DR. RICARDO ADROGUÉ
HEAD OF EMERGING MARKETS DEBT

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BEYOND THE HEADLINES: MAKING SENSE OF TODAY'S EM DEBT ENVIRONMENT

IN A RECENT INTERVIEW, DR. RICARDO ADROGUÉ, HEAD OF BARINGS' EMERGING MARKETS DEBT GROUP, DISCUSSED RISKS AND OPPORTUNITIES IN TODAY'S DYNAMIC ENVIRONMENT—AND HOW INVESTORS CAN SEEK TO NAVIGATE IT.

Broadly speaking, what is your view of EMD in today's environment?

There is no denying that 2018 so far has been a challenging, volatile year for emerging markets (EM) debt. But amid all the noise, we believe it's important to keep in mind that the economic and fundamental backdrop for the asset class remains largely positive. In fact, we continue to see a number of attractive opportunities across EM regions and countries.

Global growth is strong overall and we predict will remain so by historical standards in 2018, with some EMs leading the way. EM inflation remains at 17-year lows, which may allow local rates to continue to come down in select EM countries going forward. Balance of payments and current accounts across EM countries are generally sound. Many EM economies have seen substantial adjustments to their external accounts.

In addition, company fundamentals have continued to improve on the back of healthy economic growth and higher commodity prices. EM corporate earnings and balance sheets have continued to be generally solid, while corporate leverage is expected to decline. Corporate and sovereign default rates remain below historical averages. In many instances, recent volatility in EM debt assets has made valuations attractive relative to company fundamentals.

These trends tend to favor active managers that are focused on country picking and on bottom-up credit selection at the individual issuer level. Having said that, the current landscape continues to present a number of risks that we will be paying close attention to in the coming months.

What are some of the major risks facing the asset class?

Clearly, some of the risks are tied to policy in the developed world—including U.S. tax, deregulation and immigration policies, but mainly monetary and trade policies. The combination of a more assertive U.S. Federal Reserve (Fed), President Trump's trade protectionism policies aimed at foes and allies alike, and the announcement of a terminal date for the European Central Bank (ECB)'s quantitative easing program has put downward pressure on EM assets and may continue to do so.

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As monetary policy tightens in the U.S., Europe and Japan, EMs become relatively less attractive from an investor flows standpoint, and there is typically less liquidity available to support EM assets. Barring unforeseen events, the Fed in particular appears to be firmly on a path to continue raising interest rates in 2018 and 2019. Higher U.S. rates have hurt EM countries with large current account deficits and weak credit ratings, as well as those most in need of foreign financing, such as Turkey, Argentina and Ecuador.

Our view has generally been that, while rising U.S. rates may prove challenging for some EM sovereigns and corporates, stronger economic growth in the U.S. and other developed markets overall should benefit many EM economies and assets. That remains a valid thesis to some degree, but the problem now is that the expected benefits to EMs are being undermined by the negative effects of U.S. trade policy—tariffs, sanctions and threats of one or both. For example, growth in global trade volumes is vulnerable given aggressive U.S. implementation of trade protectionist policies.

Accordingly, one of the key risks in the months ahead lies in what policies and actions actually come out of the U.S. trade agenda and their potential impact on global trade.

What about country-specific risks that could have a ripple effect?

China is an obvious one. The country is a vital link between emerging markets and the developed world, so an economic downturn there could have far-reaching consequences. For example, commodity prices have been supportive of many EM currencies, but should China experience a material slowdown in demand or growth, it would likely put pressure on commodity-producing countries and companies. However, we believe a worst-case scenario is unlikely. In our view, China has ample resources (e.g., foreign reserves) and a political system capable of defending its economy from a major setback.

Then there's Turkey. We believe President Erdogan is on a narrow path to averting disaster—but with little room for error—and that the risk of Turkey defaulting on its sovereign bonds is low. In our view, the bigger risk is that Turkey's economic and currency crisis leads global banks in Europe to pull back their EM exposure. Earlier this year, we argued that commercial banks were poised to regain strength and provide a source of flows into EMs, thereby helping to fill the liquidity gap left by central banks and supporting EM asset prices. That argument is less powerful now in light of developments in Turkey.

Political risk is also worth watching in certain countries, particularly given the heavy 2018-2019 election calendar in emerging markets. The first half of this year saw key elections in Mexico, Venezuela, Malaysia, Hungary and elsewhere. Still to come are Brazil's high-profile general election in October 2018, followed by Thailand, South Africa and Argentina next year, among others.

What is the best way for most investors to navigate this environment, in your view?

These are just the types of headwinds and challenges that skilled, active EM debt managers are well equipped to navigate. Having the ability to sidestep unwanted risks and capitalize on potentially overlooked opportunities can make all the difference in an asset class prone to bouts of market volatility.

We believe EM country and credit selection will remain paramount through the remainder of 2018 and into 2019. Particularly at the corporate level, the macro and country-specific risks described above have little or no bearing on the health and strength of most individual issuers of EM debt. For example, brewing trade wars, tighter monetary policy in the U.S. and the crisis in Turkey are unlikely to cause a fundamentally strong EM company to default or be downgraded. If anything, the market volatility triggered by investors' angst over these issues can create opportunities for active managers in the form of attractive entry points into sound issuers that are well positioned for the long term.

Of course, not all EM debt managers are created equal. With expertise across the EM debt spectrum, the Barings Emerging Markets Debt Group follows a disciplined, transparent and repeatable process grounded in fundamental, bottom-up research in an effort to identify opportunities and build diversified portfolios in which we have the utmost confidence. The strength of our long-term convictions in our investments has enabled us to hold positions through periods of market volatility, including the commodity sell-off that began in June 2014, the 2016 U.S. election cycle and various geopolitical episodes.

> *"...we continue to invest in countries that we believe exhibit solid fundamentals and the wherewithal to withstand today's risks."*

You highlighted your team's ability to identify opportunities—where are you currently seeing opportunities in EM debt?

It's very much on an issuer-by-issuer basis, but I'll keep my comments at the country level for purposes of this discussion. Given our investment process and ability to be overweight/underweight and even zero-weight countries, we continue to invest in countries that we believe exhibit solid fundamentals and the wherewithal to withstand today's risks. These include many of the larger EM countries, such as Mexico, Brazil and Chile in Latin America; Malaysia, Indonesia and South Korea in Asia; Poland and Hungary in Eastern Europe, along with Russia; and South Africa.

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that cover

85+ COUNTRIES

and more than

1,100 CREDITS

SOURCE: *BARINGS. AS OF JUNE 30, 2018.*

DR. RICARDO ADROGUÉ
HEAD OF EMERGING MARKETS DEBT

Dr. Ricardo Adrogué is Head of Barings' Emerging Markets Debt Group, lead portfolio manager for the Emerging Markets Local Debt strategy, and co-portfolio manager for the Emerging Markets Sovereign Hard Currency Debt and Blended Total Return Debt strategies. Having worked in the industry since 1992, his experience includes portfolio management, economic strategy and academia. Ricardo holds a B.A. in Economics from the Universidad Católica Argentina, along with an M.A. in Economics and a Ph.D. from the University of California, Los Angeles.

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