The Case for Frontier Markets Debt in a Post-Pandemic World

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While frontier markets' youthful and rural populations at times muted COVID-19 case rates, the impact of the pandemic has nevertheless been significant.

These small, open economies faced the combination of an external shock (affecting trade in goods and services, but also foreign capital flows) and a domestic shock (with the slowdown in economic activity affecting the income of households, businesses, and thus that of the government).

The impact has been particularly severe on economies that rely heavily on tourism—and the slow resumption of global travel suggests that recovery will be slow for these markets.

But there are many factors that make us believe the investment case is compelling for this growing segment of the emerging markets (EM) debt universe.

Growth of the Frontier

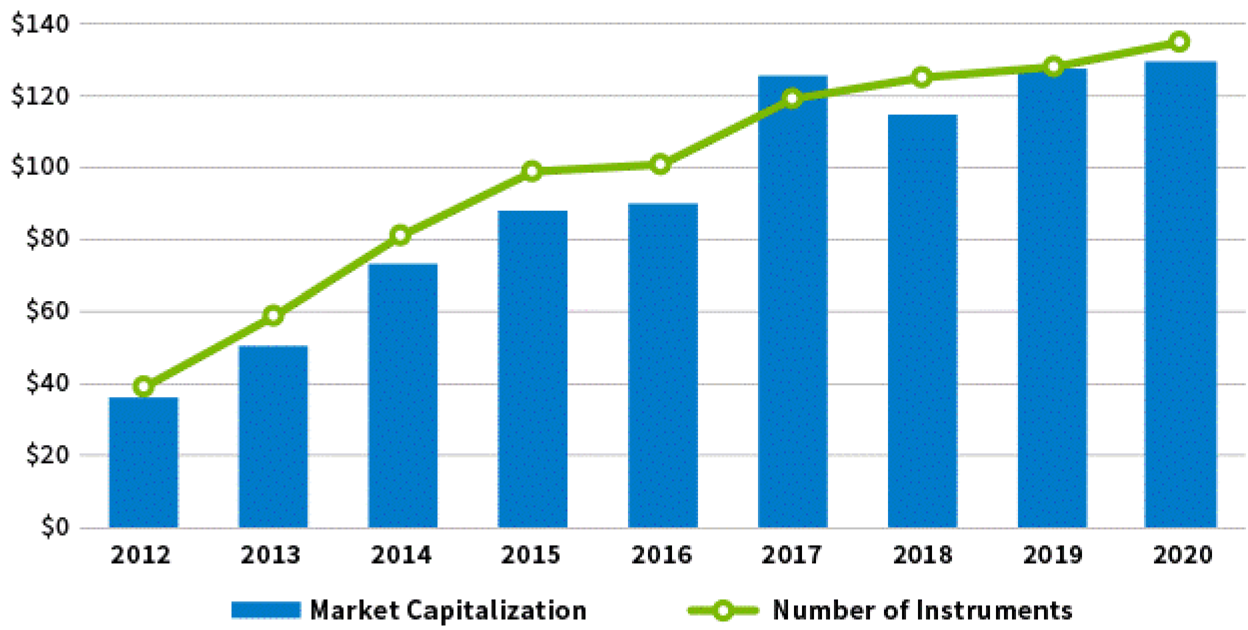
Frontier markets are part of the hard currency sovereign benchmarks that underpin allocations to EM debt, including the J.P. Morgan Emerging Markets Bond Index Global Diversified (EMBI-GD), which represents the hard currency universe with 74 issuing countries.

To be a part of the frontier markets debt benchmark—the frontier-focused J.P. Morgan Next Generation Markets

(NEXGEM) Index—countries must be geographically part of the developing world and generally rated well below investment grade. Specifically, they must be less than 2% of the weight of the J.P. Morgan EMBI-GD for 12 months; must have less than a BB+ rating; and may not be a member of the European Union (EU). Of the 74 countries in the J.P. Morgan EMBI-GD, 36 are also in the frontier-focused NEXGEM Index.

More and more frontier markets have entered this space over the past decade, as evidenced by the increasing number of debut issuers and the growth in the asset class, particularly in the five years leading up to 2015. This allowed the asset class to become increasingly diversified.

Strong Growth of Frontier Asset Class (2012-2020)



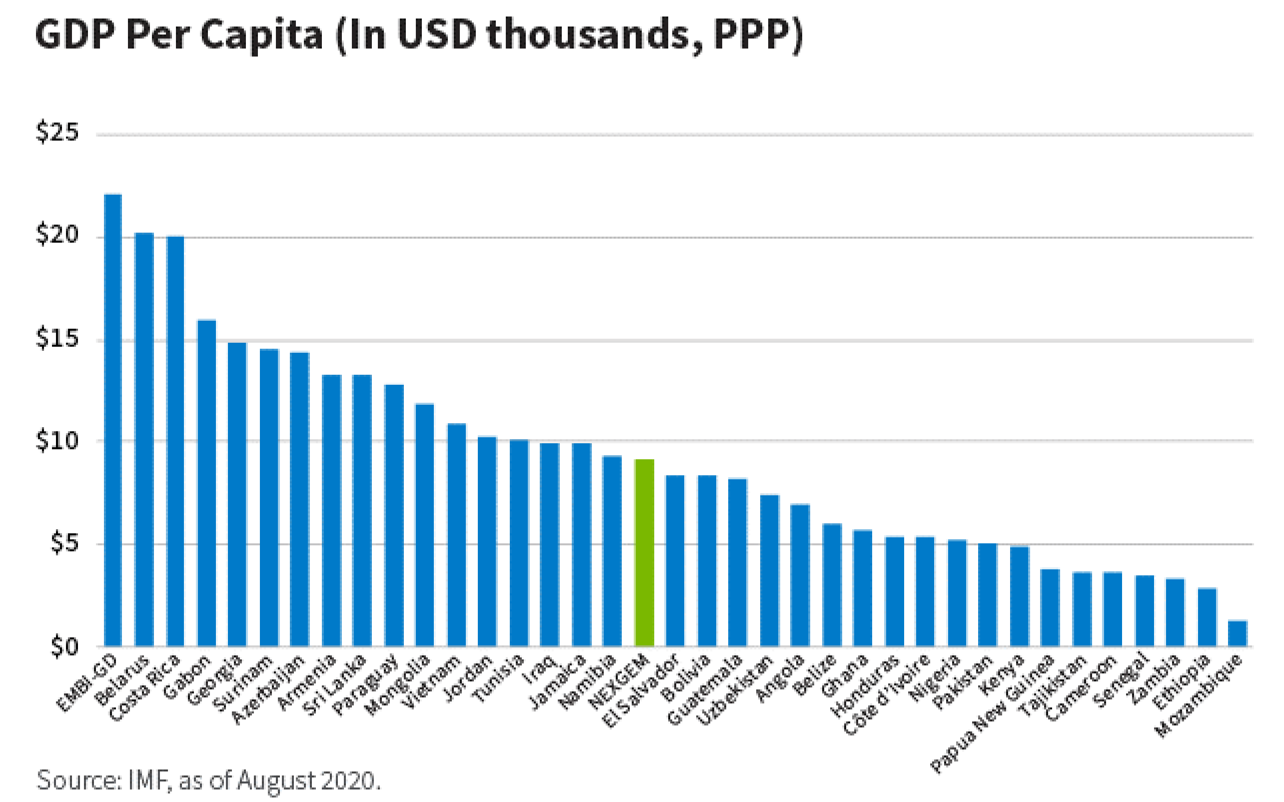
Sources: J.P. Morgan and William Blair, as of May 2021.

The same can be said for the local currency space, with frontier markets forming an important source of alpha in EM local currency strategies. The opportunity set in this space is growing as an increasing number of local currency markets have become accessible to foreign investors with the external issuance playing a role in accelerating the development of capital markets.

As my colleague Marcelo Assalin explained in "5 Differentiators in Emerging Markets Debt," we tend to overweight frontier markets because we believe the risk premium there is structurally mispriced.

Pinpointing the Opportunity

The pandemic caused severe global disruption, and frontier markets were no exception. The loss of revenue and increased expenditure burden across frontier markets have been particularly challenging in light of the large developmental challenges already faced by low- and lower-middle-income countries. Frontier markets have an average per-capita gross domestic product (GDP) of $9,100 (on a purchasing power basis), but there is significant divergence across markets.



Still, while growth fell sharply in 2020, most countries managed to achieve positive growth in 2020 on the back of shorter/less severe restrictions.

The strong rebound in developed market growth, along with the precipitous rise in commodity prices, suggests a very supportive backdrop for frontier markets. The considerable rise in energy and metal prices has allowed for much better terms of trade, especially among exporters such as Angola, Ghana, and Zambia

Against this backdrop, it will be critical for governments to stabilize their debt levels in years to come. We saw sharp growth in indebtedness beginning well before COVID-19, but it was exacerbated by the loss to revenues and increase in expenditures in response to the pandemic.

Over the past year, the market has priced an exceptional increase in perceived default risk across frontier markets. This has led to the emergence of distressed prices across numerous frontier markets. However, most frontier markets weathered this storm well and, in our view, continue to do so amid challenging circumstances. Generally speaking, these countries remain focused on prudent debt-management strategies and maintaining access to international capital markets as a complementary source of financing.

Looking at Pakistan's debt, for example, 65% is issued domestically and 17% is raised externally from multilateral financial institutions. This demonstrates that domestic markets and development partners are, and should remain, the most important source of funding for these markets. Even in Angola, where public debt is largely external and the country has borrowed more on commercial terms, development partners will offer critical support to meeting financing requirements over the medium term.

Analyzing the composition and sources of public debt is important in understanding the willingness and ability of a country to repay its debt. The ability to raise finances in domestic currency and rely on financing from development partners, are, in our view, mitigating factors when considering debt sustainability risks.

Still, while our analysis of a country's financial flows is critical, so too is understanding the myriad nonfinancial factors (often of socioeconomic and political) that drive a country's willingness to pay. These include social and environmental dynamics. Therefore, what is now coined as environmental, social, and governance (ESG) integration, we believe, has long been a critical part of our investment process.

Fundamental Backdrop Supportive

While it is clear that there are significant development challenges in frontier markets, we believe the fundamental backdrop remains supportive of their ability to service their debt.

We believe three sources of financing will offer significant support to frontier markets in the short to medium term.

First, the allocation of funds by the International Monetary Fund (IMF) to all member countries could help frontier markets—although it matters more to small economies. There is further upside if steps follow from a mechanism to redistribute Special Drawing Right (SDR) allocations from developed markets to lower-income countries. In other words, all IMF members will receive funds, but the IMF is looking for ways that countries such as the United States can use their allocations to help countries that are in greater need of liquidity.

Second, economic reform packages could be implemented with notable effort to further cement macroeconomic stability under IMF programs.

Lastly, debt servicing suspension by bilateral and multilateral partners likely offers liquidity relief to low-income countries. International capital markets are participating in liability management exercises that reduce the interest burden and refinancing risk.

Concerns for widespread application of the Group of Twenty (G20) common framework and the associated participation of the private sector in debt restructuring have proved overstated, with concerns limited to very select cases.

Overall, a supportive external backdrop, resilient fundamentals, and continued focus on macroeconomic reform (including debt sustainability and financial flows to frontier markets) bode well for this asset class, in our opinion.

Given this, valuations are even more striking. Frontier market valuations are, in our view, attractive across hard currency debt, and notably so when contrasted to high-yield corporate spreads in many developed markets.

Lastly, frontier markets have offered strong risk-adjusted returns, as evidenced by Sharpe ratios and yield adjusted by default and recovery rates. And defaults in frontier markets have been low over the past 20 years. The frontier-focused J.P. Morgan Next Generation Markets Index has a historical default rate of approximately 1.5% annualized—slightly higher than the 1% of the focused J.P. Morgan EMBI-GD, but it compensates investors with a higher carry.

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Sharpe ratio is a measure of risk-adjusted return. It describes how much excess return you receive for the volatility of holding a riskier asset.

Disclosure:

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