TOP HIGH CONVICTION EMERGING DEBT IDEAS FOR 2024

Tina Vandersteel

GMO

OVERVIEW

Value

- Emerging local debt offers a generational opportunity to play the USD's richness

Thematic

- Profiting while targeting the funding of energy transition in emerging countries (65% of global GHG)
- Preserving the high-spread characteristic of emerging debt while avoiding countries with poor democratic freedoms

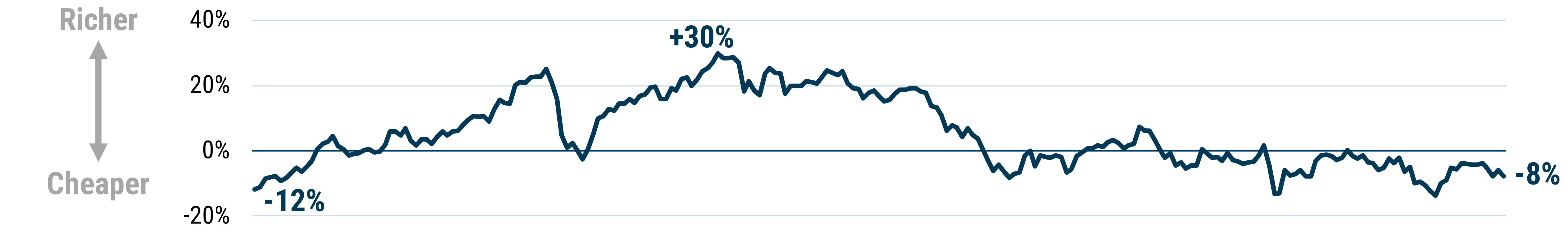
IDEA #1: FOR 2024 VALUE

Emerging local debt offers a generational opportunity to play the USD's richness

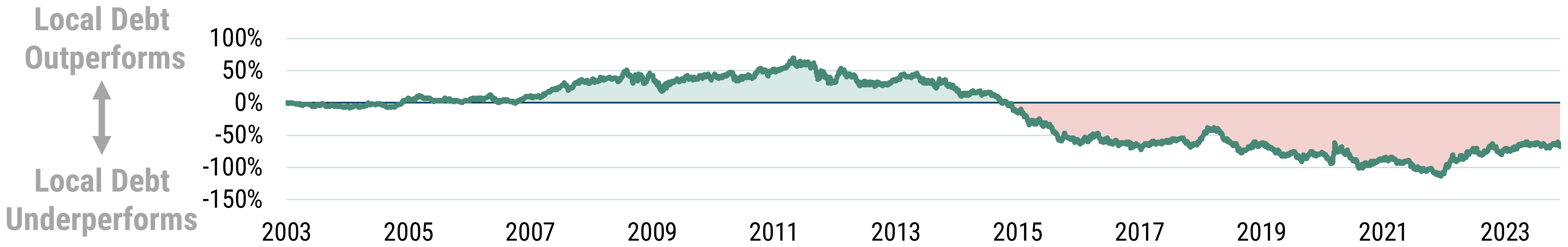
- The USD is rich, providing a tailwind to non-USD assets
- Among EMFX baskets – local debt (GBI-EMGD basket) and EM equities (MSCI EM) – local debt offers competitive value amidst a converging growth differential; diversification including 'frontier' opportunities; and robust alpha

THE U.S. DOLLAR'S POWERFUL, LONG SWING DRIVES BIG PERFORMANCE DIFFERENCES BETWEEN LOCAL AND HARD CURRENCY EM DEBT

EM LOCAL DEBT'S CURRENCY VALUATION VS USD (BEHAVIOURAL)



LOCAL DEBT VS. HARD CURRENCY DEBT CUMULATIVE PERFORMANCE



As of 30/11/23 | Source: J.P. Morgan, MSCI, Haver, Bloomberg, GMO

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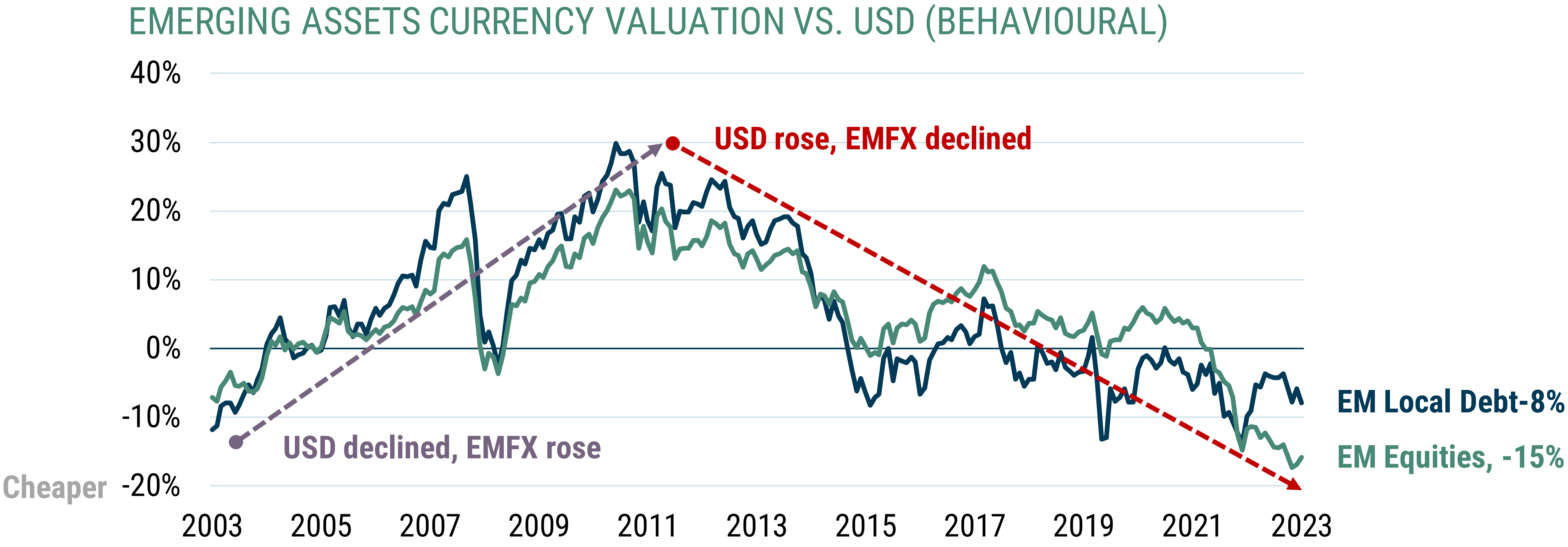
EMERGING FX ARE AS CHEAP AS THEY WERE TWO DECADES AGO



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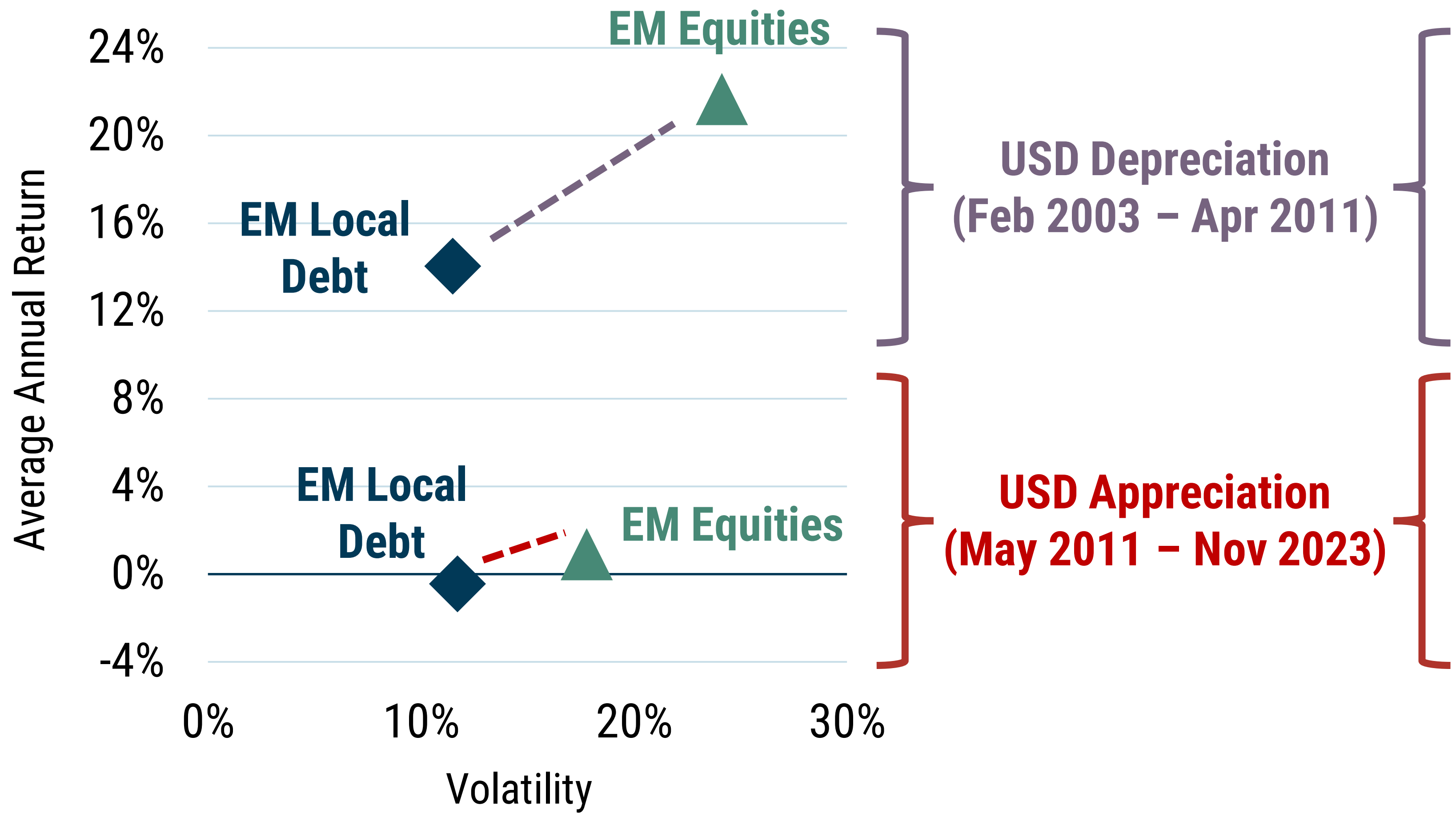
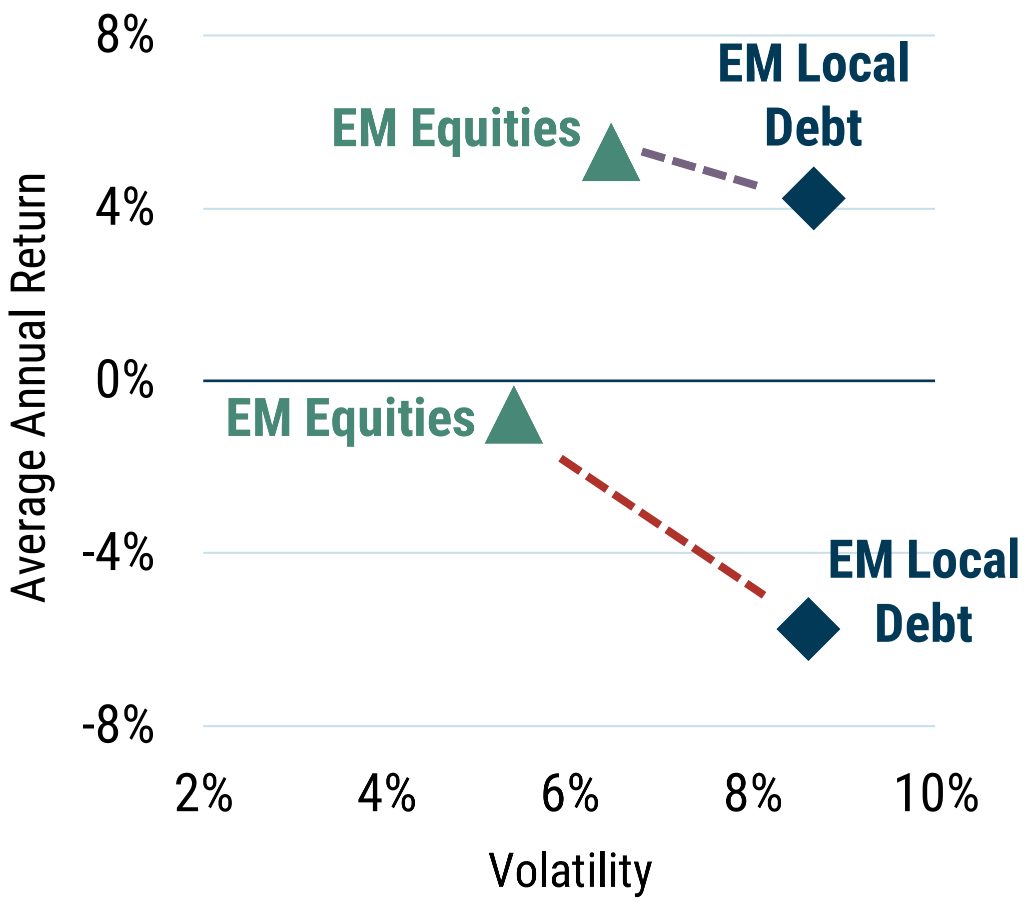
U.S. DOLLAR IMPACT ON RISK/RETURN TO EM LOCAL DEBT AND EM EQUITIES ASSET CLASSES

ASSET CLASS RETURNS AND VOLATILITY

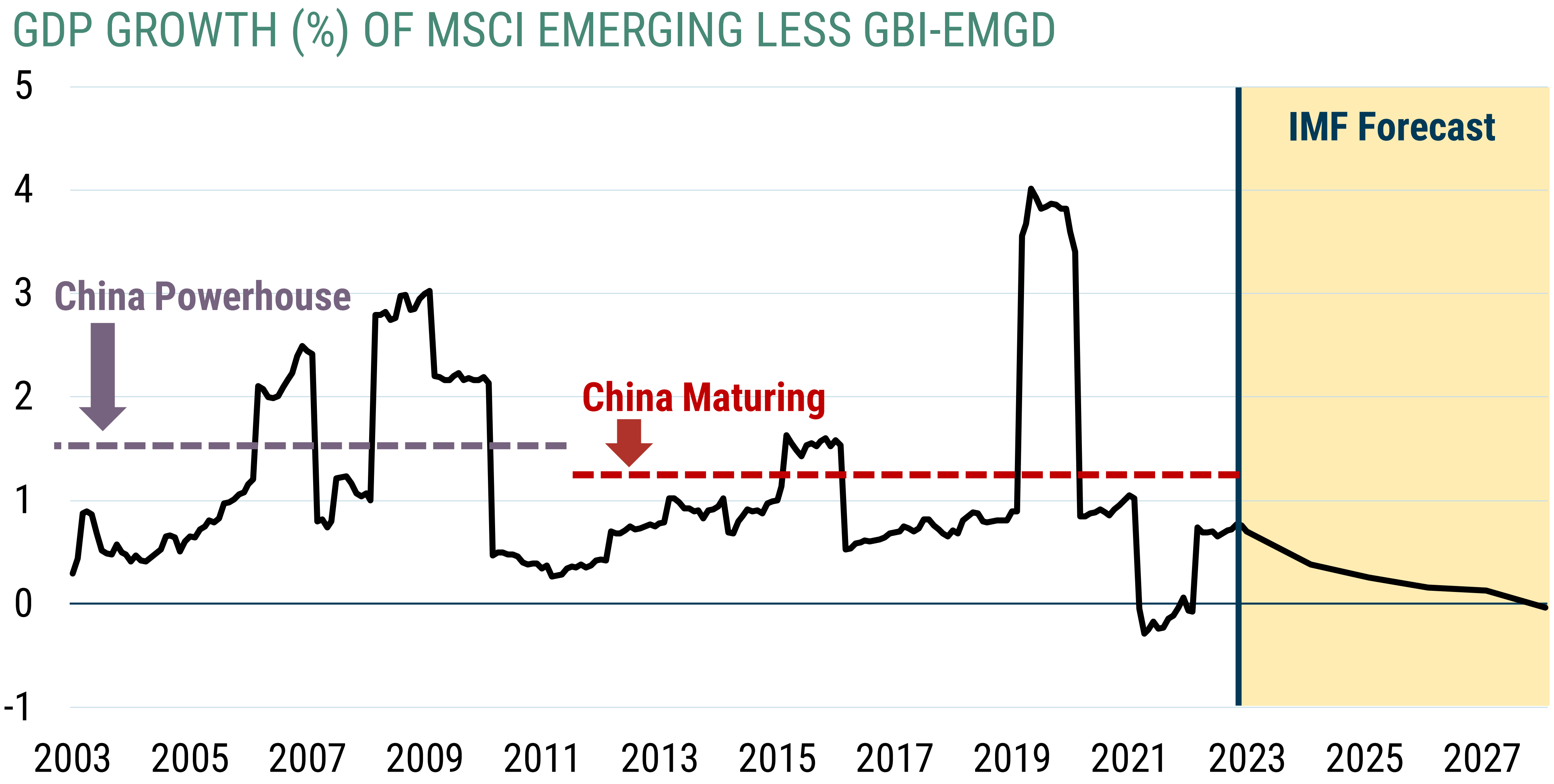


FX SPOT RETURNS AND VOLATILITY



As of 30/11/23 | Source: J.P. Morgan, Bloomberg, GMO

CLOSING GAP: DIMINISHING GROWTH DIFFERENTIAL BETWEEN MSCI EMERGING AND GBI-EMGD BASKET OF COUNTRIES



Source: J.P. Morgan, Bloomberg, MSCI, IMF

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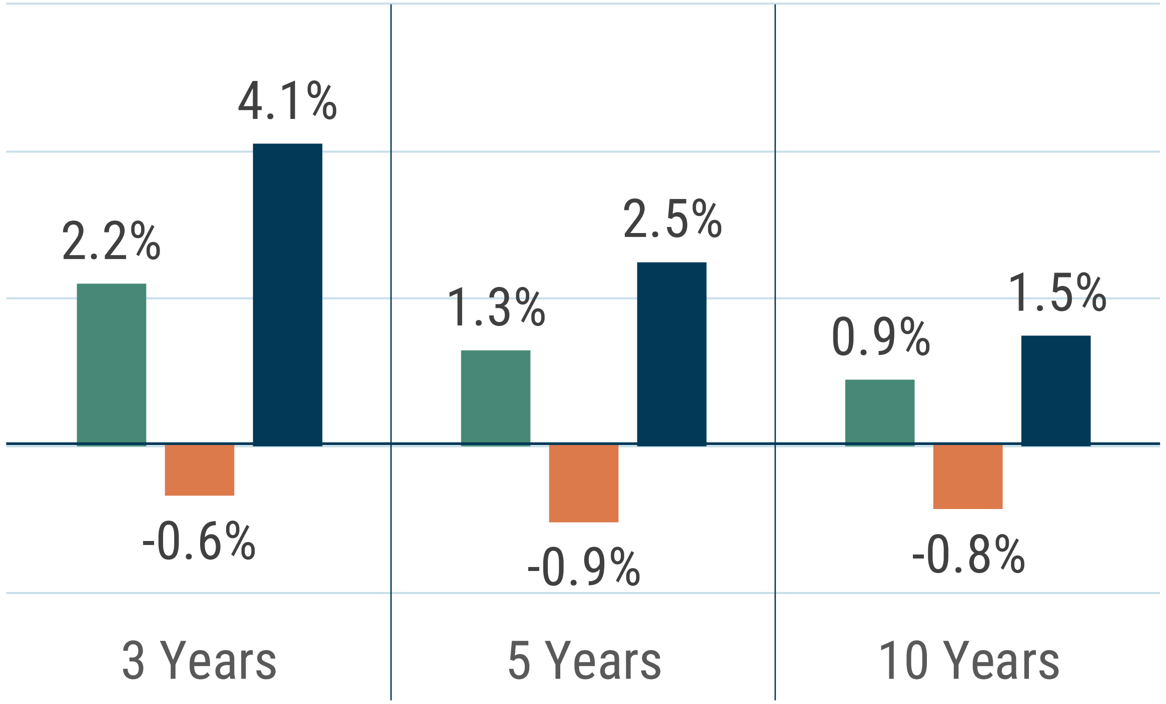
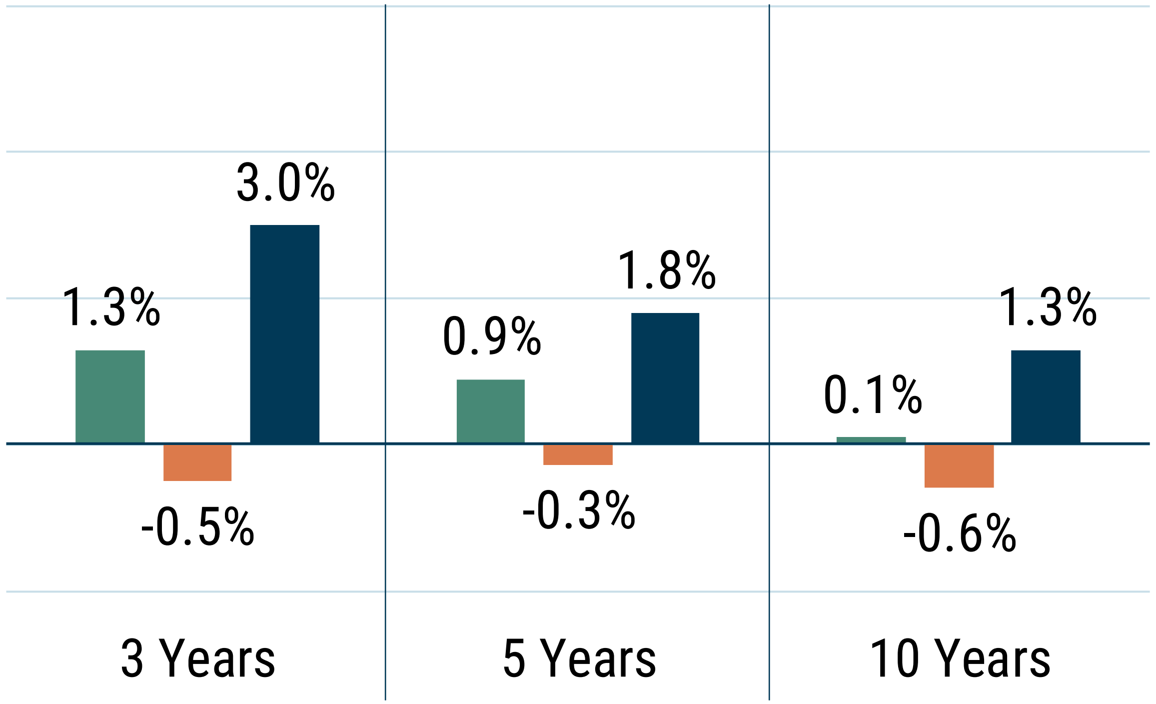
POSITIVE ALPHA TO ACTIVE MANAGEMENT…ESPECIALLY FOR GMO…AND GUARANTEED NEGATIVE ALPHA TO PRICEY ETFS

EMERGING LOCAL DEBT ALPHA



EMERGING HARD CURRENCY DEBT ALPHA



Median Manager ETF* GMO

As of 30/9/23 | Source: eVestment (median manager data), iShares by BlackRock (ETF data)
* iShares J.P. Morgan Emerging Local Government Bond UCITS ETF USD (local debt), net expense ratio 0.30%; iShares J.P. Morgan USD Emerging Markets Bond ETF (hard currency debt), net expense ratio 0.39%.
Alphas are relative to GBI-EMGD (Local debt) and EMBIG-D (Hard Currency debt). GMO alpha is net of fees.

IDEA #2: PROFITING FROM ENERGY TRANSITION IN EM COUNTRIES

- Industry ESG “solutions” strike us as neither optimised to deliver energy transition nor returns
- Rather, they seem optimised to garner regulatory-driven ESG designations…at scale
- GMO has never been scale-driven – instead, we seek the highest return, usually by uncovering complexity/liquidity premia
- The EM energy transition space is ideal for us – combining elements of complexity with a focus on “quasi sovereign” issuers and specific project finance
- After all, 65% of GHG come from the emerging markets, so serious investors should focus here!

FUNDING ENERGY TRANSITION IN EMERGING COUNTRIES

Investment needs

Electricity Demand		Build Cost		Funding Need		Current Projections…
"Greening" Existing Capacity: 1,500 GW + New Renewable Capacity: 3,000 GW	×	$2.5 Billion/GW	=	$11.3 Trillion	VS.	$4 Trillion

Source: IEA, IMF, Bloomberg, Capital IQ

FUNDING ENERGY TRANSITION IN EMERGING COUNTRIES

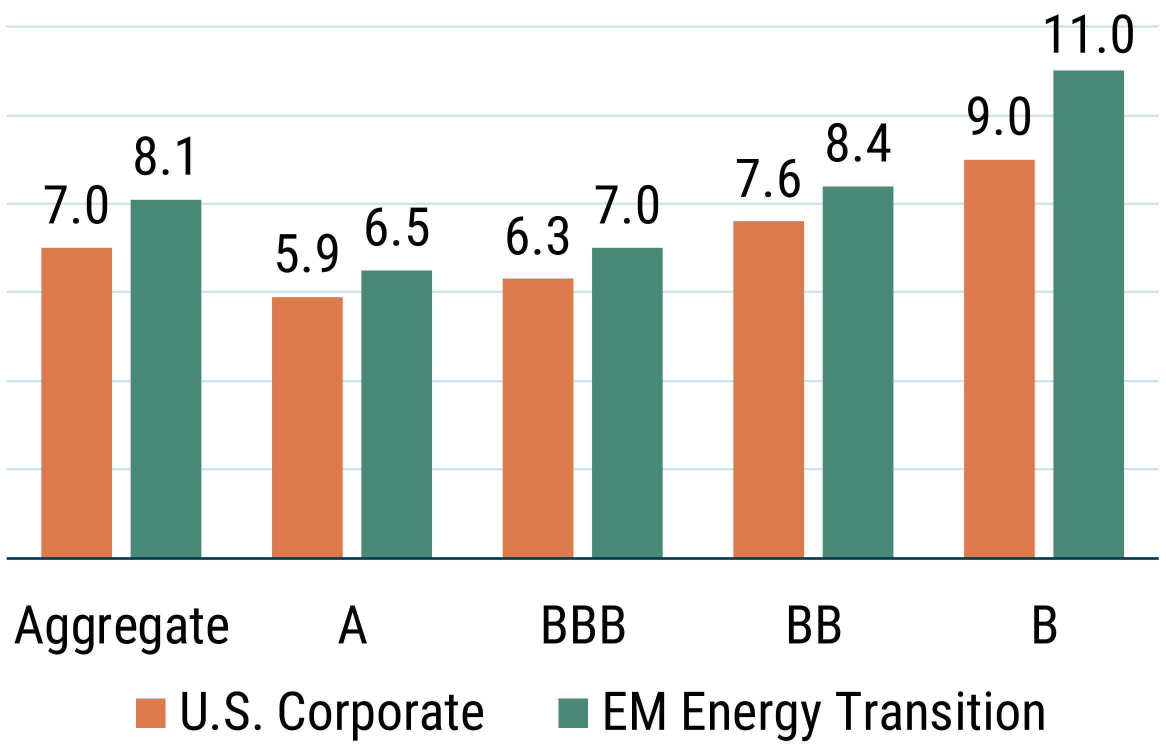
Focusing the solution

	INDUSTRY SOLUTIONS	GMO's FOCUSED IDEA
Align investment universe with the theme	▪ ESG scored portfolios ▪ Green bond portfolios ▪ Exclusion lists	▪ Specific project finance plus companies with solid energy transition plans, particularly those whose greening can have the most impact on GHG emission reductions ▪ Holistic issuer engagement provides real-time assessment of forward-looking plans than ESG scores
Ensure the transition result	▪ Not clear, hence "greenwashing" allegations	▪ Project finance contains much stronger contractual recourse than sovereign "green bonds" for use of proceeds
Earn highest returns	▪ Investors pay "greenium" or ESG/quality premium	▪ Investors earn a complexity premium for project finance, and a spread to sovereign for solid quasi-sovereign corporates

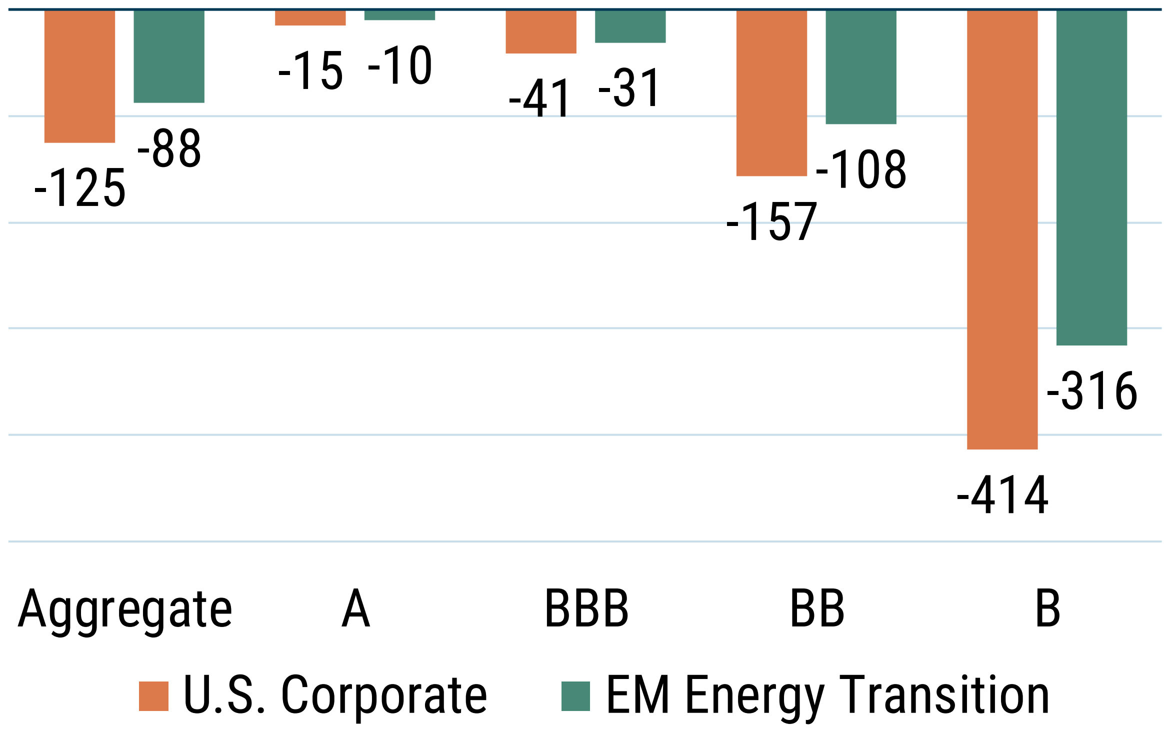
FUNDING ENERGY TRANSITION IN EMERGING COUNTRIES

Profiting from emerging markets and complexity premia

YIELD (%)



EXPECTED CREDIT LOSS (BPS)



As of 30/9/23 | Source: J.P. Morgan, Bloomberg, S&P

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QUASI-SOVEREIGN ISSUERS ARE OUR SPECIALTY, REQUIRING CAREFUL COORDINATION WITH OUR SOVEREIGN TEAM

A disciplined, emerging markets-oriented approach

Corporate Finance

- Profitability
- Solvency
- Liquidity

Issue Characteristics

- Issuer's Ability to Change Terms
- Creditor Rights and Enforcement Features

Energy Transition Plans

- Emission targets
- Renewables mix evolution

Strategic (Quasi-Sovereign) Considerations

- Sovereign's willingness to support a company in financial distress
- Sovereign's ability to support the company

IDEA #3: PRESERVING THE HIGH-SPREAD CHARACTERISTIC OF EMERGING DEBT IN MORE FREE AND DEMOCRATIC COUNTRIES

- A focus on E+S+G is simply a quality bias, including quality's lower yields and returns. A focus on Freedom and Democracy is returns neutral and may eliminate some geopolitical left tails

GMO
WHITE PAPER

DOES DEMOCRACY MATTER FOR EMERGING SOVEREIGN DEBT?

Eamon Aghdasi and Mina Tomovska | August 2023

EXECUTIVE SUMMARY

Russia's 2022 invasion of Ukraine and the ensuing war have prompted new and difficult questions for sovereign debt investors. One such question is how best to approach illiberal and autocratic countries, like Russia, within the asset class. Indeed, this question may be more important now than ever in the wake of such an event (in which a relatively undemocratic country within emerging debt benchmarks[1] attacked a relatively democratic one), particularly amid continued investor interest in environmental, social, and governance (ESG) sustainability. In this paper we outline a process by which investors can develop an emerging hard currency debt portfolio that prioritizes freedom and democracy while preserving the key investment characteristics of the asset class. We believe such an approach may help investors reduce exposure to certain costly political events akin to the ones witnessed in 2022. At the very least, it should help sustainability-conscious investors to establish emerging debt portfolios that are freer, more democratic, and better aligned with their own values.

The undemocratic nature of emerging countries is a longstanding issue

Are emerging countries more undemocratic or unfree? Undoubtedly, defining – let alone measuring – such concepts can be elusive and subject to debate. Though one may be tempted to answer such a question by focusing on anecdotes and news developments – an allegation of voter fraud in a recent election, an arrest of an opposing politician, a closing of a popular news outlet, and so on – we prefer a more systematic approach. Unfortunately for emerging debt investors, the data do not paint an encouraging picture.

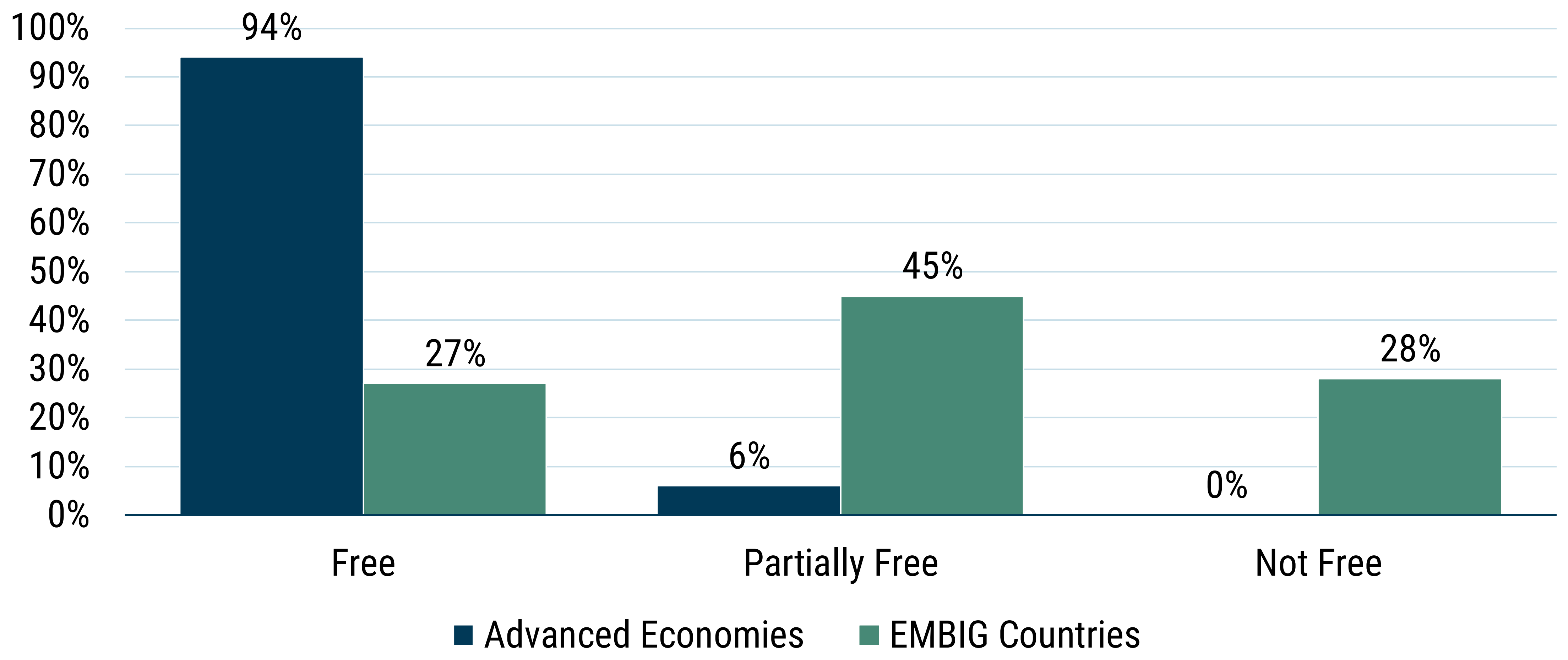
First, a note on data: while a number of organizations measure the extent to which countries are free, open, and democratic, for the purposes of this paper we will use the World Bank's Voice & Accountability (V&A) metric as a proxy for this broad theme. One of six Worldwide Governance Indicators (WGIs) established in the mid-1990s, V&A captures "perceptions of the extent to which a country's citizens are able to participate in selecting their government, as well as freedom of expression, freedom of association, and a free media."[2] We find this metric especially suitable for this paper, given its long and respected track record, breadth of country coverage, and use of a wide range of sources in its methodology.

In our 2021 paper[3] on the integration of ESG factors (including V&A) in sovereign debt investing, we discussed at length a conundrum for emerging sovereign debt investors: the inverse relationship between the strength of countries' ESG characteristics and their overall level of development. In plain words, richer countries tend to perform better with regard to ESG, while poorer countries tend to perform worse. We are hardly the first to shed light on this fact, but in recent years as the conversation around ESG investing has become more sophisticated, we sense a growing recognition of the link between income and ESG at the country level.[4] The key implication is that investors in emerging country asset classes will, all things being equal, hold a worse portfolio in terms of ESG than their developed country counterparts.

1
J.P. Morgan, the main benchmark provider in this area, included Russia in both its external and local currency indices, the Emerging Markets Bond Index – Global Diversified (EMBIG-D) and the Government Bond Index – Emerging Markets (GBI-EM), respectively. For the purposes of this paper, we will use EMBIG-D for country comparison purposes given its wider breadth of investable countries (70 versus 20).
2
The Worldwide Governance Indicators: Methodology and Analytical Issues (Kaufman, Kraay, and Mastruzzi 2010).
3
Sovereign ESG Integration: An Alpha-Oriented Approach for Emerging Debt (Aghdasi 2021).
4
See, for instance, the World Bank's 2021 publication, *A New Dawn – Rethinking Sovereign ESG*, which asserted, "More-developed countries tend to have stronger institutions, more equality, and more prosperity. Therefore, higher income tends to be tied to better ESG scores, especially regarding Social and Governance issues. Because of this ingrained income bias, about 90% of ESG scores can be explained by a country's gross national income."

EM HARD CURRENCY (EMBIG) HAS COUNTRIES IN VARIOUS STAGES OF POLITICAL DEVELOPMENT

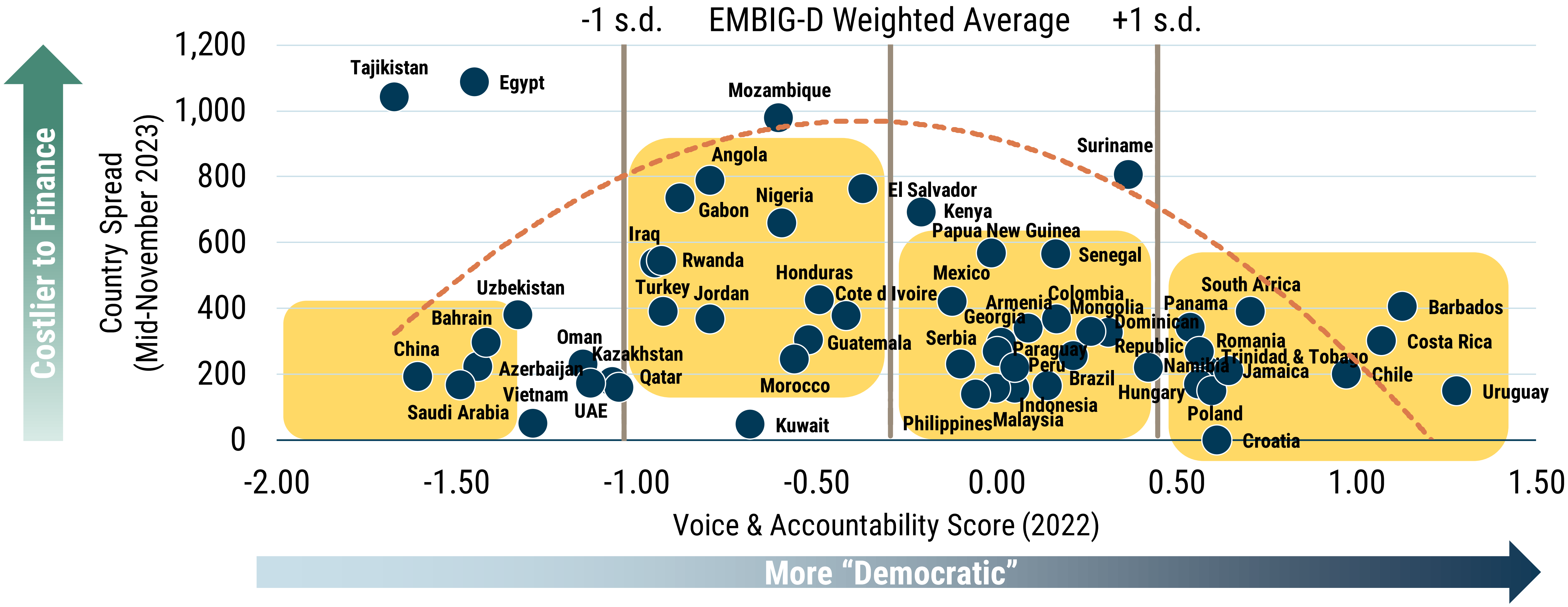
SHARE OF COUNTRIES IN EACH "FREEDOM IN THE WORLD" CATEGORY



As of 2023 | Source: Freedom House, "Advanced economies" as defined by the International Monetary Fund

FREEDOM AND DEMOCRACY SCORES ARE ORTHOGONAL TO SOVEREIGN SPREADS, UNLIKE STANDARD "ESG" COMPOSITE SCORES

EMBIG COUNTRIES' WORLD BANK VOICE & ACCOUNTABILITY SCORE VS. SOVEREIGN SPREADS



Source: J.P. Morgan, World Bank
Countries shown exclude those with spreads above 1,200 bps. Fit line is derived from all index countries, excluding Venezuela and Lebanon (spreads > 10,000 bps).

USING VOICE & ACCOUNTABILITY IN THE INVESTMENT PROCESS

5-Year Trend

	Severe	Very Poor	Moderately Poor	Adequate
	EXCLUDE	LIMIT	INCLUDE	INCLUDE
+1.0 s.d.	EXCLUDE	EXCLUDE	INCLUDE	INCLUDE
+0.5 s.d.	EXCLUDE	EXCLUDE	LIMIT	INCLUDE
-0.5 s.d.	EXCLUDE	EXCLUDE	LIMIT	INCLUDE
-1.0 s.d.	EXCLUDE	EXCLUDE	LIMIT	INCLUDE

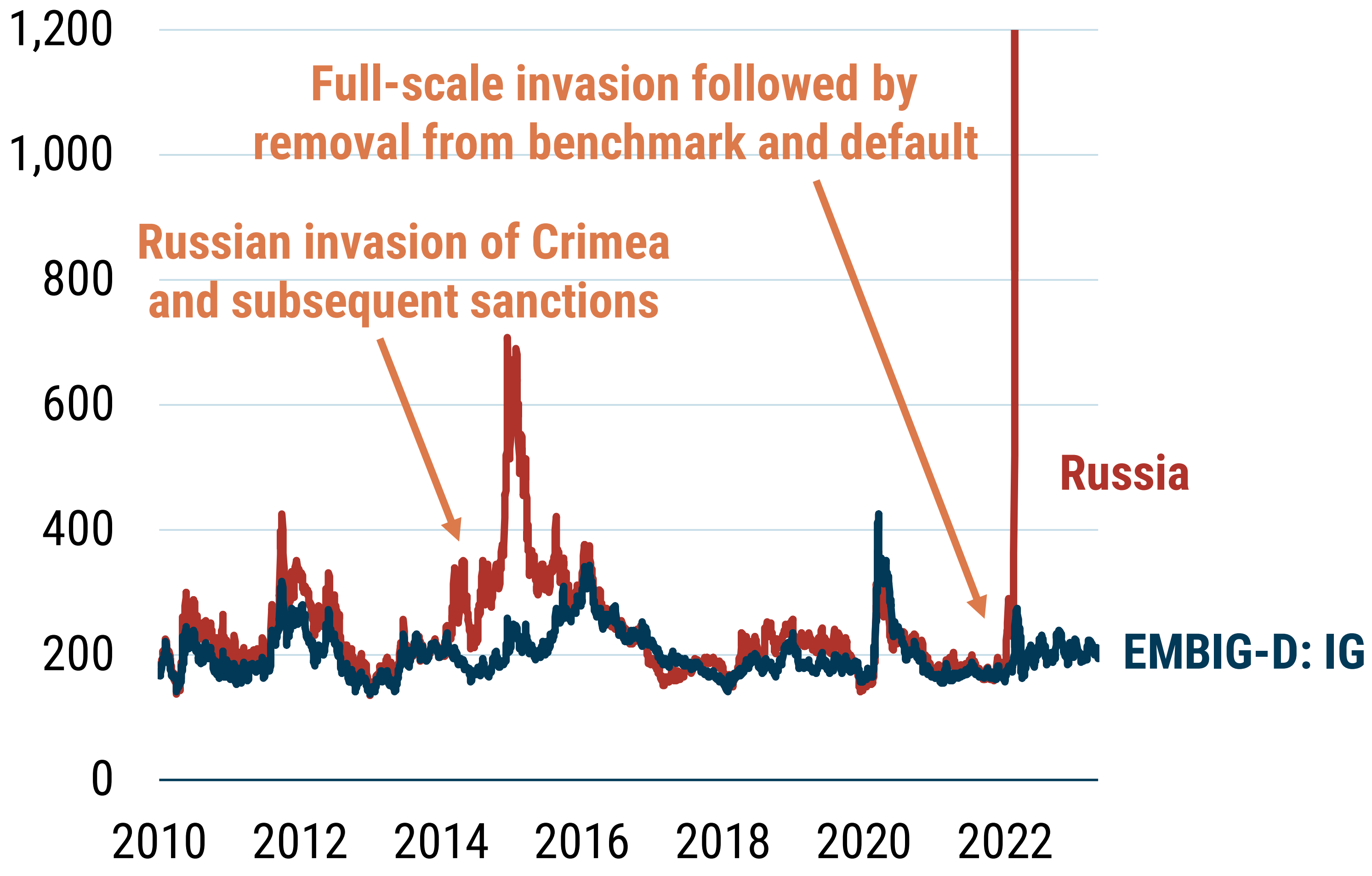
-1.5 s.d. | -1.0 s.d. | -0.5 s.d. | Mean

Voice & Accountability Score

We apply a 0.75 factor to the par value of the countries in the LIMIT category.

LATELY, GEOPOLITICS/SANCTIONS PUSHED HIGH (CREDIT) QUALITY RUSSIA INTO DEFAULT

RUSSIA'S BOND SPREADS WERE IN LINE WITH THOSE OF OTHER INVESTMENT GRADE CREDITS FOR MOST OF THE PAST DECADE



As of 4/5/23 | Source: J.P. Morgan, GMO

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EMERGING DEBT INSIGHTS

WEIGHING THE RISK OF SANCTIONS IN EMERGING DEBT

Carl Ross | June 2023

Political risks have always been present in emerging debt markets and we've long taken them into consideration within our overall country risk process. However, economic and financial sanctions on emerging countries have increasingly become a realm of political risk we need to consider because of their recent proliferation and staggering impact on bond prices. From our perspective, the proliferation is due to a host of reasons, including the rising number of autocracies and dictatorships around the world; geopolitical realignments such as Russia's *declining* great power status under Vladimir Putin and China's *rising* power; and a tilt toward nationalism in many countries. Regardless of the reasons and although economic sanctions have been around for centuries, recent cases (e.g., Venezuela and Russia) have generated outsized losses for retail and other savers invested in emerging debt mutual funds, in large part because sanctions have been imposed on the secondary trading of bonds, not just the *primary* issuance.[1] In other words, sanctions have gone wider and deeper into the marketplace.

Estimating the likelihood of sanctions

In considering these new risks, we must address the issue from the vantage point of being a U.S.-based asset manager with funds domiciled in U.S. and European jurisdictions. There is no doubt that this inserts a bias, but it is unavoidable. Our basic methodology is to identify countries that, due to their geopolitical misalignment with the west, behavior, or political orientation, are more or less likely to be subjected to sanctions by the U.S. and Europe.

The graphic below identifies four factors of this risk assessment that we believe could have an impact on sanctions likelihood, arranged in the order that we view as most relevant.

SANCTIONS RISK INPUTS

We identify four factors that may impact sanctions likelihood

Conflict and Aggression	Democracy	Human Rights	Financial Transparency
World Bank Conflict/Fragile States	EIU Democracy Index	UN Human Rights Ratifications	EU Fair Taxation List
Russia Condemnation Vote	Freedom House "Not Free"	UN Third Committee Voting Alignment	FATF Grey/Black List

Most Relevant → Least Relevant

1 Sanctions imposed by Western governments (albeit for horrific behavior) are a key reason that several countries have been forced into a default status, including Russia, Belarus, and Venezuela). I wrote about this recently in The Many Faces of Sovereign Default (March 2023).

SUMMARY

Emerging local debt offers a generational opportunity to play the USD's richness

- Relative to other alternatives, it offers relative value, diversification, and alpha

Profiting from funding the energy transition of emerging countries

- We've designed a strategy to optimise on two objectives: profiting by earning both an emerging and complexity premium while directly funding energy transition in countries that contribute 65%+ of global GHG emissions

Preserving the high-spread characteristic of emerging debt in more free and democratic countries

- A focus on E+S+G is simply a quality bias, including quality's lower yields and returns. A focus on Freedom and Democracy is returns neutral and may eliminate some geopolitical left tails

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