Dispelling the myths around emerging market debt

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At a glance

- Today's emerging markets bear little resemblance to those that were rocked by financial crises in the 1980s and 1990s, with the asset class diversified across geography, investment grade, high yield, sovereigns and corporates
- With the JP Morgan EMBI Global Diversified Index yielding 8%, and central banks set to ease policy rates, we believe there are good opportunities
- Columbia Threadneedle Investments has a dedicated team of 22 emerging market investment professionals seeking to unearth the best investment ideas via an active management research-driven approach

Things in emerging markets are not always what they seem. In December 2023, Argentina elected as president Javier Milei, a rabble-rousing populist fond of brandishing a chainsaw on the campaign trail. Milei had a radical agenda, including dollarising the economy and abolishing the central bank – just the kind of policies that alarm investors.

In the event, his actions have been surprisingly market friendly. Since coming to power he has devalued the Argentinean peso and cut transport and energy subsidies. He has even earned the praise of the International Monetary Fund (IMF).

Milei may yet prove to be the market's bogeyman. But reckless policymaking in the main emerging market economies is now the exception rather than the rule. The perception that emerging markets have not moved on much since the 1980s and 1990s, when financial crises rocked Latin American and Asian countries leaving some unable to service their debts, is an outmoded one. In the past 30 years many emerging market (EM) governments have adopted institutional frameworks that guarantee prudent macroeconomic policy and contain imbalances. Sovereign defaults do occur, but in a small minority of a large and diverse investment universe.

Indeed, at a time when emerging markets fixed income is an attractive asset class with attractive yields, outdated perceptions are in danger of holding investors back. We think three myths in particular need dispelling.

The three myths

Myth 1: Emerging markets are generally economic "basket cases"

Most major EM economies now boast stable rates of growth underpinned by orthodox policy frameworks. Many have embraced central bank independence, inflation-targeting monetary policy and fiscal rules.

Of the rest, several have shown that even persistent offenders can sometimes seek redemption. Take Turkey, which has endured years of very high inflation. President Erdogan opposed raising policy rates to tackle price pressure, claiming that higher rates were themselves inflationary. Yet in the past year Turkey's central bank has raised rates nine times, by a total of more than 400 basis points. Interest rates are now 50% and inflation is at 75%[1]. Everything is relative, but Turkish policy appears to be moving in the right direction.

As Argentina and Turkey show, there is no single EM "story". The EM hard currency fixed income universe comprises more than 70 countries, all with their own idiosyncratic circumstances. We believe there is the opportunity, via active management, to build a diversified portfolio while minimising potential tail risk events

Myth 2: Emerging market bonds are mainly junk

Nothing could be further from the truth. The hard currency EM index carries an investment grade average rating of BBB-, thanks in part to the inclusion in 2019 of Middle Eastern states such as Qatar, Saudi Arabia and the UAE.[2] In fact, nearly 60% of the JP Morgan EMBI Global Diversified Index is rated as investment grade.[3] The wealth of active management opportunities in the asset class reflects the broad range of credit qualities.

Myth 3: There is significant contagion risk

Correlated imbalances were once a hallmark of emerging markets. But two decades of structural reform and policy improvement has greatly diminished the danger of a crisis in one country spilling over. The diversified exposures and idiosyncratic nature of the asset class provides much greater insulation against exogenous shocks.

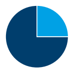
Consider China's recent economic slowdown, the war in Ukraine and the crisis in the Middle East. All events that might once have spelled a systemic crisis for EM debt have in fact demonstrated its resilience and diversity and provided opportunities for active investors.

[1] From October 2022 to June 2024, as per Bloomberg data.
[2] Marmore Mena, GCC's inclusion in J.P. Morgan's EM Bond Index: The "Hurray" Moment, 15 October 2018
[3] JP Morgan EMBI Global Diversified Index, as at May 2024

A diversified asset class

When it comes to constructing investment portfolios, the number of countries pursuing distinct economic policies fosters a diversification that mitigates many remaining tail risks. What is more, investing across EM fixed income's three sub-asset classes can deliver further diversification. Firstly, there is the hard currency sovereign debt universe. More than 70 countries issue their debt in dollars or euros. Secondly, there is the fast-growing corporate debt sector. And, thirdly, there are the 18 countries that issue debt in their own currencies. Only those with the most credible economic policies can do so: consequently, the number of borrowers is smaller and the credit rating higher at BBB+ (Figure 1).

Figure 1: an attractive income proposition across a diversified asset class

	Hard EMD	Corporate EMD	Local EMD
	JPM EMBI Global	CEMBI Broad Diversified	GBI-EM Global Diversified
Market size ($bn)	1,230	521	1,536
Number of countries	70	58	18
Inv. grade/High yield %	IG  HY	IG  HY	IG  HY
Average credit rating	BBB-	BBB-/Baa2	BBB+
Duration	6.8	4.3	5
Yield to maturity	7.2	7	6.6
2023 index return	10.50%	9.10%	12.70%

- Following the most widely used definition, EMD currently consists of 70 countries and 929 bonds, a significant increase from the 14 countries and 51 bonds available in 1993
- Investing in EM debt gives access to government and company debt, in both investment grade and high yield, around the world
- EMD is an underinvested asset class

Source: JP Morgan, as at 31 March 2024

The resulting asset class is diversified across geography, investment grade, high yield, sovereigns and corporates. At Columbia Threadneedle Investments, we have 22 investment professionals in the emerging markets fixed income team, located across three continents, dedicated to unearthing investment ideas including the best relative value opportunities. With just under $4 billion under management we are big enough to access all the major market counterparties, yet small enough to be nimble at times of market stress.[4]

[4] All figures as at March 2024

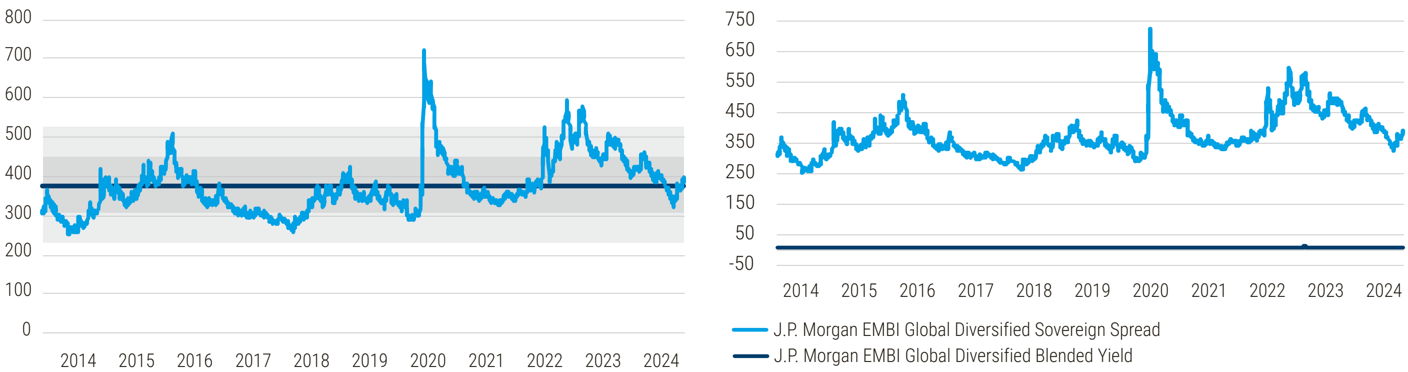
An opportune time

We are encouraged by current opportunities in emerging markets fixed income. The JP Morgan EMBI Global Diversified Index is yielding about 8% – an attractive rate – although a tight yield spread over US Treasury bonds indicates the asset class is fairly valued (Figure 2).

Figure 2: spreads tighter but yield still attractive

Index valuation vs 10-year average

EMBIG diversified spread and yield



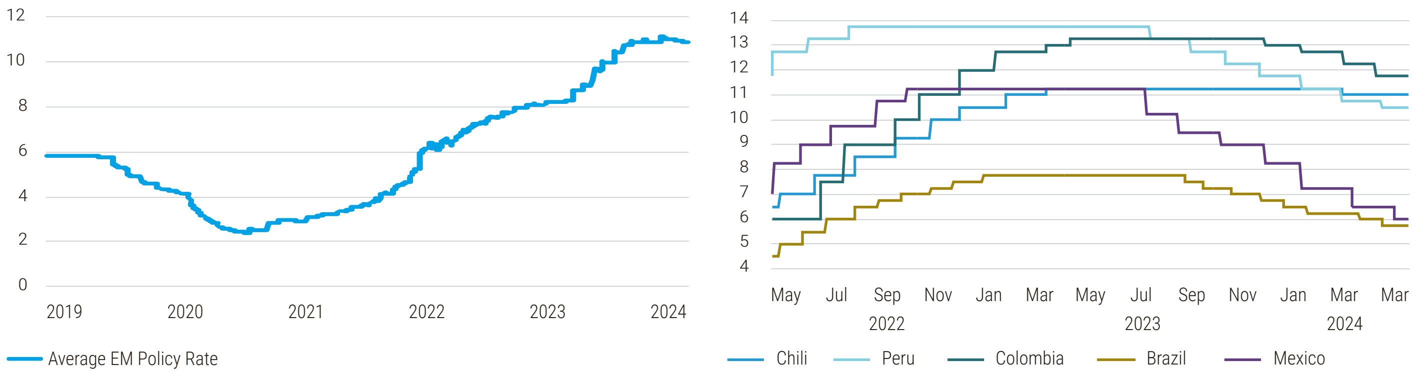
Source: Macrobond and Columbia Threadneedle Investments, as at 30 April 2024. Past performance is not a guarantee of future returns.

At the same time, the headwinds faced in recent years from high interest rates are dissipating. Easier US monetary policy should loosen funding conditions for issuers and support emerging markets fixed income. In the meantime, Latin American central banks such as Brazil have already begun cutting (Figure 3), taking advantage of disinflation. This should stimulate economic growth in emerging markets, which the IMF has forecast will be 4.2% in 2024 against 1.7% for developed markets.[5]

Figure 3: rate cutting cycles have commenced in emerging markets

Average EM policy rate (14 major local markets)

Latin America interest rates



Source: Macrobond and Columbia Threadneedle Investments, as at 30 April 2024

Meanwhile, the IMF is helping reduce the risk of debt distress among EM issuers by making loans conditional on the implementation of reforms aimed at strengthening economic resilience. For instance, it agreed to increase its loan facility to Egypt from $3 billion to $8 billion, but insists it raise interest rates and float its pound to prevent imbalances.

There is a new reality in emerging markets, far from the myths of yesterday. We believe improving policy making is strengthening the investment case for an asset class where yields are highly attractive and falling policy rates should provide a fair wind.

[5] World Economic Outlook, April 2024: Steady but Slow.

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