A Brighter Outlook for Emerging Markets Debt

January 27, 2022

The past year was a study in contrasts for investors; this was true for many asset classes, but particularly so in emerging markets (EM) debt.

After a remarkable recovery in global economic activity in the first half of the year, new concerns related to virus variants, inflation, and monetary-policy tightening emerged in the third and fourth quarters.

The result was a challenging backdrop for EM debt as investor sentiment deteriorated, leading to outflows out of EM debt portfolios, widening EM debt credit spreads, higher EM local bond yields, and weaker EM currencies.

We anticipate that EM debt investors will continue to face several headwinds in the first half of 2022. These issues include a slowdown in Chinese economic activity, supply-chain disruptions, dysfunctional labor markets, rising energy prices, and persistently high inflation rates.

Inflation in particular poses significant challenges, and many EM central banks have started to tighten monetary policy in an attempt to rein in escalating prices. EM countries have started tightening as a way to get ahead of the U.S. Federal Reserve' (Fed's) tapering of its bond-buying program, which we expect to be concluded in March 2022, followed by rate hikes later in the year.

Despite these headwinds, we anticipate brighter days for EM debt. Increased vaccine supplies should help narrow the "vaccination gap" between emerging and developed markets, leading to a more broad-based reopening of economies. Similarly, we expect disruptions in supply chains and labor markets to slowly resolve as countries around the world continue to improve their management of the pandemic. Inflation should peak as a result of easing supply-side bottlenecks, slower increases in food and energy prices, and monetary tightening. Finally, by mid-2022, we expect that a majority of EM policy tightening will already be completed.

Against this backdrop, we examine the fundamental, technical, and valuation factors that are shaping the opportunity set and risks in EM debt in early 2022.

EM Fundamentals Continue to Improve

The current environment suggests that fundamentals for EM debt are on track to keep strengthening.

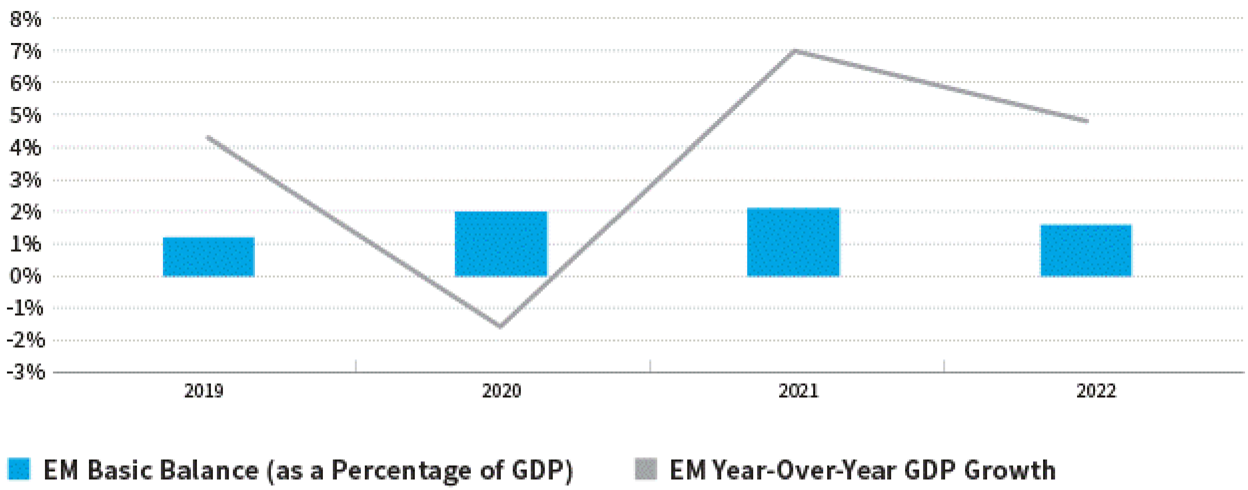
We estimate that gross domestic product (GDP) growth in EM countries will hit 4.8% in 2022, below the 7% growth rate in 2021 but above pre-COVID trend levels. We believe EM fiscal accounts should improve to -5.5% of GDP in 2022, from -6% in 2021 and -7.7% in 2020.

At 1.6% of GDP, EM countries have maintained fairly strong basic balance levels, highlighting the resilience of EM external accounts even during the pandemic. EM countries' current account surplus is expected to decline somewhat, driven by stronger domestic demand, but should remain at healthy levels.

We anticipate that EM government debt as a percentage of GDP will stabilize at just over 60%. Inflation in EMs is expected to decline to 4.2% in 2022 from 4.3% in 2021. We anticipate that EM exports will increase by 7.9% in 2022 from 2021, reflecting improvements in global trade and high commodity prices.

EM Countries Show Strong Fundamentals and Resilience

After falling into negative territory in 2020 because of the COVID-19 pandemic, GDP growth in EMs bounced back strongly in 2021. Despite slowing growth rates projected for 2022, EM countries should be able to maintain fairly robust basic balance levels, highlighting the resilience of these economies even through global turbulence.



Sources: Oxford Economics and William Blair estimates, as of October 2021. Shows GDP-weighted figures.

In 2022, we foresee no systemic crisis and anticipate, in our opinion, very low default rates. EM countries should benefit from strong multilateral and bilateral support, with ample and affordable funding. In particular, the International Monetary Fund (IMF) has taken proactive measures through the increase of special drawing rights (SDR) allocations during the pandemic.

Country-specific risks remain, particularly in China. After struggling significantly in 2021, the Chinese economy appears poised to improve in the first half of 2022 and should benefit from stimulus support initiated in late 2021. Still, the country's overall growth trend will likely decline as Beijing places an emphasis on the quality of growth and on higher value-added sectors.

Corporate Credit Cycle May Hit an Inflection Point

After benefiting from years of fundamental credit improvement, the EM corporate credit cycle is starting to show signs of accommodation. At an aggregate level, balance sheets and maturity profiles remain healthy, despite a slight increase in capital expenditures.

Corporate capital structures cannot improve in perpetuity, but a renewed focus on growth or shareholder returns, if executed prudently by corporate issuers, shouldn't be viewed as a negative for lenders, in our opinion.

Nonetheless, while default rates should remain well contained, we don't believe that credit improvement will be a tailwind for the asset class in the near term.

Commodity Prices Remain Elevated

Higher commodity prices have presented a mixed picture for EM countries. Elevated prices should provide a tailwind for commodity exporters, though spiking energy prices negatively affected oil- and gas-importing countries.

Commodities overall experienced quite a rebound in 2021, with energy prices leading the way. For the year, crude oil prices (West Texas Intermediate) rose 61% and natural gas prices rose 38%, according to the Energy Information Administration.

These sharp increases were driven by higher demand, constrained supplies by Organization of the Petroleum Exporting Countries (OPEC) and non-OPEC countries, and weather-related disruptions. We believe that supply and demand dynamics will remain supportive of energy prices in 2022.

Rebounding economic activity also supported demand for copper and iron ore. Iron ore prices began to normalize as investors assessed 2022 supply and demand activity, while copper prices remained elevated on the back of low inventories.

Looking ahead, the transition to electric vehicles and the infrastructure required for their operation will lead to new demand drivers for metals such as copper, nickel, and aluminum, benefiting countries with significant exports of these increasingly valuable resources.

Technical Conditions Appear Generally Positive

In addition to healthy fundamentals, we believe the technical backdrop should also be supportive for EM debt in 2022. Supply should remain constrained as a result of declining net refinancing needs due to improved fiscal accounts and prefinancing activities.

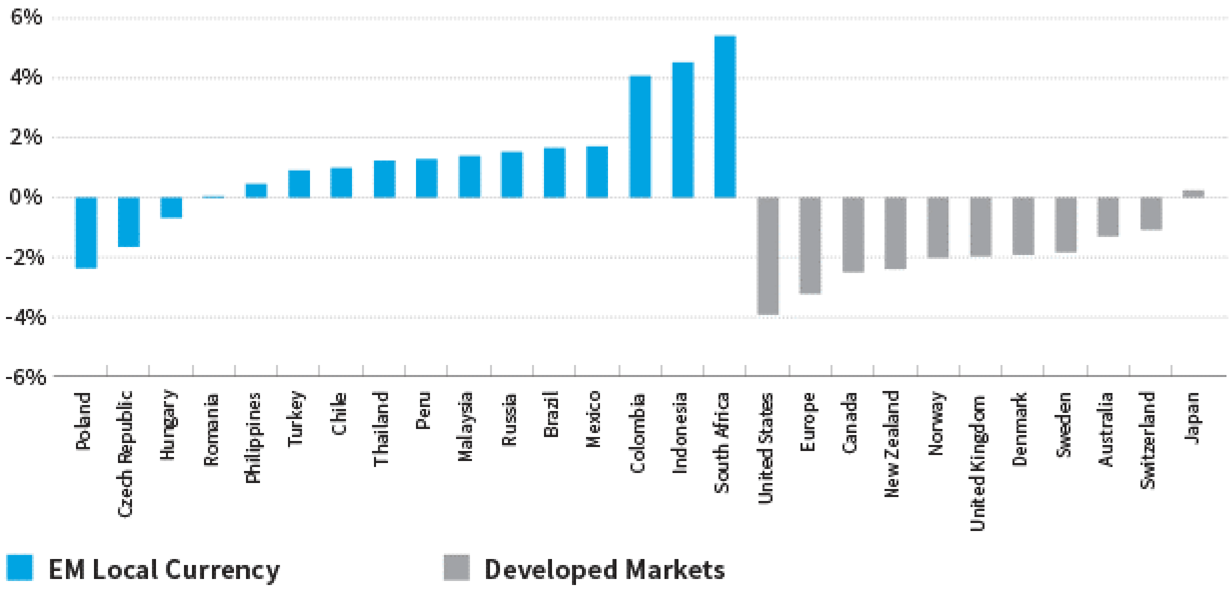
In our view, Inflows into EM debt should continue to recover as allocations to EM debt by global investors are well below peak levels and not in line with the size of the opportunity set. J.P. Morgan estimates that 2022 inflows will total $30 billion to $40 billion, just below long-term averages.

Investor positioning is also supportive. Throughout 2021, investors reduced their positioning in EM debt during the “risk-off” sentiment, though we believe that a more benign environment could lead to larger allocations and inflows from investors in 2022, especially later in the year.

On a relative basis, we believe EM debt should remain attractive compared with other fixed-income assets. Continued low global rates—including negative interest rates in many developed markets—should benefit EM debt. In addition, global liquidity, while past its peak, should remain ample, and we believe that any deterioration following tighter monetary policies should be very gradual.

Local-Currency EM Debt Offers Premium in Real Yields

Compared with other fixed-income assets, yields on local-currency EM debt remain attractive. With few exceptions, inflation-adjusted yields of local-currency EM debt were in positive territory, in stark contrast to the negative real yields for most developed markets.



Source: Bloomberg, as of November 2021. Shows real yields, which represent nominal 10-year bond yields less the Consumer Price Index.

Valuations for EM Debt Remain Attractive

In our view, EM debt appears attractively valued on both an absolute and relative basis, as spreads have remained wider than historical levels. EM sovereign high-yield spreads appear very compelling, as they are at heightened levels compared with their 10-year averages.

We view EM sovereign high-yield spreads are particularly attractive versus U.S. high yield levels. EM credit spreads are well above developed-market credit spreads, again significantly wider than their 10-year averages.

Valuations for EM Sovereign High-Yield Debt Appear Attractive

Valuations for EM sovereign high-yield debt appear very attractive heading into 2022 compared with U.S. high yield bonds, as spreads have widened considerably from the long-term average. Since the onset of the COVID-19 pandemic, EM sovereign high-yield spreads have remained wider than their U.S. counterparts despite what we see as attractive fundamentals.

Sources: Bloomberg and J.P. Morgan, as of November 2021. EM sovereign debt yields are presented by the J.P. Morgan Emerging Market Bond Index (EMBI). Global Diversified U.S. high yields are represented by the Bloomberg U.S. Corporate High Yield Total Return Index.

In our view, EM debt investors are more than adequately compensated for default and loss-given-default risks. Our conservative probability-weighted default projection is approximately 2%, resulting in a potential negative impact of approximately 50 basis points (bps) on the index level.

Still, this projection is very conservative, and there is a significant chance that we do not see any sovereign credit defaults in 2022. We see value in selected EM corporate credit, where investors have a spread pick-up to sovereigns but with a significantly lower duration.

In the local currency space, we believe EM currencies remain fundamentally undervalued and feature a higher carry compared with developed-market currencies. Balance-of-payment trends have become more positive in many markets, as many EM currencies are cheaper and interest-rate differentials versus developed markets have widened. EM local yield curves are steep and have already increased significantly. While developed-market central banks have generally maintained accommodative policies, in many EM countries monetary tightening is much closer to the end than the beginning of the cycle, in our opinion.

Virus, Geopolitical Tension, and Chinese Real Estate Loom as Significant Risk Factors

The COVID-19 pandemic, with the potential for more disruptive variants, has the most potential to cause widespread market volatility. We will continue to monitor policy responses to the virus, along with the resulting impact on consumer sentiment, industrial production, and economic growth.

If the pandemic escalates again because of new vaccine-evading variants, we anticipate that central banks, including the Fed, are likely to pull back on the pace of tapering, and anticipated rate hikes will likely be delayed. As a result, in a situation in which the virus continues to disrupt the global economy, we anticipate that elevated liquidity levels will remain for longer.

Geopolitical tensions are a continued threat to global markets. In particular, we are monitoring ongoing tensions between the United States and China, Russia and Ukraine, and China and Taiwan.

The political cycle in EM countries could also have broader effects, particularly with important elections in Latin America that could lead to a populist shift.

Lastly, the Chinese real-estate sector, which experienced significant volatility in late 2021, could affect markets beyond China’s borders.

We expect several issuers to default and/or exercise distressed exchanges given current bond prices. Although the landscape is uncertain, we believe that it will ultimately create significant opportunities for issuer selection within the sector.

Opportunities in Hard Currency and Local Currency Debt

We believe that investors should look past near-term headwinds in early 2022 and focus on the fundamental value of EM debt.

In this environment, we have a tactical preference for hard currency over local currency debt, as the attractiveness of local markets should remain clouded by a still low growth differential between emerging and developed markets for most of 2022. We also see the potential for increased market volatility in the currency space as the Fed begins its tightening cycle.

In our view, hard currency EM debt should provide better volatility-adjusted returns to investors, especially in the first half of the year. We remain strategically overweight high-yielding, frontier-market countries. But we have recently reduced exposure to high- and medium-beta countries and raised cash levels as we anticipated more appealing valuations to reposition the portfolios in the next few months.

We have maintained our exposure to EM corporate credit, where we see generally favorable technical conditions. In particular, we have identified several issuers with strong credit profiles that have more attractive spreads than their sovereign counterparts. Our positions are focused on the commodity, consumer, utility, and financial sectors in Latin America; financials and commodities in Central and Eastern Europe, the Middle East, and Africa; and utilities, financials, industrials, and real estate in Asia.

While we prefer hard currency EM debt, we see potential for local currency EM debt to perform well in the latter part of 2022 as the rising growth differential between emerging and developed markets leads to increased capital flows into EM countries.

We see opportunities in frontier markets as well as in countries that are likely to be added to benchmarks in 2022, such as Egypt, Ukraine, and India. Lastly, we find attractive several high-beta markets where rates have risen the most and valuations are at very compelling levels.

Emerging Markets 2022 Outlook Series

Marcelo Assalin, CFA, partner, is a portfolio manager on and head of William Blair's Emerging Markets Debt team.

Disclosure:

This content is for informational and educational purposes only and not intended as investment advice or a recommendation to buy or sell any security. Investment advice and recommendations can be provided only after careful consideration of an investor's objectives, guidelines, and restrictions.

Information and opinions expressed are those of the authors and may not reflect the opinions of other investment teams within William Blair Investment Management, LLC, or affiliates. Factual information has been taken from sources we believe to be reliable, but its accuracy, completeness or interpretation cannot be guaranteed. Information is current as of the date appearing in this material only and subject to change without notice. Statements concerning financial market trends are based on current market conditions, which will fluctuate. This material may include estimates, outlooks, projections, and other forward-looking statements. Due to a variety of factors, actual events may differ significantly from those presented.

Investing involves risks, including the possible loss of principal. Equity securities may decline in value due to both real and perceived general market, economic, and industry conditions. The securities of smaller companies may be more volatile and less liquid than securities of larger companies. Investing in foreign denominated and/or domiciled securities may involve heightened risk due to currency fluctuations, and economic and political risks. These risks may be enhanced in emerging markets. Different investment styles may shift in and out of favor depending on market conditions. Individual securities may not perform as expected or a strategy used by the Adviser may fail to produce its intended result.

Investing in the bond market is subject to certain risks including market, interest rate, issuer, credit, and inflation risk. Rising interest rates generally cause bond prices to fall. High-yield, lower-rated, securities involve greater risk than higher-rated securities. Sovereign debt securities are subject to the risk that an entity may delay or refuse to pay interest or principal on its sovereign debt because of cash flow problems, insufficient foreign reserves, or political or other considerations. Derivatives may involve certain risks such as counterparty, liquidity, interest rate, market, credit, management, and the risk that a position could not be closed when most advantageous. Currency transactions are affected by fluctuations in exchange rates; currency exchange rates may fluctuate significantly over short periods of time. Diversification does not ensure against loss.

There can be no assurance that investment objectives will be met. Any investment or strategy mentioned herein may not be appropriate for every investor. References to specific companies are for illustrative purposes only and should not be construed as investment advice or a recommendation to buy or sell any security. Past performance is not indicative of future returns.