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Emerging Market Debt Whitepaper

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Welcome to CAMRADATA's Emerging Market Debt Whitepaper

Emerging Market Debt continues to grow in absolute terms and as a percentage of institutional investors' portfolio. At the start of 2022, the germane questions for investors and their advisers revolve around risk and correlation. Emerging Market Debt spreads offer an initial attraction versus other kinds of public fixed income. Bad management at issuing corporate and sovereign-level can be mitigated by good active selection among the widening pool of choice. Healthy current accounts – more than in many DM treasuries - are a buffer for most EM sovereigns. Growth prospects in Asia especially remain superior to richer, mature regions such as Western Europe.

Yet risks remain. Last year yet again demonstrated that in times of uncertainty, foreign capital withdraws from EM. Looking ahead, there is the impact of possible rate hikes in the US as it recovers from the pandemic faster than most other nations. Another also relates to the US: the strong dollar's contribution to poor returns from EM local currency issuance.

Then there is the green energy transition and what it means in Emerging Markets. As many rich-world institutional investors set pathways for decarbonising their portfolios, there are threats and opportunities for EM borrowers. Threats include a higher cost of capital if they are slow to decarbonise; and lower revenues from fossil fuel exports. Opportunities include higher revenues from commodities such as copper, lithium and silicon needed for electrification. Lenders to these kinds of organisations will be evaluating more and more these issues as ESG deepens and spreads.

Emerging Market Debt Roundtable

The CAMRADATA Emerging Market Debt Roundtable took place virtually in London on 20th January 2022.

Investors in Emerging Markets have had a tough time recently. Waves of the COVID-19 pandemic has forced governments had to spend extraordinary amounts to protect their populations. Many sectors such as tourism saw revenues disappear. On a relative basis, richer countries such as the US have returned to economic health faster. That has seen some gains for Emerging Markets issues in the commodities complex; but not enough to lift the asset class generally. Returns have been poor on an absolute basis, and really poor relative to some sectors of DM markets.

CAMRADATA's Emerging Market Debt (EMD) roundtable 2022 began by asking how sectors of EMD would fare over the next 18-24 months. The responses were varied. Kristin Ceva, head of EMD at asset manager, Payden & Rygel, offered hard-currency High Yield sovereigns as her top sector, followed by High-Yield corporates. She noted off-benchmark local markets as a very nice diversifier to the benchmark JP Morgan GBI-EM index.

Parth Kikani, portfolio manager for Emirates NBD Asset Management's Emerging Markets Debt fund, gave hard-currency corporates as his top pick, given their shorter duration as rates rise. Within the sector, he picked out Nigerian banks and selected secured bonds of commodity providers, giving Tullow, Shelf Drilling, MC Brazil and Vedanta as examples.

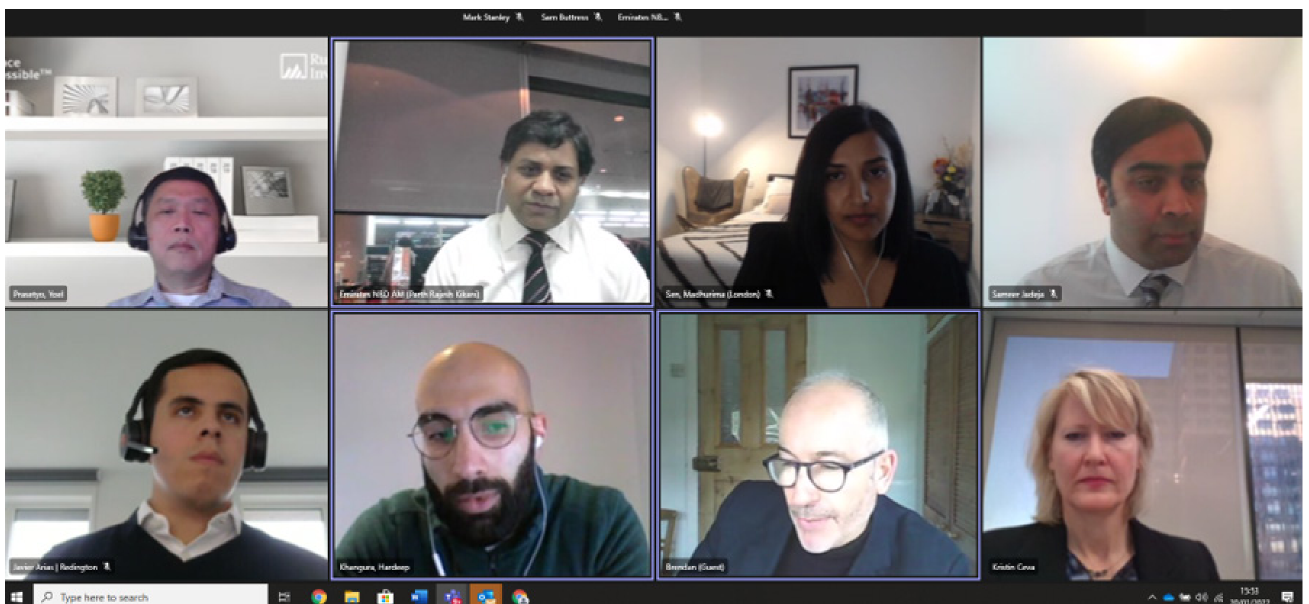
> ***"Jadeja's one warning on sector rotation was that quality assets would appreciate first on the back of rate hikes in the US, followed by riskier issues."***

His second sector was local-currency sovereign debt. Among these, Egyptian bonds have been a top-five holding in the Emirates NBD fund for the last three years.

Sameer Jadeja, senior investment manager and EMD specialist at Charles Taylor Investment Management (CTIM), made local-currency sovereigns his top pick, followed by hard-currency sovereigns. His reasoning was that the local-currency market got battered in 2021, leaving spreads very attractive against long-run averages. He also expected benefits from exporters of commodities such as copper, aluminium, nickel, cobalt and silicon required for a low-carbon economy. Jadeja's one warning on sector rotation was that quality assets would appreciate first on the back of rate hikes in the US, followed by riskier issues.

Javier Arias, fixed income manager researcher at Redington, followed Jadeja. "The consensus among the asset managers that Redington monitors in the EM space is that the local-currency sector can outperform other segments of EMD if there is a shift to a more positive global growth trajectory," he told the CAMRADATA panel. High commodity prices coupled with still relatively low interest rates made EM Corporates attractive, particularly in the High Yield space.

For WTW's lead on EMD manager research, Rima Sen, the local-currency sector was attractive in the longer term but following Jadeja's warning, she agreed that volatility could last six to nine months or more if the dollar strengthens. Sen emphasised that she saw



> *“ Arias then asked the managers whether they subscribed to the notion that EMD tends to underperform in the period leading up to rate hikes in the US and once the hikes occur, the asset class tends to do well from a performance perspective.”*

volatility as a good thing because it presented opportunities. But it also had to be seen in terms of client expectations. Sen agreed with Ceva that there are opportunities in hard-currency High Yield but observed there are reasons why spreads are so high. She saw high-quality, hard-currency sectors still offering stable carry.

Yoel Prasetyo, senior fixed income researcher at Russell Investments, started by laying out the risks currently in Emerging Markets. He noted that the average duration for hard-currency high-quality sovereigns was eight years, which makes this asset class very sensitive to the changes in the interest rate, particularly in the 10-year area. That matters in a world expecting more rate rises.

For local-currency issues, Prasetyo pointed out that rising inflation made currencies more volatile. Currency fluctuation matters as the EM Currency Spot Index has lost about 50% of its value in the past decade; so it is a hurdle investors should have in mind as the carry may struggle to mitigate the currency factor.

Hardeep Khangura, fixed income researcher at SEI and responsible for its multi-manager EMD offering, completed the circuit of panellists with Local Frontier and High-Yield sovereigns as his top sectors, with a trend in trades with lower sensitivity to Treasury moves and market beta.

He noted that, contrary to consensus thinking, the US dollar could remain strong in part because of Fed tightening should it hover ahead of market pricing. SEI was thus cautious on local-currency beta. Egyptian T-bills have their attractions but even here Khangura noted rising foreign ownership of Egyptian sovereign issuance along the rest of the curve as it comes into the JP Morgan GBI-EM – Global Diversified Index at the start of 2022.

Regarding rate hikes by the Federal Reserve in the US, the majority of the CAMRADATA panel expected three this year, resulting in a 1% rate by the end of December. Kikani expected an additional 25 basis points (equivalent) to come specifically from Quantitative Tightening. Prasetyo warned that the key was inflation in the US – it is expected to moderate but non-transitory elements such as food and energy may have longer-lasting effects.

Arias then asked the managers whether they subscribed to the notion that EMD tends to underperform in the period leading up to rate hikes in the US and once the hikes occur, the asset class tends to do well from a performance perspective. Ceva responded that in previous cycles dating back to 1994, hard-currency EMD did perform well after US rate hikes. She added that local-currency issues also benefited because the US dollar had weakened following all but one hike period since 1994.

“What is different this time is that central banks in Emerging Markets have been proactive, tightening ahead of the US Fed to influence inflation expectations,” she said. This occurred as early as Q1 last year, mostly in Latin America but also Central Europe.

Kikani offered similar conclusions. Emirates NBD Asset Management focused its research on the behaviour of EMD spreads when US five-year treasury yields rose during 2004-5 and 2017-8. In both periods, after initial spread widening there was significant tightening which followed as markets and expectations stabilized.

The next topic of debate was whether EMD managers ought to be selected on a benchmark-aware

or Total Return basis. Khangura said with SEI's significant client footprint in the US, these clients begin with a US Dollar-base. For them, the starting question was whether local-currency markets are material enough to warrant a dedicated allocation. Blending a benchmark of hard-currency sovereigns and corporates with local-currency issuance increased the volatility of currency exchange.

Total Return or Absolute Return strategies were nevertheless developed in the previous decade to give EMD managers more flexibility to realise their best ideas. In practice, Khangura said he had been underwhelmed by most offerings in this space. He felt most managers claiming to be Absolute Return still had high beta exposure, the high cost of carry dissuaded shorting, and there was too much rigidity within strategies.

Prasetyo agreed with this verdict. He said that a blended strategy made sense for people who want balanced exposure to Emerging Markets. Beta management, however, remained important. "We have seen managers with aggressive, beta-orientated strategies that perform well in risk-on markets but not risk-off," he said.

Sen told the CAMRADATA roundtable she had a similar experience of Total Return. "Products tend to be structurally defensive or overweight beta. You can do that cheaper elsewhere," she said.

But WTW has gone one stage further and designed a lower-volatility local currency index "with historically better beta and alpha than the standard index over the cycle."

For more sophisticated clients, WTW has an alternative credit fund of funds bringing together specialist managers across public and private markets in EMD and other areas.

For CTIM, Jadeja stated that local-currency issues are off-benchmark because of the nature of its clientele, many of whom are insurers. "So if we put any local-currency positions on, then something has to come out," he explained. "Over the last two years, foreign exchange has become easier to control because we've done the hedging using forwards ourselves inhouse."

This has worked really well for CTIM although Jadeja noted that there is always a question of timing. Going forward, he said it didn't make sense to hedge this year.

For Redington, Arias said clients still steer away from the local-currency sector in spite of its larger size and better liquidity profile. His belief is that local-currency investments provide a diversification benefit and give exposure to economies with higher growth potential. "Local-currency EM has been used primarily as a beta play," he said. "But Redington's preference is to be long-term investors rather than short-term tactical allocators." He clarified that as a consultancy, Redington relied on asset managers to rebalance between EM segments.

Risks on the road

Jadeja then asked his fellow panellists what risks they saw in EMD for the year ahead. He noted that at the start of 2021, the consensus had been that markets were set for stellar performance. That did not materialise in 2021; how could it be different this year?

Kikani offered two reasons. First, valuations look even more attractive than twelve months ago. Second, as money flows out of other asset classes (on monetary and quantitative tightening) which seem overvalued and could potentially be volatile in the short term, flows may return into 'spready' products.

Ceva observed that globally, flows are going out of public and into private credit, which she defined as a structural risk. She added that there was geopolitical risk, notably Russia and China's everchanging regulatory environment. "We have to make sure we are aware of these risks when sizing positions."

Prasetyo followed Kikani's first point on valuations. He said that everything looks cheap in EM using effective currency hedging. "But it could be cheaper," he warned. As a warning of underappreciated risks, he singled out Turkey as a recent extreme example of where non-orthodox monetary policy had contributed to out-of-control

> ***"At the start of 2021, the consensus had been that markets were set for stellar performance. That did not materialise in 2021; how could it be different this year?"***

inflation. He also noted that EMD valuations had been cheap at the end of 2012 but followed by three bad years.

Khangura responded that benchmark construction matters. SEI uses not just market-cap-weighted but equal-weighted methodologies to assess market valuations, which has "taken some of the edges off" from underperformers such as the Chinese real estate sector.

On commodities, Khangura described boom returns as "interesting". He was phlegmatic that increases for fossil fuels in 2021 could back-off in 2022. Moreover, there is not an immediate path for Emerging Markets away from carbon dependency, in spite of the pressure from investors in other parts of the world, notably Europe, for a lighter carbon exposure in their portfolios.

Risks for Sen were that markets will be more sensitive going forward as central banks remove support. That could mean more volatile flows and reaction to news and noise.

She added that inflation was a political issue because food and energy account for more of the household budget in developing economies.

Kikani said that differing demographics between EM and DM mattered in understanding inflationary effects. He noted that with higher population growth generally, there was more consumption in EMs and therefore more inflation. Moreover, less stable currencies introduced inflation another way, via currency depreciation.

In terms of risk, Arias noted that there were idiosyncratic risks in the form of national elections in several Latin American countries this year.

Returning to Turkey, Ceva said it was an exception to the broader set of EM Central Banks proactively addressing inflation, "entirely due to a policy mistake."

On decarbonisation and fossil fuel commodity prices, Ceva said she expected energy prices to rise as traditional energy companies suffer from less capital and consequent

under-investment in their wells and refineries. "Renewables cannot straightaway pick up the slack," she said. "The push to green energy will raise commodity prices." Some will be part of the green energy development such as copper and lithium. Others such as natural gas will benefit as a bridging fuel.

Ceva said there were lots of aspects to the transition and thus lots of potential for Emerging Markets. Jadeja agreed: "commodity prices are still elevated because we still need these raw materials. In the last eighteen months, commodity prices have been going up while EMD Local Currency has been going down."

For Jadeja, some EMD currencies have in the past followed the commodities path. He argued that in this cycle there is a gap because other inflationary pressures and not purely commodities prices are driving interest-rate expectations which are impacting currency movements.

On the direction of commodities, Ceva said that traditionally, investment managers would look at China for guidance. But that profound demand has waned as the Chinese economy orientates towards services.

Nevertheless, she saw China as still important in the push towards decarbonisation and its associated commodities. Sen agreed. "If you travel through the Atacama desert in Northern Chile, there are mining signs in Mandarin." This is one of the richest regions in the world for copper and lithium.

On the direction for commodity prices, Ceva said the outlook for 2022 was pretty positive. She saw strong demand from the US and Europe albeit with risks in the form of OPEC intervention in oil production or China reducing industrial production if another Covid lockdown was required.

Turning Emerging Markets green

The CAMRADATA roundtable then turned its attention fully to ESG. Khangura said that DM investors had to acknowledge that advanced Western economies have had their carbon credits "in advance" and have been benefitting ever since the Industrial Revolution. He said that countries still developing economically like India could not be expected to switch to renewables overnight. "They live with frequent power outages already," he said.

"Risks for Sen were that markets will be more sensitive going forward as central banks remove support. That could mean more volatile flows and reaction to news and noise."

At the same time, SEI clients have their own ethical policies plus regulation to consider. Which brings the challenges of mapping their portfolios to a Net-Zero Carbon metric. "There is a lack of data to do that," said Khangura. "SEI assesses sub-advisers at their organisational and fund level for ESG and carbon." He emphasized, however, that these mandates are still governed by financial objectives and decarbonisation is a derivative of what is trying to be achieved.

Ceva has sat on the UN PRI working group on sovereign debt for the last three years, collaborating with other asset managers to think through how to practically implement ideas in ESG. She noted that touchpoints in EM were various. For example, roadshows led by officials from Central Banks were not appropriate for raising human rights issues. But she warned that complexity and nuance between separate E, S and G issues was no reason to simply exclude certain issuers. She said that while many countries scored lowly on ESG; that was probably a reason to engage with them. How else would those scores improve?

As a researcher of managers, Prasetyo said that the challenge was that everyone is now doing ESG but doing it differently. There are a variety of ESG implementations but he expected that Articles 8 and 9 of the EU's SFDR will begin greater clarity.

Jadeja said EM sovereigns were behind the curve when it came to getting good data. He contrasted corporates which publish the number of women on the executive board or number of industrial accidents as standard. CTIM has built its own ESG model.

Kikani agreed that engagement was key. "India is not going to be able to switch off coal in five years' time [coal currently provides the lion's share of the country's energy]. But we are looking for improvements." He gave Indika Energy as an example of a pure-play coal miner in Indonesia seeking to diversify into gold and other commodities.

Arias said that most Redington clients expect that their investment managers have ESG policies and are compliant with the latest regulatory demands and this led to the firm to come up with a sustainability framework for all its asset classes, including EMD. The target for EMD is to achieve one-third fewer CO2 emissions than the benchmark. In the hard-currency universe, this is possible. But Arias said that in the local-currency universe, 38% of the benchmark would have to be eliminated on a market value basis.

Sen agreed that it was a struggle to 'walk the line' as a Net-Zero-Aligned investor. "You could be green in some parts of your portfolio but not all, and not necessarily aggressively in EM where E and S can conflict," she said. "It is difficult with clients because unless you refine the reporting, EM just scores a big red number." Ways of refinement Sen suggested included equating scores to a country's level of income, or Carbon Intensity to nominal GDP per capita.

Sen followed Ceva's remarks on engagement by saying that it was important to keep the conversation going. "Even if a finance minister does not want to hear what a bondholder believes, if he hears the same message from sixty bondholders, then there will be an effect. It's like water on stone."

Ceva ended the roundtable by observing that these kinds of conversations were already having a positive effect. "Countries are putting together much better information on ESG in virtual roadshows, for example on carbon exposures and how they intend to diversify the economy," she said. "Engagement by investors is bearing fruit in terms of countries being more aware and divulging more information."

IN FOCUS

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Roundtable Participants

Parth Kikani, CFA

Director Fixed Income

Emirates NBD Asset Management

Personal Profile

Parth Kikani joined the Emirates NBD Asset Management Fixed Income team in 2013. In his role as Director of Fixed Income and Senior Portfolio Manager, he is directly responsible for managing over USD 225 million in public funds, as well as a range of discretionary portfolios on behalf of institutional clients investing in regional and broader emerging markets fixed income. Parth also manages the Emirates Emerging Market Debt Fund, a Morningstar rated fund, which has consistently delivered top quartile performance when compared to international peers.

Active in the regional Asset Management industry for over a decade, Parth has developed a strong experience analysing and covering Emerging Markets bonds and securities. Prior to joining Emirates NBD Asset Management, he was part of the team managing Dubai Group's Global Emerging Markets Portfolio and held assistant portfolio manager and analyst roles for Al Mal Capital and Emirates Financial Services.

Parth is a CFA charter holder, chartered accountant and has completed his MBA from SP Jain Centre of Management, majoring in Investment Banking.

Company Profile

Emirates NBD Asset Management Limited, established in the Dubai International Financial Centre and regulated by the Dubai Financial Services Authority as a Category II Firm, is the wholly owned asset management business of Emirates NBD, one of the largest banks by assets in the MENAT region.

Emirates NBD Asset Management provides a wide range of investment solutions, from in-house managed public funds to tailor-made discretionary solutions. It manages funds across a variety of asset classes, including equity and global fixed income, global risk profiled solutions, UAE real estate, and a wide range of Shari'a compliant instruments, structured to cater for diverse risk appetites.

Each of the Emirates NBD Asset Management managed funds are currently domiciled in either Jersey (regulated by the Jersey Financial Services Commission) or Luxembourg (regulated by the Luxembourg Commission de Surveillance du Secteur Financier). As of 31st December 2021, Emirates NBD Asset Management had assets under management of approximately USD 6.1 billion.

Kristin J. Ceva, PhD, CFA,

Managing Director

Personal Profile

Kristin Ceva, PhD, is a Managing Director at Payden & Rygel. Kristin is a member of the firm's Investment Policy Committee and is a Senior Portfolio Manager directing the firm's emerging market debt strategies. She also is a frequent speaker at industry forums, focusing on topics related to international investing and emerging markets.

Prior to joining Payden & Rygel, Kristin worked as a consultant for Deloitte & Touche, and with a number of international policy institutes including: the Pacific Council on International Policy, the Center for U.S.-Mexican Studies and the North America Forum at Stanford University.

Kristin serves as board member for EMpower, a non-profit organization founded by emerging markets financial professionals to support at-risk youth and is on the California Committee of Human Rights Watch.

Kristin earned a PhD from Stanford University in Political Science with an emphasis on international political economy. She was a Fulbright Scholar based in Mexico City. Kristin has completed extensive economic and political research on emerging markets and is fluent in Spanish. She received a BBA in Finance from Texas A&M University.

Payden&Rygel

Payden & Rygel

Company Profile

Payden & Rygel manages in excess of £100 billion in assets for sophisticated institutional clients including Insurance Companies, Pension Funds, Central Banks and Sovereign Wealth Funds. Founded in 1983; Payden & Rygel is now one of the largest employee-owned global investment management firms offering a full array of investment strategies.

We focus on delivering superior risk-adjusted returns in highly customised portfolios including, Emerging Market, Investment Grade & High Yield Corporates and Multi-Sector Fixed Income.

Roundtable Participants

Sameer Jadeja

Senior Investment Manager

Sameer is the emerging markets asset class specialist at Charles Taylor Investment Management (CTIM) with a particular focus on both local and hard currency fixed income bonds. CTIM manages in excess of $2 billion, principally on behalf of insurance businesses, including the mutual insurers managed by the Charles Taylor Group. Client exposure to emerging markets is predominantly managed internally but there is the capability to compliment the exposure with third party managed funds. My role at CTIM also includes being the portfolio manager for two insurance clients. These client portfolios invest in short maturity corporate bonds and U.S. Treasuries.

I've worked at CTIM since 2003 and during this time over different periods I've traded different asset classes (G7 government debt, emerging market debt, investment grade corporate bonds, foreign exchange, and equities) and had oversight of third party managed alternative strategies. My experience of trading different asset classes was the reason for me taking the lead in ensuring the firm met the MiFID2 regulatory requirements.

Sameer holds an IMC as well as a BSc in Business Administration and Computer Science.

Javier Arias

Associate

Javier joined Redington in 2017 after completing a master's degree in Climate Change & Finance at Imperial College. He works as an Associate in the Manager Research Team covering liquid and semi-liquid fixed income strategies with a particular focus on Emerging Market Debt.

Prior to joining Redington, Javier worked as an Analyst at PGIM Real Estate, where he was responsible for the assessment of new investment opportunities in Mexico. Javier's work led to the development of an industrial park, 6 industrial buildings and the signing of ~50 industrial property leases.

Charles Taylor Investment Management

REDINGTON

Yoel Prasetyo, CFA, CAIA

Senior Research Analyst,

Global Fixed Income

Yoel Prasetyo is a senior fixed income researcher for Russell Investment, where he conducts manager research, mainly in the broad U.S. fixed income, emerging market debt, and unconstrained fixed income strategies for Russell Investments' multi-manager product suite and consulting client solutions.

Yoel joined Russell Investments in 2010 and had worked for Dell Inc. and Coca-Cola Enterprises in multiple capacities.

Hardeep Khangura

Portfolio Manager

Hardeep Khangura serves as a Portfolio Manager for the Investment Management Unit with responsibilities for multi-manager portfolios including for the emerging market debt portfolio. He was previously a member of SEI's fixed income manager research team with coverage of global fixed income manager exposures across emerging markets, credit, sovereign and FX.

Previous to this covered various Manager Research activities as a Senior Fixed Income Manager Researcher at Willis Towers Watson.

Moderator

Madhurima Sen

Credit Manager Research

Rima is a Director within Manager Research, focusing on liquid strategies across traditional and alternative credit. She leads on Emerging Market Debt research within the team. Rima also leads the Inclusion & Diversity working group in Manager Research and sits on the Investment Committee for the Towers Watson Alternative Credit Fund. Rima previously worked at KPMG Investment Advisory (now Isio), splitting her time between client consulting and manager research. Prior to this, she was a Policy Analyst at HM Treasury and an Investment Strategist at Barclays Wealth and Investment Management.

Rima studied Government and Economics at the London School of Economics and is a Chartered Financial Analyst (CFA) charterholder.

Brendan Maton

Freelance Journalist

A highly experienced financial journalist with an expansive network of contacts in the UK and across Europe. Brendan has written about pension schemes and national welfare systems from Finland to Greece for 18 years and understands the retirement savings industry in each European country.
Brendan has interviewed EU commissioners and national ministers; central bankers; pension scheme heads; insurance chief executives; chief investment officers; actuaries; union officials; professional and lay trustees.He worked at Financial Times Business for eight years, finally as editor-in-chief of all international pensions titles.

Brendan has spent the last ten years as a freelancer for a number of publications, including Financial Times, Responsible Investor, Nordic region pensions news and IPE. He is also Chief webcast host for IPE.
Brendan has acted as conference chair for Financial News, the UK National Association of Pension Funds, Dutch Investment Professionals Association (VBA), Corestone, Insight Investment, Marcus Evans, Robeco Asset Management, Sustainable Asset Management (SAM), Towers Watson.

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Inflation: Drivers, Effects and Response in EM vs DM

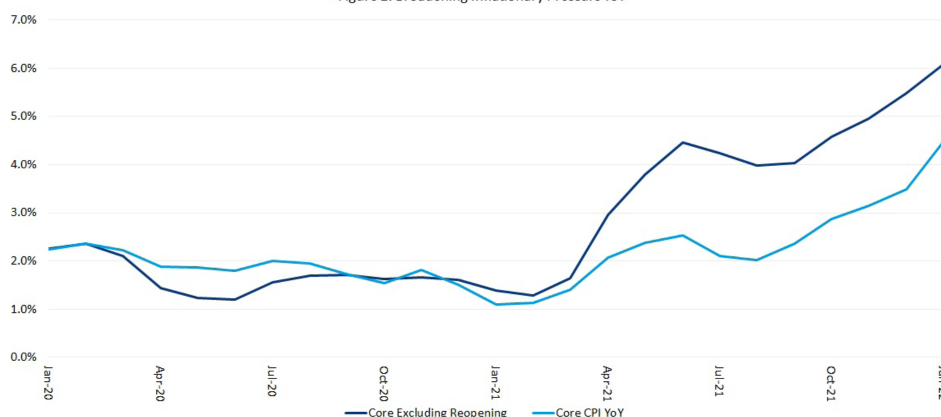
Emirates NBD ASSET MANAGEMENT

“At a seemingly fully recovered labor market, the push for a more aggressive move to raise rates by the Fed remains clear.”

Inflation Drivers: As a young boy living in Southeast Asia, one of the simplest joys on a Monday night was having the whole family seated around the FM radio, waiting, and listening to the local station’s weekly program. More than two decades later, with similar urgency and keenness, global investors all over (including yours truly) hunch over screens digesting the latest inflation data while scrutinizing every line in FOMC speeches. Inflation as we know it is here to stay as the US Fed’s “transitory” narrative disintegrates and morphs into a more hawkish stance.

With the US January 2022 CPI Inflation print above consensus at 7.5% YoY, expectations are now headed for a higher near-term number before some expected relief towards the end of the year on base effects. Core CPI components like shelter and food rose 4.4% and 7.0% YoY giving consumers and businesses good reasons to worry. There is no doubt that the current inflation is broad-based and even if we were to remove what we believe as “reopening components” (Figure 1) from Core CPI data, inflation pressures show no signs of easing. At a seemingly fully recovered labor market, the push for a more aggressive move to raise rates by the Fed remains clear.

Distinctively, quite a few Emerging Market (EM) countries have managed to keep better control over inflation led by the Asian region. Although Latin America (LATAM) remains closely correlated to the US through trade/FDI and the Central and Eastern Europe Middle East and Africa (CEEMEA) grapples with higher energy prices, central banks have been more proactive and ahead of the curve raising interest rates from as early as summer of 2021 to keep inflation in check. Another reason for lower inflation in EM is overall lower food costs and more conservative pandemic management that has muted the effects of inflation.



* Core CPI ex-reopening exhibits rebased core CPI index after excluding autos, airlines and lodging away from home.
Source: Bloomberg, Bureau of Labor Statistics and Emirates NBD Asset Management.

Effects of the Inflation Problem: The elevated inflation risk to growth remains well documented. As a result of continuing large relative price shocks, countries could see output losses. The International Monetary Fund (IMF) forecast to global growth has now been downgraded by half a percentage point to 4.4% in 2022 reflecting markdowns in the two largest economies (US and China) after overly optimistic projections based on the very rapid recovery seen early 2021. Downside risks to growth include supply chain disruptions, energy price volatility, and localized wage pressures mainly pointing towards inflation. The uncertainty in prices in the current inflationary environment could also potentially distort investment decisions that could lead to further unproductive or lower level of aggregate investment. Aside from the adverse effects to growth, local currency deterioration has already reared its ugly head. As an example, given the distinct inflation levels seen in LATAM, the region is home to four of the six worst performing currencies in overall EM in 2021 before aggressive rate hikes as a response underpinned broad recovery in FX.

Authors:

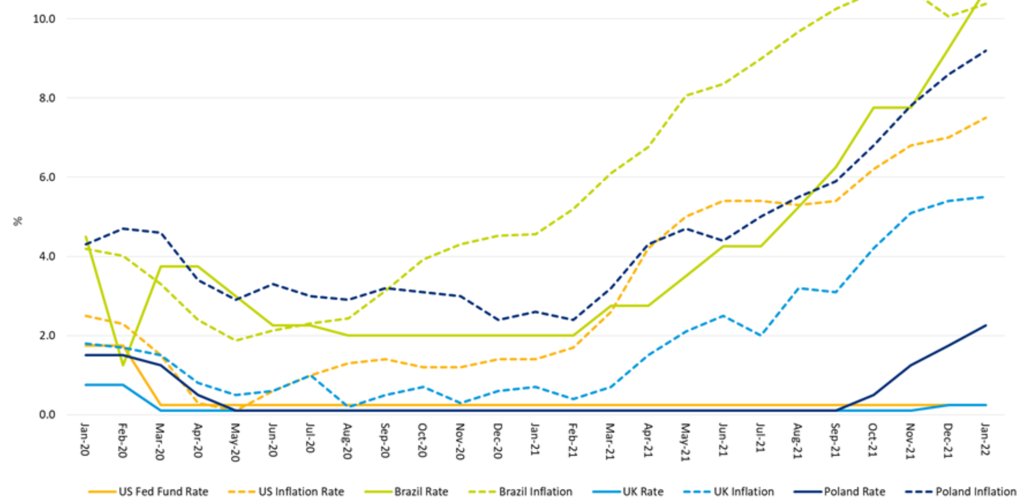
Parth Kikani, CFA
Director Fixed Income

Daniel Koh
Senior Analyst

Affordability is also a big concern in the face of high inflation in both DM and EM economies. Whether it is a transitory or a structural problem, the rise in prices in the most visible parts of the economy such as food, energy, and shelter impacts global households at various levels highlighting growing economic inequalities. Across the world, the decline in affordability has led to social unrest with varying degrees of disruptions and has been key to the plummeting political popularity of incumbent governments. The unsettled political backdrop increases investor exposure to political risk while the populist measures such as increased social fiscal spending (subsidies, "helicopter money", social handouts) directly increases the sovereign' fiscal & rating downgrade risk. Going back to the US, current democratic party's messaging on inflation has seen a clear erosion of credibility. White House officials including President Biden and other Democrats have disappointingly pivoted their messaging toward populist talking points about how "corporate greed" is to blame on the current historic inflation levels.

Response to the Inflation Problem: Both DM and EM central banks now face the challenge to find a "sweet spot" and balance in terms of monetary tightening while avoiding an output drop. In Figure 2, while we have selected major economies for the purpose of comparison, the overall DM central bank policy response to increasing inflation has been relatively slow compared to EM countries. Despite clearly rising inflation prints for most of 2021 and 2022, aside from the Bank of England's relatively small rate hikes, DM governments have been reluctant to raise rates in time. In EM, especially in LATAM and parts of CEEMEA, aggressive policy tightening have been well underway keeping inflation relatively in check and FX supported. Additionally, for EM, the challenge remains that incumbent governments not only need to raise rates but propose additional policy reforms as a means to raise potential growth and keep inflation on target.

Figure 2: Selected major DM & EM economies benchmark rate vs Inflation YoY Inflation rate



Source: Bloomberg and Emirates NBD Asset Management (as of 31 January 2022).

Conclusion: While the inflation story has yet to be concluded, we believe that thus far, central banks in EM have certainly been the more prudent and proactive in the fight to stabilize prices and keep inflation in check compared to DM. While broad inflationary pressures will eventually moderate as government stimulus recedes and supply-chain bottlenecks ease, we believe that global policymakers must remain vigilant and be ready to act sooner than later.

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Mark H. Stanley, FPMI
mhstanley@payden.com

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edelomier@payden.com

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Don’t Stop Believing: EM Inflation Journey and Central Banks’ Response

Payden&Rygel

“For 2022, we think EM central bank action and decelerating inflation are key ingredients that will support allocations to EM fixed income.”

Global inflation was the big surprise in 2021. Across the Emerging and Developed world, inflation surged above central bank targets. But unlike their Developed world counterparts, Emerging Market (“EM”) central banks have already reacted; many are far along in their hiking cycles. For 2022, we think EM central bank action and decelerating inflation are key ingredients that will support allocations to EM fixed income. In the medium term, it is worth thinking about “greenflation” – a term for the inflationary implications of climate change. Below, we highlight a few of the core considerations around these topics.

Understanding the Inflation Impulse

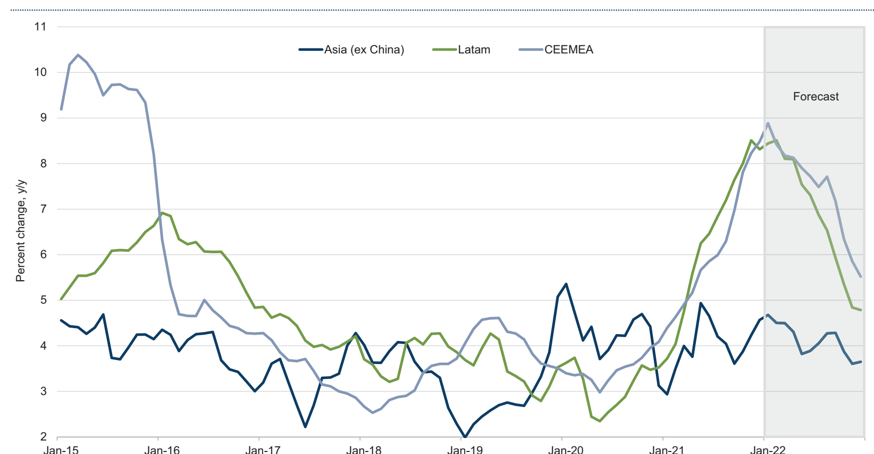
Starting with the nature of the recent inflationary impulse, a significant part of the surge in EM headline inflation was a function of food and energy prices. Part of this is mechanical. Emerging markets have high food and energy weights in their basket, with food accounting for nearly 27% of the EM basket while energy accounts for about 9.5%.

Second, EM inflation cannot be painted with the same brush across all countries. Breaking down inflation pressures by region, shows that EM Asia has been spared the brunt of the inflation surge. This appears to be a function of the fact that Asian food prices have remained contained. Turning to energy, price pressures across EM are more uniform. EM fuel inflation averaged nearly 20% y/y in December 2021.

Last, from a central bank perspective, the step-up in core inflation is the most important question. One driver of core inflation is ‘supply chain’ issues that are impacting goods markets globally. A measure of this is JP Morgan’s EM goods inflation aggregate, which shows price pressures building since mid-2020. However, that is not the full story. Looking at services inflation, we see a number of EMs (CEE, Russia, and Chile) facing demand-side pressures.

Looking ahead, we see much of the headline inflation surge as transitory. All else equal, if food and energy prices are steady near current levels, inflation will decelerate. The question mark is the evolution of core inflation—the preferred metric for understanding underlying price pressures. To be sure, we would expect the supply-chain component of core goods inflation to be transitory, as some PMI delivery data already suggest. Nevertheless, for countries where homegrown demand pressures are materializing, which is evident in accelerating service inflation and tight labor markets, more vigilant policy action is necessary and increasingly priced into rates markets.

EM Headline Inflation by Region
Percent change, y/y



Source: Haver and JP Morgan

Central Bank Response Leading to Market Opportunities

In contrast to their counterparts at the U.S. Federal Reserve (the "Fed") or the European Central Bank, inflation has already elicited a response from EM central banks. This sequencing is not the norm. In the past three Fed hiking cycles, EM central banks only began hiking after the Fed lifted off. In this cycle, EM central banks have begun hiking well ahead of the Fed's first move. As with inflation, there are significant differences between regions and countries. Central banks in Latin America, the CEE, and Russia have moved rates meaningfully, while Asian central banks have not yet needed to respond.

Policy tightening and market forces shifted local interest rate curves higher last year. Given our expectation that inflation will decelerate during 2022, leaving real rates positive, we believe the case for investing in EM local markets will build as the year unfolds. A review of recent Fed hiking cycles supports the notion that EM swap rates typically rise in the months leading up to the Fed's first hike, but then tend to decline during the hiking cycle itself. A similar relationship exists with respect to the U.S. dollar, whereby U.S. dollar strength fades after Fed hikes materialize. In market parlance, bad news tends to be "priced in" to EM local markets in anticipation of developed world tightening, allowing for reasonable performance thereafter. While country selection will remain important, we believe that valuations and technicals will support EM local markets in 2022.

Author:

Kristin J. Ceva,
Managing Director &
The EM Team

The "E' (of ESG) and Inflation

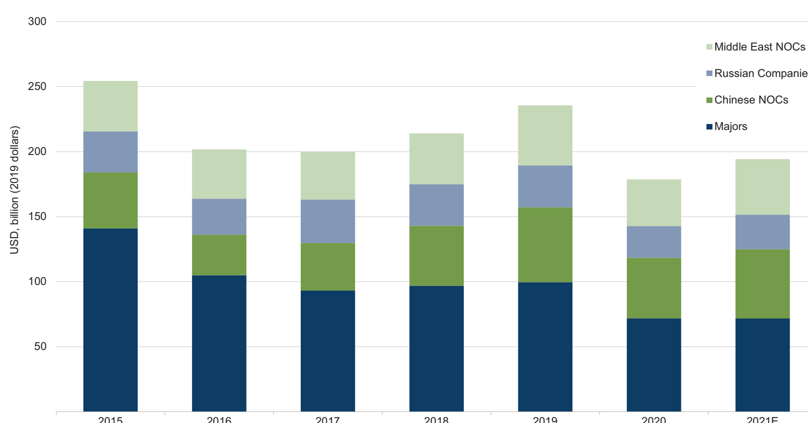
In the medium term, we think it is worth thinking through nuances around "greenflation." The move towards decarbonization has impacted capital allocation, as environmental, social, and governance (ESG) considerations become more relevant for investors. This has implications for the energy market. Investment spending in upstream oil and gas projects has come down consistently since 2014. This is expected to translate into a weaker pipeline of oil and gas supply. In an environment where renewables have yet to fill the gap, the risk of oil price shocks has increased.

The move away from the dirtiest fossil fuels presents another set of price pressures. Natural gas, which is half as polluting as coal, is viewed as a "stop-gap solution" as we move to "greener energy." The problem is that when renewable energy sources are unreliable, gas prices can surge. This drove electricity prices higher in the EU in 2021 and is also a vulnerability for Asia. [1] Another example is the transition away from combustion engine vehicles, which creates higher demand for minerals that are used heavily in electric vehicles. There is little modeling on whether this will impact headline inflation, but the transition is already having an impact on commodity prices, particularly rare earths.

Last is the implementation of carbon taxes. Many economists agree that a carbon tax is an efficient way to reduce greenhouse emissions. Goldman Sachs published work on the impact of such taxes on inflation, suggesting that a $100 per ton carbon tax could have a 0.3% upward impact on headline inflation in China annually over the next two years. However, the adoption of such taxes, particularly in EM, where there are pressing development needs, presents challenges. Our view is that a meaningful EM carbon tax regime is still a ways off, although a few EM countries, including China, do have taxes or emissions trading schemes. We see this as an area that will be gaining more attention in coming years.

[1] Schnabel, Isabel "Looking Through Higher Energy Price? Monetary Policy and the Green Transition." American Finance Association 2022 Virtual Annual Meeting, 8 January 2022.

Upstream Oil and Gas Spending USD, billion (2019 dollars)



Source: *International Energy Agency (2021), World Energy Investment 2021, IEA, Paris*

Meet the Team!

Sean Thompson

Managing Director

Natasha Silva

Managing Director, Client Relations

Amy Richardson

Managing Director, Business Development

Sam Buttress

Associate, Business Development

Mithursha Kesavan

Database and Publication Support Associate

Sarah Northwood

Marketing and Events Coordinator

CAMRADATA

CAMRADATA
5th Floor, 11 Strand,
Charing Cross, WC2N 5HR

+44 (0)20 3327 5600
camradata.com

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