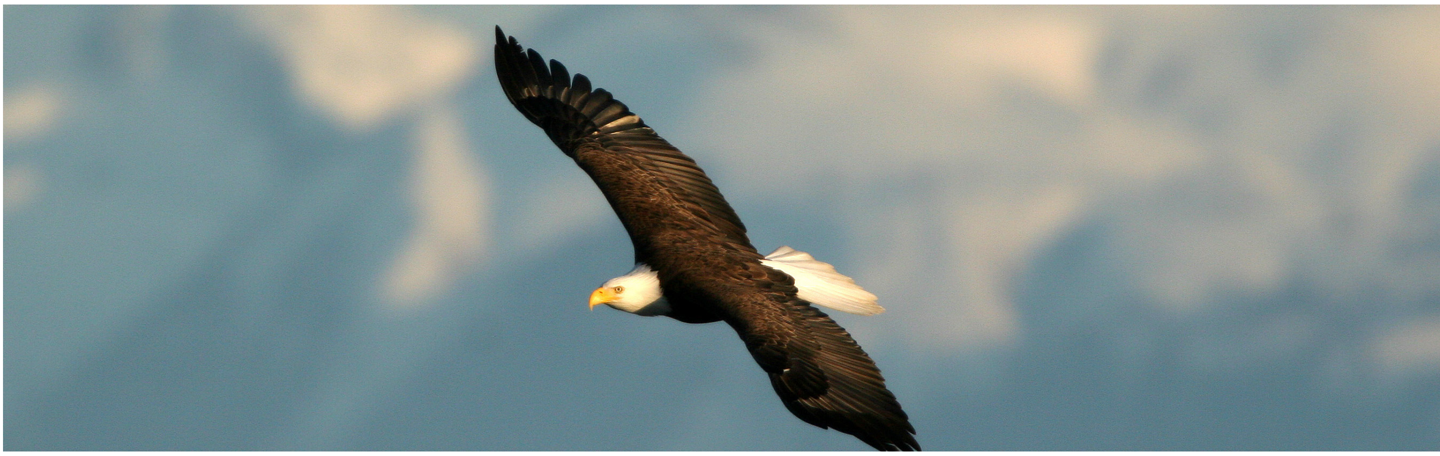


Emerging Market Debt: The merits of an unconstrained approach

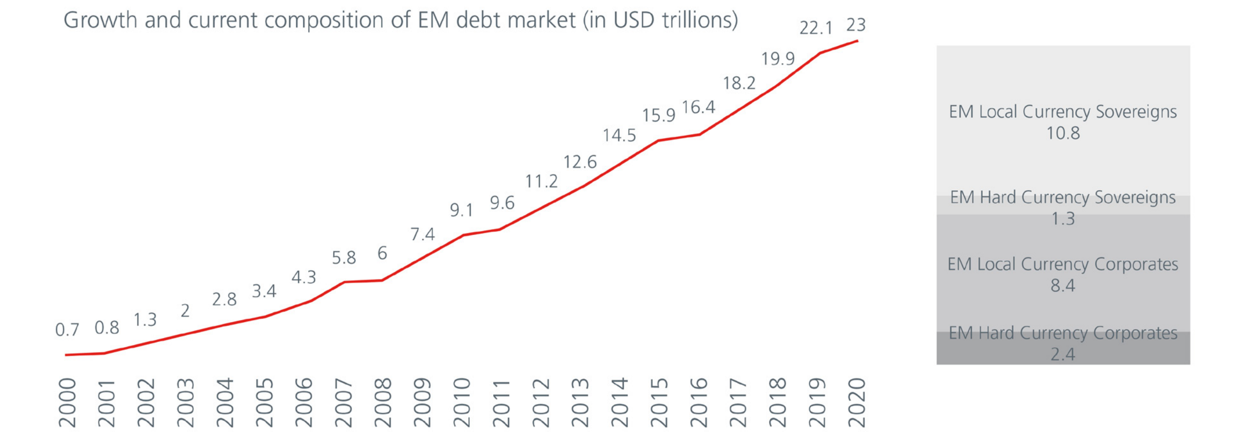
Guilherme Barros, Portfolio Manager, Fixed Income, Eastspring Investments

An unconstrained approach to Emerging Market Debt can help investors tap the market's potential high returns while navigating sovereign debt defaults, elevated inflation and other "noisy" headlines within the emerging market universe. Selecting well will also result in a more ESG-aligned portfolio.

Along the famous Calle Florida in Buenos Aires, Argentina, the locals are not always there to take in the sights. They are often there to shop for US dollars, offered by "arbolitos" - small black-market money changers. This behavior, developed through a succession of crises since at least the turn of the millennium, is just one of the many idiosyncrasies within the Emerging Market (EM) complex. Yet behind the colourful stories lies attractive opportunities for experienced bond investors, convincing us that the EM Debt market has a place in globally diversified portfolios.

The EM Debt universe has grown more than 32-fold over the last 20 years, reaching USD23 trillion by the end of 2020. Fig. 1. It is large and liquid enough to be

Fig 1. The growth and composition of the EM debt market

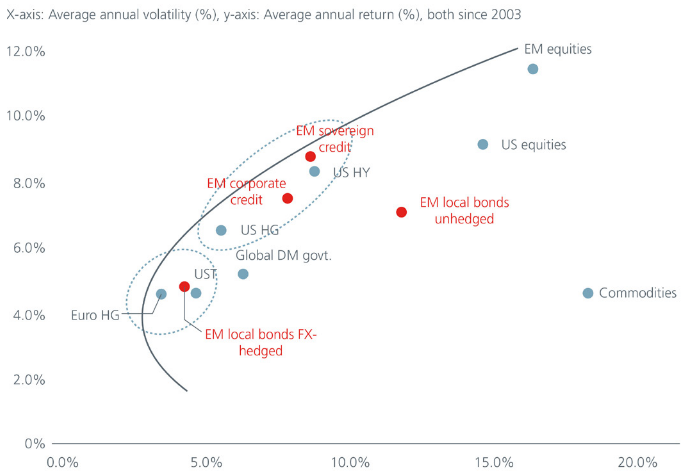


Source: JP Morgan. December 2020.

viewed as mainstream and should be a core part of sophisticated investors' fixed income allocation, in our view.

The appeal of EM Debt is obvious – the 5-year annualised returns of the hard currency sovereigns (EMBI Global Diversified Index) and corporates (CEMBI Broad Diversified Index) are north of 7% (as at end 2020). That said, the 5-year annualised returns for the EMBI Global Diversified Index falls to around 5% if we include the most recent quarter ending March 2021, where bond yields rose. History suggests that the long term expected returns for the EMBI Global Diversified Index are somewhere between 5 to 6% p.a. The asset class is highly efficient, with risk adjusted returns above 1 for the EMBI Global Diversified and CEMBI Broad Diversified Indexes. In Fig. 2., the EM sovereign, corporate as well as the local currency bond markets can be found close to the edge of the efficient frontier.

Fig. 2: The EM debt market is highly efficient



Source: JP Morgan. December 2020. The EM sovereign credit, EM corporate credit, EM local bonds FX-hedged and EM local bonds unhedged are represented by the EMBI Global Diversified, CEMBI Broad Diversified, GBI-EM Global Diversified (Hedged and Unhedged) Indexes respectively.

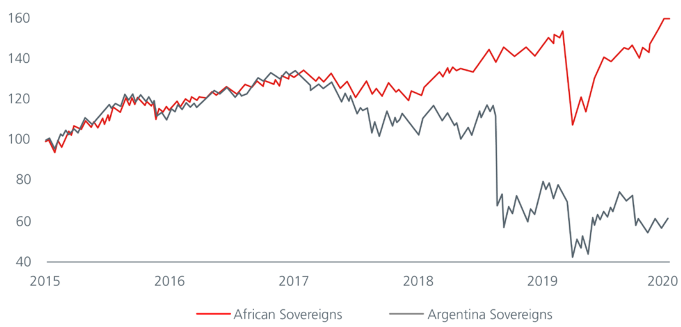
THE IMPORTANCE OF SELECTING WELL

The EMBI Global Diversified Index, one of the most widely followed EM bond indexes, consists of over 70 countries with the weight of the largest country not exceeding 5%. This diversity means that investors often have to navigate "difficult" stories, such as the debt restructuring in Argentina, currency volatility in Turkey and a credit downgrade in Sri Lanka. This highlights the importance of selecting well within the EM Debt universe and the advantages of an unconstrained strategy.

Within EMs, sovereign debt defaults tend to have higher recovery values relative to corporate counterparts. EM sovereigns that have a good relationship with the International Monetary Fund (IMF), can enjoy assistance from the IMF and other multi-lateral agencies. These assistance programmes can be a catalyst for reforms or more orthodox monetary/fiscal policies, leading to improved bond performance. EMs that pursue sound macroeconomic policies are often rewarded with continued financing, not only from bond markets but also often from multilateral development banks at concessional rates. An unconstrained strategy allows investors to focus on these issuers and gain exposure to high yielding debt that is expected to perform better. Fig 3 contrasts the 60% return from the African sovereign debt to the 40% loss suffered by the Argentina sovereign debt over 2015-2020.

Through an unconstrained strategy, investors can have the flexibility to access all segments of the EM Debt universe, including EM corporates which can

Fig. 3. It pays to be selective in EM debt



Source: JP Morgan. Eastspring Investments. December 2020. African Sovereigns represented by the African Sovereign sub index within EMBI. Argentina Sovereigns represented by the Argentina Sovereign sub index within EMBI. Performance is rebased to 100 from end December 2014.

potentially present opportunities for greater alpha generation. Within EM corporates, experienced investors, through active and careful selection, can identify companies that have healthier balance sheets and higher yields compared to similarly rated corporate issuers in the US. EM corporates also tend to have lower duration and owning them can help lower portfolios' sensitivity to rising rates. An unconstrained strategy can also dial down exposures to underperforming segments within the corporate and sovereign space.

Historically, within the EM Debt universe, emerging Asia looks particularly attractive. Fig. 4 shows that the 1, 3 and 5-year risk adjusted returns for sovereigns and corporates in emerging Asia (denominated in both USD as well as local currencies) are superior to their broader EM benchmarks. This plays to our expertise as well as deep understanding of the Asian markets, and enhances our ability to deliver alpha through an unconstrained strategy.

An unconstrained approach is also able to better select and have meaningful investments in sovereign and corporate issuers with stronger Environmental, Social and Governance (ESG) credentials. Investors can limit exposures in oil and coal producers within the EM corporate bond universe while increasing exposure to renewable energy companies. While EM sovereigns typically have reasonable ESG scores, the quasi sovereigns may warrant more careful analysis, as many tend to be involved in the energy sector. An unconstrained approach can thus create more ESG-aligned portfolios versus the benchmark, while delivering attractive yields.

AN INCREASINGLY BIFURCATED EM WORLD

The fundamental outlook for the EM complex has grown increasingly bifurcated post the COVID-19 pandemic. Debt levels have risen as governments had increased spending to soften the economic impact of the pandemic. As such, the importance of selecting well and the merits of an unconstrained strategy are even more evident.

For example, the outlook for the oil exporters in the MENA region has been buoyed by rising commodity prices in 2021, likewise for the copper exporters in Chile, Peru and Zambia. Meanwhile, Asia's stronger external position and larger fiscal space have allowed policy makers to adopt counter cyclical measures and dampen the impact of the pandemic, while still being able to retain reasonable debt levels and a limited build up in vulnerabilities. Given still contained inflationary pressures, most Asian central banks are unlikely to hike rates anytime soon.

Fig. 4: EM Asia's debt provides better risk adjusted returns

		5y			3y			1y		
		Ann Return	Ann Vol	Sharpe	Ann Return	Ann Vol	Sharpe	Ann Return	Ann Vol	Sharpe
Hard Currency Sovereigns (EMBI Global Div)	Index	7.1%	6.5%	1.1	5.0%	7.7%	0.7	5.3%	12.0%	0.4
	Asia	6.2%	4.7%	1.3	5.2%	5.2%	1.0	3.8%	8.1%	0.5
Corporates (CEMBI Broad Div)	Index	7.1%	3.4%	2.1	6.0%	4.0%	1.5	7.1%	6.5%	1.1
	Asia	5.6%	2.4%	2.3	5.6%	2.7%	2.1	6.9%	4.1%	1.7
Local Currency Bonds (GBI-EM Global Div)	Index	6.7%	9.7%	0.7	3.0%	9.6%	0.3	2.7%	12.7%	0.2
	Asia	7.3%	6.2%	1.2	7.3%	6.5%	1.1	7.6%	8.4%	0.9

Source: JP Morgan. Eastspring Investments. December 2020.

On the other hand, other EM economies may take longer to recover. Inflationary pressures have pushed Brazil to hike rates. Russia has embarked on a rate hike cycle while financial conditions have tightened significantly in Turkey. A second wave of COVID-19 infections has recently forced Argentina to impose stricter mobility restrictions. Austerity and economic orthodoxy are not high on the agenda given the need to battle the pandemic and prioritise growth. Meanwhile, political risks weigh on Peru.

A WORTHY VENTURE

Despite the challenging stories within the EM complex, the region's higher bond yields and attractive risk adjusted returns are a worthwhile venture for experienced investors. The EM's bifurcated outlook and the risk of rising US bond yields set the stage for an unconstrained strategy to prove its worth. Greater flexibility in duration management, currency exposures, as well as the ability to dynamically allocate between sovereigns, corporates and quasi sovereigns within the EM universe can help investors harvest the region's higher yields, while managing volatility at reasonable levels.

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