Why investors should focus on unconstrained EM strategies

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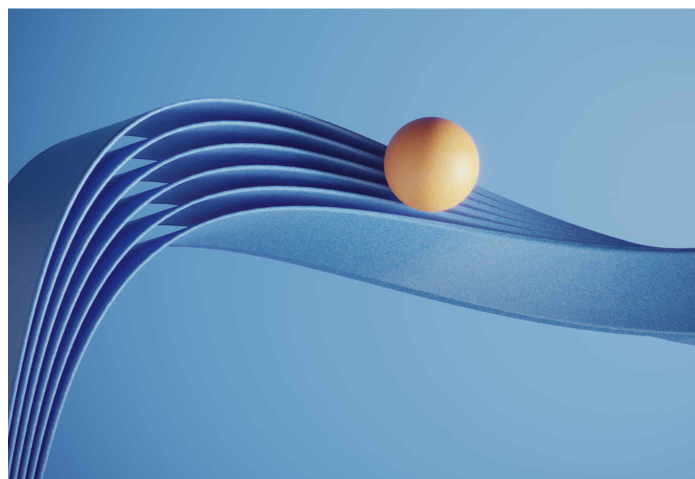
This year has seen heightened levels of dispersion within emerging markets and one of the largest drawdown periods in the asset class's 30-year history. We asked Anthony Kettle, Senior Portfolio Manager, to explain why investors should consider a flexible, unconstrained portfolio solution to both protect downside in volatile markets and capture upside when markets turn.

Where do you currently see the biggest risks in the bond market?

While central banks are pushing front end bond yields higher, it is government led fiscal expansion that is adding further momentum to rising longer dated yields across many government bond curves where sharply negative year to date returns have highlighted the risks from duration this year.

In terms of emerging markets (EM), local market bond curves repriced significantly in 2021 as EM central banks did not have the luxury of calling inflation transitory and instead embarked on an aggressive hiking cycle. While there are divergences across regions, many of the early hikers are now in a position where they are, at or close to, the terminal rate for this cycle. This is in stark contrast to most parts of the developed markets which leave the fiscal outlook as the biggest risk to most EM local bond curves.

A part of EM where we do see significant risks is in frontier economies which are typically smaller countries with a high reliance on external funding. The rapid rise in US rates has curtailed the external financing channel at a time when many of these countries are dealing with high inflation and slowing growth rates which is constraining government budgets. While the IMF and other multilateral agencies have been forthcoming with some support it is unlikely to be enough to restore market access until some of the structural imbalances are rectified in these economies.



> "An unconstrained approach offers the ability to make positive returns by expressing both positive and negative views around ESG metrics."

What is your outlook? Optimistic, or pessimistic?

EM fixed income continues to suffer from outflows although a lack of primary market supply has helped the market to absorb some of this selling pressure. Volatility in core rates markets will continue to present a headwind to EM fixed income although this has left yields on EM sovereign credit at nearly 10% (and above 13% for the high yield sub-component) while local currency yields are close to 7.5%. We also note that in countries that have been hiking rates since the early part of last year, such as Brazil, we have already seen inflation peak and begin to trend down. In the example of Brazil, inflation peaked at 12% in April, began to meaningfully step down in July and is now close to 7%. We expect this trend to be followed in many other parts of EM as rate hikes begin to exert downward pressure on inflation.

There remain multiple headwinds in the form of the Ukraine war and sticky inflation across certain regions, including the developed markets, but we think catching the bottom of the market will be challenging and note that historically these levels of yields have represented a good entry point into the asset class for investors willing to take a medium-term view.

Which bond segments and regions do you favour in the current environment?

In the hard currency space, one area where we see value is in issuers exposed to commodities such as energy and agriculture. Here we have seen some of the commodity exporting credits, such as issuers in the Middle East and Latin America, sell off in line with the commodity importers, even though in many cases the current environment has benefitted their credit profiles.

The dual sell-off in both US rates and EM credit spreads has also led to a large component of the EM credit universe trading at cash prices well below par and for certain credits this represents an interesting asymmetry in the risk/return profile.

In the EM local markets, our preference is to focus on those countries that are at or near the end of their hiking cycles as we expect inflation to continue moderating over the coming months. This should provide opportunities to receive rates in those countries as the fall in inflation will provide central banks with greater flexibility to soften their monetary policy stance at some point in 2023.

Why should investors focus on flexible "unconstrained" strategies instead of traditional bond funds or ETFs?

The twin shocks of Russia's invasion of Ukraine and tightening monetary policy have led to one of the largest drawdown periods in emerging markets' 30-year history. This has been particularly painful for investors who had moved towards passive allocations to EM fixed income over the last few years given the heightened levels of dispersion seen within the asset class this year.

In a world that is likely to remain uncertain over the coming months, we believe investors would do well to consider taking an unconstrained approach to investing. Investing through an unconstrained vehicle gives investors the agility and flexibility to invest anywhere and use a variety of instrument in order to access a broad universe of opportunities and capitalise on mispriced assets on both the positive and negative side. This flexibility also permits managers to construct portfolios that can capture the upside of the potential returns while also protecting on the downside during market downturns.

We also view environmental, social and governance (ESG) risks as critical to protecting downside and delivering positive returns. Importantly, investors need to not only analyse ESG risks, but also implement their views in the portfolio. An unconstrained approach offers the ability to make positive returns by expressing both positive and negative views around ESG metrics.

> **"There remain multiple headwinds in the form of the Ukraine war and sticky inflation across certain regions."**

An unconstrained portfolio solution that employs the strategies highlighted above should be capable of both protecting downside in volatile markets and capturing upside when markets turn. We believe investors should consider this kind of flexible approach as part of their strategic EM fixed income allocation.

What opportunities (and risks) do the now rising interest rates bring?

We previously noted that frontier markets would suffer disproportionately as US yields move higher over the coming months. We also mentioned risks in the degree of fiscal slippage that occurs more broadly across global economies as governments try to cope with a slowdown in growth due to the ongoing tightening in monetary policy.

On a more constructive note, one of the key tailwinds supporting the investment case in EM remains the strong commodity backdrop and the orthodox monetary policy being implemented by the majority of developing countries. The commodity backdrop has translated in a meaningful improvement in the current account dynamics for the majority of EM countries, with over two-thirds of the universe being commodity exporters. Orthodox and proactive monetary policy in most EM countries has resulted in close to double-digit policy rates following two years of rate hikes, allowing them to be on the front foot when it comes to inflation management. Over the last 20 years, several EM countries have also actively developed deeper local markets that allow them to rely on domestic markets when external markets are closed. This helps to mitigate some of the risks from rising interest rates while also providing a more diverse opportunity set within the asset class.

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