Approaching uncertainty with confidence in emerging markets fixed income

The war in Ukraine has added continued volatility to emerging markets fixed income assets. According to our latest study, institutional investors around the world are wary of the war's market and economic impacts but remain optimistic for the months ahead.

Vontobel surveyed more than 300 institutional investors and discretionary wealth managers globally in North America, Europe and Asia-Pacific during the first quarter of 2022. According to the survey, 72% of institutional investors across the globe were optimistic about GDP growth, inflation and bond yield premiums in European emerging markets prior to Russia's invasion of Ukraine. However, among responses received after the invasion, only 55% of institutional investors were optimistic.

Despite decreased optimism around European emerging markets, emerging markets as a whole are appealing for institutions. More than half (64%) of institutional investors report that they plan to increase (somewhat or substantially) their asset allocations to emerging markets fixed income over the next 24 months.

The top three reasons that institutional investors cite for increasing their allocations included: diversification benefit versus current holdings (56%), highly liquid market (48%) and favorable ESG prospects (47%).

Despite market headwinds, institutional investors recognise the need to diversify to provide both higher yields and insulation from market and geopolitical volatility in other asset classes. Emerging markets fixed income can meet those needs in investor portfolios but requires an experienced active manager to navigate the unique challenges associated.

Emerging markets fixed income offers investors an opportunity to offset portfolio risk in their non-emerging markets holdings, and to direct their capital toward income-generating assets that are aligned with their ESG objectives. However, they're held back by asset-specific concerns and market factors. When investing in emerging markets fixed income, institutional investors globally indicated the top challenges their institutions face as: concern about default rates and debt load (51%), liquidity (48%), volatility (45%) and concern about corporate governance, data quality and transparency, and reporting standards (38%).

These concerns are not new; the asset class is still treated as an exotic niche by many investors. However, for active investors that understand the asset class, it offers enormous opportunities—the impact of default rates is often exaggerated, and volatile periods offer excellent opportunities to exploit opportunities.

Investors activate ESG mandates in emerging markets fixed income

Given the heightened importance of monitoring ESG factors in emerging markets, almost all (91%) of institutional investors across the globe report using ESG investment strategies in their emerging markets fixed income allocation, including: impact investing (55%), systematic screening to include or exclude securities (54%) and engaging with issuer management to influence ESG policies and practices (49%).

Despite the widespread adoption, institutional investors report several barriers that hold their institutions back from making ESG-focused investments in emerging markets fixed income: data inconsistency by third-party providers (62%), skepticism about the positive impact of ESG investments (61%), the perceived higher risk associated with emerging markets fixed income (43%) and the lack of suitable ESG offerings from external asset managers (43%).

Within the last few years, ESG has become table stakes for institutional investors, and emerging markets fixed income investors are finding that the asset class presents a unique position to generate returns while making a positive impact. Our study found that institutional investors are more interested than ever in sustainable investment products, and rely on the expertise of active managers to identify attractive and sustainable investment opportunities while managing the unique risks inherent in emerging markets.

Figure 2: Most significant challenges to investing in emerging market fixed income assets (%)

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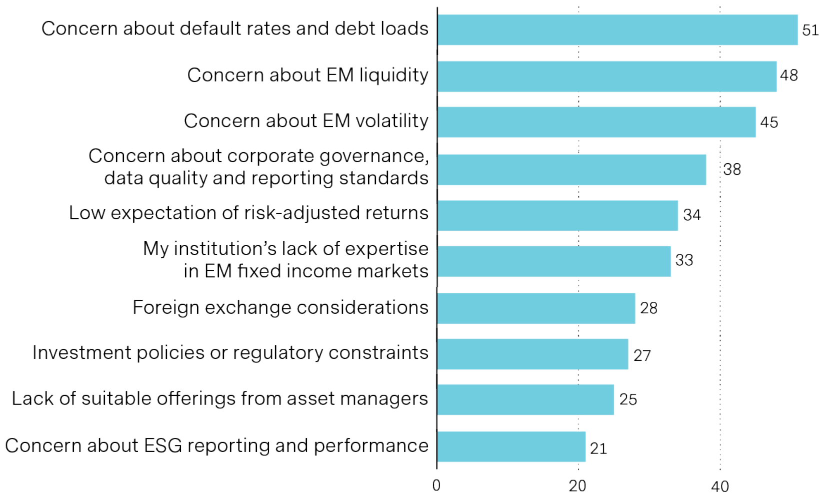
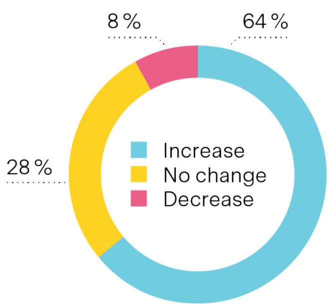


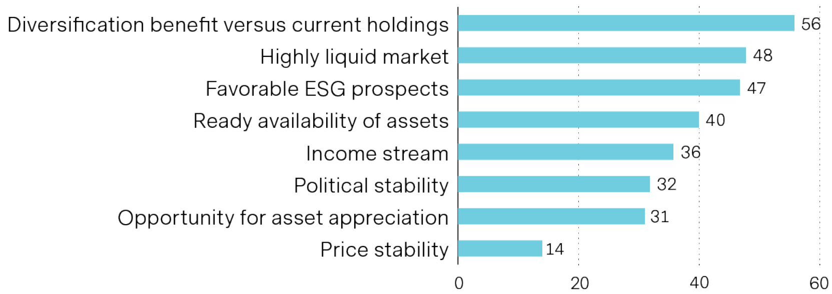
> **"Investors' success hinges on their ability to find good opportunities and to master the dynamics of fixed income markets and their issuers."**
>
> Simon Lue-Fong
> Head of Fixed Income,
> Vontobel

Figure 1: Those likely to increase EM fixed income overall do so in search of diversification, ESG alignment, and yield

Likely changes in holdings of emerging market fixed income overall



Most pressing reasons for increase in emerging market fixed income overall (%)



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