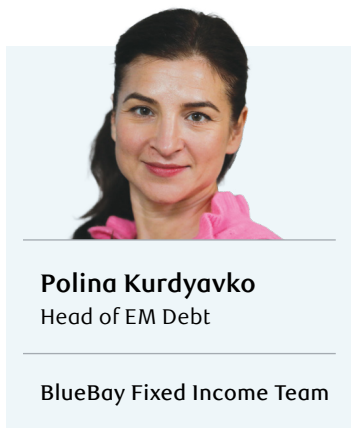


Polina's Perspective

A journey to maturity – reflections from the window seat



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There is something truly special about travelling in a window seat. A few weeks ago, on a tour of South America – visiting Brazil, Argentina, and Colombia following the IMF annual meetings in Washington D.C. – I found myself gazing out of the aeroplane window, contemplating the vast landscapes below.

Such moments provide, literally, a bird's-eye view and offer time for reflection on both the challenges and opportunities facing these countries. As investors, maintaining perspective is key, and a reminder that the policies we advocate can also have significant side effects once implemented.

What was our wishlist?

1. The shift towards monetary orthodoxy: looking back over the past 25 years, one of the biggest changes in emerging markets has been the widespread adoption of monetary policy orthodoxy, which has enabled countries to have more influence on local inflation dynamics while also developing deep and sophisticated domestic markets. This shift has significantly reduced reliance on external debt, with over 90% of all emerging market debt now issued locally, thereby mitigating vulnerability to external financing shocks. However, even well-intentioned policies can have unintended consequences.

Consider Brazil as a case in point. In response to significant service inflation, driven by what central bank president, Galipolo, describes as the most robust labour market in 30 years, the bank has increased interest rates by 425bps over the past year, resulting in a policy rate of 15%. This measure has been effective in curbing inflation that has been exacerbated by employment dynamics and fiscal policies.

However, it has also rendered corporate borrowing substantially more costly. In other words, Brazilian companies with a leverage level of over 3x now spend 60% of their EBITDA on servicing their interest bills. Even some of the companies that I met in Sao Paulo, with an investment grade rating that relied on the domestic funding market, saw their leverage and interest bills almost double over the last year. This unsustainable position has resulted in a high level of defaults in the local market.

According to Bloomberg analyst Gabriel Gusan, 31% of all companies in Brazil (including micro-enterprises) were behind on their loan payments as of June 2025. Across the world, Turkey has also joined Brazil in this double-digit rate environment after hiking rates, from 8.5% in June 2023 to 50% in March 2024. Despite rates cuts this year, with the policy rate at 39.5%, Turkish corporates are still feeling the strain, though many rely more on external rather than domestic funding.

Looking ahead to 2026, we expect corporate defaults to rise, particularly in some portions of the Brazilian market, where paying the price for orthodox monetary policy has crippled balance sheets, especially in the sectors that also experienced demand slowdown and margin pressure. The silver lining is that most Brazilian corporates have weathered many crises over the past two decades, which has fostered resilience. Although default statistics are likely to show an increase, the overall asset quality of Brazilian companies remains strong, presenting opportunities for positive performance for discerning investors. Moreover, we favour opportunities in the local market in Brazil, given attractive real rates and continuous policy orthodoxy.

2. Growth of the domestic market: another area of focus has been the development of deep local markets, which allow companies and countries to refinance their debt domestically and increase their resilience to external volatility.

Over the last decade, the local market universe in EM has grown to over USD25 trillion, almost equivalent to the size of US Treasury market, offering funding to corporates, governments, and municipalities. Whilst higher participation of retail investors has contributed to this growth, it has also presented new challenges, such as the creation of structured products that have, in some cases, also led to excessive leverage and volatility in the system.

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In Brazil for example, poor performance of hedge fund products and the equity market in recent years has driven explosive growth in the domestic corporate debt market, now approaching USD400 billion. Tax incentives have encouraged direct retail investment, while some funding has been provided through structured notes issued by local brokers (such as COE – Certificados de Operações Estruturadas) that can incorporate certain price triggers via an added derivative leg that can increase market volatility when activated.

Recently, excessive volatility has tested these structures, causing forced sales and technical-driven dislocation. In some cases, investment grade corporates have traded at double-digit yields due to these technical factors, rather than fundamental concerns. Additionally, domestic investors often operate in non-regulated segments, which can introduce further leverage and volatility. A recent example is Argentina, where negative provincial election results in Buenos Aires led to sharp swings in bond prices, exacerbated by leveraged domestic positions of local brokers.



In my meetings with policymakers in Buenos Aires, I was surprised to discover that 45% of M2 money supply of ARS51.29 trillion (USD34 billion) in the country was in US dollars. It felt as though the country was operating like a large hedge fund, making a bet on its own policy mix. We felt that this technical offered a good opportunity to trade Argentina's sovereign bonds as the price action did not necessarily reflect the fundamentals ahead of the mid-term elections.

As EM investors observing the ongoing evolution of local markets, we must also acknowledge that they, too, are susceptible to the speculative bubbles and volatility that we experience in developed markets and, moreover, that external markets will not necessarily be immune to these bouts of volatility. This underscores the importance of staying close to local dynamics, even if not investing directly in these markets.

3. A defined path towards FX market liberalisation: investors have also historically advocated the liberalisation of foreign exchange markets. While most major emerging markets have adopted floating FX regimes and open capital accounts, some are still progressing towards this orthodoxy. In Argentina, the government has taken steps to liberalise FX by creating an FX corridor and allowing capital movement.

However, these measures initially prompted outflows, as foreign investors – including long-standing foreign companies, such as Exxon Mobile, Petronas, Procter & Gamble, and HSBC Carrefour to name a few – seized the opportunity, following the lifting of capital controls to exit their Argentine businesses, given uncertainty around repatriating investment proceeds and the business environment going forward.

Although markets welcome further liberalisation, the central bank's lack of adequate reserves could lead to heightened volatility during this transition. Without full FX and capital account liberalisation, it will be challenging to attract international investors back to Argentina. However, in addition to this, some of the foreign businesses are likely to wait to see the impact of a change in government from the current team to the opposition in order to confirm policy stability before re-entering the market.

Local companies are seeing this as a great opportunity to acquire assets at attractive valuations. Some companies in electricity and energy sectors have been prudent and relied in large part on internal cashflow to finance the expansion while keeping leverage low. We think this provides an interesting opportunity for EM corporate investors to participate in in hard currency issuance by these names. That said, local market development in Argentina is likely to have a longer road ahead to building investor confidence.

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At the other end of the spectrum, China is cautiously experimenting with capital account liberalisation, launching small pilot projects in Shanghai. The memory of nearly USD1 trillion in outflows during the last major attempt in 2015 has made the government wary of nationwide reforms, preferring incremental steps to test the path towards broader liberalisation.

In this case, we believe tactical local currency exposure could provide an interesting opportunity to benefit from positive sentiment as the liberalisation momentum picks up, against a backdrop of a more conciliatory tone between the US and China, albeit in the short term.

4. IMF policy advice and financial support for weaker countries: despite the IMF and World Bank's initiative to provide financial assistance to Heavily Indebted Poor Countries, or the so-called the HIPC Initiative established in 1996, the majority of these countries are again facing challenges two decades later.

Many have participated in numerous IMF programmes, however, the combination of demographic pressures, challenges in tax collection, and corruption have increased fiscal burdens and led to restructurings in the last few years in countries like Ethiopia, Ghana, and Zambia, to name a few. Some, such as Senegal, still face challenges, struggling to get a staff-level agreement from the IMF that would provide much-needed funding support.

Investors are also demanding a high price for providing liquidity in frontier markets. The Republic of Congo, for instance, recently tested the market with a new bond yielding 13.7% – a clearly unsustainable level longer term, particularly for a country facing high social needs including electricity, water, and health, and an election year ahead of it. The country only finished restructuring its local debt in November 2024 and yet leverage remains elevated with total debt to GDP at 95%.

Investors need to differentiate between countries, as some – like Zambia – have successfully emerged from restructuring and are trading at single-digit yields, while others continue to face significant challenges. We maintain a relatively cautious view on this universe and continue to closely monitor steps that these countries are taking to emerge on a more sustainable path.

Interestingly, this topic also raises debate within the IMF circles. During my trip to Washington D.C., I met with some IMF officials who equally expressed their concerns regarding debt sustainability in some HIPC countries, and we discussed the need to perhaps consider a different approach to supporting these countries going forward.

Summary

Emerging markets are on their journey to maturity. Over the past two and a half decades, they have evolved significantly, benefiting both the countries themselves and their investors. Looking forward, the ongoing growth of these markets means that greater differentiation between corporate and sovereign debt, as well as between local and external market performance, will be crucial.

Investors who remain flexible and can take a holistic approach to research across the various asset classes are likely to be best positioned to achieve strong risk-adjusted returns. Likewise, taking the time to adopt a bird's-eye view also reminds investors that, especially when it comes to the policies we champion, it is important to distinguish between growing pains versus deficiencies when analysing outcomes, as these markets try to progress in their maturity.



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