EMERGING MARKET DEBT
THE SEARCH FOR YIELD IN HIGH BETA MARKETS

The sanitary and economic crises have seriously hit Emerging markets, but growth is expected to be strong in 2021 in our view.

INTERVIEW

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According to the International Monetary Fund (IMF), Emerging Markets' Gross domestic product (GDP) should reach 6% and 8.2% for China, on the back of vaccine deployments and accommodative central banks. Combined with attractive credit fundamentals, yield hunters will likely be drawn to the emerging market credit space in 2021, **boosting flows and high yield[1] issuance**.

Above all, this has lifted commodity prices like oil and metals. Emerging debt also tends to perform better in weak dollar environments and the Fed's accommodating stance has piled pressure on the US dollar.

HIGH COMMODITY PRICES SHOULD BENEFIT EMERGING MARKET CYCLICAL SECTORS

A recovery in demand in China, the US and Europe, among others, **should continue to support commodity players throughout Emerging Markets**. We expect cyclical sectors to outperform, with metals & mining, energy, transportation and infrastructure (especially in Africa) sectors leading the way.

Most base metal prices including iron ore, copper and nickel are now exceeding their late-2019 levels and led by a recovery in demand, we expect them to remain at these levels.

Angola sovereign debt, for instance, now looks relatively cheap against its peers. The country is politically stable with a solid financial support framework from three significant bilateral creditors:

- **China** with $6.2 billion in **debt relief**[2];
- the **suspension of a coupon payment** of $1.78bn to the **G20** and;
- **IMF financial support deal** of $4.5 billion over 3 years[2].

In addition, oil accounts for 95% of Angola's exports[3]. The sharp fall in oil prices at the start of the sanitary crisis had prompted Angola to recalibrate its budget and spending plans to account for oil at $35 a barrel, down from $55[4]. Now, at current oil prices of over $55 a barrel, Angola should have fewer concerns over its deficit and may well profit as markets reopen.

CREDIT FUNDAMENTALS FAVOUR HIGH YIELD ISSUES

In a world where central banks are keeping rates low and the number of bonds yielding below 0% interest are skyrocketing, **appetite for emerging market debt should rise**. Spreads[5] on emerging sovereign high yield issues are at historical highs, even trading roughly 100bps above pre-Covid crisis levels versus investment grade[6]. **So the potential to capture the remaining alpha is significant!** Sovereign names as well as corporates that survive the crisis, such as national airports for example, will likely shine.

Meanwhile, **credit fundamentals of emerging corporates** are still stronger than for their developed-market counterparts. Spreads on the EM Corporate High Yield segment also remain at a very attractive level. They are trading roughly 300 bps[7] versus Investment Grade issues and above their pre-Covid levels. Also, default rates for EM High Yield corporates reached 2.7% in 2020[8], according to JP Morgan, compared with 6.8% for US High Yield markets. Forecasts for 2021 suggest this trend is likely to continue with the latter easing to 3.5% against 2.2%[8] for defaults expected in emerging market corporates. With these low default rates, **high yield issues should outperform investment grade issues in our view.**

A HIGH CATCH-UP POTENTIAL IN HIGH-BETA MARKETS

We believe there is **a high catch-up potential in high-beta markets, notably Argentina, Ukraine, and Turkey,** which are still undervalued in our view.

Turkey has little debt and growth remains strong. It is one of the only countries to have recorded positive growth in 2020. The sharp fall in Turkish assets following the exit of the Central Bank chief Naçi Agbal should provide an interesting entry point for this country with a diversified economy. Indeed, today Turkey is trading at the same yields as Nigeria but with a more robust banking system and fundamentals.

These trends, which are good news for emerging markets in our view, could well last throughout 2021. **Key sectors like energy and mining/metals could benefit from any recovery**. As for emerging government debt, countries in high beta markets should make up for lost ground if their respective geopolitical risks fade. Note, however, that although high-risk countries should generate good returns, long-duration bonds could be hit by any rise in US long bond rates, potentially in the second half of the year.

HIGH BETA MARKETS: A high level of volatility and therefore risk. While high-beta investments tend to outperform the market when the market is going up, they also will accelerate their losses when the market moves down.

1. Corporate bonds with a higher default risk than investment grade bonds but which pay out higher coupons.

2. Source: Reuters. Data as of September 2020.

3. Source: IMF. Data as of September 2020.

4. Source: Reuters. Data as of 29 March 2020.

5. The spread is the difference between the actuarial rate of return on a bond and the rate of return on a risk-free loan with the same maturity.

6. Bonds rated as high quality by rating agencies.

7. Source: Bloomberg. Data as of 31 December 2020.

8. JP Morgan Global Credit Research data as at 06.01.2021. Corporate default rate refers to the CEMBI Index.

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