Frontier International

Taking the good with the bad in emerging market debt

May 2022

frontieradvisors.com.au

frontier

About us

Frontier has been at the forefront of institutional investment advice in Australia for over 25 years and provides advice on $600 billion of assets across the superannuation, charity, public sector, insurance and university sectors.

Frontier's purpose is to empower our clients to advance prosperity for their beneficiaries through knowledge sharing, customisation, technology solutions and an alignment and focus unconstrained by product or manager conflict.

AUTHOR

Andrew Kemp

Principal Consultant,
Head of Debt and Currency

Andrew Kemp joined Frontier in 2016 and is the head of the Debt and Currency research team, leading Frontier's fixed income and currency research program. Andrew has around twenty years of experience in the asset management industry both domestically and globally, having worked in Australia, Singapore and the UK. Andrew was Head of Fixed Income at DBS Asset Management (Singapore) for three years and prior to that spent a decade as Fixed Income Portfolio Manager at Alliance Bernstein Australia. Andrew joins Frontier from Chimaera Capital, where he was the Director of Asset Management, most recently in Melbourne, but chiefly in the Capital Management division in Singapore. Andrew holds a Bachelor of Commerce (Finance) from Otago University (NZ) and a Graduate Diploma of Applied Finance and Investment from Finsia.

AUTHOR

Iain McMahon

Senior Consultant

Iain McMahon joined Frontier in 2019 and is a Senior Consultant in Frontier's Debt and Currency research team. He is currently responsible for investment advice and manager research across Debt, Currency and Alternatives strategies. His coverage also includes Derivatives advice. Prior to joining Frontier, Iain spent seven years at J.P. Morgan in a range of risk management functions. Four of these years were based in London providing quantitative and qualitative portfolio analysis as a market risk manager. Prior to working in London, Iain worked on a Sydney trading desk in an operational capacity. He holds a Bachelor of Commerce (Finance) and a Bachelor of Science (Statistics) from the University of Melbourne. He is also a CFA charterholder and a Certified Financial Risk Manager (FRM).

frontier

BACKGROUND

Taking the good with the bad in emerging market debt

As the negative impacts of the Russian war in Ukraine, a collapse in the Turkish Lira and China’s property developer collapse dominate the short-term narrative, it can be easy to overlook the proven long-term returns the emerging market debt (EMD) asset class has delivered for Australian investors, who have a natural advantage in this asset class.

Frontier has researched emerging market debt managers over many years and more recently that research has been extended to cover Asia and emerging market corporates. In March, Frontier met ‘virtually’ with a range of EMD and Asian credit managers to consider recent events in EMD and review the broad opportunity set for active managers where value is on offer for longer-term investors.

The dynamic risk backdrop is creating opportunities. Frontier’s Capital Markets Team has upgraded its view on EMD as yields, spreads and currencies point to a more favourable entry point for Australian investors.

Frontier has for some years advocated a blended total return ‘go anywhere’ approach to EMD, which in our view helps avoid areas of over-concentration found in many index aware strategies. Yet this approach can be implemented differently and the results have been diverse over the last year.

This paper revisits the asset class following a difficult year and highlights the manager alpha generation which has been surprisingly positive and perhaps at odds with the historical ‘risk-on’ bias exhibited by many EMD investors in the past.

EMD flashpoints dominate short-term headlines and returns

While the Russian invasion of Ukraine dominates the headlines and ensures risk sentiment remains subdued, the diversity and size of the opportunity set means the vast majority of EMD assets continue to offer risk-adjusted yields albeit at better levels than before.

While searching for yield at the asset class level is not guaranteed to drive strong returns, investors in EMD tend to focus on valuations, which have improved for the better-quality assets in the opportunity set.

Below we separate the market into its three major components as represented by major index provider JP Morgan. Returns have been hampered by a range of factors over the last year and there have been few places to hide, a confronting situation faced by investors across all fixed interest asset classes.

Below we provide some qualitative comments on the year that was, and Table 1 highlights some key market metrics and return attribution statistics.

- A rising rate environment for US Treasury bonds has negatively impacted returns on hard currency sovereign and corporate bonds.
- The additional risk aversion from the war in Ukraine caused some credit spread widening in EM hard currency asset classes, damaging returns over the last year.
- Local currency bond yields have risen steadily for most of the year. Higher inflation in EM economies has been dealt with by central bank rate hikes much earlier than those in developed markets. The tightening bias combined with general risk aversion caused a negative influence on local bond yields causing capital losses.
- EM currency performance versus the AUD has been a modest positive over the year. Some EM currencies have begun to appreciate, the effects of higher commodity prices a perceived benefit to EM commodity exporters.

Table 1: Nowhere to hide across the EMD universe over a difficult year

	EMD sovereign hard (AUD H)	EMD corporate hard (AUD H)	EMD sovereign local (AUD UH)
1 year return %	-14.05%	-9.58%	-8.38%
1 year volatility %	6.54%	3.35%	9.31%
Max drawdown (1 month) %	-9.32%	-6.64%	-12.60%
UST yield change – 1 year	+124bp	+162bp	N/A
Spread change – 1 year	+92bp	+55bp	N/A
Local currency yield change - 1 year	N/A	N/A	+176bp
Top-down attribution – 1 year	UST return **-7.63%** Spread return **-6.44%**	UST return **-5.21%** Spread return **-4.41%**	Local bond **-9.69%** EM FX (vs AUD) **+1.31%**

Source: Bloomberg, Frontier, JPM Indices. Data as at 27 April 2022.

The impact of Russia's invasion of Ukraine

The Russian invasion of Ukraine is a devastating humanitarian disaster and also a key risk event in most financial markets, with the EMD sub-asset classes directly impacted.

Frontier's research trip found most managers held Russian exposure, whether hard or local currency sovereign or some form of corporate exposure.

The sanctions imposed were so severe they caused local currency sovereign bonds to extend declines to close to zero. Ukrainian bonds were impacted given sovereignty fears and the situation remains far from resolved.

Overall losses in Russian bonds are difficult to estimate. Most managers have limited ability to transact and are therefore awaiting some form of resolution to the conflict and for liquidity to return. Index providers used different approaches to Russia, but all major index providers expelled Russia over the month of March at highly depressed levels.

Table 2: Russian bonds trade at zero for a period, Ukraine hit too

	EMD sovereign hard (AUD H)		EMD corporate hard (AUD H)		EMD sovereign local (AUD UH)	
	Weight – 1 year ago	1 year perf	Weight – 1 year ago	1 year perf	Weight – 1 year ago	1 year perf
Russia	3.36%	-75.64%*	4.23%	-66.63%*	7.26%	-91.98%
Ukraine	2.45%	-63.30%	0.78%	-48.51%	0.00%	N/A

Source: Bloomberg, Frontier, JPM Indices. Data as at 27 April 2022. Weights as at 31 March 2021.
*Prior to removal from benchmark as at 31 March 2022.

Manager observations

- Prior to the invasion most managers acknowledged Russia as an attractive allocation based on both fundamental and valuation grounds. While most managers (and the broader market) ascribed a low likelihood of invasion, the investment case for Russia was tested in the weeks preceding the invasion. Russia's actions were consistent with its historic precedent of inferior governance practices. While there were some examples of managers proactively reducing their exposures in Russian debt, most were unable to divest in advance of western sanctions.
- Blended EMD total return (benchmark agnostic) approaches benefitted from more modest initial Russian exposures. Such approaches were not only able to benefit from non-ownership, but also in some cases from explicit short exposures. These short positions were highly tactical and incepted as idiosyncratic macroeconomic hedges. The best performed managers utilised an array of hedges including (but not limited to) short Russian ruble, long protection on Russian credit default swap (CDS) and EM credit default index swaps (CDX). These positions were monetised during March and mitigated the losses from underlying physical positions.
- After the imposition of western sanctions and subsequent closure of local Russian exchanges, liquidity in Russian debt was minimal. Despite the removal of Russian exposures from market benchmarks and Australian Government insistence, divestment from all Russian assets was not possible. Managers reduced holdings where possible, yet most were burdened with residual positions.
- While many managers decided to not add to exposures, few were willing to exit in a price agnostic manner. Most unconstrained approaches opted to retain Russian and Ukrainian exposures in the anticipation of price mean reversion and improved future liquidity.

EMD corporates - dominated by China's property sector collapse

Frontier has long viewed China's inclusion into EMD indices as a positive influence in the sense it provides a large, liquid and high-quality exposure which improves the overall EMD exposure set.

However over the year, a massive performance disparity became evident between onshore Chinese government bonds ~+13% and the offshore USD Asian credit market which fell heavily ~-13% as many Chinese property issuers defaulted.

Blended EMD total return (benchmark agnostic) approaches typically trade corporate securities where valuations are attractive. Many managers were swayed by the attractive valuations on offer in USD Asian credit and were subsequently caught out as bond prices of Chinese property developers, Asian high yield's largest sector, crashed to distressed levels. Conversely China's onshore bond yields fell as growth slowed under the weight of the regulatory crackdown, its performance reminiscent of developed bond market outcomes, perhaps validating its recent inclusion in developed market bond market indices such as the Bloomberg Barclays Global Aggregate Index.

Table 3: China's influence on EMD is disparate

	EMD sovereign hard (AUD H)		EMD corporate hard (AUD H)		EMD sovereign local (AUD UH)	
	Weight – 1 year ago	1 year perf	Weight – 1 year ago	1 year perf	Weight – 1 year ago	1 year perf
China	**4.41%**	**-4.35%**	**7.31%**	**-12.56%**	**10.00%**	**13.51%**

Source: Bloomberg, Frontier, JPM Indices. Data as at 27 April 2022. Weights as at 31 March 2021.

What has happened in China?

China's intention to deliver a soft landing for its property sector has failed. The government plan to limit house price appreciation, which has historically been 5-10% per annum, and curb property speculation has been poorly implemented. Judged by many to be a prudent policy, China's '3 red lines' policy was designed to limit property developer debt levels according to a range of financial metrics. An attempt to create sustainable supply of homes has been scuttled by a massive demand side shock driven by government induced bank lending caps and changes to developers working capital facilities during construction. A lack of capital market funding and local bank capital halted by policy caused Evergrande to collapse and a number of other highly indebted developers to follow. Bond pricing has been incredibly weak, with even the stronger investment grade developer's bond prices trading down, and the default rate from start of 2022 has been estimated at over 30%.

A massive confidence crisis has ensued as Chinese owner occupiers have become unwilling to purchase off the plan apartments, which typically require a 30-40% deposit placed in escrow.

Developers historically had access to these escrow accounts to pay suppliers during the construction period, but this was cut off meaning other sources of funding were needed, placing USD bonds under severe pressure as corporate balance sheets headed toward bankruptcy.

Better sentiment was noted from around December when banks were instructed to support the growth aspirations of the PBOC and loosen lending standards. Consumer confidence remains very poor within the housing sector. Consumers now need to assess the financial strength of developers in their region, and many are not willing to make the initial deposit or take that risk without government backing (which seems contrary to initial government intentions).

There are a few other policy tools being used to try to correct the slump in confidence. Certain people are now allowed to buy investment properties in some areas. M&A activity has been excluded from the '3 red lines' policy calculations, meaning stronger developers can buy the assets and debt of weaker players and not fall foul of the debt ceiling calculations. Some of the stronger property companies have been able to borrow, likely ordained by the Chinese government.

frontier

Manager observations

- Managers of Asian USD assets have performed very poorly. Prior to the collapse, Asian high yield bond markets were dominated by Chinese property developers (~50%) and many Asian managers tilt heavily toward these assets given a growth focussed management style is commonplace amongst the Asian cohort.
- During 2021 there were notable examples where managers had remained underweight, but the dramatic price action saw many add risk, often too early, with detrimental results.
- Forward looking views were difficult to establish but most managers reluctantly conceded the only exit from the market would result from continued government intervention.
- One manager noted China needs to build 8 million apartments per year to meet its urbanisation demand, and current supply (and demand) are well below that, meaning the ultimate outcome may be for greater house price appreciation in the future as urbanisation rates continue.

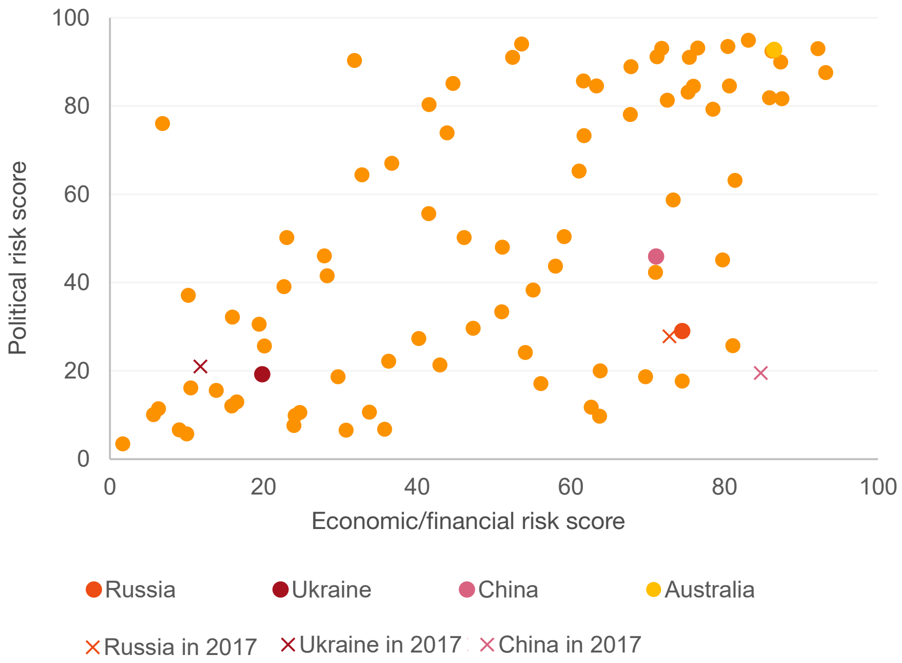
frontier

EMD ESG vs fundamentals

Through an ESG lens, Russia was universally acknowledged by managers as having poor governance practices which have been unchanged for some years.

This reflected inferior ESG scores relative to fellow EM jurisdictions as shown in Chart 1. Limitations of ESG data providers include non-timeliness, dispersion of scoring across providers and non-predictivity of ESG scores with investment outcomes. As tensions escalated, data provider ESG scores and metrics were slow to reflect the worsening sanctions. This is reflective of the longer-term focus on ESG rating services.

Chart 1: Country risk scores by sovereign



Source: Bloomberg, Frontier. Data as at December 2021.

Manager observations

- Almost all managers cultivate their own proprietary ESG scores. These scores evidence the manager's own ESG analysis and data sourced from multiple market providers. Proprietary scoring methodologies are widely relied upon and typically improve upon the limitations and lack of timeliness of third-party ESG vendors.
- However, the extent to which ESG informed actual positions varied drastically across the manager cohort. While the most common positioning resulted in neutral weighting, we did find some evidence of managers reducing Russian risk ahead of the invasion on the basis of worsening ESG scores. At the extremes were managers who deemed Russia 'non-investable' well in advance of the invasion, whereas others believed pre-invasion valuations represented adequate compensation for poor ESG practices.
- Our overall observations of ESG integration in relation to Russian exposure were modestly positive, yet we found it interesting many managers having drawn similar conclusions on the worsening ESG assessment in Russia, did not act swiftly preferring to lean on Russia's economic fundamentals which as shown in Chart 1, were ranked quite highly versus other EM countries.

EMD manager alpha - a positive in the weak market environment

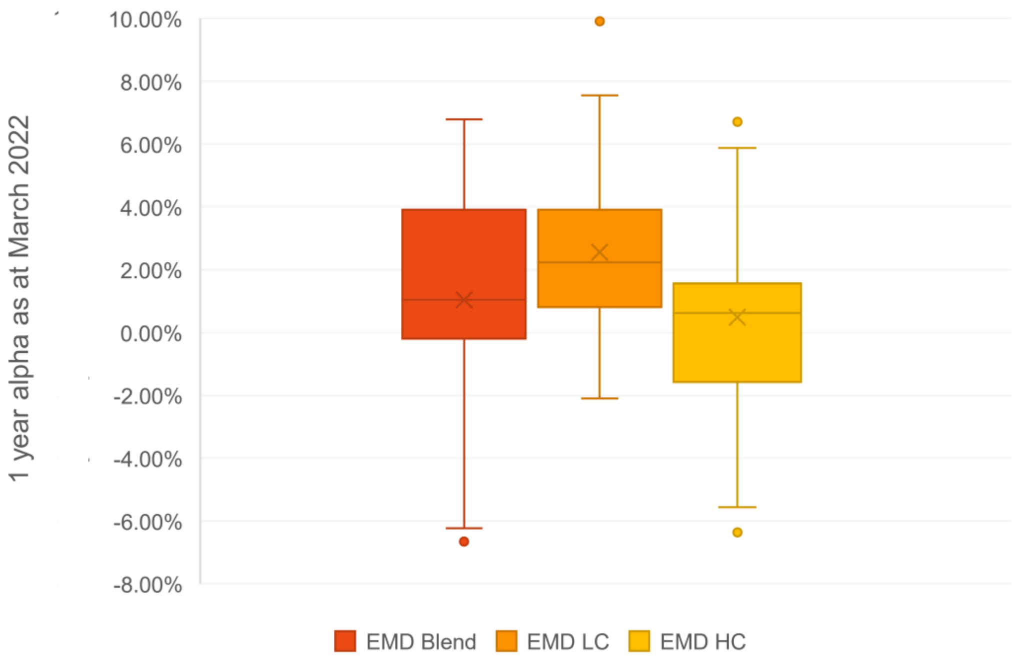
EMD manager alpha has been a bright light in the market weakness, with some notable exceptions.

Local currency bond manager alpha was one of the better EMD cohorts with most managers ahead of benchmark over the last year, fundamental rate hiking cycles in EM economies more easily forecasted than idiosyncratic shocks.

Blended total return approaches can help avoid the impact of duration given the unconstrained nature of the approach. Some of these strategies did allocate heavily to high yield corporate securities e.g. Chinese property developers, and accordingly underperformed, in some cases by significant margins.

Demonstrated upside and downside capture statistics are important for investors to understand. While blending different EMD sub-asset classes is preferred, managers also must dynamically adjust the market beta based on top-down macro inputs, rather than simply rely on bottom-up country selection.

Chart 2: Manager alpha in EMD has offset some of the market losses



Source: External managers, Frontier. Data as at 31 March 2022.

EMD in the rising rate environment

As a duration-based asset, EMD performance has been negatively impacted as interest rates have risen.

The market often ascribes EMD the stereotype of underperformance in US rate hiking cycles, yet it can be often worse ahead of the first-rate hike as the market prices likely changes in monetary policy. Hard currency EMD is directly impaired by rising US treasury yields, however blended EM total return approaches incorporating unhedged local currency exposures can prove diversifying for an Australian investor.

Blended total return approaches typically also incorporate an EMD corporate hard currency allocation and practice tactical duration hedging, limiting the extent of US Treasury duration versus developed market exposures. While there is a limited sample, EMD returns in recent hiking cycles have remained protected by emerging market idiosyncrasies and a higher starting yield cushion.

Table 4: Comparing return profiles prior to and during US rate hiking cycles

	Jan-94 to Feb-95	May-99 to May-00	May-04 to Jun-06	Nov-15 to Dec-18	Feb-22	Median
Length of hiking cycle (months)	13	12	25	37		26
12 month performance prior to first rate hike (%)						
EMD HC (AUD H)		-8.6	6.3	2.1	-7.8	2.1
EMD LC (LC)			2.9	2.8	-6.1	2.8
EMD LC (AUD UH)			-4.1	-3.6	-3.9	-3.8
AUD/USD	4.4	3.6	9.5	-15.1	-6.3	-0.8
EM FX (vs AUD)			-7.0	-6.3	2.2	-6.6
Performance during the rate hiking cycle (%p.a.)						
Fed funds rate (start)	3.0	4.7	1.0	0.1	0.1	4.0
Fed funds rate (end)	5.9	6.5	5.0	2.4		8.0
Fed funds rate (change)	3.0	1.8	4.0	2.3		3.2
EMD HC (AUD H)		13.8	14.2	4.9		13.8
EMD LC (LC)			10.2	6.7		8.4
EMD LC (AUD UH)			11.2	6.0		8.6
AUD/USD	3.7	-12.1	2.0	-0.9		1.4
EM FX (vs AUD)			1.0	-0.7		0.1

Source: Bloomberg, Frontier. Medians encompass longest available data sample for each asset class.

The final word

EMD asset classes have been universally weak over the last year as the impacts of higher US Treasury yields and emerging market idiosyncrasy have weighed on returns.

Frontier's favoured blended EMD sovereign benchmark (50% HC sovereign AUD H /50% LC sovereign AUD UH) fell by ~-7% in February 2022 during the Russian invasion of Ukraine. This represents its third worst month on record behind COVID-19 (March ~-10%), and the GFC (Oct 08 ~-8%). Off benchmark EMD credit exposures were also hit hard, falling over 10% in the last year. Overall macro sentiment and idiosyncratic issues in China particularly drove this weakness.

Yet EMD manager approaches to the market stress were diverse and resulted in highly differentiated performance outcomes. Generally strong alpha was noted across all EMD sub-asset classes, particularly local currency sovereign. Some managers have performed very strongly, the defensive positioning offsetting the negative effects of market weakness which was seen particularly in duration sensitive assets.

Blended total return approaches generated diverse returns with a tail of very good and poor performance for a small number of managers highlighting the importance of overall portfolio risk control in this asset class.

EMD has endured a range of crises since COVID-19 and this can make it easy to forget the solid long-term returns this asset class has generated over time. The improved valuations and depth of active management options available, make for an attractive allocation for long-term investors looking for a highly liquid and growth focused debt investment.

Want to learn more?

Frontier has undertaken extensive research on emerging market debt and is well placed to advise investors on this theme. We encourage investors to reach out to Frontier's Debt and Currency Team for a discussion on how we may be able to help.

frontier

Frontier

Level 17, 130 Lonsdale Street, Melbourne, Victoria 3000

Tel +61 3 8648 4300

Frontier is one of Australia's leading asset consultants. We offer a range of services and solutions to some of the nation's largest institutional investors including superannuation funds, charities, government / sovereign wealth funds and universities. Our services range from asset allocation and portfolio configuration advice, through to fund manager research and rating, investment auditing and assurance, quantitative modelling and analysis and general investment consulting advice. We have been providing investment advice to clients since 1994. Our advice is fully independent of product, manager, or broker conflicts which means our focus is firmly on tailoring optimal solutions and opportunities for our clients.

Frontier Advisors Pty Ltd ABN 21 074 287 406 AFS Licence No. 241266