RBC Global Asset Management

Pondering the questions that are vexing our clients

July 2024

"Emerging markets are a group of approximately 80 vastly diverse countries, characterized by a higher growth potential but also susceptible to higher volatility."

Since the COVID-19 pandemic, macroeconomic factors have been driving market performance. However, 2024 marked a shift in this trend, with policy changes driving growth in a wide array of EM countries including Egypt, Argentina, Serbia, Ecuador, Tunisia, Zambia, UAE, and Sri Lanka.

In local markets, EM central banks have been ahead of the curve and should continue to successfully combat inflation, providing room to cut interest rates and drive yields lower. We maintain a constructive outlook for emerging markets debt driven by these favorable policy trends, contributing to expectations of meaningful spread compression and opportunities for alpha generation.

In what ways do you envision China influencing the EMD opportunity set?

In our view, China will continue to impact EMD opportunity set in important ways. As a key external creditor and major importer of commodities for many emerging market countries, China's roles in third country debt restructuring talks would be closely monitored by market participants. Its outward investment strategy (i.e. Belt and Road) would continue to gives us clues in terms what their priorities might lie. Domestically speaking, while growth impulse have slowed, it remains at a reasonable pace of 4-5% for the next few years, which is still reasonably high for the second largest economy in the world.

What are the main factors that differentiate high-performing emerging economies from underperforming ones?

Emerging markets are a group of approximately 80 vastly diverse countries, characterized by a higher growth potential but also susceptible to higher volatility. Although often grouped together as one, EM economies are complex and have vastly different characteristics based on their stage of development.

While on a short-term period, idiosyncratic drivers typically dictate the success of a particular EM nation, over the long term, higher performing emerging economies tend to be those that focus on capital market development and higher domestic savings.

Amongst others, we also find the factors below are typical of emerging economies that outperform over the long term:

- Well-established, liquid local debt markets
- Established local insurance/pension fund industry
- Structural reforms to engender competitiveness within the economy
- Established regional and international banking system
- Free-floating currency/liberalized exchange rate regime
- Open economy (lack of strict barriers to entry/tariffs etc.)
- Clearly-defined and enforced institutional framework (i.e. laws/regulations etc.)
- Orthodox, independent, inflation-targeting central bank
- Market exchange + regulatory framework

How to determine the appropriate allocation to EM within a broader fixed income portfolio

Overall, the appropriate allocation will typically depend on the investment objectives and risk and return characteristics of a particular investor. However, with an asset class that is over US$25tn in size and offers significant return potential and diversification benefits, EM's merit a core allocation in any investor's portfolio.

Below, we consider a typical US investor's portfolio (USPP) with 45% allocation to US IG corporates, 25% allocation to asset back securities, 20% to US high yield and 10% to other asset classes (proxied by Global Aggregate). We then analyze the historical return/ volatility based on the USPP portfolio and addition of a blended EM solution BEMD (40% hard currency Sovereign, 40% local currency sovereign and 20% hard currency corporates). As demonstrated by the efficient frontier below, the addition of the BEMD portfolio enhances returns while reducing volatility up to a 25% allocation.

We also considered a hypothetical fixed income portfolio for a typical UK pension portfolio (UKPP) with 50% allocation to Global Aggregate bonds, 22% allocation to alternatives, 7% to UK Equities, 18% to Global Equities and 3% in properties. Once again, we analyze the historical return/ volatility based on the UKPP portfolio and this time with an 'unconstrained' best ideas, daily liquidity EM strategy (denoted EM unconstrained). Our results below show that for a comparable risk profile, the addition of EM unconstrained has significantly increased the return potential of the portfolio.

Overall, we would recommend an allocation to EM anywhere from 10% to 25% depending on the requirements and objectives of a particular investor.

Can you explain the role of active management in navigating the complexities of emerging market debt?

When it comes to emerging market debt, active management offers strong advantages over a passive approach:

1. EMD is an inefficient asset class where periods of high volatility are not uncommon. These inefficiencies can provide a rich source of opportunities for active managers and, equally as important, in the absence of active selection, this volatility could also be a potential minefield for passive investors. The primary benefit is the ability to apply bottom-up fundamental analysis to select investments that are expected to outperform or underperform outright, and also relative to the index. This allows for a superior risk/return profile for the portfolio and also the avoidance of potential pitfalls associated with deteriorating credit developments within individual issuers in the benchmark.

   - A recent example is the Russia-Ukraine conflict, where in the lead up to the invasion of Ukraine, the team took the decision to close all positions in Russia, based on the view that tensions are likely to escalate. Once Russia initiated the full-scale invasion of Ukraine, the EM sovereign index declined by 6.5% in February 2022 (month-on-month), while our Emerging Market (sovereign) Bond Fund was down 3.5%.

   - Another example is China, where macro-economic weakness has continued after the turmoil seen in the property sector. Our funds are currently underweight China but has the ability to alter its exposure to Chinese corporates as the situation continues to evolve. With the possibility of a second Trump administration and a re-emergence of US-China trade tensions, this ability to alter positioning allows a greater degree of flexibility compared to passive funds.

   - Active funds can also benefit from a larger investable universe with the option of investing in off benchmark positions. These may include bonds that lie outside the index with higher risk adjusted return potential or bonds issued by smaller issuers that the index might not capture due to liquidity constraints in the index.

"The primary benefit is the ability to apply bottom-up fundamental analysis to select investments that are expected to outperform or underperform outright, and also relative to the index."

2. For accessing less liquid markets like certain parts of EMD, passive ETFs are a suboptimal vehicle with several technical deficiencies:

   – Consider for example when the index provider announces the inclusion of a country that was previously not part of the index. Active managers can proactively adjust their own positioning ahead of the inclusion into the index, benefitting from potential price movement once passive funds also begin to allocate to match the index.

   – Also consider the scenario where the market expects an up/downgrade of a particular issuer that can potentially result in flows into the asset class or, alternatively, forced selling of bonds —the active manager can increase or decrease exposure in anticipation of the change in credit rating and potential price movement after the event.

   – Additionally, unlike a passive fund, an active manager can actively participate in attractively priced primary market issuances.

3. Economic, Social and Governance considerations can be applied through active management- these factors not only have a large impact in emerging markets but are also often key drivers of risk-adjusted returns.

4. Economic, Social and Governance considerations can be applied through active management- these factors not only have a large impact in emerging markets but are also often key drivers of risk-adjusted returns.

How do you manage exposure to countries where election outcome can significantly alter economic policy?

When conducting our research on EM sovereigns, apart from fundamentals, we are cognizant that sovereign spread risk encapsulates a broader set of factors which pose implications for emerging market issuers; most importantly political risk but also ‘E’, ‘S’ and ‘G’ as well as other subjective factors. To exploit these inefficiencies, we leverage the team’s deep experience in emerging markets, insights from on-the-ground research trips and political risk assessments from specialist third parties (e.g. Maplecroft and Eurasia Group). News reports are followed closely (with a growing focus on social media). There is substantial interaction with policy makers at every level, politicians, civil servants, central bankers, journalists, captains of industry, trade unions and other economic agents. The combination of these factors enables us to have a structured approach to fluid political developments, thereby allowing our portfolio managers to be prepared for all eventualities and not be over-reactive to headline risk.

To gain an in depth understanding on the political backdrop and developments, portfolio managers, traders and sovereign analysts in our team devote a significant amount of time on the ground meeting with a broad range of sources including the abovementioned politicians, policy makers, central bankers, civil servants and trade unionists. In addition, we closely monitor market developments, cross-checking our own observations with independent local players and market participants. By regularly sharing and comparing our individual findings amongst the team, we are well positioned to construct a more complete aggregate understanding of political, macroeconomic and industry specific developments. This, in turn, helps form our investment views and leads to alpha.

As an example, one of the major elections in our space this year was in South Africa. At the end of last year, as a team, we conducted a scenario analysis of the potential election outcomes and assigned probabilities to each scenario, we then outlined our forecasts for the outcome for South African assets across hard currency sovereign bonds, Eskom’s spread-to-sovereign on unguaranteed USD denominated bonds, South African local currency bond yields and the South African rand versus the USD (see figure below).

Given our cautious outlook and asset levels at the time, we decided to assume a neutral stance on South African assets in approach to the elections, whilst re-evaluating the scenario probabilities as facts on the ground evolved and more accurate and timely polling data emerged. This then enabled us to capture asymmetric investment opportunities across South African assets into and post the election.

Can you provide an insights into the current state of corporate debt markets in emerging economies.

At over US$2.5tn in size, the hard currency denominated EM corporate debt is a diverse and very well-established asset class. The asset class has seen strong growth in the last decade driven by robust investor demand, rapid long-term EM economic growth, and increasing integration into global capital markets. Despite being a majority IG rated asset class, EM corporate debt has offered higher yield over similarly rated developed market (DM) corporates, a reflection of the higher risk premium investors typically require when investing in EM. However, investor perception of risk in emerging markets is changing as corporate governance is improving in private markets and macro policy across the EM universe has become more orthodox. Meanwhile, events in Europe and the US have demonstrated that political risk exists in the developed world too.

At a company level, fundamentals have seen considerable improvement over the last few years as EM corporates have consistently reported lower leverage and higher cash to total debt ration than their US counterparts. At the onset of Covid, however, this relative strength shrank to the point that gross leverage was almost the same and the net leverage differential was the smallest across both asset classes in the past ten years. Since then, and despite the higher rate environment, EM corporates de-levered faster than US credits. Currently, the difference in net leverage and cash to debt ratio in EM vs DM stands above 10-year highs.

> **“As the year progresses, we note that the global economy remains remarkably resilient, with growth holding steady as inflation returns to target in many economies.”**

We also see the EM corporate asset class as a particularly attractive proposition in the current environment. In the IG segment, yields are close to 15 years high, and although spreads are tight on a historical basis, they remain attractive vs US IG. On the HY side, EM corporate defaults having peaked in 2022, at the height of the Chinese real estate crisis, have been coming down materially since that point and are expected to trend closer to the historical average by the end of this year. On the other hand, according to JPMorgan, the US and European High yield default rates are likely to rise somewhat this year. Defaults rates are thus converging between EM and DM corporates as EM defaults fall while DM defaults rise. Looking at the valuation argument, despite strong performance YTD, EM HY still offers a +55bps spread pick-up over US HY, which is 1 standard deviation cheap relative to the 5yr average.

We also believe, that as interest rates normalize globally, asset classes offering higher relative yields and spreads, such as the EM corporates, will stand to benefit more in terms of compression. Investors will therefore be able to capitalize on both carry and potential upside in capital appreciation. Moreover, our observation is that the issuance in the EM corporate sector has been declining in the last few years, and negative on a net financing basis, given buybacks/liability management. We expect this trend to continue in the coming period, making the technical conditions favorable for investment. This is even further enhanced by the argument that EM corporates are underrepresented in investor global portfolios, should put the asset class in strong footing going forward.

What are your expectations for growth and inflation in key emerging markets for the coming year?

As the year progresses, we note that the global economy remains remarkably resilient, with growth holding steady as inflation returns to target in many economies. Despite the many headwinds including uncertain geopolitical environment and global monetary policy tightening, the world has largely avoided a recession, the banking system continues to be resilient, capital flows to most emerging market economies excluding China have been buoyant, and some frontier economies regained market access. Moreover, the inflation surge appears to have already dissipated in most regions within EM.

In terms of overall growth, our expectations are in line with those of the IMF, expecting EM economies to continue to outgrow DM economies.

We also closely monitor leading macro indicators such as PMI data for major EM economies, noting that the slow done seen in the last two years appears to have ended and the trend is now positive. This is true specifically across Latin America and Middle East (GCC), two regions where we have a positive view and positioning based on the improving fundamentals, which are yet to be reflected in valuations.

Inflationary trends continue to show improvement across the EM universe. EM central banks have been running a mostly orthodox set of monetary policies since 2020, helping get ahead of the curve compared to developed markets. EM economies, on average, did not face the same core service-driven inflation pressure, driven by tight labour markets, that we have seen across a number of DM economies. Core goods disinflation, driven by China, has been an important component of the inflationary tailwinds that EM economies faced.

However, EM central banks have been very cautious not to embark on too aggressive a rate cutting cycle, whilst we have had uncertainty on the future direction and peak of policy rates, particularly from the Fed.

However, we now have a fair amount of conviction, the Fed is done, and this in and of itself should give the EM central bankers who have garnered the hard-won credibility, the opportunity to follow through on a deeper cutting cycle, anchoring duration trades across the landscape. We also feel that the base case for oil prices should remain range bound at current levels, but with a greater tail to the downside, which could translate to further downside pressure to headline inflation and more scope for EM central banks to ease restrictive policy stance further.

What are the key drivers of idiosyncratic risk in emerging markets that investors should be aware of?

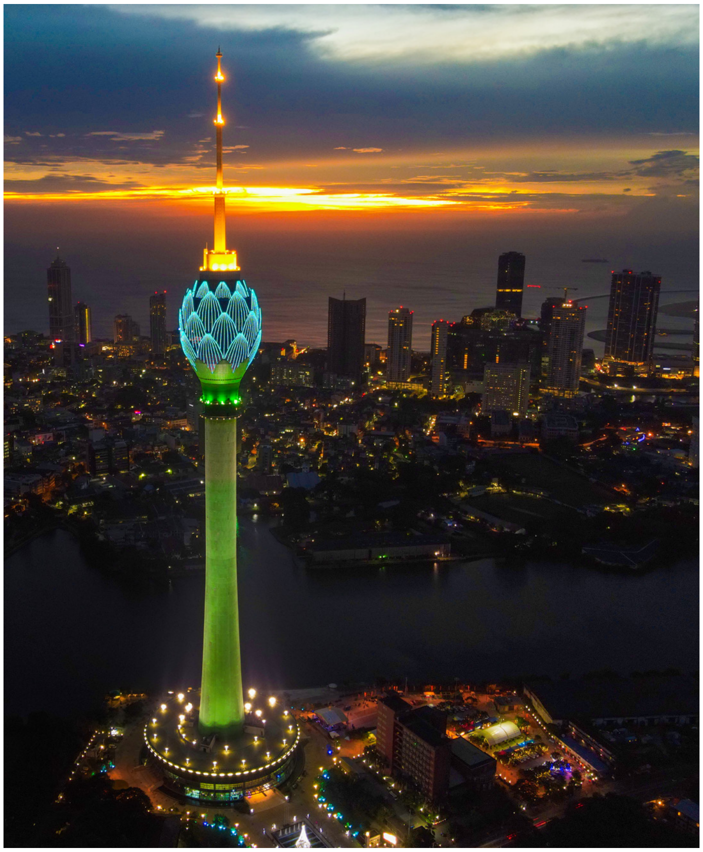
There are various risks associated with investing in Emerging markets that investors should be cognizant off. At times Emerging markets may be more volatile due to a greater risk of less government supervision, legal regulation and less well-defined tax laws and procedures than in countries with more developed trading markets. Emerging markets can be particularly sensitive to political instability, which can result in greater volatility and uncertainty, subjecting their investment to the risk of losses.

After this, the key drivers of risk in emerging markets, to a large extent, are dependent on the particular EM sub asset class. On the hard currency side, the key drivers of risk and return are US rates and credit spreads while on the local currency side, it is local rates and currency movements.

> **"Sovereign credit analysis is carried out internally by our team of dedicated sovereign specialists and portfolio managers."**

Additionally, EMD offers a vast opportunity set and remains an under-researched asset class, leading to the risk of market inefficiencies within this asset class. These can be technical, supply and demand, or institutional in nature. Along with being a risk, these inefficiencies can also present an opportunity to generate alpha. As bottom-up investors our responsibility is to identify such price discrepancies, in light of fundamental and technical factors, and take a view to generate optimal risk adjusted returns over the medium to long term.

On an investment level, the key market risks that investors should be cognizant of can be summarized in the investor framework for evaluating emerging markets below.



Discuss the role of sovereign credit ratings in your investment process for EM debt.

Sovereign credit analysis is carried out internally by our team of dedicated sovereign specialists and portfolio managers. As part of the bottom-up analysis, the team independently establishes the strength and weakness of a country's balance sheet to determine its ability to honor debt obligations. This includes analysis on various macroeconomic indicators, stock measures (level of external and public sector debt), flow measures (trade, fiscal balances) and financial vulnerability measures (adequacy of international reserves). The sovereign specialists are expected to form a strong opinion on the fundamental creditworthiness of the issuers they cover, whilst keeping a value-oriented approach and having the ability to generate trade ideas in their respective regions.

Whist we do our own internal analysis, it is also important for us to consider the impact rating agencies can have on spreads/prices in the event of a ratings change, given their influence on investment parameters and guidelines for many investors. Part of our analysis is to be fully conversant with the agencies analysis (views) at any point in time when formulating our own opinion. Broadly speaking, we are trying to be ahead of any downgrades or upgrades before they are communicated by credit rating agencies.

How do you differentiate between opportunities in local currency vs hard currency EM debt?

Within the EM asset class, the hard currency and local currency debt sub asset class have different characteristics as well as different drivers of risk/return.

On credit (hard currency) side, the key return drivers are US rates and credit spreads and in local currency, it is local rates and FX.

In sovereign credit, we aim to establish the strengths and weaknesses of the country's balance sheet, while determining the ability of the country to honor debt obligations. The key parameters that help us assess this are, among others; the level of external and public sector debt within the country, the fiscal balance and the adequacy of international reserves to prevent potential financial vulnerability.

In corporate bonds, we utilize both a bottom-up and top-down approach to assess the attractiveness of corporate debt. Our bottom-up, fundamental analysis involves looking at each company in depth, in terms of financials, covenants and corporate structure. In addition, we will not invest in a corporate without first meeting the management, to gain a valuable insight into how the company is run. In terms of our top-down analysis, we focus on the broad macroeconomic outlook, in addition to specific industry dynamics and idiosyncratic country factors.

In terms of local currency opportunities, in our rates analysis, we utilize a 12-month forward forecast of monetary policy to better understand the front end of a country's yield curve. This enables us to think like an orthodox, inflation-targeting central bank and allows us to predict and pre-empt potential policy responses.

"On credit (hard currency) side, the key return drivers are US rates and credit spreads and in local currency, it is local rates and FX."

In FX, we perform analyses to identify currencies that are over or undervalued and thus should adjust relative to other currencies. Our analysis combines fundamental currency valuations and our 12-month forecasts which focus on changes in GDP growth, current account balances and changes in terms of trade. Consequently, on any given country, our FX and rates view may diverge, based on the relative merits of each individual investment opportunity.

Portfolio Manager Perspectives
Our experts offer their perspectives on the latest developments in global credit and the state of the markets.

LEARN MORE

RBC Global Asset Management (U.S.) Inc.
800.553.2143 | **rbcgam.com**