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Published by: Institutional Asset Manager, 8 St James's Square, London SW1Y 4JU, UK
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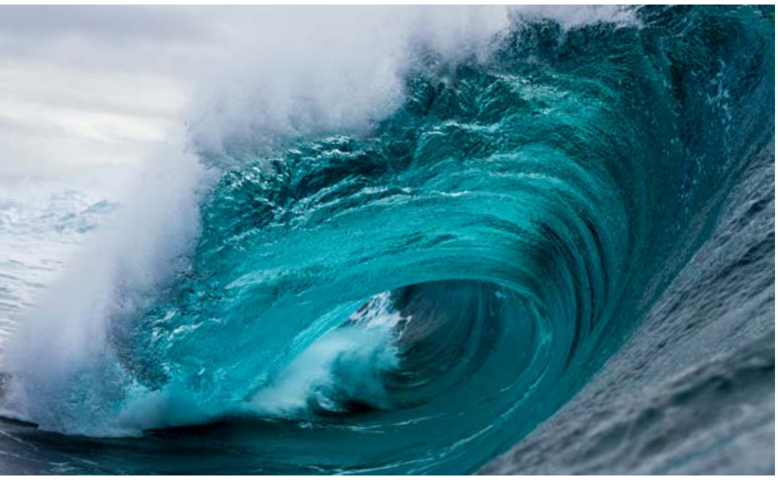
A discerning view on EMD opportunities

By A. Paris



The benefits of diversification have been highlighted in the past 18 months and in this context, institutional investor appetite for emerging markets has increased. As they hunt for returns in a low interest environment and seek to take advantage of dislocations resulting from the Covid-19 turbulence, investors and asset managers have underscored the role an allocation to developing markets can play within portfolios.

Although investment in emerging markets typically represents greater levels of risk, the opportunity identified is currently considered worthwhile, according to managers and institutional investors.

“Conditions for emerging market debt outperformance in 2021 appear to be in place. First, a global backdrop of steady, extended monetary accommodation, prospects of a large-scale deployment of Covid-19 vaccines, and, to a lesser extent, expectations of fiscal stimulus in the US, should boost the growth-sensitive segments of the asset class,” wrote the Morgan Stanley global fixed income team in an outlook briefing. “Therefore, high yield credit, emerging market FX and local currency high-yielders should outperform investment grade, which has less of a valuation cushion, and is vulnerable to potentially steepening yield curves in our opinion.”

Large investors in the space cemented their commitment to emerging markets over the course of the year. In its latest annual report, released in May 2021, The Canada Pension Plan detailed the growth of its investments in emerging markets from USD87.6 billion to USD104.2 billion, representing 21 percent of the fund’s total assets of USD497.1 billion.

“Despite the magnitude and scope of the recent global health crisis and economic shock, other fundamental long-term trends that underpin our investment strategy remain in place. For instance, we still project emerging markets will account for a higher share of total global economic activity over the coming decade, with the share of world GDP accounted for by emerging economies expected to surpass 50 percent during this time,” the fund outlined.

Kevin Sneader, global managing partner, McKinsey gives a cautiously optimist view, underscoring the need for a discerning approach. He wrote in an article: “While it would be rash to assume that any emerging economy could be immune to global volatility, those with strong macroeconomic fundamentals and a stable of competitive companies remain the world’s likeliest source of long-term growth.”

In a recent roundtable discussion, Mirko Cardinale, head of investment strategy and advice at USS said: “Emerging markets are not a very homogeneous group – they are very different, so you have to be selective.”

Asset management firm Edmond de Rothschild shares this view, stating: “Emerging markets are benefiting from favourable trends where select countries and sectors offer real opportunities.”

Currency plays are also a potential source of return. Emerging market currencies have experienced a strong rally, gaining over 10 percent since the pandemic broke out. Despite some investors expressing concern about the asset class getting expensive, James Barrineau, Head of Global EMD Strategy, Schroders believes the rally still has legs, noting this view fails to take into account the damage done by the 2013 Taper Tantrum. This was an event which triggered a spike in US Treasury yields when the Federal Reserve announced it would be tapering its quantitative easing programme.

In a briefing note, Barrineau asserts: “Even with some recent deterioration, surpluses are very near 20-year highs. For us, that represents a margin of safety against a Federal Reserve (Fed) taper that might come sooner than thought a few months ago. Continued slack across economies, even as growth resumes, makes it unlikely that we will see a return of structural inflation eroding currency value.” ■

The network effect: creating new opportunities for emerging markets bond traders

By Craig McLeod

Today's emerging market (EM) traders are different to just a few years ago, with an increasing need for information, access and liquidity for a broader spectrum of emerging markets to meet the investment profile of portfolios.

Electronic trading has created liquidity and information opportunities for those trading EM debt, in both hard and local currency. Billions of data points combined with innovation enables dealers and investors to be connected like never before, combining liquidity from both domestic and international participants interacting with each other daily to uncover more liquidity. While large international investors remain critical to global EM debt flows, a network of on-and-offshore investors underpin the ability to maximise liquidity and minimise trading cost by centralising what was commonly seen as a distributed liquidity landscape.

MarketAxess has been at the forefront of this change. As one of the leading venues for trading emerging market debt, it sees much of the growth going on in this asset class. USD562 billion was traded globally in EM across MarketAxess in 2020, distributed across hard currency and 26 local debt markets – our EM business has grown at 31 percent CAGR over the last five years.

This momentum will continue over the next few years. To address key market challenges (fragmented liquidity, efficient execution and increased automation) through technology innovation.

Piecing together fragmented liquidity

Inventory is increasingly shifting to the hands of traditional investors and domestic participants, a symptom of an asset class which has grown 200 percent in 10 years at a time where regulators have constrained bank balance sheets globally – a liquidity challenge. MarketAxess has systematically built a marketplace underpinned by a network. Creating the broadest range of emerging market debt streaming liquidity from 26 local EM currencies across LATAM, CEEMEA and APAC – with now over 1,600 EM trading participants – both buy-and-sell-side.

Unpredictable and rapid changes in liquidity conditions also cause challenges. That's why solutions that help traders make intelligent decisions across the deepest liquidity pool, empower them to have impact in their investment process. Solutions like Smart Select take a data-driven approach to help buyside investors select the "optimal" set of dealers, for their liquidity needs.

Levelling the playing field

Covering these markets on our platform isn't the only thing that's important. Building and supporting an infrastructure, breadth of trading protocols and global marketplace that fosters liquidity and drives a more efficient and active market is also critical.

Open Trading™ is the world's largest fixed income all-to-all marketplace, allowing market participants access to liquidity globally outside of their usual dealer-dealer channels. A local bank or buyside investor in Thailand can anonymously transact with any one of the 1,800 participants on our Open Trading network. Through this innovation, we routinely see traders in Cape Town transacting with dealers in Mexico City or Lagos with Mumbai.

Innovation is levelling the playing field for participants, and Open Trading represented 45 percent of emerging markets hard currency volume last year for MarketAxess. Introducing significant cost savings versus the next best price from a traditional liquidity provider, bringing back alpha to the investment funds of our clients.

Another innovation is Request-for-Market (RFM), a 2-way market at the fingertips of our users. The fastest growing protocol in the emerging market debt landscape in recent years, which has made the transition from emerging market rates, to emerging market credit. RFM has allowed traders to risk transfer large block orders electronically, keeping their intended trading side discrete, enabling true and fair price information on a competitive landscape while benefiting from all the efficiencies of electronic trading.

Switch Trading is another solution where we have seen immediate momentum in H2 2020 where you can simultaneously buy and sell short and long durations in 26 local currencies. Not only will you save valuable time by making only a single trade, you'll experience improved pricing from a wider variety of participants in the broadest global liquidity pool. We have seen increasing demand across all local emerging market jurisdictions.

A complete toolkit

The ability to cater for the diverse liquidity and strategy needs of market participants is essential, and we have developed our offering according to the demands of sophisticated traders globally.

There is huge global momentum within automation, and this has been widely adopted in emerging markets in the past 12 months for orders requiring a lower-touch approach. In 2020 we saw a rise of 159 percent in trades being submitted using auto-execution protocols. Through better pricing and tools that automate trading flows, investors are now able to reach more deeply and broadly into emerging markets.

A new era for emerging markets

It is a new era where emerging markets debt isn't just traded exclusively out of New York, and London, but directly by onshore participants. Last year we saw more trading activity done from locations such as Cairo, Sao Paulo, Johannesburg and Warsaw.

The number of regional onshore participants trading local debt has exploded by 50 percent this past year, supporting the move to electronic trading domestically. In APAC, we saw a 90 percent increase in trading volume YoY in 2020, and a 13 percent rise in the number of APAC-based firms using our platform.

This is a sign of things to come. With the right tools and the network, there is a new-found potential to transact with every corner of the world. ■

Craig McLeod
Head of Emerging Markets, MarketAxess

Craig McLeod joined MarketAxess in September 2018 as head of the firm's emerging markets business. Here he has been responsible for helping grow what is now the broadest pool of emerging market liquidity in the world, across both hard currency and local market bonds. Prior to joining MarketAxess, he was the head of global fixed income and FX trading at Investec Asset Management, a role in which he was twice awarded the title of Trading Rising Star by several notable trade publications. Craig has been a senior credit trader, portfolio manager and leader of fixed income trading operations in the US, Europe, the Middle East and Asia. He is an expert in global bond trading trends, technologies and investment strategies.