Emerging-market debt a potential source of protection and diversification

Claudia Calich, Head of Emerging Market Debt

"Adding emerging-market bonds to your portfolio can help limit erosion of your assets during inflation. And it allocates capital for new investments at the same time."

Claudia Calich, Head of Emerging Market Debt at M&G Investments

When you seek to protect your assets against inflation, emerging-market debt is probably not the first asset class to come to mind. It is true that a series of crises in foreign exchange and excessive price rises have marked the history of some countries and left scars on their collective memory. Yet with around twenty-five years' experience in these markets, including several economic and political cycles, I can attest to the opportunities that this field offers to help you protect your assets against inflation.

Standard and indexed bonds

The first of these opportunities might be in indexed bonds, even though not all emerging markets use them. These loans linked to consumer price indices were introduced in the 1980s in regions where inflation was high. Investors once strongly endorsed these bonds, which have remained an integral part of the debt programmes of countries such as Brazil, Mexico, Chile and Uruguay. Poland and Turkey also offer this type of bond, but with insufficient liquidity.

Yet what I would mainly like to underline are standard bonds. Several central banks have been vigilant regarding the abundance of liquidity available and have proactively tightened credit conditions, starting from as early as 2021. This has been the case in Latin America, for example. These vigilant central banks even acted before their counterparts in developed countries (ECB, Federal Reserve, Bank of England) did – despite the latter being bound by targets and strict mandates.

Not only do these bonds offer outstanding nominal yields, in my view, but they also offer – above all – remarkable real yields. This can especially be true in Latin America, where inflation forecasts have fallen in recent months, and, to a certain extent, in South Africa as well.

Local central banks should assert themselves

You have probably understood our view by now. We have a favourable opinion of Latin America. Eastern Europe is also due to occupy a larger place in our portfolios. But this depends on local central banks asserting themselves even more to keep prices stable in the long term.

We are much more cautious about Asia, especially China, where inflation has stayed very weak in recent years and bond yields do not seem particularly attractive to us. Yet in this area of the world, we like Indonesia, where high nominal rates are combining with a positive economic outlook and a low budgetary deficit.

Investors should not neglect this emerging-market debt, the nature of which should protect their portfolio against inflation through a comfortable buffer of yields. But that is not all. What I have always liked about this asset class are the many exceptions to the general situation. These exceptions can offer many opportunities and sources of diversification, whether in state loans or corporate bonds. The same event can have different effects on economies. For example, a rise in crude oil prices will have opposing effects on countries, which can be producers or consumers of oil.

A world of contrasts

The world of emerging-market debt is characterised by sharp contrasts between geographical regions, both in terms of growth and inflation. While some regions are slowing down, others are performing well due to their distance from the conflict in Ukraine or their assertive budgetary policies. Asia's sluggish recovery is offset by the relative stability of bordering markets like Africa with its rather homogenous growth rate of 3–4% for the whole continent. Wherever we invest, we analyse the inflationary outlook as closely as possible. Yet the way in which an asset manager in emerging-market debt carries out analyses has more dimensions than that of an investor specialising in Western markets, where price changes are the deciding factor.

To try to protect yourself against any defaults on payment, other essential criteria are economic growth, budgetary deficit and foreign exchange reserves. The dynamics are different in this field.

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