Emerging Market Debt
In the Year of Living Dangerously

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Seeking Alpha’s Leland Montgomery recently spoke with Robert to explore his insights on how emerging market (EM) debt may perform in 2012, especially when compared with emerging market equities.

Portfolio Construction

Seeking Alpha (SA): How would you generally describe your investing style/philosophy?

Robert Abad (RA): We are long-term fixed-income value investors; our analysis is fundamentals-based, incorporating both top-down and bottom-up views. To produce the best risk-adjusted returns over changing market conditions, our strategy in emerging markets focuses on identifying and exploiting relative value opportunities across the three subsectors of the asset class: sovereign debt, corporate bonds and local-market debt.

SA: To which index or fund—if any—do you benchmark your performance? Has this changed recently, and if so, why?

RA: We use J.P. Morgan’s Emerging Markets Bond Index Global as the benchmark for our diversified strategy portfolios, which represent a mix of US dollar-denominated emerging market sovereign bonds, US dollar-denominated emerging market corporate bonds, and emerging markets local-market exposure (either FX or cash positions in local-currency-denominated debt).

SA: Some describe the current era as “The Great Deleveraging.” Do you agree/disagree, and does this macro consideration affect your investment planning process?

RA: I agree with this characterization. In 2010, my colleague, Matt Graves, and I wrote a paper titled Emerging Markets: Revisiting the Investment Thesis in an Era of Debt. We argued that the massive accumulation of public debt in the developed world over the past decade—which helped fuel growth rates and bolster market valuations in the short run—will eventually act as a silent and debilitating force in the long run, as the rising debt servicing costs on a still increasing debt stock limit the productive use of domestically and externally generated cash flows. Therefore, and in a break with the past, the thesis for investing in emerging markets should not take shape around the higher rates of expected growth in those countries vis-à-vis the developed world. Rather, in a market characterized by uncertainty and concern over rising sovereign debt risk, the more compelling rationale for investing in emerging markets centers on the improved debt-sustainability metrics these nations now enjoy.
Global Markets

SA: Global macro considerations dominated the headlines in 2011. Do you see 2012 unfolding differently? If so, how?

RA: Global macro risks in 2012 will be greater, mainly as a result of an escalation of the sovereign debt problem in Europe (with associated contagion risk), heightened geopolitical risk in the Middle East, which will fuel commodity price volatility, and rising socio-political risk globally—we saw flashes of this throughout 2011 (e.g., North Africa, China, Russia, the global “Occupy” movement, etc).

SA: Eurozone contagion: Will it continue to drive the market’s direction, and how are you protecting client assets from potential fallout there?

RA: This is a critical issue. Financial turmoil in Europe, combined with a potential slowdown in the US, would be a serious short-term threat to emerging markets, as the fiscal position, growth dynamics and monetary stance across the developed world are much weaker today than they were in 2008–2009—leaving global growth much more exposed to downside risk than was the case in 2008. Clearly, the systemic nature of such a crisis would create mark-to-market risk across the entire spectrum of “risky” assets.

However, and keeping in mind emerging markets’ solid fundamental positioning and their performance throughout 2008–2009, our focus is on trying to avoid those assets that would be most directly impacted by such a crisis. This approach seeks to offer our portfolios the opportunity to benefit from a bounce-back in emerging market asset prices.

Regarding strategy: precisely because the transmission of risk from Europe to the rest of the world would flow directly through global financial channels, we have been underweight emerging market banks for some time. To mitigate broader market risk, we’ve continued to emphasize diversified investments in strong balance-sheet countries and in securities with the greatest amount of liquidity by rotating across the three emerging market sectors: US dollar-denominated sovereign debt, local-market debt and emerging market corporate credit. It’s an investment philosophy that makes sense and that has served our clients well during volatile times.

SA: Tell us your view on the relative attractiveness of EM equities versus EM debt.

RA: Historically, investors have gravitated toward EM equity over EM debt because equity was perceived to be the most liquid and direct way to take advantage of the emerging markets’ growth story. If you look only at data from the past decade, that thesis certainly appears to have some merit, as EM equities outperformed EM debt in absolute terms year after year.

But again, I want to stress the pitfalls inherent in assessing an asset class using only backward-looking data, particularly when doing so in the context of a global paradigm shift. Are the factors that drove such spectacularly positive performance throughout most of the last decade still in place? While it’s impossible to say with certainty, an environment characterized by a slowly deleveraging developed world certainly challenges this view. And this gets to the heart of what we think really separates EM debt from EM equity: the opportunity for superior risk-adjusted returns.
With this in mind, the fundamental argument against the traditional growth-driven investment thesis for emerging markets is even more persuasive. Slower global growth, exacerbated by the massive public and private debt burden in the developed world, increases the probability of economic and socio-political risk globally, which eventually impacts market valuations. We’ve already started to see this.

What should matter more to investors going forward, then, is how their investments can be expected to perform over a very wide range of potential economic scenarios—or, in other words, their expected risk-adjusted returns. The balance-sheet strength and financial flexibility currently enjoyed by many emerging countries would be critical to weathering the shock of another protracted global growth slowdown or broad-based financial crisis, providing a floor for EM debt prices under even the most negative of scenarios. Conversely, the inability of emerging countries to sustain the kind of growth rates seen in recent years under such a scenario would likely weigh very heavily on EM equity performance. As such, we would expect EM debt to continue to consistently outperform EM equities on a risk-adjusted basis.

SA: Where are the real growth stories overseas right now?

RA: In Brazil, Mexico, Peru, Indonesia, Malaysia, to name a few.

SA: The Iran nuke situation and a potential Israeli, US or global attack—how serious would such an event be to oil prices and, subsequently, the global economy/exchanges? Is this something you’re positioning for, and if so, how?

RA: It’s no secret that energy markets are highly sensitive to geopolitical risk. We have to remember that for the best part of a century, oil (and more recently natural gas) has been produced primarily by the 12 OPEC countries (comprising West Africa, Middle East and Venezuela)—they alone harbor approximately 80% of global oil reserves while responsible for approximately 36% of global production. With US influence in these parts of the world waning, any event (particularly man-made) that seriously impairs production or further hinders the US’s ability to maintain its role as “stabilizer” in those regions (especially the Middle East) would re-introduce significant volatility to oil prices, which in turn, could have immediate and long-term consequences for both oil/gas importers and exporters, and place downward pressure on an already stressed global economic environment.

While we are cognizant of these “tail risks”, we nonetheless hold a positive, long-term (secular) view on commodities as we continue to see the global industrialization and urbanization story playing out further. Our view that demand factors versus supply factors will continue to buoy commodity prices is reflected in our overweight positions in EM oil and gas and metals and mining-related credits (both sovereigns and corporate bonds). We think our focus on EM investment grade credits in these sectors makes sense, as a result of these corporations’ continued strong US-dollar earnings power (supporting their ability to pay) and, at the sovereign (country) level, the desire by EM governments to preserve their newfound geopolitical status and access to the capital markets (supporting their willingness to pay).

US Market

SA: We are coming up on an election year. Will this be good or bad for markets? Are you positioning for different potential outcomes?
RA: We are coming up on a big election year globally: the US, France, China (change in leadership), Russia, India, Mexico, Venezuela, etc., which will have a strong effect on market sentiment (potentially negative) as governments continue to wrestle with strategies to contain domestic and external stress (e.g., European contagion). In the US, decisions ranging from fiscal policy to relations with China and the Middle East will certainly have implications on the economic outlook and contribute to noise around issues such as the US sovereign ratings outlook.

All in all, investors should always bear in mind that emerging markets are, have been, and always will be a price taker of G-3 risk. Indeed, if markets become unglued because of increasing US political brinkmanship, which results in a greater probability assigned to another US downgrade (resulting in even greater global risk aversion), then we should expect increased volatility to once again test investors’ loyalty to the EM asset class. However, in our view, that possibility—in and of itself—is not the adequate reason to avoid the asset class. The implicit message coming out of the headlines announcing continued downgrades in the developed world is that the fundamental risk/reward balance continues to favor emerging markets.

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