Ninety One

Previously Investec Asset Management

EM Debt in the COVID era

A fundamental asset-class assessment

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We are an independent, active global asset manager dedicated to delivering compelling outcomes for our clients.

Since we started in '91 in an emerging market, we learned the importance of recognising and embracing change and uncertainty. It's taught us that active investing can be a force for good. It's also given us a different perspective on the issues that matter – from how we invest sustainably, to the major thematic and structural challenges facing investors. Today we offer distinctive investment strategies spanning equities, fixed income, multi-asset and alternatives to help institutional investors, those advising others and individuals navigate an ever-changing world. Our corporate structure ensures employees are stakeholders in the firm and with our founding leadership still in place, we are well positioned to offer stability and a long-term outlook for our clients.

We focus on where we can make a real difference for our clients. We work with clients based all over the world who have entrusted us to manage US$128.2 billion in assets (as at 31.03.20).

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Investment involves risk; losses may be made.

Contents

The fast view

- **Emerging market (EM) fundamentals are solid, overall.** They are well placed not only to weather the global crisis, but to maintain faster growth than developed markets (DMs) through the COVID era and beyond, in our view.
- **Predictions of doom for EM fail to appreciate how the asset class has come of age in recent years.** Monetary policies are credible, inflation is subdued, and debts are significantly lower than in DMs and appear sustainable.
- **Global trade fears are often overblown.** Deglobalisation, to the extent it is actually happening, is less of a threat to EMs than many realise, given increasing regionalisation and rising consumption across the developing world.
- **The EM universe is diverse, and the COVID era is widening the gaps between the strongest and weakest nations.** A selective investment approach and active management will be key to tap the opportunity.
- **We think this is an attractive entry point for the asset class.** We expect EM debt to continue to offer a valuable yield pick-up versus debt in DM, and we believe valuations look attractive in both local and hard currency debt. But, again, selectivity will be key.

Introduction

Introduction

The pandemic has sparked some doom-laden predictions about EM economies. To assess their ability to weather the COVID-19 storm, we take a deep dive into EM fundamentals from a fixed income investor's perspective.

Although the coronavirus struck at the end of a challenging decade – with the developing world buffeted by China's slowdown, a reversal in capital flows and political headwinds in some key markets – EM entered the COVID crisis in resilient shape.

Consequently, we believe this global crisis will have a negligible longer-run impact for most EMs. In fact, as the world emerges from the COVID recession, we think these markets will be well positioned to benefit from the recovery in a low-yielding world.

However, the gaps between the strongest emerging nations and the weakest are widening. While we expect EM overall to outperform developed nations, investors will need to take a careful and selective approach to building an EM debt portfolio.

> We think emerging markets will be well positioned to benefit from the recovery

Fundamental resilience, but a widening gap between winners and losers

Those anticipating that emerging economies will collapse overlook how the developing world has progressed in the past decade. We expect EMs to maintain faster growth than developed nations during the coronavirus crisis and beyond.

As we discussed last year in 'Emerging markets: cycles past and future', EM debt has come of age as an asset class. In this section, we examine what EMs' recent development history tells us about how they may perform, and why this global crisis is likely to be different.

Fundament
but a wider

Emerging markets are hardy and likely to outgrow developed markets

As recently as the 1990s, swathes of EMs were under Marxist socio-economic models or right-wing military dictatorships, with serious civil conflict in some countries. But after the collapse of the USSR and as China moved towards a market economy, EMs entered an unprecedented period of growth, underpinned by improved governance, regulatory reform and the expansion of global trade. At the same time, their growth became much less volatile. Today, these markets account for about 40% of global GDP, up from 20% in 1980[1].

Much of the catch-up to DMs is due to China's rise and its continued role as the global growth engine – specifically, as a large net importer of raw materials and goods, and a net exporter of manufactured output. While global trade remains intrinsically linked to EM growth, it is important to note that EMs now account for 40% of global consumption. This makes them less dependent on trade with the rest of the world and gives them a greater ability to generate their own economic weather. Moreover, the stronger governance and supportive policy direction, which have been crucial in sustaining EM growth, remain largely in place.

The past decade has not been easy for many EMs. Following the 2008/9 Global Financial Crisis (GFC), their growth slowed as China's expansion naturally eased from the 10%+ annual rate it maintained in the early to mid-2000s. In 2013, the 'Taper Tantrum' exposed a reliance on dollar liquidity among many EMs, causing some painful but required adjustments in their credit growth and current accounts. More recently, the current White House administration's protectionist agenda has hindered global trade and further weakened EM expansion. Yet even in this more difficult period, these markets have outgrown their developed world peers, as Figures 1 and 2 show.

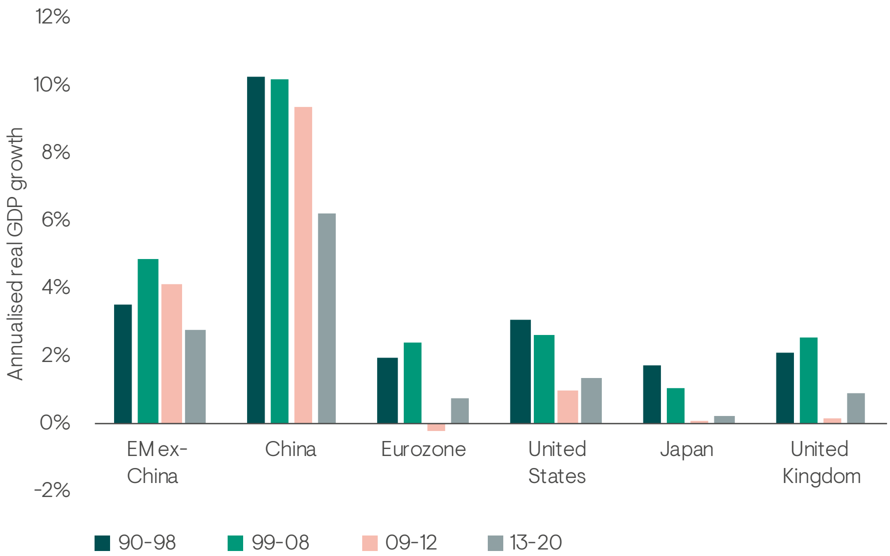
> The stronger governance and supportive policy direction, which have been crucial in sustaining emerging markets growth, remain largely in place

1. In PPP terms, EM is actually 56% of global GDP. Source: IMF, World Economic Outlook, April 2020.

In the near to medium term, the full effect of COVID-19 on EM growth is unclear, but we already know that the pandemic's impact is unprecedented in the modern era. However, given EMs' better demographics (their younger populations are less at risk) and the fact that EM economies were not locked down to the same degree as developed ones, the hit to EM growth will likely be relatively modest. Indeed, IMF projections suggest the EM/DM growth differential will increase this year to its widest level since the GFC[2].

Looking further ahead, the key drivers of EM growth are intact. After a long period of reform and adjustment, EMs are pursuing orthodox macroeconomic policies on the whole; they have competitive labour and exchange rates; and their workforces are increasingly educated. These factors underpin the higher potential growth and productivity across EMs compared with DMs.

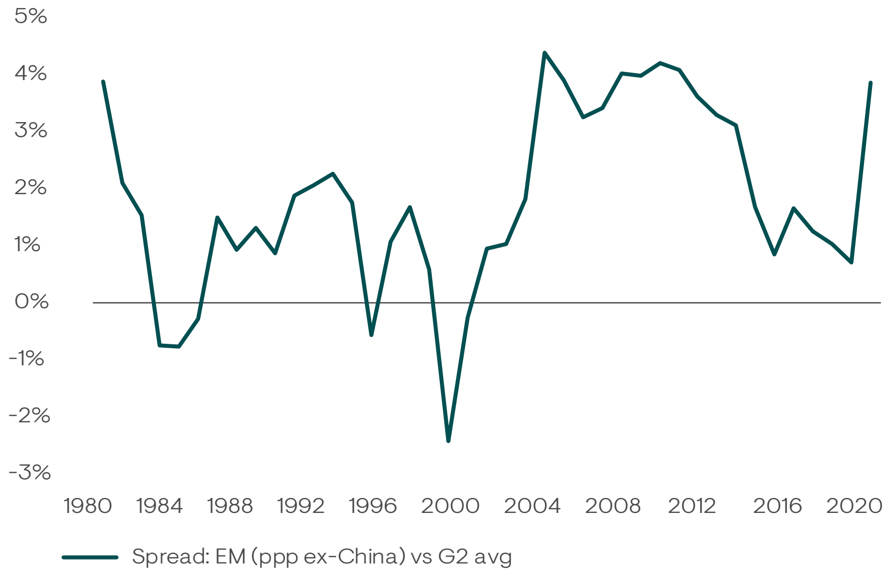
Figure 1: EM growth superior but it has slowed over the last decade



Source: Ninety One, Haver Analytics, Bloomberg, June 2020.

2. Source: IMF, World Economic Outlook, April 2020.

Figure 2: The EM growth premium over DM remains intact



Source: Ninety One, Haver Analytics, Bloomberg, June 2020.

Insulated from the threat of deglobalisation

Aside from the coronavirus, the biggest risk to EM growth at present is the re-escalation of the US-China trade dispute, and rising protectionism more broadly. But we see low risk of a widespread balance-of-payments crisis across EMs. Their current accounts are generally strong, as Figure 3 shows. And on average, emerging nations have more-than-sufficient reserves to avoid a balance-of-payments problem if global trade deteriorates. In Figure 4 we can see that on average, emerging economies are maintaining reserves equivalent to 140% of the IMF's reserve adequacy measure.

In any case, it is far from a foregone conclusion that deglobalisation, to the extent it is actually happening, will be bad for EMs. In this work-from-home world, it is clearer than ever how interconnected the global economy is, and how difficult those links will be to disentangle. Globalisation of services at least seems, if anything, more likely to accelerate from here. Furthermore, increasing regionalisation should help to insulate some emerging economies from global trade frictions. Indeed, south-south trade flows (i.e., developing economies' trade with each other) has more than doubled in the past decade[3]. Finally, it is far from impossible that the protectionist trend of recent years could be reversed. A victory for the Democratic Party in the 2020 US presidential election would likely herald a return towards more orthodoxy in US policy both domestically, internationally and in foreign trade, even though tensions with China are likely to remain.

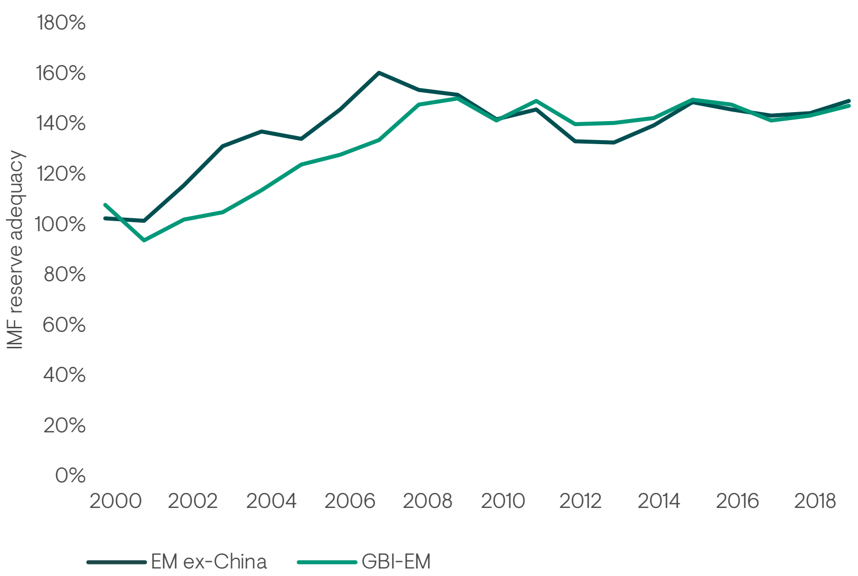
3. Source: McKinsey, 2015.

Among other important risks, the sustainability agenda will be particularly key in this next phase of EM growth, and investors need to keep a close eye on national policies and progress towards sustainability goals (or lack thereof). Environmental threats are rising, requiring prudent expenditure on climate adaptation measures and the energy transition to help mitigate them. This topic merits deeper analysis that we have space for here: for a detailed discussion on assessing sustainability-related risks at the country level, please see our recent paper.

Figure 3: EM current account balances are generally strong

Source: Ninety One, Haver Analytics, Bloomberg, June 2020.

Figure 4: EM reserve adequacy remains robust on the whole



Source: Ninety One, Haver Analytics, Bloomberg, June 2020. EM ex-China: GBI-EM: JP Morgan GBI-EM. For further information on indices please see Important information section.

Capital flows: mixed picture near-term, but a much more attractive picture further out

EMs' substantial reserves were accumulated partly thanks to strong flows of foreign direct investment (FDI). However, FDI has stalled in recent years as EM productivity has slowed and the rise in protectionism has weighed on international companies' investment plans.

The outlook for capital flows to EMs is mixed. COVID-19 led to significant financial outflows in the first few months of 2020, which have only marginally reversed, and the disease continues to disrupt supply chains and other cross-border flows (remittances, tourism, etc.).

However, on the whole these are transitory factors and we would expect flows to pick up again as the global economy begins to recover, for reasons including the following:

1. EM currencies remain at multi-decade lows, which should facilitate exports, and inward financial flows.
2. As noted earlier, we expect EMs to continue to outgrow DMs; faster growth tends to drive capital inflows.
3. International investors are structurally underweight EMs. With such slim yields on offer in DMs, institutional investors will be tempted to correct this imbalance in their portfolios.
4. Fixed income benchmarks are evolving to include more debt EMs, for instance China and also smaller frontier markets as they come of age, driving further inflows into the asset class.

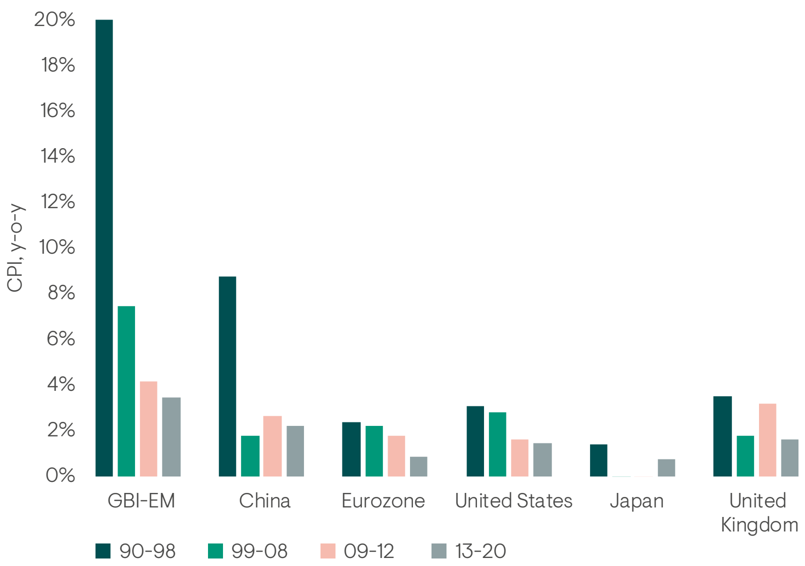
Inflation is typically stable, thanks to credible monetary policies

Another reason that EMs are more resilient today is that inflation is mostly under control. From the 1990s onwards, improved governance and a move towards independent central banking and inflation-targeting have led to a structural decline in inflation across EMs, from 25% in that decade to less than 4% in recent years. Inflation has also become less volatile, partly because emerging central banks have earned credibility - both domestically and internationally - allowing them to anchor inflation expectations[4].

There is, of course, differentiation within the asset class. Inflation has been rampant in Turkey, for example, where the central bank – under the thumb of the government – has failed to control it. But such instances are the exception.

With inflation largely subdued, the average policy interest rate across EMs has reduced from above 20% in the 1990s to around 5% over the last few years. This has allowed real rates to fall significantly. But they remain positive, unlike in DMs where real yields have been negative for the last decade. This trend is likely to persist in the aftermath of COVID-19, with the added debt burden in DMs increasing the pressure on them to keep nominal yields low. As the chart below shows, EMs continue to have attractive nominal rates relative to their developed peers.

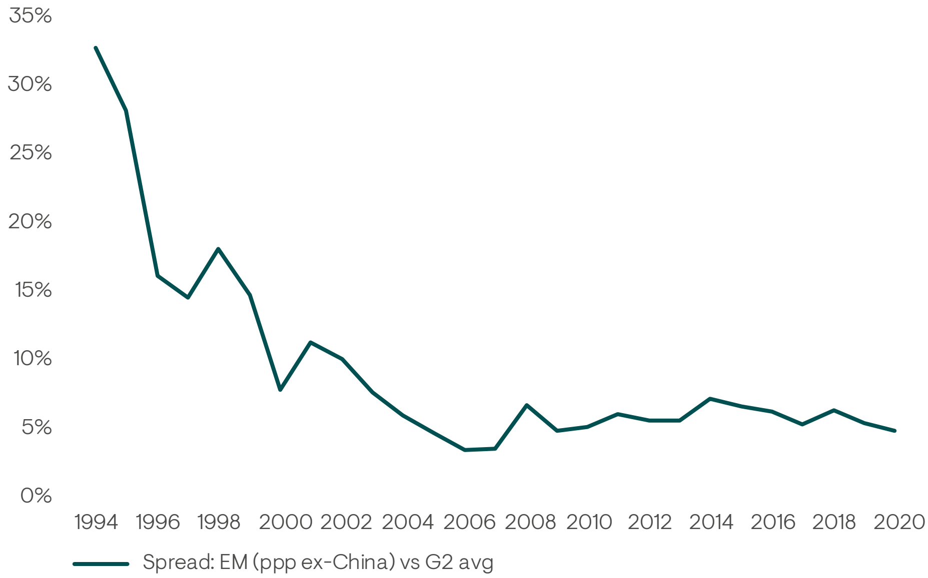
Figure 5: Credible monetary policy has suppressed inflation



Source: Ninety One, Haver Analytics, Bloomberg.

4. Source: R. Sousa and J. Yetman, Inflation expectations and monetary policy (BIS Papers No 89, 2017).

Figure 6: Nominal policy rates



Source: Ninety One, Haver Analytics, Bloomberg.

Debt levels are manageable and should remain much lower than in developed markets

A common concern is whether emerging nations' debts are sustainable. It is certainly true that debt everywhere is on an upward trend. From a long-term cyclical low, over the last 20 years global borrowing has been pushed up by the GFC and now by COVID-19[5].

While EM debt has grown significantly – the total EM marketable debt stock has increased by 15% a year since 2000 and now stands at US$26 trillion[6] – EMs' debt burden is manageable, in our view, and significantly lower than that of developed countries. This is especially true if one excludes China, which has a debt/GDP ratio of over 250% due to substantial local government and corporate borrowing. Leaving out China, government, household and corporate debt is much lower on average across EMs.

Government borrowing was already on an upward trend globally: in the US due to the current administration's fiscal stimulus; and in EMs due to slowing growth, particularly since the commodity boom faded and public deficits widened in response. Deficits will balloon this year in EM and DM, as COVID-19 hits both the revenue (lower tax intake) and expenditure (higher social spending) sides of government ledgers.

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5. For more details on bond market developments over the long-term we recommend reading Reinhart, CM., The curious case of the missing defaults. J. Int. Money Fin. (2018).
6. Source: Bank of America Securities, EMD Primer, July 2020.

The IMF estimates that the US debt/GDP ratio will rise by about 20% to 131% this year, while the EU will see a 13% rise to almost 100%[7]. EMs are expected to see a more modest increase, due to their stronger growth and better fiscal balances. The GBI-EM weighted debt/GDP ratio is forecast to increase from 47% to a still-manageable 57%. As our colleagues have argued in a recent paper[8], DMs will likely be forced into a sustained period of financial repression to reduce their larger debt burdens, a fate that EMs should be able to avoid.

Even so, debt sustainability is going to be a key risk worldwide. While the average EM debt is modest, individual countries such as Brazil will have sizeable burdens, and more vulnerable markets (especially those with large external debt liabilities) may find their debt trajectories unsustainable. In the last 12 months, for instance, Lebanon and Ecuador have defaulted and entered debt restructuring with creditors.

The risks for investors are somewhat mitigated by the sizeable IMF support for weaker countries, as well as the increased momentum towards granting relief on non-commercial and bilateral debt. External risks are further ameliorated by the fact that domestic debt makes up an increasing share of the tradeable EM debt universe, at around 85% of the total[9]. However, as we explore below, risk profiles vary across the EM country group, and are higher in particular in the long-tail of frontier names.

An increasingly diverse picture

As we suggested earlier, fundamentals may be solid for emerging nations overall, but there is significant variation within the country group. As Figures 7 and 8 show, debt/GDP ratios range from well over 100% in Brazil to about 20% in Russia. Against this backdrop, and with the gaps widening as COVID-19 puts the global economy under heavy strain, bottom-up investing will be key.

It is crucial to dig into the fundamentals and policy drivers in each country. Taking the two highest debt/GDP ratios in Figure 8, we see a significant variance between the outlooks for Brazil and Egypt. The latter, which is participating in an IMF programme at present, may have an 80% debt/GDP ratio, but it is taking appropriate measures to maintain stability and position for a recovery, in our view. Having absorbed huge outflows from its capital account during the height of the crisis, money is now flowing back in. In contrast, we are concerned about the debt burden in Brazil, which at the time of writing continues to suffer badly from the pandemic. In short, we think it is crucial for investors to focus on countries that are managing their finances and economies well, and that are best placed to emerge strongly from the COVID crisis.

7. Source: IMF Fiscal monitor, April 2020.
8. https://ninetyone.com/-/media/documents/insights/91-institute-great-shutdown-dealing-with-the-debt-burden.pdf
9. Source: Bank of America Securities, EMD Primer, July 2020.

Figure 7: Large fiscal deficits in some markets

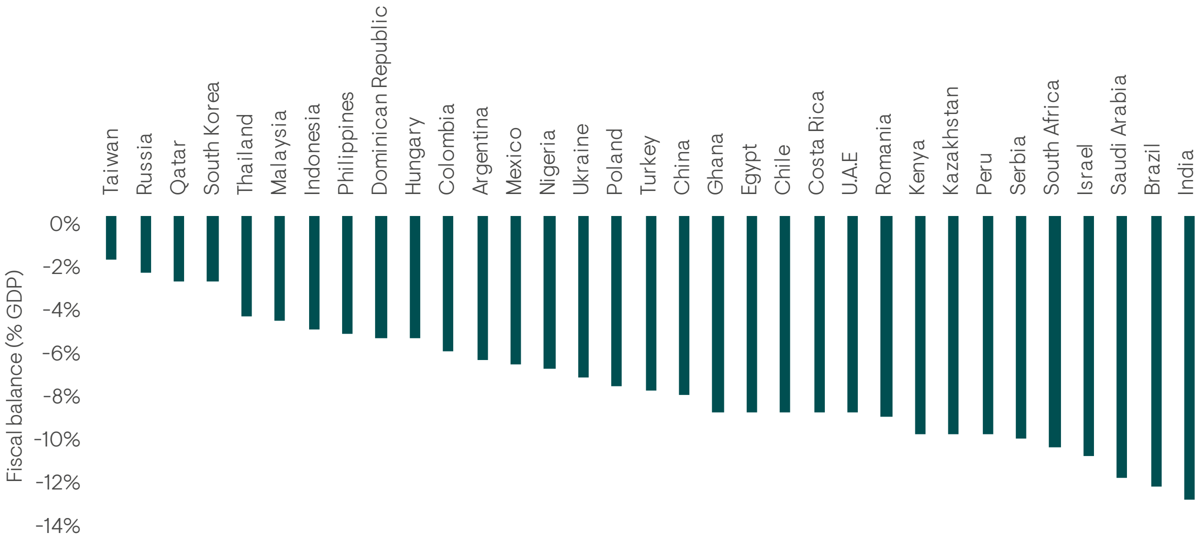
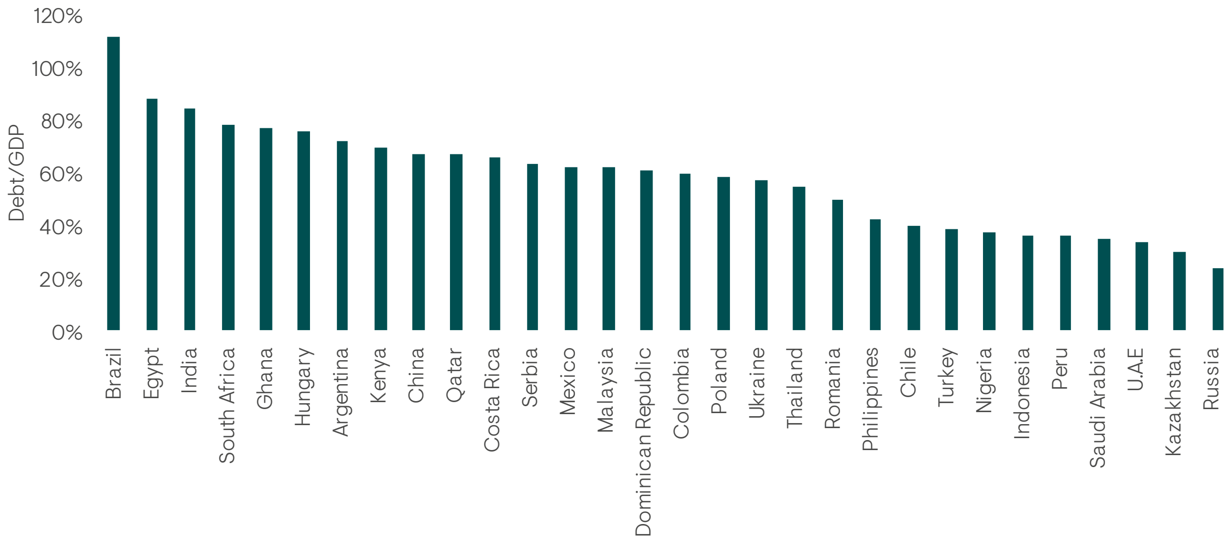
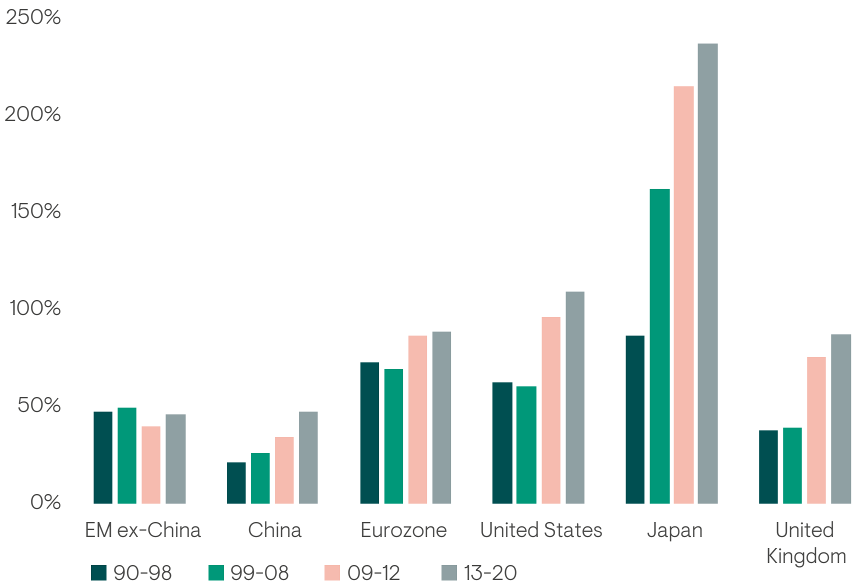


Figure 8: Fiscal deficits exacerbate the divergence in debt/GDP levels



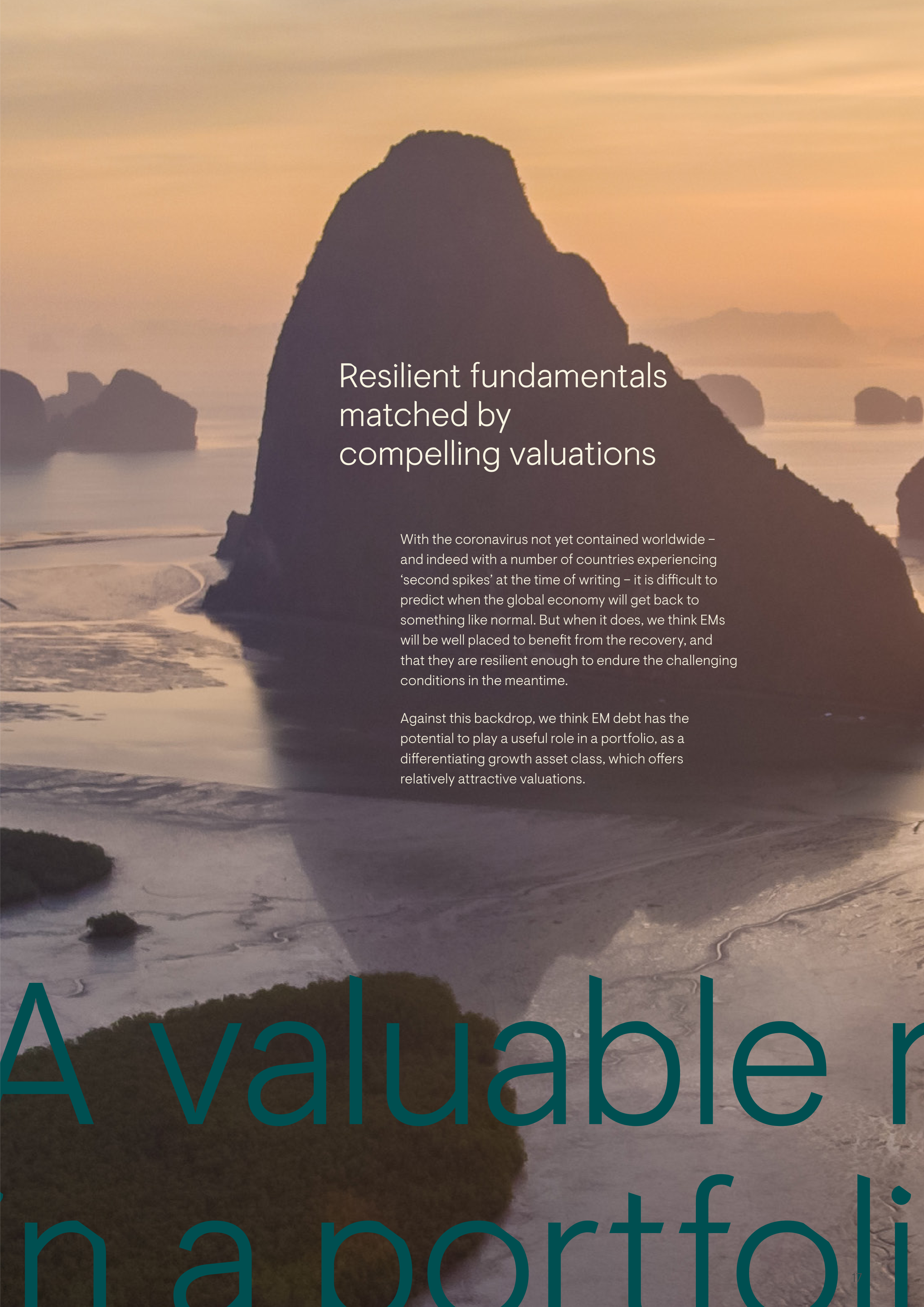
Source for Figure 7 and Figure 8: Ninety One analyst forecasts, as at July 2020.

Figure 9: Debt-to-GDP ratio



Source: IMF, Haver Analytics.

> Fundamentals may be solid for emerging nations overall, but there is significant variation



Resilient fundamentals matched by compelling valuations

With the coronavirus not yet contained worldwide – and indeed with a number of countries experiencing 'second spikes' at the time of writing – it is difficult to predict when the global economy will get back to something like normal. But when it does, we think EMs will be well placed to benefit from the recovery, and that they are resilient enough to endure the challenging conditions in the meantime.

Against this backdrop, we think EM debt has the potential to play a useful role in a portfolio, as a differentiating growth asset class, which offers relatively attractive valuations.

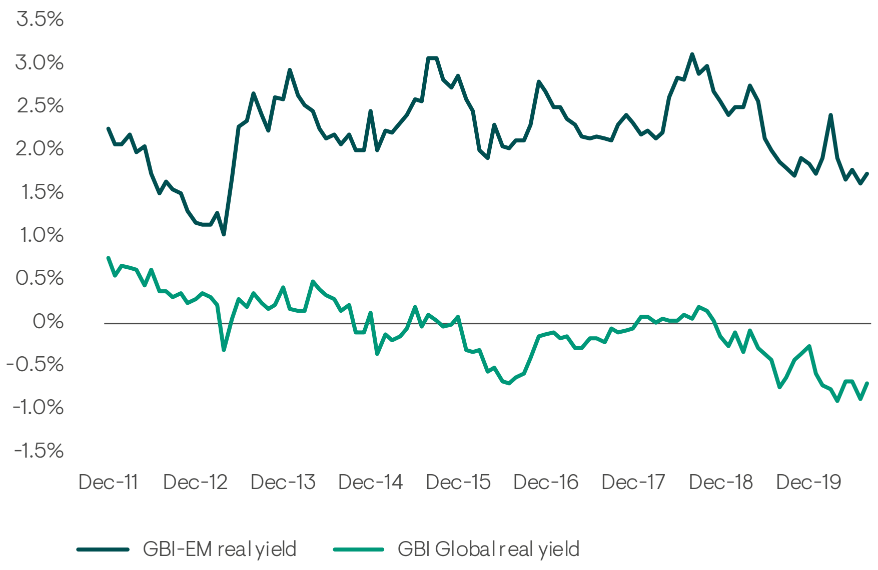
A valuable r
n a portfoli

In a low-yield world, we expect EM debt to continue to offer a significant yield premium to DM debt – not least because, as we mentioned earlier, DMs will likely be forced into a prolonged period of financial repression to manage their heavy debt burdens. Globally, there is now US$33 trillion of debt yielding less than 0.5%, which is inadequate for many pensions, insurers and other investors. As investors are looking for fixed income assets that offer more substantive yield, we expect flows to increase towards EM, further underpinning asset prices.

As we noted briefly earlier, EM currencies are at a multi-decade low valuations. To us, that suggests this may be an attractive entry point to local-currency debt. Overall, local currency bonds offer a significant yield pick-up relative to DM debt, with real yields looking particularly attractive in the high-yield space, as shown in Figure 10. After several years of disappointing returns in EM currencies, we believe investors have only very modest exposure to the asset class. We expect this to change in coming years as the cycle turns.

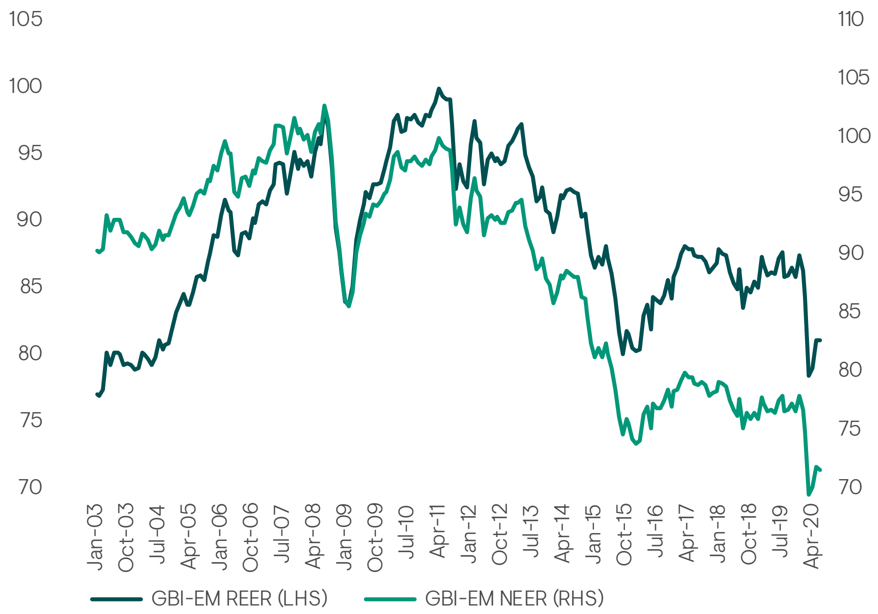
EM hard currency debt, both in corporates and sovereigns, continues to offer a meaningful yield pick-up relative to spreads on DM debt, particularly relative to US high yield. We believe these spreads over-compensate for the risks, given the fundamental outlook we have pictured above.

Figure 10: EM vs US real yields



Source: Bloomberg, Haver Analytics. 1 January 2011 to 31 May 2020. For further information on indices, please see the Important information section.

Figure 11: Nominal and real effective exchange rate (GBI-EM weighted)



Source: Bloomberg, Haver Analytics.; 31 January 2003 to 30 June 2020. REER: inflation-adjusted currency valuations. inflation-adjusted currency valuations. For further information on indices, please see the Important information section.

Conclusion

In our view, the fundamental case for EM debt is solid:

- We expect EM economies to continue to outgrow their developed peers through the COVID era and beyond
- Monetary policies are credible on the whole, allowing for controlled inflation and the gradual moderation of real interest rates over time; EM rates remain significantly higher than DM rates
- We think EM debt levels will remain manageable on the whole, and significantly below those of DMs
- EMs are resilient to external shocks, with cheap EM currencies facilitating exports and inward financial flows

We believe that valuations on EM debt are compelling:

- EM local yields offer a compelling pick-up in both nominal and real terms
- EM currencies are at multi-decade lows and the US dollar is structurally overvalued
- EM credit spreads offer an attractive pick-up relative to DM credit markets

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