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TO BOLDLY GO: WHY FRONTIER AND EMERGING MARKETS ARE WORTH EXPLORING

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Emerging Markets (EM) and Frontier Markets bonds stand poised to deliver substantial value for those ready to explore their full potential, says Witold Bahrke, Senior Macro & Allocation Strategist at Global Evolution, part of Generali Investments. In particular, frontier markets can offer a compelling role in fixed income portfolios, given their high yield potential combined with low duration.

- Despite the challenges posed by weak global growth, global easing policies create fertile ground for positive EM and frontier market bond returns, which are expected to outperform developed market high yield bonds.
- The combination of reduced macro-financial risk and improving growth-inflation points to better risk-reward profiles in EM bonds going forward, which can help offset slowing growth in China.
- Frontier markets offer high yield potential with relatively low volatility, partly due to factors like lower duration and significant local investor bases, which helps to hedge against geopolitical as well as inflation risks, but also improves liquidity in periods of global financial stress.

The business cycle is bending, not breaking

Emerging market debt (EMD) is our exclusive focus at Global Evolution. Our investment approach is conviction-based and active. We invest only where we see potential, often taking substantial positions beyond the benchmark when confidence is high. We are pioneers in frontier market investing, where our expertise, established since 2010, is extensive and nuanced.

Looking through the headline risks surrounding the US election, a number of key factors currently underpin a remarkably positive environment for EMD and frontier markets. Firstly, we think the economic cycle is bending, not breaking – while growth is cooling, we don't anticipate a recession in the next few quarters. The neutral rate, or the economy's interest rate pain threshold, has risen, and the US labour market remains resilient, which reduces the likelihood of a major downturn. All being said, macro uncertainty remains high as inflation and geopolitical risks linger. Our scenario analysis points toward quite bifurcated outcomes. We therefore believe the real debate for 2025 is between reflation and recession, not goldilocks and recession.

For now, however, inflation has come off the boil, enabling EM and DM central banks to initiate broad rate cutting cycles. This transition from tight to more accommodating monetary policies is paving the way for favourable conditions in EMD. Despite the challenges posed by weak global growth outside of the US, these easing policies create fertile ground for positive EM bond returns, which are expected to outperform developed market (DM) high yield (HY) bonds. Currently, yields are particularly attractive, with EM hard currency (HC) bonds offering a yield-to-maturity (YTM) of 7.7%, providing a meaningful yield pickup relative to DM HY bonds.

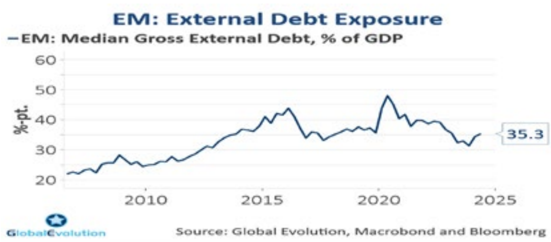
Frontier markets present even higher yield potential, enhancing their appeal to yield-seeking investors. Frontier markets is a slightly misunderstood asset class; while typically high yielding, it's often perceived as overly risky. We would counter that the actual numbers tell a different story: frontier markets serve as valuable diversifiers, offering downside protection in turbulent times without sacrificing much upside in favourable markets.

EM central banks have been ahead of the curve

Looking longer term, the structural picture for emerging markets is encouraging. Overall, macroeconomic foundations are robust, and the growth-inflation trade-off is improving. External debt levels have declined lately, and current account balances have moved back into positive territory. Indeed, EM's have increasingly avoided borrow externally in local currencies (see Figure 1). Moreover, leverage has only risen moderately outside of China.

Policy discipline in emerging markets has improved, with central banks generally ahead of the curve in managing inflation. This is in stark contrast to developed markets, which also saw fiscal balances deteriorate significantly more post-pandemic. The proactive monetary policy stance in EM has allowed inflation to return to pre-pandemic levels much faster than in DM (Figure 2). This combination of reduced macro-financial risk and a structurally improving growth-inflation picture points to better risk-reward profiles in EM bonds in the future. These dynamics are particularly important as they can offset the slowing growth trajectory in China.

Figure 1 and 2: Policy discipline is laying the groundwork for an improving growth/inflation trade-off in EM



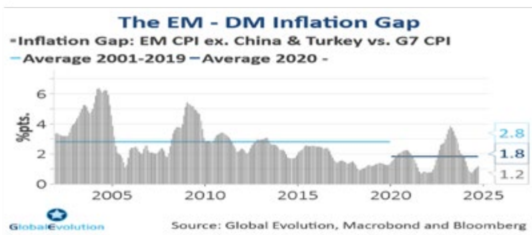
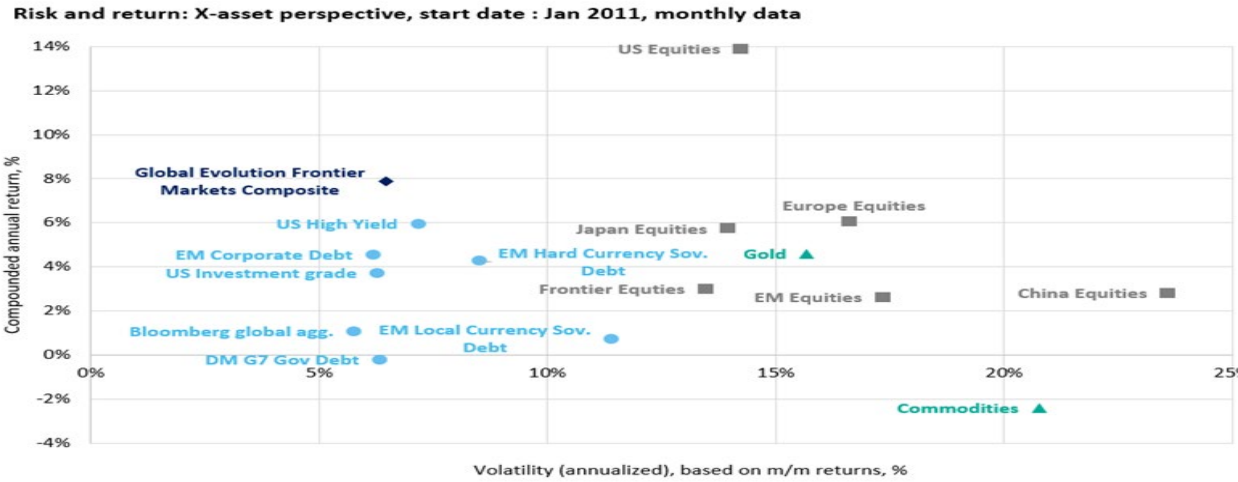


Figure 1 source: Macrobond and Bloomberg as at 11 October 2024

Figure 3: Frontier markets composite has delivered high relative returns and low volatility



Prepared by Global Evolution as of Aug. 30, 2024. Performance is calculated in USD, gross of fees. Performance is calculated in USD, gross of fees. Past performance is not indicative of future results. Strategy inception: Dec. 15, 2010. Please see the "GIPS Performance & Disclosure" for Frontier Markets Composite at the end of this document. The data above is supplemental to the data contained therein and information on fees are present. All composite performance presented after December 31, 2022 is subject to final annual revision and re-calculation where the result will be adjusted due to changes in management fees, performance fee, custody fees and administration fees or non-material errors in pricing. Please see definitions page at the end of this document for clarification of indices.

Frontier Markets: An under-researched reflation hedge

Frontier markets, which are early-stage, fast-growing economies, represent a substantial yet under-researched segment within EMD. Often viewed as high-risk, we believe they offer attractive returns potential with relatively low volatility, partly due to factors like lower duration and significant local investor bases. This base can provide liquidity during periods of global financial stress, as seen during the 2020 pandemic. With currently yields of around 14%, frontier markets present an attractive opportunity, balancing high yield with diversification benefits and risk mitigation. The potential net result is an attractive risk-reward profile as compared to other asset classes (see Figure 3).

Structurally, frontier markets are particularly well-positioned as part of a broader portfolio strategy. Their low duration makes them an effective hedge against structurally higher inflation, and their low correlation to global risk factors imply less vulnerability to geopolitical uncertainty. Frontier markets typically offer yields that surpass those of traditional EM HC (currently averaging around 8%) and DM HY (approximately 7% at present).

> **Low correlation to global risk factors and low duration implies less vulnerability to two of the dominant risks in 2025: geopolitics and inflation** ”

Reform momentum

Year-to-date, we have preferred hard currency bonds over local currency bonds. Positive surprises in U.S. economic data and fiscal uncertainty in the aftermath of the US election means the risk is tilted towards fewer rate cuts from the Fed than the market is pricing at the moment. However, EM currencies have taken a big hit already and we remain vigilant for entry points to pivot towards local currency bonds, which tend to perform well in easing monetary conditions and are supported by structural improvements in the growth-inflation balance, benefiting EM currencies from a structural perspective.

Looking ahead, we are particularly optimistic about certain countries due to their reform momentum. Turkey, for example, stands out for its recent economic policy shifts and punitive forward-looking real rates, which support carry trade opportunities. Ecuador, buoyed by new government policies, and Argentina, which holds potential for a macroeconomic turnaround, are also on our radar. In the local currency space, EM duration exposure appears favourable, as inflation risks are already priced to a large degree, particularly in Latin America. Asia, on the other hand, appears less attractive from a total return perspective amid low yields and weak currency prospects.

Conclusion

Despite increasing geopolitical noise, emerging and frontier markets are navigating a positive juncture – both from a tactical and a structural perspective. The easing of monetary conditions, coupled with resilient growth and disciplined policy frameworks, is setting the stage for favourable returns. While frontier markets may appear risky at first glance, their structural advantages — including high yield potential and effective diversification— highlight their compelling role in diversified investment portfolios. Low correlation to global risk factors and low duration implies less vulnerability to two of the dominant risks in 2025: geopolitics and inflation. As global dynamics shift, we believe EM and frontier bonds stand poised to deliver substantial value for those ready to explore their full potential.

GlobalEvolution

Global Evolution is part of the Generali Investments platform. It is a specialist emerging and frontier markets debt investment manager with an established track record. The company is an active manager and has been integrating ESG into the investment process for many years.

- Founded: 2007
- AUM: €9.7bn*

*Source Global Evolution,data as at end of Q2 2024. The AUM figure represents the combined global assets under management of Global Evolution Asset Management A/S and its subsidiaries.

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