BlueBay
Asset Management

Your EMD questions answered

Our experts tackle the questions that could shape your emerging market debt allocations this year.

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In a world starved of growth and income, where do the opportunities lie for EM investors?

POLINA KURDYAVKO, HEAD OF EMERGING MARKETS

If we were to grab a map of the world, I'd pinpoint four interesting opportunities for active EM investors to explore in 2021.

1. Asia
The Chinese real estate market boasts a stable footing and what we view as attractive relative valuations – arguably valuations that are not available elsewhere. This is primarily because of a lack of transparency; the fundamentals of the sector are stable.

2. Turkey
Despite its very poor policy mix for the past few years, a lot of Turkish corporates and financials are proving robust. As a result, we see opportunities for returns there.

3. Argentina
Argentina restructured its debt in 2020 and has a poor policy mix, which will likely continue. However, it has mid-term elections coming up towards the end of the year, which could shake-up the status quo. Its sovereign bonds are well priced and offer attractive yields, in our view.

4. Angola
The Angolan economy suffered significantly in 2020 because of the lower oil price. Now that oil is bouncing back, it has gained some relief from multilateral agencies and yields are high, representing a potential opportunity to benefit on the upside.

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What are the key macro and geopolitical risks facing EM?

BRENT DAVID, SENIOR PORTFOLIO MANAGER

In our view, the two major macro challenges that EM face in 2021 are the ongoing Covid-19 pandemic and any sharp reversal in global liquidity conditions driven by developed-market central banks.

1. Covid-19

The pandemic is far from behind us, even though an end is potentially in sight with the roll-out of vaccines across the globe. The challenge a number of EM countries now face, in our view, is balancing the economic recovery with the pick-up in cases. Further downside surprises to growth and revenue estimates, driven by more severe lockdowns, will put already-challenging fiscal outlooks at greater risk.

2. Liquidity

Developed-market central banks provided unprecedented amounts of liquidity in 2020, with a number of EM central banks following suit. Any reversal of that trend could pose significant challenges to the EM asset class this year.

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How could EM be impacted by a Biden presidency?

ANTHONY KETTLE, SENIOR PORTFOLIO MANAGER

A Biden presidency is broadly seen as positive for EM, as it is likely to provide fresh impetus regarding globalisation. We anticipate the US will likely return to its role as a global leader and take a more multilateral approach to world affairs. This should stimulate a pick-up in global trade and a reduction in geopolitical risk.

Asia is seen as a prime beneficiary as further risks around trade are mitigated and as global growth starts to rebound. However, China is likely to see the least benefits, in our view, as the US maintains a relatively hawkish stance there and as multinational corporations attempt to diversify supply chains away from China into other Asian countries.

We also expect there will be a greater focus on China's human rights record. As a result, India is likely to benefit as an established democracy and as a useful military ally for the US in its efforts to tame Chinese ambitions.

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Will the recent trend of EM issuers raising capital through green & social bonds continue?

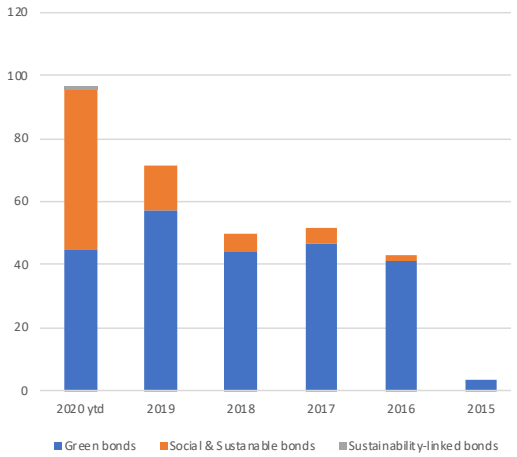
JANA VELEBOVA, SENIOR PORTFOLIO MANAGER

We believe the EM sustainable bond market is set to grow in 2021 at an accelerating pace, in response to both the urgent need to fund global environmental and social sustainability challenges and as a result of growing investor demand. We also expect issuers to increasingly link their funding costs to the achievement of relevant 'sustainability' targets through recently introduced sustainability-linked bonds (SLBs).

While rapid growth of the sustainable bond market has many positives, it isn't without its challenges. There is work to be done on the standardisation of labelling and taxonomies, as well as on some of the objections often raised against these innovative formats – such as the lack of penalties against non-adherence to green/social objectives.

As investors, we need to remain selective and hold issuers to high standards while working with the industry to encourage greater standardisation and improved rules around this promising, nascent market.

EM SUSTAINABLE BOND MARKET (LOCAL & HARD CURRENCY)



Source: HSBC, as at November 2020.

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Should investors consider EM local currency for their portfolios having experienced volatility over the last 10 years?

GAUTAM KALANI, EM FX STRATEGIST/ PORTFOLIO MANAGER

Despite the high historical volatility observed in the EM local currency asset class, we believe it is an attractive proposition for investors for three reasons:

1. Attractive valuations for EM FX – in both nominal and real terms, EM FX is still at multi-year lows. As a result, on simple medium-term metrics like purchasing power parity, EM FX is still at historically 'cheap' levels despite the rebound in Q4 2020 (see chart).

2. Expectations are that we are at the start of a multi-year downtrend in the broad dollar, driven by the US's negative real rates, widening twin deficits, continued monetary stimulus from the Federal Reserve and the dollar's fundamental overvaluation.

3. The local duration component of the asset class remains attractive, in our view. In a world with a huge amount of assets in negative-yield territory, EM local yields offer significant pick-up, with steep curves compensating for the fiscal deterioration seen across markets.

AVERAGE EM MISALIGNMENT

Source: Macrobond as at January 2021

The local duration component of the asset class remains attractive, in our view.

What challenges face Latin America?

GRAHAM STOCK, EM SENIOR SOVEREIGN STRATEGIST

Our key theme for Latin America is 'recovery'. In our view, the region's governments need to recover from the contraction induced by Covid-19, recover control over their public finances and recover the trust of populations that have suffered from both the pandemic and inconsistent measures to contain it.

As fixed income investors, we will be watching the 2021 budget approval cycle and subsequent implementation carefully to see if spending can be brought under control. In our view, eliminating emergency Covid spending will not be enough to put the public finances back on a sustainable path in many countries.

There is some good news to brighten the outlook though. The global recovery should boost demand for the region's exports. That should continue to support the recovery of capital flows to Latin America, both in direct investment and via portfolios.

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Has Turkey turned a corner?

TIMOTHY ASH, EM SENIOR SOVEREIGN STRATEGIST

Turkey has undergone some major changes both at its central bank and its wider economic policy team.

To us, the changes mark a 180-degree shift in terms of economic policy – which we view as long overdue. They seem to reflect an acceptance that the policies of the former management had fundamentally failed.

Foreign investors have so-far been encouraged by these changes, with USD1.5bn in portfolio inflows in November, which followed over USD12bn in portfolio outflows in the prior 10 months. Higher policy rates should slow domestic demand, and with it import demand, which would act to shrink the current account deficit and help support the lira.

While these developments are encouraging, what really matters is the behaviour of locals and whether the trend towards dollarisation reverses. Watch this space.

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How should investors position EM fixed income within their portfolios?

SOM BHATTACHARYA, PORTFOLIO MANAGER

EM local currency could prove a viable provision for institutional investors who can absorb month-to-month volatility in exchange for potentially healthy long-term returns.

For investors who cannot consider exposure to local currency assets, we think a diversified hard currency aggregate approach could prove an appealing alternative. In particular, we would highlight a short duration aggregate approach for 2021.

For EM investors who are struggling to find yields in an environment where nearly USD17 trillion of global developed market debt is yielding negative returns, a buy-and-maintain approach could prove appropriate. Investors can select from a USD3 trillion hard currency EM universe depending on their circumstances and investment needs, potentially adding both yield and diversification to portfolios without taking on additional credit risk.

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