RBC Global Asset Management

Strong tailwinds arise in emerging market debt

Monetary policy and strong current accounts make a strong case for allocations.

Head of Emerging Markets and Senior Portfolio Manager of the BlueBay Fixed Income Team, ***Polina Kurdyavko****, recently sat down with Institutional Investor to discuss some of the most pressing issues facing EM investors today through an up close and personal look at the current state of emerging market debt.*

There is always a case to be made for emerging markets (EMs) in institutional portfolios, but the argument for structural allocation to EM fixed income is especially compelling right now. Even in this challenging environment, EMs account for half of global GDP and two-thirds of the global growth, despite the current low-growth environment. In more established emerging markets countries, EM debt – even dollar-denominated – is providing over 10% yield.

"That is something we haven't seen consistently since the early 2000s," says Polina Kurdyavko, Head of Emerging Markets and Senior Portfolio Manager on the BlueBay Fixed Income team. "There are no risk-free assets and diversification still matters in the current environment. War in Europe could end tomorrow – or not. Gas supply could start to normalize, and commodity prices start to correct – or not. It's difficult for investors to position themselves for binary scenarios that depend solely on developed markets."

Moreover, there are strong tailwinds EMs derived from higher commodity prices and more orthodox monetary policy. Two-thirds of the emerging market countries are commodity exporters, and higher commodity prices have helped improve current account balances.

"On one hand you have countries who already have positive current account balances – Saudi Arabia has gone from 5% to 15% surplus – but even countries that had current account deficits of 3% to 4% have reduced that to 1%, as is the case in some Latin American countries," says Kurdyavko. "That is a significant indicator of lower vulnerability in emerging market economies, even more so than it was in the 1980s and early 2000s."

Due to a structural lack of supply, Kurdyavko says she doesn't anticipate a sharp downward adjustment of commodities prices even if the BlueBay Fixed Income Team's best-case scenario materializes and the conflict in Ukraine ends soon. That's a positive for commodities exporters in EMs.

The power of monetary policy in EMs

More orthodox monitoring policy is the biggest structural change in emerging markets over the last 20 years. Double digit inflation is common in EMs rather than some "new" thing to worry about, so policymakers don't have the luxury of acting only after inflation reaches elevated levels. That's why EM policymakers have racked up 300 interest rate hikes since the beginning of 2021, preemptively and hawkishly managing inflation down.

Earlier preemptive measures by central banks combined with positive current account dynamics also means that EM currencies have been relatively stable – and that's another reason EMs are well positioned at the moment.

Emerging market fixed income today accounts for about $23 trillion, with only $4 trillion denominated in USD. The remainder is local currency. That is a noteworthy transition that has occurred over the past 20 years, and merits the attention of institutional investors. As monetary policy becomes more orthodox and confidence in policymakers rises, domestic investors – pension funds, domestic banks, and insurance companies – are more willing to fund the fiscal deficit when it comes to sovereign or corporate balance sheets.

"This provides additional stability in years like 2022, where dollar-denominated sovereign and corporate issuance has halved," says Kurdyavko. "Most EMs with well-established domestic markets have reverted to them, reducing exposure to dependence on external markets."

Overcoming concerns around local currency

Investors have historically viewed the U.S. dollar as their preferred currency when uncertainty is high. EM foreign exchange (FX) has devalued by more than 60% in nominal terms over the last 12 years. In other words, the dollar experienced a bull run for more than 10 years – but Kurdyavko believes that run is coming to a close.

"Strong current account dynamics support emerging market currencies, which have outperformed developed

market currencies like the euro or pound, year to date," she says. "Eventually, when uncertainty recedes as the Fed stops hiking rates, we feel there's compelling proposition for valuations in emerging market FX. Another aspect of currency valuations is the difference between real yields in emerging markets versus real yields in developed markets, which today is about 5% – the highest it has ever been."

Assigning valuation anchors for local debt is admittedly a challenge, Kurdyavko says, which means volatility in local currency will remain elevated during uncertain times. However, she adds, "Over a five- or ten-year horizon, I have high level of confidence that local currency will actually outperform hard currency overall, based on the U.S. dollar's bull run coming to an end."

A need to address frontier market challenges

There's a perfect storm occurring in frontier markets which requires action to prevent a prolonged problem, according to Kurdyavko. To her mind, this is the biggest challenge in EMs, including the war and happenings in China.

Frontier markets are around 10% of the total emerging market sovereign bond index – big enough to be considered important in the context of potential downside risks. They tend not to issue a lot of corporate debt, but they do have dollar-denominated sovereign issuance.

"Frontier markets have been the darlings of investors and EMs for the past 15 years or so, and they've accumulated substantial debt," says Kurdyavko. "If you look at the sub-Saharan African countries, their bonded debt went from $5 billion in 2009 to a $100 billion in 2021. But they will struggle to digest higher core rates in the US. Fed policy rate, which makes the funding for those countries more expensive, and in some cases unsustainable. In addition, they still face Covid with low vaccination rates, and some countries like Kenya and Ghana are commodity importers. They've struggled, obviously, in the current commodity environment. Those risk factors might be effectively dealt with independently, but together they make the debt burden potentially unsustainable for many frontier countries."

Kurdyavko advocates for a coordinated approach to restructuring commercial debt in frontier market countries, including mechanisms which reprofile existing debt and links it to key performance indicators "so we have more visibility on what countries are actually delivering." Secondly, she suggests, new funding could be secured via high-quality collateral, allowing frontier to come out of the crisis "rather than experience a lost decade of fiscal austerity and a low-growth environment for years to come."

Currently, at the portfolio level, "we underweight that space. We prefer a barbell approach that overweights higher quality, export-oriented countries and companies – mostly in the Middle East and Latin America – and recent serial defaulters that have no debt to pay for the next three years. We feel that's a better portfolio construct than a B-rated frontier market which could be more vulnerable."

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