BlueBay
Asset Management

Emerging markets: unloved value

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Are you overlooking higher return prospects in favour of a home bias? In a world starved of growth, we believe emerging market assets will deliver for those willing to invest a little further afield.

Summary

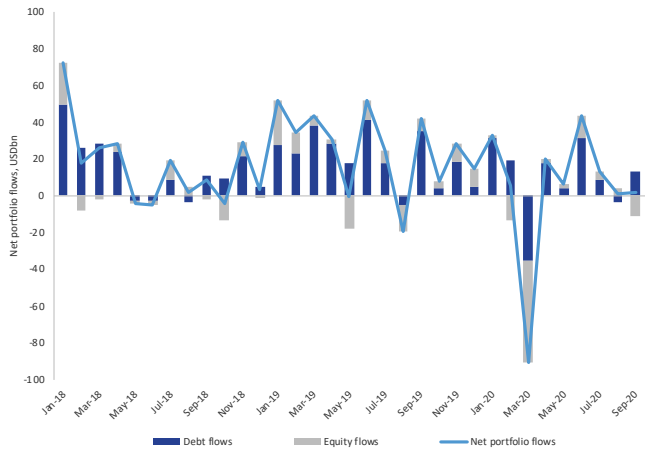
- We believe emerging markets have higher return and recovery prospects than developed economies, yet flows data suggests they remain under-owned by international investors.
- Emerging markets should benefit from a global recovery in activity and trade, higher commodity prices and a softer US dollar.
- Corporate default rates and leverage are lower than developed market levels, hence we believe emerging market debt offers an attractive risk-adjusted pick-up in yield.
- With the Federal Reserve staying dovish, a softer US dollar and Biden rather than Trump in the White House, we believe 2021 is a year for emerging market assets to outperform.
- We believe the assets of emerging market economies displaying favourable economic and political fundamentals offer enhanced return and diversification benefits in global fixed income portfolios.

Emerging markets (EM) remain an unloved asset class, despite offering more attractive valuations, higher prospective returns and a more robust 2021 recovery forecast than developed economies. We believe the home bias of international investors in the face of the coronavirus pandemic has left the asset class under-owned across many global portfolios.

Many international investors responded in typical fashion to the shock of Covid-19 and the associated recession by fleeing EM for the supposed safety of their home economies. Capital outflows from EM in Q1 2020 were on a par with those during the global financial crisis of 2008-09. But international capital markets remained open for most EM sovereign and corporate borrowers. Moreover, investors have begun returning to EM, although the recovery in capital flows is so far modest by historical standards. As the global economy slowly rights itself and risk appetite takes hold, commodity prices, trade and capital flows are expected to rebound.

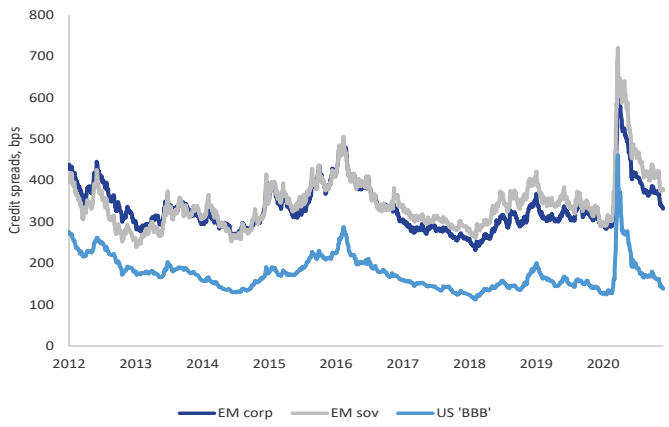
The pandemic and its aftermath are yet another reminder that the catch-all reference to the vast geographic region that falls under the banner of 'emerging markets' fails to reflect the country-specific fundamentals of its components. Some

Chart 1: Net portfolio flows to emerging markets



Source: Institute for International Finance (IIF), latest data for September 2020

Chart 2: EM credit spreads vs US 'BBB' spread



Source: JP Morgan EMBIG (EM sov) & CEMBI (EM corp) index spreads; spread on Bloomberg Barclays US Agg 'BBB' index; latest data at 27 November 2020

sovereigns have defaulted even as the balance-of-payments fundamentals of many countries are improving and benefiting from continuing access to international capital markets.

The global backdrop for emerging markets is very favourable, in our opinion. The discovery of effective vaccines should support a global synchronised recovery in activity and trade, led by China, and as in 2017, will likely be associated with a weaker dollar and higher commodity prices.

Joe Biden rather than Donald Trump in the White House is another potential positive for EM. The region has suffered collateral damage from the Trump administration's 'America First' approach and trade war with China, hence a more predictable, multilateralist and quiet US administration should come as a relief for investors. Over the medium-term, younger and faster-growing populations, coupled with the productivity 'catch-up' effect, underpin the more attractive growth potential of EM over developed economies.

As well as country differentiation, there are meaningful differences in performance and outlook across industry sectors. Leverage levels and the pace of corporate defaults are lower in EM than in developed markets (DM), yet EM credit spreads remain meaningfully wider. With some USD14 trillion of negative-yielding fixed income and credit in DM, we believe EM debt offers attractive risk-adjusted pick-up in yield.

Portfolio outflows and the impact of the pandemic on global growth and trade prompted a sharp depreciation of many EM currencies. Despite a modest rebound since March, most EM currencies remain meaningfully below their pre-crisis

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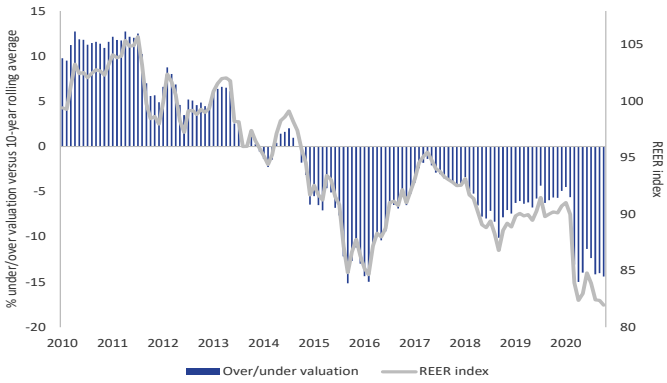
Chart 3: Average EM real effective exchange rate



Source: BIS; BlueBay calculations; latest data for October 2020

levels, even though balance-of-payments fundamentals have improved across many EM economies. Historically, both EM currencies and assets have performed positively against the backdrop of a sustained recovery in global activity and trade that is also typically associated with a weaker US dollar.

In a world starved of growth and income, we believe the assets of EM economies with disparate economic and political fundamentals offer potentially enhanced return and diversification benefits in global portfolios.

DISCLAIMER

Disclosure