EM DEBT: OUR 2021 VIEW

THE BLUEBAY EMERGING MARKETS INVESTMENT TEAM

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In a world starved of growth and income, where do the opportunities lie for EM investors in 2021?

POLINA KURDYAVKO, HEAD OF EMERGING MARKETS

The fate of the global economy hangs in the balance of successful vaccine deployment. This backdrop of uncertainty poses opportunities for active investors, particularly in our view, those open to taking an absolute return or 'unconstrained' approach, which seeks to capitalise on the dispersion and asymmetry caused by such an environment.

Starting with Asia, the Chinese real estate market continues to represent what we view as quite attractive relative valuations – arguably valuations that are not available elsewhere. The reason behind this is primarily the lack of transparency. Fundamentally, the sector appears to be on a stable footing.

Another interesting idiosyncratic story is Turkey. Despite its very poor policy mix for the past few years, where it has spent a large portion of its FX reserves, a lot of the corporates and financials are proving robust. As a result, we see opportunities for returns there.

Next up is Argentina. It restructured its debt last year and has an extremely poor policy mix, which will likely continue. However, it has mid-term elections coming up towards the end of the year, which could shake up the status quo. Its sovereign bonds are well priced and offer attractive yields.

Finally, Angola interests us. It suffered significantly last year because of the lower oil price. However, now that oil prices are bouncing back, it has some relief from multilateral agencies and yields are high – so it represents a potential opportunity to benefit on the upside.

If we were to mark these four examples on a map of the world, you can see the broad set of opportunities open to active emerging market (EM) investors in 2021.

Overall, we believe EMs offer more attractive valuations, higher prospective returns and a more robust 2021 recovery forecast than developed economies. Despite being a consensus view for many investors for some time, the home bias of international investors in the face of the coronavirus pandemic has left the asset class under-owned across many global portfolios. Yet, in our view, prospective returns on EM assets have become relatively more attractive compared to their developed market (DM) counterparts, many of which have elevated valuations on the back of central bank liquidity and zero/negative cash interest rates.

In a world starved of growth and income, we believe the assets of EM economies with disparate economic and political fundamentals offer potentially enhanced return and diversification benefits in global portfolios.

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What are the key macro and geopolitical risks facing EM in 2021?

BRENT DAVID, SENIOR PORTFOLIO MANAGER

EM assets face numerous macro and geopolitical challenges, particularly coming off a year dominated by the global pandemic and record levels of liquidity being injected into the system by central banks. The change in US leadership also poses a number of potential geopolitical flashpoints.

In our view, the two major macro challenges that EM face in 2021 are the ongoing Covid-19 pandemic and any sharp reversal in global liquidity conditions driven by DM central banks

1. The Covid-19 pandemic is far from behind us, even though an end is in sight with the roll-out of vaccines across the globe. The spike in cases, death rates and lockdowns remain a cause for concern and uncertainty. The challenge a number of EM countries now face, in our view, is balancing the economic recovery with the pick-up in cases – with an eye toward securing enough vaccines for the general population. The fiscal risks that EM countries already face has increased significantly; further downside surprises to growth and revenue estimates, driven by more severe lockdowns, will put already challenging fiscal outlooks at greater risk.

2. The liquidity that has been provided by DM central banks has been unprecedented in 2020, with a number of EM central banks following suit. Any reversal of that liquidity, particularly by DM central banks in the face of faster-than-expected recoveries in the developed world, led by greater access to vaccines and economic recovery, would pose significant challenges to the EM asset class this year, in our view.

Geopolitically, the change in US leadership could also pose a number of challenges for EM, particularly the ongoing tensions between the US and China and how the Biden administration will handle trade and technology security. The new administration could very well be less openly confrontational, however, the administration may need to be more aggressive on China, particularly around security issues to appease the Nationalists.

Iran and the re-negotiations of the Joint Comprehensive Plan of Action nuclear deal could pose a number of flashpoints in neighbouring Middle Eastern countries. The Biden administration has significant immediate priorities and Iran may try to force its hand if it gets frustrated at the pace of negotiations.

The debate around Eastern Mediterranean gas is also expected to hot up, with relations between Turkey, Greece, Cyprus, Egypt and Israel all playing a vital role. How this all unfolds with the US trying to bring Turkey back into the NATO fold as a strategic play against further deterioration in US/Russia relations poses significant uncertainty and potential risk events during 2021.

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How could EM be impacted by a Biden presidency?

ANTHONY KETTLE, SENIOR PORTFOLIO MANAGER

A Biden presidency is broadly seen as positive for EM, on the basis that it is likely to provide fresh impetus around the theme of globalisation that suffered so much under the prior administration. We anticipate the US will likely return to its role as a global leader and take a more multilateral approach to world affairs. This should imply a pick-up in global trade and a significant reduction in geopolitical risk.

Asia is seen as a prime beneficiary as further risks around trade are mitigated and as global growth starts to rebound. However, China is likely to see fewer benefits, in our view, as the US maintains a relatively hawkish stance there and as multinational corporations attempt to diversify supply chains away from China into other Asian countries. We also expect there will be a greater focus on China's human rights record. As a result, India is likely to benefit as an established democracy and as a useful military ally for the US in its efforts to tame Chinese ambitions.

In Central and Eastern Europe, a Biden presidency could be much more hawkish on Russia, as it seeks to hold Putin to account after a series of largely unanswered provocations during Trump's time in office. This would likely mean a more difficult relationship between Russia and the US, particularly as we expect a Biden presidency is likely to try and constrain Russian influence in Europe, including Belarus and Ukraine. We believe there will also be more pressure on Turkey given bipartisan willingness in DC to roll out sanctions. However, Turkey remains very important from a geopolitical standpoint and the Democratic establishment understands this, meaning that ultimately Turkey's future actions will determine its relationship with the Biden administration.

In Latin America, Mexico should benefit from the improved geopolitical backdrop while Brazil will no longer benefit from the personal affinity between Trump and Bolsonaro, although we would expect the two countries' strong economic and geopolitical relations to remain. One area to watch will be Brazil's adoption of 5G and Chinese technology – will Brazil choose to align itself with the US or Europe on this matter?

Policy towards Venezuela is also an open question. With the very real possibility of a failed state on the doorstep of the US, the Biden administration could adopt a more pragmatic attitude in which it seeks some form of political compromise to ease pressure on the country.

We also expect the Biden administration to have a much greater focus on democracy and human rights and will therefore have the challenging task of balancing these concerns against its economic and strategic interests in countries like Saudi Arabia, Turkey, Egypt and Russia, amongst others.

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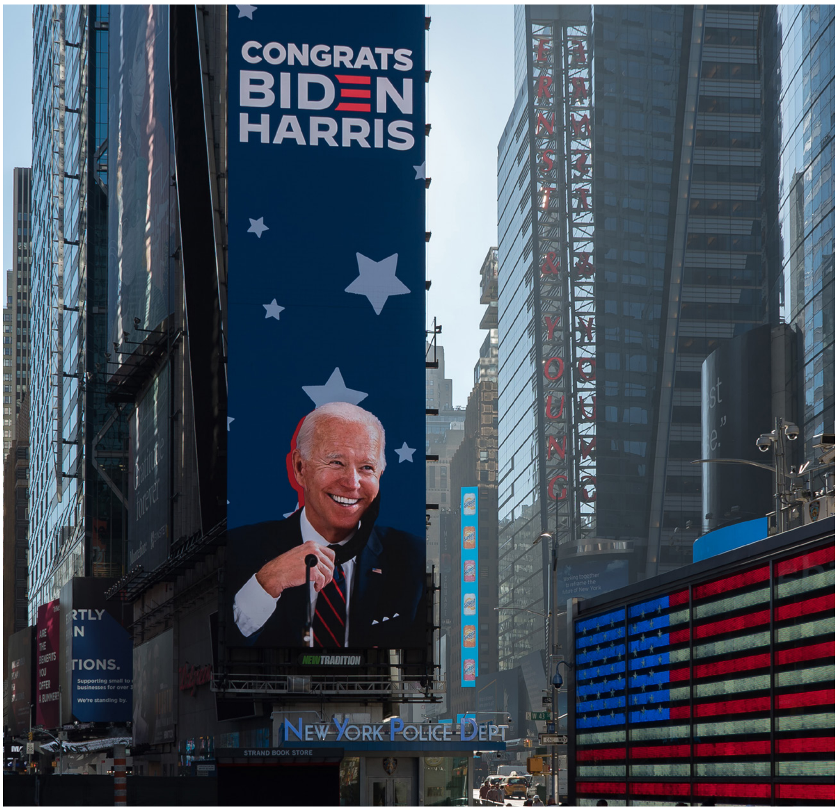

Will the recent trend of EM issuers raising capital through green & social bonds continue?

JANA VELEBOVA, SENIOR PORTFOLIO MANAGER

While small at present, we believe the EM sustainable bond market is set to grow in 2021 at an accelerating pace, in response to both the urgent need to fund global environmental and social sustainability challenges and as a result of growing investor demand. We also expect issuers to not only use this use-of-proceeds funding mechanism to finance eligible green and social projects, but also to increasingly link their funding costs to the achievement of relevant 'sustainability' targets (as pioneered in developed markets by an Italian energy company in 2019, and in EM by a Brazilian pulp and paper producer in 2020), through the recently introduced sustainability-linked bonds (SLBs).

In 2020, almost USD100 billion worth of issues released by EM sovereigns and corporates in hard and local currencies could have been categorised as green, social or SLBs, although definitions and structures continue to vary depending on the taxonomy followed. While green bonds have seen steady issuance, mainly from emerging Asia over the past five years, social and sustainable bonds are very much a recent phenomenon within EM, to some extent expedited by the Covid-19 crisis. Not only do we expect all sustainable issuance to accelerate, echoing the exponential increases witnessed in DM, but also to broaden out into all EM regions and across all parts of the credit spectrum. Last year brought the issuance of the first sovereign high yield green bond and the first EM sovereign social bond. We expect more new frontiers to be broken in 2021 in this regard.

While rapid growth of the sustainable bond market has many positive externalities for the market as a whole, it isn't without its challenges. Given the relatively early stages of the sustainable bond market development, there is more work to be done on standardisation of labelling and taxonomies, as well as on some of the objections often raised against these innovative formats – such as the lack of penalties against non-adherence to green/social objectives. As investors, we need to remain selective and hold issuers to high standards while working with the industry to encourage greater standardisation and improved rules around this promising, nascent market.

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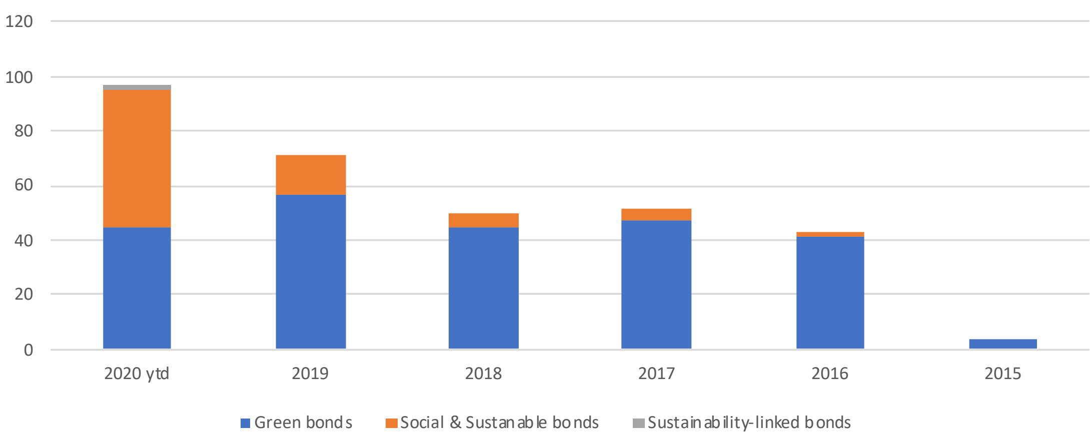
EM SUSTAINABLE BOND MARKET (LOCAL & HARD CURRENCY)



Source: HSBC, as at November 2020

Should investors consider EM local currency for their portfolio in 2021 having experienced volatility over the last 10 years?

BRENT DAVID, SENIOR PORTFOLIO MANAGER
GAUTAM KALANI, EM FX STRATEGIST/ PORTFOLIO MANAGER

Despite the high historical volatility observed in the EM local asset class, we believe it is an attractive proposition for investors going into 2021 for three key reasons:

1. Attractive valuations for EM FX – in both nominal and real terms, EM FX is still at multi-year lows. As a result, on simple medium-term metrics like purchasing power parity (PPP), EM FX is still at historically cheap levels despite the rebound in Q4 2020 (see chart).

2. Expectations that we are at the start of a multi-year downtrend in the broad dollar, driven by the US' deeply negative (and record low) real rates, widening twin deficits (exacerbated by Democratic control of both houses increasing the ability to pass fiscal stimulus), continued monetary stimulus from the Fed and the dollar's fundamental overvaluation.

3. The local duration component of the asset class remains attractive, in our view. In a world with a huge amount of assets in negative territory from a nominal and real perspective, EM local yields offer significant pick-up on both fronts, with steep curves compensating for the fiscal deterioration seen across markets.

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AVERAGE EM MISALIGNMENT

Source: Macrobond as at January 2021

What challenges face Latin America in 2021?

GRAHAM STOCK, EM SENIOR SOVEREIGN STRATEGIST

Our key theme for Latin America in 2021 is 'recovery'. In our view, the region's governments need to recover from the contraction induced by Covid-19, recover control over their public finances and recover the trust of populations that have suffered from both the pandemic and inconsistent measures to contain it.

The International Monetary Fund expects Latin America's GDP growth to rebound to 3.5% this year, after declining 8% in 2020. In our view, this means that economic activity will only recover to its 2019 level well into 2022, or even later.

Against this sluggish backdrop, we believe Latin America needs to put in place measures to at least stabilise, and ideally push back down, debt ratios. These will require fiscal adjustment, which is unpopular at the best of times – and the aftermath of a pandemic that has already claimed at least half a million lives in the region is definitely not the best of times.

As fixed income investors, we will be watching the 2021 budget approval cycle and subsequent implementation carefully to see if spending can be brought under control. In most cases, it seems that income support measures can be removed. In our view, eliminating emergency Covid spending will not be enough to put the public finances back on a sustainable path in many countries.

There is some good news to brighten the outlook though. The global recovery should boost demand for the region's exports. In the last six months, prices for Latin America's main commodities (oil, coffee, iron ore, copper and soybeans) have risen between 20% and 40%. Interest rates should also remain low as central banks in core markets continue to stimulate their economies. That should continue to support the recovery of capital flows to Latin America, both in direct investment and in portfolios.

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Has Turkey turned a corner?

TIMOTHY ASH, EM SENIOR SOVEREIGN STRATEGIST

Turkey has undergone some major changes both at its central bank and its wider economic policy team. In November 2020, the former central bank governor, Murat Uysal, was fired, forcing the resignation of his mentor, the Treasury minister and son in law of President Erdogan, Berat Albayrak. Albayrak was the country's economic policy Tsar, so his resignation, along with the departure of Murat Uysal was viewed as seismic from a market perspective. Naci Agbal was appointed as the new central bank governor and Lufti Elvan replaced Albayrak as the Treasury minister. Both are well regarded by the market.

To us, the changes at the central bank and the Treasury mark a 180-degree shift in terms of economic policy – which we view as long overdue. They seem to reflect an acceptance that the policies of the former management had fundamentally failed.

To recap, the former management team had run the economy on very 'hot', keeping policy rates low. Banks had been pressurised to lend, money supply exploded, inflation expectations deteriorated and the current account deficit ballooned – the latter reaching some 5.6% of GDP in November 2020. With inflationary expectations deteriorating, policy and deposit rates too low, and with a large current account deficit and external financing requirement, demand for FX accelerated as locals dollarised their capital.

The response was FX intervention, but even this was undertaken in an unorthodox and unconvincing way. The authorities were risking creating a vicious and potentially systemic crisis, as continued sales of FX reserves risked a fundamental loss of confidence in the central bank and the wider banking sector.

Thankfully, with the appointment of Agbal and Elvan, this policy course has been reversed, returning to orthodoxy. Since Agbal's appointment, the central bank has hiked policy rates twice by a combined 675bps and simplified monetary policy by setting a single policy rate – the repo rate – at 17%. Communication with the market has improved. Macro prudential policies, meanwhile, have been tightened, with an easing of the asset quality ratio which had been used to force banks to lend.

Foreign investors have been encouraged by these changes, with USD1.5bn in portfolio inflows in November, which followed over USD12bn in portfolio outflows in the prior 10 months. Higher policy rates should slow domestic demand, and with it import demand, which would act to shrink the current account deficit and help support the lira.

But while the current account position should improve and the return of foreign portfolio inflows is encouraging, what really matters is the behaviour of locals, and whether the trend towards dollarisation reverses. Watch this space…

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How should investors position EM fixed income within their portfolios as 2021 gets underway?

SOM BHATTACHARYA, PORTFOLIO MANAGER

While being shaped by individual circumstances, I think the answer broadly depends upon whether the investor is willing and able to take on EM local currency exposure.

For many institutional pension investors, EM local currency can prove a viable provision as they can absorb month-to-month volatility in exchange for potentially healthy long-term returns. We currently maintain a high conviction on both local rates and FX, due to our view on the US dollar entering a period of structural weakness combined with a benign global inflationary backdrop. Against this view, we believe high-carry EM local currency assets should perform well and investors, in our view, should consider maintaining a long bias to that asset class through 2021.

There are several different ways to obtain such an exposure. While many investors will prefer to position through standard EM local currency sovereign bond strategies or diversified 50/50 hard currency and local currency sovereign bond strategies, this may not be suitable for all clients. Notably, EM local currency, despite its return potential, is still expected to remain a volatile asset class.

For this reason, we would draw investors' attention to the more niche asset class of EM local currency corporate bonds. The asset class includes a larger proportion of less volatile EM currencies while still capitalising on the high carry in these markets. EM local currency corporate bonds have historically demonstrated less volatility relative to the standard local currency sovereign index. As such, we believe they are an interesting long-term positioning consideration.

That said, having full flexibility when managing the EM local currency asset class is arguably the best way to minimise the volatility accruing from it. For investors who are capable of taking exposure to unbenchmarked total return strategies, we suggest considering an unconstrained approach to EM investing.

For investors who cannot consider exposure to local currency assets, we think a diversified hard currency aggregate approach could prove an appealing alternative. In particular, we would highlight a short duration aggregate approach for 2021. In our view, US rates are likely to rise a little this year. Against this backdrop, a conservative hard currency product like a short duration aggregate bond strategy is likely to perform better, in our view. If we witness a US Treasury sell-off, high yield spreads could come under pressure too. As a result, we believe portfolios with a more concentrated high yield bias are likely to underperform overall. For this reason, a short duration aggregate approach wins in our view.

Lastly, we consider the merits of more customised investment solutions around hard currency sovereign and corporate asset classes for clients who are struggling to find yields in an environment where nearly USD17 trillion of global developed market debt is yielding negative returns (based on Bloomberg Barclays Global Negative Yielding Debt Index value). Insurance companies which need to match their liabilities with suitable high-quality assets under the Solvency II regime are particularly affected by this, as many investment-grade spreads have tightened rapidly or even gone into negative territory in some cases. Here, a buy-and-maintain approach could prove appropriate as investors can select from a USD3 trillion hard currency EM universe depending on their circumstances and investment needs, potentially adding both yield and diversification to portfolios without taking on additional credit risk.

Finally, the above discussion predominantly covers liquid investments in the EM debt space. It would be remiss not to mention that we are currently witnessing larger spread dislocations in the emerging market illiquid credit space than in the mainstream liquid spectrum. For investors who can accommodate an illiquid approach, we would also suggest considering an EM illiquid credit strategy within their broader portfolio.

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Global Asset Management

BlueBay Asset Management