RBC Global Asset Management

EM Debt: a bright spot in stormy skies

March 2024

Polina Kurdyavko
Head of BlueBay
Emerging Markets

BlueBay Fixed Income Team

As we head towards the end of Q1, Polina Kurdyavko discusses the opportunities and risks in EM debt, how geopolitics could impact the asset class this year, and what's top of mind for investors.

> "Despite the opportunities for double-digit yield, emerging markets debt ("EMD") as an asset class has faced challenges attracting inflows in recent years."

A resilient asset class...

Despite the opportunities for double-digit yield, emerging markets debt ("EMD") as an asset class has faced challenges attracting inflows in recent years. To understand why, it's important that we consider the wider picture with respect to the macro environment and how this has influenced the investor mindset.

In light of the prolonged economic uncertainty that has plagued markets, we have witnessed investor behaviour becoming more risk averse. This has resulted in a move to what are typically seen as safer (and more familiar) assets, with EMD seen as too much of an 'unknown', despite the potential for attractive returns.

At the same time, we have also seen two key headwinds in the asset class: firstly, the withdrawal of liquidity given the increase in Fed rates; and secondly, an increase in default rates for EM sovereign debt, driven by a number of frontier markets struggling with debt sustainability.

...and a timely moment to take exposure

In 2024, we see good reasons for long-term investors to be interested in the asset class. These include improving fundamentals driven by a combination of prolonged commodity prices, reducing fiscal and current account deficits, global tourism bringing in additional revenue and taxes, and positive economic growth helping metrics like debt-to-GDP to fall slightly.

Meanwhile, inflationary trends continue to show improvement across the EM universe. This is a result of EM central banks running a mostly orthodox set of monetary policies since 2020. These have helped their respective economies get ahead of the curve, compared to developed markets, and recover quickly from both 'Covid malaise' and 'inflation malaise'.

And finally, the yield remains very high historically, at 8.10% at the end of February for the sovereign asset class.

Where we see opportunity – and where we're cautious

Looking ahead, we tend to favour export-biased countries (particularly commodity producers) in Latin America and the Middle East. These present comparatively low credit risk, given their respective higher credit quality and exposure to commodity prices that remain elevated. Meanwhile, lower rates countries that have recently gone through restructuring, or that have managed to avoid debt restructuring entirely, also present opportunities for double-digit returns on a more opportunistic basis.

With regards to Latin America in particular, we see opportunities in some quasi-sovereign names in Mexico. We also favour Colombia in spread duration terms, and especially quasi-sovereign credit, given the commodity price environment and deleveraging of the last few years. Thirdly, we're interested in some of the corporate stories in Brazil, where bonds have been restructured but are now performing and offering double-digit yields.

On the other hand, we're cautious on Asia, as it's a region where we see greater levels of risk, for example, potential sanctions on China, or South Korea, which is driven more by valuations than anything else.

Risk is ever present, but the investment case remains compelling

There are three key risks that we would highlight. Firstly, with 2024 bearing witness to the highest number of people ever heading to the polls, there are several elections that could impact both regional and global outlooks, resulting in heightened geopolitical risk. The largest of these will be the US and what a Trump presidency holds in terms of injecting further uncertainty, and the corresponding increase in global market volatility, particularly in relation to China and global trade.

Secondly, the direction of Fed policy rates as it attempts to strike a balance between cutting rates and grappling with inflation, and finally there is the risk of a potential escalation of current regional geopolitical events to a global scale.

"We're cautious on Asia, as it's a region where we see greater levels of risk, for example, potential sanctions on China, or South Korea, which is driven more by valuations than anything else."

Yet, despite the potential volatility ahead, EMD still presents a compelling investment case for long-term investors looking to add exposure to the asset class.

We believe nimble portfolio construction, a focus on liquidity and fundamental conviction will be a crucial discipline to adhere to this year.

An active, bottom-up approach is key

Investors are typically concerned about whether rates volatility will continue to be a headwind for the asset class. On that front, we remain somewhat cautious, as we believe (given the health of the US economy as evidenced by both jobs and inflation numbers) that rate cuts could be delayed and smaller in magnitude this year. This would reinforce the theme of 'higher for even longer' than many market participants had hoped.

That said, although there is a case for re-orientation of expectations, we believe that EMD is well positioned to still post positive returns aided by higher carry, improving fundamentals and supply technicals.

We remain constructive on the asset class, especially on credit. While EMD carries with it a certain amount of risk, we believe an active, bottom-up approach is key to success. With a strong research process we are confident that the weakest credits can be avoided and that strong alpha can be generated from the rest of the asset class.

Author

Polina Kurdyavko

Head of BlueBay Emerging Markets

Polina is Head of BlueBay Emerging Markets and BlueBay Senior Portfolio Manager. In addition to oversight of investments across all EM strategies, Polina is also a lead portfolio manager for several flagship funds in EM sovereign, credit and local markets, including long only and alternative products. Polina started her career in emerging markets after the Russian financial crisis in 1998 and has, since then, gained expertise across a broad range of emerging market financial assets.

Polina joined BlueBay Asset Management (which is now part of RBC Global Asset Management) in July 2005 from UBS where she was a credit analyst in EM corporate research. Her role encompassed coverage of EM issuers as well as research support for primary issuance of corporate debt. Prior to this, Polina was with Alliance Capital where she was an emerging markets equity analyst and then moved on to pioneer emerging markets quantitative research at the firm. She started her career in a macro research boutique in Russia. Polina holds an MSc (Hons) in Finance from the People's Friendship University of Russia, Moscow and is a CFA charterholder.

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.
Minneapolis | Boston | Chicago
800.553.2143 | **rbcgam.com**