# 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

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 continue their return potential by adding bite.

### Improved environment points to increasing momentum in EMs

The outlook is certainly positive for the so-called Frontier Markets. EMD, which has performed well this US bond yields declining and the dolcurrencies.

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. indication of solid global growth.

#### Undervalued EM currencies have Higher growth will favour room to appreciate

A key question is whether global eco- markets levels. This scenario is very positive for perform well owing to several factors.

livered world-beating returns in recent conditions would remain very support- in which growth is picking up, which decades, especially for those who have ive on the back of CBs gradual move invested wisely. Picking the right assets towards policy tightening and inflows in EM economies has yielded compel- would likely persist, helping EMD ling returns for those willing to look for spreads to tighten further, both in the sovereign and corporate space.

> 'Many EMs now display significantly improved and mature credit conditions which, in some cases, are better even than those of developed markets (DMs)."

As EMD offers higher yields generfixed income, we look at how EM debt ally, it tends to outperform all other (EMD) can help investors' portfolios 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

But LC debt deserves a particularly year. The asset class has benefited from closer look: although EM currencies have appreciated this year they are still lar's weakness but also because of an undervalued by about 15%, accordimproving growth outlook, healthy ing to our estimations, and investors current accounts, falling inflation, high could see their returns enhanced if real interest rates and undervalued 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 The oil price has been quite volatile, but bonds. Countries that look attractive in their peers. oil demand remains benign, which is an these terms include South Africa, Russia. Turkev and Brazil.

## commodities and frontier

nomic growth will break through the Our alternative economic scenario ceiling of the past six years. Our base is global growth breaking out above case is that global growth will continue its current ceiling. In a well-balanced to remain rangebound around current higher growth scenario, EMD could vulnerable to external shocks. This

Emerging markets (EMs) have de- EMs as global liquidity and financial Global trade will increase in a world 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

> 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 overin 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

#### 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 should provide a strong cushion in an



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environment of globally-rising interest rates and a potentially stronger dollar.

Economic growth in EM and FM looked by investors. But the strength of economies has now stabilised amid their economic story should be borne relatively high real interest rates, undervalued currencies and stable-toimproving 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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