# Debt and currency: Geopolitical risks and return opportunities in EMD

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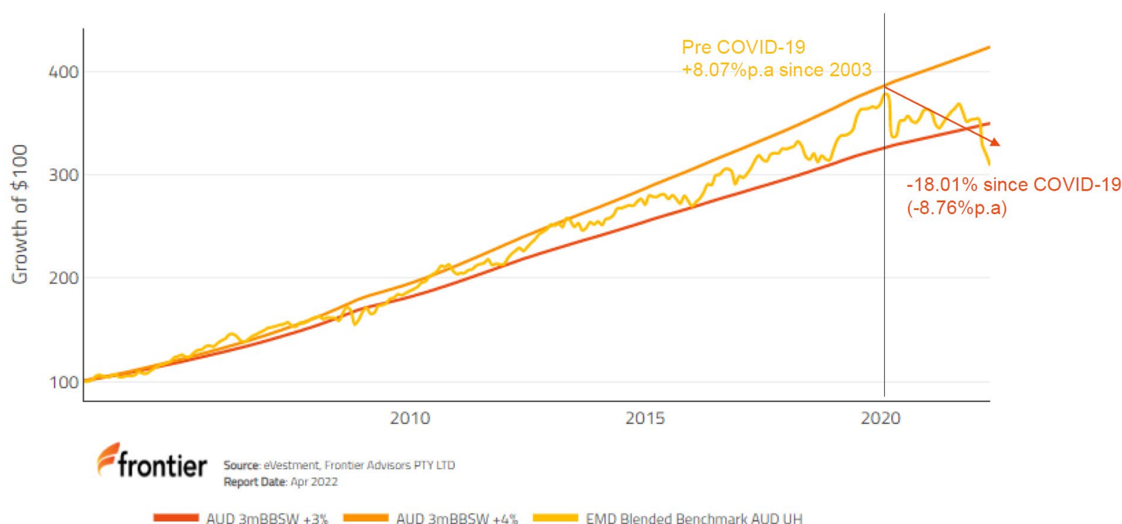
**Emerging market debt downturn offers new window of opportunity**

The performance of emerging market debt has suffered over the past 18 months but opportunities exist in sub-sectors across China and Southeast Asia.

“Performance has been challenging I think it’s fair to say, and there’s been an abundance of crises: Turkey, Egypt, Russia, Ukraine, to name a few,” said Frontier Advisors Senior Consultant, Iain McMahon.

The sector was delivering returns 3-4 per cent above cash until the COVID-19 crisis in early-2020, which prompted the longest and deepest drawdown in the (50:50 blended currency) benchmark’s history. More recently the Russia-Ukraine war (February 2022) and US Treasury yield surge (April 2022) also prompted losses.

EMD accumulation returns reconcile well against a typical Alt Debt sector objective (cash+3%-4%).




Despite the recent sell-off, realised returns for hard currency bonds since inception have still hit cash plus 4 per cent p.a. – broadly equivalent with sub-investment grade developed market credit.

While local currency bonds themselves have been well performed (comparable to cash + 4 per cent), emerging market currencies depreciated against the Australian dollar dampening returns by -3.12% p.a. since inception. This return drag has been comparable to the long-run cost of hedging emerging market currency to Australian dollar. The unhedged return profile, however has provided diversification as the Australian dollar tends to act as a shock absorber in stressed environments.

“Australian investors, when they go into EM, have a great advantage from a currency perspective in my opinion,” said Frontier Advisors Head of Debt and Currency, Andrew Kemp.

Investors should also consider the different credit exposures available in emerging markets. Investors certainly don’t need to own the whole market to achieve strong returns, so a strategy that is less constrained to benchmarks can make sense.

“Hard currency sovereigns are fine but they’re very long duration and they have a mix of some of the less desirable country exposures going around. So, adding some of the corporates to it can actually help quite substantially in terms of the risk profile, and that diversification of returns over time.”

Manulife Investment Management (Asia) Head of Greater China Fixed Income Research, Judy Kwok, said high-yield Asian debt had been hurt over the last 12 months by rising interest rates, geopolitical conflict, and particularly the liquidity crisis in China’s real estate sector.

She said government policy would now be supportive of the real estate sector, although China continues to face challenges and high yield defaults have not bottomed out.

“We expect a few more from relatively large developers in the next few months, and there might be smaller ones as well.”

However, Kwok still pinpointed investment opportunities in Chinese property as a standout, partly on relative value grounds.

“Single Bs [credit rating], we have to be very careful. Yes, default rates are still very, very high. But there is also significant reward if you take the right bet. So we have to be nimble, we have to be very careful and cautious in looking at single Bs, but well-resourced asset managers should be able to start looking and picking names and bonds from that sector already given the visibility is much better than six months ago.”

Asia accounts for more than half (53 per cent) of the global emerging market credit universe. Frontier said Asian emerging market debt corporate allocations are still underrepresented in investor portfolios and currently offer a market opportunity given valuations have improved.