Vontobel

Are EM bonds about to shine?

And are investors ready?

Asset Management

For institutional / professional investor use only.

We pride ourselves on our client focus and hearing our clients' voices, concerns and ambitions about key investment decisions is a critical way of helping us deliver for them.

In this second edition of our annual fixed income survey, we once again spoke to sophisticated investors across the globe to canvas their views on emerging-market (EM) fixed income. And, what a difference a year can make. After a very disappointing 2022, this year promises an upswing in EM bonds, including sovereign and corporate bonds, that could last for years.

Investors told us that they are once again bullish on fixed income in general, but across all regions, a majority are planning to increase their allocations to EM fixed income in particular.

This is timely, as we believe that investors need to position now or risk missing an attractive entry point, especially on local currency which has been an underloved, underperforming segment for the past years and now looks far more promising.

Managing allocations across the EM fixed income segments can be difficult, and this is boosting the appeal of blend approaches, which can offer advantages in terms of positioning and ease of access to valuable opportunities.

Finally, our respondents confirmed that active approaches remain as popular as ever for EM investing strategies.

All in all, the survey paints a picture of a sector that looks ready to shine.
Are you?

Simon Lue-Fong
Head of Fixed Income,
Vontobel Asset Management

Key takeaways

Investors are once again bullish about fixed income, and about EM fixed income in particular. They intend to allocate to all three key EM debt sectors. An active approach is overwhelmingly favored and there's a tremendous increase in the popularity of blend strategies.

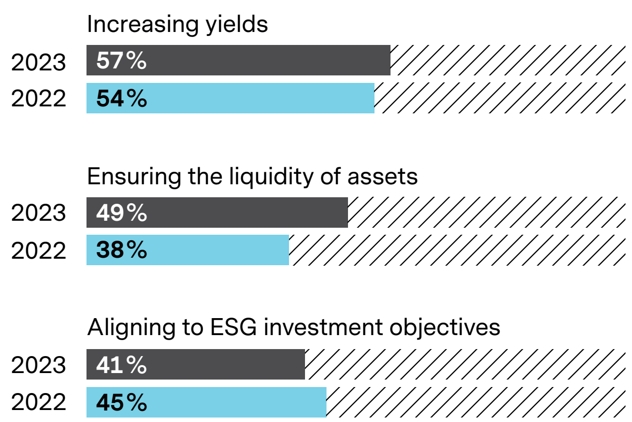
1. Investors are more bullish about fixed income

51%

Are more bullish/optimistic about fixed income in the wake of the surge in interest rates in recent months.

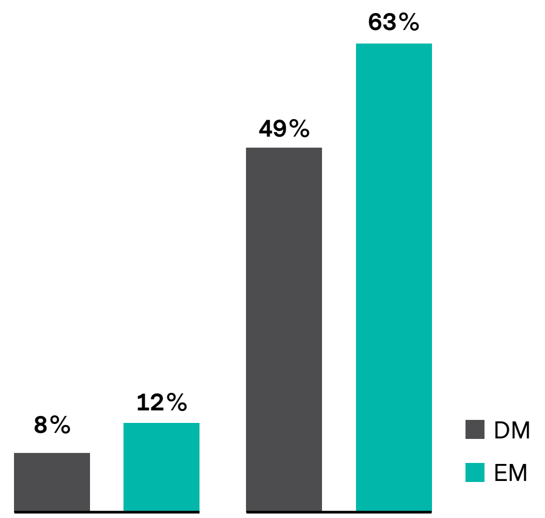
2. Yield, liquidity, ESG are priorities

Yield remained investors' top priority. Liquidity and ESG swapped places from last year for the second and third spots.



3. And, EM bonds lead the pack

They plan on allocating more to EM than developed markets (DM) over the next 24 months.



4. Why do investors like EM bonds?

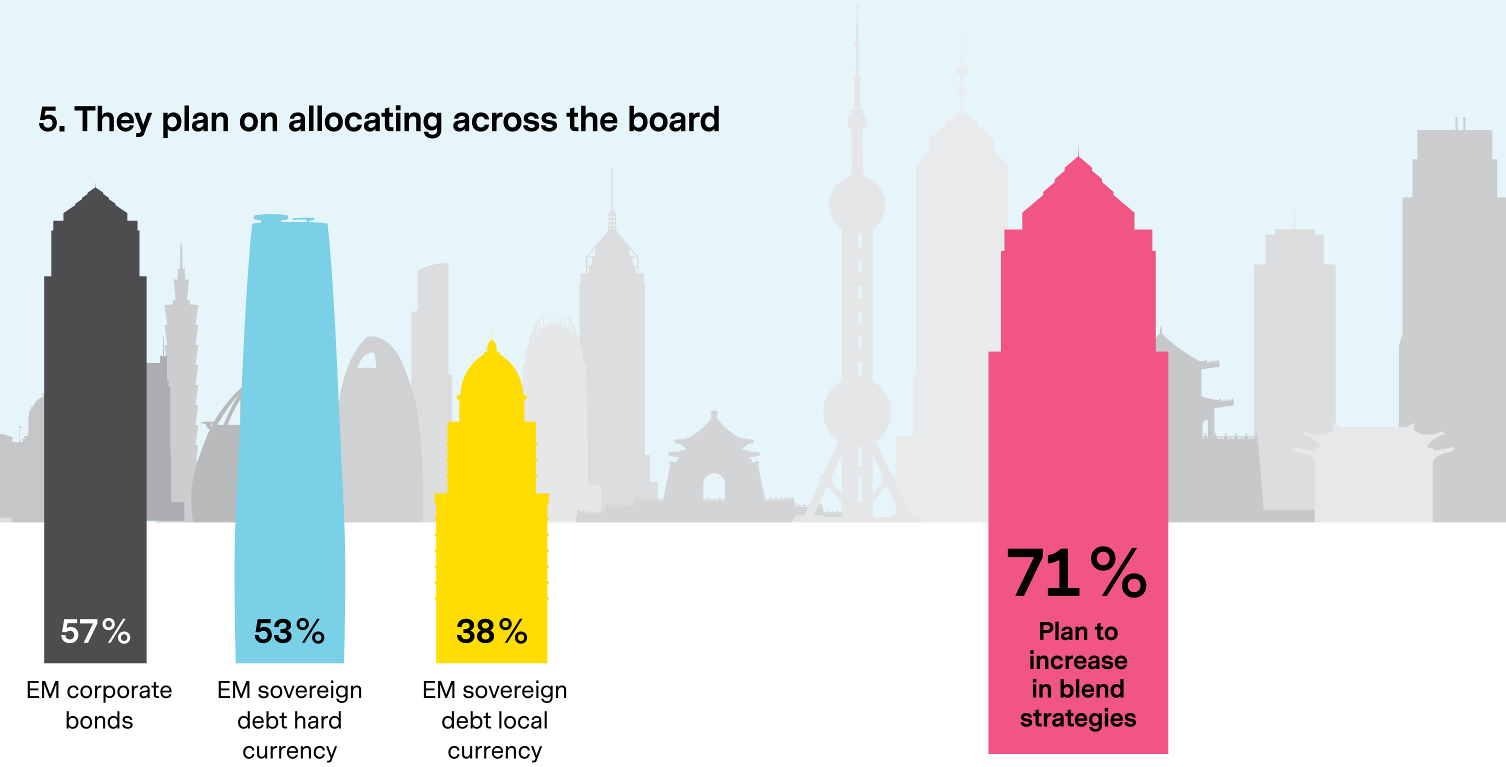
Asset appreciation, liquidity and a strong potential income stream were their top three reasons.

1 Opportunity for asset appreciation (57%)

2 Highly liquid market (45%)

3 Income stream (42%)

5. They plan on allocating across the board



6. But local underappreciated

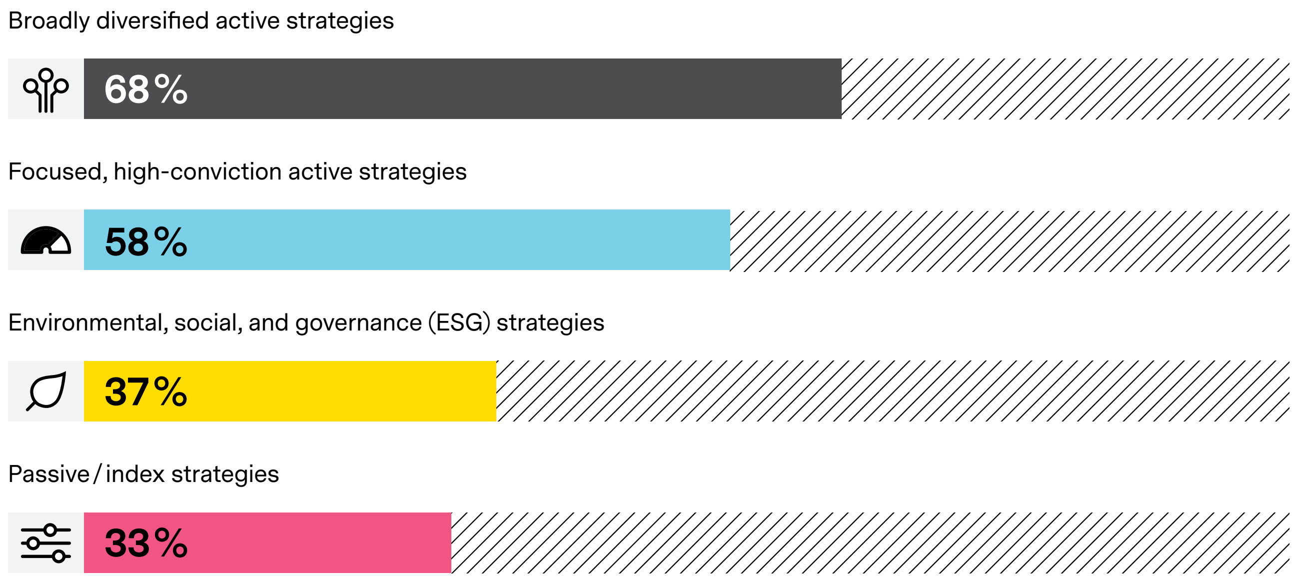
A little over a third plan on allocating to local currency bonds in the next two years. Given the sector's prospects, we think investors may be underallocating here.

7. Blend is rising

Many investors seem to recognize the benefits of blend strategies and a massive 71% plan on increasing their allocation to them over the next two years.

8. Active is by far the favored approach

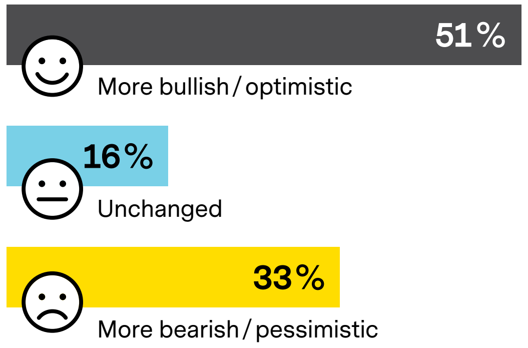
When asked what they thought the best approach to EM fixed income was over the next two years, investors favored active approaches across the board.



Investors increasingly positive on fixed income

Investors are becoming more bullish on bonds
In the current environment, where it seems that inflation and rate hikes have peaked, fixed income is once more beginning to look attractive to investors.

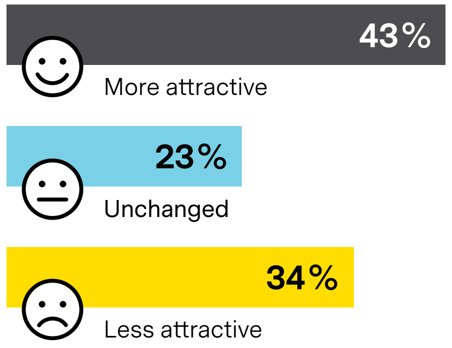
Question: In the wake of the surge in interest rates in recent months, how do investors view fixed income?



(202)
All regions

And the US Federal Reserve shift in pace is helping
The Fed's slowing rate of interest rate changes has also helped make fixed income more attractive.

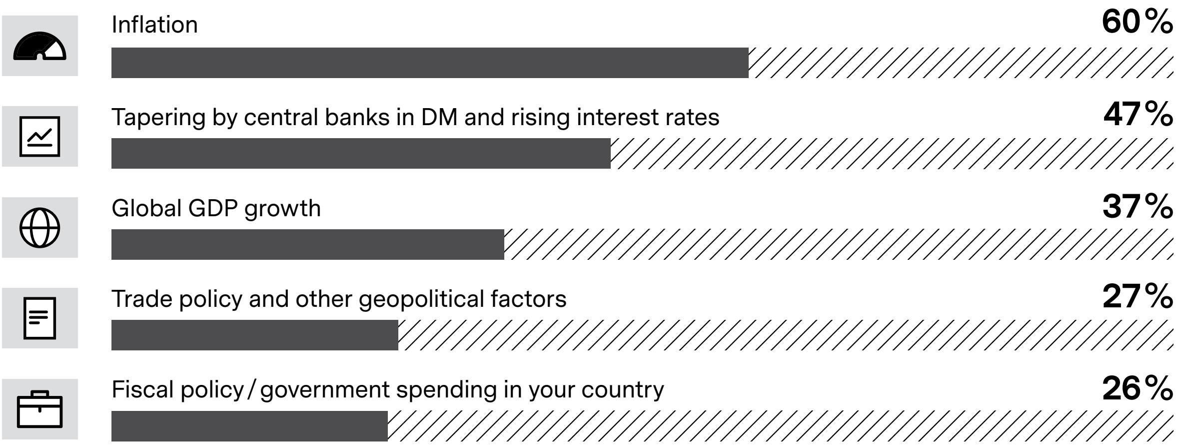
Question: Does the Fed's shift in the pace of interest rate increases make EM bonds…



(203)
All regions

Inflation and monetary policy top their macroeconomic concerns
Inflation has seemingly turned a corner and monetary policy is consequently easing. As a result, it looks like the two factors—inflation (60%) and monetary policy (47%)—that investors believe would most impact their portfolio over the next two years are coming under control. If these were investors main concerns, then now is looking like a positive time to get back into the game.

Question: Which of the following macroeconomic factors are most likely to have a material impact on your fixed income portfolio over the next 24 months?



(203)
All regions

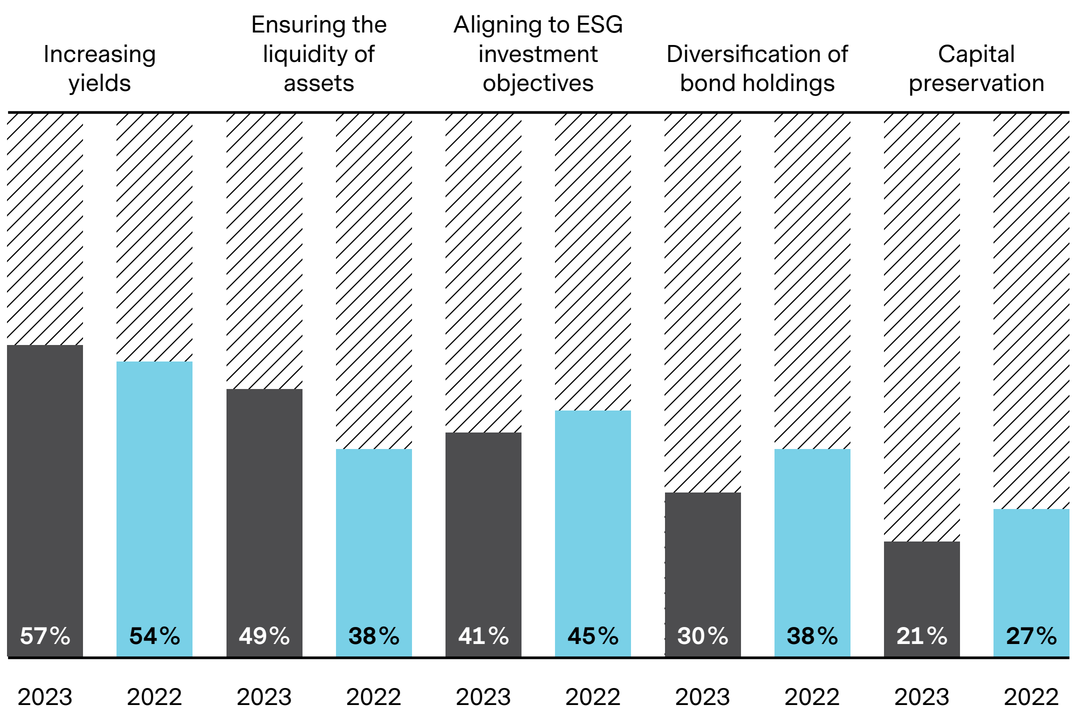
Yield remains top objective
Investors' number one priority (57%) for their fixed income portfolio is once again to increase yields. The majority of these priorities were the same across all regions, although for Asia Pacific yield (55%) shared joint first place with liquidity (55%). Ensuring liquidity was the second priority in all regions (49%).

Alignment with ESG investment objectives was third (41%). Specifically for ESG, this was a relatively higher priority in the Americas than elsewhere (51% ahead of liquidity at 43%), perhaps because investors there are starting from a lower base.

The evergreen fixed income themes of diversification (30%) and capital preservation (21%) rounded out the pack.

Evolving priorities
Yield was also the top priority in our 2022 survey. Liquidity and ESG alignment traded places for second and third this year, with ESG moving from second to third priority globally and liquidity inching into second place this year.

Question: Which of the following fixed income portfolio objectives are most important to your institution over the next 24 months?



(202)
All regions 2023

(334)
All regions 2022

How do bond investors hold EM?

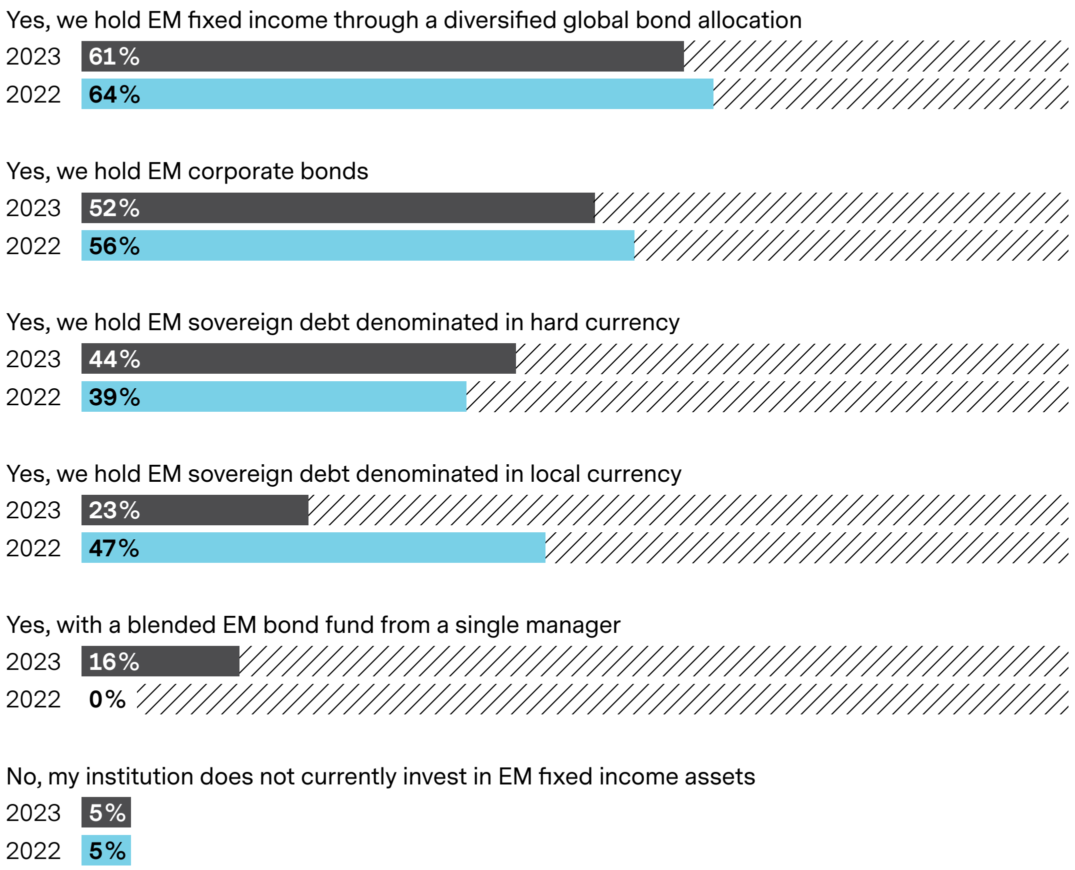
Majority hold EM via diversified allocation
Most investors hold EM fixed income via a diversified bond allocation (61%). A majority have exposure to EM corporates (52%), and both these allocations were only marginally under last year's figure. Just under half (44%) also have exposure to EM sovereign debt in hard currency and allocations are slightly up on last year's 39%.

Perhaps unsurprising is the currently low level of EM sovereign debt in local currency, as it has underperformed for many years. Investors have trimmed back from 2022's 47% to a meager 23% in 2023.

Things are changing now, however, and at Vontobel, we think it may well be time for EM sovereign debt local currency to shine (see page 15 for our analysis), causing us to wonder whether investors are underallocated.

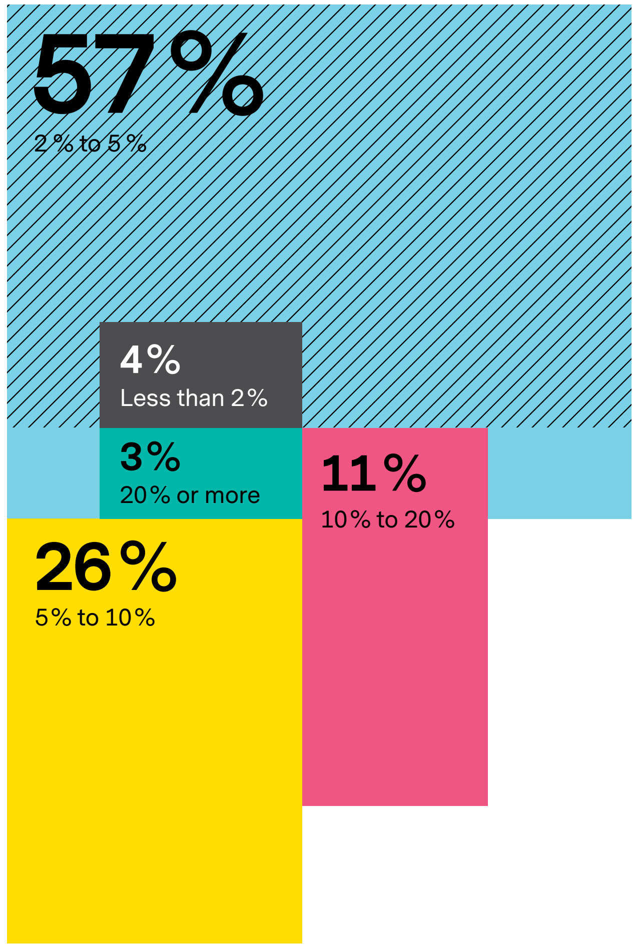
Holdings in blend funds are also beginning to make an impact, with around 16% of institutions accessing EM that way, up from basically zero last year, perhaps as investors become more aware of the benefits of this approach. In fact, as evidenced on page 16, over 70% of investors plan on increasing their allocation to such funds.

Question: Does your institution currently allocate to EM fixed income in the following ways?



(203) **All regions 2023** (332) **All regions 2022**

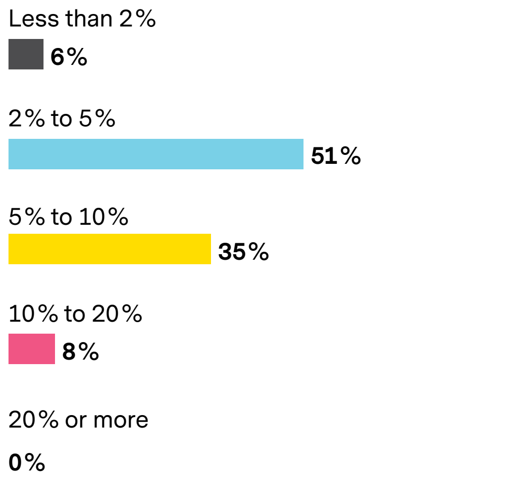
Question: Approximately what proportion of your fixed income portfolio is allocated to EM fixed income?



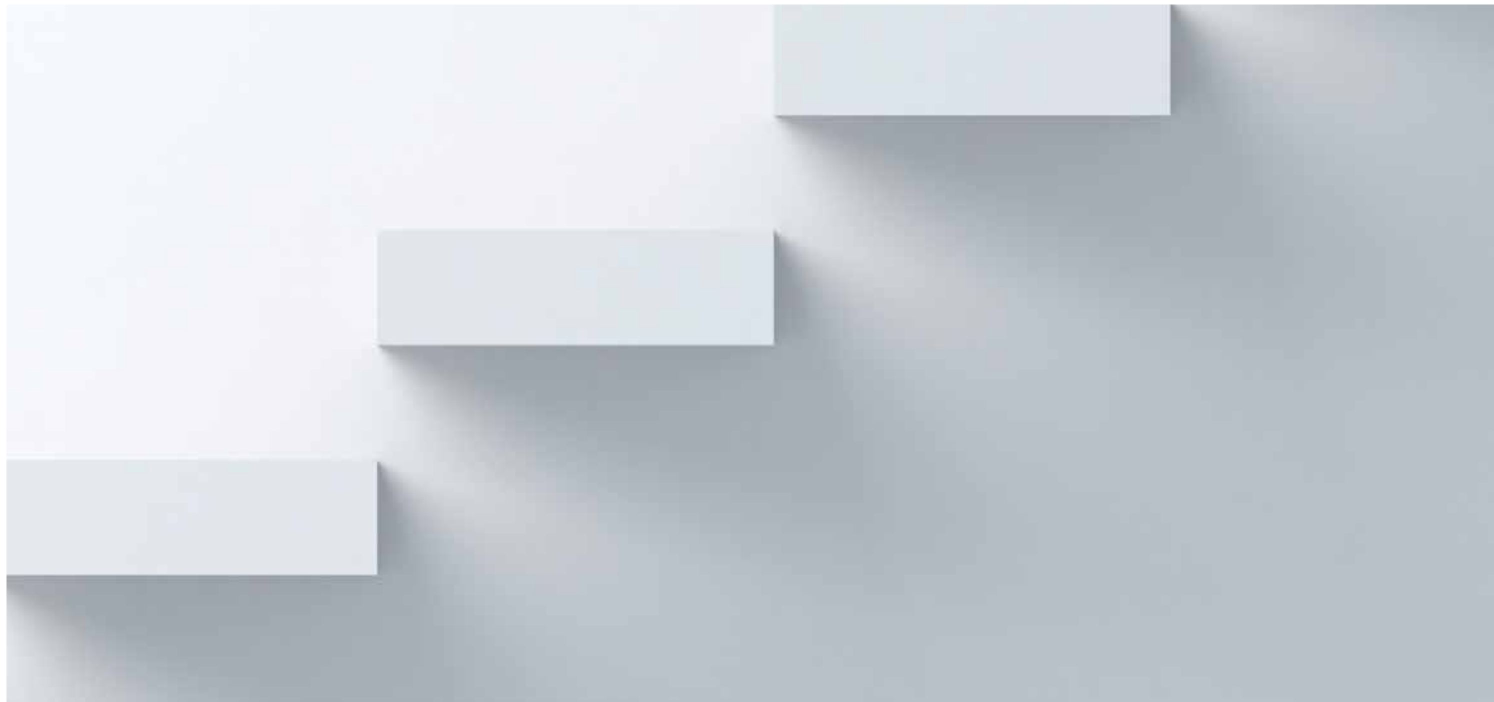
(193)
All regions 2023

Room to grow allocations
What is clear from this year's numbers is that there's a lot of room for growth. Traditionally heavy allocators have reduced in recent years with over half of respondents (57%) allocating merely two to five percent. Around a quarter hold between five and ten percent, 11% hold up to a fifth in EM and a mere 3% have holding of twenty percent or more.

Allocations to EM debt were down pretty much across the board from last year. Given prospects, the time may well be ripe for a re-allocation.



(314)
All regions 2022

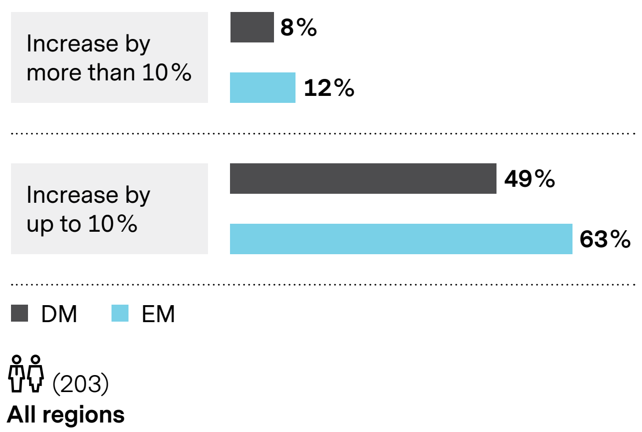


EM are a key future allocation

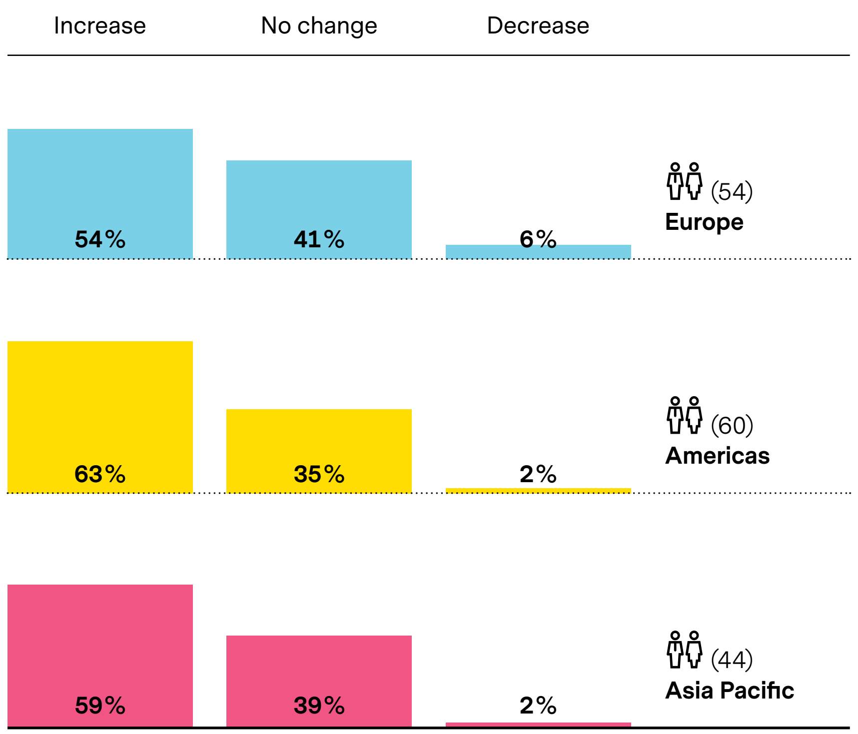
Emerging favored over developed
When we asked about investors' future plans for allocations, the majority were planning increasing either somewhat or substantially to fixed income generally.

However, EM fixed income looks to be the main winner here, with a substantial majority planning on increasing their allocations by up to 10% (63% planning) or more (12% planning). Intentions for developed market fixed income were slightly less at 49% and 8%, respectively.

Question: How do you anticipate your allocation to fixed income is likely to change over the next 24 months?



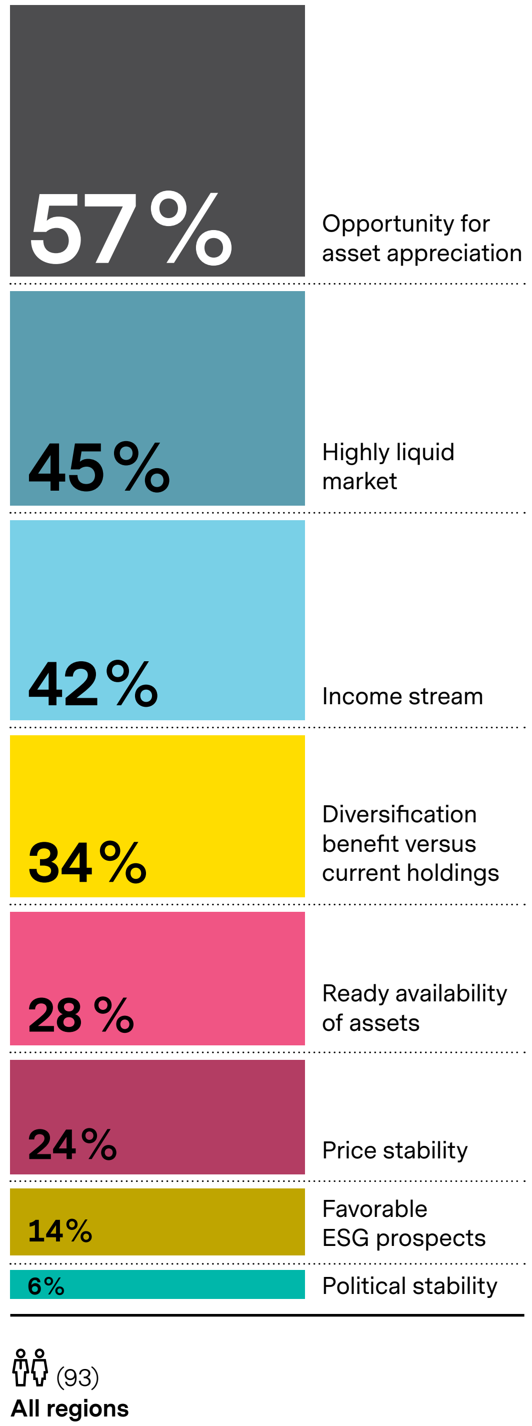
Question: How is your institution's allocation to EM fixed income overall likely to change in the next 24 months?



All regions favor EM
Overall majorities in all regions intend to increase their allocations to EM over the next couple of years.

What's the current attraction of EM?

Question: Which of the following are the most pressing reasons for your increase in EM fixed income overall?



Understanding the attraction
Very low rates in DM have traditionally been a driving force for investment into EM. However, rising rates in the developed world have recently somewhat taken the sheen off of EM. After all, the thinking goes, why take the risk of emerging when you can stay 'safe' in developed?

We believe that there are plenty of reasons to engage in EM. And, investors clearly believe that the asset appreciation opportunities exist (57%). Liquidity, at 45%, was the second reason for investors to increase. Finally, the rich income stream is important to many (42%).

Importantly, EM, with central banks that are used to controlling the vagaries of prices, seem to have largely managed to keep inflation under control.

Last year's terrible fixed income market is now very much in the rear-view mirror, and ahead is a period of potentially higher yields with the prospect of increasing growth as EM countries start to benefit from a slew of potential upsides; from a slowing dollar to participation in the bounties of the move to near-shoring.

What are the barriers to EM?
Conversely, when we asked our respondents what would lead them to decrease their allocation overall to EM debt, availability/transaction complexity and a limited income stream were the joint most-pressing barriers (40%).

From the data, we note that those investors that are currently allocating least to EM debt are also the ones planning to increase their allocation the least in the coming 24 months. We believe that some investors may miss an attractive entry point.

There are solutions to these barriers:
If the perceived complexity is working against an allocation decision, investors can go to blend for allocation assistance. If there's a lack of risk appetite, then investors may choose to go to less volatile strategies such as sustainable EM bonds or investment-grade EM strategies.

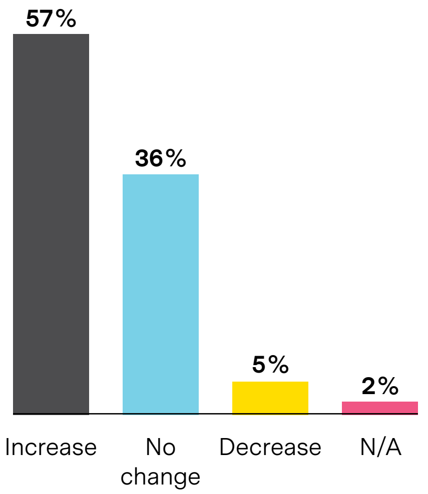
EM corporates' strong showing

An expanding opportunity
Over half (52%) of surveyed investors are already holding corporate bonds. EM corporates (57% planning to increase) were the asset that the most of our respondents planned on increasing within the next two years, beating out EM sovereign hard currency and local currency (with 53% and 38% planning to increase, respectively).

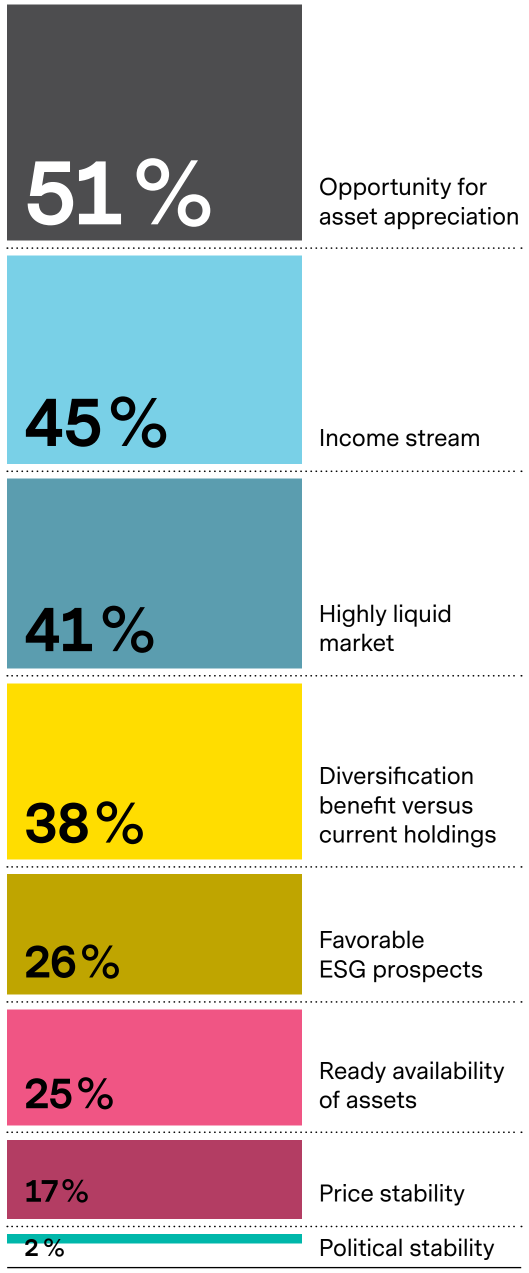
The appeal of EM corporates is evident enough: Income and asset appreciation are up. The investor base continues to grow, driving price appreciation and increasing liquidity, and demographic trends, such as growing populations and consumer demand are all helping this market.

(155)
All regions

Question: How is your institution's allocation to EM corporate bonds likely to change in the next 24 months?



Question: Which of the following are the most pressing reasons for your increase in EM corporate bonds?



(88)
All regions

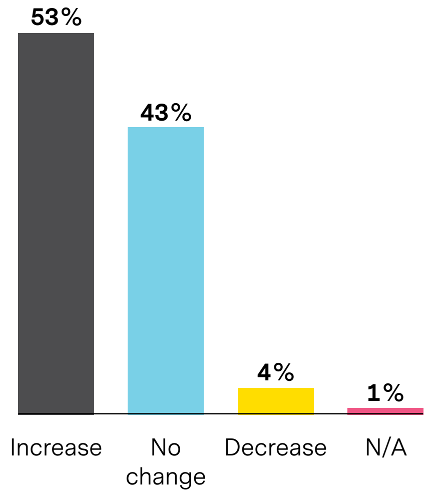
EM sovereign hard currency also set to benefit

An enduring favorite
Of the investors we surveyed, 44% are holding EM sovereign debt in hard currency. With higher yields and diversification benefits, EM sovereign debt hard currency remains favored.

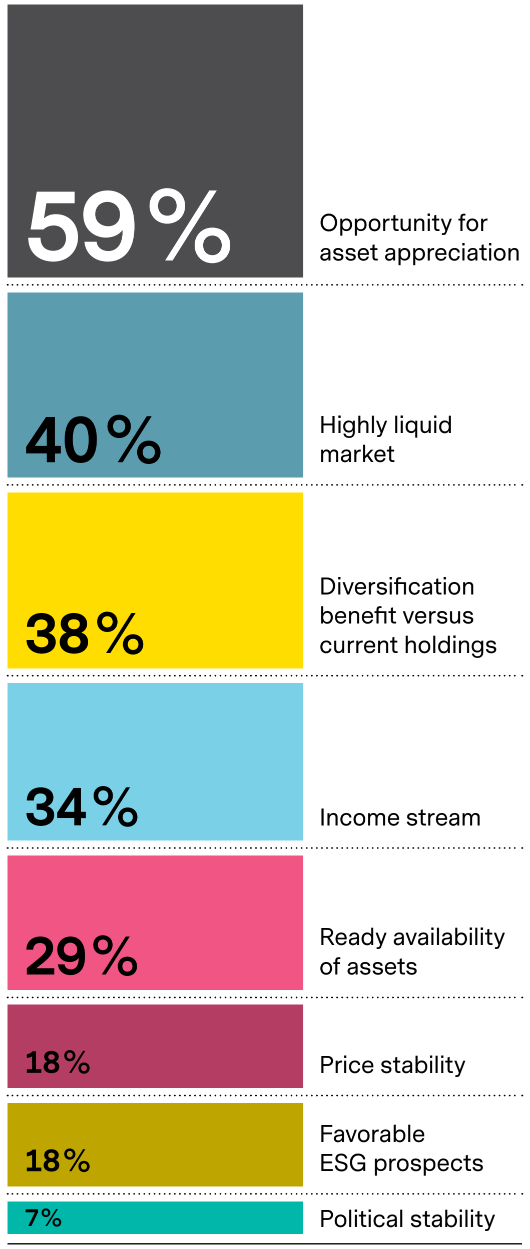
Looking to why investors plan on entering here, opportunities for asset appreciation (59%, even more so than EM corporates), the market's liquidity (40%) and diversification benefits (38%) are the key drivers.

(156)
All regions

Question: How is your institution's allocation to EM sovereign debt in hard currency likely to change in the next 24 months?



Question: Which of the following are the most pressing reasons for your increase in EM sovereign debt in hard currency?



(82)
All regions

EM sovereign local currency underappreciated

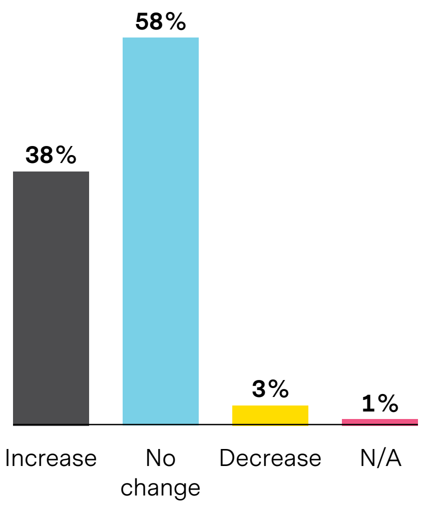
Undervalued, underallocated?
Currently held by just 23% of surveyed investors (and down from 47% last year), on the face of it, EM sovereign local currency was the least favored of the main EM debt categories in terms of investors' intentions over the next two years, although there were still plenty of investors planning to increase their allocation, over a third (38%) in fact.

For those investors that were, asset appreciation potential was a major driver (71%).

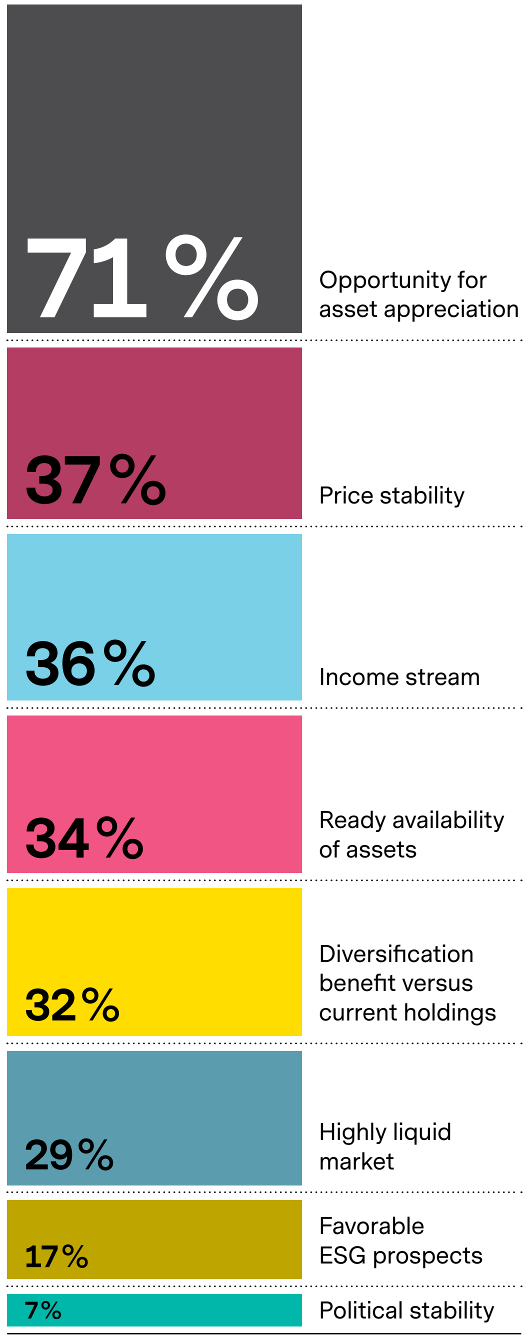
> This is a sentiment that we at Vontobel strongly agree with. The opportunity is well-priced and looks promising to us. Local currency has long underperformed, but things are changing and we believe that by neglecting this opportunity many investors could be pointing in the wrong direction.

(156)
All regions

Question: How is your institution's allocation to EM sovereign debt in local currency likely to change in the next 24 months?



Question: Which of the following are the most pressing reasons for your increase in EM sovereign debt in local currency?



(59)
All regions

Could local surprise over the next couple of years?

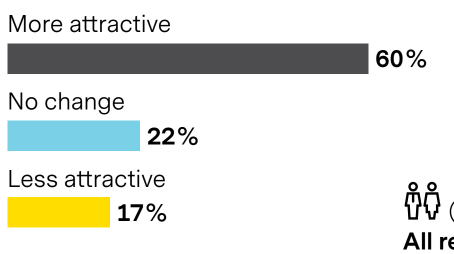
Local currency—why it makes sense to us
Changes in interest rates have made EM local currency bonds more attractive across all regions. But there's a lot more to this story.

Local currency typically offers high, enhancing income and total return.

Although in today's environment, the potential for currency appreciation is real, investors must consider the additional risk and volatility that is attendant in the currency play with such bonds.

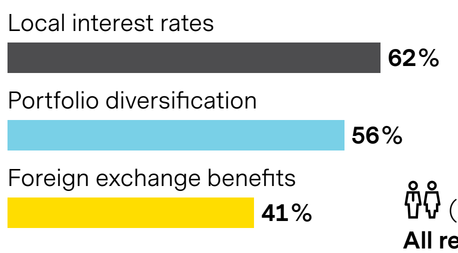
But, add in reduced vulnerability to external shocks and improved diversification benefits and suddenly keenly priced local currency starts to look very much like an opportunity worth considering.

Question: Have last year's changes in interest rates in DM made local currency bonds in EM more or less attractive to your institution?



(202)
All regions

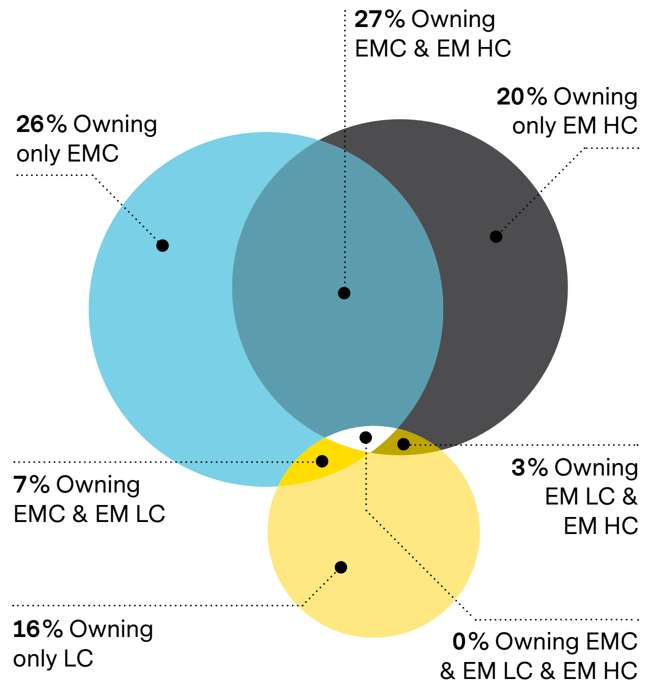
Question: Which of the following are the most pressing reasons for your increase in consideration of EM local currency bonds?



(196)
All regions

Time to branch out?
Investors tend to stick to the EM debt segment that they know and own. As our analysis shows, only very few investors allocate across the full opportunity set of EM fixed income. In fact, investors stick to one, or at maximum two, segment(s) of the universe.

Is there merit in expanding their horizons? For example, given the potential direction we see for local currency, we wonder whether more investors should be actively considering it.



Of course, some elements of these allocation behaviors may stem from a feeling that investors don't fully understand or feel comfortable with a sector that it unfamiliar to them. This is where blend strategies can help, allowing guided access into a potentially rewarding sector while still controlling risk.

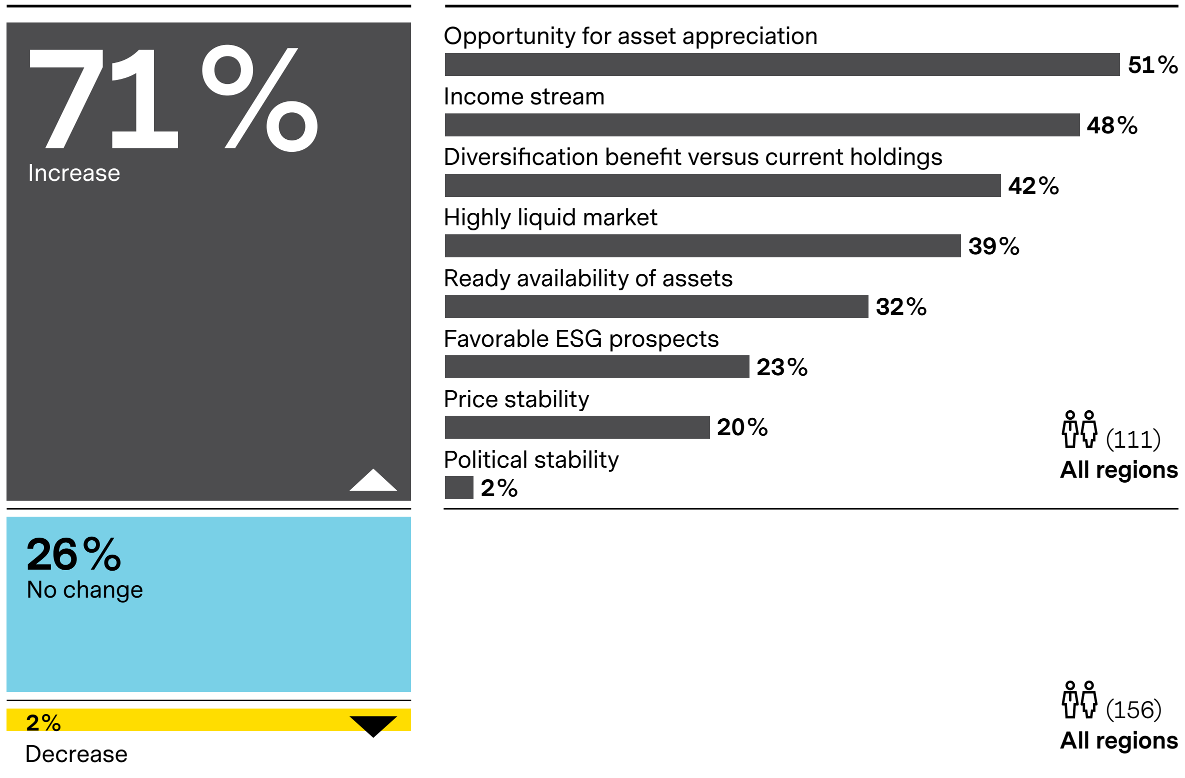
The benefits of blend

Blend powers on
Currently, 16 % of respondents allocate to blend funds, and investors in all regions told us that they planned on increasing their allocations to blended EM bond funds over the next 24 months. A massive 71 % expressed their intention to do so.

This is perhaps not surprising as blend funds offer some key potential advantages to investors such as enhanced diversification and risk management potential, the prospect of better returns and income generation as well more flexible yield-curve positioning.

Question: How is your institution's allocation to blended EM bond funds likely to change in the next 24 months? (156 respondents)

Question: Which of the following are the most pressing reasons for your increase in blended EM bond funds? (111 i.e., those who intended to increase)



Active tops the list

Active clearly favored
Our respondents overwhelmingly believe that active strategies were the way to go for EM debt over the next two years. Broadly diversified active took first place with 68 % favoring this approach and 58 % opting for high-conviction active.

Broadly diversified active strategies and focused high conviction active strategies have seen a strong increase in Intentions to invest, up 24 % each from our 2022 survey.

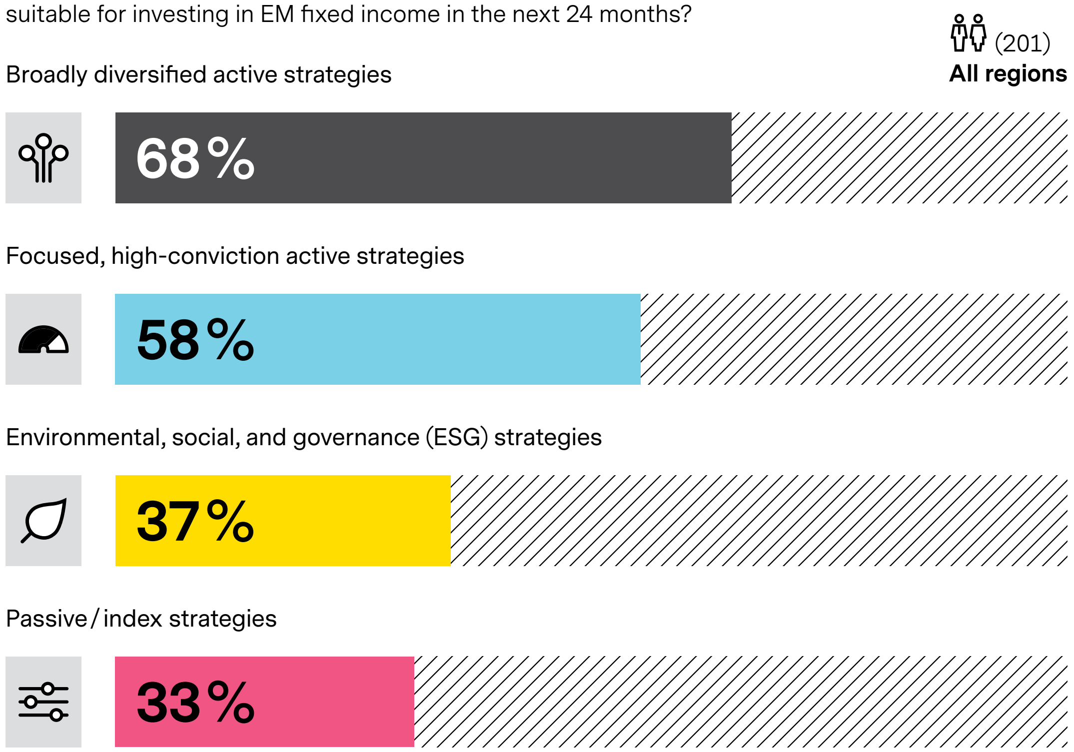
ESG still had a place in investors thoughts (37 %) and index strategies were an option for about a third of investors.

EM can be a complex area, and considering macroeconomic concerns, we think this is one asset class where experts can clearly add value.

Active can unlock opportunities for outperformance on mispriced securities, market inefficiencies and overlooked issues.

An expert active manager can move quickly to exploit transient opportunities, may allocate more to local, and may position for greater diversification or enhanced ESG characteristics.

Question: Which of the following fund strategies do you see as especially suitable for investing in EM fixed income in the next 24 months?



A final note on ESG

Investors told us that ESG was their third priority overall for fixed income as an asset class.

Yet, when we asked them to specifically consider EM fixed income, that priority fell to number 7. (Similar drops appeared within the EM fixed income segments themselves; see below.)

Why is this? ESG is clearly a priority for bond investors overall, so why is it so much less of a priority in the EM segments?

We think investors may not realize the extent to which ESG factors are now eminently attainable in the EM sector. What's more there is some evidence to suggest that issuers with higher ESG standards may also be something of a solution for volatility.

Vontobel currently manages EM Fixed Income strategies that use ESG risk integration or which promote sustainability, depending on their focus. The product range spans strategies specialized in single segments of the EM fixed income market such as EM hard currency sovereigns, corporates or local currency, as well as blended allocation solutions.

ESG is...

#3

priority overall for fixed income as a whole

Yet only...

#7 priority for EM fixed income overall

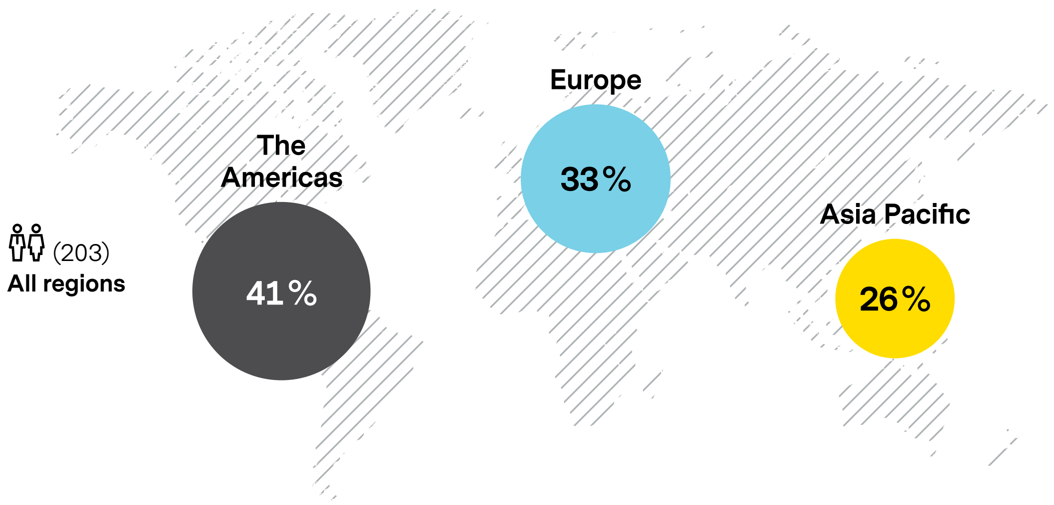
And digging deeper...

EM corporates	EM sovereign hard currency	EM sovereign local currency
#5 priority	**#7 priority**	**#7 priority**

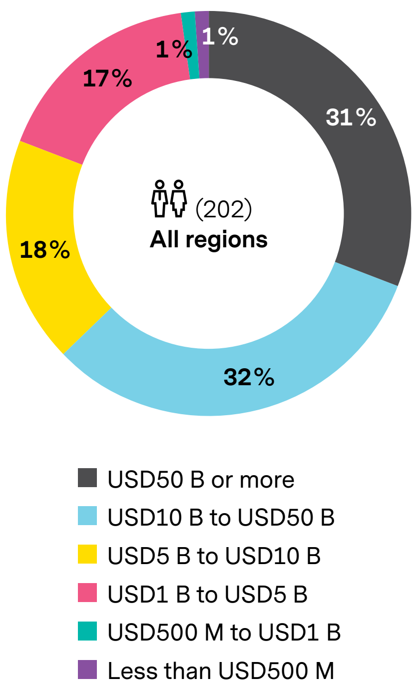
About the research

In 2023, Vontobel undertook an in-depth study of the views of over 200 institutional investors in Europe, Asia Pacific and the Americas.

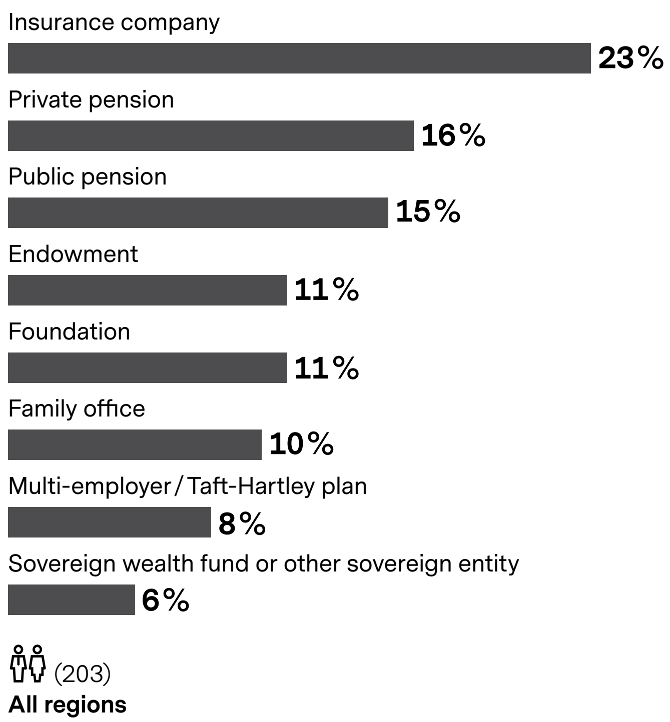
Region



Institution's AUM



Type of institution



Sources: Vontobel original research, June 2023, based on survey of 203 respondents in Europe, Americas and Asia Pacific. Data may not sum to 100% due to rounding.

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