For Investment Professionals only

Emerging Markets Fixed Income

Looking for Opportunities in a Bruising Year

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- After an extremely disappointing opening half of 2022, we examine some of the factors that we think could drive an improved outlook for emerging market debt for the remainder of the year and into 2023.
- Persistently high global inflation has forced the world's leading central banks to start tightening monetary policy. However, the prices of many of the most vulnerable emerging market bond issuers are now quoted close to – and in some cases lower – than their expected recovery value, so we think the opportunities to realise attractive investment returns in the asset class are rising.

With interest rates rising to levels not seen in well over a decade and signs that global inflation is yet to peak, you could well wonder why we think the emerging markets (EM) debt asset class currently presents some of the more compelling opportunities in fixed income. After all, there has been a comprehensive sell-off across government and corporate bonds this year, so why should investors risk returning money to the market, given the uncertain global outlook and the threat of persistent inflation?

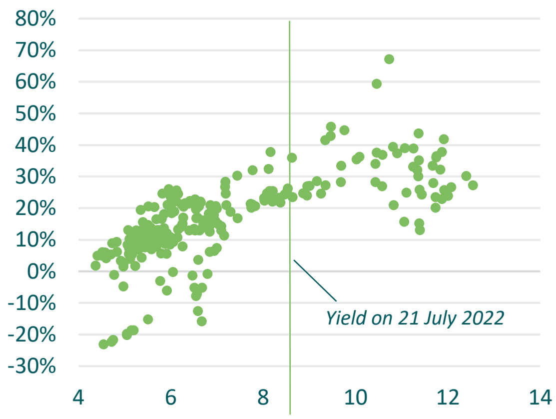
Dig a little deeper into the asset class and you uncover a number of countries that are already well ahead of the US Fed in the rate hiking cycle, on a much sounder financial footing than during previous hiking episodes and supported by solid issuer fundamentals across the corporate landscape.

Bond valuations have adjusted tremendously since the start of the year and are already pricing in a lot of the uncertainty, in our view. A blended benchmark comprising JP Morgan indices of corporate, local currency and hard currency emerging market debt is down nearly 17% in US dollar terms year to date (July 22, 2022). While several weaker sovereigns appear to be heading towards debt restructuring, we think they are already trading at distressed prices, indicating potentially limited further downside and, in some cases, the potential for significant upside.

Furthermore, the JP Morgan EMBI Global Diversified Index (representative of EM hard currency sovereign debt) currently has a yield of 8.5% at the time of writing (26 July 2022), a level that has not been reached since the great financial crisis (GFC). Historically, yields at these levels have been associated with strong returns in the subsequent 24-month period (Figure 1).

It's a similar picture in local currency markets, where many central banks have been raising interest rates since early 2021, resulting in near-record high nominal yields.

Figure 1. EMBI – 24-month returns vs starting yield



Returns shown on y-axis and yields on the x-axis. Green line: yield on 21 July 2022. Source: JP Morgan, M&G.

Past performance is not a guide to future performance.

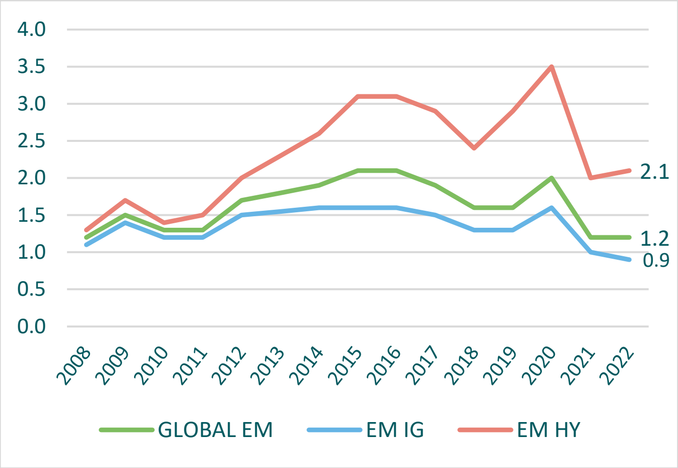
Despite robust inflation across emerging markets, many local sovereigns boast positive real (inflation-adjusted) yields, which is certainly not the case in most developed markets. Emerging markets have a higher weighting towards food and energy in their inflation indices, and the recent decline in commodity prices, combined with the lagged impact of monetary tightening in many countries, should help inflation to fall later this year, in our view. This could further support local currency yields. Many EM countries with large local markets are on sounder financial footing than during previous hiking episodes, with stronger current account positions and higher foreign currency reserves.

Many EM currencies are also still looking cheap, particularly after the recent extended episode of US dollar strength. We believe these are all important factors that should support EM sovereign bond returns when inflation starts peaking.

Healthy corporate fundamentals

Figure 2 shows that corporate net leverage, a closely-watched measure of underlying corporate strength, actually remains at very healthy levels on a historical basis across all rating bands.

Figure 2. EM corporate net leverage



Source: M&G, JP Morgan, Bloomberg, Capital IQ. As at 30 June 2022.

Among investment grade issuers it stands at its lowest level in well over a decade, reaffirming the view that corporate fundamentals are in good shape, despite the almost unprecedented corporate bonds sell-off we have seen this year. We think this presents investors with opportunities over the medium term.

A spread-driven sell-off among high yield areas of the asset class has been particularly painful for investors recently, especially in the lowest-quality parts of the market (single Bs and triple Cs). However, much of the selling appears to us to have been very indiscriminate. For example, oil producers in Africa have sold off heavily this year, despite a doubling of the oil price over the 12 months to the spring of 2022 – a scenario we would normally expect to be very beneficial for them.

Similarly, the market for subordinated bank debt (which is generally riskier, as it has a lower payback priority) capitulated throughout July 2022 (particularly in Asian markets). Yet the selling here also seemed to have little to do with the credit quality of the borrowers themselves, which were mostly solid investment grade issuers that were backed by senior bonds that were performing well. Again, it appears to us that anything deemed ‘high yield’ has come under indiscriminate selling pressure, and we think this is another reason why opportunities are now presenting themselves.

Default rates forecast to stay low

Corporate default rates are not forecast to increase substantially this year, and where they are expected to rise, we think the impact has been largely priced into bond valuations. We think this should be another supportive factor for this area of the asset class.

Last year, the corporate default rate among high yield emerging market issuers stood at 7.1%, driven largely by Asian credit due to strains in the Chinese property sector and government intervention in some sectors. The rate is expected to rise to 10.7% this year, but Asian default rates are expected to fall to 12.8% from 13.2%, and in Latin America and the Middle East rates are expected to increase only slightly. The one area where they are expected to rise substantially is in emerging Europe, largely due to the fallout from the war in Ukraine.

Round-up

We believe these arguments reaffirm our view that some areas of the market have been unfairly punished among periods of technically-driven selling. Given that the prices of many weaker sovereigns and credits are being quoted close to – or even lower – than their expected recovery value, we think this should at least cushion investors from the threat of higher US yields and prolonged global inflation, and even provide a good opportunity to seek for investors to potentially gain strong returns over the medium to long term.

However, we should keep in mind that a sustained rebound in performance throughout the asset class is unlikely to be achieved until macroeconomic news flow reaches a firmer footing, such as evidence of peaking inflation data, or stronger signs that we are not entering a prolonged global recession.

The war in Ukraine and the disruption it has caused to global food supplies remains unresolved. And it appears that geopolitical tensions between China and Taiwan are back on the radar. These are all areas we are very mindful of when selecting our investments. In our EM debt strategies, we continue to seek to mitigate these risks through a high diversification of exposure across regions, countries and corporates.

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