A tale of two EMs: core and frontier markets

The last few years have seen the emergence of a truly bifurcated EM universe, consisting of the higher-rated core EM countries and the lower-rated frontier economies. Both have very different attributes and will likely navigate any challenges ahead in very different ways.

ILLUSTRATION: SHUTTERSTOCK

By *Jeremy Cunningham*

Lower-rated economies generally struggled in 2022 with the rise in US rates combined with a sharp downturn in risk sentiment, both of which led to a sharp increase in the cost of financing. A number of these more frontier-type countries faced large currency adjustments. Some were effectively shut out of primary markets, while sovereign debt restructurings reaching record levels similar to the 1990s. As the Fed has been raising interest rates throughout 2023, higher marginal rates have slowly been feeding through to aggregate debt dynamics. For those countries facing large amortisations, higher US rates combined with lower nominal GDP growth and a strong dollar are putting continued pressure on debt stock metrics. Meanwhile, many of these countries are finding it politically challenging to cut fiscal deficits, especially as interest bills have risen.

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It has been a completely different story for some of the more developed EM countries, such as Brazil and Mexico. They have generally built up a large cushion of domestic private savings that have helped finance fiscal deficits and they are now starting to narrow. The borrowing characteristics of these countries have also changed, helping them to become less reliant on short-term foreign borrowing than in the past. They have lengthened the maturity of their issuance, while foreign ownership of their local currency bonds has broadly decreased. Many of these countries have strong enough external balance sheets and access to capital to withstand any volatility and have built large foreign exchange (FX) reserve buffers. So even with any pressure on FX reserves, they remain at comfortable levels. Finally, while EM countries have traditionally struggled with inflation, many of the more developed EM countries raised interest rates earlier and more aggressively than the developed world to avoid de-anchoring inflation expectations. As a result, inflation now looks set to return to central bank comfort zones for most EM countries by the end of 2024.

The resilience of EM was thoroughly tested in 2023. As well as the aggressive US rate hiking cycle, EMs also had to contend with two separate wars, US banking stress in March and a sharp bond sell-off. The fact that the

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more developed EMs were able to weather this volatility without too much of an impact demonstrates how much these economies have progressed.

Positive expectations for global economic growth makes for a fairly constructive backdrop for EM debt in 2024. But EMs will still likely have to navigate a data-dependent Fed, a fairly strong US dollar and a busy global election calendar.

Core EM countries

Recent EM inflation reports have exceeded expectations due to increased food prices, although the underlying trend of core disinflation remains broadly unchanged. This should allow EM central banks to credibly cut policy rates. If the first Fed cut gets delayed beyond market expectations, some Asian central banks might also postpone the start of their easing, but many EMs should still be able to keep cutting as planned provided financial conditions stay supportive.

Falling EM interest rates should provide a duration tailwind for local currency debt holders.

We currently favour owning some local duration in countries in which inflationary pressures continue to abate and monetary policies become more accommodative. Many of these are in Latin America, including in Brazil and Mexico.

Central banks in Asia are likely to cut rates later than the rest of the EM world and Asian local currency debt tends to be more correlated with global markets, but we see duration opportunities in Indonesia and South Korea.

We have generally seen less opportunities in Central and Eastern Europe, although duration in Poland is looking more attractive given relatively high carry, low foreign ownership and exchange rate tailwinds amid a relatively strong balance of payments.

Within hard currency debt, spreads are fairly tight within the core EM economies, but if there is a US recession, US dollar duration should offset the impact of spread widening on returns. These holdings also provide diversification benefits. Examples of some of higher-rated credits in which we have conviction include South Korea and Mexico.

We also find value in some corporate dollar issuers. Fundamentals within EM corporates look to be in better shape as EM corporate treasurers have for the most part taken a more prudent approach to borrowing. The geographic representation and risk structure of EM corporates is quite different from sovereigns, and so provides an element of diversification. Shorter-dated investment-grade bonds inside the corporate world have proved quite resilient during times of volatility and can help with defensive positioning.

Frontier economies

Lower US rates should reduce external financing pressures on frontier economies and also encourage investors to look towards the lower-rated economies in their search for yield, but frontier economies will continue to face headwinds from lingering dollar strength and higher US rates.

With hard currency debt, spreads are still relatively wide, offering a significant valuation cushion in many cases. Meanwhile, recent restructuring proposals have been relatively bondholder-friendly and the IMF has continued to provide financing even where there have been sustainability concerns (for example in Pakistan).

EM local currency debt markets have traditionally been limited to countries further along the development path, that have made progress in reducing inflation, encouraging domestic savings, and establishing local capital markets. In recent years, the number of sovereigns that have been able to issue debt in their own currencies has grown. These frontier issuers can offer attractive returns that are often uncorrelated with more mainstream EM local rates markets. However, they also come with higher risks, requiring a view on the credit as much as the rates and currency components of the investment decision. We are seeing opportunities in markets such as Egypt and Nigeria, where central bankers seem to be delivering on reforms, including significant devaluations in their respective currencies. ■

Jeremy Cunningham

Investment Director, Capital Group

SUMMARY

A split EM landscape has emerged: higher-rated core EM nations versus lower-rated frontier economies.

Lower-rated EMs saw a sharp increase in the cost of financing, while many developed EMs can withstand any volatility.

Latin America (Brazil, Mexico) and Asia (Indonesia, South Korea) offer duration opportunities. Corporate EM bonds also show resilience.

Frontier economies will continue to face headwinds. However, frontier issuers such as Egypt and Nigeria can offer attractive, uncorrelated returns.

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