pi roundtable

EMERGING MARKET DEBT

JUPITER
ASSET MANAGEMENT

Alejandro Arevalo | Krzysztof Lasocki
Alan Pickering | Paul Rhodes

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EMERGING MARKET DEBT

What's not to like about emerging markets? They have an abundant and predominantly young workforce, while the middle class is growing and so is their desire for goods and services. They are also benefiting from rising commodity prices as they are net exporters of raw materials.

The result is that developing nations are the engine room of the global economy, producing most of its growth.

So lending money to emerging market governments and corporates is an attractive option, especially at a time of prolonged low yields in developed nations. Indeed, 80% of debt raised globally last year was handed to borrowers in developing economies.

Yet those investing in the emerging world need to be prepared for a bumpy ride.

China is having problems, especially in its property market, which accounts for a fifth of GDP. There is war in Ukraine and many emerging economies are struggling to recover from the pandemic.

Then we have inflation, which is good for those selling oil, wheat and copper to other countries, but many emerging economies import their energy. All of these factors have spooked investors leading to $50bn (£40.7bn) being pulled from emerging market bond funds in the first half of 2022.

The question is, are investors right to ditch their exposures on the back of negative headlines or should they stay and hunt down the borrowers who will ride these storms out to influence global growth for many years to come?

The following pages of this supplement examine an asset class that continues to grow in importance for investors needing income and diversification, despite an uncertain outlook.

Mark Dunne
Editor
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EMERGING MARKET DEBT IN FIGURES

$100trn

Emerging market borrowings at the end of 2021, a record

Source: Institute of International Finance

80%

...of the $10trn debt raised in 2021 was by emerging market borrowers

Source: Institute of International Finance

$250bn

The level of distressed emerging market debt, or 17% of such debt denominated in euros, dollars and yen

Source: Bloomberg

$50bn

The amount pulled from emerging market bond funds in the first half of 2022, the most severe net outflows for at least 17 years

Source: JP Morgan

-11.4%

The performance of emerging market hard currency bond funds in the first half of 2022

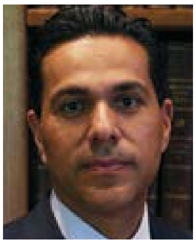
Source: Trustnet

67%

The average emerging market public debt-to-GDP ratio in 2021

Source: IMF

PARTICIPANTS

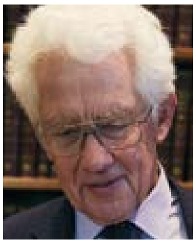


Alejandro Arevalo
Head of emerging market debt
Jupiter Asset Management

Alejandro Arevalo began his investment career in 1998 and has spent the past seven years at Jupiter. Prior to this he was an emerging markets corporate debt portfolio manager at Pioneer Investments.
Arevalo has also worked on emerging market debt strategies at Standard Bank Asset Management, Gibraltar Bank and the International Bank of Miami.

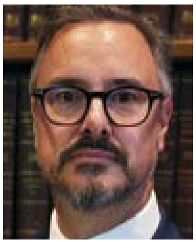
Krzysztof Lasocki
Investment manager
Royal Mail Pension Plan

Krzysztof Lasocki is responsible for investment at the Royal Mail's pension scheme. His day-to-day portfolio management duties include selecting investment managers.
Lasocki joined the pension plan five years ago to assist the chief investment officer in managing a diversified portfolio of assets worth more than £13bn.
He also has PwC, Intel, Capita and investment consultant PiRho on his CV.



Alan Pickering
President
Best Trustees

Alan Pickering is a trustee of the retirement plan for plumbers and mechanical engineers as well as for workplace scheme The People's Pension.
His experience is vast having served as a non-executive director of The Pensions Regulator and as a member of the Occupational Pensions Board. Pickering is also a former chair of the body that is now known as the Pensions and Lifetime Savings Association (PLSA).
In 2002, he wrote *A Simpler Way to Better Pensions*, a government-sponsored report on the industry.



Paul Rhodes
Trustee
Reach Pension Plan

Paul Rhodes is a member-nominated trustee for the pension plan sponsored by Reach, a newspaper and magazine publisher.
He has been a journalist for 20 years having worked on *The Scotsman*, *Daily Express* and *Daily Mirror*. Rhodes, who is currently chief sub-editor of *The Daily Star*, co-founded the Climate Impact Initiative to make climate impact investments available for defined contribution savers.

Emerging market debt

Numerous fund managers and market commentators are still reporting that the biggest misconception some investors make about emerging markets is that they are all the same. If there are problems in Argentina, for example, then there must be problems in India. It seems to be a view many investors hold judging by the outflows we have seen this year.

We invited asset owners to sit down with an emerging market debt specialist to discuss why the asset class has seen such a spike in outflows. In front of an audience, they debated how concerned investors should be about negative headlines and where lenders can find value in the developing world.

What emerging market exposure does Reach's pension plan hold in its debt portfolios?

Paul Rhodes: We have exposure to emerging markets through our default fund. For many small and medium-sized defined contribution plans, looking outside of bundled products for something more specific can be difficult. Another consideration of greater exposure is whether the reward is warranted, given the risks.

There are many positives to investing in emerging markets (EM), but when the US dollar is as high as it is now the risk of emerging market debt defaulting rises.

So the risks are high for defined contribution (DC) members to invest in these assets right now, but there could be benefits for those with a longer time horizon.

Is Reach's time horizon long enough to consider expanding its interests here?

Rhodes: We consider lots of things. Looking at the next decade, emerging markets could offer more growth than developed markets (DM). It is something to look at.

How important are emerging markets to the schemes you work with, Alan?

Alan Pickering: In defined contribution land, emerging markets play an important role during the growth phase. The challenge is to determine how much to compartmentalise the worldwide exposures during that period.

Many of us have bought into the argument that diversification is a free lunch, that it gives equity-like upside without the

There are some interesting opportunities out there but I am not jumping in yet because a lot of investors are "tourists". They like the yield, they like the story but they jump out at the first bad headline.

Alejandro Arevalo, Jupiter Asset Management

downside. People are now taking stock and wondering if it is sensible to compartmentalise the growth phase rather than sub-contract the portfolio to an asset manager who can move the money around.

Where it may have a role to play in defined contribution land is when we move into consolidation and drawdown. There is a need for diversification and income, which has the prospect of growing during a lengthy retirement period.

In defined benefit (DB) land, most of us are close to risk transfer. There are many entities to whom we can transfer the risk, and these assets can be viewed as an alignment as we move towards the de-risking process. One has to be careful of how long the timeframe is, how liquid the markets are and how volatile they are. If you want to transact when all the stars are aligned there could be a danger that some may not. It is an asset class we ignore at our peril.

Krzysztof, you attended an emerging market debt roundtable of ours before Covid struck. How has your portfolio changed?

Krzysztof Lasocki: We have a similar allocation as a percentage of our growth assets. There are reasons to hold emerging market debt, even though the short-term picture is concerning. Fundamentally speaking, the emerging market story is still that it is the powerhouse of the world's growth.

There are reasons to worry that the growth differential between emerging and developed markets could disappear, which could limit the attractiveness of EM debt in a growth portfolio.

Certain factors, such as demographics, make me optimistic from a long-term perspective but you have to be selective. There will be winners, there will be losers. Demographics are not the same in India as they are in China, for example. There will be corporates and countries that might suffer in the next six to 12 months.

It is risky now to be super bullish, but we maintain our position. We have never considered divesting due to poor performance. We have a diversified portfolio of more than 80 strategies. Emerging market debt has a place in our portfolios and it is there to stay.

Alejandro Arevalo: I agree about being selective. A big misconception with emerging markets is that in moments of stress the correlation tends to be one. You can have a diversified portfolio, but because of stress in the market everything goes down. However, we need to break it down. At every point of the cycle there will be winners and losers. We try to provide investors with the companies and sovereigns that could push through the cycle. That is where the value of investing in emerging markets will come.

If we take a blanket approach to EM against other markets, that differentiation comes down. But 10 years ago we were talking about BRICS, which was five countries. We do not use that terminology anymore because there is a wider group of sovereigns pushing growth. It is not only China, which is slowing down.

When we compare EM to DM, we need to focus on what is in that pool. We cannot generalise.

On the point of the dollar, it tends to be a risk in a sovereign emerging market context. Debt sustainability can be an issue, especially in markets where sovereigns rely on cheap financing and international investors to continue issuing debt.

A big mistake in a low-rate environment is that for many countries it is easy to issue debt. I do not know how many times Argentina has defaulted, but it has been able to come to the market again and again. Frontier markets that have problems offered attractive yields three years ago of around 7%. Now we are talking about double digits. We need to differentiate.

Thinking about the long-term development of EM, local savings have grown. Now we tend to talk about local pension funds, local insurance companies and sovereign wealth funds. The combination of local debt against dollar debt has started to change because there are deeper pools of local financing that sovereigns, quasi-sovereigns and corporates are tapping into.

When there are shocks in the dollar – we will see more defaults, especially in frontier markets if they do not refinance soon – it will not be bad for all emerging markets. As long as local markets keep growing, they should be able to fund themselves.

The other point about the dollar is that when we build a portfolio we focus on companies that have a natural hedge against a strong dollar. This means exporters, utilities, telecoms and banks.

In what other ways are emerging markets changing?

Arevalo: We are in a different place than we were 10 years ago. Central banks in many emerging market countries started raising rates well before the Fed did. Brazil raised rates to 13% and has started to wind down its tightening cycle.

The expectation that central banks are there to protect the FX and fund the government is changing. There is now more inflation targeting. Of course, there will be mistakes along the road, that is why we call them emerging, but we have seen some positive changes along the way.

With Covid, war in Ukraine, growth slowing in China and inflation, where should investors look in emerging markets for winners?

Arevalo: We divide EM by three regions when allocating capital. The region worrying us most, and where we are underweight, is Asia. This is not only because of China, but inflation, too. Many central banks in Asia have been lagging in terms of increasing rates. They are going to have to tighten quickly, which will push many of these countries into recession.

Then there is EMEA [Europe, Middle East, Africa] with the Middle East becoming a safe haven. It is about oil. Countries investors were worried would default four years ago, like Oman and Bahrain, now have a current account surplus, are undergoing reforms and are awash with liquidity.

The main defaults will be in Africa, which does not have deep local markets. They rely on commodities, which are under pressure.

We also like Latin America, even with some geopolitical risks we have seen lately. We have seen a shift from left to right to left again, but the economies tend to be net exporters.

We are in an environment where commodity prices could come down. Most of these countries have a combination of exporters and strong local economies coming out of Covid, so it has taken a long time for them to re-engage.

We are starting to see a lot of consumption coming through and central banks have been ahead of the curve, so inflation expectations are falling. If you navigate Latin America carefully you could find interesting opportunities.

least until the invasion of Ukraine. Still, most of the times wider EM suffered, Central and Eastern European currencies and bond spreads followed.

The bottom-up view is important. For example, even though you may have a negative view on the sovereign, you may find companies with potential for spread contraction and a strong ESG upside in that country.

It is important to be active in this space. Investing passively in emerging market bonds is a recipe for disaster.

Arevalo: What is interesting is that the fundamentals are out of the door. Prices are being driven by outflows. In the year to date, we have seen about $50bn (£41bn) of outflows from EM, half of that is local currency.

Across the industry you hear that prices have dropped because there are so many forced sellers. No one wants to stand on the other side. The big counterparties are not willing to take bonds into their inventory and unless someone is willing to buy the bonds they will continue to be marked down.

There are some interesting opportunities out there but I am not jumping in yet because a lot of investors are "tourists". They like the yield, they like the story but they jump out at the first bad headline.

That has created volatility, which creates opportunity. An Indonesian quasi-sovereign, for example, has tended a bond. Shortly after the announcement we could buy that bond for five points below the tender price. These forced sellers need to raise cash and were willing to give up five points because they do not want to hold the paper for the next three weeks. I have not seen that since 2008. This panic we are seeing in the market makes no sense.

Pickering: Regulators have tried to help end-users by having classifications that are simple and top-down, but, as we just heard, those classifications can make us lazy. We can tar everything with the same brush and yet differentiation is key given that within these top-down classifications there are a diverse family of assets, opportunities and risks.

Those who create standards have to be careful not to create unintended consequences when trying to make life easier for people like me. My life should be made more difficult, rather than relying on some classification where everything in the tin is homogeneous, which it isn't.

Lasocki: It is an important point about how investors see EM as a whole. That creates a number of opportunities because certain areas, regions or sectors tend to be oversold at times of stress. Countries in central Europe, for instance, usually had little to do with the worries in the global emerging markets, at

Have the sell-offs tempted you, Paul?

Rhodes: A lot of the companies mentioned are in commodities, like oil and coal. Many DC boards have net-zero targets, some of which are quite aggressive, but many emerging market countries have targets that stretch beyond 2050. So there is an argument that some of these vehicles may not be viable.

It comes down to being specific and targeting things. Some DC schemes may not be interested in buying debt from oil producers or companies with high emissions.

There are a lot of questions, especially as the regulator wants us to take climate change into account. We have to look through that lens when exploring emerging markets. If there is something we can get into, we have to ask if it fits the other criteria.

There are lots of questions involved in adding EM debt to a DC default. It could possibly be easier if there was a specific self-select fund a scheme could put to its members, for example.

Pickering: As a pension scheme trustee, I am not keen on encouraging self-select. Defaults properly structured with the members in mind should not just be default in name, but default in action.

There is scope as DC schemes move more and more to master trusts, which offer a financial wellness package of savings vehicles with access to advice, to have self-select funds in the Isa-side of the savings wrapper rather than the pensions side where the trustee is off the hook to some extent. But by providing financial advice as part of the package, those who are genuinely sophisticated and want to drill down to more focused market allocations can do so within their savings portfolio.

When it comes to the mainstream DC offering, there is a lot of scope for creative thinking because in DC there has been a false catalyst of retirement age. Where people have a DC plan and a state pension and no DB legacy, they need to arrange their savings for 20 to 30 years of life expectancy.

The trustees who are stewarding those long-term savings vehicles, without the guarantee that is part of a DB or annuity offering, there is scope for volatile asset classes within that timeframe which ought not be subject to day trading.

Rhodes: This is where, in DC, a well-formulated default fund should offer something balanced. Going forward, in looking for growth, emerging markets are likely to become a greater part of that. We rely on our fund managers to create the correct balance of exposures to all of these things as we transition to a net-zero world.

Investing passively in emerging market bonds is a recipe for disaster.

Krzysztof Lasocki, Royal Mail Pension Plan

Are developed market portfolios with emerging market debt exposures ready for a hawkish Fed?

Pickering: It is difficult to second-guess central bankers. I am glad to be an asset owner rather than the asset manager.

They are in the firing line. As we speak, we are in the throes of electing a new prime minister. Our central bank has been sucked into the electioneering for the leadership of the UK government. Until now there has been a consensus that central bankers should be hands off when it comes to political issues.

Rather than thinking about what central bankers might throw at us, we need to ask are central bankers ready for what other people might throw at them. The role of central banks may be coming under political scrutiny.

Lasocki: The political landscape in the US is tricky from an EM perspective. As ever, a strong dollar and rising yields in the US are detrimental to EM.

The question is how long politically can the Fed allow inflation to remain high in the US. Mid-term elections are coming up, so there is a lot of political uncertainty.

The US is on the brink of recession, but it is a rare recession where unemployment is low. We have the same problem in Britain and Europe – real wages lagging behind employment. There are a lot of moving parts in the US.

I hear conflicting forecasts in the US from investors, managers, economists and colleagues on how the Fed might act. Perhaps they may retract sooner than the markets expect and go back to lower rates.

To answer the question, I am not sure EM countries are ready for this. For example, I am worried about Brazil, which is highly indebted and has presidential elections this year. There is political uncertainty and the incumbent is spending a lot of money to save his re-election. On the other hand, the front-runner is a returning left wing ex-president who may have his

own spending agenda if elected. It is not an optimistic scenario for the future, whatever happens.

Brazil is running a high debt-to-GDP ratio, and the cost of servicing external debt is high. A strong dollar is exacerbating those problems.

South Africa is in a similar situation, to some extent. There is little room for manoeuvre for many countries. They cannot devalue their currencies, so they might have to restructure their debt. I appreciate it is a bearish scenario but we might have defaults in some EM countries indirectly because of what is happening with the Fed and inflation in the US.

Arevalo: I do not agree with Krzysztof about Brazil, particularly on the political side. Lula was president of Brazil for seven years and won his first mandate by being very left. When in government, he became more moderate.

What has been interesting in this cycle, is that Lula's vice president is the governor of São Paulo, who is market friendly. Lula will most likely be elected, which is not a big political risk and spreads are pricing in a worst case scenario.

Lula will likely do what he did in his first term. He is talking about the rise in poverty, which has brought him back, but I do not think he is going to derail the economy fixing it.

I see more risk with Bolsonaro [the incumbent], who is exceeding the spending cap to finance his campaign. If he is re-elected there is a risk that debt-to-GDP will increase.

Will Brazil default? It would have to be an extreme scenario for that to happen.

We are not running away from Brazil. We take a bottom-up approach of looking at the economy and its politics. Brazil has a closed economy, so most of its growth is driven by consumption. Now we have strong inflation and interest rates are high, but inflation is expected to peak in the coming months. We will see if that is correct.

It has a central bank approaching the end of its tightening

cycle, strong consumption and exports 60% of its commodities – mainly wheat and protein – to China. It will continue to see that demand.

Looking at valuations, there are some interesting opportunities in Brazil, even on the sovereign side.

And South Africa? We had a local currency position there. We closed it, not because of the rand, but due to the flight to safety and the strength of the dollar. You can put South Africa's central bank in the same pocket as Brazil's. They have been extremely bearish in trying to solve inflation and have shown their credentials for political independence.

While there are issues in the country, they are showing signs of growing and developing, which makes sense to us as an investor.

Lasocki: I agree and would not say that Brazil or South Africa are anywhere near the top of the list of worries for EM debt investors. For me it is China. Talk of a commodity boom is premature. It is a frail commodity rally. Unlike the one between 2002 and 2008, it is not based on strong fundamentals and a fantastic emerging market story, which was when China was growing at double-digit rates and most EM countries were light in debt and had a lot of room to grow.

That rally was based on the demand side, whereas now, with a few exceptions, the underlying reasons driving the rally are disruptions on the supply side, for example shocks to wheat producers or energy supply.

To me, China is the biggest risk because the commodity boom is not going to support growth in EM. China is super reliant on its real estate and financial sectors and there is little room for error left. It would be a bloodbath if a sector that covers so much of China's GDP falls further.

Arevalo: There has already been a bloodbath.

Lasocki: Some investors may see value in this if they want to exploit distressed opportunities. I would tread carefully, unless you want to rely on a recovery. This is a different way of investing.

I would not want the ups and downs of the next six to 12 months to frighten me off looking at this asset class.

Alan Pickering, Best Trustees

Arevalo: We have been looking at China's real estate sector. To give you a sense of how much of a bloodbath there has been, of the 48 companies which had dollar bonds only eight are still standing.

Real estate is about 20% of China's GDP. There have been headlines that people are not willing to pay their mortgage until their property is completed. So unless the government does something, the economy will struggle to meet the 5.5% target. In the past 10 years China has not missed its growth target by more than 50 basis points. Even if you give them some wiggle room, they will be far away from 5.5%.

If you are based in London how do you know what is happening in China, Brazil and South Africa?

Arevalo: I am lucky to have an excellent team. We have specialists focusing on Asia, EMEA and Latin America. What is also important is having strong relationships with research houses.

A question we are often asked is why doesn't Jupiter cover Asia from its offices in Hong Kong and Singapore. To me, we have reached a point where there is so much local knowledge we can access that we do not need someone to be in the country.

On top of that we travel. I have been to Latin America and my peers have been to Turkey, Indonesia and Africa. It is important when you invest to kick the tyres to see what is happening on the ground. During those trips you meet government officials, journalists and companies, so after five days you come away with a good feeling of what is happening in the country.

It is about relationships, travelling and having a good team.

Do you have confidence in the standards of ESG in the emerging world?

Rhodes: There are questions about ESG in developed markets. It is difficult because there is no single standard of measurement. Factor investing could be useful here because certain stocks are left behind, limiting your risk.

As an industry more needs to be done to set a standard metric on this. Until that happens, I do not know how much faith many trustees will have in the wildly varying reports they receive.

The industry has to do more to give trustees confidence in what is measured, how it is measured and how transparent it is.

Lasocki: ESG is critical. The conversation has evolved. It is no longer about simply asking managers if they have an ESG policy. It is not a box-ticking exercise.

It is probably the one thing pension plan members would ask me about if they met me. They probably wouldn't ask about particular names in the portfolio, they would ask what happens with their pensions money ESG-wise.

It is great to work for a prestigious name such as Royal Mail but it comes with huge responsibility. You do not want newspaper headlines telling people that the Royal Mail's pensioners ended up funding certain activities.

Going back to selectivity, there is a huge reliance in the industry on ratings and a simplistic approach. For example, Russian bank Sberbank was one of the top rated ESG companies ahead of JP Morgan and Deutsche before the invasion.

I have always been baffled by how easily investors agree to lend money to a bloody regime or companies funding it, while at the same time rightly rejecting investing in, for example, polluters.

You cannot always avoid the political context of ESG. Russia is one name, but there are other sovereigns which are questionable from a social perspective.

Investors should be mindful of certain sovereigns if they are serious about ESG.

Passive money is not good at that. With ESG you have to be selective, need an active approach, ideally someone who has ESG incorporated at every stage of the investment process, oth-

erwise it is a simplistic, knee-jerk approach. Investors should look into the future and see ESG as a source of alpha.

Arevalo: ESG is part of our process. We have a dedicated person who focuses on ESG and engagement. It's what she does all day. Sovereigns are difficult to engage with because more people are willing to give them money. That mentality has to change. Sovereigns have to be more willing to answer questions and engage with investors. It will be a slow development.

We are starting to see in specific sectors such as coal, which is a typical red flag for an ESG fund, that the number of investors is shrinking.

That is reflected in them paying higher coupons than similar rated companies in other sectors because of their ESG risk. It is coming, but slowly. There is no standard so every asset manager has to do the best they can and explain their process. We are seeing more green bonds and you have to differentiate between those that are truly green and those which are not.

One of the downsides of the ESG movement is that demand is higher than supply. There are not as many bonds outstanding as there are funds chasing them. What that has created is that green bonds tend to trade slightly more expensively than normal bonds, even if they are issued by the same company.

As supply increases valuation discrepancies between bonds issued by the same company will start to level out.

Pickering: I am much more comfortable with the ESG debate than with the ethical or socially responsible investing that were the earlier manifestations of wanting to behave better with other people's money.

I am sceptical about trying to codify the E and the S. I would rather focus on the G because governance is dynamic, it can respond to positive developments and allow you to compare and contrast.

If you try to define the E and the S you end up with spurious accuracy which is potentially a gravy train for the charlatans who will tell you that they have found the best way of measuring these things.

I am particularly keen on the just transition aspects of the S. One must not become an ESG colonist. You must appreciate the transition countries have to go through to modernise their practices. But the G is the more dynamic way of ensuring that we keep people's feet to the fire rather than having rigid measures which may become out of date as the science changes.

Picking up on the reputational point, it is important that savers know what is being done in their name. I do not want investment strategies determined by marketplace plebiscites because members watch a television programme tonight and will want you to exclude a particular category tomorrow. I am more in the engagement camp than the exclusion camp.

When encouraging people to save, if we tell them what we are doing with their money, the impact it will have on their outcomes and the direction of travel when it comes to improving outcomes for wider society, they may be willing to save more. Saving more is probably the best way to improve outcomes rather than relying on the best asset manager in the land because if we do not give them the assets they cannot manage them and they cannot improve outcomes.

Member engagement is important, but I do not want them to vote on what I do with the money.

Lasocki: For me, active engagement is generally better than simple exclusions. I am sure members would rather their money is working to improve the world we live in. I would prefer to own debt of an oil producer which is bad for the environment and force it to improve rather than allow someone else to buy it cheaply and let them continue to pollute.

Some investors will have a list of exclusions and I appreciate you cannot always engage with certain governments, but through active engagement, particularly with corporates, you can do a lot of good with your money in emerging markets.

How much influence can a bondholder have compared a shareholder?

Lasocki: I would say it is significantly more. In equities you are constantly in the secondary market, which doesn't matter that much to companies – they already have investors' money. If anything, when everyone dumps their shares, they can buy them back cheaply.

But in the debt space, they have to behave and improve because the next time they come for your money they will have to pay more for it. Debt investors are more influential than equity investors.

Arevalo: If you are able to push a company to do the right things over the medium term, spreads will tighten.

Most companies are frequent issuers as they want to diversify their funding away from equity and banks. You set targets for them, which if they miss will pay more the next time they need debt.

We have a lot of power to push them in the right direction.

How easy is it to get accurate data from borrowers to prove they have hit your targets?

Arevalo: Most companies have dedicated ESG departments, which makes it easier to access information. You also set clear

> **Looking at the next decade, emerging markets could offer more growth than developed markets.**
>
> Paul Rhodes, Reach Pension Plan

targets, which you review every six months and measure against that information.

Pickering: Entity-specific targets are a better yardstick than applying UN or other people's standards. You can measure the extent to which the targets have been met. You can then say to your members that this company was doing X tonnes of bad stuff last year but it is now doing -X tonnes of bad stuff because of our engagement.

Arevalo: There are also sustainability-linked bonds, which set targets in the prospectus. If they reach those targets their cost of funding will fall.

What are you expecting to happen in emerging markets in the next 12 months?

Rhodes: It is hard to tell. There are too many variables. It is very much up in the air at the moment.

Pickering: I cannot say what is going to happen, but whatever happens end-users like me should not discard the opportunities and risks associated with emerging markets in general and emerging market debt in particular.

I have a long timeframe in DC and not such a long timeframe in DB, but I would not want the ups and downs of the next six to 12 months to frighten me off looking at this asset class.

Lasocki: There will be a lot of opportunities. There is always the risk of trying to catch a falling knife. The fact that it has been the worst six months on record for emerging market debt in terms of performance and outflows does not mean that it cannot get even worse.

In the next six to 12 months, we may see some bad news, but longer term there is a lot to be optimistic about. Now that we are hopefully done with Covid there will be other issues. Political risk is always something to have in mind.

South America is a great place to look at and could be an area where things either go very bad or very good.

Overall, this time I am not cautiously optimistic. Performance-wise global EM debt investors paid out $10bn (£8bn) in March and while you should normally not divest simply because performance is suffering, until now those who did saved a further 10% of negative performance. Perhaps the worst might be yet to come, but I hope some EM sovereigns will come out of this situation with stronger finances.

There may be trouble when dollar issuers need to refinance. There is a lot to worry about, but also a lot of value opportunities.

Arevalo: There is a lot of uncertainty. Will the US enter recession? What will China do with the real estate sector? What will happen in Ukraine and Russia? What impact will the war have on food inflation? How will countries manage that?

We are going line by line in our portfolio and thinking about the worse-case scenario of hyper-inflation, real estate in China, food inflation and trying to see who will be the survivors during this cycle. That is what we do.

It is difficult to see six months from now, let alone 10 years, so we have a short timeframe to look at a company's financing, operations, management, political risk, how they will be impacted by China and then factor in the probability of default. You can never rule that out.

We are trying to have a solid portfolio of companies and mitigate some of the risks. We cannot hide under a rock because volatility is here to stay. You have to believe in your process, you have to believe in the fundamentals.

If you have a strong process, this volatility will give you an opportunity to lock in companies and sovereigns which have a discrepancy between valuation and fundamentals.

We are high in cash because we want to pick those cheap valuations, while conscious that outflows could continue. We are building a defensive portfolio with dry powder so when the time comes we can take advantage of that.

Alejandro Arevalo is head of emerging market debt at Jupiter Asset Management

EMERGING MARKET DEBT: WINNERS AND LOSERS

Alejandro Arevalo and Jupiter's emerging markets debt team weigh opportunities and potential risks in the asset class amid rising inflation, tighter policies and geopolitical tensions.

Emerging markets look extremely attractive relative to their history and other parts of the fixed income universe. If the past is any guide, from these valuation levels, emerging market debt tends to deliver strong risk-adjusted returns.

For many investors the question is not just when to buy – but what to buy.

Inflation is pressuring central banks. China is struggling with lower growth and zero-Covid policies. Global growth is threatened by higher prices and tighter policy. Russia's invasion of Ukraine continues. However, emerging market central banks are ahead of the curve in tackling inflation. Higher commodity prices are a tailwind for many. The presence of an emerging market middle class, particularly in Asia, has made emerging market consumption less dependent on developed markets.

Energy-related inflation, and spikes in prices of basic materials, are usually perceived as positive factors for emerging markets, but some countries are net energy importers. Wheat and other agricultural commodities can have significant effects on food importers.

In our team, we dig even deeper, asking questions such as:

– What might be the effect of higher prices at sector and company level?
– Can persistent inflationary pressures generate second-order effects on political stability?

Macro-economic shocks rarely have a uniform impact on different countries and businesses; both winners and losers emerge. Our team of emerging market credit analysts identify potential winners and losers:

XUCHEN ZHANG, EM CREDIT ANALYST – ASIA

Winners

Indonesia – One of the few net commodity exporters in Asia will likely see improving fiscal and external metrics, and robust GDP growth. The central bank has consistently kept monetary policy pro-growth and inflation is under control. We like E&P companies that generate strong cash-flows, and property developers that are set to benefit from improved household balance sheets.

Losers

China – A mixed picture: on the one hand the economy has taken a lot of pain thanks to zero Covid, and a prolonged period of tighter policy, which has taken its toll on the real estate sector. Policymakers have also shown themselves more reluctant to use the major tools at their disposal to ease conditions than in the past, instead using more local targeted measures. Simultaneously, given ambitious growth targets the direction of policy can only get easier from here.

SEA – Philippines, Thailand, Vietnam – All three are net commodity importers and government balance sheets will deteriorate. Moreover, the new Philippine government's policy remains uncertain regarding the local conglomerates that have issued the lion's share of dollar bonds.

India – Oil, metals and fertiliser together account for half of India's imports, which is a heavy blow to government and household finances. However, this also means renewable energy is more strategically important to the government as a sustainable solution. We continue to like this sector.

ALEJANDRO DI BERNARDO, EM CREDIT ANALYST – LATIN AMERICA

Winners

Mexico – Higher oil prices aid public finances via higher tax collections from state-owned PEMEX. We remain overweight on selected utilities and names that can benefit from economic reopening.

Brazil – We stay tactically overweight on blue chip exporters, able to pass-through cost increases in the chemicals and metals & mining sectors. We see value also in some producers of fertilizers. Corporates are preferred to sovereign debt.

Losers

Chile – We see limited room for the government to stimulate the economy, which is grappling with high oil prices. We are underweight across our portfolios, preferring exposure to high-yield names in the telecoms sector given attractive valuations.

Peru – High copper prices might not produce expected improvements in the fiscal position of the country given inconsistent spending targets. We stay neutral to underweight, preferring exposure to select miners and agricultural commodities exporters.

REZA KARIM, FUND MANAGER – EMEA COVERAGE

Winners

South Africa – Monetary policy is credible and inflation is well managed. Commodity exporters look particularly attractive.

African oil exporters Nigeria/Angola – Angola is expected to benefit from high oil prices and is also almost self-sufficient in food. To a lesser extent Nigeria also benefits from high prices.

Losers

Turkey – High oil prices are hurting its trade balance and disruption to tourism from geopolitical events makes matters worse. We remain underweight, but watchful.

Ghana – Its access to foreign capital markets is effectively closed. Inflation is high and so is its deficit. Without credible and strong macro-prudential policy, it is hard to see stability anytime soon.

Conclusion

History tells us that yields at these levels are not sustainable for the longer term in emerging market debt, and investors should consider returning to the asset class or increasing exposure. At the same time, the consequences of higher inflation are crucial to the relative prospects of emerging market countries and companies. Accordingly, an active, selective approach is likely to deliver materially better performance.

EM DEBT: IN THE EYE OF THE STORM

These are uncertain times for many holders of emerging market debt, but, as *Mona Dohle* discovers, this is no reason to ditch the asset class.

If there is a picture that encapsulates the crisis in emerging markets, it is that of protestors jumping into the swimming pool of deposed Sri Lankan president Gotabaya Rajapaksa. But the joyful scenes mask a grim reality for many Sri Lankans.

The government's mismanagement of the country has accelerated the effects of a global debt crisis that have plunged the country into poverty. More than 10% of country's 22 million people are living below the poverty line. The United Nations estimates that food shortages mean 70% of the population miss at least one meal a day and one in five are hungry. Pushed to the brink, Sri Lanka defaulted on $35bn (£28bn) of its foreign debt and is holding restructuring talks with China and its other major creditors.

What does all this mean for UK institutional investors who hold emerging market debt? In the first instance, it drives home the human costs of sovereign debt crises. But there is also an argument to be made that Sri Lanka may well be the canary in the coal mine for a gulf of defaults across emerging nations. Rising commodity prices, inflation and rate hikes have created a vicious cocktail that for many countries may well be too hard to stomach. In the first half of this year, emerging markets bond funds faced $50bn (£41bn) in outflows, according to JP Morgan.

Does this mean that investors should simply ditch their holdings? That may be premature, given that emerging markets account for more than half of global GDP, but only a fraction of global investment. In the UK, 37% of defined benefit (DB) schemes are invested in emerging market debt, with an average allocation of 4%, according to Mercer.

Among defined contribution (DC) schemes, 30% are exposed to the asset class, which, on average, accounts for 7% of the portfolio. But given the still relatively low yields in developed markets, the share of emerging markets in pension funds is growing. DB schemes, for example, have increased their allocation by 9% year-on-year and it also accounts for a growing share of DC schemes' fixed income portfolios, according to Mercer.

But with risks mounting, how can investors navigate the coming storm?

Dollar trouble

How did we get here? One factor that helps explain the growing share of low-and middle-income countries in international debt markets is ultra-loose monetary policy across developed nations, which has pushed interest rates down globally. As a result, the volume of emerging market debt in circulation has doubled to $9.3trn (£7.7trn) from $5trn (£4trn) in 10 years, according to the World Bank. Covid has again accelerated this trend, with the debt stock of emerging markets rising by almost 7% in 2021 alone.

And paying back the rising debt mountain has become a lot more expensive, especially for hard currency debt, which tends to be dollar denominated. The price of the dollar has reached a 20-year high (as of June 2022), pushing up the costs of servicing this debt.

For many investors, this brings back bad memories of the 2013 taper tantrum, when speculation of a Fed rate hike caused a stampede out of emerging markets. The rising dollar has also caused fund managers to ring the alarm bells. US asset manager Man Group has warned that around 10% of dollar-denominated debt is at risk of default. A record 19 emerging market countries are trading at distressed levels, which amounts to $250bn (£207bn) in debt, according to Bloomberg.

> **Nobody can completely escape the dollar, but it would be worse if they didn't have local currency debt.**
>
> Stuart Trow, columnist

Staying local

While all this is deeply alarming, there is, however, an important counteracting factor, as Stuart Trow, a columnist and former credit strategist at the European Bank for Reconstruction and Development explains: the share of local currency debt has been increasing.

It now accounts for almost all outstanding emerging market borrowings. As of 2018, local currency debt stood at just above $2.2trn (£1.8trn), compared to around $880bn (£729bn) in hard currency, according to JP Morgan.

This marks a significant change compared to the situation during the taper tantrum in 2013, when hard currency debt was more prominent.

But local currency debt is highly concentrated among the biggest issuers. For more than 80 emerging countries, hard currency debt remains dominant because investors do not have faith in the stability of their currency. These countries remain exposed to the risks of the rising dollar.

"From an investor perspective, there is now a lot more interest in local currency debt, but when you look at the market, a lot of the big issuers, such as Turkey and Russia, have disappeared and China has become less attractive as a local currency investment," Trow says.

"For international investors, the whole point of local currency debt is to wean people off exposure to the dollar," he adds. "Clearly that is playing a role now. Nobody can completely escape the dollar, but it would be worse if they didn't have local currency debt."

It is no wonder then, that international creditor bodies, such as the IMF, aim to promote the development of local currency debt markets as an important source of financial resilience.

But local currency debt is by no means a panacea, warns Dinesh Visavadia, a director at Independent Trustee Services. "From a trustee point of view, there is the challenge to consider whether you invest in hard or local currency debt and, of course, hard currency can be more reasonable because you will have more due diligence and governance. With local currency debt, you are always subject to fluctuations in the country's currency," he says.

A lot of trustees will be uncomfortable with the level of volatility in local currency debt.

Dinesh Visavadia, Independent Trustee Services

"A lot of trustees will be uncomfortable with the level of volatility in local currency debt," Visavadia adds, acknowledging that this means they would have to weigh currency stability versus heightened default risks in hard currency debt.

The China factor

Another factor to consider when investing in emerging markets is the role of China, which thwarts the overall trend. China represents a third of the of MSCI Emerging Market index and is a much more dominant force than it was nine years ago, just prior to the taper tantrum. Back then, China accounted for 18% of the index and the index was, generally speaking, more diversified. But now China accounts for more than half of all debt outstanding, owing $2.7trn (£2.2trn) of the $9.3trn (£7.7trn) emerging market debt pile. Chinese borrowing increased 14.4% last year, according to the World Bank. Excluding China, emerging market debt only rose 1.9%.

So increasingly, there is an argument to be made that China should be excluded from emerging market debt indices and treated as an entity on its own. As the world's biggest importer of commodities and given its high debt levels, China was also at the forefront of emerging market outflows. In July alone, €3bn (£2.5bn) of the country's debt was dumped, according to the Institute for International Finance.

Consequently, China has turned from an investor's favourite to an investor's foe. This is accelerated by rising commodity prices, where China is effectively importing inflation.

Asset managers have responded to this trend by increasingly offering emerging market debt strategies that exclude China. Examples include BlackRock, Amundi, Eastspring, GMO, DFA Investment and Baillie Gifford, which have all launched ex-China strategies, according to Blomberg.

This does not yet resonate with UK investors. Only 15% of British final salary schemes are considering a separate China allocation in their emerging market strategy, according to Mercer's asset allocation survey, which was, however, conducted in 2021.

But simply ditching China from emerging market strategies opens the door to another problem, that of a rapidly shrinking emerging market universe. With Russia having been booted out of most benchmark indices and Turkey facing skyrocketing inflation (79% at the time of writing), the investable universe has now become quite a bit smaller than it was at the beginning of this year, Stuart Trow says.

Navigating the storm

Given the uncertain outlook for a rapidly changing emerging market landscape, how should investors access the asset class?

Visavadia says that there is still a lot of opportunity, given that some of the default risks have been priced in, but warns that investors should access emerging markets selectively.

Visavadia sees the growing importance of ESG investing as a challenge and an opportunity for emerging markets. "Countries and companies are going on a journey in terms of ESG credibility. There is also a risk here that many may not meet the ESG criteria that international investors are setting and this could add to higher default rates in emerging markets," he says.

In terms of regions, Visavadia is particularly upbeat about Africa and any countries that are exporting commodities. While they have struggled historically, they could now benefit from rising commodity prices, he says.

This ties into an argument that Trow is making. Net exporting countries, those with favourable balance of payments, could be relatively more resilient to the impact of the rising dollar and rising energy prices. While oil exporters, such as the Gulf States, stand to benefit in the short run, but in the long run countries able to contribute to the renewable energy transition could become some of the key beneficiaries.

And there are good examples of pension funds banking in on this trend. Earlier this year, a collaboration between 12 UK pension funds, led by The Church of England's Pensions Board, was announced, which aims to fund the climate transition in emerging markets. This includes USS, BT Pension Fund, Railpen, Brunel Pension Partnership, Border to Coast Pension Partnership, Nest and Legal & General Workplace Pension Plan, which collectively manage more than £400bn in assets. They will join forces to invest in the energy transition across emerging markets.

An indication that the way UK institutional investors are accessing the asset class is rapidly changing.

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