Current opportunities in emerging markets debt

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As the uncertain global macroeconomic backdrop appears likely to persist through 2025, the search for resilient investment strategies remains top of mind. Polina Kurdyavko, Head of BlueBay Emerging Markets, shares her expertise on investment approaches to emerging market debt that stand out as particularly compelling in today's environment.

Key takeaways

- The current market environment has renewed interest in alternative fixed-income strategies in emerging markets.
- Private credit strategies that exploit the illiquidity premium in less liquid instruments and event-driven strategies that target volatility in emerging markets are well positioned to capitalize on this year's opportunities.
- The market opportunity for private credit in emerging markets lies in high quality illiquid hard currency loans that offer strong creditor protection. Investors that are able to take a longer investment horizon can further enhance returns by taking advantage of market dislocations and providing liquidity to forced sellers.
- Market volatility may magnify inefficiencies and return dispersion, allowing opportunistic generation of alpha through both long and short positioning.

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Why is the current market environment favourable to alternative fixed-income strategies in emerging markets?

PK: Looking at these strategies over the past two decades, we saw a decline in interest after the global financial crisis as investors shied away from hedge funds. However, we have seen increased interest in this space in recent periods, driven in part by market volatility and the relatively higher yields in emerging markets (EM).

As long-term investors, we believe the structural arguments supporting emerging markets debt's (EMD) outperformance remain firmly intact: high yields, strong fundamentals and attractive relative valuations. We have already seen a significant pick-up in interest from investors aiming to get ahead of the crowd, positioning themselves to benefit once flows into the asset class begin to gain momentum. The challenge for many, however, is determining the optimal EMD strategy through which to gain exposure, given the range of options.

Which specific strategies do you believe are well positioned to capitalise on the opportunity set this year?

PK: We expect market volatility – driven by geopolitical events, policy measures and commodity prices – to continue to affect investor appetite for EM credit. On the private side, market volatility and news flow can lead to banks needing to reduce their balance sheets by offloading loans, regardless of the high quality of the exposure. Moreover, any reluctance of banks to provide new lending to corporates can translate into opportunities for private credit strategies to step in.

Alternatively, investors can seek to take advantage of strategies that benefit from the volatility from credit-specific events, flows or external shocks. Such approaches focus on generating positive risk-adjusted returns regardless of the broader market environment. This can be achieved through a diversified set of long and short opportunities, as well as relative value, event-driven, and stressed trades across the liquid EM universe.

We believe that both strategies are well positioned to capitalise on the opportunity set this year. However, the optimal solution for each investor is based on their individual requirements with respect to benchmark or liquidity, and their flexibility regarding asset class exposure.

What do you believe is the current market opportunity for private credit?

PK: When we refer to 'emerging markets' we are essentially talking about every country or region in the world except core developed markets, such as Western Europe, North America, Australia and Japan.

Around 90 percent of the companies that operate in those countries bank through loans rather than bonds. But, unlike in developed markets (DM), the secondary markets in loans are not active and, as a result, liquidity is highly constrained given bank loans are generally provided on a bilateral basis to companies.

One positive outcome of this is, unlike in the European leveraged loan market, there has been no weakening of covenants and loan documentation over time. This puts EM creditors in a more robust position than their DM peers as the loans are typically executed under 'old style' documentation, with a full financial covenant package, restrictions on disposals, moving assets and dividend payments to shareholders, and enhanced creditor protections.

In our view, private credit strategies in EM, particularly those involving corporate investments, do not tend to make sense in local currencies. The illiquidity of the underlying investment, combined with local currency exposure, introduces significant FX risk that can be difficult to hedge.

At the same time, the longer-term investment horizon of a locked-up fund also means these vehicles are not susceptible to the shorter-term risk dynamics of market volatility and potential flow fluctuations in the EM asset class.

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In EM, if you have a forced seller of a loan, there are very few players that can take on that risk. As such, we can see increased returns on the secondary market. Here, we can often achieve more favorable pricing by providing liquidity in what is an overwhelmingly illiquid market while purchasing assets of strong credits, with shorter maturity profiles and better protections.

How could volatility have a positive impact on the firm's EM long-short capability?

PK: In addition to sources of dispersion and volatility within the EM universe, the global geopolitical backdrop in 2025 could also pose new questions for some EM issuers and opportunities for others. In the near term, markets are focusing on the potential implications of President Trump's policy announcements and expecting volatility to remain elevated. For investors able to invest in long-short strategies, this volatility could be key in driving return dispersion and market inefficiencies, and contributing to an ongoing, attractive opportunity.

We believe the EM opportunity set is particularly compelling from a long-short perspective, as portfolios can not only benefit from tailwinds but also take proactive short views to position for some potential headwinds. With market volatility likely in coming months, a long-short approach to investing provides flexibility to generate positive returns regardless of market direction. Given its depth and breadth, as well as inherent inefficiencies, the EMD landscape may provide the ideal environment for long-short investors to source alpha- generating opportunities.

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