

Market Insight – Sovereign Emerging Market Debt

With central banks having raised rates through 2022 and 2023, we are now at a point where bond holders can receive reasonable yields in return for holding government debt. Yields sit marginally above levels of inflation, giving bond holders real returns, which is above the level of inflation.

With higher yields, there is now greater scope for central banks to reduce rates when managing unemployment and economic growth in line with central bank mandates. This opens opportunities for investors, where higher levels of return are possible when rates are cut and debt securities reprice to reflect lower yield expectations.

In simple terms, if you held a \$100 fixed income debt security that paid \$10 interest each year (a 10% interest rate) and the interest rate required by the market dropped to \$9 (a 9% interest rate), then the value (or price) of your debt security will be worth more. That is, you are still receiving \$10 each year for your fixed income security, while the market is only requiring \$9. Therefore, the value (or price) of the fixed income security that is paying 10% interest is adjusted to reflect the lower interest rate paid.

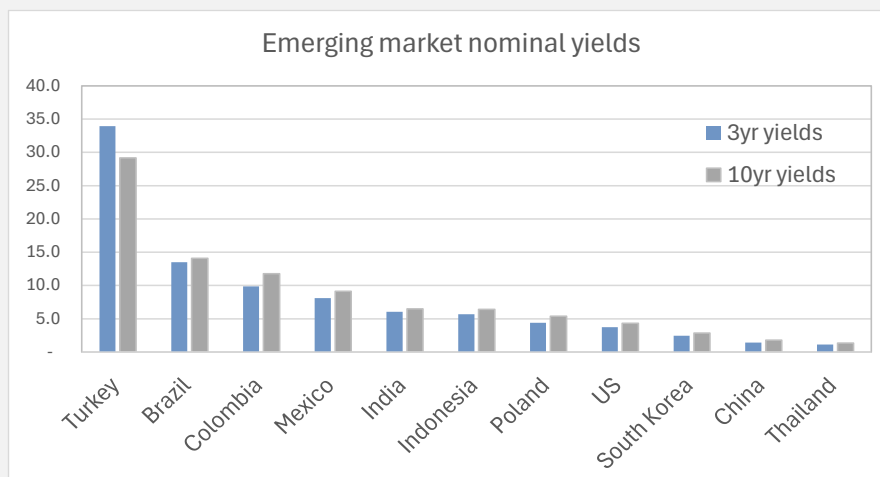
Bonds typically provide diversification benefits, although not always, as they tend to perform better when shares perform poorly. Higher rates aid this effect as investors in risk-off trades seek safe-haven assets, pushing down yields.

However, what if you could access even higher yields on government debt and central banks had even greater scope to cut rates. This is where emerging market debt may present an attractive opportunity for investors. Research has found that historically bond markets in countries with higher relative real yields have generated better returns than those with lower real yields. Currently, emerging markets offer some compelling opportunities with high real yields on offer.

Emerging market debt historically was viewed as risky and volatile, with low reserves within emerging market governments and limited ability to absorb any losses. During the 1990s and early 2000s, emerging market economies suffered crises, which drove significant reforms such that emerging markets are now better positioned and structurally stronger than many developed markets.

Whilst currency risk still exists along with country specific risks, this risk is more specific to emerging markets with weaker balance sheets. Therefore, using an active manager to manage country and currency risks is warranted in our view. Also, **over 85% of government debt in emerging markets is funded in domestic currency, of which 80% is held by local investors.** This reduces the risk of capital flight and the resultant increased volatility.

The chart below shows a selection of emerging market government debt yields set against the current US treasury yields. We see that some emerging markets are clearly higher risk, such as Turkey, where the high yields are compensating investors for the higher risk exposure. Also, we can see some attractive yield opportunities, which creates opportunities for an active manager to exploit. It is these higher yielding opportunities that can potentially deliver higher returns for investors, while helping to also mitigate some of the potential risks. Not presented in the chart are the attractive real yields available in South America, where current rates sit well above levels of inflation. Interestingly, while Turkey offers high yields on their government bonds, they do not offer attractive real yields. Again, active managers can help with identifying and managing such risks.



Source: Colchester Global Investors and Bloomberg

With rates generally expected to fall in developed countries, it may be argued that there is potential for capital gains to be made within developed market fixed income. However, we would point to likely rate cuts in many emerging markets too, with greater potential to deliver capital gains.

In fact, many emerging market countries managed COVID more conservatively than their developed market counterparts and were more aggressive in raising rates as inflationary signs arose. Thus, the easing cycle is well under way and inflation risks appear to be contained, while in the US, tariff and trade policy changes have raised caution with respect to inflationary risk.

While there is sovereign risk in emerging market debt, as there is in developed market debt, we again suggest investors appoint active managers to help navigate this risk.

Given the opportunities within emerging market debt, it seems reasonable that investors consider actively managed emerging market debt exposures. This article has spoken to emerging market government debt throughout this document; however emerging market corporate debt sits alongside the asset class.

We prefer sovereign debt within the emerging market debt asset class, with somewhat less complexity underlying the securities, with no requirement for understanding credit spreads or individual company underlying fundamentals.

However, active managers can cover emerging market credit and cover these additional risks. Investors that so choose, may consider active managers that they believe can exploit the additional risks within the credit space.

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