Rediscovering Opportunities in Emerging Market Debt

BlackRock

Quick read

Survival of the fittest and risk management

Unprecedented shocks since 2020 have resulted in EMD being more resilient and fundamentally well-positioned going into 2025.

EMD fits multi-asset portfolios, but it remains under allocated

Investors are under allocated to EMD despite potential return enhancement and diversification benefits.

Access and implementation

The BlackRock EMD platform offers various ways for investors to access the opportunities in EMD depending on their needs.

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Emerging Market Debt (EMD) experienced a resurgence of interest after challenging years. Investors are rediscovering the opportunities in the asset class, driven by improved macro fundamentals, resilient issuer performance, and attractive yield differentials compared to developed markets. We explore the evolution of EMD, its current positioning, and why it presents a compelling investment case.

The Journey of EMD: 2020 to 2024

Over the past few years, EMD has weathered unprecedented shocks. The COVID-19 pandemic in 2020 and aggressive monetary tightening by the U.S. Federal Reserve in 2022 created significant headwinds for the asset class. In response, policymakers in emerging markets took divergent paths to address these challenges, with some countries successfully implementing reforms, while others struggled under the weight of the shocks.

The aggressive rate hikes by the Fed in 2022 pushed investors to question the viability of EMD, leading to outflows as it was perceived as too risky and complex. However, by late 2022, market conditions began to stabilize. The Fed had passed its peak hawkishness, the global economy proved more resilient than expected, and emerging market spreads started to tighten.

By the end of 2022, many of the weaker issuers had already defaulted, allowing the asset class to undergo a **"survival of the fittest"** phase. This process left the market with stronger issuers and set the stage for a recovery in EMD. Fundamentals began to drive valuations once again, and emerging market debt rallied in 2023 due to improving bottom-up credit dynamics.

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The Outlook for 2025

Looking ahead to 2025, **EMD appears well-positioned for further gains**. Both top-down macro factors and bottom-up credit fundamentals support the case for continued asset price appreciation. Emerging market sovereign spreads are close to their 10-year average, with room for gradual tightening over the medium term, supported by **improving credit quality and fiscal consolidation** in many EM countries.

In addition, China's incremental stimulus measures and the resilience of the U.S. economy provide a **supportive backdrop for EM assets**. While the Fed's rate cuts may be modest, the environment remains conducive for EMD, particularly as bottom-up stories become more prominent. 2025 is expected to be a **year of bottom-up security selection**, where identifying the winners and losers will be critical to generating alpha

Risks to the View

Navigating the complex global environment will remain a key challenge for investors in EMD. The fast-moving macro landscape, geopolitical risks, and secular trends, such as climate change and inflation persistence, will continue to shape investment outcomes.

We group risks into three categories:

- **Cyclical Risks:** Hard versus soft landing scenarios for the global economy. The outcome will influence the performance of EMD, but BlackRock's access to industry-leading research provides the necessary insight to manage this uncertainty.
- **Geopolitical and Election Risks**: The U.S. election in 2024 will be closely watched, alongside other political events that could influence global markets. Scenario analysis and risk mitigation strategies will be crucial.
- **Secular Trends:** Long-term structural changes, such as climate risk and inflationary pressures, will create both challenges and opportunities within EMD.

By quantifying and understanding these risks, we seek to implement strategies to **mitigate downside** risk and **capitalize on opportunities**.

The Role of EMD in Multi-Asset Portfolios

EMD offers key potential benefits in multi-asset portfolios:

- **Return Enhancement:** EMD has consistently outperformed developed market bonds over the long term due to its yield differential. This yield pickup, even in similarly rated issuers, provides a compelling return advantage.
- **Portfolio Diversification:** EMD offers geographical diversification across more than 70 countries, each with distinct economic cycles. Additionally, the divergence between EM and developed market (DM) cycles provides further diversification benefits. EM central banks may be easing when DM central banks are tightening, or commodity cycles might benefit EM economies while hurting DMs, leading to lower correlations between EM and DM assets.

For long-term investors, EMD can be a **strategic allocation** within fixed income portfolios. Our research suggests that a **12% allocation to EMD** is optimal based on various approaches, including GDP-weighting, mean-variance optimization, and global fixed income indices.

Despite the advantages of EMD, many **portfolios remain underweight** in the asset class. For example, BlackRock's Portfolio Solutions Group found that the average allocation to EMD across 256 moderate-risk portfolios was **only 4.6%**. This underweight creates significant **upside potential** as investors rebalance toward market-weight or overweight positions in EMD.

Bottom-Up Research as a Driver of Alpha

We believe our **access to Fed watchers**, market analysts, and geopolitical experts at BlackRock enables us to integrate **top-down considerations** into our EMD strategy effectively. However, we place equal emphasis on **bottom-up research** as a critical **driver of alpha**. Given the diverse range of issuers—spanning high-GDP nations like Qatar and the UAE to lower-income countries in Sub-Saharan Africa—a granular, in-depth approach to credit analysis is essential for **uncovering opportunities and managing risk effectively.**

In investment-grade issuers, the team focuses on identifying "rising stars" and "fallen angels," constantly rotating the portfolio based on the **evolving credit profiles of countries**. In the high-yield space, the team looks for **improving credit stories**, such as Ivory Coast and the Dominican Republic, which are seeing strong macro and fiscal improvements.

For single-B and lower-rated issuers, **bottom-up selection is crucial**. Many countries that remained current on their debt despite global shocks have seen significant total returns, with standout examples like Ecuador and El Salvador, which have posted remarkable gains in recent years.

Implementation Strategies

There are several ways for investors to **access the opportunities in EMD** and benefit from the current environment. The choice of strategy depends on client preferences, risk tolerance, and views on global macroeconomic trends.

01 Hard Currency (Sovereign and Corporate) Bond Strategies

Strategically, hard currency bonds remain the centrepiece of many EMD allocations. A traditional active hard currency strategy offers income, with the ability to selectively clip coupons over time. Given the yield differentials between emerging markets and developed markets, hard currency bonds are **expected to continue attracting the bulk of allocations**. This strategy allows investors to benefit from the **income** and **improving fundamentals** highlighted throughout this paper.

02 Short Duration Bond Strategies

For clients who already have exposure to EMD but are looking to add more, short duration hard currency bonds can be a smart addition.

This approach provides the **high yield benefits** of EMD, but with **reduced sensitivity to U.S. Treasury movements**. If you believe that most of the treasury rate moves are already priced in, this is a way to increase EM exposure without taking on significant UST beta. It offers the **income potential** of EMD while **mitigating** some of the **interest rate risk**.

03 Local Currency Debt Strategies

Local currency debt remains an **attractive**, though more **volatile and concentrated**, segment of the EMD market, which sometimes results in smaller strategic allocations within investor portfolios. However, local currency bonds can offer **significant upside** during periods of sustained **USD weakness**.

At the moment, we are tactically **bullish** on local currency debt, driven by the current weak USD trend and the additional appeal of local duration components. We view local debt as a **strong short-term opportunity** in the current environment, offering both FX and duration benefits.

04 Blended and Unconstrained Strategies

For investors who prefer a more **dynamic approach**, blended or unconstrained strategies offer flexibility. These strategies allow the portfolio manager to rotate between hard currency, short duration, and local currency bonds depending on market conditions and the evolving macro environment.

By delegating the decision-making to an active manager, investors can benefit from **tactical shifts** among the different EMD segments, ensuring that their portfolios **capture income** and **upside potential** where it matters most. This approach can also help **manage risks** associated with the higher volatility and concentrated exposure seen in certain EMD segments.

Incorporating Sustainability

Sustainability considerations play an increasingly **important role** in EMD investing. BlackRock's EMD team **incorporates ESG insights** in multiple ways:

- **Issuer Selection**: ESG data is used alongside macro and credit analysis to flag potential risks and opportunities. For example, Russia's poor governance scores prompted an underweight position despite its strong balance sheet, a decision that protected the portfolio during the 2022 invasion of Ukraine.
- **Security Selection:** The rise of Green, Social, and Sustainable bonds offers new opportunities for impact investing. These bonds can trade at a premium to conventional bonds, and BlackRock's ESG team provides detailed analysis of their use of proceeds to help guide investment decisions.
- **Debt-for-Nature Swaps:** This innovative mechanism, particularly in high yield markets, allows countries to reduce their debt burden in exchange for environmental protection. This trend has provided technical support for countries like Ecuador and Kenya, creating opportunities for investors.

BlackRock's EMD Franchise and Core Philosophy

BlackRock's EMD franchise stands out for its ability to generate sustained alpha over the long term. This is achieved through:

- **Deep Research:** A rigorous top-down and bottom-up research process enables the team to diversify and express multiple high-conviction views across the portfolio.
- **Top-Down Integration:** Access to BlackRock's global research network ensures that the team is well-positioned to navigate top-down macro risks, such as U.S. duration exposure.
- **Robust Risk Management:** Comprehensive risk management tools and analytics are essential in EMD, helping the team build resilient portfolios.

Conclusion

Emerging market debt is a vast and diversified asset class that offers **ample opportunities for alpha generation**.

BlackRock's **experienced EMD team** is well-resourced, fully integrated into the firm's global fixed income platform, and equipped with a portfolio construction approach that manages EM exposure through various market cycles.

This focus on delivering **durable alpha** makes BlackRock's EMD strategies an attractive option for investors seeking to rediscover the potential of this dynamic asset class.

Risk Warning

Capital at risk. The value of investments and the income from them can fall as well as rise and are not guaranteed. Investors may not get back the amount originally invested.

Past performance is not a reliable indicator of current or future results and should not be the sole factor of consideration when selecting a product or strategy.

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A main risk related to fixed income investing is credit risk. Credit risk refers to the possibility that the issuer of the bond will not be able to repay the principal and make interest payments.

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