EMERGING MARKET DEBT: QUESTIONS AND ANSWERS

Emerging market debt is a big topic for investors in a low-yield world. In 2019, debt issued in the emerging world accounted for more than a fifth of the world's total, while emerging markets were projected to drive more than half of the globe's economic growth.
However, last year the pandemic took hold, uncertainty kicked in and investors dumped bonds issued in the emerging world. But what happened next? We assembled a panel of experts to find out.

***portfolio institutional:* How are institutional investors approaching emerging market debt?**

Gordon Ross: We have eight partner funds and they have allocations to emerging markets to diversify their fixed income holdings.
The managers we have chosen and the mandate we have chosen allows them to go anywhere within emerging markets, which will be between hard currency and local currency credit.
They have different investment profiles, different risk profiles and they will be measured against the hard currency benchmark, which historically has been the one that has performed better. Therefore, any outperformance will add to that asset allocation benefit at issuer and mandate levels.

PI: How have emerging markets been impacted by the pandemic?

Roger Mattingly: Last year was incredibly volatile for a huge number of emerging markets, but there were opportunities. Going into 2021, appetite for increased diversification and the desire for yield has never been greater as we come out of the pandemic.
Also, the need for active management in this market is greater than any other asset class because the countries that come out of this pandemic in one piece will be key in terms of where the investment opportunities lie.

Alejandro Arevalo: Last year the opportunities were wide open. You could say that emerging markets were hit by a perfect storm in the first half where you had the pandemic, oil price pressure and outflows.
It was a situation where it did not matter if you had the best emerging market bonds, everything was being marked down. In some cases by 40 to 50 points. Investors simply wanted to get out and ask questions later.
For active managers and dedicated emerging market managers, it was a fantastic opportunity. When you look at the fundamentals of sovereigns and corporates and see investment-grade names paying high-yield returns…it was a free for all.
We focus on Latin America. When you look at what is happening in developed markets, such as the US, the supply chain means countries like Mexico could benefit.

Giulia Pellegrini: The pandemic has reminded managers of the lessons of the great financial crisis. In March and April last year, we were reminded of how correlated emerging market debt has become to global risks, global politics and global health issues.
We had to find ways to protect our portfolio through hedging, looking primarily at US treasuries to cushion that blow to our portfolios.
Investors may also pick up some opportunities by allowing themselves room to manoeuvre, if they do their risk budgeting properly.

Kevin Wesbroom: I like the idea of returning to the fundamentals. When pension scheme trustees are thinking about this, they need to ask basic questions: what are we looking for? Will this asset category generate a stable income? Are you looking for a diversifier in a growth portfolio or a kicker in your matching portfolio?
Being clear on your basic expectations from the asset category is important and even more so given what we have seen in the past few years.

Diliana Deltcheva: We had to sharpen our pencils to make sure that our due diligence on specific countries is top notch to take advantage of the multiple opportunities that opened-up last year.
To us, it was almost a pleasant surprise that we could utilise more of our detailed ESG data from our sustainability framework to extract investment opportunities. We created a health dashboard, which held basic available data for most countries on immunisation rates, health capacity, child mortality and age group distribution to see which emerging world countries could be more exposed. Based on that data, we shied away from Latin America in Q2 and added back in late Q3, in line with the pandemic's first wave. Despite that age group distribution was reasonably okay for most Latin American countries, the concentration of population in large cities was not particularly helpful for larger countries like Brazil and Mexico.
The EM hard currency asset class underwent a material correction in March 2020. In 2008, high yield recovered in line with investment grade within six months after the October 2008 correction because only one country – Ecuador – defaulted. Last year, six countries out of a 74-universe did.

The default ratios can, at worst, increase to 20% over the next five years, so we are not in the best position from a debt sustainability perspective for the asset class. And we have to deal with loose fiscal frameworks, which are not improving debt sustainability dynamics in 2021.

Differentiation will be key. We expect more defaults to come through and will be cautious in the next three to five years. These are probably going to be concentrated in higher yielding and smaller issuers.

It is difficult to generalise the asset class because it is becoming more complicated, especially in local currency. Such complexity offers more opportunities, so active managers should play more of a role.

Madhurima Sen: Active management is important here. It is a core belief. Investors have taken it one step further and are starting to believe in the value of specialists. They recognise emerging market debt is not just one asset class.

There is the hard currency market, both sovereigns and corporates, and also the local currency market. All of these have different risk and return drivers and require different skillsets. We have seen investors willing to take a few more line items into their portfolios to make sure they are getting specialist access in each area. That helps to reduce volatility from having a local network and expertise, for example, which a broader, more generalist team may not have.

We have seen that evolution in portfolios. Generally, the caution in emerging market debt has started to diminish and people are willing to take on more governance.

PI: Is it better to be active or passive in emerging market debt, Roger?

Mattingly: Active management is expert, forensic management. Trying to work out the impact of policy responses to Covid and what the resulting indebtedness means for those emerging markets is going to be a challenge.

Then there is the impact of remittances. In 2019 remittances were greater than foreign investment. That plummeted during 2020 and, therefore, the need for foreign investment in many countries has never been greater.

I can see some expert cherry picking amongst local currency emerging market debt could be beneficial, but the difference between getting it right and getting it wrong will be huge. There will be serious winners and losers out of this.

Perversely, countries that came through the Russian crisis and the Asian crisis and taper tantrums might be more resilient this time around.

PI: Has there been a heightened default risk in emerging market debt since the pandemic took hold?

Alejandro Arevalo
Head of emerging markets debt
Jupiter Asset Management

Arevalo: Last year most investors were expecting a high level of defaults across the asset class. We decided to exit Africa because we saw it as high risk, but apart from defaults in Ecuador, Lebanon and Argentina there were no surprises. The asset class has become more resilient.

Going into this year, we expect defaults to be in line with 2020, which was around 1.6%. Many companies and sovereigns have taken advantage of the excess liquidity that has come from developed markets in the past couple of years by issuing at low rates and extended durations. In high yield, the average is three to five years, but we have seen longer than that.

The Covid scare has made management and governments realise that they need to be more cautious about how they operate, about maturities, about liquidity and about diversification.

PI: Are emerging market issuers more resilient?

Pellegrini: There will be fewer sovereign defaults this year. There are a couple of candidates that come to mind with Ethiopia asking creditors and the IMF for debt relief in the context of the new G20 common framework. There is talk around Mozambique or Sri Lanka doing the same, but we do not expect Sri Lanka to default. They will muddle through while Mozambique is a more likely candidate for debt relief.

The G20 common framework is an interesting addition to the tool set of emerging market debt managers. We saw notable defaults or restructurings last year from Lebanon, Zambia, Ecuador and Argentina, who did not have a playbook to go by. These countries will now look internally at their own issues before making steps forward with creditors. It appears that we are going towards using this new G20 common framework which was approved last year. It is helpful to have a framework that can help a country get back on the path to sustainable debt when it embarks on a debt sustainability analysis with the IMF. The country then agrees an IMF support programme, which looks at reform as well as financial support. They then request comparable treatment from their creditors.

Despite a default never being good news, we welcome the idea of a common framework because it is a way for creditors to sit at the table and talk, especially to those who have so far been reticent, such as China. It also brings transparency to debt relief proceedings.

In terms of defaults, there are a couple of notable cases, but we have not seen anything like last year.

PI: Big emerging market names, such as Brazil, Mexico and India, have been hit hard by Covid. What impact will this have on the investment case for emerging markets?

Deltcheva: Capacity to manage a crisis is something you consider in your creditworthiness analysis. That those countries

have not delivered during Covid is going to feature negatively in our analysis.

The issue is that different governments have different perspectives on specific topics. We are not talking about stable affairs; we are talking about a dynamic evolution. A lot of countries have elections in the coming year and we will track what prospective governments are proposing in terms of policies.

What the pandemic has established is that you have to analyse multiple dimensions and introduce different data into your analysis, such as political dynamics, government bias and ability.

The pandemic has brought challenges to policymakers globally. The lesson learnt is that they have to build out their health capacity.

There is something else that we have to be aware of. Rating agencies are not giving sovereigns, emerging and developed, the benefit of the doubt. They still consider 50% to 60% of debt-to-GDP as sustainable. Just because the US and some emerging countries have moved above 130% does not mean that the threshold is going to move up. This means that in the near term we are going to see downgrades in the developed and emerging worlds.

Mattingly: The vaccine rollout is pivotal. If economies which are dependent on leisure and tourism have marginal vaccine coverage over the next 12 to 18 months they are going to struggle to recover.

PI: Is how managers are approaching risk in emerging markets changing?

Sen: In a sense. There are elements, such as ESG, which become more and more prominent as the nature of crises changes. It is no longer just long-term debt sustainability, it could also be about the volatility of foreign flows in and out, for example.

We are now checking that the risk framework is more robust, more three dimensional. Are managers considering ESG risks? Political risk and governance have always been considered, but let's think about E and S data, such as health and climate vulnerability, and how this can impact their fundamental position.

It is also about revisiting the lessons learnt to ensure that they were learnt in 2008 and 2013 and that the risk framework is there to encapsulate that, plus understanding the new risks that could come at you. This, and incorporating ESG, requires a little bit of three-dimensional thinking.

Diliana Deltcheva
Head of emerging markets debt
Candriam

PI: What impact will the new US government have on emerging markets?

Arevalo: We now have someone more experienced, more predictable and less willing to make unilateral decisions on foreign policy.

What could change is having to forge alliances with like-minded countries to tackle what they see as a main risk, such as Russia or China. This would be a good step.

What markets do not like is volatility and uncertainty. We are still on a wait-and-see mode on how Biden will tackle China, for example. He will not be focused on trade. You are going to have corporate rights and Hong Kong. Different scenarios will be needed to come to an agreement with other countries on how they should approach it. That is good, because you are going to have better thoughts and it gives us time to adjust our views and, in some cases, our portfolios to reflect what is coming down the line.

Wesbroom: A discussion about the US brings to my mind the third factor that you have to think of when investing in emerging market debt. We have spoken about yield, we have spoken about defaults and then we have currency. Do you go for hard currency or local market currency? It seems to come down to an argument about where the dollar is going. Is it going to get dragged down by deficits or go up with rising interest rates?

You have to balance those three factors in coming up with your proposition for where you invest. From a trustee looking to invest, trying to find a manager who can juggle all of those, put those arguments in front of you and come to conclusions is challenging. A manager has to have strength in depth to do that detailed analysis, but they need that bigger enough picture to say, "don't invest".

You never call the Japanese equity desk, and the person there says, "don't buy Japanese equities". That is one of the challenges. You want a manager who is prepared to drill down to the level of detail needed to find serious opportunities.

It is quite a daunting prospect in some ways from a trustee's perspective.

Pellegrini: A change in perspective at the White House is welcome, not so much in terms of political colours rather for the predictability of foreign and economic policy, which, as an emerging market investor, we welcome.

It is clear when you consider the situation in the Middle East, where Biden has made dealing with Iran his key objective. He has spoken openly against attempts to interfere with US elections. It is the same for Turkey, which has in the past four years seen a budding relationship between Trump and Erdogan but then receives a lot of political pressure from the US. So, the erratic policymaking will change and a sense of being able to have some thought as to the direction of travel will be important.

Giulia Pellegrini
Senior portfolio manager for emerging markets debt
AllianzGI

The same goes for Central America. Biden is talking to Honduras, where you have a person who could be implicated in drug trafficking scandals and a US administra-

tion that says we will continue to support you because you are an avenue for migrants to reach our shores, but we will be doing that more carefully as to how you respect human rights and the rule of law. These are important elements for investors and that rule-based policy will help us a great deal.

The way we approach allocating to the asset class is, because the markets change quickly as we have seen, you want to be in the asset class already but being able to flexibly allocate to different components. For example, we have seen interest in our Select product, which invests hard currency sovereign, hard currency corporate and local currency sovereign.

We tell our clients that we will do that asset allocation for you because we understand that some of these changes will be more tactical, some will be more structured, but if you wait for that change to materialise to allocate you will effectively miss the bus. Being able to provide that flexibility in this ever-changing world for us has been a winning position.

Wesbroom: It is a fascinating point that this is just another complexity for trustees to struggle with. Regime change is another way of saying: is the past a reliable guide to the future? Is this a manager who looks at historic trends and builds on those? Or is he somebody who says the past may not be a good guide? Deficits have dragged the dollar down historically, perhaps this deficit is a different one.

It is another example of why you need active management – that brave thinking. It is going to be difficult for our side to trust the credibility of the people they are listening to.

Sen: One way of doing that is to give your managers flexibility across EM debt when allocating. However, if you want to use a specialist approach you can design that mandate to try and control risk. For example, in local currency, we have worked with managers to create a mandate that lowers volatility by allowing them to move into developed market assets if they feel like emerging markets as a whole is vulnerable or unattractive.

PI: If we are moving into a new commodities super-cycle what will that mean for EM debt strategies?

Deltcheva: Emerging market credit is a diverse universe. We are focussed on trading well the US interest rate cycles and the compression of high yield verses investment grade risk premiums in the hard currency space. To be fair we are finding it difficult to play the copper commodity super-cycle. Copper is going to be one of the most desirable metals during the recovery. It goes into buildings, renewables and tech – that is, it is both an old and new economy input. It is expected that copper specifically experiences a spark of global demand. Chile, Peru and Zambia are large producers of it, but it is difficult to play in the sovereign space. You have to look for equity exposure. Even in EM corporate space, valuations are not as attractive as they could be.

In terms of Oil, we are still observing a supply demand imbalance and most investment banks have upgraded their average price forecasts for the end of 2021. Yet, the current oil rally almost feels like the last hurrah for the hydrocarbon sector. In the long term, we are going to deal with issues of investors being pressured to disinvest from traditional energy sources and into cleaner ones. European regulators are looking for enhance disclosure on sustainability of investments and there are certain sectors that are not going to benefit.

We find ourselves in the expansion stage of a global growth cycle that typically benefits demand for commodities. I would not call this a commodity super-cycle or a regime shift.

EM debt, on average, despite differentiation being required within the asset class, still offers risky asset class-type returns. For hard and local currency, we expect around a 5% return on a one-year horizon. We are exposed to each of those segments. Of course, the risks around local currency are always higher because on the one hand, currencies are quite cheap from a long-term perspective but on the other, the strong dollar trend around inflation in the US, or outperformance of the US in the first half of the year, is also a strong headwind to EM currency performance.

So, hard currency in the end is the preferred asset class. Of course, you need an active manager because asset class dynamics may shift during the year and active managers are more likely to be able to exploit these. For example, currencies and corporates may offer interesting opportunities later in the year.

Ross: In the old days, emerging markets were divided into oil consumers and oil producers. Now, no matter how many variables are influencing emerging markets, such as domestic politics and geopolitics, or if a super-cycle comes or not, it is no longer easy to allocate between those two segments as markets will behave differently from how they have done historically.

Roger Mattingly
Trustee director
Ross Trustees

So, do you use historical performance to map out your expected returns? It has made it even more difficult. Add that to currency weightings, should you allocate to a domestic sovereign because in theory they can print money, or hard currency because if rates go up and the currency goes against them, they default.

There are an increasing number of variables which reiterates the consensus here that active management is giving the manager as much discretion as you can. Leave it to the experts.

PI: How are pension schemes integrating ESG into their emerging market debt decisions?

Wesbroom: ESG is becoming all pervasive

and in all asset categories you have to play the game, but you have to avoid knee jerk reactions. For example, because of what is happening with some minorities in China, it is easy to say, “that’s it, out of it”. But if you dig deeper, some Chinese corporations have robust approaches and disclosures on ESG matters. You could be surprised at what is going on beneath the surface.

ESG analysis will undoubtedly play a serious role in emerging market debt going forward.

Arevalo: A client asked me the other day if ESG is transitory or is here to stay. Absolutely, it is here to stay.

It needs to be part of your investment process. Not only because it adds value, but it is something investors are looking for.

Unfortunately, there is no formal ESG process in emerging markets, so it is up to each company to find the best way. We are moving to a universe where there will be more issuance because there is more demand. Last year, there was close to $3bn in ESG-linked issuance. Companies have started to realise that this is the way forward, so they are more empowered to make changes.

We have been engaging with Brazilian protein issuers to make changes in what they are doing with the Amazon and with cattle. They have incorporated those changes into their plants. At the sovereign level it is slightly harder, but with corporates you can be a positive influence, so long as everyone moves in that direction. ESG adds value and is here to stay.

Pellegrini: There is interest from our clients in this asset class. They are coming to us asking about ESG, it is no longer a way of looking at things that we have to propose.

The horror of the pandemic has led to questions around how capital can be used to benefit the planet and communities. This has been the silver lining from the experiences we have had.

Another reason is because we are starting to see returns. If you look at the JPMorgan Emerging Market Bond index, the ESG equivalent has outperformed by 2.4% over the past eight years.

Through an active ESG approach we believe you can enhance returns on top of those offered by a standard ESG approach.

That is why we have been teasing all the inputs out of our proprietary ESG sovereign framework. We have moved away from third party ESG data providers. We have noticed that such providers have improved the way they collect data, however, you will see a variety of outcomes in their assessment. We decided to create our own framework, using publicly available data, giving comfort to our clients in terms of transparency.

We have found the indicators we believe are most correlated to market outcomes, they have an input in the way asset prices will move to help us as investment managers. We have a much sounder framework overall.

Gordon Ross
Chief investment officer
LGPS Central

Obviously, this means using data which at times is backward looking, so we are using artificial intelligence to create higher frequency indicators to exploit information from corporates, regulators and databases to give us a forward-looking approach to ESG investing. Going forward we will see a lot more done in the space.

Deltcheva: There is no market standard, so every manager needs to define their own framework or use external providers to set some form of ESG scoring. We have an in-house ESG team, which was more than 20 years ago.

Over the past five years, Candriam has extended its broad sustainable fund range, offering fixed income, equities and a hard currency sustainable product. The risk-adjusted returns have been positive for the sustainable EM debt hard currency product, and it outperformed peers. The sustainable strategy offers lowers volatility by limiting exposure to higher yielding parts of the EM country universe, while considering social, governance or environmental indicators. Social governance has always been part of EM debt’s creditworthiness analysis because it determines a country’s ability to absorb investments and generate sustainable growth.

What we incorporate more explicitly in our sovereignty sustainability framework now is the impact that developing human, social or economic capital have on the environment. You need to manage natural resources well to progress as an economy.

A lot of countries have started focusing on how they are perceived by investors with respect to ESG factors. Of course, we have ESG leaders, like Uruguay, which has always produced a medium-term sustainability framework. Chile has joined this enhanced ESG disclosure trends. More surprisingly in conversations with Middle Eastern economies, which are primarily hydrocarbons exporters, we are receiving more ESG disclosure and sustainability framework questions.

Our ESG sovereign is proprietary and has shifted towards a clearer focus on the environment. The pandemic in a way has indicated that this environmental bias, adds value.

We welcome the development of a global standardised sovereign and corporate ESG scoring systems/frameworks. We try to help countries in any way possible. In our conversations, we advise on how to improve sustainability tracking. Same goes for companies. We provide feedback on ESG market standards and what are good ESG sources that countries and companies can follow and report into.

Mattingly: How emerging sovereigns and corporates are perceived by investors will heighten over the next two years. No emerging market participant should underestimate the increasing pressure institutional investors are under in terms

of their reporting obligations on ESG.
It is not just about climate change. It is investing in companies that are perceived to look after their workforce and supply chain.
It is no longer optional. If emerging market corporates and sovereigns want investment, being ESG friendly is increasingly a necessity.
Sen: ESG risks are increasingly becoming financially material. There are two sides to it: what is your exposure to these risks? How can you impart positive impacts?
We want managers to think about those, and we explain that they need robust integration, whether it be proprietary scoring or external data. On top of that, are they engaging with issuers? Are they talking about the issues that are relevant to their investors?
That two-pronged approach is vital, otherwise it is easy to overlook the risks or potential positive impacts.
On governance, managers say we cover ESG because we have looked at governance for decades. That conversation is moving on in that the "E" and "S" are become increasingly important.
It is up to us as a consultant, as well as other advisers, to keep pushing conversations in emerging market debt beyond just governance.
Wesbroom: One of my frustrations about ESG is that there is no agreed method. At a trivial level, if you ask for an ESG score of a particular company, agent one gives it a positive, but agent two gives it a negative. That feels silly but you have to work beyond that.
ESG is embedded in the way a manager goes about their work. Not every investment manager goes about their job the same way, so we cannot expect them to have a single way of doing it for ESG.
What we have to strive for is consistency of the underlying data. The manager can put together whatever interpretation of the data, and that applies just as much in the EM debt world as the corporate world.
There is plenty to play for here.
Sen: There is an argument to be made of: does the inconsistency create an ESG alpha opportunity? Which is the next frontier in ESG.

PI: What are you expecting to see in the EM debt market in the next 12 months?

Mattingly: I expect active forensic management to produce a mid-to-high single-digit performance over the next 18 months. The ESG component is essential to that, not just because of its financial materiality, but also the perception point that was made earlier.

Madhurima Sen
Credit manager research
Willis Towers Watson

There are huge opportunities in 2021 if you can avoid the pitfalls, but that is not easy as they are everywhere.
Wesbroom: I can see emerging market debt starting to play a greater role in defined contribution schemes as they get to grips with the decumulation challenge. They are going to be looking for assets that offer relatively high levels of stable income, plus or minus currency costs.
Arevalo: Our main thesis going into this year has not changed. Global reflation will benefit emerging markets, but different economies are going through different points of the cycle, so you need to differentiate that.
It will be a positive year for emerging markets. As dedicated EM fund managers, volatility is good for us. It is relevant to have a robust process, appropriate portfolio construction and managing drawdown for when valuations are attractive again after a prolonged period of spread tightening.
It is never on a straight line. Volatility is part of the asset class and we have to be ready for it. We know how this works. It is taking advantage of it to buy credits at valuations where we believe in the long-term fundamentals. It does not work to be a short-term investor. It is difficult to time the market. So, when everything goes down, we can sleep at night because the credits we hold will be able to repay the coupon and principal when they are due.
For us, it is having good names through the cycle and taking advantage of volatility to add more value.
Pellegrini: Avoiding pockets of drawdowns will be key for alpha generation. ESG is at the heart of this in being able to dodge those curveballs. In terms of the broader market, we see US interest rates continuing to rise, but not as sharply as we have seen in the past month or so, which has been rather disruptive to the asset class.
With reflation still the name of the game, it will pay to do more analysis in countries that have less room to hike rates to contain inflation and hence dampening a potential economic recovery.
Sen: We expect volatility. We will remind clients that this asset class is now an even more valuable diversifier than in previous years. This is cyclical diversification, not just geographical.
Deltcheva: It is going to be a big year in terms of ESG and market differentiation. It will be important to track how ESG factors are impacting the decisions asset managers make. ESG risks are gathering more attention from regulators and I am looking forward to testing the academic findings from the past 20 years in terms of confirming the value delivered by ESG factors. It will be interesting to confirm whether market participants price in higher ESG risk premiums as well. The approaches we choose – exclusion versus engagement – are something to track as well in terms of the evolution of the emerging market debt asset class.

Kevin Wesbroom
Professional trustee
Capital Cranfield