PICTET
Asset Management

ABSOLUTE RETURN EMERGING MARKETS DEBT
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Dispersion dominance: how bond investors can capitalise on emerging markets' idiosyncrasies

Because the countries that constitute the emerging market debt universe are so very different from one another, investors should consider an absolute return approach.

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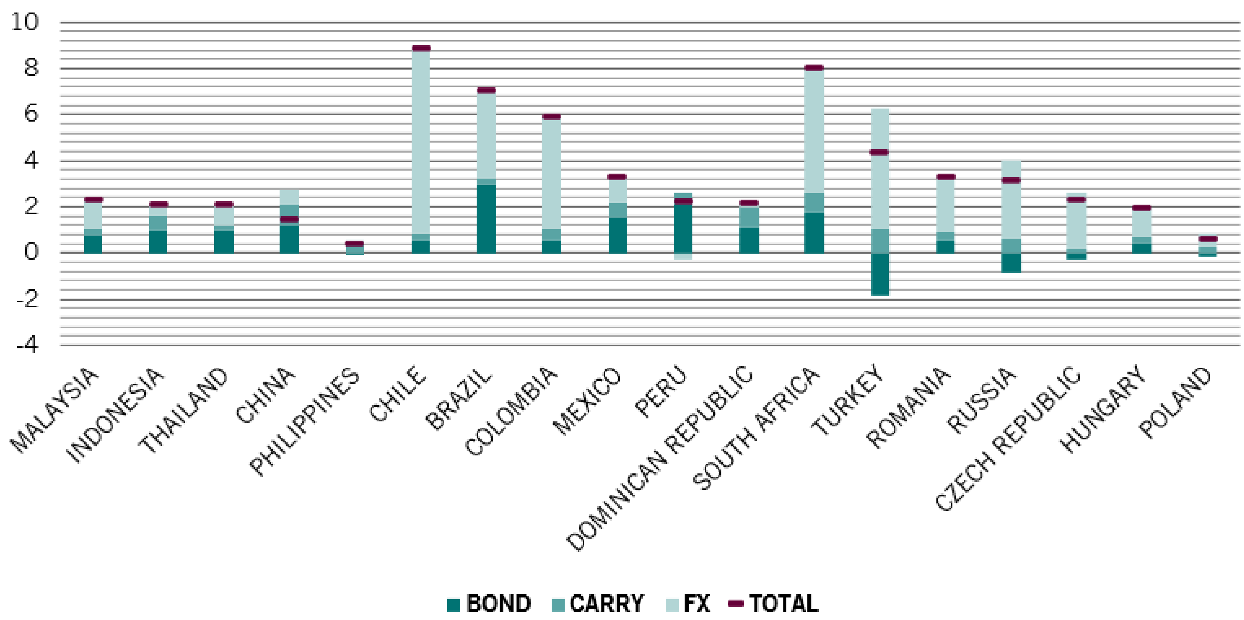
Returns in dispersion

As the economic weather turned cloudy during 2021 and storms threatened for 2022, investors became increasingly nervous about holding emerging market (EM) debt. Poor visibility on Covid and the economy made it difficult for some to commit to the market and many walked away: in 2021 net outflows from EM debt funds were the highest since 2015.[1] But in divesting wholesale, investors appear to have forgotten some of the reasons they were attracted to EM bonds in the first place.

The fact is the asset class isn't – and has never been – composed of homogenous investments. The markets that make up the EM bond universe have their own stark idiosyncrasies, which means they don't react in the same way to the same economic and geopolitical forces – unlike developed markets which more usually move in lock-step. It is this dispersion that gives emerging market debt investors the opportunity to secure excess returns and control risks.

Fig. 1 - Dispersion in good times...
Sources of returns JP Morgan GBI-EM Global Index 2020, %

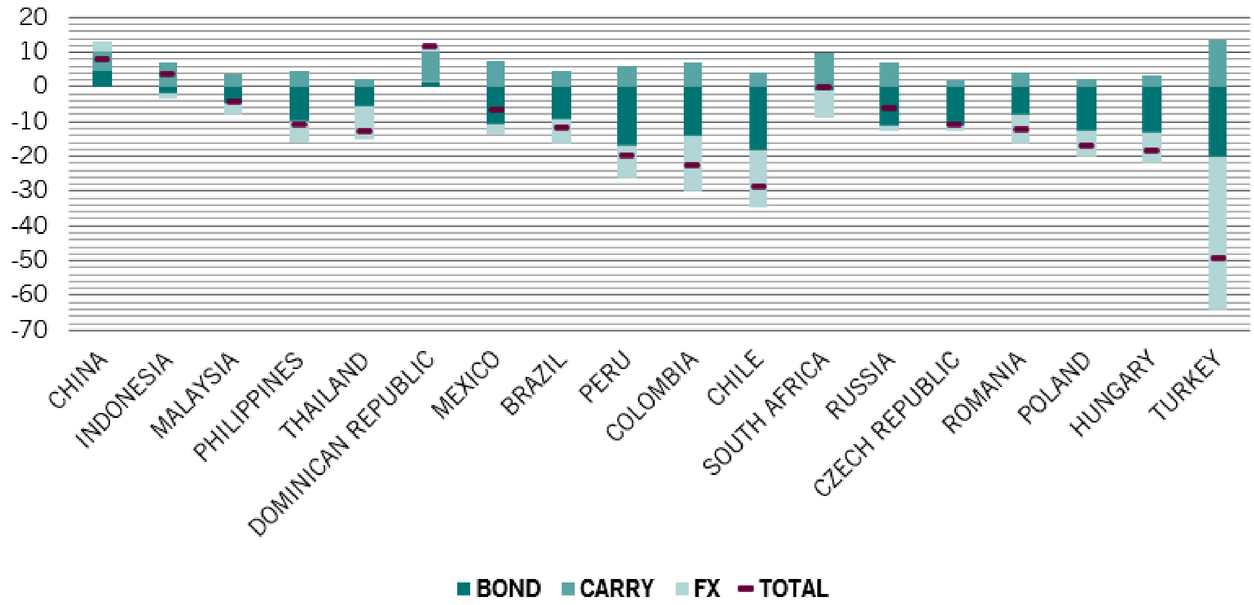


Source: JP Morgan Indices, Pictet Asset Management. Data covering period 31.12.2019-.31.12.2020

That has certainly the case over the past couple of years. Not only has there been significant dispersion of returns on EM sovereign debt between countries when they, on average, performed strongly in 2020 but also when they suffered in 2021. What's more, there has been significant variation between regions and on sources of return within countries – whether derived from the coupon payments, or bond performance or currency effects [see Figs. 1 and 2].

Fig. 2 - ...and bad

Sources of returns JP Morgan GBI-EM Global Index 2021-2022 percent



Source: JP Morgan Indices, Pictet Asset Management. Data covering period 31.12.2020-03.02.2022

An absolute return approach makes it possible to capture those returns even in those periods when the asset class as a whole suffers. So, for instance, Sirius, Pictet's emerging market's absolute return debt strategy, managed to generate positive returns net of fees in 2021 when the wider market was down 7 per cent.

And with 2022 throwing up a menu full of significant risks for the emerging universe, ranging from inflation to geopolitical tensions, an absolute approach is once again likely to prove its mettle.

[1] Broadridge GMI for European domestic and cross border funds, data as at 30.11.2021

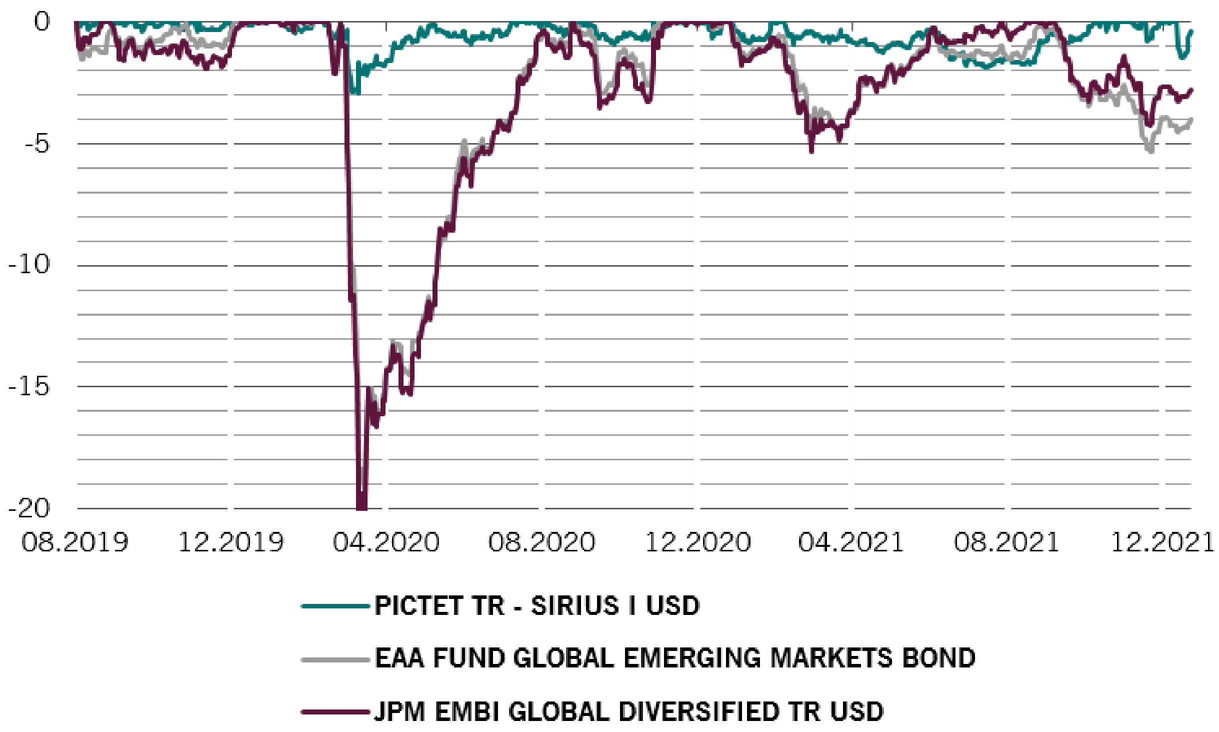
02

Risk-controlled entry into EMD

The type of dynamic, shifting environment we anticipate for 2022 is, we feel, one for which flexible long/short strategies such as Sirius are particularly well suited. For instance, in bad times, the least exposed a long-only investor can be is to have no position in the asset class. But a strategy like Sirius can be net short. Flexibility allows us to both to extract returns from dispersion while at the same time allowing us to control risks effectively, helping investors who want exposure to emerging markets to protect their capital and provide low volatility alpha.

Fig. 3 - Downside protection

Daily drawdowns, gross returns in USD, percentage peak to trough decline



Source: Morningstar Direct. Data covering period 31.07.2019-31.12.2021; All returns in USD

Careful risk control entails a minimum of exposure to market beta – which is to say to overall market direction – and ensure that correlations to other assets are kept as low as possible. So, for instance, Sirius' beta to EM debt – the broad market as represented by an equal weighting of the JPMorgan EMBI and GBI indices - is no more than 30 per cent. Volatility is controlled by using options to hedge tail risks – unlikely but extreme and potentially seriously damaging events. As a result Sirius' biggest weekly peak to trough loss during the past five years is less than 3 per cent [see Fig. 3]. And so not only is Sirius' average annual return above the average of its peers, its volatility is only around a quarter.[2] In effect, our approach takes us closer to the efficient frontier for this investment style.

One side-effect of this careful risk calibration is that it can provide a signal for investors with more traditional long-only positions, who can then track the rise and fall in Sirius' directional conviction.

[2] Mercer data. Sirius strategy average return 5 per cent vs 4.5 per cent for total return peer group median; volatility 2.5 per cent vs 9.5 per cent respectively. Return and standard deviation in USD before fees over 5 years and 4 months ending 30.11.2021, comparison with the Emerging Markets Debt – Total Return universe (monthly calculations).

03

Rising risks and growing dispersion

Our core view for the coming year is that the forces influencing the market will broadly be the same as those that played out over 2021. Government and central bank responses to economies' reopening from the epidemic will be key. Covid-19 may increasingly be accepted as a fact of life, but new variants potentially continue to pose a risk.

Inflation pressures are meanwhile mounting worldwide, cornering developed market central banks into tightening policy, even at the cost of market ructions. We will continue to monitor supply and demand imbalances and their effects on individual EM economies.

At the same time, 2022 is raises number of local and geopolitical risks. The deteriorating relations between Russia and Ukraine, which threaten to spiral into a conflict that could draw in the US as well as various European countries, is just the most immediate of these. But long-standing tensions between the US and Iran and newer ones between the US and China are also potential flash points, while we will also closely monitor the numerous elections taking place across the emerging universe this year.

We expect these risks, together with an increasing lack of synchronisation in different countries' approaches to economic and monetary policy, to engender a widening dispersion of outcomes – such as we identified in Eastern Europe last year.

04

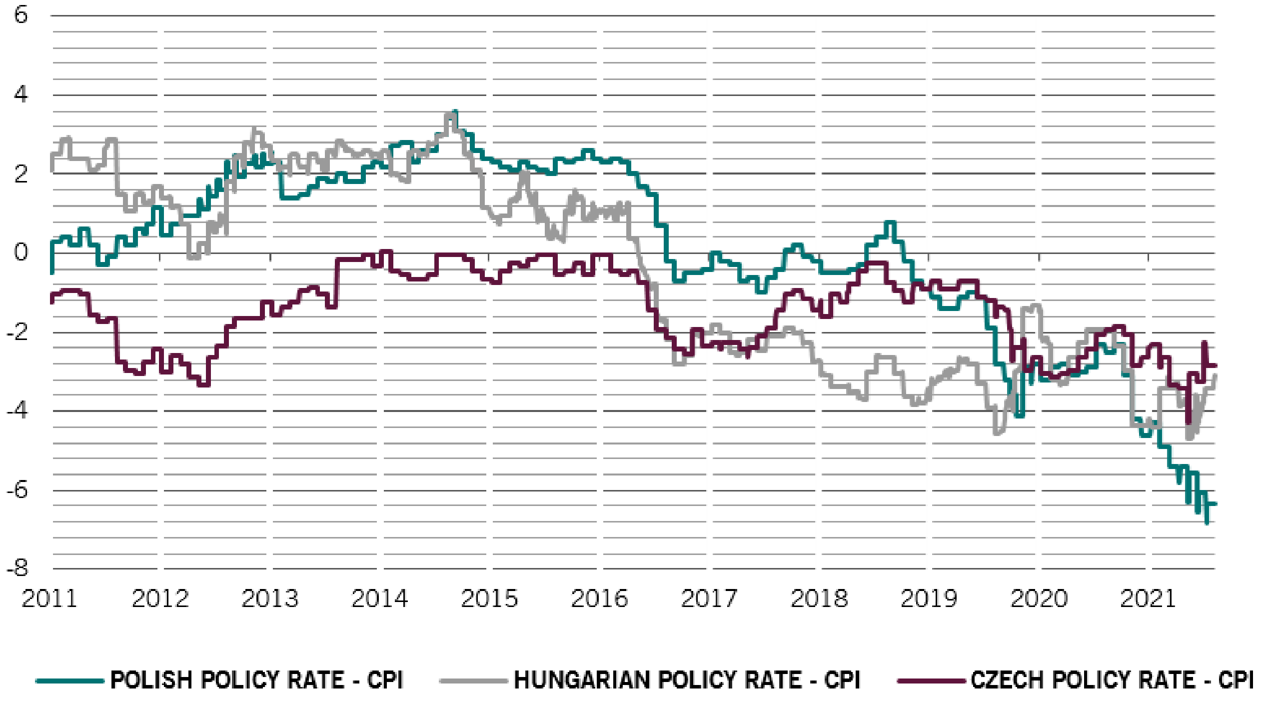
Capturing dispersion in Eastern Europe

As the initial phases of the Covid epidemic started to wind down in late 2020 and the global economy's recovery became entrenched, we increasingly focused on the macroeconomic idiosyncrasies of emerging nations. These, in turn, prompted us to take positions based on what we saw as a growing divergence in interest rate policy across the developing world.

At the same time, and in line with our investment philosophy, we looked to keep our market beta balanced and to mitigate exposure to specific risk factors.

Our view was that as the probability of wholesale market sell-offs caused by fresh waves of Covid and new variants declined, central banks in central and Eastern Europe would be forced to confront building inflationary pressures. In the first quarter of 2021, we felt this risk to be particularly pronounced in the lowest interest rate economies in the region. The central banks in these countries were likely to come under the greatest pressure to react to domestic inflationary pressures, starting with Hungary which we felt to be the most mispriced (see Fig. 4).

Fig. 4 - Spotting opportunities
Policy rates minus CPI inflation, percentage points



Source: Bloomberg, Pictet Asset Management. Data covering period 23.06.2011-31.01.2022.

As it became clear to us that this dynamic was playing out across the region, we subsequently extended our positions to Poland and Czech, the most liquid of these markets. We took profits towards the end of 2021, helping us to outperform the wider emerging markets universe in a difficult year for the asset class.

Separately, in 2019 we generated strong gains in Peruvian local bonds, an under-researched and less traded market, thanks to our analytical focus. As a result, we could take a significant long position in an attractive asset, well in excess of its weighting in the benchmark index.

The tumult in Turkey's markets during 2021 – both during rallies and slumps – was another source of excess returns. The Sirius strategy navigated the challenge by taking a fundamentally bearish stance, finishing the year with solid gains even in the face of prevailing credit and interest rate volatility and the impact of the country's high interest rates, our long/short approach afforded us the staying power to extract these returns, even as other investors fled the market.

2022 looks to throw up at least as many challenges for emerging markets as 2021 did.

But the wide variety of risks these economies face also widens the dispersion of likely outcomes.

Rather than succumbing to one over-arching trend, they will be pulled in a number of directions. In some countries, political and geopolitical strains will predominate. In others, it will be how policymakers respond and adapt to shifting economic conditions, be they domestic inflation trends or the pace of monetary policy tightening in the US and euro zone. These, in turn, will open up sources of excess returns from currencies with the potential for heightened dispersion between currencies. Furthermore, we expect inter-asset class dispersion as the interplay between foreign exchange, rates and sovereign credit plays out over the year.

In other words, there will be significant opportunities for strong returns for EM bond investors able to take both long and short positions – as we did in Eastern Europe, Peru and Turkey – though tight risk management remains essential to protect investors' capital.

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