INSIGHTS

MIRABAUD ASSET MANAGEMENT

WHY IT'S TIME TO DE-DIVERSIFY

EMERGING MARKET DEBT

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ACROSS THE 80 COUNTRIES THAT MAKE UP THE EM UNIVERSE, SOME HAVE A GOOD POLICY MIX AND MACRO BACKDROP, OTHERS DON'T.

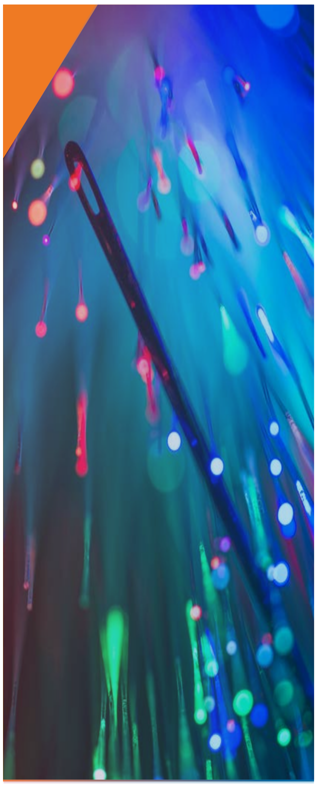
Market divergence calls for a highly targeted investment approach that can pinpoint opportunities spread across a USD30 trillion debt landscape.

After battling against a raft of headwinds through 2022, emerging markets (EM) are indicating that it's time for a change in the investment rule book. Portfolio diversification has traditionally been the '101' of sensible investing. Spread your risk to protect your capital if markets take a downward turn.

But EM suffered an indiscriminate sell-off, with over USD 110 billion flowing out of the universe over the past 18 months. Holding the broad market has been painful.

Today's EM landscape is one of divergence. Across the 80 countries that make up the universe, some have a good policy mix and macro backdrop, others don't.

A big source of this dislocation has come from G7 currency moves. Many of the frontier markets, which are dependent on external financing (typically USD-denominated) are suffering, whereas EMs that have a domestic market, with local currency-denominated debt, have a greater degree of resilience to developed market interest rate changes.



It's this divergence that's prompting an allocation adjustment. Now's the time to de-diversify your EM exposure.

> Today's investment landscape calls for a highly focused strategy, targeting very specific opportunities. Think active and concentrated, not broad and passive.

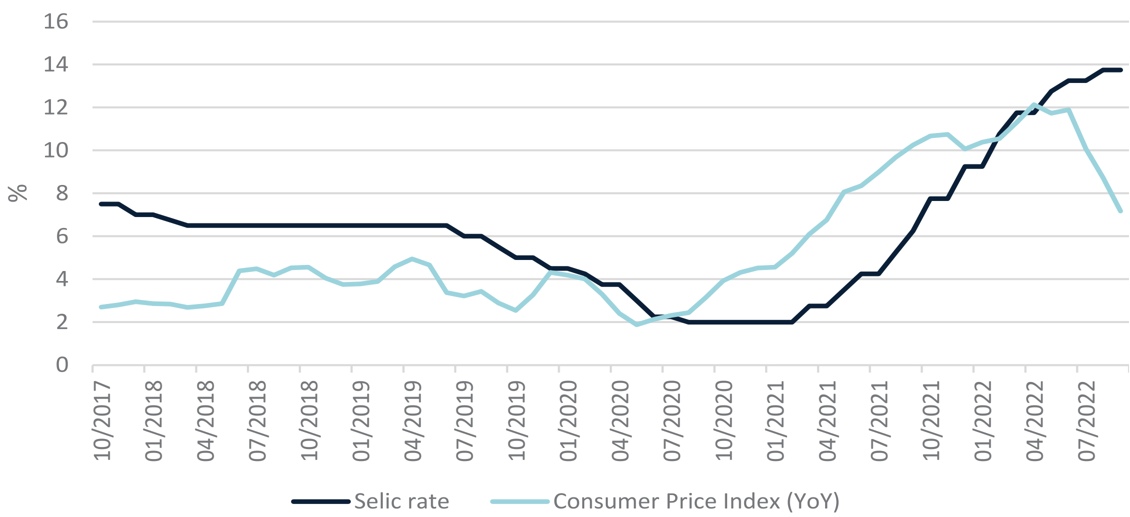
WHERE TO FOCUS?

In terms of opportunities, Brazil, Mexico and the Middle East look interesting.

BRAZIL

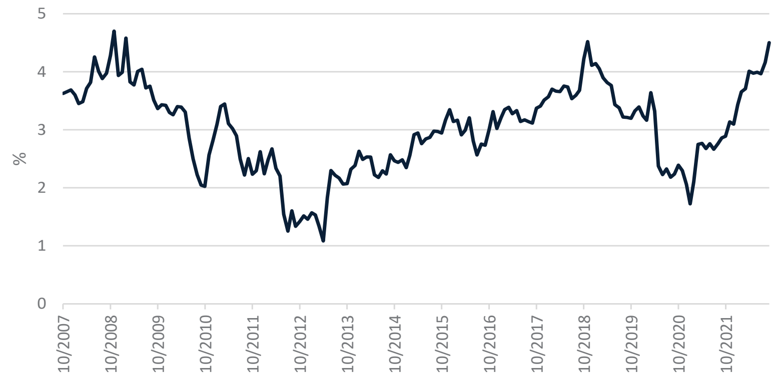
For those with the scope to hold local currency exposures, Brazil could be a good place to start. Brazilian local currency sovereign debt has delivered 14.3% year-to-date (to 3 October), whereas the hard currency equivalent is down -10.3%. Yields on real-denominated government bonds are currently 12%; inflation has peaked and has fallen below 9%, generating a positive real yield for investors.

BRAZIL: INFLATION IS ON A DOWNWARD TRAJECTORY



Source/ Bloomberg, 30 September 2022

MEXICO: 10-YEAR GOVERNMENT BOND YIELDS LOOK ATTRACTIVE



Source/ Bloomberg, 30 September 2022

MEXICO

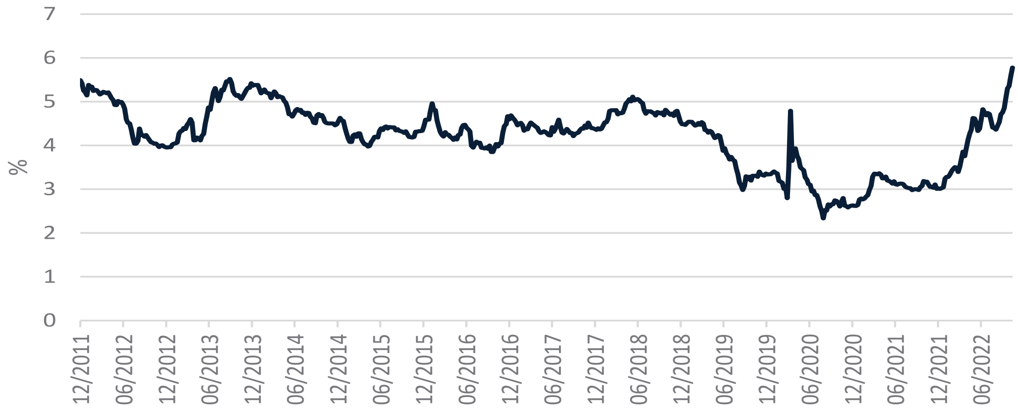
Albeit with different dynamics than Brazil, Mexico has also suffered a protracted period of stagnant growth due to low productivity, lack of investment and high operating costs. However, all these headwinds have either already begun to abate or will soon reverse, supporting the view that domestic assets now present an attractive opportunity.

Mexico has a lot to gain from the potential re-configuration of global supply chains of its northern neighbour – a consequence of both Covid-19 and America's aggressive anti-China policy stance.

Due to its proximity, favourable trade agreements (e.g. USMCA), positive demographics and labour costs that are now below those of China, Mexico is well positioned to attract a rising share of global manufacturing activity that may serve all of North & South America.
Mexico's President AMLO has pursued one of the most conservative fiscal policies in the world, with primary budget surpluses and low levels of public debt as a % of GDP. On the trade front, Mexico is running large trade and current account surpluses, yet the peso remains nearly 20% undervalued in real effective exchange rate terms. Looking across the EM landscape, Mexico is the economy least exposed to slow growth in China.

Government bond yields now average 10%, which is the highest since the 2008 global financial crisis and inflation is expected to peak in Q4 2022 – it is currently at 8.7% year-on-year (October 2022). In real terms, 10-year yields are currently at an attractive entry point.

QATAR 2042 BOND APPROACHES 6% YIELD



Source/Bloomberg, 21 October 2022

MIDDLE EAST

On the hard currency side, the Middle East is looking interesting. We're seeing high-quality bonds yielding 5-7%. You do have to take more duration exposure, but if your view is that at some point the US Federal Reserve will stop hiking, then this is still an appealing opportunity on an 18-month view.

Qatar, for example, is one of the most highly rated countries in the EM sovereign universe, rated Aa3 by Moody's. The 2042 bond was issued in late 2011 and is now trading for the first time since issue below 100 or a yield of 5.77%.

CONCLUSION

The new investment mantra for EM needs to be 'avoid diversification'. The broad universe is not attractive, but, given its size and scope, there are pockets of opportunity. Investors must differentiate by region and country very carefully – laser-focused, high-quality allocations and highly specific active management is the name of the game.

IMPORTANT INFORMATION

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