RBC Global Asset Management

Opportunities in Emerging Markets amidst volatility

July 2024

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As 2024 unfolds, emerging market debt finds itself marked by both volatility and significant growth potential, demanding astute management and strategic insight.

Key points:

- There has been a fundamental improvement in sovereign balance sheets and an improved pace of growth in emerging markets.
- We've seen a more prudent fiscal stance in the emerging markets versus developed markets in terms of expanding fiscal deficits.
- Most companies in emerging markets are funded through loans, not through bonds.
- Emerging market loans don't have liquidity, so the illiquid opportunity set is significant.

Geopolitical tensions in the Middle East and Central Europe have further complicated the risk environment, highlighting the necessity for investors to adopt nuanced approaches. For investors with a good understanding of this dynamic market, EM (emerging markets) debt still proves a compelling entry point or increase in allocation to the asset class despite current macro dislocations in some sectors.

Why Emerging Markets Debt Now?

Over the last five years, headlines surrounding emerging markets have been broadly negative, focusing on frontier countries like Zambia, Sri Lanka, and Ghana undergoing debt restructuring largely due to hard currency debt and tighter liquidity conditions. However, this narrative overlooks a more constructive story within larger EM markets. EM debt is a $25 trillion asset class spanning over 80 countries across local and hard currency instruments, with frontier economies accounting for only 10-15 countries. Major economies like Brazil, Mexico, and India have shown significant improvements in sovereign balance sheets and growth rates through challenging periods.

One prominent difference and development within the asset class that has contributed significantly to its transformation is the adoption of prudent monetary policies. "EM economies in general have not widened their fiscal deficit through the period of COVID as much as their developed market counterparts, and recently, have reduced their fiscal deficits.

What's even more surprising is that, despite relatively tight monetary policy and quite constrained fiscal policy, most EM countries have registered one of the strongest paces of growth over the last few years that we've seen over the last two decades," says Polina Kurdyavko, Head of BlueBay Emerging Market Debt and Senior Portfolio Manager at RBC Global Asset Management. "Additionally, most central bank governors in the emerging markets started hiking rates at least a couple of years before their developed market counterparts and have maintained quite a hawkish policy stance even after they've seen confirmation of inflation coming down, which in some cases has already been coming down for over a year now," she adds.

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Interestingly, macro and credit trends show an expectation of default rates in the sovereign space to be close to zero, if not zero, for the next couple of years. "On the corporate side, we expect the default rate to run below the historical average, which has been about 3.5%. In the corporate space, the run rate is less than 1% YTD, and we don't think it would be surprising if the year and default rate for corporates would be between 2-2.5%," says Kurdyavko.

From both a corporate and sovereign perspective, constructive fundamentals underpin the endurance of the asset class, despite high interest rate environments.

"We've actually seen this resilience before EM corporates came into the recent high-rate environment. Their balance sheets were actually quite healthy outside a few spots, like Chinese real estate for example. We have witnessed such an improvement in terms of the underlying balance sheets," says Mihai Florian, BlueBay Senior Portfolio Manager with the EM debt team at RBC Global Asset Management.

"If we look at the cash that these corporates hold versus the total debt, it's close to 50% at the moment and 100% and above for the short-term debt. This ability to service the debt will drive lower default rates going forward, and further, that really means there's no assumption of depreciation in the currency and no assumption of much higher inflation," Florian adds.

Current Liquid and Illiquid Opportunity Sets

Return expectations and overall opportunities in EM are defined in liquid and illiquid categories. On the bond side, the opportunities present themselves in both relative and absolute return strategies. Emerging market hard currency debt currently offers high single-digit yields and is expected to deliver positive returns in the next few years. However, Kurdyavko believes the best way to generate double-digit returns "is through the absolute return approach and through the areas of emerging markets where we've seen the biggest dislocations, which have been more on the sovereign side, particularly in frontier markets, and less on the corporate side."

Event risk in emerging markets is also high, driven by elections, geopolitical risks, and fundamental changes in corporations. An absolute return strategy is effective in managing this volatility, having delivered nearly 10% annualized returns over the past decade without a negative year, while most indices delivered largely flat returns. "Investors uncertain about market beta can still benefit from dislocations in EM fixed income through absolute return approaches," Kurdyavko adds.

On the illiquid side, which focuses on EM market loans and strategies largely developed over the last 5 years, the opportunity is significant, and Florian attributes this to EM private credit currently standing where the European market was 10-12 years ago, post-GFC. "About 90% of funding needs in EM come from banks, compared to 50-60% in Europe and 20-30% in the U.S.," Florian says.

EM corporates lack alternative capital sources like private credit lenders and insurance companies, but this might be an opportunity for the right investor. "The reliance on the banking sector was very high in the past, but as corporates begin pulling away from banks, it creates opportunities for asset managers that have deep knowledge of EM to start filling this gap. This, as an industry, is only in its beginning phases, and we ultimately believe going forward that it will grow to a large industry similar to what we have seen in the European sector" says Florian.

Current returns, sitting in the double digits and with lower risk, are perhaps a testament to documentation. "EM loans still follow old-style documentation with full financial covenants, providing better overall risk management. These companies have lower net leverage (2-4 times) compared to their developed market counterparts (5-6 times). The market has little competition, allowing managers to extract higher returns for similar or lower risk," adds Florian. Such an environment of robust covenants and less perceived risk presents a prime opportunity for investors.

Commodity Prices, Currency Risk, and China

High commodity prices can negatively impact inflation, but recently, prices have remained high without continuous increases. This has led to decreasing inflation rates in EM since June, although central banks remain cautious about aggressive rate cuts due to potential inflationary pressures down the line. Higher real rates in EM might make them more resilient, as "80% of EM funding is actually done through local markets, not through external markets," Kurdyavko points out. "Currency devaluation has been gradual, avoiding any major crises. Recently, local currency assets have outperformed hard currency assets driven by high carry and reduced volatility. We expect EM currencies to remain broadly unchanged versus the dollar due to high local rates and central bank caution amid US election uncertainty, she adds. Overall, central EM banks are more sophisticated and better equipped to manage debt and reserves more prudently.

When it comes to investing in local currency assets, Florian says "it's most effective to use active, liquid strategies. This approach allows us to respond swiftly to market changes and manage risks more efficiently. Illiquid strategies in emerging markets, particularly those involving corporate investments, do not tend to mix well with local currencies. The illiquidity combined with local currency exposure introduces significant foreign risk, which can be a major concern".

For illiquid strategies, Florian says he strictly targets hard currency instruments. "This approach helps mitigate the FX risk that is otherwise prominent in local currency investments. Additionally, we also ensure that the companies we invest in either generate export revenues or have contracts denominated in hard currencies to possess the capability to hedge their FX exposure. One good example is port infrastructure, a sector that typically has their contracts in U.S. dollars".

Another major concern when considering EM is China. Despite its massive global influence, "China is unlike the EM equity world, as in EM fixed income, China represents less than 5% of the market," says Kurdyavko. "So, it's not a hard decision to not invest in, or be meaningfully underweight in, China," she adds. China seems to be a limited fixed income asset, but its influence remains all the same. "I think from a growth perspective, it does have more of an impact, but what's interesting is the slowdown in growth we've observed in China has been compensated by higher growth in countries that benefitted from the slowdown, like India and Mexico," Kurdyavko points out.

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From a geopolitical and sanction risk perspective, Kurdyavko says there is still some risk for sanctions to be introduced, but "I do feel that the risk is not comparable at all to what happened to Russia and Ukraine. Sanctions are expected to be targeted at individual entities, rather than broad-based, due to China's significant economic influence. "At the end of the day, the economic significance of China is on a completely different level and most developed markets and EM economies know that they cannot shut out China from the global market, given the economic interlinkage," she adds.

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