Looking at Emerging Market Bonds Through New Lenses

Why recent developments could impact the asset class.

May 2020

KEY INSIGHTS

- A number of emerging markets (EM) are experimenting with quantitative easing.
- The fall in oil prices has opened up new opportunities for fixed income investors.
- There are attractive valuations in select EM corporate bonds, but security selection is key.

Where next for emerging market (EM) bonds? Significant recent developments, including the crash in oil prices and the launch of quantitative easing (QE) programs in a number of EM countries, are expected to have an impact on the asset class for the rest of 2020 and possibly beyond. During our latest policy meetings, the investment team analyzed recent events to determine how they might affect the outlook for EM bonds.

The QE Experiment in EM

QE is back in vogue. Unlike a decade ago, however, this time, it is not just limited to developed markets—several EM central banks, including Indonesia, South Africa, and Chile, among others, have unveiled bond-buying programs.

"The rationale for QE in emerging markets is different," said Andrew Keirle, a portfolio manager and member of the global fixed income investment team. "In developed markets, QE helps to reduce funding costs and improve risk sentiment. For emerging markets, QE is being undertaken as a damage limitation tool deployed to support the stabilization of markets when faced with unprecedented outflows and volatility. Helping to move ownership toward being more locally dependent is also likely to be an important motivation for why EM countries have launched QE."

While the rationale for QE in EM may be different, this doesn't guarantee that it will be any more successful. QE is very much an experiment for EM, and not all countries will prove to be successful at it. It has the potential to work best in countries with fiscal space on the balance sheet and credible fiscal institutions that markets have confidence will normalize policy when it is no longer needed. Israel, South Korea, and Thailand are possible candidates that stand out on this front, the investment team noted.

Global Fixed Income Team

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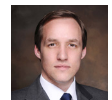

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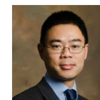

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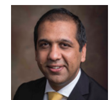

Saurabh Sud

Each month, our portfolio managers, analysts, and traders conduct an in-depth review of the full fixed income opportunity set. This article highlights a key theme discussed.

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>
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> *Portfolio Manager*

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> — **Andrew Keirle**
> *Portfolio Manager*

QE might be more challenging for countries with low fiscal credibility and little fiscal space—unless investors are convinced that it's not going to be large in size or last very long. South Africa, for example, has poor debt dynamics, but investors have so far reacted broadly favorably to its QE announcement because it is viewed as being only a short-term backstop. If that changes, both the local bond market and currency could come under pressure.

"There is a risk of currency depreciation in some EM countries," said Mr. Keirle. "To avoid this, it's more important than ever that countries maintain their fiscal discipline."

Opportunity Set Widens in EM Sovereign Dollar Space

The sharp fall in oil prices has driven a large number of countries in the Middle East back to the international bond market to bolster their finances. "The opportunity set for investors is widening—infrequent borrowers like Qatar and Saudi Arabia have returned to the international bond market," said Mr. Keirle. "The developments give investors more choice and could help with diversification."

A select number of high yield countries have also come to the primary bond market in the past few weeks. Both Bahrain and Egypt sold new dollar-denominated bonds in deals that were oversubscribed, which is encouraging.

Ultimately, the plunge in oil prices will produce winners and losers. Some oil-exporting countries, such as Nigeria and Venezuela, are particularly vulnerable in an environment of lower oil revenues, meaning that their bonds could be subject to volatility and weakness for some time yet. We think that India's bond market, on the other hand, could continue to outperform as India is a large oil importer.

Attractive Opportunities in EM Corporates, but Increased Risks

The indiscriminate sell-off in EM corporates during the crisis has left some company bond prices completely dislocated from fundamentals. This offers some great opportunities, but caution is warranted as not every company will survive this crisis.

"It's important to stay away from potential default candidates in sectors like oil and concentrate on dislocated names in sectors where our analysts have high convictions. Focusing on security selection is more important than ever to uncover those companies that are likely to survive and thrive—and, just as importantly, the companies to be avoided."

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