Tailwinds for Emerging Markets

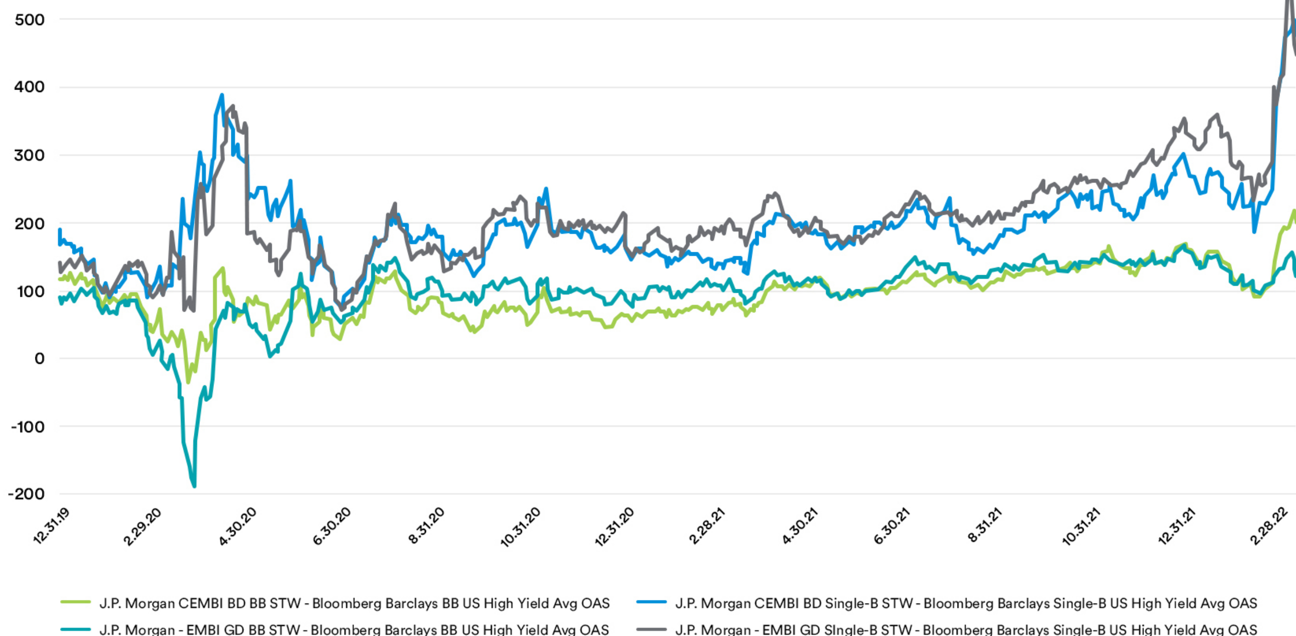
Attractive valuations, diversification benefits and increased yields could make EM debt a standout in fixed income.

Between new coronavirus variants, rising inflation, supply chain issues, China's zero-COVID policy and now a war raging between Russia and Ukraine, it has been a rough couple of years for global economies. Emerging markets, in particular, have borne the brunt of the uncertainty. As the pandemic constricted global activity, central banks in developed markets stepped in with liquidity and fiscal policymakers stimulated aggressively. On the other hand, policymakers in emerging economies were limited in their ability to provide liquidity, and fiscal balance sheets were also more constrained by lack of credit. As a result, emerging markets debt hasn't attracted the capital flows or experienced the performance of developed markets fixed income.

Now that's changing.

"Prior to the crisis unfolding in Ukraine, the developed world was having the hangover effect of all the stimulus, and the cost of it is inflation everywhere," says Todd Howard, portfolio manager for emerging market debt and multisector at MetLife Investment Management (MIM). Given recent global events, some of these factors are likely going to worsen.

Emerging Markets High Yield vs. U.S. High Yield Spreads



Source: Bloomberg L.P., J.P. Morgan

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Emerging markets do not have the same anchored inflation expectations as developed markets because investors have much more recent examples wherein inflation became problematic. With less of a price stability anchor, policymakers in Central and Eastern Europe and Latin America have already increased policy rates by hundreds of basis points—and they will continue to as necessary. This means that as the Federal Reserve or European Central Bank starts to raise rates, there's less risk that capital will flow out of emerging market debt.

"Our assumption, prior to the Russia/Ukraine war, was that inflation would likely peak this year, and as it moderates, we believe this could represent a tailwind for emerging market assets, especially the markets that have tightened the most," Howard says.

Valuations at the beginning of the year and since the crisis in Europe has begun are another potential tailwind. Over the last year, the yield spread on emerging market sovereign debt with a BB credit rating widened to 100 basis points over U.S. BB-rated debt. For B-rated EM debt, the yield spread is even wider at 150 basis points relative to U.S. B-rated debt. Currency devaluation over the past year is adding to that value, as central banks in emerging markets moved to tighten monetary policy and use some of their reserves to maintain currency stability.

For many of the markets MIM looks at, there is a lot priced in—and as we move through this year and obtain more visibility on some of the key macro drivers and specific EM-related concerns like Russia and Ukraine and Latin American politics, valuations could eventually be a catalyst for an emerging market rally.

Idiosyncratic opportunities

While there are attractive drivers for emerging markets debt, there's also a great deal of dispersion. In other words, not all emerging market opportunities are created equal.

"The market today is more divided than ever," says Scott Moses, a portfolio manager for emerging market debt at MetLife Investment Management, citing the default rates in emerging market sovereign high yield. "It's no longer 'a rising tide lifts all boats.' There are definitely some boats that are getting left behind."

"The idiosyncratic nature of the asset class has always existed, but now it's more dynamic than it's ever been." — Scott Moses, Portfolio Manager, Emerging Market Debt, MetLife Investment Management

Higher levels of uncertainty mean there is plenty in emerging markets debt that is priced cheaply until there is more clarity.

"There's some pockets of value we created within our asset class that have not been created in others," Moses says, noting there are pricing dislocations even on good assets. Investors have been concerned about macro factors such as ongoing tension between the U.S. and China or, more recently, Russia's invasion of Ukraine.

Despite the turmoil, "there are still some really good countries and companies that are going to need capital," Moses says, "but end up paying more for it because of market conditions. One example is the Dominican Republic, which could see a strong revival in tourism as COVID-19 disruptions fade."

A bright spot in emerging market debt is corporate bonds. As sovereign balance sheets continue recovering, corporate bonds have outperformed in the asset class as revenue, EBITDA and free cash flow returned to pre-pandemic levels. "Companies have proven themselves to be more resilient," Moses says, citing their ability to handle costs amid the pandemic.

As a result, corporate emerging market debt has done well. By contrast, sovereign debt has not responded as uniformly. "The idiosyncratic nature of the asset class has always existed, but now it's more dynamic than it's ever been," he says.

Another idiosyncratic opportunity MIM sees currently is with oil producers such as Angola, Oman

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and Ecuador, which are supported by high oil prices and positive underlying fundamentals. Angola, a top oil producer in Africa, delayed almost $3 billion in debt payments last year under the Group of Twenty's Debt Service Suspension Initiative. While there are concerns about this program coming to an end, there could be potential for credit-rating upgrades this year, and MIM sees opportunities in high-yield debt in the country.

In Oman, high oil prices, coupled with the country's economic reforms—which include cutting subsidies and introducing some taxes—have improved its outlook. In Latin America, Ecuador has been on the radar since Guillermo Lasso, a market-friendly banker, won the country's presidency.

A changing role in portfolios

Even though emerging markets debt has many tailwinds and pockets of opportunity, Howard emphasizes the asset class should not be considered a hedge against a down market like traditional high-quality fixed income.

That said, it can be a good diversifier for portfolios seeking income if they can stomach a bumpier road. Because emerging market debt has underperformed the last two years, some investors don't see it as an attractive asset class. "But if you want the diversification benefits and attractive valuations, I think it's an asset class that stands to benefit the most in fixed income, assuming a transitory inflation environment and no escalation of the Russia and Ukraine conflict," he says.

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