Beta Buckets: Potential Strategic Opportunities

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A negative combination of factors weighed on emerging markets (EM) debt investors in the first quarter of 2022, and we don't expect that to change in the near term. Longer term, however, we believe the outlook for EM debt is constructive, and we see scope for fundamental differentiation among countries, which we analyze using a beta-bucket approach.

Short-Term Challenges

EM debt faced strong headwinds during the first quarter of the year, thanks to rising inflation, supply-chain disruptions, monetary-policy normalization, rising economic growth risks, and, of course, the Russia-Ukraine conflict.

We expect this challenging backdrop to continue through the second quarter of the year. Rising energy and food prices and disruptions to global supply chains—which were created by the COVID-19 pandemic and exacerbated by the Russia-Ukraine conflict and China's zero-COVID policy—should continue to pressure inflation, in our opinion. This adds a layer of complexity for investors who are already navigating the prospects of faster monetary policy tightening globally. Moreover, we expect the Russia-Ukraine conflict to continue creating uncertainty as a resolution seems distant.

In this environment, we have revised our projections for 2022 economic growth in EMs downward. While many countries' financial conditions should remain well supported by higher commodity prices, inflation is likely to remain a concern, leading to additional monetary tightening.

Potential Long-Term Opportunities

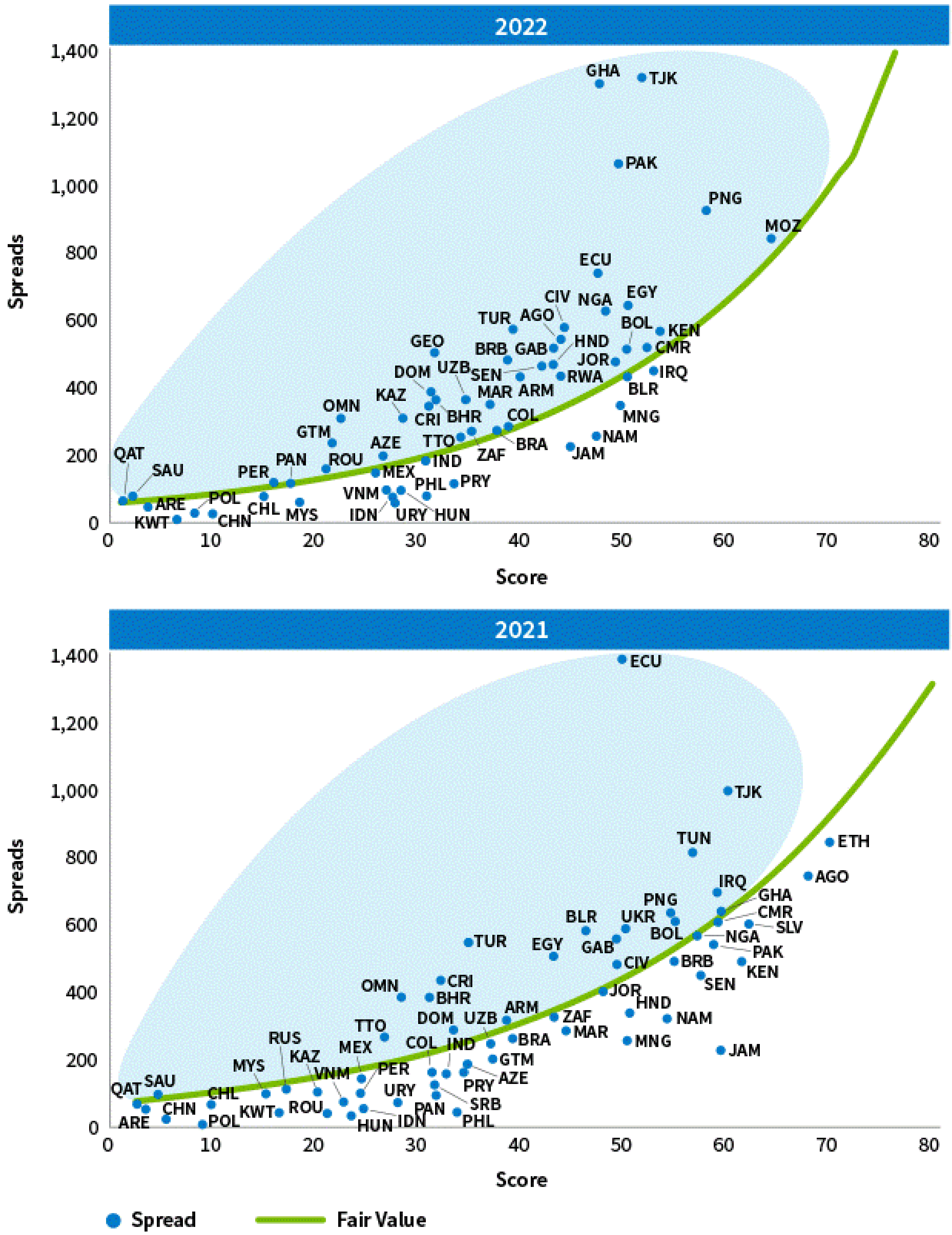
Despite these near-term risks, our medium- to long-term outlook for EM debt is constructive. We believe appealing EM debt valuations and improving technical conditions could outweigh the negative global macro backdrop and support the performance of the asset class going forward.

In terms of valuations, EM debt appears attractively valued on both an absolute and relative basis, with spreads wider than their historical levels. EM sovereign high-yield spreads are particularly compelling in our view, especially relative to U.S. high-yield debt.

To determine sovereign creditworthiness, we use a proprietary sovereign risk model (SRM) that scores countries based on factors such as economic growth and resilience; public finance health, external balances and buffers; and environmental, social, and governance (ESG) considerations. Our SRM's scores indicate that current valuations are not explained by fundamental reasons.

Opportunities Increasing

The number of countries trading “cheap” has doubled over the past year—and we believe that could bode well for active managers with the ability to invest in high-beta and distressed debt.



Sources: Oxford Economics, J.P. Morgan, and William Blair, as of March 2022. Sovereign risk model scores range from 0 (best) to 100 (worst).

In terms of technical conditions, outflows were well contained during the selloff earlier this year, and we recently started to see inflows into dedicated EM debt portfolios, reflecting growing interest in the asset class as market volatility has started to normalize. But new debt supply is constrained due to declining net refinancing needs, which occurred due to improved fiscal conditions and prefinancing activities last year, so we anticipate limited net debt issuance in the near term.

We thus believe EM debt currently offers value to investors with a medium- to long-term horizon and a willingness to tolerate a period of higher volatility.

Potential Strategic Opportunities

In this environment, we see scope for fundamental differentiation among countries.

In EM sovereign credit, we prefer commodity-exporting countries, especially in the energy space, but are cautious about countries with strong trade and financial links, or direct economic exposure to Russia and Ukraine. Overall, we prefer countries with easier access to financing, especially those that have strong relationships with multilateral and bilateral lenders. Additionally, we favor high-yield issuers over high-grade issuers, and remain strategically overweight in frontier-market countries where we believe the risk premia compensates for credit risk and volatility.

We believe Latin America, the Middle East, and Africa are relatively well positioned to benefit from higher commodity prices. By contrast, Central and Eastern European countries should be more negatively impacted by higher commodity prices given their greater dependence on commodity imports and geographical proximity to the Russia-Ukraine conflict. In Asia, prospects are clouded by the recent resurface of COVID-related restrictions.

In EM corporate credit—which is a rapidly growing asset class—we believe a combination of differentiated credit fundamentals drivers, favorable technical conditions, and attractive relative valuations should continue to provide ample investment opportunities. Our positions are focused on the commodity; TMT (technology, media, and telecommunications), utility, and financial sectors in Latin America; financials, TMT, and commodities sectors in Central and Eastern Europe, the Middle East, and Africa; and commodities, financials, utilities, and real estate sectors in Asia.

Our highest-conviction overweight and underweight positions are shown in the table below.

Beta-Bucket Approach: Largest Active Positions

To achieve an efficient deployment of our risk budget, we divide the investable EM debt universe into three risk buckets—high-beta countries, medium-beta countries, and low-beta countries.

Beta Segment	OVERWEIGHT	UNDERWEIGHT
HIGH	Nigeria	Kenya
	Ecuador	Mozambique
	Angola	Costa Rica
MEDIUM	Bahrain	Jamaica
	Colombia	Brazil
	Dominican Republic	Armenia
LOW	Romania	Malaysia
	Qatar	Hungary
	Indonesia	Chile

Source: William Blair, as of April 2022. Beta buckets are based on the team's quantitative and qualitative analysis. Beta buckets are provided for illustrative purposes only and are not intended as investment advice or as projections of future returns.

High-Beta Bucket

In the high-beta bucket, our largest overweight positions are in Nigeria, Ecuador, and Angola, and our largest underweight positions are in Kenya, Mozambique, and Costa Rica. Our thinking is as follows:

Nigeria (overweight): We believe the external sector and fiscal balances will benefit from elevated oil prices.

Ecuador (overweight): High oil prices have led to an improvement in the country's credit fundamentals. Although President Guillermo Lasso has recently run into some governability challenges, the dramatic increase in oil prices we've seen during the first quarter has increased our optimism about Ecuador's credit trajectory.

Angola (overweight):

We have confidence in the country's prudent fiscal and monetary policies. Oil prices and stabilized production volumes are also supportive of the external sector.

Kenya (underweight): We believe fundamentals could deteriorate ahead of a possibly contentious election, and valuations are unattractive relative to comparable commodity-exporting countries.

Mozambique (underweight): Fundamentals remain weak while the security situation in the northern region remains fragile. We have, however, become more constructive on the prospects for the development of natural gas projects, given the changing external backdrop and International Monetary Fund (IMF) staff reaching an agreement on a potential program.

Costa Rica (underweight): We moved to an underweight in the first quarter due to relative outperformance of the credit as valuations compressed. First-round presidential election results in February led us to believe there is a strong probability of policy continuity into the next administration. In addition, the IMF program will likely be preserved. However, we no longer see significant upside as valuations reflect the improved outlook.

Medium-Beta Bucket

In the medium-beta bucket, our largest overweight positions are in Bahrain, Colombia, and the Dominican Republic, and our largest underweight positions are in Jamaica, Brazil, and Armenia. Our thinking is as follows:

Bahrain (overweight): Although debt levels are uncomfortably high and growing, we believe that current valuations adequately compensate investors for the risks given the strength of regional support and confirmation of measures announced to reduce the fiscal deficit, most importantly the increase in the value-added tax (VAT) rate.

Colombia (overweight): Valuations price in an overly pessimistic scenario ahead of the primary elections in March, but we believe rising oil prices and declining poll numbers of left-wing presidential candidate Gustavo Petro have led to an improved outlook for the country.

Dominican Republic (overweight): In our opinion, this country is one of the brightest spots in Latin America. The government announced a preliminary estimate of 12% gross domestic product (GDP) growth in 2021 as tourism reopened and vaccination rates remained high. Fiscal deficits are also controlled, and we believe will likely fall below 3% of GDP in the coming years.

Jamaica (underweight): Despite still relatively high debt-to-GDP levels, Jamaica has shown a strong willingness to consolidate its fiscal position. The administration has a strong relationship with the IMF and the country will likely be supported if faced with severe economic hardship. But our underweight position is primarily driven by our preference for shorter-duration bonds.

Brazil (underweight): Brazil has undergone a much needed and very impressive fiscal consolidation under the Bolsonaro administration; however, its fiscal trajectory is unclear if former President Luiz Inácio Lula da Silva wins the election in the fall.

Armenia (underweight): We have concerns about the economic impact caused by the Russia-Ukraine conflict through more limited trade and tourism, the tail risk of a pickup in tensions with Azerbaijan, and poor liquidity in the secondary market of benchmark bonds.

Low-Beta Bucket

In the low-beta bucket, our largest overweight positions are in Romania, Qatar, and Indonesia, and our largest underweight positions are in Malaysia, Hungary, and Chile. Our thinking is as follows:

Romania (overweight): We find valuations attractive in U.S.-dollar-hedged, euro-denominated instruments relative to U.S.-dollar-denominated benchmark bonds and continue to hold overweight positions at levels we find attractive relative to regional peers such as Hungary and Serbia.

Qatar (overweight): Although credit spreads are already tight, we hold an overweight position due to the positive impact of higher energy prices and the most positive fiscal outlook in the region.

Indonesia (overweight): We find quasi-sovereign bond valuations attractive and are overweight the national energy company given its strong financial profile and leading position in Indonesia's energy market. We believe it could benefit from the high-oil-price backdrop despite domestic price controls on retail fuels because the government reimburses the company via subsidies.

Malaysia (underweight): Valuations are unappealing in the typically longer-duration sovereign and quasi-sovereign bonds. The rebound of global growth and strong performance of commodity markets should bode well for an economic recovery, but we believe that the upside has already been fully priced in.

Hungary (underweight): We anticipate an increase in foreign-currency bond issuance, with additional debt supply potentially leading to wider credit spreads and underperformance.

Chile (underweight): We have concerns about the timing of the constitutional referendum process and already tight valuations, which leave less of a cushion should spreads widen.

We will continue to update our thinking around our beta-bucket insights and post updates quarterly.

Marcelo Assalin, CFA, partner, is the head of William Blair's emerging markets debt (EMD) team, on which he also serves as a portfolio manager.

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