Opportunities hidden in Emerging Market Debt can add bite to investors' portfolios

➤ Many EMs have improved balance sheets

➤ Frontier market debt and local currency bonds offer strong prospects

Emerging markets (EMs) have delivered world-beating returns in recent decades, especially for those who have invested wisely. Picking the right assets in EM economies has yielded compelling returns for those willing to look for them.

Many EMs now display significantly improved and mature credit conditions which, in some cases, are better even than those of developed markets (DMs). With global markets set to enter a new phase of monetary policy normalisation and rising interest rates, should fixed income investors broaden their search for investment assets?

In the latest of our article series on fixed income, we look at how EM debt (EMD) can help investors' portfolios continue their return potential by adding bite.

Improved environment points to increasing momentum in EMs

The outlook is certainly positive for EMD, which has performed well this year. The asset class has benefited from US bond yields declining and the dollar's weakness but also because of an improving growth outlook, healthy current accounts, falling inflation, high real interest rates and undervalued currencies.

The EM environment looks even better now, as China has surprised on the upside, with very decent growth figures in the past few quarters. Industrial metals have recovered strongly since 2016. The oil price has been quite volatile, but oil demand remains benign, which is an indication of solid global growth.

Undervalued EM currencies have room to appreciate

A key question is whether global economic growth will break through the ceiling of the past six years. Our base case is that global growth will continue to remain rangebound around current levels. This scenario is very positive for EMs as global liquidity and financial conditions would remain very supportive on the back of CBs gradual move towards policy tightening and inflows would likely persist, helping EMD spreads to tighten further, both in the sovereign and corporate space.

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As EMD offers higher yields generally, it tends to outperform all other fixed income asset classes in the long term, in both hard (HC) and local currency (LC) strategies. In a rangebound economy, this means further spread compression for HC assets, especially the higher yielding part of the universe the so-called Frontier Markets.

But LC debt deserves a particularly closer look: although EM currencies have appreciated this year they are still undervalued by about 15%, according to our estimations, and investors could see their returns enhanced if EM currencies regain even some of the ground they have lost over the past five years. Furthermore, real interest rates are currently high in EMs and there is scope for central banks to cut rates as inflation remains benign. This will reduce yields and raise capital values of bonds. Countries that look attractive in these terms include South Africa, Russia, Turkey and Brazil.

Higher growth will favour commodities and frontier markets

Our alternative economic scenario is global growth breaking out above its current ceiling. In a well-balanced higher growth scenario, EMD could perform well owing to several factors. Global trade will increase in a world in which growth is picking up, which strongly benefits EMs and their currencies' appreciation potential. Higher growth should also boost commodity prices. Several EMs, especially frontier Markets (FMs), are commodity exporters and they will benefit strongly in this scenario.

Frontier Market Debt (FMD) captures the potential of the next generation of EMs: higher economic growth, favourable demographics and higher return opportunities. They can also deliver ample diversification possibilities to investment portfolios due to their low correlation with other asset classes, relatively low duration and high yields.

FMs have many of the characteristics that EMs did when they were first identified as a group in the 1980s. Most FMs are still only at the very earliest stages of economic, political, financial, institutional and business development and therefore have attractive long-term prospects.

It is because FMs are viewed as early stage investments they are often overlooked by investors. But the strength of their economic story should be borne in mind: the vast majority of the 25 fastest-growing economies over the past decade have been in the FM category. Their growth outlook is reasonably good in the medium term and very good in the long term. Among FMs, the African and South Asian economies should continue to expand faster than their peers.

Strong opportunities

Crucially, EM countries have much healthier balance sheets than in the past. Many major EM countries that ran current account deficits in the taper tantrum of 2013 are now running surpluses. This makes them less dependent on external financing and less vulnerable to external shocks. This should provide a strong cushion in an environment of globally-rising interest rates and a potentially stronger dollar.

Economic growth in EM and FM economies has now stabilised amid relatively high real interest rates, undervalued currencies and stable-to-improving commodity prices. This positive combination of factors means that investors looking to balance their portfolios against the potential headwinds created by normalising monetary policies and rising interest rates should broaden their search to these often-ignored or under-invested assets, irrespective of whether the global economy remains rangebound or breaches its current ceiling.

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