Emerging Markets Debt: Treading Water but Not Drowning

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Emerging Market issuers have benefited tremendously from robust capital inflows since the 2008 Financial Crisis as a result of the rotation out of equities into fixed income and the subsequent easy monetary policy by developed market central banks. The hunt for yield and relative stability (amidst the Eurozone Crisis and the U.S. fiscal pressures) led to indiscriminate buying of EM debt across the sovereign, corporate, and local space. The strong inflows, coupled with the commodity price super-cycle, led in many cases to appreciated currencies, which in some cases prompted capital controls or unorthodox policy. The lack of market discipline generated complacency by many EM policy makers as EM bond prices soared. This summer, the Fed's reintroduction of volatility with talks of QE tapering and fears of a sharper than expected slowdown in China's growth caused significant repricing in EM assets broadly.

Reform on the EM agenda

After years of experiencing significant investor inflows, EM economies must adapt to changing sentiment and address policies at the local level. Credit and consumption have driven growth in several EM economies from 2008-2012. Implementing structural reforms to improve competitiveness and the investment climate and adopting a coherent policy framework will be critical if governments do not want to face further investor outflows.

This summer's market correction and the threat of reduced liquidity has been a wake-up call for EM policymakers, some of whom are embracing more productive measures for addressing their challenges and restoring confidence. In some EM countries, such as Serbia, talks have begun or were reopened for IMF programs to serve as policy "anchors," pushing reforms, which will help ease investor concerns if actually signed. Many of the larger EM economies, on the other hand, will remain challenged due to limited drive for reform ahead of elections, such as Brazil, Indonesia, Turkey, India and South Africa Others have started tackling structural reforms or are adopting more coherent policy making. Mexico, for instance, is pushing through long awaited reforms in the key areas of energy, electoral and fiscal. The varied responses prove that emerging markets remain too disparate an asset class to be viewed at an aggregate level and differentiation will remain key as investors will continue to reward leaders in policy reform versus laggards.

Risks are Better Priced Today

While in the short term there remains scope for additional repricing of EM assets on the back of a stronger U.S. dollar and rising U.S. Treasury yields, asset valuations are more realistic now than they were in early 2013 and may present good opportunities through 2014. Investors, however, would do well not to view the asset class as a monolith. While EM debt has matured as an asset class over the last decade, the prospects for individual countries vary greatly, underscoring the importance of a nimble approach backed by fundamental research. One way to maximize risk adjusted return would be through a "blended approach," which would entail tactically investing in local currency debt and out-of-benchmark corporates. Blended styles allow the investor to make use of relative value across the spectrum of EM sovereigns, corporates FX and local rates.

Long-Term structural drivers for emerging markets debt remain intact

Despite these recent challenges and rising volatility, other demand- and supply-side factors continue to support the asset class in the long-term. On the demand side, aging populations in developed markets should support investors' increased appetite for fixed-income assets like EM debt. Meanwhile, the rapid growth of local insurance and pension funds within EM countries will help support emerging markets that in prior decades were dominated by foreign investment. While EM debt is gradually becoming a core allocation to global fixed-income portfolios, investor surveys frequently report a structural underweight in the asset class. From the supply side, opportunities for EM debt should continue to expand as corporations and governments turn to the capital markets for funding needs.

Real gross domestic product (GDP) growth in emerging markets should also continue to outpace developed markets by 3% through 2018, according to the latest projections by the International Monetary Fund. Though demographic trends should remain favorable for emerging markets overall, the dispersion in growth outlooks among EM countries is becoming more pronounced. China's aging population, for example, may have negative implications for growth. India, by contrast, will continue to have a relatively young population for decades, which should provide a demographic dividend. In addition, the drivers of growth in some countries are becoming more complex. Advanced EM economies such as Brazil and Russia will need to depend more on policy reform to drive growth. Smaller countries with simpler growth models and higher levels of political risk will require political reforms and the strengthening of institutions to attract sustainable levels of investment.

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Differentiation and active management are keys to long term success

With this as a backdrop, TIAA-CREF's Emerging Markets Debt team sees compelling opportunities for excess returns over time through active management because the breadth and differentiation among emerging markets may hinder efficient capital allocation among issuers. Active managers who understand the full spectrum of EM sovereign and corporate debt opportunities across currencies can capitalize on temporary market inefficiencies that are less common in more developed markets.

TIAA-CREF's EM debt team also believes a "blended" EM approach, one that combines hard currency (U.S. dollar) sovereign and corporate debt with local currency opportunities, also gives investors access to the full spectrum of EM fixed income while offering greater diversification compared with investing in these sectors by themselves. A full-blend EM debt strategy offers structural and tactical allocations around external sovereign debt to corporate credit either in U.S. dollars or in local currency terms, as well as local market sovereign debt. Fundamental credit analysis at the sovereign and the corporate level is critical to enhancing performance, adjusting allocation and improving security selection—particularly given the challenges ahead for EM debt. Tactically, investing in local currency markets can provide capital appreciation opportunities from movements in foreign exchange rates as well as changes in local rates. EM corporate investing strengthens diversification and enhances yield because corporates typically trade at spreads that are wider to the underlying sovereign. ■

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