RBC Global Asset Management

Discipline pays off: The new opportunities in Emerging Markets

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Polina Kurdyavko, BlueBay Head of Emerging Markets and Senior PM at RBC Global Asset Management, recently sat down with Institutional Investor to share her insights on opportunities within emerging market debt against the current state of the geopolitical backdrop.

Emerging markets have had an interesting trajectory amidst the recent backdrop of economic uncertainty. The past year has provided a mixed bag of market conditions for emerging market economies and their debts, with disciplined emerging market countries primed for investor opportunity. Ongoing geopolitical reshuffling, orthodox monetary policies and rate hike uncertainties have created the perfect mix of conditions to forge a new landscape in the future of emerging market investing.

Opportunity born amidst chaos

Geopolitical problems arising from the Russia-Ukraine War surprisingly offered a big tailwind for emerging markets this year. Commodity prices soared during the onslaught of the war, which have unfortunately remained for much of this past year. The problem was further compounded by new international ESG regulations tightening the supply of commodities overall. For emerging markets though, this created a new wave of opportunity. Two-thirds of emerging market countries are commodity exporters, meaning elevated commodity prices allowed many of these countries to avoid a payment crisis and bypass lending issues and simultaneously boost economic activity.

Despite this silver lining, emerging markets nevertheless remain tethered to global macro conditions. "When we think about the aftermath of the pandemic, the disappointing global recovery meant that we are unlikely to see stimulus for growth going forward like we've seen in early 2000s, which means our outlook for global growth is quite subdued," says Polina Kurdyavko, Head of Emerging Markets and Senior Portfolio Manager at RBC Global Asset Management.

Historic and consistent interest rate hikes have further complicated the problem. "The hiking cycle meant that for the first time in a while we've seen the cost of liquidity being substantially higher. Now, even though emerging markets have started the hiking cycle a year prior and have created a tailwind for themselves with the orthodox monetary policy, tighter liquidity makes the allocation of capital a lot more selective, and that also has implications on emerging markets," adds Kurdyavko.

Disciplined markets pave the way for future opportunity

In many ways orthodox monetary policies see emerging markets impose more stringent measures on their own economies than their larger counterparts. Orthodox monetary policies mean the primary use of interest rate hikes to influence an economy's prices, whereas more developed economies often employ unconventional means such as purchasing assets or central banks as lenders of last resort. Self-imposed austerity has actually positioned emerging market countries to weather current market turbulence and inflation in better, more disciplined ways.

"For the last 30 years, the biggest challenge that emerging market countries have faced have been inflation. And they've learned that the only way to tackle inflation is to implement an orthodox monetary policy mix. And to some degree, to implement it quickly enough so that inflation doesn't become a systemic problem driven by inflation expectations. Very few central banks can address inflation expectations once you get to a hyperinflation environment. And as a result, we've seen them starting to hike a year before developed markets," Kurdyavko says.

This has grown investor confidence in domestic investor bases. Emerging market fixed income markets top $23 trillion, with over 85 percent in local currency. Kurdyavko adds that most of these countries are relying on domestic investors for their funding needs, not external investors. These domestic investors in turn demand orthodoxy in order to continue to invest in domestic securities of their home nations., and by doing so, the larger emerging market countries are ensured continuous funding through periods of low growth.

This has set the opportunity for both domestic and international investors alike.

"Now, it also has created very interesting opportunity for local currency investors, both international and domestic because we're seeing double-digit rates in terms of policy rates, for example, in most of Latin American region with Brazil having core rates at 13 and three quarters while inflation is 4 to 6% range, and real GDP growth of 1 to 2%. In other words, it's the highest real rates we've seen in emerging markets for a long while," Kurdyakvo adds.

Investors have the potential to earn double-digit returns in local currency debt, in some cases 8 percent YTD returns outperforming hard currency fixed income, she says. Such opportunity does not come without a price, as one implication investors will need to keep in mind is the potential negative impact on growth. Kurdyavko adds that should a policy like this be kept for too long, "it means you will have a negative implication on growth."

"If I think about the central bank governors, I probably have met seven or eight year-to-date across the main emerging market countries, they all sound quite hawkish because they're worried more about inflation than about the growth outlook," Kurdyavko states, highlighting the dilemma that underpins all emerging market investing – the delicate balance between growth and controlling prices.

Ultimately, as long as central banks maintain a hawkish stance, investors will be better off investing in local currency sovereign debt or hard currency sovereign debt and "being very cautious on corporates, because these are the companies that will pay the price for low growth down the line if central banks do not reverse their stand in near future," Kurdyavko says.

Bullish sovereign, bearish corporates

Traditionally, institutional investors do not allocate large amounts of their portfolios to emerging market assets, but the last five years has seen a shift in sovereign debt that is now creating new areas of interest for investors at all levels. "We are also seeing yields in sovereign debt at the most elevated levels over the last 20 years in both hard currency and local currency. So, that's where we think the time is now to start adding exposure as long as you can manage actively the risk on the frontier markets, which I still don't think a hundred percent out of the woods," Kurdyavko says.

Timing is of utmost importance in this strategy. If the Fed indicates a rate cut, all risk assets will rally. Kurdyavko offers "The question is: How fast will this adjustment take place? And would you still be able to earn your double-digit yields if you wait for that to happen? So, for us, the green light is already on for some of the sovereign investments."

As far as corporate assets are concerned, Kurdyavko warns investors to be cautious – and not just in emerging markets. "I think when growth is mediocre and inflation pressures are still not subdued - as a corporate, you're in a very difficult environment because your cost of liquidity is high, your margins are being squeezed, and if you are the lucky one who actually generates profits, more likely than not the government will go after you because they also need additional funding through taxes and royalties. So, to me, this is the time to be cautious in global corporates while we are seeing the growth recovery or the shape of the growth recovery a bit too early in this cycle.

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