6 Themes Driving Emerging Markets Debt

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Emerging markets (EM) debt could benefit in 2021 from a favorable combination of factors—such as improving global growth and ample liquidity conditions—but adding to our optimism is our belief that several important themes will likely unify the landscape for EM debt. These include the weakening U.S. dollar, a changed U.S-China relationship, supportive commodity prices, and an increased focus on sustainability.

The Dollar Weakens

The positive global macro backdrop should be conducive to risk-taking that encourages a rotation away from safe havens such as the U.S. dollar. This would lead to a weakening of the dollar, which could be exacerbated by any potential political difficulties arising from a slim Democratic majority in Congress.

Still, the market consensus is short the U.S. dollar, so there is room for it to recover at the margin as the year progresses. EM currencies remain undervalued on a real effective exchange-rate (REER) basis, and we expect some catch-up to the majors as global economic conditions normalize.

U.S.-China Relationship Under a New Geopolitical Order

In the United States, the Biden administration will likely have a more conciliatory approach to China, especially regarding trade. It is likely to adopt a predictable multilateral approach to foreign policy, engaging allies in a more coordinated response to China's rising global influence.

However, we see scope for continued bipartisan backlash against China on issues related to technology, industrial policy, growing militarism, climate change, human rights, and aggressive nationalistic diplomacy.

While a less protectionist stance on trade would benefit the global economy (EM countries in particular) in the near term, a potential ideological divide between China and the Western world may lead over time to a more bipolar, less efficient global economy, as well as heightened geopolitical risks. This, in turn, could have significant implications for EM countries, from supply chain integration to trade to financing, while also providing investors with investment opportunities. These dynamics require constant monitoring.

Oil-Price Uncertainty Continues

Commodity markets experienced significant volatility in 2020, with unprecedented fundamental dislocations affecting oil in particular.

Economic shutdowns reduced demand by more than 20% at its trough. This made higher-cost production uneconomic, and markets did not stabilize until the OPEC+[1] supply curtailment agreement was enacted in April. Although increased mobility and economic activity has since led to a demand rebound, the market is still supported by lower supply from OPEC+. Current demand appears to be 5 million to 8 million barrels per day lower than in 2019.

With a further demand recovery likely in the second half of 2021, we expect prices to be supported, but they are unlikely to spike, as a result of still-high inventory levels, supply restoration, and uncertainty about how behavioral changes will affect longer-term demand.

With approximately 60% of crude oil refined for transportation use, oil markets will likely continue to be hurt by the growing use of electric vehicles (EVs), as detailed below.

Chinese Demand Drives Metals Markets

While metals markets are diverse, they are unified by a single theme: Chinese demand.

Copper prices troughed in March and have since risen by more than 50%. That rise in demand was driven, in great part, by China's 14th five-year plan and a global manufacturing rebound, which created conditions for a steady rise in prices. We believe prices will remain elevated given that a supply response will take time.

While the same demand factors affected iron ore, supply played a bigger role, driving prices to their highest levels in the last decade. With limited large projects in the pipeline, recent downgrades to production guidance from a major producer in Brazil have created a market imbalance as we go into 2021, and pricing should remain elevated.

New Demand Factors Transform Commodity Markets

Some commodity markets are also experiencing new demand factors—related to environmental, social, and governance (ESG) concerns—that are likely to be transformative in the medium term.

The popularity of electric vehicles (EVs) is driving substantial demand for lithium, nickel, aluminum, and copper. As we transition to a more sustainable future, these metals will likely play an important role. The rise of EVs will also

likely affect electric energy demand and transportation fuel consumption.

Renewable energy sources will provide a growing part of electric generation, but the energy demands of a growing world are high, and natural gas should also see increasing electric demand as a cleaner alternative to coal generation.

Increased Focus on Sustainability

In recent years there has been an increased focus on the application of ESG indicators to EM debt investing.

The concept is not new to us. The analysis of ESG factors has been integrated into our investment process for many years because we believe analyzing ESG factors is critical to properly assessing risks and risk premia in EM debt.

Moreover, we find evidence of a strong long-term relationship between ESG factors (particularly governance indicators) with the evaluation of risk premia measured by credit spreads. In the long run, positive changes in governance indicators tend to lead to positive changes in environmental and social factors and macroeconomic indicators. Therefore, clearly understanding how a country’s ESG factors evolve is critical to assessing that country’s present and future creditworthiness, which is ultimately reflected in the ability to service its debt.

In addition to being critically important to the fundamental analysis of EM credit, asset owners’ rising interest in sustainable assets has also had significant implications for the supply and demand dynamics of EM debt.

Strong flows into sustainable investment products have resulted in strong demand from asset managers for ESG (particularly green-labeled bonds). Demand for green-labeled bonds far outstrips supply, creating a positive technical factor for lowering financing costs for countries and companies that have the ability to demonstrate strong compliance with ESG factors.

This creates a positive feedback loop as lower borrowing costs incentivize issuers to adopt appropriate ESG factors more readily and quickly. As best practices evolve, countries improve productivity, increase potential growth rates, and enhance their citizens’ living conditions.

Similarly, economic and business models that are built on a more balanced and sustainable framework both improve working conditions for employees and potentially raise profitability levels.

As the momentum for ESG investing continues to grow, it is clear to us that issuer adherence to these factors will help issuers create value through an improvement in fundamentals that leads to lower borrowing costs and increased investor demand. Our process seeks to identify these opportunities early, assess the associated risks appropriately, and create value on behalf of our client base by recognizing these positive powerful changes.

Emerging Markets Series

Part 1: Emerging Markets Roar Into the 20s
Part 2: 2021: The Strongest Growth in a Generation?
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Part 4: Emerging Markets Debt Well Supported
Part 5: Emerging Markets: Localized Opportunities
Part 6: 6 Themes Driving Emerging Markets Debt
Part 7: China's Unwavering Growth Journey

[1] Many of the largest oil-producing countries in the world are part of a cartel known as the Organization of Petroleum Exporting Countries (OPEC). In 2016, OPEC allied with other top, non-OPEC, oil-exporting nations to form OPEC+.

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