Emerging Market Debt – Taking Stock

A market recap and opinion piece by Francesc Balcells, CIO GEM Debt, FIM Partners

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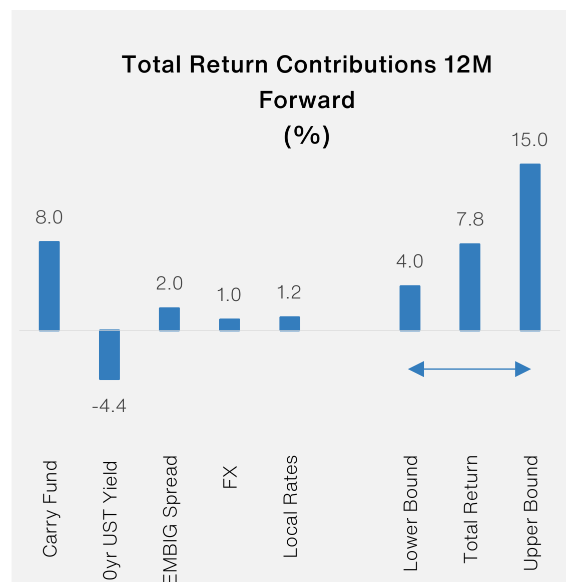
Returning through Carry: View on EM Returns over the next 12 months

- Expect global markets to swing thematically between reflation and global-growth concerns.
- There is room for modest spread compression in EM debt (and currency appreciation) as fundamentals and valuations remain supportive, but don't count on it as the main return driver.
- Carry is to be our main source of returns going forward. We make sure it is as uncorrelated as possible to global risk through positions in frontier local, front-end sovereigns in high-yield dollar debt, and Middle Eastern corporates.

What kind of returns to you anticipate for EM debt in the next 12 months?

We expect a 6-9% return driven by a combination of carry, a modest spread compression, and a negative contribution from US Treasuries.

While we think EM has two big aces up the sleeve – attractive relative valuations and strong external fundamentals (see more below) – the combination of FED normalization in the background, and the balance of risks in global equity valuations may limit somewhat the scope for spread compression (and currency appreciation) in the coming months.



As such, our strategy is very much focused on collecting carry as a source of return and doing so in a way that is as uncorrelated as possible to global risk.

Our aim is in fact to be long carry while threading lightly on the EM *beta,* which we have reduced lately, as to minimize the risk of the portfolio given the context described above.

Our sources of carry include local currency frontier positions, short-dated hard currency debt in the high-yield space, and selective corporate opportunities off the beaten path, mostly in the Middle East (more below).

Our fund carries a 7.5% yield, which is 300bps in excess of our reference index, and has a 0.7x *beta* to market. The portfolio has a duration of 5 years, which is two years underweight vs. the benchmark.

What kind of market environment do you anticipate?

When it comes to the environment, we think of two key variables influencing EM performance currently – global risk and US Treasury yields.

The market has been experiencing distinct permutations of the two since the Covid outbreak last year.

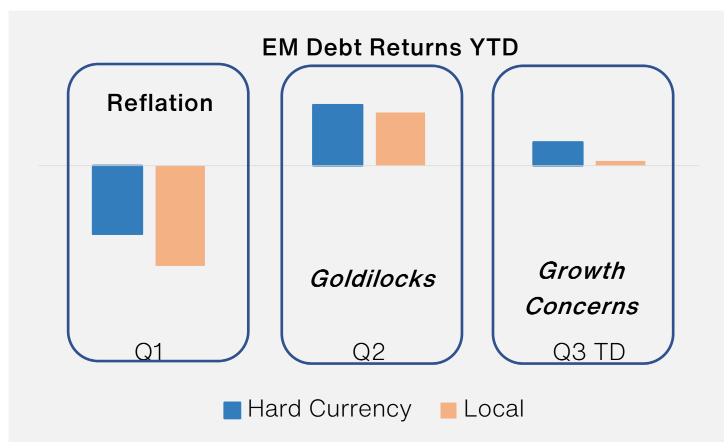
There was the reflation phase (lower-right quadrant in the adjacent table) where yield curves steepened, breakevens widened, and commodity prices and stocks rallied. The FED was dovish and the market anticipated an economic recovery. This was a so-so environment for EM – debt spreads were stable but total returns suffered from the duration sell off, and by occasional moves in real yields.

		US TREASURY YIELDS	
		LOWER	HIGHER
RISK	OFF	Global Growth Concerns	Taper Tantrum
	ON	FED *Put*	Reflation

Then there was the environment where the market was concerned about global growth on the back of the emergence of the delta variant, and weak economic data out of China. That environment (upper left quadrant) was adverse for EM, weighing on commodity prices and stocks/risk.

EM has been straddling across these two scenarios this year, explaining why total returns have been somewhat lacklustre to date.

There was a spell of calm in Q2, a goldilocks scenario of lower Treasury yields and accelerating global growth, which produced spectacular returns -- a reminder of how returns can escalate quickly given the right global environment.



Our base case going forward is that of a tug of war between reflation and global growth concerns, with the former being re-energised by the eventual passing of the delta variant spike in the US, and the latter being spurred by the phasing out of the fiscal and monetary stimuli, also in the US.

At the end of the day, we see both scenarios somewhat playing each other out, recognizing however that the market is probably more positioned towards reflation than to global growth deceleration.

To that base case, there are two tail scenarios which we need to be cognizant of but which we assign lower probabilities of. There's the left-tail scenario of a taper tantrum, whereby a sudden tightening of liquidity conditions triggers a move higher in real yields, precipitating in the process a risk off event and a widening in EM spreads. And there's the right tail scenario, where the FED either caps yields should the reflation story get out of hand, or engineers more stimuli in the event of a greater than expected global growth deceleration.

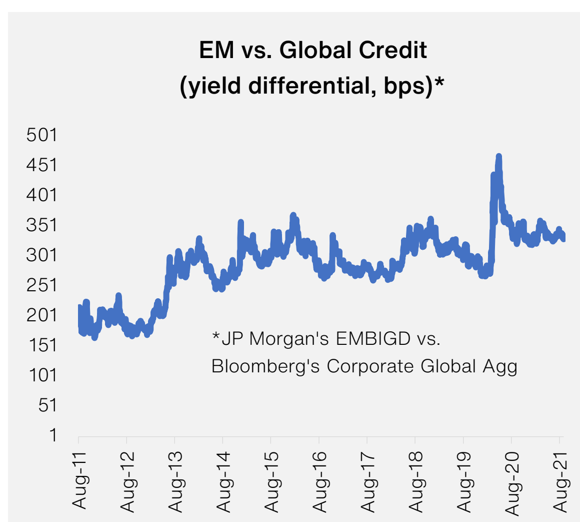
We think a pre-condition for taper tantrum is the surprise element of a FED catching the market off guard, which is unlikely to be the case now given positioning -- our gauge on positioning is that investors remain UW duration to this day --, and given the nature of the current FED leadership, with its emphasis on communication and predictability.

That doesn't mean US rates will not go higher, but we think the move up doesn't have to be a taper tantrum scenario. The terminal rate as indicated by the Eurodollar curve does indeed strike us as too low given trend nominal GDP growth in the US, but any bearish view on rates must be tempered by positioning and by the acknowledgement the US economy is passed peak growth while some of the fiscal stimuli will go into reverse in 2022.

To sum up we view an external environment that will continue to swing thematically, but with the tails seemingly under control. The path of least resistance will be that of a gradual rise in Treasury yields, with occasional bouts of risk off as the market keeps reassessing the growth outlook. In that context, the valuation pull of EM should give investors some comfort to support returns but spread compression in hard currency debt, or appreciation in currencies should be relatively modest, and thus our focus on carry.

Is there value in EM?

The EM hard currency spread as measured by the JP Morgan EMBIG Diversified is now trading at 67% percentile of its 10yr range, when excluding the tails of Covid and the oil crash of 2015, or a 51% percentile when excluding only the former. By this measure EM debt is trading somewhat cheap to its own history, with most of the cheapness concentrated in the high-yield segment of the asset class.



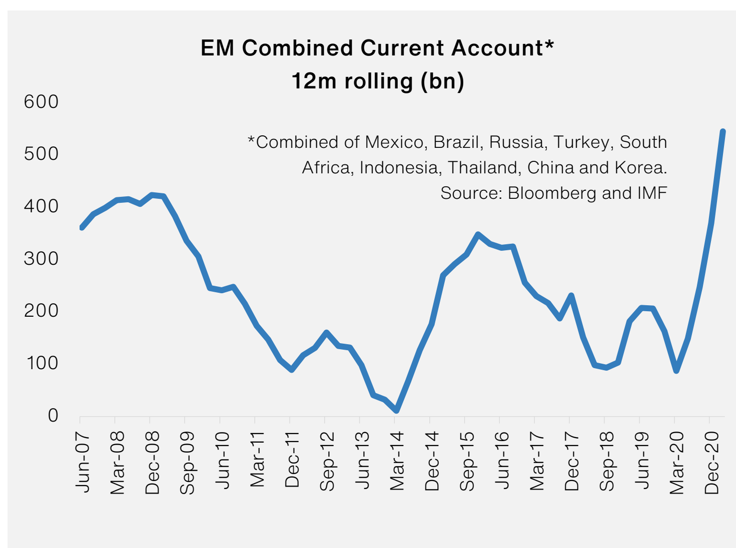
The valuation case, however, is stronger on a relative basis, when comparing EM dollar debt to US IG and HY, with EM trading 1-2 standard deviations cheap to either.

We think that valuation gap will attract flows into EM, particularly by cross-over investors whose asset allocation has been very much skewed toward developed-market credit.

In the local space, EM real rates have dropped significantly as the inflation surge has not been accompanied by a concomitant rise in policy rates. Fiscal concerns pose a challenge to supply risk. As such the value proposition in mainstream local duration strategies comes across as unappealing, and we are less involved now.

What's the fundamental picture like in EM?

The fundamental backdrop is mixed and has a different implication across asset classes.



On the one hand, EM external balances have never been as robust as they are today. The combination of a positive terms of trade shock and still tepid domestic demand has led to an unprecedented strengthening of current account surpluses.

Traditional current account deficit countries such as South Africa and India, which were part of the infamous "fragile 5" in 2013 along with Indonesia, Turkey, and Brazil, are now running significant surpluses on a twelve-month rolling basis.

As a result, EM FX reserves are now back to peak levels, even before accounting for the latest IMF SDR expansion. This is a supportive fundamental backdrop for EM hard currency debt. Yes, external debt stocks have risen but so have the dollar "cash flows" and the FX buffers.

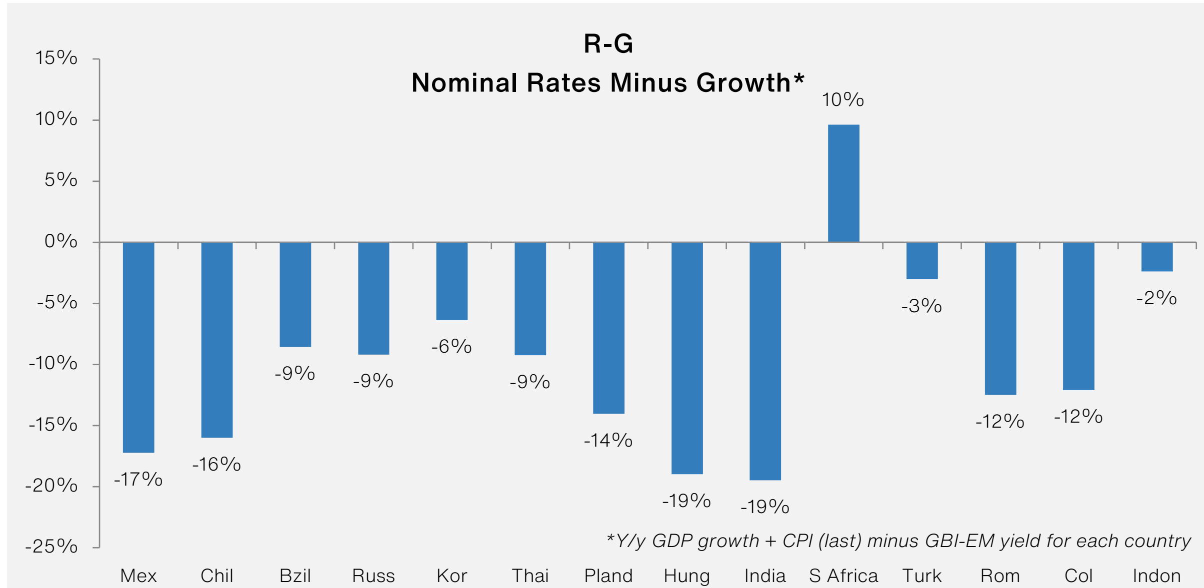
On the growth side, we think the cyclical decoupling in global growth between EM and DM experienced since Covid is unlikely to last given the linkages between the two. To the extent EM economies emerge last from the Covid shock we would expect growth to catch up with that of developed markets, or at least the growth sugar-rush in the latter to come down a notch or two once the fiscal impulse fades away.

Against that constructive view on growth, there's the reality of political risk, with a heavy election calendar ahead in some of the key EM countries, which could potentially dampen the post-Covid recovery story. Brazil next year, in what's likely to be a highly polarized election, comes to mind.

We expect the contribution of China to global growth to remain modest as the country prioritises quality (e.g., more balanced) over quantity of growth and shies away from prime pumping the economy.

EM's fundamental Achilles' heel remains fiscal. Debt burdens have been rising across many countries on a combination of fiscal spending to fight Covid and sluggish growth.

Many countries are not far off a *fiscal dominance* scenario, with very limited space for fiscal expansion when the next recession hits. For now, however, the combination of accelerating growth and inflation will mask those debt vulnerabilities, with debt dynamics seemingly looking good across the "mainstream" EM economies.



For some of the frontier countries the fiscal pressures are even more acute, with unsustainable debt dynamics, prohibitively high debt servicing costs and low levels of FX reserves. We expect a high degree of involvement by the IMF in that space, providing interesting catalysts and trading opportunities as a result.

Where are the opportunities?

From a portfolio construction we are aiming at two objectives. First, to build a portfolio that reflects our view of the world – which is, as highlighted above, a portfolio that is long carry, light risk, and underweight duration.

Second, we want to make sure the portfolio is well-diversified from a returns perspective even if ours is a high-conviction strategy.

On the first objective the way we square the circle is by focusing on high-carry opportunities that are relatively short-dated in duration and that have a low correlation to global risk. An example of this are our positions in local-currency frontier such as bonds in Uganda, and FX exposures in the Zambian Kwacha (via NDF). Those, and others similar, give us yields of 10-15% on average, little duration and very low correlation to global risk. We are running 20-25% of the book in this space, which we monitor and know very closely.

Likewise, in external debt we look for opportunities in middle eastern corporates, which we scout via our Sukuk and Mena Credit Funds and through our team members in Dubai. For example, we recently participated in the new 7.88% coupon 5-year DNO dollar-issue, a Norwegian oil and gas operator focused on the Kurdistan region of Iraq.

We continue to like high yield EM sovereigns, such as Oman, and we like to have some IG names in the portfolio, mostly Mexico, as potential recipients of the "rotation flow" we anticipate from crossover investors into EM. In general, however, we have reduced the exposure to "mainstream" EM credits where we see the room for spread compression as relatively small.

In terms of diversification a staple of our strategy is our high-conviction approach to investing, but also making sure the portfolio has different streams of returns to spread out the risk.

The idea is to make sure the portfolio can generate returns under different market conditions. For example, the portfolio has a "pull-to-par" sleeve, which includes solvent front-end opportunities which we hold to maturity, such as an Egyptian T-bill.

There's also a high-quality sleeve, where we tend to buy longer-duration IG paper, say a 30-year Mexican dollar- bond. Or a "special situations" sleeve made up of distressed debt opportunities such as the bonds we bought in Ecuador after the restructuring. All these sleeves are meant to be uncorrelated to one another so as to reduce the drawdown risk of the fund.

In Summary

We see EM fixed income as arguably the only space in fixed income offering value and interesting returns. But we expect a number of crosscurrents in global markets which will limit the possibility of meaningful spread compression and currency appreciation in EM. As a result, we rely on a carry strategy to generate returns, making sure our trades are uncorrelated to global risk. We see several good trades that meet those criteria, in local frontier, Middle East corporates, and in high yield sovereigns. It's hard to say there are covid "winners" but a high conviction approach focused on idiosyncratic risks helps avoid the losers.

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Contact Information

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