FRONTIER DEBT HAS COME OF AGE

Door Thomas Christiansen

Frontier debt has grown significantly over the past decade and now warrants serious consideration as a dedicated allocation in the portfolios of investors.

Fixed-income frontier markets have seen significant growth in both importance and liquidity over the past decade. While still mainly thought of as part of global EM investments, frontier markets have 'grown up' and deserve to be considered separately. Around fifteen years ago, frontier markets (as defined by JP Morgan's NexGEM Index) included fewer than ten countries with a combined market capitalisation of USD 15 bn. In fact, at that time there was no index. The NexGEM Index was created in 2011, but data were backdated to end-2001 and the index only includes US denominated hard currency bonds.

Since then, the markets have seen impressive growth. Ten years ago, the index counted just 16 countries and a USD 37 bn market cap. Five years ago the numbers were 34 countries and USD 88 bn. At the end of 2019 the index had 35 countries and a market cap of USD 129 bn. Despite this significant growth, resulting in a substantial investment universe of frontier debt, most investors appear satisfied with allocating to emerging market debt broadly (mostly through funds managed against the JP Morgan EMBI Global Diversified Index), in a similar structure to what they might have done a decade ago.

Photo: Archive UBP

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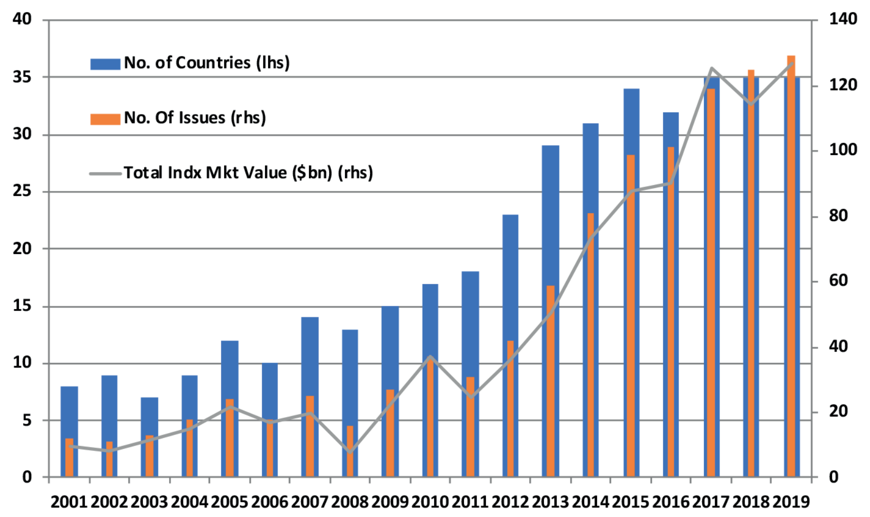
Most asset managers are not incentivised to tell their clients to do otherwise. The capacity of dedicated frontier funds is lower than traditional broader EMD funds. This means there is a commercial disincentive for managers with large 'traditional' EMD funds to consider frontier as a stand-alone investment, as they may risk cannibalising their existing businesses. Further, most fund managers tend to be overweight in frontier debt compared with their respective indices, using it as a way of generating alpha, and in the local currency space for increasing diversification. So the group of dedicated frontier debt funds is small and clients may not appreciate just what this asset class can offer.

Not viewing investments in frontier markets as stand-alone investments causes two separate problems. Firstly, the specific facets of this investment universe are ignored and are instead grouped together with broader emerging markets, with which they at times have little in common. Secondly, investing through larger global EMD funds means one could be foregoing significant alpha opportunities within the frontier debt space. Of the 35 countries included in JP Morgan NexGEM Index at the end of 2019, twelve have USD 1 bn or less worth of bonds outstanding. A manager with a large global EM sovereign fund would be practically unable to invest in a country which has only USD 500 mn worth of bonds outstanding. If this hypothetical fund wanted to build a 1% position, it would end up owning too much of the outstanding debt. Acquiring such a position – or potentially selling it later on – would take a significant amount of time and, even with the most skilled trader(s), it would move the market, both on the way in and on the way out. As a result, most large sovereign EMD funds get their entire frontier exposure from a smaller subset of larger countries, leaving significant opportunities on the table.

Frontier markets offer an attractive investment opportunity for a number of reasons. The most obvious is that returns have outpaced most other fixed-income asset classes through all relevant periods. The risk premium imbedded in the yields of EM sovereign bonds overcompensates for the risk associated with defaults. This is due to the combination of defaults being relatively rare and recovery rates being relatively high. Firstly, sovereigns are usually loath to default, as it means losing access to capital markets and US dollars. At the same time, multilateral institutions are often on hand and willing to provide concessional financing and technical assistance for any reforms that are needed, as well as support during any restructuring. We have indeed seen this dynamic play out in 2020, between the G20 DSSI (Debt Service Suspension Initiative) and the rapid financing provided by the IMF. While all sovereign debt benefits from this, the 'arbitrage' is most significant for the higher-yielding frontier part of the investment universe.

Figure 1: Market Value Frontier Markets in relation to number of Frontier Countries and number of Debt Issues.



Source: UBP, JPMorgan as of 31/12/2019

This is because defaults only comprise a slightly higher proportion of the frontier than of the broader emerging market space, while recovery rates are similar. The slightly higher incidence of defaults is not nearly enough to wipe out the pick-up in yields. As noted, the NexGEM Index was launched in 2011 but the data have been created back to end-2001, meaning there is almost twenty years of data for analysis. Over this period, the NexGEM Index returned 9.7% (annualised to 30 September 2020), significantly outpacing all other EMD sub-asset classes.

Frontier debt also outperforms all DM (developed market) bond indices that we have reviewed over time. The most natural comparison is US high yield (both indices are purely high yield and USD-denominated). Since the start of 2002, frontier bond markets have outperformed US high yield by 2.35% (annualised) to the end of August 2020. Yields on NexGEM have historically been only marginally higher than US high yield (50-75bps), but defaults have been meaningfully lower and recovery rates higher. Frontier markets have seen average default rates of 2%, with average weighted haircuts of 37% on those defaults. In the meantime, US High Yield have had 4.4% average default rates with 59% haircuts. These combinations mean that frontier markets have seen average annual realised losses of just 0.7%, while US High Yield has averaged realised losses of 2.6%.

In addition to the historical returns, three of the main traditional macro arguments for investing in EMD - faster growth rates, higher yields, and diversification benefits - are even more true for frontier markets. Frontier countries continue to deliver average annualised growth rates outpacing those of both broader emerging and developed markets. Meanwhile, the frontier index yielded 7.7% at the end of September, which compares to just under 5% for the widely used hard currency index. And the efficient frontier of an investor who is allocated to global equities and bonds improves significantly more when adding frontier debt than when adding broader emerging markets.

Today, frontier markets are the highest yielding liquid debt markets and, as seen above, compelling arguments can be made for considering frontier debt as an alternative to both traditional EM sovereign debt, and US high yield. In a world that is starved for yield, with close to $16 trillion of negatively yielding assets (as of 30 September 2020), investors could stand to benefit significantly from doing so. «

- Frontier markets have grown significantly in recent years and now warrant consideration as a stand-alone investment.
- This is a well-kept 'secret' as large asset managers are not incentivised to publicise this.
- Looking at the merits shows frontier markets significantly outperforming both traditional EM sovereign markets, but also US High Yield.
- This is due to higher average yields, but also lower realised losses from defaults.
- Frontier markets offer one of the last areas of liquid fixed income where one can find substantial yields in 2020.

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