



# Frontier fortunes



**Polina Kurdyavko**

Head of Emerging Markets,  
Senior Portfolio Manager,  
Emerging Markets  
BlueBay Asset Management LLP

Published October 2022

**“When it comes to emerging markets, there are often plenty of volunteers lining up to predict a doom and gloom scenario for the asset class, especially during times of uncertainty.”**

**Have you ever been to a fortune teller? I tried it once, approaching the experience with a fair degree of scepticism. Looking back, many of the comments were quite generic, but some of the other ‘readings’ ended up being surprisingly accurate. The key unknown of these predictions remains the timing.**

When it comes to predicting market dislocations, it feels that investors can rarely spot a crisis before it unfolds. Yet looking in the rear view mirror, the warning signals often appear quite obvious. Only recently we were on the brink of the collapse of the UK pension fund system following extreme volatility in the British pound and gilts – an event that very few had predicted.

When it comes to emerging markets (EM), there are often plenty of volunteers lining up to predict a doom and gloom scenario for the asset class, especially during times of uncertainty. Commentators point to a range of potential triggers: balance of payments crises, liquidity tightening (given countries’ reliance on external markets), sharp currency devaluations and geopolitical risk. The asset class has registered its worst performance on record, with EM hard currency debt down close to 25% in the first nine months of this year. The sell-off has been indiscriminate. However, I would observe that there is a growing distinction between a group of countries that are in a stronger position, benefitting from a few tailwinds that support the broader EM beta investment case, and those that are likely to face a crisis ahead.

Key tailwinds supporting a constructive case for investing in EM are the strong commodity backdrop and orthodox monetary policy. The commodity backdrop has translated into a meaningful improvement in the current account dynamics for the majority of EM countries, with over two-thirds of the universe being commodity exporters. In countries like Saudi Arabia, the current account surplus increased from 5% to 15% over the last year, but even countries with current account deficits have seen the gap narrow. Mexico and Brazil, for example, have seen their current account deficit fall from 3% of GDP to 1%. This dynamic has also been supportive of domestic currency performance. Orthodox hawkish monetary policy in most EM countries has resulted in close to double-digit policy rates following two years of rate hikes, allowing them to be on the front foot when it comes to inflation management. Indeed, in some countries like Brazil and South Africa we have seen signs of inflation peaking over the last couple of months.

When it comes to liquidity, the depth of the domestic market is equally important. Out of USD23 trillion of EM fixed income assets, only USD4 trillion are denominated in hard currency. Over the last 20 years, several EM countries have actively developed deeper local markets that allow them to rely on domestic markets when external markets are closed. Mexico is a good case in point. Here, pension funds are expected to grow from 20% of GDP to 50% of GDP over the next five years. This translates into a double-digit growth rate that is more than sufficient to fund the country's fiscal deficit.

Prudent fiscal management is also key; even in countries with mixed policy credibility, like Chile, we have seen a meaningful drop in the fiscal deficit from 7% to 1% of GDP, reducing the reliance on funding sources. So, those who argue that EM are likely to relive the 80s style balance of payment crisis might be overly pessimistic, given the dynamics and evidence of policy evolution above.

However, higher US Fed rates will create headwinds for a select group of EM countries, and possibly structurally impair their ability to service their debt. The higher cost of debt and increased volatility in core rates translate into limited access to external funding for the credits, which have substantially increased their debt stock and also lack alternative funding sources. Most have struggled to implement structural reforms over the years and are now facing the headwinds of higher commodity prices. As a result, it is looking increasingly unlikely that they will be able to escape the current global macro environment without a debt restructuring of some form. Frontier economies – the segment of EM that includes smaller countries with high reliance on external funding – are likely to be vulnerable to landing in this position. These economies comprise roughly 9% of the EM tradeable universe. Countries in Sub-Saharan Africa, specifically, account for almost half of the JP Morgan NEXGEM Frontiers Index.

**“When it comes to liquidity, the depth of the domestic market is equally important. Out of USD23 trillion of EM fixed income assets, only USD4 trillion are denominated in hard currency.”**

Many of the Sub-Saharan African credits haven't fully recovered from Covid, with only 20% vaccination rates, and have witnessed 28 million people falling into extreme poverty over the last three years. Net exports have detracted from growth during this time and consumption is currently under pressure, given the high level of inflation. The growth outlook is even bleaker, with the limited resources for investment and constraints on the government budgets. This deterioration adds to already large structural imbalances, with 60% of Sub-Saharan African economies in the index facing twin deficits above 10 percentage points of GDP. These countries have also sustained the fastest growing stock of debt, with bond issuance alone increasing from USD5 billion in 2009 to USD100 billion in 2021. So far, the region has received USD30 billion of developmental assistance and USD60 billion of IMF emergency funding.

We would caution against taking comfort in the light bond maturities profile over the next twelve months or relying on a muddle-through scenario, in the hope that we will return to a better growth environment. With existing elevated levels of indebtedness (debt-to-GDP in high double digits) and high gross financing needs, it seems unlikely that either bilateral lenders or bondholders would be prepared to lend more money into these countries, without being confident that the issues outlined above will be addressed.



Could this play out over the next couple years in the form of ad-hoc sovereign restructurings or are we likely to see a broader spillover in the region that could impair regional growth prospects and investors' risk appetite in this segment of the market? We think the risk of the latter outcome cannot be discounted. The historical default rate in the high-yield segment of EM hard currency sovereign debt has increased significantly from 1% in the period from early 2000s to 2018, to the high single digits in the last five years. However, until recently the default cases were mostly idiosyncratic. We have seen countries like Argentina and Ecuador – so-called “serial defaulters”-- going through a debt-reprofiling exercise. Meanwhile, smaller countries such as Suriname and Mozambique have suffered setbacks by pursuing an unsustainable policy mix, followed by Sri Lanka, which has also been struck by the economic shock of the Covid pandemic.

**“The real challenge in a sovereign debt restructuring lies in creating a framework that brings direct investment and portfolio flows, as well as a policy mix that is designed to improve growth prospects going forward and put debt servicing on a sustainable path.”**

This time around we might face a more systemic event. Here, despite the willingness to pay and implement a correct policy mix, the Covid pandemic and raw material pressure, combined with a relatively high debt load and higher global funding rates, puts the Sub-Saharan African economies' debt profile on an unsustainable path. Some of the countries might fare better than others. However, we are concerned about contagion risk given the conflation of numerous factors, including growth uncertainty, continued outflows from the asset class, increasing cost of funding and lack of clarity on support measures and liquidity to restore the path to growth.

When approaching a restructuring, the challenge in applying an appropriate framework doesn't lie in agreeing on the magnitude of the haircut required to repair the sovereign balance sheet. Over the last 30 years, the size of haircuts has had little to no correlation with the medium-term recovery outcome for investors. If anything, countries like Argentina and Ecuador, which in 2001 to 2009 negotiated some of the more punitive haircuts in the area of 70-80%, had to subsequently restructure multiple times given their unsustainable policy mix. The real challenge in a sovereign debt restructuring lies in creating a framework that brings direct investment and portfolio flows, as well as a policy mix that is designed to improve growth prospects going forward and put debt servicing on a sustainable path. IMF analysis suggests that following a debt restructuring, an EM country will typically lose five percentage points of output per year and witness a 40% drop in private-sector borrowing, given the reputational damage.

What solution could support a quicker recovery in these economies and a chance to regain market access? We would argue that in the case of Sub-Saharan Africa a comprehensive approach would be most effective, but it would likely require some features that are new to the market. These would focus not only on the existing debt, that could be reprofiled in a new instrument linked to key Sustainable Development Goals as KPIs, but also on potentially providing additional liquidity through an *ESG-linked 'new money' solution* that could be tightly monitored and linked to specific strategically-important projects. If a broader investor pool were to be targeted, these new money solutions could also offer high-quality collateral for additional comfort. One such example could entail tapping into international reserve assets such as SDR (Special Drawing Rights) as a backstop for lending. In 2021, Sub-Saharan Africa received USD20 billion in SDR out of the total pool of USD660 billion. Currently a number of developed countries do not use their share of the SDR allocation. Putting together a framework that could reallocate a share of this amount towards frontier market economies with attached conditionality and tighter monitoring could be a win-win for both investors and countries in need.





## **“While fortune tellers might struggle to predict the future, they often provide some clues that could be helpful in navigating a challenging period in our lives. Today we see a number of structural challenges that are facing frontier economies.”**

For years, investors and multilateral creditors have struggled with transparency and corruption in frontier markets. A new collateralised instrument could aim to address this problem, while allowing these countries funding access for certain ESG-related projects that could bring back growth prospects. The documentation could include certain covenants related to transparency metrics and use of proceeds, as well as other deliverables and KPIs.

Looking back in history, this type of framework can be loosely compared to the Brady Bonds plan in the 1980s that helped reprofile most of the commercial debt of EM and gave birth to EM sovereign debt as an asset class. At the time, given the lack of a buyer base, the US Treasury guarantee was included as collateral to give investors comfort with the risk of an EM creditor. Today this type of explicit guarantee might not be necessary, but a similar framework with a focus on ESG-linked projects, both on an unsecured and SDR-backed basis, could open a wider pool of investors and ultimately help the region recover at a faster pace.

Why should investors care if they can avoid the space? The continent is home to 1 billion people, 30% of world's mineral reserves, 12% of the world's oil reserves and 8% of the natural gas supply. Sub-Saharan Africa imports account for USD250 billion or 23% of the aggregate GDP with China, India, US, Switzerland and South Africa being the main trade partners. Lack of action on investors' and creditors' side might translate into another “lost decade” for frontier markets.

In addition to the economic and humanitarian motivations, there are environmental arguments for providing ESG-linked capital to Sub-Saharan Africa. The region currently accounts for only a small fraction of CO<sub>2</sub> emissions globally, yet a recent study by the Mo Ibrahim Foundation reports that the continent contains the 10 most climate-vulnerable countries in the world. The IMF and African Development Bank estimate that Africa as a whole needs to mobilise USD1.6 trillion between 2022 and 2030 to meet their Nationally Determined Contributions to fight climate change, but on current trends is raising less than 10% of that amount. With the financial burden of mass poverty and lack of resources, it is optimistic to expect that ‘net zero’ and adhering to Paris Club Agreements will feature strongly on the priority list for policymakers.

Early intervention through funding and support would go a long way in pre-empting the potential environmental impact of these structural trends on both the global and local fronts. Indeed, without this support, Africa's rising CO<sub>2</sub> emissions could very well offset the efforts in the rest of the world to transition to net zero. By providing new conditional capital with the backing of SDR funds, developed market nations, multilateral organisations and, indeed, global investors, could be strongly aligned in providing an avenue for these credits to address their economic, financing and ESG requirements.

While fortune tellers might struggle to predict the future, they often provide some clues that could be helpful in navigating a challenging period in our lives. Today we see a number of structural challenges that are facing frontier economies. We ought to pay attention to these clues and act proactively in order to avoid a crisis on our doorstep. It is certainly easier to get into a crisis than to get out of it.

This document may be produced and issued by the following entities: in the European Economic Area (EEA), by BlueBay Funds Management Company S.A. (the ManCo), which is regulated by the Commission de Surveillance du Secteur Financier (CSSF). In Germany and Italy, the ManCo is operating under a branch passport pursuant to the Undertakings for Collective Investment in Transferable Securities Directive (2009/65/EC) and the Alternative Investment Fund Managers Directive (2011/61/EU). In the United Kingdom (UK) by BlueBay Asset Management LLP (BBAM LLP), which is authorised and regulated by the UK Financial Conduct Authority (FCA), registered with the US Securities and Exchange Commission (SEC) and is a member of the National Futures Association (NFA) as authorised by the US Commodity Futures Trading Commission (CFTC). In Switzerland, by BlueBay Asset Management AG where the Representative and Paying Agent is BNP Paribas Securities Services, Paris, succursale de Zurich, Selnaustrasse 16, 8002 Zurich, Switzerland. The place of performance is at the registered office of the Representative. The courts of the registered office of the Swiss representative shall have jurisdiction pertaining to claims in connection with the distribution of shares in Switzerland. The Prospectus, the Key Investor Information Documents (KIID), where applicable, the Articles of Incorporation and any other applicable documents required, such as the Annual or Semi-Annual Reports, may be obtained free of charge from the Representative in Switzerland. In Japan, by BlueBay Asset Management International Limited which is registered with the Kanto Local Finance Bureau of Ministry of Finance, Japan. In Australia, BlueBay is exempt from the requirement to hold an Australian financial services license under the Corporations Act in respect of financial services as it is regulated by the FCA under the laws of the UK which differ from Australian laws. In Canada, BBAM LLP is not registered under securities laws and is relying on the international dealer exemption under applicable provincial securities legislation, which permits BBAM LLP to carry out certain specified dealer activities for those Canadian residents that qualify as “a Canadian permitted client”, as such term is defined under applicable securities legislation. The BlueBay group entities noted above are collectively referred to as “BlueBay” within this document. The registrations and memberships noted should not be interpreted as an endorsement or approval of BlueBay by the respective licensing or registering authorities. Unless otherwise stated, all data has been sourced by BlueBay. To the best of BlueBay’s knowledge and belief this document is true and accurate at the date hereof. BlueBay makes no express or implied warranties or representations with respect to the information contained in this document and hereby expressly disclaim all warranties of accuracy, completeness or fitness for a particular purpose. Opinions and estimates constitute our judgment and are subject to change without notice. BlueBay does not provide investment or other advice and nothing in this document constitutes any advice, nor should be interpreted as such. This document does not constitute an offer to sell or the solicitation of an offer to purchase any security or investment product in any jurisdiction and is for information purposes only. This document is intended only for “professional clients” and “eligible counterparties” (as defined by the Markets in Financial Instruments Directive (“MiFID”)) or in the US by “accredited investors” (as defined in the Securities Act of 1933) or “qualified purchasers” (as defined in the Investment Company Act of 1940) as applicable and should not be relied upon by any other category of customer. No part of this document may be reproduced, redistributed or passed on, directly or indirectly, to any other person or published, in whole or in part, for any purpose in any manner without the prior written permission of BlueBay. Copyright 2022 © BlueBay, is a wholly-owned subsidiary of RBC and BBAM LLP may be considered to be related and/or connected to RBC and its other affiliates. ® Registered trademark of RBC. RBC GAM is a trademark of RBC. BlueBay Funds Management Company S.A., registered office 4, Boulevard Royal L-2449 Luxembourg, company registered in Luxembourg number B88445. BlueBay Asset Management LLP, registered office 77 Grosvenor Street, London W1K 3JR, partnership registered in England and Wales number OC370085. The term partner refers to a member of the LLP or a BlueBay employee with equivalent standing. Details of members of the BlueBay Group and further important terms which this message is subject to can be obtained at [www.bluebay.com](http://www.bluebay.com). All rights reserved.

This has been provided by RBC Global Asset Management Inc. (RBC GAM) and is for informational purposes, as of the date noted only. It is not intended to provide legal, accounting, tax, investment, financial or other advice and such information should not be relied upon for providing such advice. RBC GAM takes reasonable steps to provide up-to-date, accurate and reliable information, and believes the information to be so when provided. Past performance is no guarantee of future results. Interest rates, market conditions, tax rulings and other investment factors are subject to rapid change which may materially impact analysis that is included in this document. You should consult with your advisor before taking any action based upon the information contained in this document.

All opinions constitute our judgment as of the dates indicated, are subject to change without notice and are provided in good faith without legal responsibility. Information obtained from third parties is believed to be reliable but RBC GAM and its affiliates assume no responsibility for any errors or omissions or for any loss or damage suffered. RBC GAM reserves the right at any time and without notice to change, amend or cease publication of the information.

This document may contain forward-looking statements about a fund or general economic factors which are not guarantees of future performance. Forward-looking statements involve inherent risk and uncertainties, so it is possible that predictions, forecasts, projections and other forward-looking statements will not be achieved. We caution you not to place undue reliance on these statements as a number of important factors could cause actual events or results to differ materially from those expressed or implied in any forward-looking statement. All opinions in forward-looking statements are subject to change without notice and are provided in good faith but without legal responsibility.

® / ™ Trademark(s) of Royal Bank of Canada. Used under licence.  
© RBC Global Asset Management Inc., 2022

Published October 2022



**Global Asset  
Management**