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Alpha Opportunities in Emerging Markets

Global macro uncertainty has affected Emerging Markets (EM) stability over the past year, but certain EM economies are still positioned to deliver alpha. Inflation has begun to cool after a historic run; however, it is being questioned by market participants as to where the current cycle will exactly land.

Thomas Smith, Portfolio Manager on the **Emerging Markets Debt** team at **MetLife Investment Management Public Fixed Income** notes that persistent uncertainty in global market conditions do not necessarily point to recession. “From a portfolio perspective, we think it’s prudent for investors to build out various scenarios and to take on positions that are nimble and focused in liquid securities that can be modified.”

“Central bank inflationary targets in Developed Markets like the United States have yet to be met,” says Smith, “but are still underpinned by resilient global growth which has buoyed markets to some degree.”

Emerging Markets are intrinsically tethered to overall global macro conditions, which, at the moment, remains untethered to one specific outcome, in our view. “We are on a very narrow path; if we fall off one side we’re in a recession, or if we fall off the other side we have inflation and growth that is too hot and central banks will have to do more for longer. Just a couple of months ago, we were all very concerned about the banking problem in the United States and Credit Suisse in Europe. Now those concerns have abated, but that’s not to say that a few months down the road we could be more concerned about growth than inflation yet again.”

In this kind of environment, EM strategies need to remain nimble and we believe certain markets have remained disciplined and attractive enough to generate alpha.

“Differentiation is key as we have to assess who is going to survive the current cycle without defaulting on their debt.”

– Thomas Smith, Portfolio Manager, Emerging Markets Debt team, MetLife Investment Management (MIM)

Both investment grade and non-investment grade deliver
In the higher-quality space, which broadly includes all of EM investment grade and BB securities, Smith says, “What we’ve seen is a normalization of fundamental drivers where there’s been a good deal of stabilization post-pandemic: stabilization of both ratings and of debt trajectory.”

Therefore, bond market access is available for higher quality issuers, who weathered the storm of the pandemic through disciplined fiscal adjustments and orthodox monetary policies amongst other strategies. Smith sees significant potential in the space, saying, “We believe within the BB group, there are some interesting things going on. We can identify four or five BB sovereigns that we think have upgrade momentum in their ratings and could be what we call ‘rising stars’ and perhaps go to investment grade over the next two to three years if all goes well for them.”

In the lower rated EM sovereign space (debt classified as single-B and lower), Smith says, “we do consider this portion of the market as the greatest potential source of alpha in the sovereign universe.”

Although distressed sovereigns have been under significant pressure over the past year, Smith believes, “differentiation is key as we have to assess who is going to survive the current cycle without defaulting on their debt.”

So far, the current cycle has been very difficult for more vulnerable EM sovereigns who had to endure a pandemic, global liquidity tightening and a war in the Ukraine with profound impacts on food and energy markets.

The case for Ghana, Sri Lanka, and Zambia
Countries in the lower quality EM space vary in their paths to restructuring. There are countries that are showing no progress or hope of moving beyond their default status, like Lebanon and Venezuela, to countries that appear to be on the right track and offer areas of opportunity.

Three such countries include Zambia, Ghana, and Sri Lanka, which Smith says, “were mired in a very slow, disappointing process in terms of progress towards restructuring, and finally just in the last few months we’ve seen quite a bit of momentum.”

Just three months ago, U.S. Treasury Secretary Janet Yellen urged for debt relief packages for the countries, as all three had already defaulted on their overseas debt.

“We’ve seen a really good trend unfolding in the last month or so of these restructurings finally making progress and heading towards the ultimate end game, which is for these countries to have their debt current again.”

Distressed vs. defaulted
Smith points out that he believes there is significant opportunity in countries that are classified as distressed, but not yet in default. These include countries like Pakistan, Ecuador, Argentina, El Salvador, Egypt and Tunisia measured by sovereign bond spreads over 1000 basis points. “These are perhaps the most interesting names in our universe because they continue to service their debt. In some of these cases, we have seen attractive current yields of 15 to 20%,” Smith says.

A recent example is Pakistan. The country recently rallied from 33 cents on the dollar to 45 cents on the dollar in the last month based on an IMF bailout announced. “This group of credits is cheap for a reason, and we believe that there are still pretty impactful downside risks from current prices if default does eventually transpire in any of these cases…and hence the importance of differentiation,” Smith adds.

EM corporates and local currency

“We do see space for EM central banks to cut rates and based on current valuations and in this environment, we think local currency bonds can outperform hard currency bonds. We’ve actually been seeing that already in places like Brazil and Colombia and a few others.”

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Fundamentals and key metrics in the EM corporate space stand out against their own historical series and in relation to their US and European credit counterparts.

“On this front, we see issuers have not really needed to come to the international market, or they have funded themselves in their own local markets,” Smith states.

Beyond the corporates space, we believe local currency EM investing is also an area of potential opportunity. "There is this other sub-universe of EM countries that issue in local currency which doesn't have the best long-term track record over the past 20 years or so, but, in our view, it is an attractive hold under the right set of macro conditions," Smith offers.

Those conditions include a gradual tapering off of the Fed hiking cycle, which could ultimately influence central EM banks to cut their own rates as well.

"We do see space for EM central banks to cut rates and based on current valuations and in this environment, we think local currency bonds can potentially outperform hard currency bonds. We've actually been seeing that already in places like Brazil and Colombia and a few others including Mexico," Smith says.

As the global economy recalibrates, EM investors will have the opportunity to take advantage of countries who've focused on repayments. Several EM economies that were only a couple of months ago thought to be on a different path are now appearing well on their way to restructuring. We see there are others that are moving towards the investment grade space, giving investors more options and transforming EM even further.

Learn more about MetLife Investment Management's EM Debt approach.

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