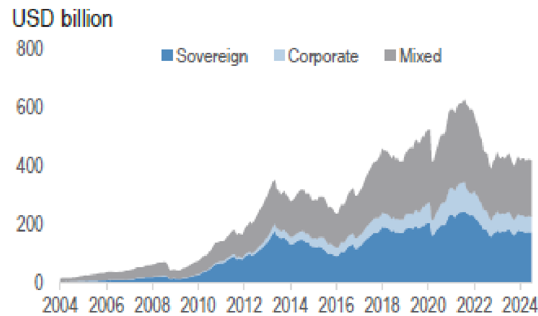
Since our founding we have been enthusiastic advocates of emerging markets investment. In fixed income, investors can find higher yields from borrowers with solid creditworthiness in growing economies. Many fixed income investors choose local markets where higher rates in local currency can diversify and boost global bond portfolios. Others add sovereign debt in hard currency for yield and liquidity reasons. Equity investors have been attracted to higher expected rates of growth and cheaper valuations. However, despite these compelling attributes, the asset classes experienced an exodus of funds since 2021 and cumulative funds under management have declined over the last three years.



Source: JPM EM Flows Weekly, July 5, 2024

While emerging markets are entrenched as an asset class, events over the last five years cast doubts about its legitimacy and reliability. The Covid-19 pandemic affected countries differently, and emerging economies were forced to expend a larger share of resources to alleviate their infections. Given limited debt capacity and a global economic slowdown, the experience resulted in elevated levels of debt and numerous sovereign defaults. According to rating agencies, 11 countries defaulted in 2022 and 2023 a record number over that short a time horizon.

The pandemic was followed by Russia's invasion of Ukraine in February 2022. The intrusion precipitated immediate and widespread condemnation and sanctions from the U.S. and other Western aligned nations. The country was withdrawn from emerging markets equity and debt indexes by the end of March causing severe losses in a region that had garnered recognition from investors. At the time of its withdrawal Russia represented about 4.5% of the EM corporate index and about 7.5% of the emerging markets equity indexes. That sudden and unmanageable hit had a jarring effect on investors as well as the asset class.

Finally, during 2020 and ensuing years, Chinese authorities played a more intrusive role in the country's financial markets. In November 2020, authorities abruptly canceled a fintech company's IPO, and subsequently reigned in some of the country's successful and, at times, outspoken industry leaders. Furthermore, to quell a perceived real estate bubble, the government constrained the sector's access to funds and tightened regulatory hurdles. Both domestic and foreign investors lost confidence in the country. Despite this, China's presence in global markets and indexes remains huge given the country's size and debt funded development.

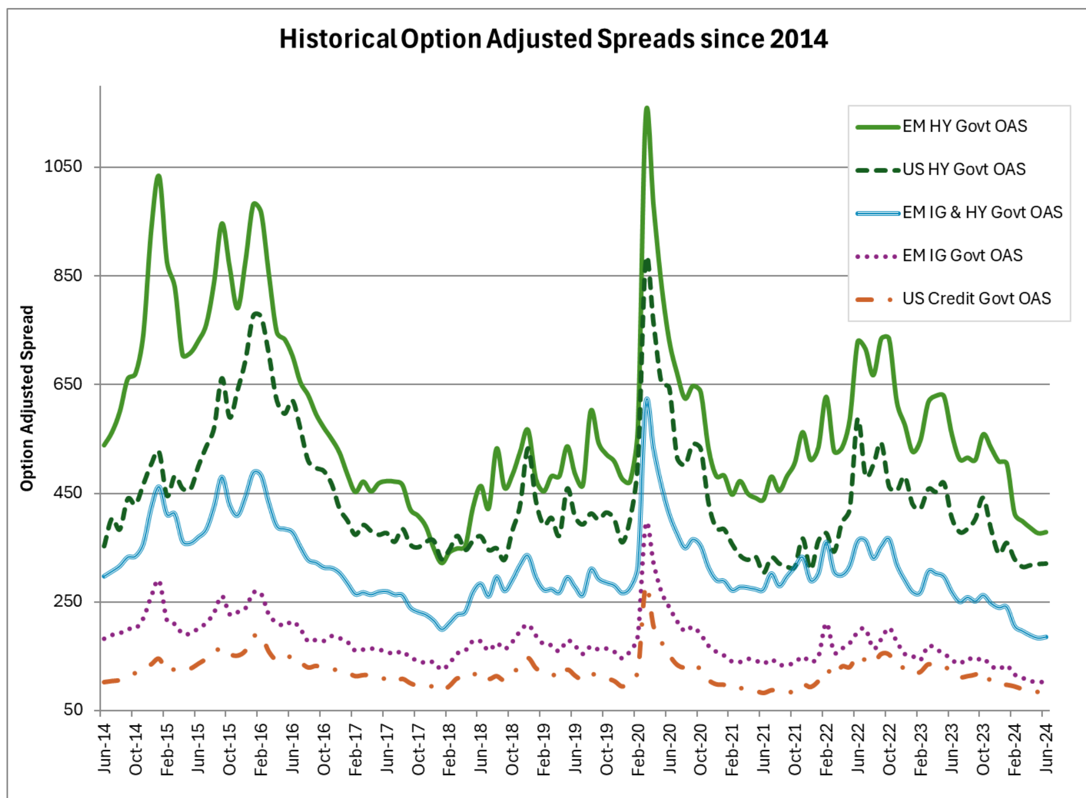
Events over the last four years highlighted the "risk" factors investors contend with in the asset class. Understandably, they have become apprehensive about outcomes that in many cases were hard to forecast or price. In asset allocation exercises, emerging markets occupy the higher risk echelons and are generally expected to deliver higher returns. In fixed income better returns have been realized, while EM equities have underperformed. A legitimate question is whether the risk associated with the asset class is too high to warrant ongoing inclusion.

Fixed Income

Fixed income investors benefited in relative terms from positioning in emerging markets. Even with the drawdowns associated with the Russia/Ukraine war and China's real estate collapse, emerging markets bonds delivered higher returns than other fixed income sectors. The nearby table shows returns of various fixed income sectors over the last decade. As can be seen, emerging market bonds in investment grade, high yield, and local currency, both corporate and sovereign outperformed comparable sectors in developed markets.

Ten-Year Fixed Income Annualized Returns in USD (6/2014 - 6/2024)		
	IG	**HY**
EM Corp (USD)	*2.69%*	*4.61%*
EM Sovereign (USD)	*2.00%*	*3.02%*
EM Local Currency	*-0.87%*	
US – Corp	2.39%	4.21%
US Treasuries	0.93%	

In current markets, spreads are below historical levels although they remain higher than developed market alternatives. This is occurring at a time when strategists, including J.P. Morgan, upgraded expected returns on EM corporate bonds citing robust fundamentals, low default rates, and a supportive technical picture.[1] The graph below shows the evolution of credit spreads for various sectors over the last decade.

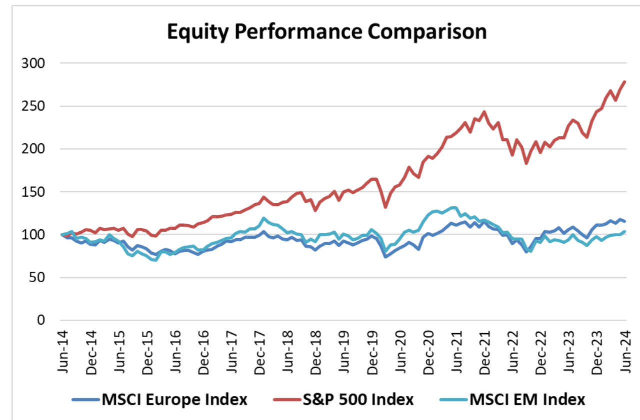


Source: Bloomberg, ICE BofA Indexes: EMHY, H0A0, EMUB, EMHG, CY00.

J.P. Morgan, "Emerging Markets Corporate Strategy Presentation," July 2024.

Equity Markets

In equity, the story has been different. EM equity has performed worse than U.S. and developed market equity for a number of years. The poor returns occurred due to the sizeable influence of underperforming countries in the index, notably China and South Korea. Not surprisingly, a few countries have delivered excellent returns, but many are small with lower representation in the major equity indexes.



Source: Bloomberg.

On July 16, 2024, the IMF released its updated World Economic Outlook in which it raised global growth expectations for 2025 by a modest 0.1%. Notably, relative to April's projections, the multilateral increased its emerging markets forecasts for 2024 and 2025 by 0.1% to 4.3% led by firmer growth in China and India. By comparison, growth expectations for developed economies are 1.7% in 2024 and 1.8% in 2025. The U.S. is expected to slow from 2.6% in 2024 to 1.9% in 2025.[2]

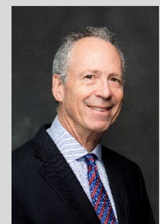
After a period punctuated by unusual events, the world appears ready to return to a more traditional state of development and growth. Geopolitical tensions will continue, although their tenor and violence will likely moderate as governments focus on improving conditions for their citizens. The unruly outcomes of the Russian/Ukrainian and Israeli/Hamas conflicts have provided evidence of the needless deaths and costs associated with bellicose adventures. Most nations understand the need to focus on economic stability to raise living standards and promote ongoing development.

Over the last three years over a hundred countries held elections, many to determine the nation's leader. In many, the outcomes were surprising, and often undesired by international investors whose preferred candidates tend to espouse more orthodox policies. However, in many of the undesired cases, the worst outcomes have not materialized, or remain challenged by legislators or the courts. In some countries unliked governments were voted out of office. While absolute democracy is hard to assure in any nation, its existence implies policies will ebb and flow. Governance changes are inherent to the democratic process and often offer opportunities for investors. We believe a valuable benefit of emerging markets investing is the diversification countries and regions bring to otherwise highly correlated exposures.

July 15, 2024

Eduardo Cortes
Chief Investment Officer

Economic Analysis and Strategy
Sectors: Mortgages, Treasuries, Agencies, and Emerging Markets



[2] IMF, World Economic Outlook Update, "The Global Economy in a Sticky Spot," July 2024.

GIA Partners, LLC

At GIA Partners, credit is in our DNA. We are a bottom-up credit manager who has managed credit portfolios in virtually every part of the world's fixed income markets as well as through some of the most severe credit events in history. Additionally, our investment team has the distinction of being among the first to recognize and actively invest in global high yield and emerging markets debt.

We have a thorough understanding of fixed income investments and their role in a globally diversified portfolio, which has rewarded our clients throughout market cycles.

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