EM unconstrained: through Covid and beyond

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Capitalising on regional volatility and dispersion to capture alpha in a global low-yield landscape.

The fate of the global economy currently seems to hang in the balance of successful vaccine development. While this backdrop creates great economic uncertainty, it also poses potential opportunities for active investors.

We believe the current macroeconomic environment could prove particularly fruitful for those open to taking an unconstrained approach to investing, which seeks to capitalise on the dispersion and asymmetry caused by uncertainty.

Unconstrained, or 'go anywhere' approaches, in our view, give investors the agility and flexibility to invest in the best ideas across their chosen universe, using the most appropriate instruments. These attributes seem particularly pertinent as we wait to see how and when the world will ultimately emerge from the Covid-19 pandemic.

Going unconstrained in EM

In our view, unconstrained approaches look particularly compelling when investing in emerging markets (EM), where the universe of securities is highly diversified. EMs makes up 60% of the world's economy and the debt universe totals some USD24 trillion with four distinct fixed income sub-asset classes (hard currency sovereign debt, hard currency corporate debt, local currency sovereign debt, local currency corporate debt).

Difference between the best and worst-performing EMD sub-components

2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
11.8%	8.2%	7.5%	9.4%	5.5%	11.2%	5.1%	5.5%	3.9%	12.7%

Source: BlueBay Asset Management, as at 31 December 2020

EMs are also naturally volatile – with or without a global pandemic taking place. This inherent volatility can create significant dispersion between the out and under-performers across the asset class.

How did EM unconstrained perform during the height of the pandemic?

Covid-19 triggered an unprecedented drop in global growth which was met with record amounts of fiscal spending and ultra-easy monetary policy. The ensuing global growth rebound has been rapid but uneven, creating some sharp divergences in the performance of different markets.

In a way, we've seen a whole economic cycle manifest across a 12-month window.

The height of the Covid 'stress' period in March and April 2020 was a period when EM FX markets were under severe pressure as EM central banks were prioritising rate cuts at the expense of FX stability. This initially created opportunities in the local markets to be received in the front end of rates curves and to be short in FX markets versus the USD.

Once the initial leg of the recovery had taken place, opportunities emerged to take long positions in select EM FX pairs versus the USD given US interest rates were at historical lows and EM FX had depreciated substantially.

Stability in oil prices, albeit at lower levels, and improving visibility on the growth outlook also made it possible to re-engage with parts of the performing high yield market.

There was a portion of the credit markets which had been unable to weather the storm and had sought to restructure or reprofile their capital structures. This created a further opportunity to participate in some of the situations which were likely to be trading below their ultimate recovery values due to forced selling from investors who were unable to hold defaulted credits.

The next phase of the cycle began when US fiscal stimulus increased by much more than the market expected, fuelling both the US recovery and a sharp move higher in US yields at the same time as growth in other parts of the world lagged. This created a significant bout of volatility in EM local markets with both rates and FX repricing in the first quarter of 2021. The move in EM rates appeared outsized compared to moves we have witnessed in the past when US Treasuries have moved by a similar amount. This provided a buying opportunity in the EM local rates space at the start of 2Q 2021.

The post-pandemic opportunity set

The last 12 months have highlighted more than ever the importance of having an investment approach that can go anywhere within the EM fixed income landscape in search of the best ideas and which can dynamically change its risk allocation according to the evolving opportunity set.

With the region displaying a positive growth trajectory – EM represents three-quarters of global growth, having doubled in the last 20 years – we think EM is an attractive proposition in the current low yield environment, best captured through higher conviction, more concentrated, nimble and shorter-duration portfolios.

An unconstrained approach allows us to harness dispersion, capturing upside potential across the universe while smoothing the volatility profile and limiting downside.

Global Asset Management

BlueBay Asset Management