

# Emerging Opportunities in Emerging Markets Debt

Disruptive Forces in Investing

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**Anu Rajakumar:** Emerging markets, a subset of economies that strive to be more engaged with their developed counterparts, have not been immune to today's market challenges. Between the pandemic and the Russia-Ukraine war, these markets have seen a significant adverse impact on sovereign balance sheets, inciting a wave of sovereign debt default that's been ongoing over the past two years. With global yields rising, we've seen many of these countries fail to meet external liabilities. So is this a continuing downward trend in emerging markets, or could we see a silver lining up ahead?

My name is Anu Rajakumar, and joining me today to discuss these implications and more is Kaan Nazli, Senior Economist and Portfolio Manager on Neuberger Berman's emerging market debt team to share further insights on this disruption to the global economy. Kaan, thank you for coming on the show.

**Kaan Nazli:** It's a pleasure. Thanks for having me.

**Anu:** To get us started, Kaan, could you give us some updates on what's been going on in the emerging market space and also how would you say that the market is currently constructed?

**Kaan:** It has definitely been a difficult time for emerging markets. I mean, when we look at the socio-economic data that is coming out of 2020, we are still at a point of recognizing how difficult it has been when we look at public health numbers, education numbers and so forth. And then right after the conclusion of the pandemic, we had the cost of living crisis, which obviously wasn't only in emerging markets, it was a global phenomenon, where we saw a lot of low-income countries come under a lot of pressure.

And that was particularly important through the food inflation, which was rising across the board. With the Russia-Ukraine war, of course, food inflation, commodities inflation got only worse. We had worsening of the supply chains, and that all puts more and more pressure. In that backdrop, the Fed started raising rates, and that really led to an increase in borrowing costs for a lot of these emerging markets. And ultimately, the dollar market was closed for, pretty much, a lot of the frontier emerging markets that we cover.

I would like to make a differentiation a bit. Of course, when we talk about emerging markets, we think about the 1990s, the peso crisis, the Asian financial crisis, but actually the emerging markets that we are really focused on the dollar debt market right now are very different. The countries that went through those challenges in 1990s, 2000s, like Mexico, or Thailand or South Korea, they have developed their local funding markets quite significantly, and it really reduced their exposure to dollar debt. So when we talk about emerging markets of today in the dollar debt market, that are providing the yields that are making the asset class attractive, those are really frontier market economies or low-income economies that come from, Asia, Sub-Saharan Africa, pockets of Latin America and so forth.

**Anu:** Okay, perfect. And are there particular areas that, you know, you mentioned there are some areas that you focused on, just explain what that is, just geographically is that Latin America, Eastern Europe, Asia, et cetera? Just talk a little about the market that you really focus on?

**Kaan:** We invest globally. So really what makes a frontier emerging market is the size of the market, and whether they have local funding markets that they can rely on. So a lot of the traditional emerging markets have developed this. So when you look at places like let's say, Thailand or, you know, Korea, they don't have reliance on dollar debt anymore.

However, for a lot of these economies, like let's say, Sri Lanka, in Asia, Nigeria, Egypt, in Africa, countries like Paraguay in Latin America, those are small economies. They don't have strong local funding markets and they rely on the external market in order to meet their funding needs.

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**Anu:** Sure, absolutely. So now Kaan, I understand that the sovereign debt issue is quite complex. Could you share a little bit about what aspects investors should be aware of from both an economic and geopolitical standpoint when considering emerging market debt?

**Kaan:** Given the closure of the dollar debt market, the main focus for all of us was refinancing. How can the economies fund themselves? And in the beginning of the pandemic that was very proactively handled by the multilateral organizations, like the IMF and the World Bank, very quickly rolling out funding programs. But coming to 2021, we came to a point that the private sector had to take a bigger role.

And then at that point with the Fed's rates rising, and then that leading to higher yields across the board, that really made it much more expensive for these economies to fund themselves. So as a result, we still saw multilateral funding come in, various countries taking programs with the International Monetary Fund, the World Bank, some countries in central and Eastern Europe receiving funding from the European Union, also to tackle the impact of the Russia-Ukraine war.

So those were all important. But even with this type of support, we've seen several countries going to default. So we've seen a wave of sovereign defaults that we hadn't seen for a long time in emerging markets.

**Anu:** Maybe you could also touch on the role that China plays, in the situation when some of these emerging markets do get into default. How does China get involved? How do they play a role here?

**Kaan:** Sure. Starting with the frontier markets that went into default due to not meeting their FX funding needs, I mean so those are names like Sri Lanka, Zambia, Ghana. So, those are very much what you would expect in this type of cycle. We also had a lot of idiosyncratic defaults, like Russia, Ukraine, Belarus, obviously because of the war, you had a default in Lebanon, which actually has a pretty developed financial sector, but there was a political and socioeconomic crisis there.

But going back to the sovereign debt defaults that you would expect in this environment, we see when we look at history that you don't actually have sovereign debt defaults that often. It's very different from a corporate debt type of index where you would already account for 2 to 5% defaults at any given year, and you try to choose the good ones.

The sovereign debt defaults are more exception than a rule, but when they happen, they are very messy. And we have seen that, with Greece in the developed market space, with Argentina and Venezuela in our space. In this situation certainly it was even more complicated because of the role of China. So China has been a meaningful creditor to various frontier market economies. It is also an important trade partner, a political partner, and it has been a significant source of FDI.

So from early on, the Paris Club, the G7 countries, the multilateral organizations, have been engaging China and trying to get a common stance to provide a safety net for these countries that were facing payment challenges. But that took a really long time. For example, in the case of Zambia, it took almost a year longer than it would've been, just to bring China on board. And then one additional complication was that, how do you classify debt from different Chinese entities?

So you had, obviously the state funding, but then you also had development banks, like the export import banks, would be considered sovereign or commercial. So there were other complications as well. And on top of that, of course, given the current context of the relationship between US and China and West and China, it all got very political and complicated, but we're definitely making progress.

**Anu:** Okay. Excellent. Maybe shifting to the macro side of things, I know that there's different cycles, economic cycles and you've talked a little bit about the impact of the Fed raising rates on some of these emerging economies. Could you discuss that a little bit more in detail? How does the economic cycle work in emerging markets?

**Kaan:** Sure. I mean, the main opportunity here is that the funding challenges have forced the sovereign issuers to actually do the work and tackle the macroeconomic challenges. So in a lot of these cases, these markets are almost takers of the global market conditions. I mean they singlehandedly wouldn't be able to change the supply chain challenges, wouldn't be able to tackle food CPI themselves. So they are part of a global makeup.

And then we have seen indeed, like especially several African countries, growth rates go lower as a result. So typically for an African economy growing 7 to 10% is a normal year, if you look at places like Ivory Coast, Senegal, Nigeria, Ghana. But then we have seen now growth coming at 2 to 5% sometimes lower, and given the population dynamics and demographic dynamics in these countries, that is almost a recession. So definitely economies took a hit, reserves that these countries had built over

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the past decade or so dwindled and we really saw a reform process come out of this. So I suppose that is the positive part of it.

Particularly when we look at IMF programs that are being rolled out in these economies, we're seeing much more focus on governance reform. This is something that started during the COVID-19 pandemic. The IMF was funding the countries in need very rapidly. So they had to have a safety net to make sure that the money was used efficiently and there was no case for corruption. And you would have improvements in public financial management as a result, and you wouldn't have a repeat of these defaults.

So certainly we've seen a lot of action towards that, and that is something positive. But because otherwise when we look at what led the default cases, you see a lot of cases like Zambia where there wasn't much transparency on how they built up the debt. Sri Lanka, one of the reasons for the default was a very ill-timed set of tax cuts that shouldn't have been there. And that obviously led to the country default once they had faced the shock of the Russia-Ukraine war and the increased costs there.

Or you had situations like Nigeria. Nigeria funded their budget mostly from their central bank last year at 18.5% policy rate plus a spread. Obviously, that type of funding becomes unsustainable very quickly. So the government had to restructure the debt it owes to its own central bank as a result. So certainly, seeing these multilateral funding programs and the reform processes as an opportunity for the asset class.

**Anu:** Absolutely. Maybe just continuing the conversation about macro. Obviously emerging markets can be vulnerable to a rising dollar. How do you think about that in terms of outlook kind of going forward and where there might be opportunities should things change in terms of the dollar strength?

**Kaan:** Sure. When we look at the history, certainly the asset class is very vulnerable to a strong dollar. And we've also seen most recently in 2018, 2019, when you have a bifurcated global economy, as in the US growing quite fast but the rest of the world cannot keep up. And that is not only, emerging economies, but also the Eurozone and the other G7 economies. You do see more assets going into the US supporting a dollar, as the less risky currency. And then that would mean capital outflows out of the asset class.

So the impact of a dollar is really important. But going forward, we think we are coming to a point that the rate cycle is slowing down and the worst of inflation is behind us. And the Fed is at this point still talking about hikes, but coming to a point that it's not going to be that aggressive going forward. We might get one or two more hikes. So that creates opportunities that we go back to a world where, you do get the Eurozone, China, the emerging economies catch up with the US and you would essentially have the capital flow structure reverse.

**Anu:** Absolutely. So speaking of these opportunities, what are some other areas that you are excited about in emerging markets debt? You know, you mentioned Zambia, Sri Lanka, et cetera. Any other areas of opportunity or excitement that you see?

**Kaan:** So, one area that we are very excited about is social, green and sustainable bond issuance. We've definitely seen a pickup in those. Year to date, they were about 15% of all sovereign issuance. And even in 2022, which was a tough year for issuance, it was around 15%, same with 2021. So, this is definitely a growing area. We also see that as part of the restructuring processes, they become sometimes a solution for these restructuring processes to conclude.

We've seen that with Ecuador, getting funding to buy back its debt so that it can spend on some climate needs. Similarly with Belize, we saw a restructuring that was helped by that. Particularly in a place like Ukraine, which obviously faces significant reconstruction needs when, fingers crossed, the war is finally over. These options will definitely get more prevalence. Another gain of course from sustainability bonds is that it allows private capital to take an increasing part in achieving sustainable development goals, particularly climate change and reducing carbon emissions.

So already, we're seeing the official sector, putting in more funding into these areas. We had a \$8.5 billion package and asked for South Africa for them to wean themselves off of coal and improve their climate change planning. Senegal recently, as an oil and gas producer, received 2.5 billion from G7 to meet their climate goals. So certainly, this is an area that we are getting more excited about. In terms of the main areas we focus with our investing, of course we're still at a point where you have a lot of uncertainty about inflation, monetary policy, the global growth outlook.

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So refinancing is still an important theme. So we will remain selective on the sovereign credits, that we can see these alternative financing sources, whether these are local or multilateral, and then also improving capacity to deal with the external challenges. And of course, that capacity development is important. So that is one of the reasons that we look at the IMF programs and the fact that they focus so much on governance as a positive thing, so that we can actually move on to the next step with these frontier markets and move on to the next generation to the speak.

**Anu:** Perfect, and just on the note of environmental, social, and governance opportunities, are you familiar with any engagement opportunities with any partners within emerging markets debt? Can you share any examples of that?

**Kaan:** Yeah, sovereign engagement is definitely gaining ground. Of course, it has its unique challenges, different from engagement with corporate partners. But certainly as COP27 then COP28 has brought forward the issue of climate change, and essentially offered a roadmap for various countries, including the major emerging markets to, move towards climate change.

There's definitely a lot of focus. So it's no longer strange for us to go to a debt management office, and then ask about climate trends, climate change measures, how can we help with our own suggestions, or with any sort of a sustainable bond framework. So this is definitely picking up.

**Anu:** Excellent, lovely. And just as we wrap up here, looking ahead, Kaan, would you please share some thoughts on your medium to long-term outlook for emerging markets debt?

**Kaan:** Certainly, as I said, you know, there's a large uncertainty on inflation growth and monetary policy. So it is a situation where we think the countries that either can rely on a strong sovereign balance sheet such as, say Colombia or Mexico, or those that are entrenched with the Western financial system like Romania, who get significant amount of funding, or reforming names, such as the Ivory Coast, Dominican Republic. So we think it will pay to remain selective in names, and certainly governance and having access to alternative financing will be a significant part of that discussion.

**Anu:** Thank you very much, Kaan. That was terrific. I can't let you go without a quick bonus question. So I'd love to hear about one of your favorite summer holiday spots, where you'd like to see yourself or your family in the next few months. Any plans that you have or just a favorite place you'd like to share?

**Kaan:** Um, a recent trip that I took was to Namibia. It's actually one of the countries in our universe as well. Wonderful nature. It was so picturesque that I couldn't believe. I felt that I was in a screen share or a-- [chuckles] You know.

[laughter]

**Kaan:** What do you call them like a wallpaper. Um, I mean, the views were phenomenal. I would definitely recommend that to be in everyone's travel bucket list.

**Anu:** That's great. Thank you very much for sharing. Well, this has been a great conversation, Kaan. You've shared some excellent perspectives on the sector. Going from the challenging environment from the last two or three years between COVID, the cost of living crisis, food inflation, but also sharing the opportunities of some of the macro dynamics shift from inflation, monetary policy and growth potentially. So, once again, appreciate you sharing these insights, and we look forward to having you again soon.

**Kaan:** Thanks so much, Anu.

**Anu:** And to our listeners, if you've liked what you've heard today on *Disruptive Forces*, you can subscribe to the show via Apple Podcast, Google Podcast, or Spotify, or you can visit our website, [www.nb.com/disruptiveforces](http://www.nb.com/disruptiveforces) for previous episodes, as well as more information about our firm and offerings.

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