William Blair

EMERGING MARKETS DEBT

Investment Management
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# Opportunities and Challenges for Emerging Markets Debt Investors


As we announce the launch of our emerging markets (EM) hard currency debt strategy, markets are in turmoil. At this time of rising uncertainty and heightened volatility, we share our latest thoughts on investment opportunities across emerging markets debt (EMD).

April 2020

**William Blair Emerging Markets Debt Team**

“We see an elevated opportunity to generate alpha from security selection. Forced selling and the inclusion (or not) of individual bonds in ETFs or indices are creating dislocations in pricing across an increasing number of sovereign curves.”

**Marcelo Assalin, CFA,** Head of William Blair’s EMD Team

# Introduction

As we announce the launch of our EM hard currency debt strategy, investors across the globe are continuously reassessing their portfolios and asset allocation due to the uncertainty created by COVID-19 and its potential impact on both the global economy and prices. At this time of rising uncertainty and heightened volatility, we share our latest thoughts on investment opportunities across EM sovereign debt and how we seek to capture them.

> "There are many structural reasons that investors may look through the current challenges."
>
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# Fundamentals Are Under Pressure but Support Has Increased and Buffers Have Accumulated Over Time

The fundamental landscape in emerging markets has deteriorated sharply as the global economy prepares to dive into an economic recession, and we have concerns about the ability of policymakers in EMs to both contain COVID-19 and manage its resulting socioeconomic implications. While there are encouraging signs from a policy response perspective (fiscal and monetary, macro and micro), the magnitude of the potential impact on EM credit metrics remains an open question.

However, we do not believe that the deterioration in measures of debt sustainability will translate into widespread EM sovereign defaults. We anticipate strong multilateral and bilateral support. Indeed, the International Monetary Fund (IMF) and World Bank have already announced significant support programs, and we expect a strong response from the G20.

Stepping away from the present environment, there are many structural reasons that investors may look through the current challenges described above.

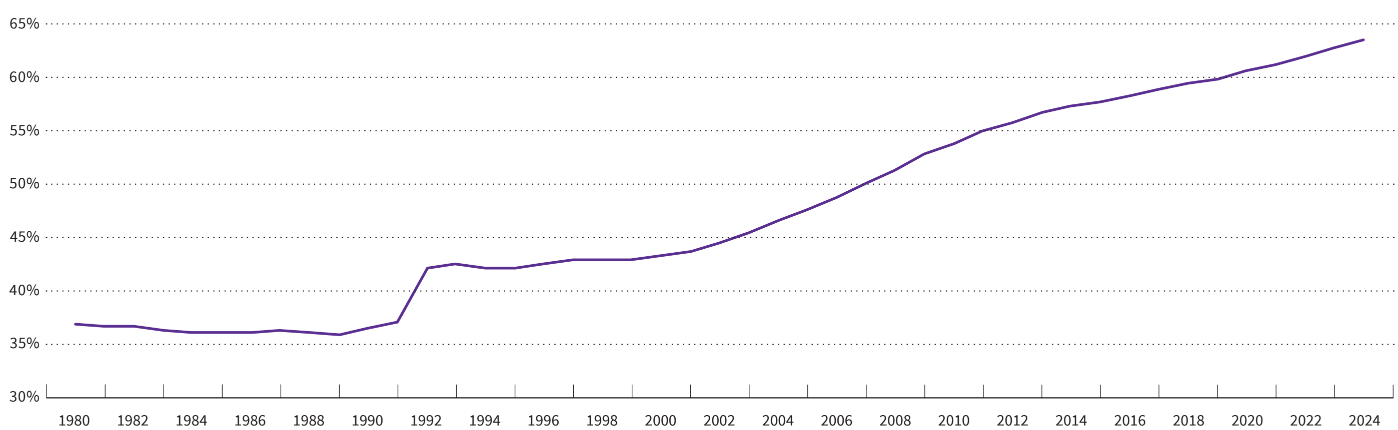
The first is growth differentials. EM countries have matured over the past several decades. Growth has outpaced that of developed markets by an average of more than 2%, and we forecast that this gap will widen further over the next five years. As a share of gross domestic product (GDP) using purchasing power parity (PPP) dollars, EM countries have grown from approximately 37% of total global output in 1980 to approximately 60% today.

Second, macro buffers have been established and improved in terms of their ability to act as shock absorbers during periods of market and economic stress. For example, international reserve accumulation in EM countries has outpaced developed market (DM) reserve accumulation by more 50% since 1980. In addition, EM countries are slowly becoming more resilient, not only with respect to economic shocks, but also to reversals in capital flows as domestic capital markets have deepened.

Lastly, EM assets have still not shaken off now-defunct historical stigmas in the minds of global investors. Major global bond indices tend to underrepresent EM fixed-income assets, and bond investors tend to be underweight the asset class despite attractive Sharpe ratios. From a supply perspective, EMs represent 20% of global fixed income but have less than a 5% weight in widely followed fixed-income benchmarks.

EXHIBIT 1

## Emerging Markets' Share of GDP Rising




Source: IMF World Economic Outlook, as of October 2019.

# Valuations Are Now Extremely Attractive and Many Weaker Credits Are Already Priced at Distressed Levels

Taking the above view of the macro backdrop into account, we find valuations to be very attractive. A significant part of the investable universe is currently priced below what we perceive to be fundamental fair value, with spreads overstating both the probability of default and loss given default relative to other fixed-income asset classes and historical levels.

While we acknowledge that there is scope for EM defaults to increase in 2020, we still believe this is an attractive entry point. Even before the current crisis and its subsequent impact on asset prices, EM hard currency debt has historically been an incredibly mispriced asset class, with expectations of losses greatly exceeding those realized ex-post.

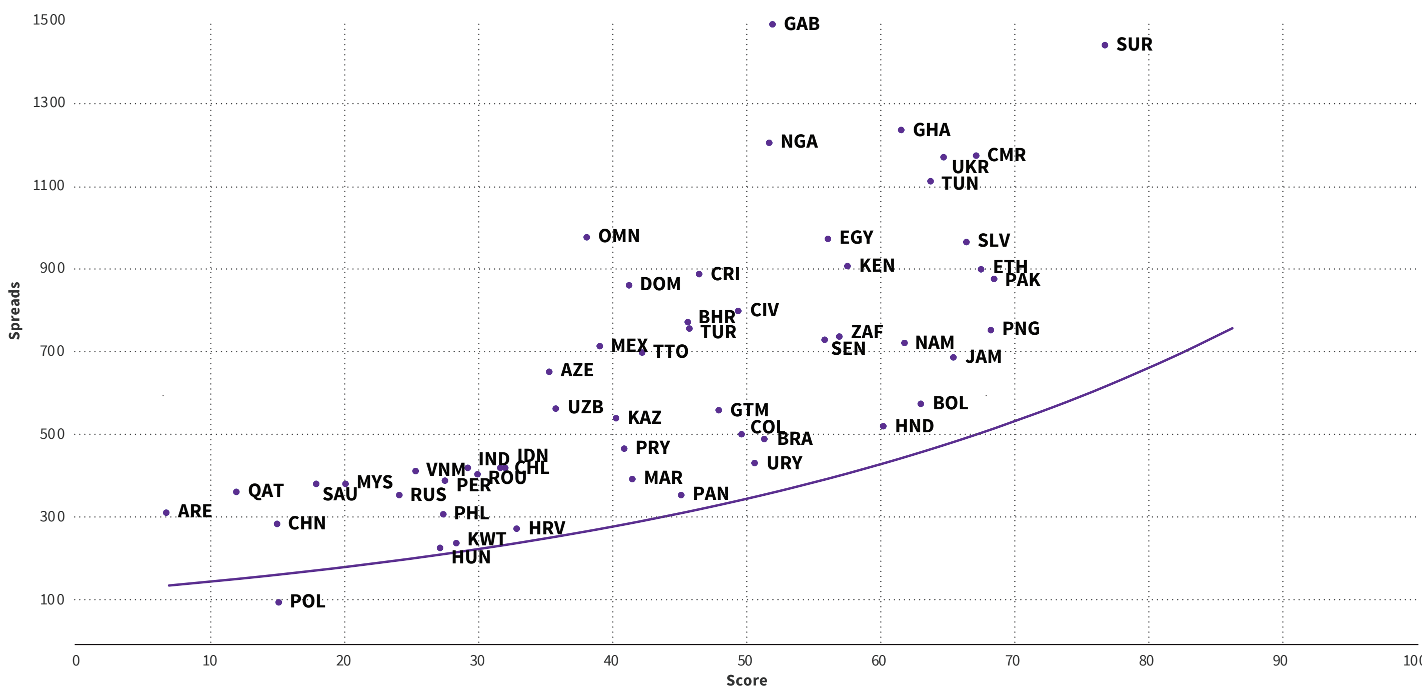
From 1980 to 2016, Moody's estimates that the average default rate of hard currency EM sovereigns was approximately 0.78%. In addition, the median recovery rate was approximately 54 cents on the dollar. Thus, investors in EMD hard currency have historically been overcompensated for the actual risks.

We find that home-country bias and outdated memories of 1980s-style economic meltdown and contagion could be reasons that excess risk aversion is priced into EM credit markets.

EM sovereigns benefit from technical and monetary assistance from international financial institutions such as the IMF and World Bank as lenders of last resort, and this can help improve credit quality by reducing liquidity risks.

EXHIBIT 2

## Due to Heightened Risk, Aversion Our Entire Universe Is Trading Cheap Relative to Fair Value Estimates




Source: William Blair, as of March 20, 2020. Score is the output of our quantitative model that ranks the creditworthiness of all the countries in our universe from 0 to 100.

# We Have Seen This Movie Several Times Before

While history does not always repeat itself, it is still helpful to look to recent experience in evaluating the current crisis. In 2008, as markets in most of the developed world were melting down, EM bond spreads blew out and correlations increased significantly.

This proved to be a huge overreaction. In truth, outside of Ecuador (which was more for political reasons), we did not see a single hard currency sovereign default as a result of the Global Financial Crisis.

In recent weeks we have seen a rapid repricing of risky assets in a similar fashion. At one point in the past weeks, the largest EMD exchange-traded fund (ETF) experienced unprecedented outflows, which drove its share price to trade with a discount of up to 7% to its underlying assets. These outflows created massive forced selling pressures in the market, leading to significant price dislocation.

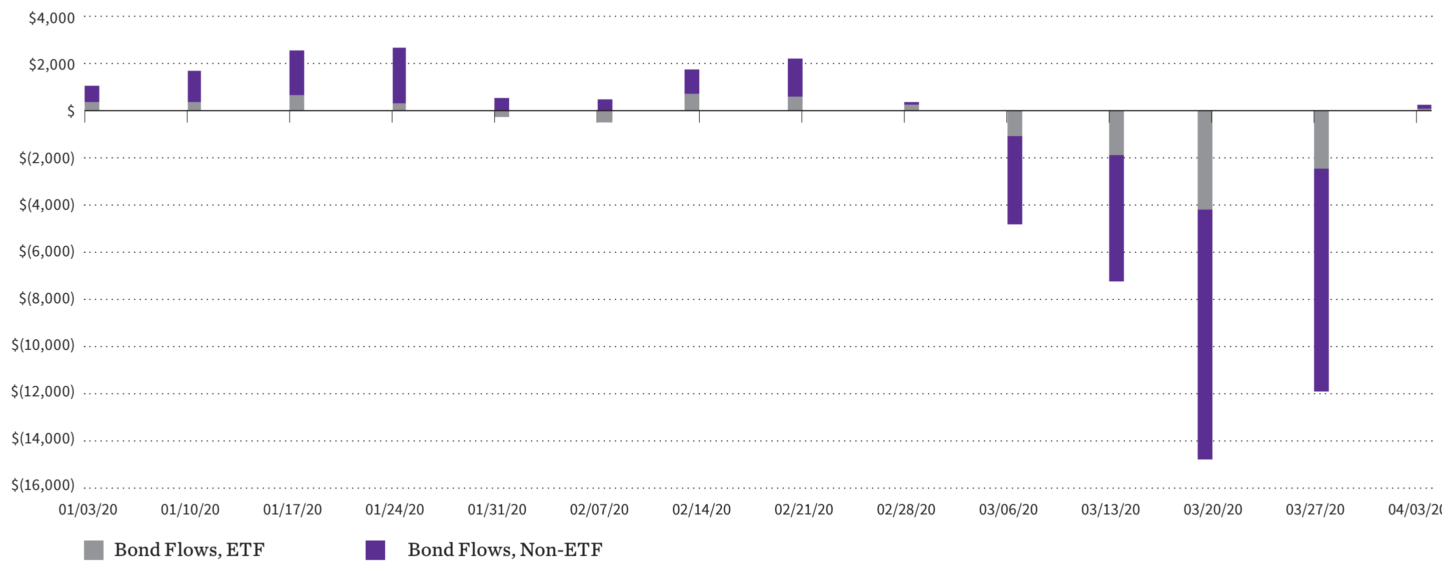
Ultimately, while we do not expect volatility in EMs to fall while other global asset volatility remains extremely high, we think that investors are being more than adequately compensated for the risks.

# Technical Conditions Remain Challenging Near Term, but There Are Reasons for Optimism

Significant outflows from EM funds amid very low liquidity have contributed to the major price dislocations described above, especially in the less liquid and more volatile high-yield space. While we believe market conditions should remain choppy in the very near term, improving liquidity conditions, declining outflows, and strong monetary easing globally provide reasons for optimism. Scheduled sovereign and corporate cash flows (coupons plus amortizations) of $60 billion in April and multilateral funding should provide additional support.

EXHIBIT 3

## Technicals Have Turned Sharply Negative (In Millions)




Sources: JPMorgan and EPFR, as of April 3, 2020.

EXHIBIT 4

## Historical EM Bond Flows (In Billions)

| | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Total EM Bond Flows | $14 | $31 | $35 | $34 | $(2) | $50 | $83 | $47 | $100 | $6 | $11 | $(21) | $40 | $116 | $19 | $67 |
| Of Which = Hard Currency | $14 | $25 | $25 | $13 | $(17) | $32 | $34 | $22 | $74 | $(3) | $15 | $(6) | $33 | $74 | $9 | $56 |
| Of Which = Local Currency | $1 | $6 | $10 | $22 | $16 | $18 | $49 | $25 | $26 | $10 | $(4) | $(15) | $7 | $43 | $10 | $12 |
| Of Which = Retail Flows | $4 | $14 | $10 | $16 | $(6) | $27 | $69 | $20 | $74 | $(20) | $(8) | $(38) | $23 | $82 | $(10) | $43 |
| Of Which = Hard Currency | $3 | $11 | $6 | $4 | $(13) | $14 | $26 | $9 | $56 | $(13) | $1 | $(16) | $20 | $52 | $(12) | $35 |
| Of Which = Local Currency | $1 | $3 | $4 | $12 | $8 | $13 | $44 | $11 | $18 | $(6) | $(9) | $(22) | $3 | $30 | $1 | $8 |
| Of Which = Strategic Flows | $10 | $17 | $25 | $18 | $4 | $23 | $13 | $27 | $26 | $26 | $19 | $17 | $17 | $34 | $29 | $24 |
| Of Which = Hard Currency | $10 | $14 | $20 | $9 | $(4) | $18 | $8 | $13 | $18 | $10 | $14 | $10 | $13 | $21 | $21 | $21 |
| Of Which = Local Currency | $- | $3 | $6 | $10 | $8 | $5 | $5 | $14 | $8 | $16 | $5 | $7 | $4 | $12 | $8 | $3 |

Sources: JPMorgan and EPFR, as of February 26, 2020. Strategic flows are mandates/institutional money.

# A Summary of Our Positioning

Although we are comfortable with the risk/reward profile of the asset class generally, the dramatic fall in oil prices is putting extreme pressure on oil-exporting countries where buffers are more limited and policies are less flexible. These pressures will become critical if low prices are sustained over a longer period by successive demand (global pandemic) and then supply (inventory buildup) shocks.

Therefore, we are careful to shy away from countries where we have concerns about medium-term debt sustainability and where bond prices are not yet reflecting our full-probability estimate of the potential for restructuring. Some of the weaker African and Gulf Cooperation Council (GCC) countries fit this description.

In contrast, we are happy to be overweight oil exporters that have sufficient resources to service debt despite current low price levels, particularly in instances where bonds are trading at levels that do not reflect this resilience. Commonwealth of Independent States (CIS) countries are well placed in this regard.

We also believe that there are more opportunities in selected high-beta names than in low-beta names, and as a result we are currently overweight non-investment-grade sovereigns.

A lack of liquidity and forced selling have contrived to create dislocations in markets, with bonds trading below our view of their underlying fundamental fair value. We consider Ukraine, Ghana, and Ivory Coast as examples of countries that fall into this category.

Conversely, Lebanon, Argentina, and Ecuador are all markets currently pricing at highly distressed levels. Although we do not doubt that all of these markets will ultimately restructure, we believe recovery values are very likely to be higher than where bonds are currently being marked and we see value in each.

Complementing our sovereign security selection, we include corporate issuers at attractive spreads above their sovereign benchmark using our proprietary spread-over-sovereign (SOS) model. In this environment, we look for corporate issuers that show low liquidity concerns, are leaders in their cost structures, and have solid business profiles. We are dipping into lower credit quality with caution given uncertainty over the length of the economic shutdown, yet we can currently incorporate quality corporate issuers at historically attractive levels.

Our SOS model has captured what we believe are opportunities across investment-grade markets, where spread levels have similarly widened in excess of our fundamental assessment. In Brazil we see more value in the corporate space; this is also the case in Peru, among other countries.

Lastly, we see an elevated opportunity to generate alpha from security selection. Forced selling and the inclusion (or not) of individual bonds in ETFs or indices are creating dislocations in pricing across an increasing number of sovereign curves.

EXHIBIT 5

### Select Overweights and Underweights by Beta Bucket

| | Overweight | Underweight |
|---|---|---|
| High-Beta | Argentina<br>Ecuador<br>Ukraine<br>Lebanon | Oman<br>Iraq<br>Turkey |
| Medium-Beta | Guatemala<br>Qatar<br>Brazil Corporates | Bahrain<br>Saudi Arabia<br>South Africa |
| Low-Beta | Hungary<br>Russia<br>Kuwait | United Arab Emirates<br>Indonesia<br>Peru |

Sources: William Blair, as of April 2, 2020.

# Why William Blair EMD?

We believe it is important for active investors in any asset class to follow a process that is designed to identify alpha opportunities in a structural and comprehensive manner, under a range of market conditions, while maintaining rigorous risk management controls. During periods of exceptional volatility as we are now experiencing, this is particularly essential.

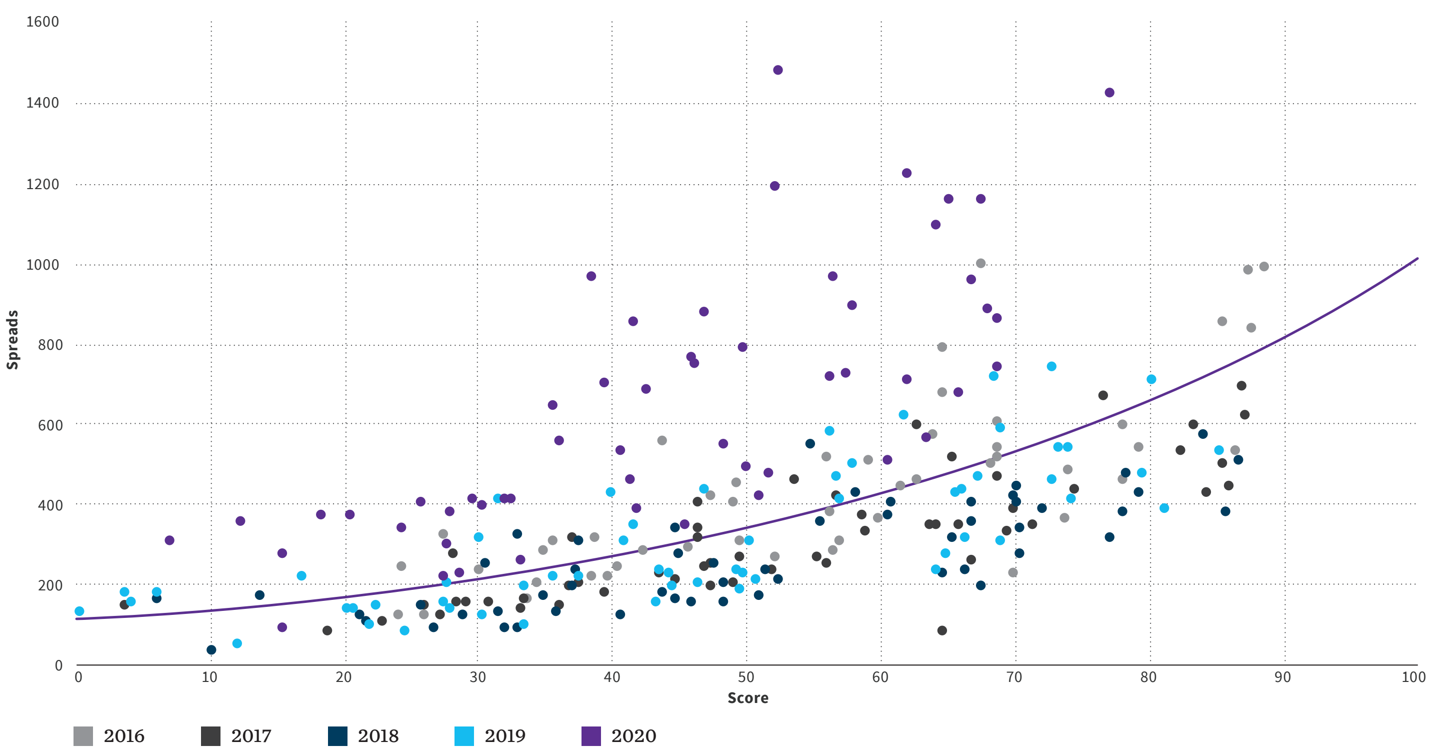
We believe the diversified beta-bucket exposure methodology our team has been successfully using for many years allows us to navigate choppy waters better than many peers with a similar style. By dividing the world into three major beta buckets (or risk categories), we believe we can manage risk and identify opportunities more effectively while ensuring a strong risk management discipline relative to the benchmark. As the relative spread differential between high-beta and low-beta countries has expanded markedly, the opportunity in risky countries has become attractive.

Our proprietary quantitative model helps us identify strong relative value ideas. This model tells us that we have not seen such opportunity to capture alpha in the past five years. We believe investors with longer-term time horizons have very rarely seen such an attractive opportunity to go long EMD. Ex-post credit losses versus what is priced in by markets today are likely to differ wildly, potentially boosting returns for the long-term investor.

Our fundamentals-first approach to corporate credit analysis enables us to thoroughly understand issuer risks. Through our corporate risk model, our analysts comprehensively assess an issuer's credit-risk profile. This assessment gives us the confidence necessary when including corporate issuers to complement our sovereign portfolios.

EXHIBIT 6

## Opportunity Set Attractive




Sources: William Blair, as of March 20, 2020. Score is the output of our quantitative model that ranks the creditworthiness of all the countries in our universe from 0 to 100.

# The William Blair EMD Team

The William Blair EMD team is a dedicated group of professionals focused on delivering strong results for our clients. We have a global presence (New York, London, and The Hague) in both research and trading, giving us extended access to markets. Our portfolio managers have dual functions of evaluating and selecting securities and participating in trade execution. The team maintains constant contact with the market and other William Blair investment teams, responding quickly to new developments.

Our investment approach combines the deep fundamental expertise and experience of our team members with quantitative tools to generate investment ideas and contextualize the large quantity of available data. Our research incorporates a broad combination of macroeconomic, ESG, and market data, covering an extended universe of more than 80 EM countries.

We believe that diversification of alpha sources is the best way to meet our strategy objectives through the full market cycle and under a range of market conditions. Our diversification discipline effectively means constructing portfolios by deploying a relatively large number of small active positions, which we believe has the potential to lead to superior risk-adjusted returns over the medium and long term.

The team is supported by William Blair's broader resources. William Blair has always been committed to ensuring that its activities are aligned with the needs of its clients. As an independent, 100%-employee-owned business, the company can maintain a sole focus on investment. Partnership and remuneration are directly aligned to the contribution that individuals make to the success of the firm's clients, and by extension, the firm. This empowers the firm's people to focus on what is best for its clients.

William Blair's reputation for creating a culture that empowers its investment teams was a critical reason for us joining the business. We believe the firm's entrepreneurial spirit and unfaltering commitment to client success are very much in line with our own convictions, and we are confident that this new opportunity will serve as a growth platform for our team and support our ability to deliver alpha for clients.

EXHIBIT 7

## William Blair Emerging Markets Debt Team Differentiators

| People | Process | Platform |
|---|---|---|
| **Experience**<br>Portfolio managers average 16 years of experience and have managed portfolios across multiple market cycles | **Focus**<br>Portfolios have a relatively large number of small active positions | **Partnership**<br>A private partnership structure aligns client and firm interests, allowing the team to focus on long-term alpha generation |
| **Diversity**<br>Team members come from 10 countries and speak 8 different languages, leading to fresh perspectives | **Value**<br>The team is not afraid to take a contrarian stance | **Stability**<br>William Blair offers a demonstrated history of attracting and retaining world-class investment professionals |
| **Location**<br>Team members are situated across the globe, providing extended market coverage | **Fundamental/Quantitative**<br>Fundamental research is combined with proprietary quantitative models | **Team**<br>The team leverages William Blair's broader macro and global/emerging markets expertise |
| **Regional Orientation**<br>The team has expertise across emerging markets with a strong regional orientation, including a specialized focus in frontier and high-yield debt | **ESG**<br>ESG analysis is integrated in the research process | |
| | **Risk Management**<br>A beta-bucket model enhances the team's ability to identify attractive opportunities while ensuring strong risk management relative to benchmarks | |

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