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Analysis

Emerging Markets – The End of Free Money?

February 2022

Despite a shaky start to the year for risk assets, emerging markets have held up relatively well and we believe offer encouraging investment opportunities which are backed by economic recovery

A Difficult Start

January was a difficult month for capital markets; government yields rose, and curves flattened,[1] driven by a hawkish US Federal Reserve. Credit spreads moved wider, and equities fell,[2] while emerging markets outperformed their developed market counterparts.[3]

The only sectors that performed well were commodities and industrial metals, with aluminium outperforming and energy products rising into the double digits as supply chain disruptions and surging demand drove prices higher.[4]

However, the first month of the year was not a standard risk off market because it was unusual to see government yields move higher, emerging markets outperform developed markets and commodity prices so robust.

End of Free Money?

In our view, the headline from The Economist sums up best what capital markets are facing, "The End of Free Money"[5] and, at the margin, a pickup in geopolitical uncertainty and maybe reduced liquidity as Asia moved into the Chinese New Year holiday season.

As a bond investor, this means staying out of low coupon bonds. It also means that, as spreads widen, high yield is a buy. Fundamentals will likely remain strong and a preference for higher yields could bring buyers back, in our view.

Warren Hyland

Portfolio Manager

Prior to joining Muzinich, Warren worked for Schroders, where he was a Global Portfolio Manager, and later the Senior Portfolio Manager for Global Emerging Markets. In the latter role, he managed about US$2billion and helped to develop the firm's emerging markets corporate capabilities. Previously, Warren was the Head of European Money Markets at UniCredito Italiano. Warren has a BSc in Mathematics for Business from the Middlesex University London, and later received his MSc in Shipping Trade and Finance from the CASS Business School. He holds the Chartered Financial Analyst designation.

1 Muzinich & Co. views and opinions as of February 2022, and subject to change without notice.

But will EM suffer from the end of free money? In the period between 1980 to 2000, I would say yes, that is exactly were the free money went, but not in the last 10 years. Today, in aggregate emerging market sovereigns are in current accounts surplus,[6] driven by high commodity prices and strong trade.

Economic growth is above its long-term trend with fiscal deficits falling in comparison to the last two years. Foreign exchange reserves are ample, and EM central banks have normalised monetary policy ahead of the US. A good example is the net supply of EM corporate bonds in 2021, -US$25bn - the universe shrunk by US$25bn and our estimate for this year is that the universe could shrink by up to -US$40bn.[7]

This may be partially due to the Middle East & Africa reverting to a previous policy of paying royalties from their energy dividends and away from bond issuance. A heavy election calendar in Latin America in the second half of the year, and a deleveraging trend in Asia should also help reduce supply. In our opinion, this time around the free money has gone into low-coupon products such as investment grade, the technology/digital sector and special purpose vehicles.

Investment Themes for 2022

The Reopening Trade

Against this backdrop, we see several themes within emerging market corporate debt that we believe present interesting investment opportunities.

In 2021, countries like India, Indonesia and the Philippines were hard hit by the Delta Covid variant which stilted growth. However, we believe these economies are likely to experience a sudden growth surge this year, with forecasters currently anticipating growth of 5% for Indonesia,[8] 9% in India[9] and 6%[10] for the Philippines.

At a sector level, this theme is likely to feed down into areas such as airlines, airports and transportation more broadly as consumers resume their travel schedules. We also believe we're likely to see a surge in demand for energy as growth picks up steam.

Coupled with growing awareness and action towards combatting climate change, this is likely to result in more activity in the renewable energy sector, which could also lead to some interesting investment opportunities.

Global Pricing Power

With the increased demand for goods and services as global economies rebound, we find sectors with global pricing power attractive.

These include mining companies within the commodities complex as well as food producers. At the sovereign level this translates into a preference for commodity-linked countries such as Chile (e.cg. copper and iron ore) and Nigeria (e.g., oil, gas and cocoa).

Deleveraging

The growth and recovery themes should translate into deleveraging in sectors such as banks and energy, where high pricing power and demand for financing should benefit companies looking to pay down debt and shore up balance sheets.

Dislocation

Last year's Chinese property crunch led to broader sector dislocation in the property sector, and we believe has created a good entry point in high quality Asian property credits.

Meanwhile sovereign downgrades in countries such as Colombia, Mexico, China and Argentina have resulted in spread widening in their associated quasi-sovereign credits. While the sovereigns are deemed weaker by rating agencies this doesn't necessarily translate into the quasi-sovereign credits but offers a good entry point into what we believe are attractive credits with solid underlying fundamentals, trading at a discount.

Sell the Rumour, Buy the Fact

Geopolitical risk is an ever-present danger for investors globally. Our approach is to the sell the rumour, buy the fact and look to be underweight geopolitical and political events.

When the event occurs, we seek value opportunities where we can put money to work. Inflation is also something to be watched closely as we have discussed. However, in aggregate, we believe EM offers several interesting recovery themes that investors may seek to exploit over the coming months.

Overall, we prefer high coupon, high yielding credits with the potential for further upside, while maintaining a focus on fundamental credit analysis to drive our investment decisions.

1. US 10 Year Treasury Index, 10-Year German Government Bund Index, as of 31st January 2022
2. ICE BofA ML US Corporate Index (C0A0), ICE BofA ML Euro High Yield Index (HE00), ICE BofA ML US Cash Pay High Yield (J0A0), ICE BofA ML Euro Corporate Index (ER00), S&P 500 Index (S&P), Dax Index (Dax), ICE BofA ML High Grade Emerging Markets Corporate Plus (EMIB), ICE BofA High Yield US Emerging Markets Liquid Corporate Plus Index (EMHY) as of 31st January 2022
3. MSCI Global Equity Index, MSCI Emerging Markets Index, as of 31st January 2022
4. London Metal Exchange Aluminium 3 Month Commodity Index, West Texas Intermediary, as of 31st January 2022
5. The Economist, 29th January 2022
6. JP Morgan Emerging Markets Outlook and Strategy, 10th January 2022
7. BofA EM Corporate Credit Strategy – EM Corporate Credit Chartbook, 3rd February 2022
8. International Monetary Fund, as of January 2022
9. International Monetary Fund, as of January 2022
10. International Monetary Fund, as of January 2022

Index Descriptions

C0A0 - The ICE BofA ML US Corporate Index tracks the performance of US dollar denominated investment grade corporate debt publicly issued in the US domestic market. Qualifying securities must have an investment grade rating (based on an average of Moody's, S&P and Fitch), at least 18 months to final maturity at the time of issuance, at least one year remaining term to final maturity as of the rebalancing date, a fixed coupon schedule and a minimum amount outstanding of $250 million.

HE00 - The ICE BofA ML Euro High Yield Index tracks the performance of EUR dominated below investment grade corporate debt publicly issued in the euro domestic or eurobond markets. Qualifying securities must have a below investment grade rating (based on an average of Moody's, S&P and Fitch), at least 18 months to final maturity at the time of issuance, at least one year remaining term to final maturity, a fixed coupon schedule and a minimum amount outstanding of EUR 250 million.

J0A0 - The ICE BofA ML US Cash Pay High Yield Index tracks the performance of US dollar denominated below investment grade corporate debt, currently in a coupon paying period that is publicly issued in the US domestic market. Qualifying securities must have a below investment grade rating (based on an average of Moody's, S&P and Fitch), at least 18 months to final maturity at the time of issuance, at least one year remaining term to final maturity as of the rebalancing date, a fixed coupon schedule and a minimum amount outstanding of $250 million.

ER00 – The ICE BofA ML Euro Corporate Index tracks the performance of EUR denominated investment grade corporate debt publicly issued in the eurobond or Euro member domestic markets. Qualifying securities must have an investment grade rating (based on an average of Moody's, S&P and Fitch), at least 18 months to final maturity at the time of issuance, at least one year remaining term to final maturity, a fixed coupon schedule and a minimum amount outstanding of EUR 250 million.

EMIB – The ICE BofA ML High Grade Emerging Markets Corporate Plus index is a subset of the ICE BofA ML Emerging Markets Corporate Plus Index (EMCB) including all securities rated AAA through BBB3, inclusive.

EMHY - The ICE BofA High Yield US Emerging Markets Liquid Corporate Plus Index is a subset of The ICE BofA US Emerging Markets Liquid Corporate Plus Index including all securities rated BB1 or lower. The ICE BofA US Emerging Markets Liquid Corporate Plus Index tracks the performance of U.S. dollar denominated emerging markets non-sovereign debt publicly issued in the major domestic and eurobond markets.

S&P 500 - The Standard & Poor's 500 Index (S&P 500) is an index of 500 stocks seen as a leading indicator of U.S. equities and a reflection of the performance of the large cap universe, made up of companies selected by economists.

DAX - The German Stock Index is a total return index of 30 selected German blue chip stocks traded on the Frankfurt Stock Exchange. The equities use free float shares in the index calculation.

MSCI Emerging Markets Index - The MSCI EM Index is a free-float weighted equity index that captures large and mid cap representation across emerging market countries. The index covers approximately 85% of the free float-adjusted market capitalisation in each country

MSCI World Index - The MSCI World Index is a free-float weighted equity index. It was developed with a base value of 100 as of December 31, 1969. MXWO indexed developed world markets and does not include emerging markets. MXWD includes both emerging and developed markets.

WTI – West Texas Intermediary (WTI) is a light, sweet crude oil that serves as one of the main global oil benchmarks. It is the underlying commodity for the NYMEX's oil futures contract.

GA10 - The ICE BofA ML Current 10-Year US Treasury Index is a one-security index comprised of the most recently issued 10-year US Treasury note.

G4D0 – The ICE BofA ML 7-10 Year German Government Index is a subset of the ICE BofA ML German Government Index (G0D0) including all securities with a remaining term to final maturity greater than or equal to 7 years and less than 10 years.

You cannot invest directly in an index, which also does not take into account trading commissions or costs. The volatility of indices may be materially different from the volatility performance of an account.

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