



EMD: Trends, benefits, and opportunities

▶ MetLife Investment Management (MIM) portfolio manager of emerging market debt (EMD), Scott Moses, speaks to *Pensions Age* about the latest trends within EMD and the opportunities these can provide for pension fund investors

Talk me through the macro events of the past year; how they affected investments in EMD, and how Covid-19 impacted emerging market regions and credit investments within them? Emerging markets (EM) was as impacted, if not more, than many other markets during the pandemic, due to it being a global growth sensitive asset class.

The first reaction to the pandemic was developed market policy makers stepping in to support their economies, provide liquidity and boost asset prices. That support eventually bled into the emerging world as we started to see significant debt forgiveness and aid packages from official creditors and governments, while companies re-established liquidity lines and prices began to recover from pandemic lows.

The flow of capital started in the high-quality space and worked its way down the quality spectrum, boosting high-yield assets in the latter half of 2020.

There has been some big distinctions in how different portions of the EM landscape have performed. We have seen corporates be the better performers with lower default rates, consistent ability to manage balance sheet liquidity, and more stable performance. On the opposite side, we saw significant demands on the sovereign balance sheet, with economies with larger buffers being the best performers.

That trend continues to be the

focal point for how people think of allocations in the emerging spaces. They are thinking about what demands are being put on different balance sheets across the globe. For many EM issuers their financing options are constrained by their limited ability to conduct QE and therefore, rely on multiple funding sources for support.

During the pandemic, awareness of the power investors can have in helping tackle climate change, promote changes in corporate governance and even impact social awareness has grown.

How has EMD been influenced by this? Emerging market investors are at the beginning stages of influencing ESG issues but are not as impactful as in other more developed areas just yet. The latest statistic per J.P. Morgan is roughly 17 per cent of issuance year to date has some factor of sustainability link to it in the EM space.

Much more attention is being given at the corporate management level as to what ESG policy looks like on the company side. Therefore, I think this has positive impacts over time as it relates to climate, governance, and social issues.

As a team, we are spending more time on company and even sovereign engagement and I am sure our counterparts are doing the same.

However, we are still at the infancy stage within EM, but investors are coming up the curve very quickly.

European pension schemes are the

leaders on the ESG front, with equity capital being the lead driver and fixed income investors coming up to speed quickly. Historically, European investors were driving the ESG conversation and that is no longer the case as it is becoming a global phenomenon. Now it feels like a race within companies and even sovereigns to become smarter on ESG policy and its impact on raising capital in the short to medium term.

In such changing, and challenging, times, how does MIM ensure it finds the best investment opportunities?

We rely heavily on the human capital we have across the globe. It's based on using our people within the different geographies that we invest in and focused on communication among the entire team. This is more important today than it has ever been, as it is harder to get on a flight and go to Latin America or Asia, for example. Therefore, having over 50 analysts, many of those in-market, has been a significant benefit to how we identify ideas.

Are there any regions or areas of opportunity in EMD that your research teams are excited about?

Latin America is a region we have historically spent a lot of time on and continue to focus on because there is so much differentiation within it. There might be just as many risks as opportunities. I think we were ahead of the game in Colombia as far as the deterioration of their balance sheet, which was going to lead to the loss of investment grade ratings; but now, post that downgrade, are there opportunities in that marketplace?

We feel there are also pockets of opportunity in Egypt, Angola, and

Indonesia. All three countries have well executed and favourable policy mixes, in our view.

Our corporate and sovereign teams have done a wonderful job across the board. For example, when you think about some of the troubles we have seen in the Chinese corporate market as of late, the team has used some of those pitfalls as opportunities or as reasons to change risk within portfolios.

Investing in emerging markets is ever-increasing in complexity. Is it time to stop thinking of 'EM' as one region?

From the allocator standpoint, in the emerging markets space, you have much different pockets of volatility and risk.

For an investment team, it gives you more levers to pull to increase or reduce risk in a broader EM allocation. For example, a lot of pockets within Asia are going to react with lower risk volatility, and have much higher interest sensitivity, than the rest of the developing world, and can be used to offset volatility risk that you can take elsewhere.

Europe for the most part is a local currency question now, outside of some of the more idiosyncratic stories like Romania and Turkey. Countries like Poland and Hungary are very much extensions of Western Europe and are viewed as a currency play for us.

Then you get to the 'traditional' EM markets that are very growth sensitive and typically high yielding. That's frontier or Sub-Saharan Africa, and portions of Latin America.

The opportunity set allows you to customise an EM allocation that will behave potentially very differently, depending on the goal of the scheme, the plans risk tolerance and the outlook both at the country and market level.

For pension schemes that are risk seeking and return seeking, you're going to want more flexibility. If you think about a pension programme needing something a bit more liability matched, you might consider quality restrictions. These considerations tend to be more important than geographic restrictions.

Is there a case for China to be considered on its own when looking at investments, as opposed to being grouped as one of the BRIC countries?

There are two ways we think about it. One is the hard currency, US dollar side of the China market. That part of the market correlates well with the other areas of similar quality assets across the globe. However, it will be interesting to see if the growing focus on ESG changes views on Chinese investments over time.

Where we have seen the discussion pick up on individualised China strategies is on the local currency side. The reason is because the local China market is developing so quickly, from original government issuance to now significant corporate bond issuance in local currency. The government issuance is becoming a big portion of global local currency indices and has performed well.

Effectively, people have almost been forced into it and it's an asset that has been low volatility and extremely efficient to own. Because of that, global investors are looking at it and saying 'hey, do I need to segregate the local currency China allocation? Is it going to become liquid and diversified enough to warrant its own allocation?'

We have seen a big uptick in Chinese bond funds looking to capitalise on those allocations. How that evolves over time I think is truly going to answer

that question; if that continues to evolve and the China local corporate market liquidity picks up, I do think you are going to see investors with an EM view and a separate China view.

However, I think people are going to be a little cautious about its ability to handle risks as the market is still in its infancy. Because of that, there is a bit more volatility within the local corporate space than people expect.

Looking beyond just China, what other developments do you expect to see in the future for EMD as an asset class?

We have increasingly seen, from an allocation standpoint from European investors, a more strategic longer-term use of the EM corporate world as a part of other dedicated allocations. The reason is that historically, allocators have looked at EM from just a hard currency side and local currency side, with corporates as an add-on within the hard currency allocation.

If you look at EM corporate returns over the past eight to 10 years, they have been an efficient use of capital in our view. In some ways you've taken less default risks than in the sovereign world. I believe one of the longer-term trends will be more dedicated allocations to the corporate space because of the efficiency as the return stream potential.

The other development is that the ESG phenomenon is likely here to stay. I do expect issuance to get more intelligent and meaningful. Investors are getting smarter about the questions they ask around ESG within EMD.

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