

## Emerging Market Debt: Ugly duckling no more

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*Emerging market debt is a fast-maturing asset class that is converging with the global bond universe. But Joseph Mariathasan finds managers struggling to break out of top-down country-risk constraints*

Emerging market debt (EMD) has for years been the ugly duckling of investment markets, but it is rapidly becoming the graceful swan. Blais Antin, head of EMD research at TCW, points out that while EMD in all its forms accounts for around 10% of global investable debt, institutional investors, on average, still have only around 1-1.5% invested. “We are only in the second or third innings of a nine-innings game,” Antin says.

Exposure also varies dramatically between regions. Aberdeen Asset Management has found great interest in the Netherlands and Scandinavia, according to head of EMD Brett Diment, with some clients allocating as much as 15% of their bond exposure. In the US, on the other hand, allocations tend to be less than 2%.

The ugly duckling status is undoubtedly down to the perception of greater credit risk in emerging markets. But the fact is that the true distinction between developed and developing economies is increasingly that of per-capita income rather than credit risk. Today, the contrast between the emerging economies of Asia, Latin America, Africa and the Middle East and the ‘submerging’ economies of peripheral Europe could not be more stark. The growth in importance of EMD reflects a fundamental and generational shift in global economic power. As a result, as Jim Craige, EMD portfolio manager at Stone Harbor Investment partners argues, EMD is making the transition from tactical to a strategic investment. “For institutional investors in the developed world, the question has become not whether to invest in EMD, but how best to,” he says.

EMD originated as a hard currency, predominantly US\$-denominated asset class. During a sustained period of outperformance through the 1990s it was very much seen as high risk/high return and lumped alongside high-yield bonds. Today, returns are more subdued and spreads above US Treasuries much narrower – reflecting an asset class that has become investment grade. During 2010, there were 27 upgrades and only six downgrades, while to the end of June 2011 there were a further 17 upgrades and six downgrades. “The improvement in credit quality is under-appreciated globally,” says Craige. “A number of countries will see significant upgrades.”

That hard currency market is declining in importance in the face of burgeoning local-currency issuance. This is all the more surprising since, as recently as 2008, the World Bank and International Finance Corporation felt the local currency bond market needed a stimulus through the Global Emerging Markets Local Currency Bond programme (GEMLOC). Most EMD managers have launched local currency funds or are in the process of doing so – including iShares, the biggest provider of ETFs. Stone Harbor, for example, currently splits its \$28bn of EMD assets at around 45% in hard currency sovereign, 45% in local currency sovereign and 10% in hard currency corporate debt; over the next 3-5 years, Craige expects hard currency sovereign to reduce to around 35%, with local currency sovereign overtaking it to 40%, with around 20% in hard currency corporate debt and the remaining 5% in local currency corporate. The future of EMD sovereign debt is definitely that of a local currency dominated asset class.

Why has demand been so high? As Antin points out, on a purchasing power parity basis, IMF projections imply that virtually all emerging market currencies are undervalued. And even if local inflation is high enough to make local-currency real yields look low, nominal yields matter for international investors based in euros or sterling.

“Five-year local paper in Brazil is yielding 12.5% while Brazilian US-dollar bonds are only yielding 4.1% – just 100bps over US Treasuries,” he explains. “The problem the government is facing is to slow down the appreciation of the currency.”

### Corporate debt

With both hard and local currency sovereign debt markets now well-established, we are seeing the development of the corporate debt markets. This remains predominantly hard currency, with about two thirds investment-grade and one third high yield. Since 2004, there has been an explosion in issuance which, in 2010, reached a record \$211bn (while EM sovereigns issued just \$75bn).

“Traditionally, emerging market corporates would borrow from local banks at whatever the cost,” says Antin. “Only in recent years has there been a rotation from traditional bank finance to bonds. Corporates are able to fix borrowing for periods of five, seven or 10 years, and for entities like commodity producers with large capex needs, it makes sense to issue long-term paper. We see this as a healthy development.”

In countries like Turkey, this process is still at a relatively early stage. “There are only a handful of companies coming regularly to the dollar market for bonds,” says Antin. “Most still rely on Turkish banks, but we are seeing a lot of Turkish banks issuing dollar bonds. We would like to see more corporates.”

There are basically two types of high-yield corporate: companies that are themselves very risky, with high beta, and require strong due diligence; and high quality high-yield companies domiciled in countries with a low credit rating. Aberdeen, for example, favours bonds from countries like Brazil, Mexico, Russia and Indonesia where it is confident of the fundamentals but sovereign valuations are unattractive.

As Sergio Trigo Paz of BNP Paribas Investment Partners explains, this is why managing emerging market corporate bonds is about more than understanding company fundamentals. “The ownership of a company and its links to government can be relevant,” he observes. “Is the company in grace with the regime or in disgrace? With some Chinese companies, what is stated in the accounts is not what is happening. You need emerging markets specialists – not high-yield specialists.”

Diment agrees: “The Middle East is all about knowing how close the corporate is to the sovereign,” he notes. “Some sense of implicit government support gives comfort. In Dubai, if the real estate companies were not government entities, we would have difficulty in buying the debt as they are very opaque, since we do not get all the figures.”

Antin adds that quasi-sovereign issuers like Pemex, Gazprom and Petrobras often need to be treated like corporates – until the Dubai World crisis in November 2009, such entities were assumed to have guaranteed sovereign backing – and that ratings can also be misleading. A lot of lower ratings are due to the legacy of the sovereign rating ceiling that agencies methodically applied until 2005 (the ceiling meant that no corporate could have a higher rating than that of the country it resided in, even if its revenues were based primarily on exports). There are still only a few EM corporates sporting higher ratings than their country of domicile: of the 107 companies in 21 countries rated higher than their sovereigns, only 36 are in emerging markets, where it is rare to have a rating beyond 1-2 notches above the sovereign. Argentina is a case in point – and TCW is overweight there.

Logan Circle’s blended EMD strategy, covering credit alongside country and currency risks, specifically seeks to de-emphasise country and political risk. It describes itself as seeking the best operators of assets within any specific sector, regardless of location, so it might compare Russian steel makers with Brazilian ones, for example.

Even so, Scott Moses, head of EMD at Logan Circle partners, describes the decisions around EMD to be all about ability to pay, willingness to pay, the political environment, access to capital markets and liquidity. His firm applies a combination of qualitative analysis (monetary and fiscal policy, policy credibility, political environment and structural reforms) and quantitative analysis (balance of payments data, budget assumptions, debt service and coverage ratios, international reserve levels, inflation and GDP). It also works out a ‘z-score’ based on the current account, which gives an indication of how much the issuer relies on outside capital; GDP per capita growth, which describes how fast the middle class is expanding; and inflation volatility, a proxy for monetary and fiscal policy (inflation is measured differently by different central banks, so how well they manage inflation within a band gives the best idea of their effectiveness).

Much of this revolves around the idiosyncrasies of political risk, of course, which can prove difficult to call well.

During the financial crisis, Logan Circle was, with hindsight, too bearish on Latvia. That country’s government put in place a drastic set of cuts to deal with with a huge current account deficit, which changed the credit rating of the country. “They offered a new issue which we liked but thought too expensive,” recalls Moses. “But on issuance, it tightened even further.”

By contrast, TCW was too optimistic on Belarus. “We misread the sovereign credit outlook,” concedes Antin. “We thought that President Lukashenko would come to his senses. Instead, he was ‘re-elected’ in December 2010 in a fraudulent election.”

Craige at Stone Harbor regrets positions on some euro-related countries. “We were underweight Hungary, Poland and the Czech republic, but Hungary has gone up 20% to mid-July this year,” he observes. The firm remains very bullish on Venezuela: “It is a unique case. There is a lot of political instability but 90% of revenues are from oil exports. Its crude is difficult to refine, but most of its refining capacity is in the US so its willingness to service its debt is very high, as a result.” On the other hand, while Ecuador is up 25%, it does not fit into the firm’s investment criteria: “Its willingness to

service its debt is completely dependent on the President's whim," says Craige. "It is only a question of time before it will default again. I met three Presidents over a handful of weeks during the 1990s!"

Elsewhere in Latin America, Aberdeen's Diment reflects on the Peruvian elections that returned the leftwinger Ollanta Humala as President. Aberdeen went into the election underweight, anticipating just such a result, and watched the subsequent sell-off. "We are now overweight," says Diment. "Peru could follow the path of Brazil, with Humala emulating former President Luiz Inácio Lula da Silva."

Still, anyone watching the brinkmanship between US Democrats and Republicans on the budget deficit, and the rating agencies threatening downgrades, can see that convergence is happening in both directions. Political risk is emphatically not limited to emerging markets anymore – which should shift attention onto economic fundamentals. As Craige declares: "We view the EMD market as global. Anywhere, any currency, sovereign and corporate."

For EMD, that means the chance to spread its wings at last.

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