Seeking out good alpha opportunities in emerging market debt

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- The steady recovery of the asset class since Q2 has been every bit as remarkable as the initial blow-out in spreads back in March. Much of the higher-rated EM universe now trades at spreads over US Treasuries roughly equivalent to those prevailing at the start of the year.
- With valuations in EM sovereigns around long-run averages – and with balance sheet risks now more pronounced – we are cautious about the potential for significant further spread tightening in hard-currency fixed income. But total return opportunities in the year ahead remain attractive, especially when accompanied by judicious credit selection.
- A steady global growth recovery supported by more constructive and multilateral US trade policy may just create ideal conditions for EM currencies to correct some of their underperformance against the US dollar.
- The semi-mature state of EMD markets creates good alpha opportunities across sovereigns and corporates in both hard and local currencies.

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The legacy of Covid-19 in emerging markets (EMs) may take some time to become clear. Having lagged advanced economies' initial surge in cases in March and April, lower income countries experienced highly concerning case growth at the end of the summer, before once again being eclipsed by the developed markets' second wave (Figure 1).

There are reasons to expect a slower and less comprehensive vaccine roll-out among EMs than in richer countries, and the fiscal damage done to already-fragile sovereign balance sheets may increase vulnerabilities.

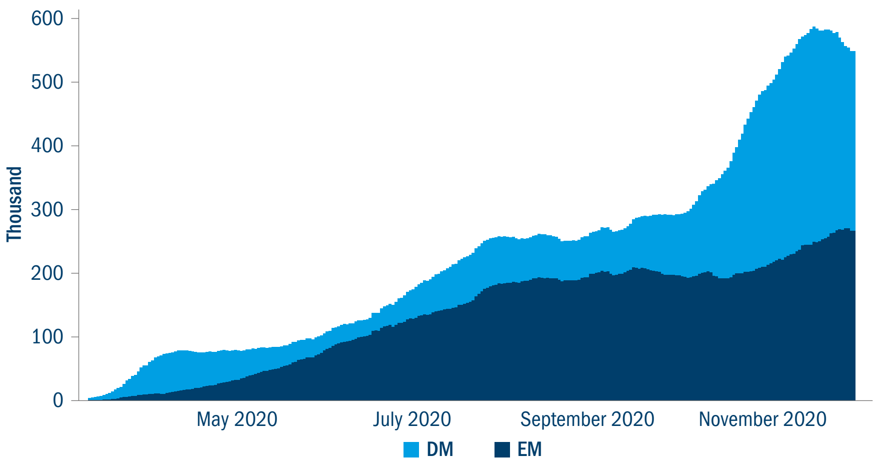
But the steady recovery of the asset class since Q2 has been every bit as remarkable as the initial blow-out in spreads back in March. Much of the higher-rated EM universe now trades at spreads over US Treasuries roughly equivalent to those prevailing at the start of the year.

With valuations in EM sovereigns around long-run averages – and with balance sheet risks now more pronounced – we are cautious about the potential for significant further spread tightening in hard-currency fixed income. But total return opportunities in the year ahead remain attractive, especially when accompanied by judicious credit selection. So far this year EMD performance has still to fully catch up with other parts of the fixed income asset class.

The structural tightening of spreads in the early years of the 21st century have given way to a much more cyclical market; the EM credit asset class displays a strong correlation with developed market corporate credit and is well positioned for even a modest global growth recovery in 2021.

Moreover, the global rate environment remains conducive to EMD performance with inflation benign, central banks expected to maintain accommodation and the stock of negative-yielding assets at around $15 trillion.[1] Meanwhile, allocations to the asset class among international investors are still low, suggesting persistent inflows in coming years.

Figure 1: New Covid-19 cases, 7-day moving average



Source: WHO, November 2020.

[1] Bloomberg, Negative-Yielding Debt Hits Record $15 Trillion on Trade Woes, 5 August 2019.

Our attention is focused on the higher-yielding end of the EM sovereign and credit markets, where performance has lagged that of both higher-quality EM credits and equivalently rated developed market corporate bonds (Figure 2). The excess yield available in EMD relative to US High Yield does not adequately reflect the lower default rates and higher recovery values observed in the former.

In the EM corporate space, despite a tough year for revenues and increased gross leverage, balance sheets tend to be rich with undeployed cash and deleveraging potential as earnings recover next year. As ever, selectivity and discerning fundamental analysis are essential.

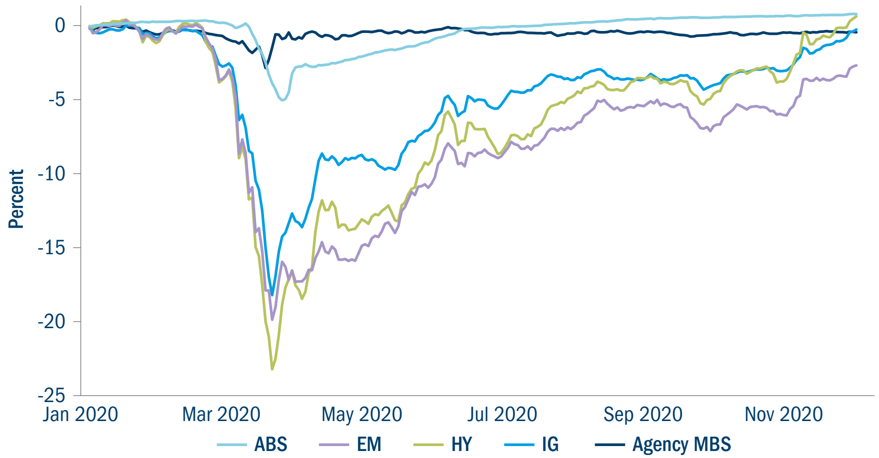
EM local currency bonds also present an interesting opportunity as we move into the next phase of the Covid cycle. The combination of deteriorating fiscal health, as governments rushed to insulate their economies, and aggressive monetary easing enabled by tame inflation, has left many local currency yield curves unusually steep.

It will be unwise to ignore the vulnerabilities implied by those policies over the longer run. But relative to those on offer in advanced economies, real yields are attractive even on a currency-hedged basis.

More importantly for returns, a steady global growth recovery supported by more constructive and multilateral US trade policy may just create ideal conditions for EM currencies to correct some of their underperformance against the US dollar.

As ever, the semi-mature state of EMD markets creates good alpha opportunities across sovereigns and corporates in both hard and local currencies. We continue to focus on pairing rigorous, fundamental analysis with macro research to identify the best risk/reward opportunities.

Figure 2: YTD excess returns by sector



Source: Bloomberg, November 2020.

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