CAMRADATA
A With Intelligence Company

# Emerging Market Debt Whitepaper

Sponsored by

Amundi ASSET MANAGEMENT

MFS

UBP Union Bancaire Privée

## Clear and Independent Institutional Investment Analysis

We provide institutional investors, including pension funds, insurance companies and consultants, with data and analysis to assess, research and report on their investments. We are committed to fostering and nurturing strong, productive relationships across the institutional investment sector and are continually innovating new solutions to meet the industry's
complex needs.

We enable institutional investors, including pension funds, insurance companies and consultants, to conduct rigorous, evidence-based assessments of more than 5,000 investment products offered by over 700 asset managers.

Additionally, our software solutions enable insurance companies to produce consistent accounting, regulatory and audit-ready reports.

## To discuss your requirements

+44 (0)20 7832 6517
info@camradata.com
LinkedIn
@camradata

camradata.com



## Contents





# Welcome to CAMRADATA's Emerging Market Debt Whitepaper

The year 2022 was one emerging market debt enthusiasts may prefer to forget. With significant outflows, spurred by a risk averse investing public and returns ranging from unimpressive to significantly negative,[1] many of the sector's markets failed to deliver as the world recovered from the worst of the global pandemic.

But, no stranger to whimsical investor sentiment or the uncontrollable movement of the US dollar, these markets also offer a certain resiliency along with myriad long-term opportunities as the world's economy shifts.

Firstly, the outlook for many of these economies is rosier than for their developed market counterparts. No recession is looming for EM, according to the International Monetary Fund,[2] which was less positive for other, supposedly leading nations.

The sector's central banks take some credit for this, moving more quickly than many richer economies to raise rates to offset the worst ravages of inflation,[3] but it is also the many underlying themes that should see these countries bringing investor cash back in.

Some of the answers to considerable global issues will take shape in these economies – and they need funding. The world's growth engine of China has begun to engage its gears once again, while the bulk of the resources – both natural and human – that will be vital for the global energy transition can be found in these regions too.

On the topic of sustainability, investors are demanding more clarity of purpose from businesses, governments and other issuers, with many emerging markets no longer the grey area for data and reluctance to engage they may have once been.

With a hunt for yield ever-present on investors' agendas as inflation continues to bite, emerging market debt has begun to tempt them back already[4] -- and government issuers are leading the way.[5]

What ideas and inspiration can asset managers and investment houses offer their clients in this vast, multifactored and ultimately growing range of emerging market fixed income options to bring them back for the long term?

[1] JP Morgan Emerging Market Bond Index Global Diversified declined 17.78% in 2022, longer-duration investment-grade segment reported losses of 19.76%; high-yield debt contracted by 15.68%.

[2] https://www.imf.org/en/Publications/WEO/Issues/2022/10/11/world-economic-outlook-october-2022

[3] https://www.reuters.com/markets/global-central-banks-deliver-historic-rate-hike-blast-2022-2022-12-23/

[4] https://www.reuters.com/markets/emerging-markets-november-foreign-inflows-most-since-june-2021-iif-2022-12-08/

[5] https://www.ft.com/content/ab26195f-dd30-41dc-bea2-21a1c6fe67fe

## Meet the Team

Sean Thompson
Managing Director

Natasha Silva
Managing Director, Client Relations

Amy Richardson
Managing Director, Business Development

Sam Buttress
Associate, Business Development

Sarah Northwood
Marketing and Events Coordinator

# Emerging Market Debt Roundtable

The CAMRADATA Emerging Market Debt Roundtable took place in London in February 2023.

At a recent CAMRADATA roundtable, participants discussed how investors' approach to emerging market debt is changing and the ESG opportunities developing in the asset class.

Emerging market debt is often viewed as a niche part of the fixed income universe by asset allocators, with many deterred by concerns of downgrades, defaults, and corruption. However, in recent years, there has been a growing understanding of what attributes the asset class can bring to a portfolio.

Steve Hickey, head of credit research at pensions and investment consultancy XPS Investment, says while emerging market debt formed a relatively small part of client portfolios during much of the past decade, exposure has risen "fairly dramatically" more recently.

"Growing exposure has really coincided with the popularity of multi-asset credit funds that offer investors access to a wide range of different liquid assets, including emerging market debt," he explains. "Emerging market debt seems to have matured, and accessibility has increased. Liquidity is also more aligned with traditional areas of credit, like developed market corporate bonds. While this has driven some growth momentum for the asset class in recent years, it is still a small part of client portfolios."

Hickey says that traditionally, emerging market debt has been a satellite allocation and is at risk of outflows when investors require liquidity. Greater education, he believes, will encourage more investors to make bigger allocations.

"Generally, the perception is that emerging markets are nowhere near as mature as developed markets, which is not always the case," he says. "There is a perception that investment-grade emerging market debt is very different to investment-grade developed market debt."

### Challenges for the asset class

One of the biggest challenges the asset class has had to overcome is the perception of emerging market debt as a higher investment risk than other areas of the credit universe. One recent example is Russia's invasion of Ukraine, which caused losses for some emerging market debt strategies and impacted sentiment towards the asset class.

> ***"Emerging market debt seems to have matured, and accessibility has increased. Liquidity is also more aligned with traditional areas of credit"***

"The Russian invasion of Ukraine is a classic example of the sort of risk that makes people reluctant to invest, and they are very difficult to price-in," explains Nick Cooney, senior consultant and head of credit at consultancy Lane Clark & Peacock. "For example, if schemes had invested in January 2022 just before the invasion, some would have lost a lot of money."

The fear of such 'headline risk' can be difficult for some investors to overcome, says Amundi's co-head of emerging market fixed income Sergei Strigo.



"We have seen a lot of institutional money coming in, but all of this is in predominantly investment-grade debt and quite often excludes countries where investors perceive there is the potential for a downgrade or some sort of political or geopolitical event," he says. "This cautiousness is really driven by the fact that investors have guide-lines and are afraid of having headline risk in their portfolio.

"But if you calculate the amount of money lost on defaults like in Ghana or Zambia, it is really very small. And nobody is going to have 10% of their portfolio invested in these countries."

Headline risk has led to many investors trying to 'time the market', agreed Katrina Uzun, fixed income institutional portfolio manager at MFS, which can be very difficult to do and result in missing out on investment opportunities or limiting return potential.

"We have seen negative drawdown of 26% in emerging markets over the 10 month period, but then we had a very positive fourth quarter where they rose by 8%," she says. "And people were asking, 'did I miss the bottom? Should I invest money here?' We expect near-term volatility but suggest to our clients that rather than trying to time the market, which is very difficult to do perfectly, ask to really think of it as a strategic asset class in terms of the five-to-10-year return potential."

### Taking the long view

A longer-term investment horizon is essential for such an asset class, particularly when the investment horizon is experiencing considerable change itself. Hardeep Khangura, portfolio manager at SEI, says investors looking to make an allocation now could make some attractive returns.

"There are many exciting and attractive spread and local rate opportunities in emerging markets today," he says. "We have had 10-12 years of attractive market returns [in developed markets] fuelled by quantitative easing, reducing attention given to emerging market debt. We are going through a regime shift and need to adjust to a higher starting [real] yield.

"It is quite a different funding environment, and that is going to be a major shift arguably more so for developed markets, whereas emerging governments and corporates are accustomed to these higher yields."

A more optimistic long-term outlook may have to overcome what was a challenging year for emerging market debt in 2022, however.

"We caution our investors about putting too much emphasis on recent historic returns when going into an asset class," says XPS Investments' Hickey. "And when you see the returns in the last few years, it can be hard to try and change their mind.

> ***If you want an ESG portfolio with a bigger delta, then look at emerging markets. That is how you are going to have a bigger impact,"***

"But there are really good growth stories behind emerging markets, and they could potentially have a very favourable few years ahead of them."

While central banks around the world have increased interest rates to combat rising inflation, there is still a strong argument for investing in emerging market debt, says Amundi's Sergei Strigo.

"Yield enhancement is what everyone is looking at, and that is what we see as the main reason for investors to go into emerging market debt," he explains. "On top of that, there is a strong economic diversification argument, although it really depends on how much is allocated and where."

MFS's Katrina Uzun says the asset class has continued to grow over the past decade and now represents around 15% of the overall global fixed income asset class, and the credit quality has also improved since its inception.

"Going under the hood of emerging markets and looking at the fundamentals within the asset class, if you look at the basic balances of emerging market countries, i.e. current account plus foreign direct investment, they are in surplus in recent years," she says. "That means emerging market countries, on average, do not need to borrow and do not need to rely on external financing to support them.

"This is a very different environment from what we had in 2013 when we had the 'Taper Tantrum', and we had fragile economies with large current account deficits. There was a big fear that they default and there would be contagion within emerging markets. We are in a much better situation today."

## Towards a more sustainable future

Emerging market debt is also playing a key role in helping institutional investors meet their ESG and sustainability goals and to have a more positive impact on the world around them.

Amundi's Sergei Strigo says investors increasingly demand reports to see the ESG impact of emerging market debt strategies. At the same time, regulators are putting more pressure on asset managers to disclose ESG data.

"The trend is very clear, and we are going to get a certain level of minimum requirements on sustainability, certainly across our European funds," he says. "But what is very interesting and encouraging is that we are seeing a lot of traction from issuers in the emerging markets space, both on the sovereign and corporate side.

"It is quite a diverse universe, of course, and some countries are bit more advanced than others. The more developed countries tend to have already developed green or sustainable bond frameworks."

Strigo says there has already been a lot of work on the climate and 'E' of ESG within emerging markets, but since the Covid-19 pandemic, more attention has focused on the social aspect of investing. Greater awareness of ESG issues has made investors more cautious about how their capital is put to work by fund managers, says Lamine Bougueroua, portfolio manager at UBP Asset Management, prompting many asset managers to put ESG processes in place.

"We have an ESG integration framework that helps us distinguish the countries where the money is put to good use and social projects towards education, health, and helps the country develop and increase its productivity," he explains. "And we will exclude countries that score poorly on corruption." There are different approaches to ESG, however. For example, MFS's Katrina Uzun says her firm does not take an exclusionary approach when investing in emerging market debt because it may unfairly punish some countries and issuers.

"If you think about emerging markets versus developed markets, it is no surprise that emerging markets on average are behind developed markets on environmental, social and governance issues," she explains. "We incorporate environmental, social, and governance issues into our analysis of the countries and look for the rising stars and allocate more to those with improvement upside.



more to those with improvement upside.

"We do not want to miss some rising stars within emerging markets that have done a lot but may be behind their counterparts. Even if the economic indicators are lower, it is the improvement that we are after, which will over time mean sustainable balanced growth with lower risk.

"One of the important things for us is not to punish poorer countries for being poor. So, when we created our ESG scoring, we created a system that looks at the ESG score of every country and compares it with the level of development in that country."

## ESG challenges

For many asset managers, when looking to measure their ESG impact, data remains a challenge. Data availability has improved, but as a multi-manager we are mindful that each data vendor will have their preferred methodology for collecting and processing data, says SEI's Hardeep Khangura, which can result in different [reporting] outcomes for investors.

"What we tend to find is that if you want an ESG portfolio with a bigger delta, then look at emerging markets. That is how you are going to have a bigger impact," he says. "If you want a high absolute score, which is appealing for reporting, you may be simply picking only high quality credit or US Treasuries. This is not really in the essence or the spirit of ESG.

"A lot of focus has been placed on climate because it is more measurable," says Khangura. "The overlooked element is social. If we improve social empowerment, ultimately, that is your biggest delta. But it is hard to do that because improving education in a country increases energy requirements. And if you improve energy output, you increase your environmental footprint."

MFS's Katrina Uzun says the labelling of ESG strategies has also been a big issue that the industry has had to tackle amid accusations of greenwashing.

"There are some countries that are taking a different approach, like Chile, for example, which was the first country to issue a sovereign sustainability bond with specific greenhouse emission targets and a linked coupon step-up to the share of renewables as part of their energy metrics," she says. "That is changing the behaviour of that government. And that is what we encourage in our engagement with sovereigns and we are seeing more of that in the market."

David Will, senior manager at Scottish Widows, says sustainability is not just about climate and that there are many other ways that issuers can have a positive impact.

"Chile is a good example. It has quite aggressive sustainability goals, and some of the corporates are issuing similar sustainability-linked bonds," he says. "But you have other things going on like development banks issuing bonds with the intention of financing low carbon agriculture projects or low-income housing."

"And we are also asking our asset managers to encourage some of the corporates to improve reporting. Some corporates are doing a lot of good things, but it is not necessarily being reported upon in the way that perhaps it is in developed market companies."

Nick Cooney says while ESG integration is helping to drive better governance among issuers, it also serves as an important risk management exercise for investors.

"For bond investors, the timeline is quite short. Many want to get their money back in X number of years or longer for some sovereign bonds," he says. "But some of the ESG challenges are long-term, and they will affect future issuance and not necessarily the bonds you hold today."

Increasingly, investors are looking for ESG investment strategies that do more and are willing to sacrifice some returns to achieve a bigger impact.

"All of our investors will be in funds that incorporate ESG in terms of risk management, but some of our clients may hold a strong view in terms of sustainability and/or having a non-financial impact," says XPS Investments' Steven Hickey. "So, we split the ESG bucket into three; responsible, sustainable and impact funds.

"With impact funds, they are explicitly pursuing a non-financial objective. There's a spectrum of approaches ranging from those that don't sacrifice risk-adjusted financial returns to those that are willing to do so in order to achieve the impact identified."

### Multi-asset credit, passive, or pure-play?

A growing understanding of the asset class and an attractive entry point has helped fuel interest in emerging market debt, but what contributed to inflows in recent years has been a relatively new type of vehicle: multi-asset credit.

"For many smaller schemes that do not have the governance budgets or the scale to make too many standalone discrete allocations, there are one or two managers that do have quite large emerging market debt teams," says Scottish Widows' Will. "So, if it is within their skill set, and they can use that within a wider credit portfolio, then why not?"

Lane Clark & Peacock's Nick Cooney says while multi-asset credit can offer more investors exposure to emerging market debt, it may not be the panacea that leads to greater inflows in the longer term.

"We prefer to keep multi-asset credit as a pure-play credit product," he explains. "There might be some solutions where we are happy for the manager to allocate to emerging markets, but we think managing emerging markets is different, and the credit rates component, in particular, is much more important for an emerging market product."

Passive products have offered many investors a low-cost way to access emerging market debt, but there are drawbacks to such an approach.

MFS's Katrina Uzun says some investors have suggested that with emerging markets at a low entry point, passive strategies might be a more attractive prospect than active ones.

"People are thinking that the market is recovering or might be turning a corner and that passive may be the best way of investing going forward," she says. "We would advise against it because performance of different countries and sectors can diverge due to trends in credit fundamentals, including political and economic developments, economic cycles, and external economic and market developments".

"When these divergences happen, as an active manager we can exploit discrepancies between fundamentals and valuations among countries and credits as well as local bonds and local currencies. As an active emerging market debt manager we are also not constrained from reducing the beta or risk level of the fund in anticipation of a market downturn as a way to protect the portfolio on the downside.

She adds: "There is also the fact that benchmarks undergo quite significant adjustments over time. Passive funds are forced to buy high and sell low because when a country drops out of the bench-mark, they have to sell it. And that can hurt your performance over time."

For institutional investors looking for an emerging market strategy, Sergei Strigo says a more blended approach might offer the flexibility to react to new opportunities and help protect investors from some of the headline risks.

"Blended solutions, for me, are the best solution within emerging market debt because the asset manager ultimately has a lot of levers to pull and the ability to hedge exposure," he says. "Instead of selling positions in a very difficult market, I can easily put a hedge on. So, I am not constrained to one single asset class."



# Roundtable Participants

## Sergei Strigo

Co-Head of Emerging Market Fixed Income

### Personal Profile

Sergei Strigo is Co-Head of Emerging Market Fixed Income at Amundi London Branch. He helps manage over 30 billion euros in Emerging Markets Debt portfolios including Emerging Markets Green Bond Fund AP EGO.

He joined Amundi London Branch (formerly Crédit Agricole Asset Management) in 2004 as a Global Fixed Income Trader and was appointed Emerging Market Bond Portfolio Manager in January 2006. He joined from Caboto IntesaBCI in London, where he was an emerging markets fixed income trader for three years. His career began in Canada in corporate finance/accounting.

Sergei holds a Bachelor's degree in Administrative and Commercial Studies from the University of Western Ontario, Canada, and a MSc. in International Accounting and Finance from the London School of Economics and Political Science.

### Company Profile

Amundi, the leading European asset manager, ranking among the top 10 global players[1], offers its 100 million clients – institutional, corporate and retail - a complete range of savings and investment solutions in active and passive management, in traditional or real assets. With its six international investment hubs[2], financial and extra-financial research capabilities and longstanding commitment to responsible investment, Amundi is a key player in the asset management landscape. Amundi clients benefit from the expertise and advice of 5,400 employees in more than 35 countries. A subsidiary of the Crédit Agricole group and listed on the stock exchange, Amundi currently manages nearly £1.7 trillion of assets[3].

[1] Source: IPE "Top 500 Asset Managers" published in June 2022, based on assets under management as at 31/12/2021.
[2] Boston, Dublin, London, Milan, Paris and Tokyo
[3] Amundi figures including Lyxor as of September 30th 2022

Amundi
ASSET MANAGEMENT

# Roundtable Participants

## Katrina Uzun
Fixed Income Institutional Portfolio Manager

### Personal Profile

Katrina Uzun is an institutional fixed income portfolio manager at MFS Investment Management® (MFS®). In this capacity, she participates in portfolio strategy discussions and communicates portfolio investment strategy and positioning to prospects, clients and consultants.

Prior to joining MFS in 2018, Katrina served for 11 years as an investment director at Wellington Management, where she was responsible for emerging market debt. Before that, she worked as a trader and portfolio manager at South Trust Bank for four years, handling municipal debt and US Treasury markets.

Katrina earned a Bachelor of Science degree, magna cum laude, in finance from the University of Alabama and a Master of Business Administration degree from the MIT Sloan School of Management.

Our portfolio managers are supported by our entire team of investment professionals in nine worldwide offices. The team employs a proprietary investment process to build better insights for our clients. The core principles of our approach are integrated research, global collaboration and active risk management.

### Company Profile

Founded in 1924, MFS is a global, active investment manager with capabilities spanning all major asset classes, serving institutional investors and consultants for over 40 years. MFS has aligned our active investment approach and the way we serve clients with a sole purpose: to create long-term value responsibly.

Through our powerful global investment platform, we combine collective expertise, thoughtful risk management and long-term discipline to uncover what we believe are the best investment opportunities. With investment and industry professionals located in nine global financial centers, MFS is committed to its role as a valued partner for clients and consultants worldwide.

MFS®



## Lamine Bougueroua
Portfolio Manager

### Personal Profile

Lamine Bougueroua is a Senior Fund Manager at UBP Asset Management. Lamine joined UBP in 2020 from Nordea Asset Management, where he managed local currency and total return funds and later co-managed its sovereign ESG fund.

Prior to that, Lamine worked for four years at First State Investments, in a similar role. He started his career as an EM fixed income strategist with UBS Investment Bank and Deutsche Bank.

Lamine read Physics at the University of Bristol and the University of Oxford and holds a Master's degree as well as a Certificate in Risk Management in Banking and Finance from City University London.

### Company Profile

UBP is one of Switzerland's leading private banks, and is among the best-capitalised, with a Tier 1 ratio of 26.7%.

The Bank is specialised in the field of wealth management for both private and institutional clients. UBP is based in Geneva and employs 1,960 people in over twenty locations worldwide; it holds CHF 140.4 billion in assets under management (numbers as at 31 December 2022).
www.ubp.com

UBP
Union Bancaire Privée

# Roundtable Participants

## Nick Cooney
### Senior Consultant

**Personal Profile**

Nick is a Senior Consultant at LCP in London and is responsible for high quality investment and manager research across a range of global fixed income opportunities.

He has international experience helping some of the world's largest institutional investors meet their objectives and has expertise across traditional credit and more esoteric solutions.

Nick is Head of Liquid Credit at LCP and is a senior member of the Private Credit Team.  He has a degree in Economics from Durham University and is an MBA Candidate at DUBS.

## David Will
### Senior Manager

**Personal Profile**

David is a Senior Manager in the Investment Office at Scottish Widows. His responsibilities include investment governance, fund manager oversight, search and selection as well as acting as the fixed income investment lead.

Prior to joining Lloyds Banking Group, he worked as an investment consultant where he had responsibility for advising clients on asset allocation, manager selection, liability hedging, strategy implementation and investment governance.

David has over 30 years' industry experience and extensive knowledge of fund manager research across a variety of asset classes.  One of his previous roles was that of Head of Manager Research at JLT, now part of Mercer.  In addition to his role at Scottish Widows, David is a regular speaker at industry events.

## Hardeep Khangura
### Portfolio Manager

**Personal Profile**

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

## Steven Hickey
### Head of Credit Research

**Personal Profile**

Steve leads XPS's Credit research and, more generally, works with Chief Investment Officer to drive forward XPS's research efforts across the team. As such, he has vast research experience across the key public and private asset classes utilised by UK DB pension schemes. Alongside his research responsibilities, Steve is responsible for the day-to-day management of a handful of trustee clients, advising them on a full range of investment related matters.

Steve joined XPS in 2015. He is a CFA Charterholder and holds the CFA UK Level 4 Certificate in Investment Management (formally IMC).

# Moderator

## Elizabeth Pfeuti

Chief Client Officer

### Personal Profile

Former Dow Jones staffer Elizabeth Pfeuti is Rhotic's Chief Client Officer and a member of the Rhotic Media executive leadership team. A highly-decorated journalist, Elizabeth has been in financial journalism for around 15 years. At Dow Jones, she covered the asset management, investment banking and investor services beats for Financial News, where she also wrote on a wide range of regulatory themes

She was previously the European Editor for CIO Magazine and boasts an exceptional contact book of buy-side and in-house institutional CIOs and asset management executives. More recently she has worked on corporate briefs for pension consultants, investment banks and asset management groups.

RHOTIC

# Emerging Markets Outlook by Amundi Institute

*"Although we do not expect a hawkish-to-dovish shift from the Fed, we also do not believe this year will contain a similar chain of events as last year, and therefore we have a cautiously constructive outlook on EM"*

**Sergei Strigo**

Co-Head of Emerging Market Fixed Income

## The Case for Emerging Markets in 2023

The Fed has responded to the spike in inflation with the second-steepest hiking cycle since the 1970s, with rates rising by 450bps since March 2022. In response, we've seen higher interest rates in the US and a stronger dollar, and these have had an impact on all asset classes, with very negative performances in both bonds and equities in 2022. Emerging Markets (EM) have been no exception in this regard. Although we do not expect a hawkish-to-dovish shift from the Fed, we also do not believe this year will contain a similar chain of events as last year, and therefore **we have a cautiously constructive outlook on EM.**

**Looking forward, we see four main factors underpinning the case for a more optimistic view on EM this year:**

1. The first main theme contributing to this expected outcome is the **reopening of China**, which will be a major catalyst for EM in 2023. The **economic recovery after the reopening is well on track**, and even the modest growth target of 5% for 2023 announced by Chinese authorities could be seen as healthy, unaffected as it is by the large 'artificial' short-term stimulus. If there are no bumps in the road, we might see an upside surprise in terms of growth. Moreover, we expect some positive spill-overs in EM countries that have strong trade relations with China, especially in Asia because many Asian economies supply consumption goods to the Chinese market and are favoured destinations for Chinese tourism.
2. The second supportive point is linked to the first as China's earlier-than-expected reopening should contribute to a widening **EM-DM growth differential in favour of the former.** The economic outlook is supportive for EM: on the one hand, we expect higher growth in EM, while on the other hand, we expect mild economic growth in DM, especially in the US, where growth dynamics could deteriorate in H2 2023.
3. Although there is already a lot of monetary tightening in the pipeline, there are still expectations of further tightening in advanced economies and the global scenario is complex due to the stickiness of inflation. This is not likely to easily return to CB targets, though we expect **more stable monetary policy**. It is difficult to see the same magnitude of movement taking place as that observed in 2022 for the two main headwinds for EM countries; we expect a more stable US dollar in the first half of the year and a weaker dollar moving into H2 2023 as even if the Fed's tightening cycle is not over, a pivot should be approaching.



4. After significant **monetary policy tightening in many EM countries** over the past two years, when central banks in general have stood out for their orthodoxy, they **are in an advanced stage compared to DM**. Inflation dynamics are also more advanced in terms of the declining path relative to DM, and CBs' prompt responses in raising interest rates have already acted to cool inflation (with food and energy having much higher weights in EM CPI baskets compared to advanced economies). The tightening in EM may be behind us in the vast majority of cases, but the EM landscape is very diverse.

Even though the outlook for EM remains cautiously constructive, investors need to be aware of various risks from a global-to-local perspective. The main risk to watch out for is a stronger-than-expected tightening by the Fed. The outlook will remain challenging until interest rates in the US (and also Europe) have peaked. Another issue to monitor is geopolitical risks, which are still rising, as evidenced by the ongoing war in Ukraine and the tensions in Taiwan. The final point worth mentioning is the likely increase in sovereign defaults due to higher refinancing costs, large outflows, loss of market access and weak fundamentals. There are two significant reasons for this risky trend: first, some countries have sold a substantial percentage of their reserves to mitigate currency depreciation; second, many countries depleted their domestic savings to deal with the Covid shock and the subsequent Russia-Ukraine war and they will therefore be even more dependent on foreign capital looking forward. Some low-income countries have already been impacted by these factors, especially frontier markets, which heightens the risk of additional defaults. However, it's worth noting that the EM space is not a single block and there are huge differences between countries.

In terms of asset allocation and considering the previous context, we see opportunities in all EM segments:

- **EM bonds offer an interesting entry point in terms of carry and spreads** after the surge in yields in 2022, and also in relative terms to DM bonds. We see opportunities in HC, local rates and FX. However, we are selective and we prefer commodity exporters (Mexico, South Africa, Indonesia) thanks to China's reopening, as well as other Latam countries supported by their higher carry over other regions. We are also constructive on countries that are at the end of their tightening cycle and where CBs have been proactive, for example, Colombia and Thailand look attractive. In terms of FX, we have opened some tactical trades in Colombian Peso, South African Rand, Hungarian Forint, Indian Rupee and Indonesian Rupiah.
- On the **equity** side, EM **should benefit from the Chinese reopening, reasonably attractive valuations and earnings expectations,** which have improved recently. Based on our macro scenario, we expect double-digit upside for the MSCI EM in the next 12 months, however, this is dependent on the evolution of the backdrop. We favour EMEA and Latam countries at this stage, and we maintain a positive on China.
- **Play the internal demand story** with a mid-to-long-term horizon; apart from China we believe that India deserves a special mention due to its demographic dividend and its increasing domestic demand. Gaining exposure to **China and India** should allow investors to diversify their portfolios but not correlate their returns.
- **The importance of ESG in EM**: the expansion of sustainable finance is evident and this is becoming crucial for EM. However, there is room to go even further when we consider that the effects of climate change are among the most visible worldwide in EM. China is leading the energy transition globally.

# When to Allocate to Emerging Market Debt

*" Emerging market countries will also be an important driver of the transition towards renewable energy. Investing in their bonds could provide UK pension schemes a route to exert positive influence on countries and companies, as well as to help meet their own sustainable investment targets"*

**Katrina Uzun**

Fixed Income

Institutional Portfolio

Manager

It wasn't long ago that developed market sovereign bonds were considered risk-free return. More recently, we saw them providing return-free risk. And last year, in a mini-budget-driven mini crisis, UK gilts offered very risky return. Why does this matter?

Over the last twenty years, pension funds have increased allocations to bonds with the aim of reducing funding volatility and better matching their liability profile. The result is that schemes, in aggregate, now hold more bonds than equities in their portfolios. Despite the 2022 LDI crisis and spike in gilt yields, UK pension schemes generally saw improved funding levels. Where does this leave schemes now?

With the inflation and growth outlook still uncertain, trustees need to carefully manage their portfolios, balancing the need to generate appropriate risk-adjusted returns while providing cashflows to pay members' benefits as they fall due.
Emerging market debt (EMD) has the potential to provide attractive returns and portfolio diversification for UK schemes. While investment has generally been via absolute return or multi-asset credit funds, could EMD hard currency be worth a standalone allocation?

### Reasons for UK schemes to consider EMD

From a strategic allocation viewpoint, there are a number of reasons to consider EMD. The size and increasing maturity of the market means the asset class is 'too big to ignore'. Emerging market bonds now make up approximately 15% of the global fixed income landscape.

The quality of EMD has also risen markedly in the last decade — more than half of the bonds in the universe have an investment grade rating. The investor base is more stable as a result, and the commitment from institutional investors continues to grow. EMD may also confer diversification benefits on an aggregate portfolio with the opportunity to diversify across region, country, maturity, currency and emerging market sector.

Emerging market countries will also be an important driver of the transition towards renewable energy. Investing in their bonds could provide UK pension schemes a route to exert positive influence on countries and companies, as well as to help meet their own sustainable investment targets.

### Is now a good time to invest in emerging markets?

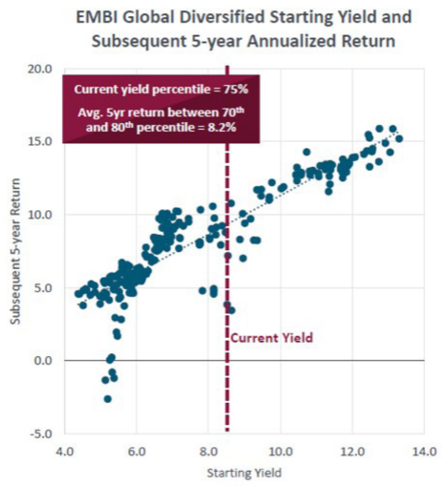
Historically, EMD has provided a yield advantage over other fixed income asset classes. This remains the case today.



**Exhibit 1: EMD yields are elevated versus recent history**


*Source: J.P. Morgan, Bloomberg. Daily data from 2 January 2007 through 31 January 2023. EM Global Diversified = J.P. Morgan EMBI Global Diversified.*

**Exhibit 2: Starting yield has shown a positive correlation to subsequent return**




*Source: J.P. Morgan, Bloomberg, FactSet. EM Global Diversified = J.P. Morgan EMBI Global Diversified. Monthly data from 31 December 1998 through 31 January 2023. Subsequent 5-year returns are in USD and annualised.*

As Exhibit 1 shows, EMD hard currency yields are at their highest level since 2009. Historically elevated yields and the proximity to the end of the US Federal Reserve's hiking cycle could be beneficial to EMD returns. To support this optimistic view, our analysis shows that higher starting yields have historically been associated with higher long-term investor returns, as you can see in Exhibit 2.

It's worth noting that EMD performance can be volatile. However, the asset class has historically shown strong returns following drawdown episodes. For example, when EMD sold off 27% in 2008, it rallied 53% in the following year. When it returned -12.5% during the COVID-19 selloff, it rallied 22% over the next 12 months. Given the -26% return in 2022, we are hopeful of a strong rebound this year.

EMD tailwinds may also be starting to strengthen. During Q4 2022, China went from zero tolerance COVID policy to something close to zero restrictions. This focus on growth has excited markets but we will wait to see if it is more than a cyclical boost. Globally, it appears headline inflation may have peaked, and central banks may be close to the end of tightening cycles. Offsetting these, potential headwinds remain the possibility of a second wave of inflation, the Fed tightens more than expected, the US dollar suddenly strengthens or global growth nosedives.

Given the nature of EMD and the ongoing macro uncertainty, a focus on active security selection may be key to unlocking its return potential. The present environment will undoubtedly create opportunities in EMD for long-term investors and managers who are able to navigate the current market environment and successfully differentiate among winners and weak performers.

For more information about MFS' emerging market debt capabilities, please contact Kelly Tran, Managing Director – UK & Ireland Institutional Sales, via ktran@mfs.com.

# Emerging Markets Local Bonds are set to benefit from China re-opening

*" China's sooner Than expected reopening from its zero-covid policy has caught investors unprepared in terms of timing and pace of change. Previously, the consensus had been that a gradual re-opening would take place starting in Q2 2023 "*

**Lamine Bougueroua**

Senior Portfolio Manager, Emerging Markets Fixed Income

### Outlook and investment opportunity: A favorable environment for 2023

2023 has just started but has already thrown a number of major economic surprises that investors should be very attentive to. Notably, China's faster than expected reopening and a fall in inflationary pressure across the globe. UBAM – EM Responsible Local Bond fund is designed to allow investors gaining exposure to both EM currencies and EM duration

Going forward, the investment team expects the macroeconomic environment to remain favorable for the asset class for several reasons:

- **China's sooner than expected reopening** from its zero-covid policy has caught investors unprepared in terms of timing and pace of change. Previously, the consensus had been that a gradual re-opening would take place starting in Q2 2023. Instead, all restrictions were lifted suddenly with no-pre warning and in a matter of weeks. The investment team argues that global markets need time to absorb a shift of this magnitude in the world's second largest economy.

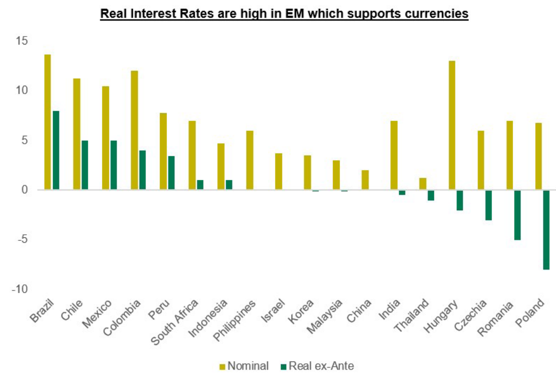
  In a further sign that China's policy makers are determined to focus on growth this year, several legislative measures were taken to reverse previous restrictions in the technology and real estate sectors. In fact, the latter now benefits from an explicit policy support.

  We consider the recently announced 5% growth target set by the State Council to be close to Goldilocks for the asset class as it is sufficiently high to increase external demand without adding to ongoing inflationary pressures.


Source: UBP, Bloomberg, February 2023

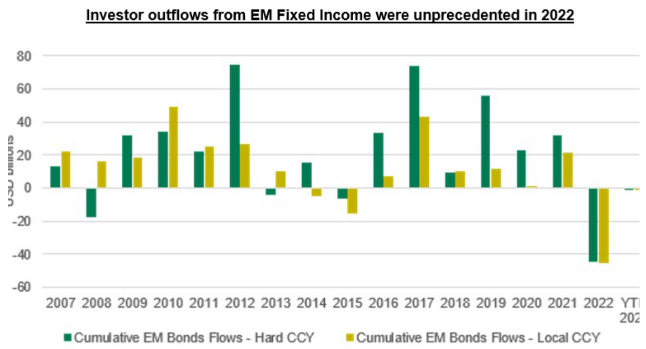


- **Inflation is falling faster than expected**. Emerging markets have been able to manage inflationary pressures better than developed markets in the past two years. Unusually, most EMs have registered lower inflation peaks than developed markets. This was due to the fact that EM did not inject as much economic support into the economy during Covid-19 pandemic as the US and the Eurozone. Furthermore, EM policy makers have been generally more accustomed to dealing with inflation pressures resulting from supply chain disruptions than DMs for which the situation was unusual and seen as transitory. EM central banks always maintained high real rates (with the exception of Eastern Europe which faced an energy price shock).




Sources: UBP, NatWest, National Central Banks, February 2023.

- Over 2022, the asset class saw its largest outflow historically, which is an indicator of the extreme market bearishness, meaning investors are currently under-allocated in EM Fixed Income including local bonds. This should at least partially reverse in 2023 and be a further tailwind for the fund. It also offers an attractive entry point into the asset class and the fund.




Sources: UBP, JP Morgan, January 2023.

- Geopolitics remains the main risk to watch for 2023: the investment team is attentive to the risk of a renewed escalation of the conflict in Ukraine. It is also aware that social risks from the significant increase in food and fuel prices could cause some countries to tip into a period of political instability. This means that ESG attributes will continue to have a strong influence in the country allocation decisions.

# Important Notice



**CAMRADATA**
With Intelligence
One London Wall
London
EC2Y 5EA

+44 (0)20 7832 6500
camradata.com

Join us on LinkedIn