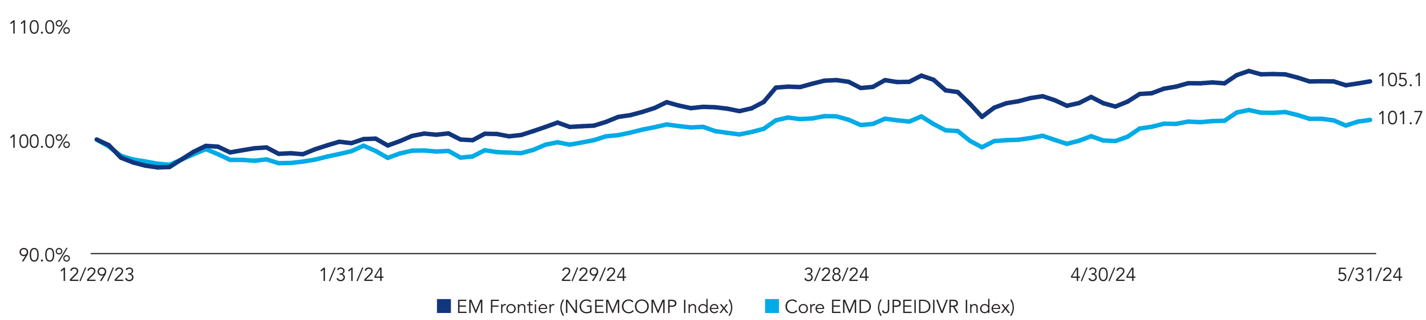
In Mexico, market expectations had centered for months around Claudia Sheinbaum as the most likely replacement for outgoing president Andrés Manuel López Obrador, so her election was not a surprise. However, despite the positive undertone brought by her being the first female Mexican president, her focus on continuing her predecessor's popular social programs does constitute a significant challenge, considering the current fiscal deficit (circa 6%).

We believe that investors can potentially generate total returns in EMD by tactically overweighting EM frontier credits.

Frontier vs. core EM/BRICS – what defines a frontier country?

EM has evolved from a homogenous to a much more heterogeneous asset class. Mainstream EM can be defined by the 'BRICs' term coined in 2001, and the EM countries included in the enlarged G20, such as Indonesia, Saudi Arabia, South Africa, and Turkey. Frontier EM is the sub-asset class that has appeared largely due to the evolution of debt capital markets and the broad scale of issuance. For our purposes, EM frontier is defined as smaller EM countries with:

- High growth potential but low absolute levels of GDP
- Infrastructure deficits
- A low industrial base and low domestic savings
- High dependency on imports of mainly manufactured goods
- Issuers in need of 'catch up capital'
- Bilateral and multilateral support needed to manage economies



Source: Bloomberg, as at 31 May 2024.

Why we like EM frontier issuers

The external and fiscal imbalances of frontier countries can typically only be corrected by assistance via the International Monetary Fund (IMF) and/or donor support such as the International Development Association (IDA), a part of the World Bank assisting low-income countries. During the post-Global Financial Crisis low-interest rate environment and periods of QE, a number of smaller and speculative-grade EM countries were able to expand their footprint. The tightening of global financial conditions in the wake of Covid and the Russia/Ukraine war was a setback, driving frontier-market yields and spreads to historically high levels and driving defaults. Today however, several potentially positive factors are supportive of frontier countries, making their debt an effective diversifier from other risk assets and core EM.

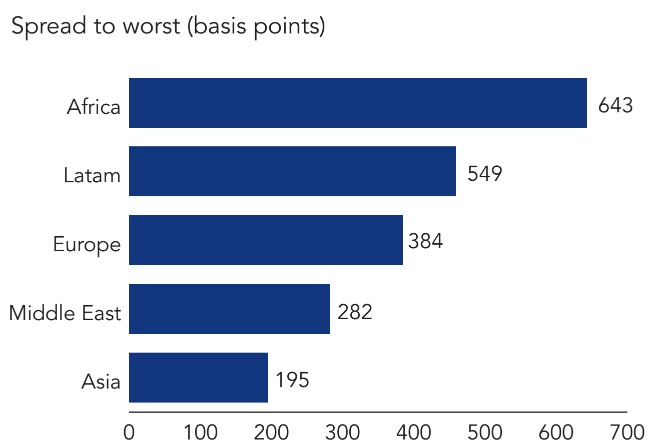
Diversification and growth potential

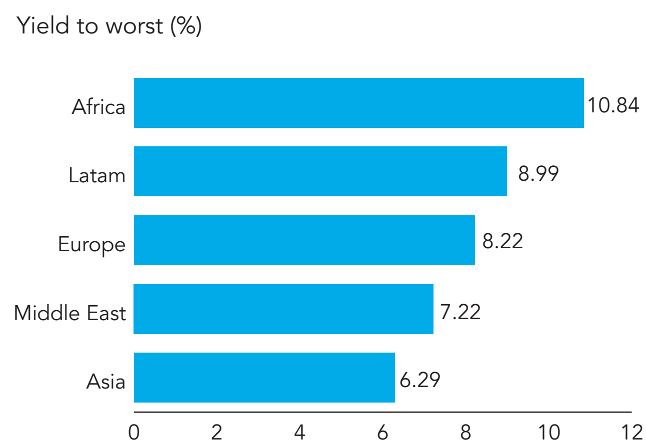
Today, frontier countries are well insulated from the ebbs and flows in global risk appetite, largely due to their hard currency bond performance being driven by a broader set of factors such as bilateral and multilateral support, exchange rate fluctuations and domestic policy shifts. Frontier bonds are slightly more illiquid and don't typically move on a like-for-like basis with core EM, also offering an illiquidity premium.

With the adoption of orthodox macroeconomic policies, IMF/WB support, credible central bank oversight and the building of FX reserves, defaulted names are successfully restructuring their defaulted debt on attractive terms to bondholders. Countries such as Zambia and Suriname have restructured their Eurobond obligations with new longer coupon bonds, with upside potential via instruments linked to GDP growth targets.

Attractive relative valuations and yields

While a significant proportion of EM countries are now trading at tight levels compared to historical averages, frontier markets such as Sub-Saharan Africa demonstrate investors being compensated for the risk taken, especially considering the implied vs. realised default rates differential. One example is Sub-Saharan Africa Eurobonds (ex-South Africa which is core EM): in 2010 they represented just 2.27% of the J.P. Morgan EMBI Global Diversified Index, and as at 1 May 2024 are 10.50% of the index.





Source: Bloomberg, J.P. Morgan as at 28 June 2024.

Fits well within our satellite trade allocation

Regardless of which region of the EM world we are looking at, we believe the best results in the asset class are achieved through investment discipline, and built up through an assessment of fundamental value. To that end, we employ a disciplined investment process anchored by our Macro Sovereign Scoring Framework.[1] The portfolio typically allocates circa 65-85% in Core EM names and 15-35% in satellite EM trades. The satellite trades allocation typically includes more special situations investments/frontier markets and is managed very dynamically in order to generate alpha as well as mitigate risks.

Frontier cases in point: Pakistan, Egypt and Argentina

Pakistan: We opened a position in September last year, as Pakistan secured IMF support in July. We increased our exposure in the lead-up to the elections, taking the view that we would look through the election noise and expect a strong commitment to address the external imbalances and to secure the new IMF program ultimately approved in April 2024. We expect the new program to be $6-8 billion plus $3-4 billion from the World Bank, with the coalition government able to deliver on the IMF targets for the first two to three reviews. We also expect the newly elected government to maintain its strong relationships with Saudi Arabia and the UAE and to secure funding from these countries, although not on the same scale as Egypt. Pakistan has been among the top performers year to date with cash price for the 2026 bonds up 3.5 points since we added to the position on 14 February.

Egypt: We came away from a visit in February feeling more positive on the prospects of the country being able to secure enough FX liquidity to meet its near- and medium-term funding needs, clear the FX backlog and secure a new IMF deal. Later that month, Egypt announced the biggest investment deal with the UAE in its history, with the UAE agreeing to develop Ras El-Hekma on the north coast of Egypt by investing $35 billion. $24 billion will be new external financing, which will be enough to clear the FX backlog and to liberalise the exchange rate. The latter helped pave the way for a new IMF program approved in March 2024.

Recent price improvement of an Egyptian sovereign bond:

Government of Egypt, 7.625%, 29 May 2032

Source: Bloomberg as at 28 June 2024

Argentina: Given the prospects of significant fiscal reform and additional IMF support, upside potential exists relative to current trading levels. President Javier Milei's aggressive approach to fiscal consolidation will likely bode well for Argentina's ability to negotiate further financing lines from the IMF. The key to Argentina unlocking its long-term high economic potential is its ability to cut fiscal expenses, control inflation and then attract foreign direct investment (FDI). President Milei sees the imperative need to cut excess spending and has been very persistent in addressing his fiscal goals. We are growing more and more optimistic regarding his ability to achieve this task which will subsequently tamp inflation and encourage investment.

Past performance is no guarantee of future results.

[1] Our Macro Sovereign Scoring Framework is an in-depth assessment of over 40 macroeconomic variables across 70 EM countries, supplemented by a qualitative overlay, taking into account both quantitative data as well as analyst-led convictions and idiosyncratic risks. The framework forms the basis for the team to then express country views through bottom-up security selection.

Views are as of 6/30/24 and are subject to change based on market conditions and other factors. These views should not be construed as a recommendation for any specific security or sector.

Investments are subject to risks and fluctuate in value.

International investing involves special risks including currency risk, increased volatility, political risks, and differences in auditing and other financial standards.

Prices of emerging-market and frontier-market securities can be significantly more volatile than the prices of securities in developed countries, and currency risk and political risks are accentuated in emerging markets.

Bond prices are sensitive to changes in interest rates, and a rise in interest rates can cause a decline in their prices.

High yield, lower-rated securities generally entail greater market, credit/default and liquidity risks, and may be more volatile than investment-grade securities.

Diversification does not assure a profit nor protect against loss.

BRICS is an intergovernmental organization consisting of Brazil, Russia, India, China, South Africa, Iran, Egypt, Ethiopia, and the United Arab Emirates.

ICE BofA US High Yield Index (H0A0) tracks the performance of US dollar denominated below investment grade corporate debt publicly issued in the US domestic market.

ICE BofA Euro High Yield Index tracks the performance of Euro denominated below investment grade corporate debt publicly issued in the euro domestic or Eurobond markets. Qualifying securities must have a below investment grade rating (based on an average of Moody's, S&P, and Fitch).

ICE BofA US Corporate Index: tracks the performance of U.S. dollar-denominated investment-grade corporate debt publicly issued in the U.S. domestic market. Qualifying securities must have an investment-grade rating (based on an average of Moody's, S&P and Fitch) and an investment-grade rated country of risk (based on an average of Moody's, S&P and Fitch foreign currency long term sovereign debt ratings). In addition, qualifying securities must have at least one year remaining term to final maturity, a fixed coupon schedule and a minimum amount outstanding of $250 million.

J.P. Morgan CEMBI Broad Diversified Core Index tracks the performance of US dollar-denominated bonds issued by emerging market corporate entities1 . The CEMBI CORE follows the methodology of the flagship J.P. Morgan CEMBI Broad Diversified (CEMBIB Div) closely, while offering a more liquid and higher credit quality subset.

J.P. Morgan Emerging Markets Bond Index Global ("EMBI Global") tracks total returns for traded external debt instruments in the emerging markets and is an expanded version of the JPMorgan EMBI+. As with the EMBI+, the EMBI Global includes U.S. dollar-denominated Brady bonds, loans, and Eurobonds with an outstanding face value of at least $500 million. It covers more of the eligible instruments than the EMBI+ by relaxing somewhat the strict EMBI+ limits on secondary market trading liquidity.

J.P. Morgan NEXGEM tracks USD-denominated debt issued by sovereign and quasi-sovereign next generation issuers. The Next Generation Markets Index (NEXGEM) countries are selected from the universe of EMBI Global Diversified countries. A unique set of country criteria exist for the NEXGEM to select only the smaller emerging countries of lesser credit quality. The index was launched in November 2011 with daily historical index levels and statistics available from Dec. 31, 2001

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