After the Shock: Picking Winners and Losers in Emerging Markets

Financial markets are experiencing sharp declines this year driven by rising inflation, Russia's invasion of Ukraine, challenges to the growth outlook in China and general investor pessimism. In 2022 so far, most debt and equity markets have declined, with few exceptions. For emerging markets, returns have varied widely with a very broad range of outcomes. We believe that the asset class is now attractively valued overall, but we will likely continue to see wide dispersions of returns. For this reason, active management and the correct country and credit selection will be crucial.

For many current and potential investors in emerging market debt, the sharp decline has raised the question whether the asset class is still worth holding, or even if now is potentially a good entry point. We believe that spending time in the market is more important than trying to perfectly 'time the market'. Over longer periods investors in emerging market debt have benefited from providing capital to facilitate the journey towards development for countries and corporates. Over the last decade, the total return for emerging market sovereigns in hard currency stands at 34.02% (2.98% annualized) as measured by the J.P. Morgan Emerging Markets Bond Index. Furthermore, the current yield level for dollar bonds issued by Emerging Market sovereigns of 7.75% is 2.45% higher than on January 1st, a level that, in the last 10 years, was surpassed on fewer than 10 occasions.

In a recent post, we discussed reasons to think this downturn will not last. Here we will discuss how the opportunities we see in the current setting can potentially add return with research-based active management. Historically, the wide dispersion of country returns has made country selection in particular a rich potential source of alpha (Figure 1).

Rising inflation has also been on the forefront of investor's minds. The war in Ukraine has contributed to surging food and energy prices, while lingering supply chain pressures have caused problems for goods manufacturers with some input prices rising sharply for scarce inventory. Service sectors across many nations have experienced a surge in demand as many countries have lifted all Covid-related restrictions. Central banks across the globe are responding by hiking policy rates.

FIGURE 1: EMERGING MARKET YIELD IS ATTRACTIVE RELATIVE TO ITS OWN HISTORY
EMBI GLOBAL DIVERSIFIED INDEX YIELDS

Data as of May 16, 2022.
Sources: Bloomberg, JPMorgan EMBI Global Diversified Blended Yield

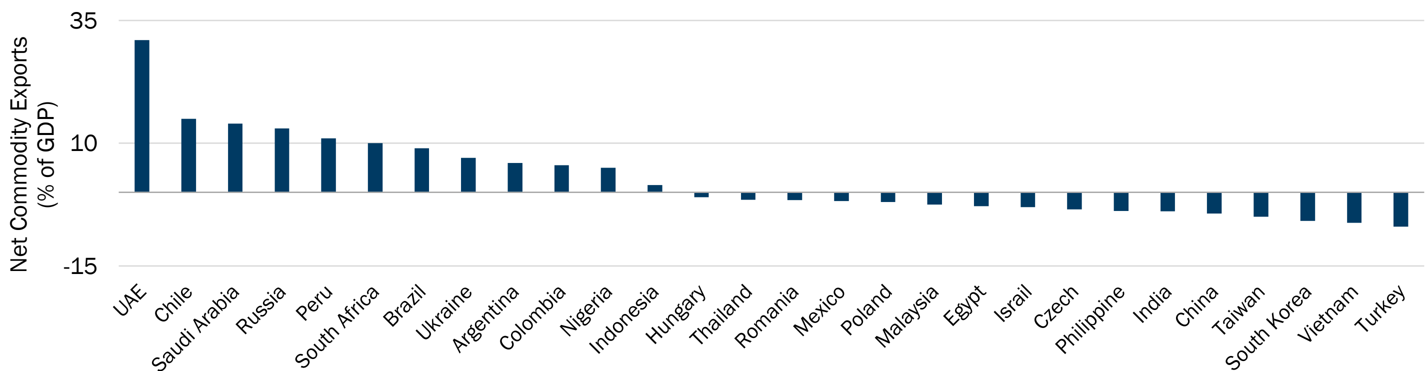
Fortunately, some central banks in emerging markets have recognized this danger early. In an unusual and welcome departure from historical behavior, most have tightened policy rates in a front-loaded fashion to ward off inflation. The resultant gain in credibility and the positive impact from a rise in export prices relative to import prices has underpinned some local currencies, which particularly benefitted Latin American foreign exchange valuations. Asian currencies on the other hand have underperformed as the region generally imports commodities in large quantity and many central banks there have only hiked timidly and with delay.

Likely winners in the corporate universe include oil, gas and fertilizer producers; most are already enjoying windfall revenues and profits from higher prices. Commodity exporters in the Middle East, Africa and Latin America should benefit, while net importers of energy and metals in Asia and Europe will likely face headwinds (Figure 2). However, the tendency to focus on macroeconomic themes, such as the surge in inflation driven by the sharp rise in raw materials or concerns over the impact of the Zero-Covid strategy in China, have left many companies that are only tangentially impacted in the wake of broader based sell-offs. We find compelling investment opportunities in companies that were punished for macroeconomic reasons, but where credit fundamentals remain strong.

In short, we believe that rising commodity prices, early central bank rate hikes and strong commitments from the international community to secure alternative sources of key inputs for production can potentially create a fertile environment for investment returns going forward.

FIGURE 2: RISING COMMODITY PRICES CREATE WINNERS AND LOSERS

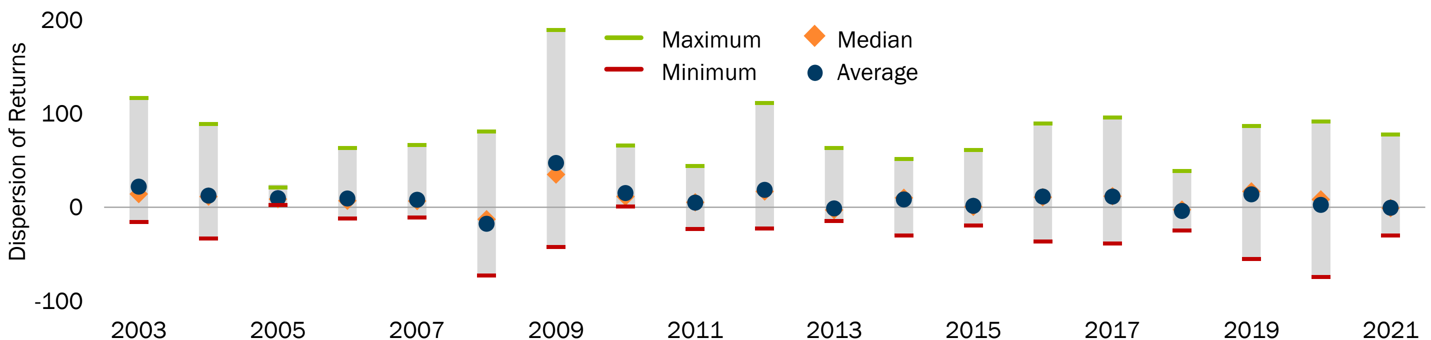
MIDDLE EASTERN AND LATIN AMERICAN COMMODITY EXPORTERS ARE DUE TO GAIN, ASIAN AND EUROPEAN IMPORTERS STAND TO LOSE FROM THE COMMODITY PRICE IMPACT ON TRADE.



Source: Bloomberg

FIGURE 3: EMD—A STRATEGIC ASSET CLASS WITH ALPHA OPPORTUNITIES

WIDE DISPERSION OF RETURNS OFFERS OPPORTUNITIES FOR ACTIVE COUNTRY AND CREDIT SELECTION



Source: Bloomberg, JPMorgan. J.P. Morgan EMBI Global Diversified Index data

It is not possible to invest directly in an index. See disclosures for index descriptions. **Past performance is not indicative of future results.**

Meet the MacKay Shields EMD Team

Diverse team with average **17 years experience** brings unique perspectives and skills:

A combination of bond experience across sovereign, local currency, and emerging market corporates

10 unique languages spoken among the team members

Prior to joining MacKay, the team led management of approximately **$4 billion** across EMD sovereigns and corporates.

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J.P. MORGAN EMBI GLOBAL DIVERSIFIED INDEX — The J.P. Morgan EMBI Global Diversified Index tracks liquid, US Dollar emerging market fixed and floating-rate debt instruments issued by sovereign and quasi-sovereign entities.