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In focus

How investors can capitalise on the new dawn in emerging markets

We explain why changes in the post-pandemic world warrant a multi-asset approach to emerging market investment.

December 2020

Global investors have had various concerns relating to emerging markets (EM) over recent years. These include the dismantling of global supply chains, the difficulty of the middle income trap, lower environmental, societal and governance standards and slowing growth in China. And of course, the fact that EM equities have underperformed relative to developed market equities.

As multi-asset investors, we believe there are plenty of reasons to be positive about investing in EM. And as we start to emerge from the Covid crisis, we expect the post-pandemic period will mark a new dawn for the asset class, driven by three key factors:

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With special thanks to Ben Popatlal and Maurice Hewins

1 Quantitative easing (QE), previously unheard of in EM, is becoming surprisingly widespread.
2 Yields in EM debt and the income differential between EM currencies and the US dollar are at record lows.
3 With fiscal balances across EM forecast to widen to historic deficits, solvency and debt sustainability are becoming pressing issues.

This new era will bring about a divergence between strong and weak EM countries, with the former increasing their importance in the global economy and the latter becoming ever more indebted and susceptible to default.

In this paper we suggest three changes that investors could make to capitalise on changes in the post-pandemic world.

1. Be flexible to capture the full range of opportunities

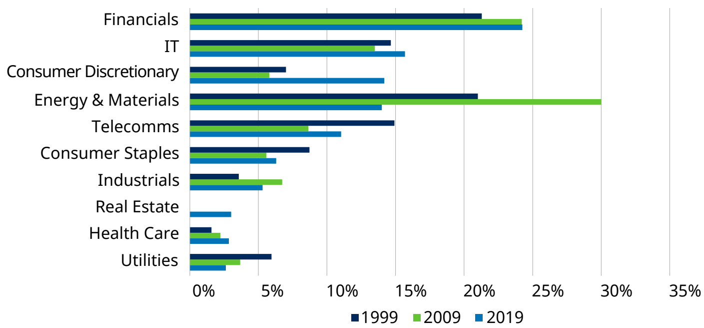
The sectors expected to be the drivers of the future are high growth, and consumer and technology focused. And these are tilted more towards Asia than in the past. This is not a trivial change.

As recently as 2009, energy and materials stocks constituted 30% of the components of the MSCI Emerging Markets Index. Today, that category represents less than 15% of the stocks in the index (Figure 1). Looking forward, consumption and highly innovative services are set to become the catalysts driving EM equities returns.

Unfortunately these changes also present us with some hazards: over the years, the MSCI Emerging Markets Index has become far more concentrated. As at 20 November 2020, just four companies accounted for nearly 25% of the index (Figure 2).

Taken together, these developments have important implications for future returns and correlations with other EM asset classes. While EM equities offer attractive growth opportunities, an unconstrained and diversified approach that avoids the pitfalls of the concentrated benchmark universe is likely to deliver benefits.

Figure 1: The sector composition of EM equities has shifted from commodities and materials to consumer and technology



Source: Schroders, Refinitiv, using MSCI Emerging Markets Index. As at December of each year.

The increasing concentration of the EM equity index also suggests that diversification into other asset classes of the EM universe such as hybrids or real estate investment trusts (REITs) should be beneficial.

Hybrids are perhaps the least well known EM investment option, sitting somewhere on the risk spectrum between bonds and equities. This area of the market is often overlooked, and typically includes convertible bonds, subordinated financials, and corporate hybrids. Those investors with an income bias can also benefit from looking higher up the capital structure and exploring opportunities within the hybrid universe. We come back to this topic later when we examine the benefits of considering how the EM mosaic fits together in a portfolio context.

On the debt side of the equation, returns from EMD$ come from a combination of the yield from US treasuries and the credit spread of EM government bonds over the equivalent US government bonds. With spreads having widened and with US treasury yields at record lows, the spread component is likely to be the dominant driver of overall EMD$ returns going forward (Figure 3).

While Figure 3 shows us the overall spread contribution of the EMD$ index, beneath the surface lies a lot of variation. Active investors can enhance the amount of spread as well as credit quality by being selective at the country level, something we illustrate in Figure 4.

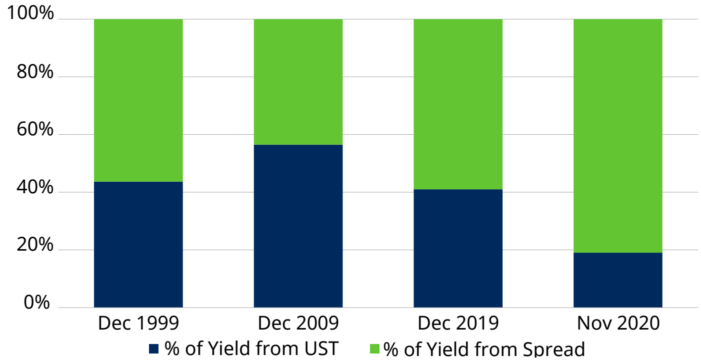
This also leads us to think about diversifying our source of spread within the EMD universe. EM corporate debt, a relative newcomer, can often be subject to mispricing, particularly as their credit ratings are often capped by the rating of the country in which

Figure 2: Four stocks make up 23% of the EM equity index

Alibaba	Tencent (inc. Naspers)	Taiwan Semiconductor	Samsung Electronics
6.9%	6.0%	6.0%	4.5%

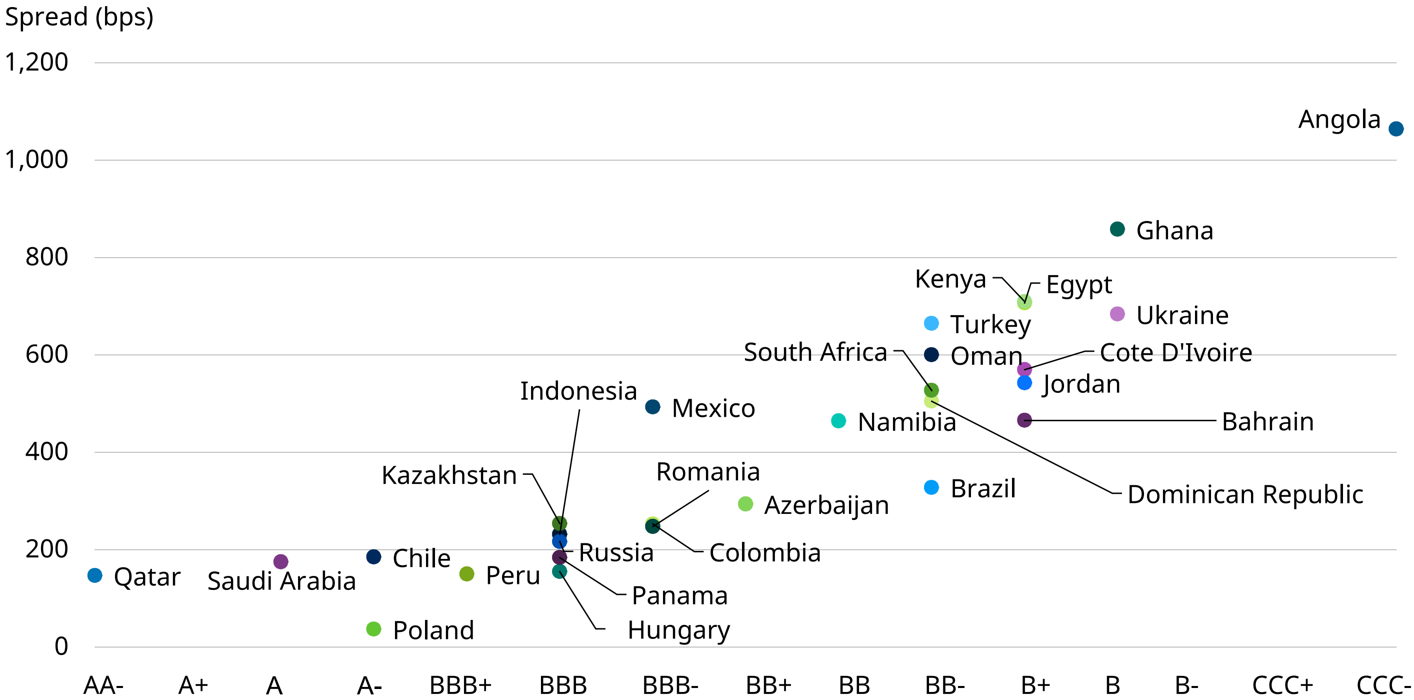
Source: Schroders, Refinitiv, using MSCI Emerging Markets Index. 20 November 2020.

Figure 3: The spread component in EMD$ is likely to be the more dominant driver of returns going forward



Source: Schroders, Bloomberg, using JPM EMBI Global Diversified Index.

Figure 4: Being selective at the country level can add value



Source: Schroders, J.P. Morgan. 27 November 2020. Spread is Option-adjusted spread.

they reside. This offers the active investor opportunities for excess returns from spread compression. Figure 5 shows that EM corporates are currently more attractively valued than their DM corporate or EM sovereign counterparts.

We believe hard currency EM debt should be considered for a core place in a multi-asset portfolio, given its diversifying characteristics and strong relative performance[1]. But just as investors should diversify within EM, they should also diversify within EMD.

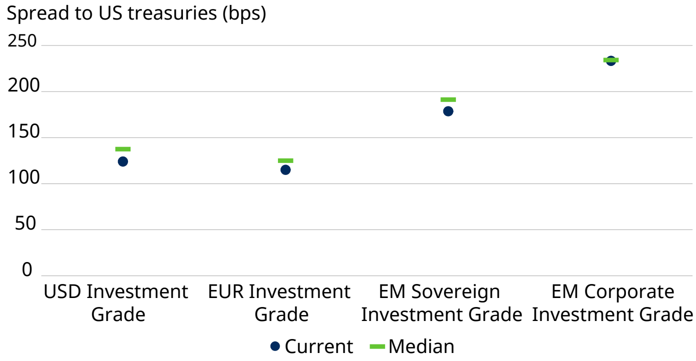
Local EMD offers investors a more tactical opportunity for portfolios, due to the attractive yields offered and the reasonably low probability of default for some countries. Local EMD has lower default risk because governments can issue in their own domestic currency, but the asset class carries currency risk for foreign investors buying the bonds.

A pressing tactical opportunity today is that of Chinese government bonds (CGB): at US$16 trillion, the CGB market is simply too big to be ignored, but CGBs are under-represented in global bond indices and hence in passive portfolios. Active investors have a tactical opportunity to profit from investing in CGBs, which we describe in more detail in the sidebar.

Steep yield curves and compelling currency valuations support the argument for buying local currency EMD. But it is important to look at governments' abilities to reduce fiscal deficits, the shape and size of QE programmes, and the path of inflation, in order to locate the best opportunities.

For all of these reasons, from a multi-asset perspective, we tend to see local currency EMD as more of a tactical than strategic allocation. In Figure 6, we show the yield on the local government bonds plotted against the duration (interest rate sensitivity). The size of the circles represents the size of the country in the index and the colour shows its credit quality (red being poor, green being good). As of the end of October, the chart highlighted some interesting tactical opportunities.

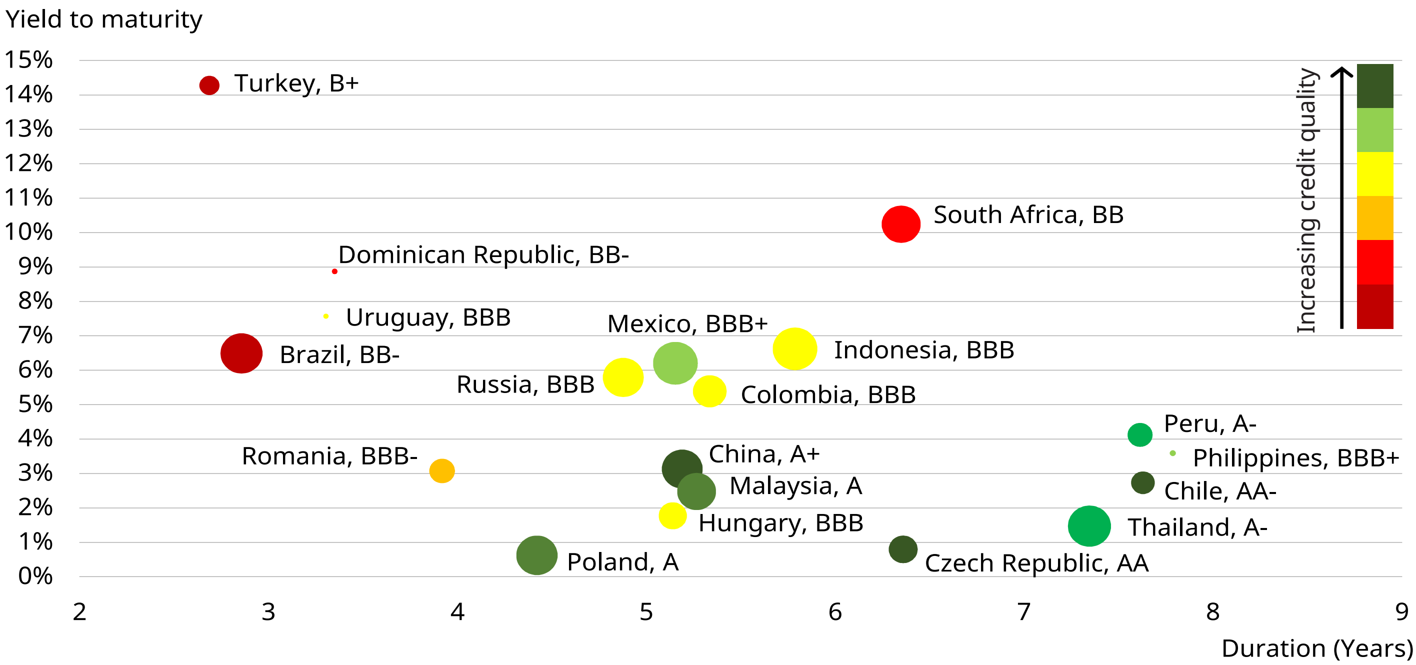
Figure 5: EM corporates offer opportunities for spread pickup amid higher chance of mispricing



Source: Schroders, Bloomberg, November 2020. USD IG uses Bloomberg Barclays US Aggregate Corporate Avg OAS, EUR IG uses Bloomberg Barclays Euro Aggregate Corporate Avg OAS, EM Sovereign IG uses J.P. Morgan EMBI Global Diversified IG Sovereign Spread, EM Corporate IG uses J.P. Morgan CEMBI Diversified Broad High Grade Blended Spread.

With major central banks around the world slashing or maintaining record low interest rates to shore up financial markets reeling from the Covid-19 pandemic, CGBs, which yield slightly more than 3%, stand out as an unusual and effective source of diversification. When EM bond markets experienced extreme volatility in Q1 this year, CGBs not only outperformed their counterparts but US Treasuries too, thus solidifying their resilience and place in the portfolio. Additionally, the renminbi (RMB) is becoming more attractive after performing strongly this year. China has demonstrated good control over the virus when compared to other developed markets and, as China begins to open up, the RMB looks set to perform in a global recovery and weak dollar environment.

Figure 6: Local emerging market debt presents tactical opportunities to be selective between countries



Source: Schroders, JP Morgan, Bloomberg, 31 October 2020.

[1]Further discussed in 'The case for a core allocation to emerging market debt' https://www.schroders.com/en/gr/professional-investor/insights/thought-leadership/the-case-for-a-core-allocation-to-emerging-market-debt/.

2. Diversify within the EM universe

EM hard currency debt (which is debt issued by emerging market countries, typically in US dollars) has produced robust returns against a backdrop of declining interest rates and a strong dollar regime of the last ten years. The usual support from rising commodity prices, however, has been notably absent (Figure 7). The drivers of EM assets in the past, such as commodities and exporting industries, are unlikely to be the drivers in the future.

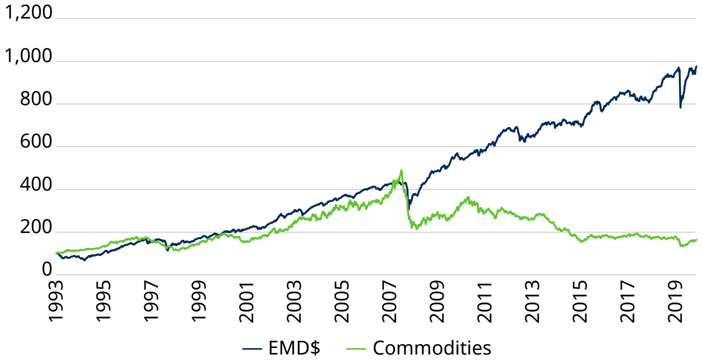
EM equities have typically been seen as playing the role of 'growth' asset within EM, since the end of 2009. But in the aftermath of the global financial crisis, EM debt has outperformed equities, with much lower risk. Evidently, a change to the return drivers in EM could mean a change to the roles played by assets within the EM universe (Figure 8).

These seemingly drastic changes in behaviour suggest to us that investing in a variety of asset classes within the EM universe might make sense for investors looking to diversify their return sources.

EM equities still offer the potential for growth over the long term, while EM debt offers the potential for both a stable income stream and a valuation uplift. Hybrids, which feature both debt and equity characteristics and which we discuss in more detail later, can provide further diversification through access to different, and often high growth, companies.

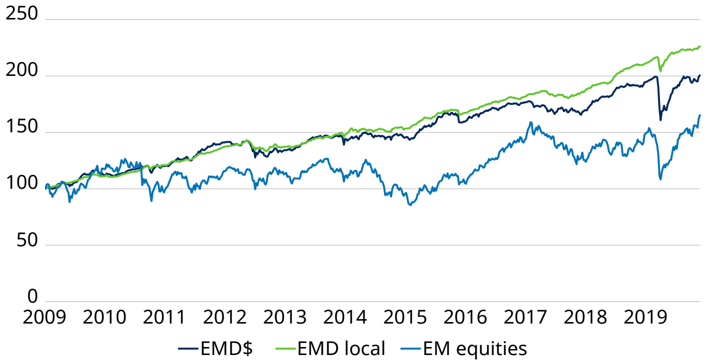
Bringing together the idea that the EM universe is not merely a single asset class, Figure 9 shows a correlation matrix between the major EM asset classes over the last 10 years. This illustrates the strength of the relationship of different pairs of EM assets; whether their performance tends to move in the same direction. While the performance of some EM asset classes, such as EM corporates and EM hard currency debt (EMD$) have a high correlation, others such as EM convertibles and EMD local have a weaker relationship.

Figure 7: The drivers of EM assets in the past are unlikely to be the drivers in the future



Source: Schroders, Refinitiv, 24 November 2020. EMD$ uses JPM EMBI Global Diversified Index, while commodities uses Bloomberg Commodity Index.

Figure 8: EM debt has outperformed EM equities since the end of 2009



Source: Schroders, Refinitiv, 24 November 2020. EMD$ uses JPM EMBI Global Diversified Index, EMD local uses JPM GBI-EM Global Diversified, and EM equities uses MSCI EM Index.

Figure 9: There are diversification benefits within the emerging market universe

	EM equities	EMD$	EMD local	EM corporates	EM REITs	EM convertible
EM equities	1.00	0.62	0.49	0.58	0.59	0.83
EMD$	0.62	1.00	0.71	0.90	0.65	0.60
EMD local	0.49	0.71	1.00	0.64	0.46	0.39
EM corporates	0.58	0.90	0.64	1.00	0.69	0.66
EM REITs	0.59	0.65	0.46	0.69	1.00	0.63
EM convertible	0.83	0.60	0.39	0.66	0.63	1.00

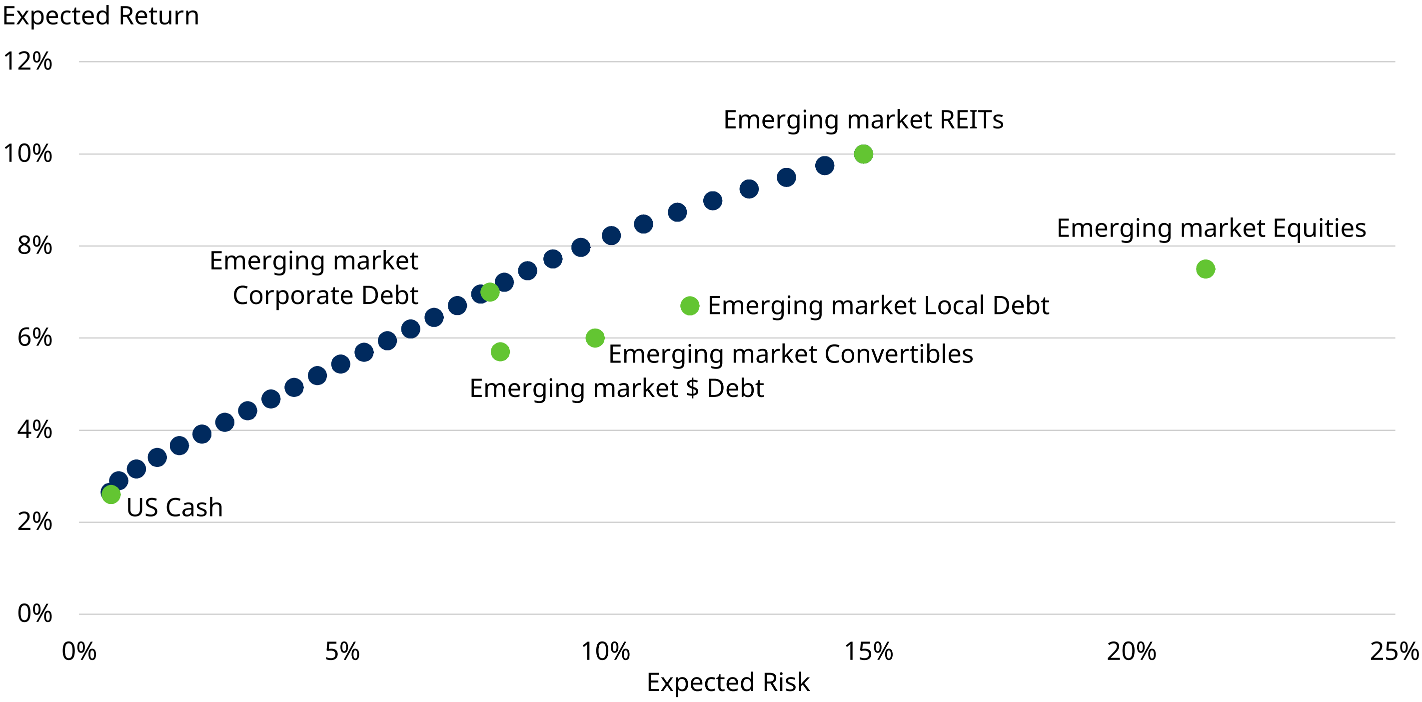
Source: Schroders, Refinitiv, November 2010 to November 2020, using weekly data. EMD$ uses JPM EMBI Global Diversified Index, EMD local uses JPM GBI-EM , Global Diversified, EM equities uses MSCI EM Index, EM corporates uses JPM CEMBI Broad Diversified Bond Index, EM REITs uses MSCI EM Diversified REITs Index, EM convertibles uses Asia ex Japan Convertibles Index. Shading represents each asset's degree of correlation where red is highly correlated and green is less correlated.

3. Consider how EM fits together in a portfolio context

By combining a range of EM asset classes together, investors can achieve a more favourable risk/return profile than by investing in individual asset classes. Figure 10 shows that even the static starting point is more favourable for combinations (along the efficient frontier) than for individual assets. Adding dynamic asset allocation to the portfolio, as described in the previous sections, can enhance the risk/return profile even more.

Employing a broad and capital structure agnostic approach allows investors to gain access to pockets of the EM universe which may otherwise be overlooked, providing exposure to different return drivers as well as diversification benefits. Looking beyond traditional EM equity and fixed income markets into alternative segments such as REITs, convertibles, and corporate hybrids can help to maintain returns and reduce risk, while also offering enhanced income. That yield cushion can be a helpful buffer in times of crisis, when returns from capital appreciation are compromised.

Figure 10: A combination of various EM asset classes can result in a better risk/return profile



Source: Schroders, Refinitiv, Bloomberg. November 2020. Efficient frontier constructed using an unconstrained mean-variance optimisation, using monthly returns over 20 years.

A multi-asset approach is key to unlocking the opportunities in EM

As we have shown there are numerous reasons to adopt a multi-asset approach to in investing EM:

- EM equities are increasingly focused on growth due to the change in sectoral composition towards technology and Asian economies
- Hard currency EM government debt can provide consistency to a portfolio
- EM corporates are relatively high quality and offer opportunities for diversifying sources of spread
- Local currency debt currently offers tactical opportunities
- REITS and hybrids provide diversification and opportunities to exploit an under-utilised part of the market
- A combination of these assets classes can offer further enhancements to the risk/return profile of a multi-asset portfolio, over and above investing in the individual asset classes.

For these reasons, we believe that an active approach, spanning the entire capital structure, with the emphasis on security selection, is the optimal way to capture and combine the individual strengths of each asset class.

With EM countries poised for continued economic growth, we believe that it is important to get the right mix of asset allocation and security selection. This should provide a smoother journey whilst capturing the most attractive growth prospects these vibrant economies have to offer.

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