



Emerging Debt: Exploring Opportunities

60 seconds with the
fund manager



MARCH 2024

This marketing communication is intended for
non-professional investors.





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Diliana Deltcheva, Head of Emerging Markets Debt at Candriam, elaborates on the significance of this asset class within a bond portfolio. She discusses the importance of Candriam's investment process, with its emphasis on relative value and risk management. This approach is intended to allow the strategy to adapt the ever-changing markets over the course of an economic cycle.

Why is emerging market debt an attractive investment?

The speed at which emerging countries have developed since the 1980s has fuelled fast-paced growth in their debt markets. Emerging market external sovereign debt provides access to more than 80 countries with outstanding debt in excess of \$1.6trn⁽¹⁾. External debt should present a limited currency risk as it encompasses government debt denominated in hard currency, mainly US Dollars and Euros. Nowadays, these markets may offer attractive yields and diversification benefits closer to US and European rates and credit markets.

How can investors integrate emerging debt into their portfolios?

The emerging debt asset class has benefited from improvements in economic stability, institutional strength and political decision-making in these countries. Over the past 40 years, emerging market debt has developed at a spectacular pace, and today offers a wide variety of opportunities for investors to capitalize on: government bonds (denominated in USD, EUR, or local currency), corporate debt and emerging markets currencies. As a result of these changes, emerging debt evolved from a niche to a major asset class by the late 1990s.

What are risks to be considered when investing in emerging debt?

Since our primary aim is to generate risk-adjusted returns, we continuously analyse the risks associated with this asset class.

Investing in emerging market debt presents a number of important risks that need to be carefully considered. First and foremost, US interest rate policy has a strong impact on these markets. Higher US interest rates translate into higher borrowing costs for emerging countries, which can impact their ability to repay their debt.

The volatility of the US dollar is also a major concern. A stronger dollar can increase the burden of dollar-denominated debt for these countries, as their tax revenues remain in local currency.

Raw materials are also key. Many emerging nations are heavily dependent on exports. Fluctuations in commodity prices can affect the fiscal health or the foreign exchange reserves of these countries and, consequently, their funding costs and ability to meet their debt obligations.

60 SECONDS WITH THE FUND MANAGER

(1) Source: JP Morgan, December 2023.



China's influence should not be underestimated. As a major trading partner for many emerging countries, changes in China's economic policies or trade relations can have far-reaching consequences, affecting both the economic stability of other emerging nations and the attractiveness of their bonds to investors.

As a result, a comprehensive understanding of these risks is essential to making informed investment decisions in emerging market debt.

Why is relative value such an important part of your investment process?

Our emerging markets debt investment process include a bottom-up analysis to assess the issuers and an analysis of the security based on the relative value. Relative value plays a pivotal role in our investment process as it allows us to pinpoint the right security across various countries and/or companies, aligning with our investment convictions. By measuring relative value through an analytical and disciplined approach to valuations, we are able to identify the bonds which, in terms of risk/return profile, best reflect our views. Then, we are able to build a portfolio enhancing the opportunities and managing the risks emanating from the debt emerging markets.

For example, once a conviction has been identified through our fundamental analysis, this conviction can be incorporated into the strategy through different types of bond instruments, such as sovereign, quasi-sovereign, corporate, long-term or short-term debt, denominated in US Dollars or Euros. This analytical approach empowers us to align our investment choices with our investment objective.

What aspects of relative value do you take into account?

We identify relative value opportunities in securities issued by sovereign, quasi-sovereign and corporate issuers, based on three levels of analysis.

Firstly, we carry out a quantitative analysis, particularly through our sovereign risk modelling framework, to assess the creditworthiness of each country. This analysis standardizes risk assessment across all Emerging Markets, based on an analysis of macroeconomic and ESG trends.

The analysis of issuers' creditworthiness forms the foundation of our approach which drives value creation.

Subsequently, we complement the quantitative analysis with a qualitative review of the macroeconomic and structural reform, political risk trends to which emerging sovereign issuers are exposed. This qualitative review, drawing from both external sources and internal research, serves to capture nuanced performance drivers and political risks, enhancing our Sovereign Risk Model insights.

We integrate the results of the quantitative Sovereign Risk Model with our qualitative assessment to arrive at our final portfolio positions.

In addition, the team examines relative valuations of instruments, typically with comparable risk categories. On the instrument side, relative value opportunities tend to cover several dimensions: type of security, cross-analysis of currencies, maturities.

What are the main strengths of Candriam's emerging market hard currency debt strategy?

Our methodology was developed – and is continuously being improved – to meet our objective of generating risk-adjusted performance. Our approach aims to identify investment opportunities through an analysis of issuing countries and instruments, while controlling risk.

This approach largely explains our track record in a wide variety of market configurations since the strategy's inception in 1996.

Our team draws on a comprehensive set of analytical tools, developed in-house, to identify investment opportunities. Our process is based on rigorous fundamental analysis and relative value assessments. It incorporates ESG (Environment, Social & Governance) factors, which are essential for us to judge the creditworthiness and long-term development potential of countries and companies.

We pay close attention to risk, not only when choosing what to invest, but also during the implementation phase. Our internal investment limits, together with an analysis of the overall market environment, guide us in building the portfolio. We only include those risks that we consider worth taking.

Finally, we have a dedicated investment team and a flexible, collaborative decision-making process. Our team's experience in emerging markets is reinforced by complementary product and regional expertise.

The main risks of the strategy are:

• Risk of capital loss:

There is no guarantee for investors relating to the capital invested in the sub-fund in question, and investors may not receive back the full amount invested.

• Interest rate risk:

A change in interest rates, resulting in particular from inflation, may cause a risk of losses and reduce the net asset value of the sub-fund (especially in the event of a rate increase if the sub-fund has a positive rate sensitivity and in the event of a rate reduction if the sub-fund has a negative rate sensitivity). Long term bonds (and related derivatives) are more sensitive to interest rate variations. A change in inflation, in other words a general rise or fall in the cost of living, is one of the factors potentially affecting interest rates and consequently the NAV.

• Credit risk:

Risk that an issuer or a counterparty will default. This risk includes the risk of changes in credit spreads and default risk.

Some sub-funds may be exposed to the credit market and/or specific issuers in particular whose prices will change based on the expectations of the market as regards their ability to repay their debt.

These sub-funds may also be exposed to the risk that a selected issuer will default, i.e. will be unable to honour its debt repayment, in the form of coupons and/or principal. Depending on whether the subfund

is positively or negatively positioned on the credit market and/or some issuers in particular, an upward or downward movement respectively of the credit spreads, or a default, may negatively impact the net asset value. When evaluating the credit risk of a financial instrument, the Management Company will never rely solely on external ratings.

• Emerging market risk:

Market movements can be stronger and faster on these markets than on the developed markets, which could cause the net asset value to fall in the event of adverse movements in relation to the positions taken. Volatility may be caused by a global market risk or may be triggered by the vicissitudes of a single security. Sectoral concentration risks may also be prevalent on some emerging markets. These risks may also heighten the volatility. Emerging countries may experience serious political, social, legal and fiscal uncertainties or other events that could have a negative impact on the sub-funds investing in them. In addition, local depositary and sub-custodial services remain underdeveloped in non-OECD countries and emerging countries, and transactions carried out in these markets are subject to transaction risk and custody risk. In some cases, the fund may be unable to recover all or part of its assets or may be exposed to delays in delivery when recovering its assets.

The risks listed are not exhaustive, and further details on risks are available in regulatory documents.



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