Clouds Clearing for Emerging Markets Debt?

July 27, 2022

While the near-term outlook for global economic growth remains clouded by a combination of recession fears, inflationary pressures, and the possibility of faster monetary policy tightening globally, we expect an improvement in investor sentiment during the summer and have recently upgraded our medium-term outlook for emerging markets (EM) debt.

Solid Positioning

The fundamental backdrop remains constructive across EMs despite less favorable near-term fiscal and debt dynamics driven by softer economic conditions.

While there are pockets of fundamental weaknesses, especially among some energy- and food- importing countries, external accounts should remain well supported by high commodity prices in most countries. In addition, real interest-rate levels are significantly higher in EM than they are in advanced economies, supporting local currencies and adding to the positive fundamental landscape.

All things considered, we believe the asset class as a whole is well positioned to withstand a period of weaker global growth.

Compelling Valuations

We also believe EM debt valuations remain compelling on both an absolute and relative basis, with spreads wider than their historical levels. EM sovereign high-yield spreads are particularly compelling relative to U.S. high-yield levels.

In the distressed credit space, we believe current prices are overestimating probabilities of credit events and underestimating potential restructuring and recovery values.

Overall, we believe current valuations overcompensate investors for credit risks and volatility, and EM debt currently offers value to investors with a medium- to long-term horizon and a willingness to tolerate a period of higher volatility.

Elevated Volatility

That said, we believe volatility is likely to remain elevated in the near term because of still-challenging technical market conditions.

While the supply of new debt remains constrained because of declining net refinancing needs, which occurred due to improved fiscal accounts (mainly by oil-exporting countries) and most of the high-yield countries not having market access, the recent pickup in outflows from dedicated EM debt portfolios should continue to pressure bond prices, especially in the context of reduced liquidity during the summer months.

However, we expect outflows to stabilize in the next few months, which—together with lower net debt issuance, reduced long investor positioning, and high investor cash levels—should add to a more positive technical conditions picture in the coming months.

Potential Strategic Opportunities

Although we have been gradually increasing risk exposure, we have not changed the strategic positioning of the portfolios. We continue to favor high-yield issuers over high-grade issuers and remain strategically overweight in higher-yielding frontier-market countries, where we believe the risk premia continue to overcompensate investors for credit risk and volatility.

However, we continue to see scope for fundamental differentiation among countries. We prefer commodity-exporting countries, especially in the energy space, but are cautious about countries with strong trade and financial links to Russia. We also remain cautious about countries with strong dependence on food and energy imports.

We also continue to see opportunities in select distressed debt positions, where we believe bond prices do not reflect realistic assumptions for default risk and recovery values.

Lastly, we continue to prefer countries with easier access to financing, especially those that have strong relationships with multilateral and bilateral lenders.

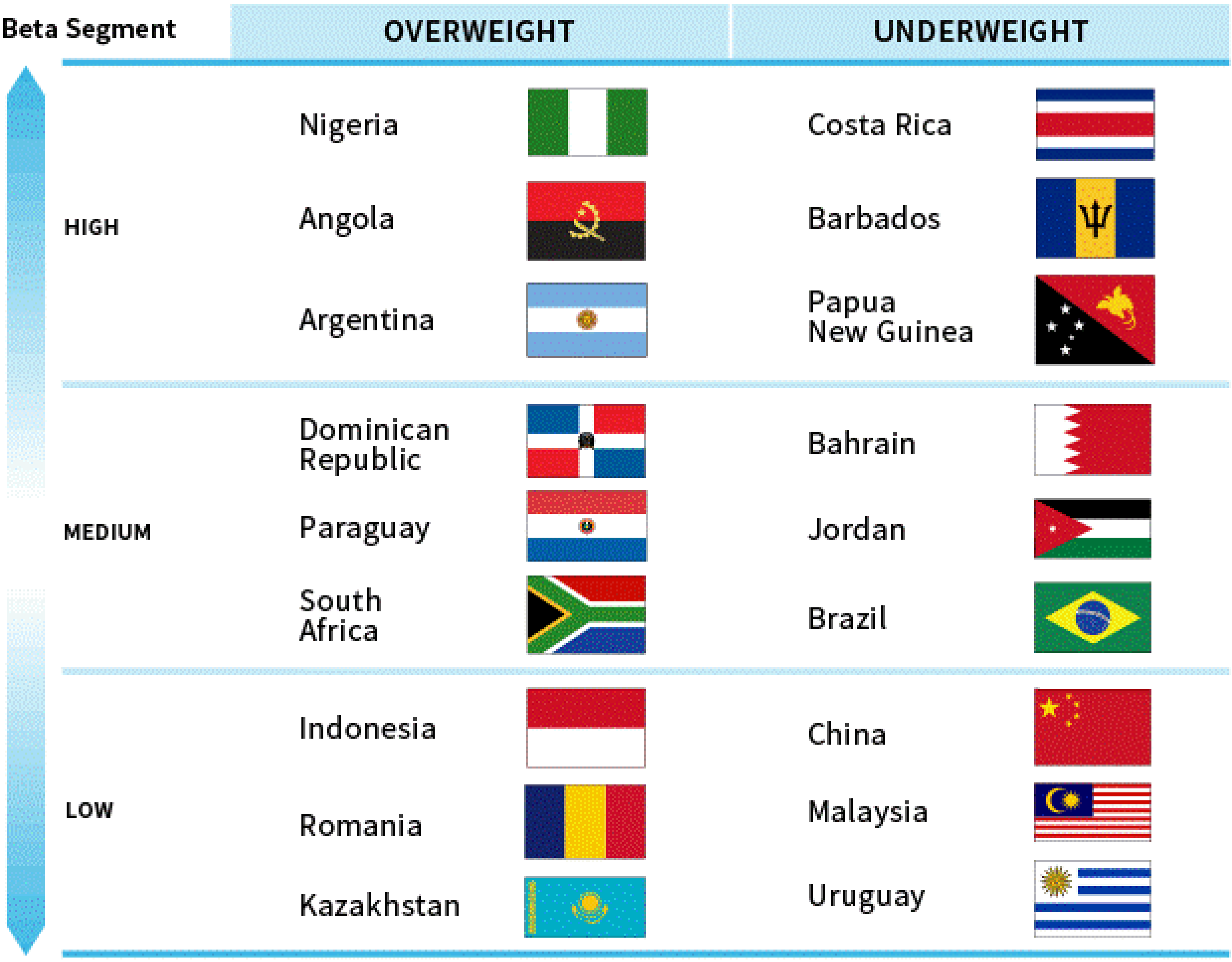
In EM corporate credit—which is a rapidly growing asset class—we believe a combination of differentiated fundamental credit drivers, favorable supply technical conditions, and attractive relative valuations should continue to provide ample investment opportunities. But given uncertainty in the near term, we focus on issuers with low refinancing needs.

In Latin America, our positions are diversified across oil and gas; technology, media, and telecommunications (TMT); utilities; and financials. In Central and Eastern Europe, the Middle East, and Africa, our positions are diversified across oil and gas, financials, and real estate. In Africa, our positions are diversified across oil and gas, financials, utilities, and real estate.

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.



Source: William Blair, as of July 2022. Beta buckets are based on the team's qualitative and quantitative analysis. Risk 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, Angola, and Argentina, and our largest underweight positions are in Costa Rica, Barbados, and Papua New Guinea.

Nigeria (overweight): We believe the external sector should benefit from elevated oil prices and the ratio of debt to gross domestic product (GDP) staying low relative to peers.

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.

Argentina (overweight): We are overweight Argentine provincial bonds due to the stronger fundamentals and more attractive carry.

Costa Rica (underweight): We moved to an underweight in the first quarter due to the credit's relative outperformance, which occurred 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 country's International Monetary Fund (IMF) program will likely be preserved. However, we no longer see significant upside because valuations reflect the improved outlook.

Barbados (underweight): We believe Barbados bonds remain expensive given the high ratio of debt to GDP and the uncertain macroeconomic outlook. In addition, Barbados remains a relatively small part of the J.P. Morgan EMBIGD.

Papua New Guinea (underweight): There is poor liquidity in the country's sovereign bonds. However, general elections are underway and may bring more volatility and potentially better entry opportunities.

Medium-Beta Bucket

In the medium-beta bucket, our largest overweight positions are in the Dominican Republic, Paraguay, and South Africa, and our largest underweight positions are in Bahrain, Jordan, and Brazil.

Dominican Republic (overweight): One of the brightest spots fundamentally within Latin America, the Dominican Republic announced a preliminary estimate of 12% GDP growth in 2021 as tourism reopened and vaccination rates remained high. Fiscal deficits are also under control and will likely fall below 3% of GDP in coming years, in our opinion.

Paraguay (overweight): We like Paraguay's low debt-to-GDP ratio. The country has also shown strong resilience in the past. Despite a drought weighing on growth this year, we believe Paraguay's history of prudent policies will continue to act as a strong anchor and allow a decent recovery in the real economy. We added to our position due to appealing valuations when Paraguayan bonds sold off in late April and early May.

South Africa (overweight): South African sovereign bonds screen inexpensive on our sovereign risk model, and the country's fundamental trajectory was helped by improved terms of trade in the first half of 2022. While South Africa still has serious structural issues, we believe the long-dated bonds are attractive from a risk/reward perspective.

Bahrain (underweight): Although Bahrain's bond valuations are compelling relative to the country's oil peers, we believe spread levels are relatively tight given that debt levels are still high and oil prices have fallen on the weaker global economic outlook that markets are now pricing.

Jordan (underweight): High debt levels and sensitivity to rising food prices and energy prices are concerning. Jordan is also vulnerable because it runs a large current account deficit in an environment of declining international investment.

Brazil (underweight): We reduced our sovereign and corporate positioning due to recent outperformance and concerns about potential jitters ahead of the presidential elections in October. Brazil has undergone a much-needed and impressive fiscal consolidation under the Bolsonaro administration. It is unclear what the fiscal trajectory of the country will look like if former President Lula wins the election in the fall. However, we maintain some corporate exposure in the oil and gas corporate sector.

Low-Beta Bucket

Across the low-beta universe, our largest overweight positions are in Indonesia, Romania, and Kazakhstan, and our largest underweight positions are in China, Malaysia, and Uruguay.

Indonesia (overweight): We find quasi-sovereign bond valuations attractive and are overweight a particular credit in the oil and gas sector given its strong financial profile and leading position in Indonesia's energy market. This issuer could benefit from the high-oil-price backdrop because—despite domestic price controls on retail fuels—the government reimburses the company via subsidies. We also complement our positions in corporate issuers in the metals and mining and financials sectors.

Romania (overweight): We find valuations attractive in U.S.-dollar-hedged, euro-denominated instruments relative to U.S.-dollar-denominated benchmark bonds. We continue to hold overweight positions at levels we find attractive relative to regional peers such as Hungary and Poland. The majority of Romania's Eurobond issuance has also been completed, leaving us less concerned about supply overhang.

Kazakhstan (overweight): Strong fundamentals and high oil prices should help support the country's bonds in the coming months. Pipeline closures are expected to be temporary. Constitutional changes should also prove positive in the effort to promote economic reforms.

China (underweight): We are underweight sovereign bonds and overweight corporate bonds. With COVID-related restrictions easing, nascent signs of housing sales picking up, and an expected rise in infrastructure spending, we believe the Chinese economy will gradually recover, supporting Chinese corporate credits over sovereign bonds.

Malaysia (underweight): Valuations are unappealing in 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.

Uruguay (underweight): We believe most bond valuations remain too tight and dollar prices too high. While Uruguay remains on an improving credit trajectory, we believe there is limited upside.

Marco Ruijer, CFA, is a hard currency portfolio manager on William Blair's emerging markets debt (EMD) 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.