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Beyond the frontier

Investing in frontier market local currency debt

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"Investing in frontier market local currency debt offers very attractive risk-adjusted returns from the fastest growing economies around the globe and requires a very skill-based expertise that has been developed over a substantial number of years."

Jetro Siekkinen, LGT Capital Partners

Front cover: stock.adobe.com, Basket of dried chili pepper

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Prelude

Globalization has connected the world over the last two decades and offered investors access to a growing set of investment opportunities and capital markets, particularly in emerging markets. Strong capital inflows, improved liquidity conditions and higher research coverage have since helped mature these once unconventional markets. Those interested in novel investment opportunities have in turn started to move toward investing in frontier economies.

In our view, investors should consider having exposure to frontier economies for the following reasons:

- Investing in frontier economies offers access to some of the world's fastest growing economies, growing working-age populations, and fast urbanizing societies.
- The heterogeneity of the frontier market universe provides investors with relatively uncorrelated returns compared to developed and emerging economies and reduces contagion between frontier markets.
- Environmental, social and governance ("ESG") factors play a vital role in selecting countries that are on a positive development path and avoiding countries that are on a deteriorating path.
- Frontier economies offer an attractive real yield pick-up compared to emerging and advanced economies.
- Frontier market currencies have shown lower volatility against the US dollar than traditional emerging market currencies.

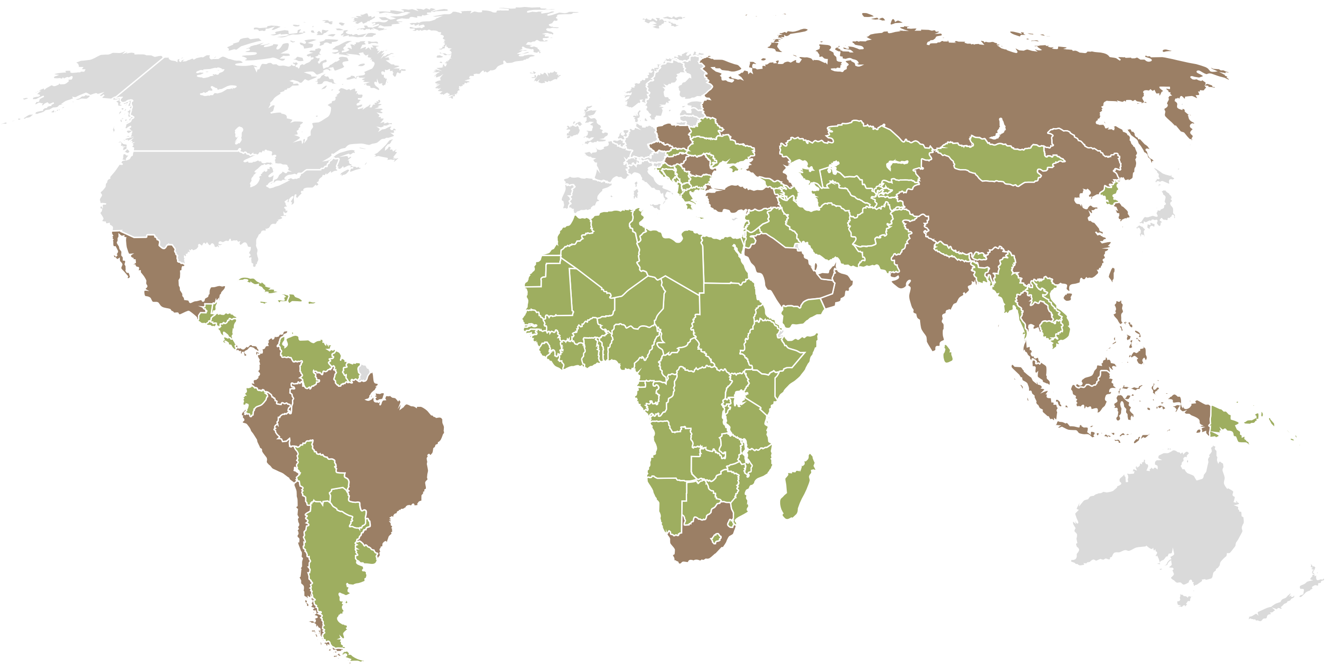
Over the following pages, we will elaborate on the investment case of frontier market local currency debt.

Introduction to frontier markets from an economic point of view

The term frontier market was coined in 1992 by the International Finance Corporation, a subsidiary of the World Bank Group that focuses on private-sector development in less developed countries. The term describes investable developing countries that are often smaller, less developed or less accessible than countries generally classified as emerging markets. In general, the lines between advanced, emerging, frontier and other developing nations are blurry, and different organizations and index providers use slightly different definitions. We consider frontier economies as part of the extended emerging market universe.

Frontier markets are a very heterogeneous group of countries, spanning from borderline emerging economies like Vietnam or Egypt to some of the least developed and poorest economies on the planet like those of Niger or the Central African Republic. However, per capita income is not necessarily low.[1] In consequence, finding unifying criteria to subsume these close to 140 economies is inherently difficult. More often than not, a frontier market is a rapidly growing and industrializing economy, with less developed capital markets and younger populations. In value-added terms, frontier economies are more heavily grounded in agriculture and manufacturing and it is not uncommon for some of these countries to have export structures that are geared toward commodities.

Graph 1: Market universe



Developed market Emerging market Frontier market

Source: CIA World Fact Book, LGT Capital Partners

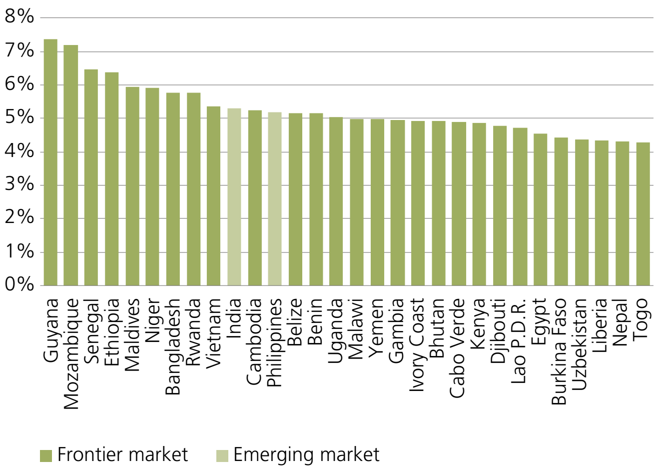
[1] E.g. real per capita GDP in Croatia exceeds the level of every member of the BRICS emerging markets (Brazil, Russia, India, China and South Africa)

Fast growing economies

There are several compelling reasons for investors to consider frontier economies in their asset allocation process on an outright or complementary basis:

A key premise of frontier and emerging market investing relates to the growth potential they offer, and indeed, frontier economies have been outgrowing developed markets by about 2 percentage points per annum over the last 20 years. According to forecasts of the International Monetary Fund ("IMF"), 28 of the 30 fastest growing economies between 2022 and 2026 are considered frontier markets (Graph 2). Among them are many Sub-Saharan African economies as well as various Southeast Asian countries like Bangladesh, Vietnam or Cambodia.

Graph 2: Annualized real GDP growth (2022–2026, IMF forecasts)

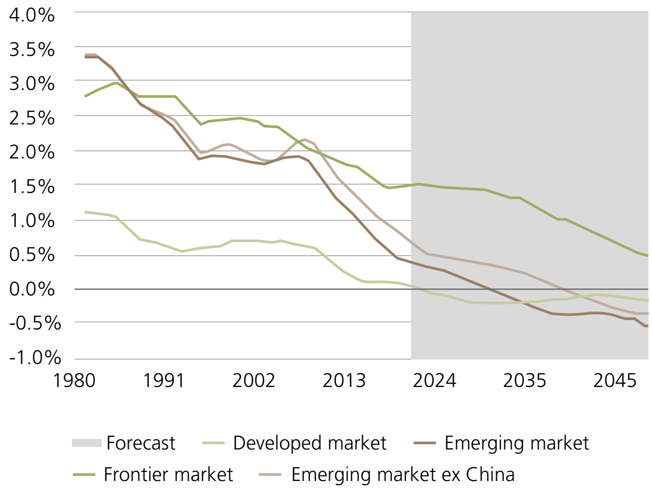


Source: IMF, LGT Capital Partners

Structural forces beneficial for frontier markets

In contrast to advanced economies, emerging markets in general, and frontier markets in particular, continue to enjoy a favorable demographic backdrop in the form of strong population, and more importantly, working-age population growth (Graph 3). Historically speaking, countries that successfully reap this demographic advantage tend to experience a two-to-three-decade boost to productivity.

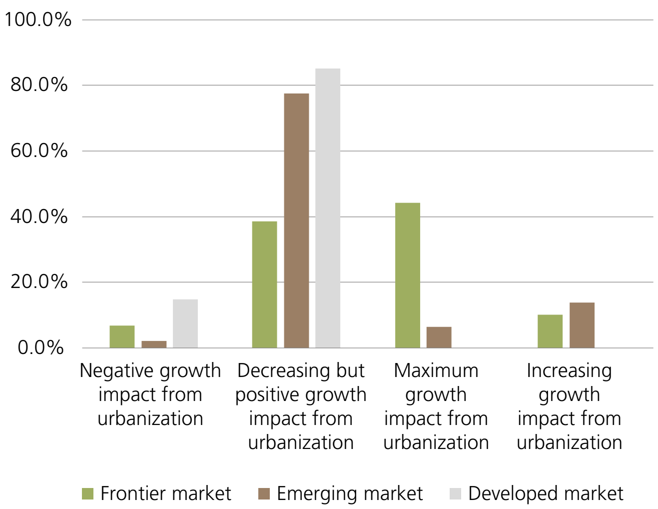
Graph 3: Working-age population growth (3m moving average)



Source: United Nations, LGT Capital Partners

The growing manufacturing and service sectors in frontier economies foster urbanization, as people leave employment in the rural low-wage agricultural sector for higher earning jobs in cities. Consequently, infrastructure, clusters of innovation, and economies of scale are created, boosting productivity in the process. According to the World Bank, about 80% of global GDP is generated in cities. As the relationship between urbanization and growth tends to be non-linear (for example workforce training needs to keep up with growing infrastructure and public transportation), the highest productivity gains are associated with urbanization rates between 35% and 55%. No less than 45% of all frontier markets are currently in this urbanization sweet spot, and about 91% of all frontier economies remain at urbanization levels associated with positive contributions to productivity (Graph 4).

Graph 4: Urbanization and productivity growth



Source: IMF, World Bank, LGT Capital Partners

Efficiency gains in frontier economies are further accelerated by technological leapfrogging, that is the opportunity to skip expansive and less efficient legacy infrastructure like telephone landlines or ATM systems and jump directly to using wireless communications and mobile payments. A famous example in this regard is Kenya's M-PESA mobile phone-based money transfer service. The technology provides access to the formal financial system without the need for readily available banking infrastructure like ATMs, resulting in cost efficiency and broader access to financial services and fostering financial inclusion in an otherwise largely cash-based society.

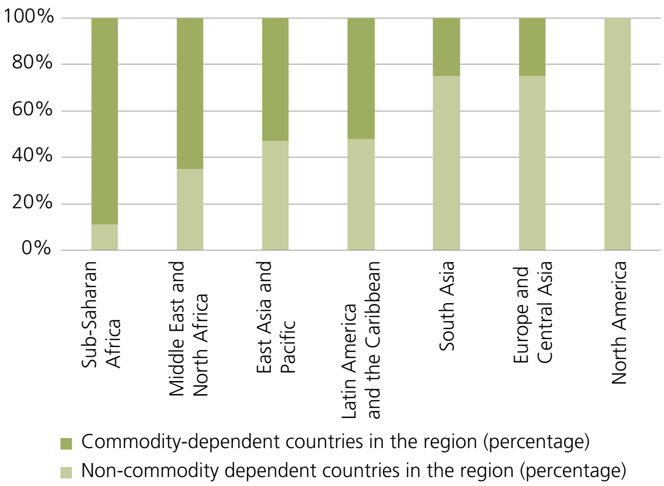
Moreover, the ability to leapfrog also changes origin and direction of innovation flows, as certain innovations are introduced or commercialized in frontier and emerging economies first. Social media, e-payments and e-commerce as well as digital health care or online education are just a few fields that come to mind. These dynamics are likely to strengthen as internet adoption increases. Today, almost 60% of the population in developing economies is connected to the internet. By comparison, less than 25% was in 2010. Moreover, internet adoption growth in developing nations has been much faster since 2009 than in their developed counterparts, with 90% of all new internet users now coming from emerging economies.

Improving access to education is a further boon to economic growth. Although growth in emerging and frontier economies is still strongly associated with commodities and/or manufacturing, the picture is more nuanced nowadays, especially in the larger developing economies. Economies like China or India are no longer one-dimensional but often notably tech-savvy, competing at the cutting edge of R&D efforts alongside advanced economies. For example, Chinese patent applications currently outweigh US applications by a ratio of 4:1. While these levels of technological innovation are not yet the norm in frontier economies, sustained increases in secondary and tertiary education over the past decade, combined with strong population growth, will continue to rapidly enlarge the talent pool and human capital in developing economies, improving and diversifying the drivers of growth concomitantly.

Commodities remain an important source of growth

At the same time, natural resources remain an important growth driver in many developing regions. According to the 2019 State of Commodity Dependence report from the United Nations Conference on Trade and Development, almost 90% of all Sub-Saharan economies and roughly two thirds of all developing countries are commodity dependent, that is commodities account for more than 60% of their total merchandise exports in value terms (Graph 5). The climate change-related energy transition will foster the need for, as examples, metals used in electric vehicles like nickel, and other raw materials like lithium, cobalt or copper. Developing nations rich in these resources will see positive structural demand over the coming decades.

Graph 5: Commodity dependence



Source: United Nations Conference on Trade and Development, LGT Capital Partners

The similarity between growth drivers in frontier markets and "traditional" emerging markets will close existing market and economic misalignments

As of today, most countries that are frontier markets are still economic featherweights. For example, Egypt, the largest frontier market in gross domestic product terms, accounts for only about 1% of global activity despite boasting a population of 100 million inhabitants. Even adding the roughly 140 countries in the investment universe together, they still only amount to 13% of the world's annually produced goods and services, although they comprise about 30% of the global population and represent close to 40% of the planet's landmass. The mismatch between size and representation is even more striking in financial markets. Less than 1% of all globally traded stocks are from frontier economies and they account for just 1% of global outstanding debt.

However, similar misalignment between economic potential and market representation used to exist between developed and traditional emerging economies two decades ago. At the turn of the millennium, emerging economies accounted for 35% of global GDP but for only 5% of globally traded stocks and for about 2% of global debt markets. Today that gap has narrowed as traditional emerging markets now account for 48% of global GDP, and 40% and 22% of international stock and debt markets, respectively.

The previously discussed growth factors that most frontier economies share should allow them to outgrow developed and emerging markets in principle and to attract foreign capital, which enables them to gradually close the gap that currently exists in economic and market standing.

Risk associated with frontier market economies

Investing in frontier economies, like with other asset classes, has its own specific risks. While macro resilience had generally improved prior to the pandemic, vulnerabilities vary widely across economies and are generally higher compared to emerging and advanced economies (Table 1). Poverty, pollution, disease, and corruption, as well as weak governance and institutions, are some of the risks that investors need to account for. Liquidity and transparency concerns and regulatory opacity can be problematic from a market perspective. Moreover, given their geographical distribution, which is heavily skewed toward Africa and Southeast Asia, and hence more affected by rising sea levels or droughts, frontier economies are also more prone to suffer from the effects of climate change, especially when compared to advanced economies. Lastly, not all risks are easily quantifiable. For example, resource nationalization, changes to foreign exchange regulations or capital mobility have often occurred following a regime change or economic duress and are therefore relatively unpredictable.

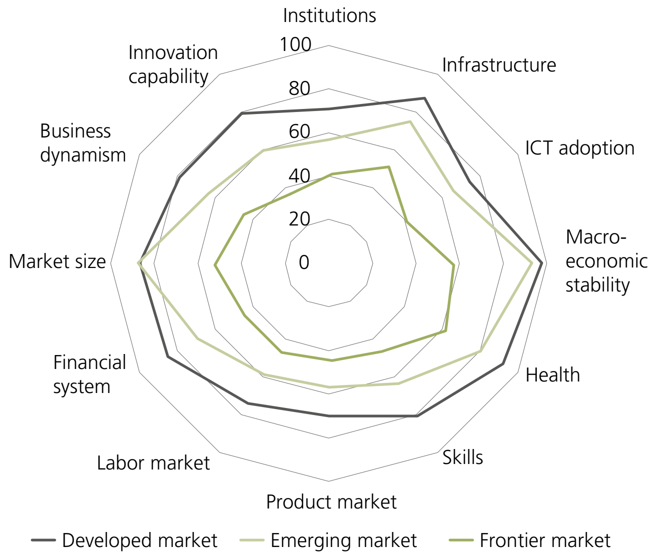
Table 1

Date	Vulnerability	Developed market	Emerging market	Emerging market ex China	Frontier market
	External				
2021F	Current account (% of GDP)	-0.10%	1.30%	1.10%	-2.30%
2021F	Inward FDI (% of GDP)	2.10%	2.40%	2.80%	2.10%
2021F	External debt (% of GDP)	165.80%	31.20%	41.50%	47.60%
2019	Foreign exchange reserves (% of GDP)	65.40%	213.80%	212.10%	126.80%
	Borrowing				
2021F	Net lending/borrowing (% of GDP)	-10.70%	-7.30%	-5.80%	-5.80%
2021F	Government debt (% of GDP)	127.80%	63.30%	59.50%	61.00%
2021	Nonfinancial corporate debt (% of GDP)	100.20%	103.40%		25.90%
2021	Household debt (% of GDP)	77.70%	46.30%		16.40%
2021F	Savings rate (% of GDP)	21.70%	33.70%	26.70%	22.30%
	Political				
2019	Political stability rank	0.66	0.35	0.33	0.25
2019	Rule of law rank	0.89	0.50	0.52	0.31
2019	Governance score	1.45	-0.08	0.02	-0.61
2021	Index of Economic Freedom	74.09	61.37	62.98	55.10
2020	Corruption Perception Index	71.38	42.19	42.84	32.64
	Environmental				
2019	Climate change vulnerability	0.31	0.40	0.41	0.45
2019	Environmental performance rank	0.20	1.48	1.27	1.44

Source: IMF, Oxford Economics, IIF, World Bank, Transparancy International, Notre Dame Adaption Initiative, Thomson Reuters, Heritage Foundation, LGT Capital Partners

Still, most vulnerabilities can be identified and subsequently addressed via structural reforms. And there is indeed significant potential to implement economic reforms across frontier economies. On all 12 pillars of the World Economic Competitiveness Index, frontier markets score inferiorly compared to emerging economies (Graph 6).

Graph 6: Global Competitiveness Index



Source: World Economic Forum, LGT Capital Partners

However, structural reforms that guarantee long-term economic success require painful adjustment phases at first which pay off over time. Good examples are the positive turnaround stories in Uzbekistan and Angola, where a clear reform agenda put the countries on an improving path on various aspects.

The presence of supranational lenders reduces the investment risk in frontier markets despite their higher macroeconomic vulnerabilities

The participation of supranational lenders like the World Bank, the Organization for Economic Co-operation and Development ("OECD"), or the IMF can improve the probability of success and in turn lower the actual risk that investors take. Firstly, supranational participation can contribute to a large field of expertise in the reform process, for example in the fields of standardization of capital markets, adoption of contemporary market regulation, and the correction of macro imbalances. Secondly, their system of lending conditionality is designed to promote national ownership of strong and effective policies and to break complex reforms down into smaller steps, improving the chances of eventual conclusion of the reform and the staying power of the incumbent government process. Thirdly, the supranational lenders in frontier economies offer additional benefits for investors in the form of local currency bonds issued by the supranational entity. Such bonds blend high quality and high yield. Supranational lenders are typically ranked AAA by rating agencies due to their advanced economy shareholder base, abundant liquidity, and robust capital bases. They also enjoy preferred creditor status.

Currently, several frontier markets, such as Ghana or Egypt, benefit from such programs. It is worth noting that aid to low income economies is granted on more generous terms – currently at zero interest rates due to the pandemic – and that the IMF acts as a development partner in these cases.

Geopolitical multipolarity increases the necessity to engage with, and lend to, frontier economies and increases the investment universe.

The transition toward a more multipolar geopolitical backdrop has advanced the role of non-traditional donors. One example is the Chinese belt and road initiative ("BRI"). As one of the world's largest creditors, China has invested more than US dollar 500 billion in projects related to the BRI, often lending to developing economies – particularly in Africa and Latin America. As China expands its practice of lending and doing business, its geopolitical adversaries are bound to follow.

For example, in 2019, the US introduced the US International Development Finance Corporation ("DFC"). The DFC acts as America's development bank and explicitly ties development finance to foreign policy aims and is widely acknowledged as a means to compete with Chinese lending to developing countries. In a similar spirit, USAID, the United States Agency for International Development, is also said to be pushing for localization of development aid in an attempt to counter China's influence.

Likewise, the European Union and India agreed in July 2021 to explore their own initiative as an alternative to the BRI. The partnership resembles a similar partnership the EU set up with Japan back in 2019 which aimed to provide "sustainable, rules-based connectivity from the Indo-Pacific to the Western Balkans and Africa", according to the former Japanese premier, Shinzo Abe.

The rising geopolitical necessity to engage with developing economies is therefore likely to expand the opportunity set of countries for developing economies to borrow from – as is the influx of non-conditional and conditional funds from institutions that offer an alternative to the Bretton Woods based global lending landscape.

The geopolitical backdrop will thus continue to widen the opportunity set over the secular horizon in the supranational debt universe (see also previous section) through new participants like the Beijing-based Asian Infrastructure Investment Bank ("AIIB") or the European Investment Bank. For example, the latter issued local currency denominated debt in Georgia for the first time ever in May 2021.

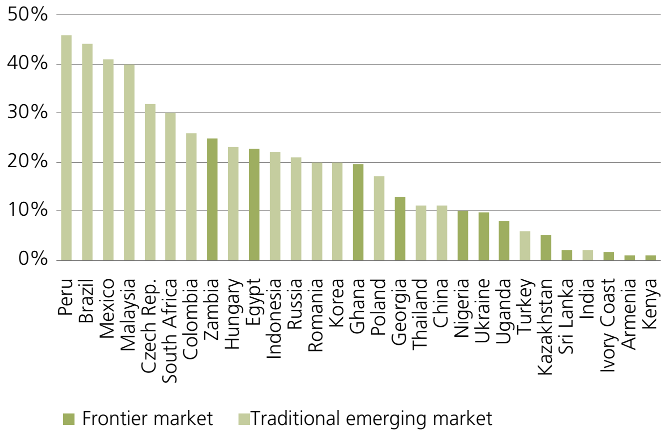
Frontier market local currency debt as an asset class

Diversification

As mentioned above, investing in frontier economies offers access to some of the world's fastest growing economies, growing working-age populations and rapidly urbanizing societies. In addition, the frontier universe spans across 140 countries, and in turn, economic outcomes differ considerably, from some of the poorest nations like Zambia or Bangladesh to countries like Croatia or Serbia that are converging with developed market living standards on a variety of metrics. In consequence, frontier market returns tend to be relatively uncorrelated – not just with global capital markets but also within the frontier market universe. After all, the discovery of new oil and gas reserves off the coast of Guyana are unlikely to affect growth rates in export-oriented Vietnam. Likewise, a regime change in Uzbekistan bears little significance for the economic outlook of service-oriented Seychelles.

As a result, the heterogeneity of the frontier market universe provides investors with greater natural diversification compared to developed and emerging economies and reduces contagion among frontier markets. Another important driver of diversification is the structure of the market. In contrast to traditional local currency and hard currency bond markets, foreign ownership is extremely low (Graph 7). Instead, the local financial system (pension funds, insurance companies, banks) in frontier markets serves as the "natural" buyer of government bonds denominated in the local currency. As a consequence and in case of exceptional high or low risk aversion among global investors, frontier markets are substantially less driven by massive inflows or outflows compared to other asset classes. As such, positive and negative outliers driven by "hot" and fast-moving money have not been observed in this asset class. As a result, correlation and volatilities are low/lower.

Graph 7: Foreign participation in local currency markets Non-resident holdings of local currency debt in% of total local currency debt[2]



Source: IIF, national central banks, debt offices, LGT Capital Partners

[2] Data as of 31 August 2021

Fiscal and monetary prudence

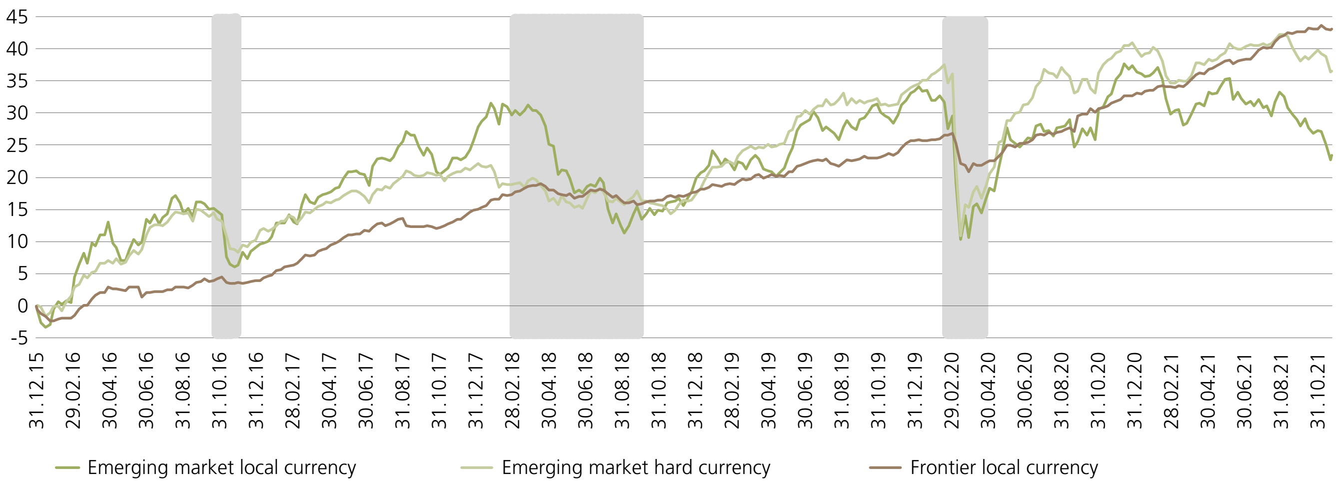
As stated in the previous section, many frontier countries are still in the early stages of their development path and there are clear identifiable vulnerabilities as local financial markets and institutional framework are still immature. However, during the last decade, frontier market policy makers have understood the importance of the transparency and clarity of both fiscal and monetary policy. Governments and central banks have taken huge steps forward on both fronts and have upgraded the predictability of the fiscal and monetary policy framework by moving into budget planning and updating as well as inflation targeting.

Inflation targeting was first adopted in New Zealand in 1990 and followed by several other developed countries in the early 90s (e.g. Canada, UK, Australia and Sweden). Nowadays, frontier countries like Armenia, Georgia, Ghana, Kazakhstan, Kenya, Serbia and Uruguay are also using inflation targeting as the base for their monetary policy. Central bank's more transparent communication and inflation targeting builds a base for more credible and reliable long-term monetary policy. Together with prudent fiscal policies, governments had the opportunity to lengthen their average funding maturities (e.g. in Armenia, Georgia, Ghana, Kenya, Serbia, Uganda, Ukraine and Uruguay) by issuing longer instruments and diversifying into inflation-linked instruments. The latter allow investors to hedge against inflation risks, which has historically been a challenge in certain frontier markets.

The consequence of these changes has also been evident during the recent global stress periods (for example the US presidential elections in the fall of 2016, tighter monetary conditions in 2018 and the Covid-19 crisis in 2020), when frontier market local currency debt performance has proved to be more defensive than traditional emerging market local and hard currency bonds (Graph 8).

The combination of 1) diversification benefits within the universe, 2) low correlation to other asset classes and 3) increased fiscal and monetary prudence in many countries results in very favorable absolute and relative risk-adjusted returns over time. Despite the risks that are associated with frontier markets as mentioned earlier, drawdown characteristics in crisis periods have been exceptional – a result of the three factors mentioned.

Graph 8: Emerging market and frontier cumulative returns (in USD; crisis periods highlighted in gray)



		US presidential election 2016		Tighter monetary condition 2018		COVID-19 crisis	
	Vol[3]	Draw-down	Recovery[5]	Draw-down	Recovery	Draw-down	Recovery
Emerging market hard currency	7.9%	-5.4%	74	-6.4%	47	-21.0%	119
Emerging market local currency	10.2%	-8.1%	81	-16.2%	335	-19.6%	183
Frontier local currency[4]	2.5%	-1.2%	31	-2.6%	82	-4.8%	81

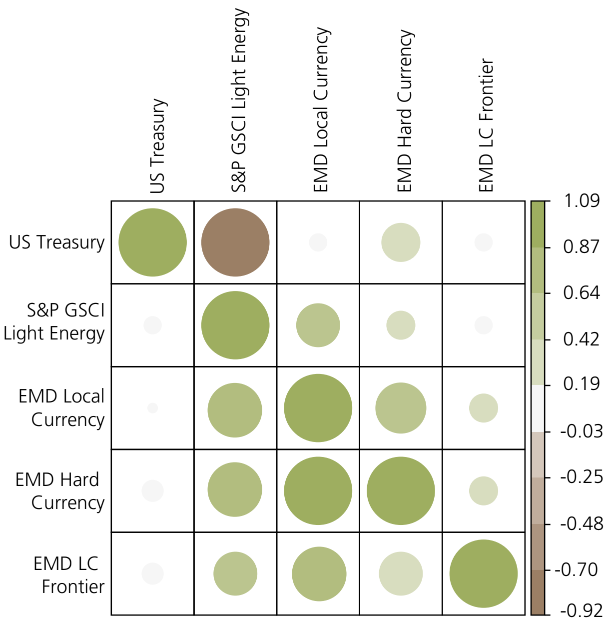
Source: LGT Capital Partners, Bloomberg, JPM

[3] Weekly data 31.12.2015 – 30.11.2021
[4] Simulation based on fx and yield component
[5] Recovery as weekdays

Frontier market dynamics

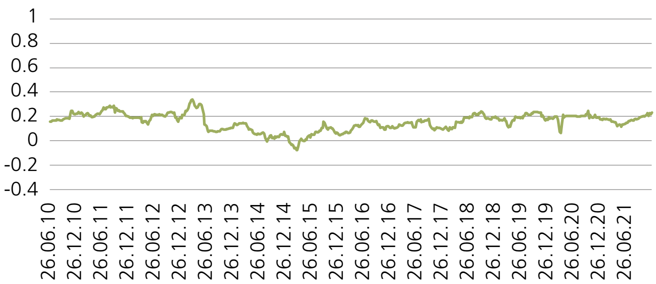
The heterogeneity of the frontier market universe has historically provided investors with relatively uncorrelated and low-beta returns compared to other asset classes (Graph 9) and reduced contagion between frontier markets. Frontier market beta versus traditional emerging market local currency fixed income markets also stayed very low throughout the last decade (Graph 10).

Graph 9: Beta matrix (row=market; weekly data; emerging market debt LC Frontier is based on a simulation of 38 currencies and a yield component)[6]



Source: LGT Capital Partners, Bloomberg, JPM

Graph 10: Frontier local currency beta versus traditional emerging market local currency (in USD; 26 weeks rolling)

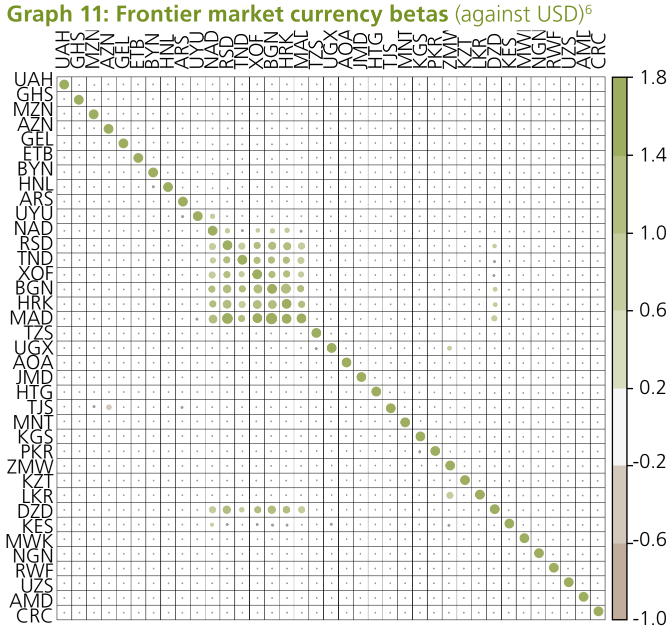


Weekly data 26.06.2010–30.11.2021
Source: LGT Capital Partners, Bloomberg

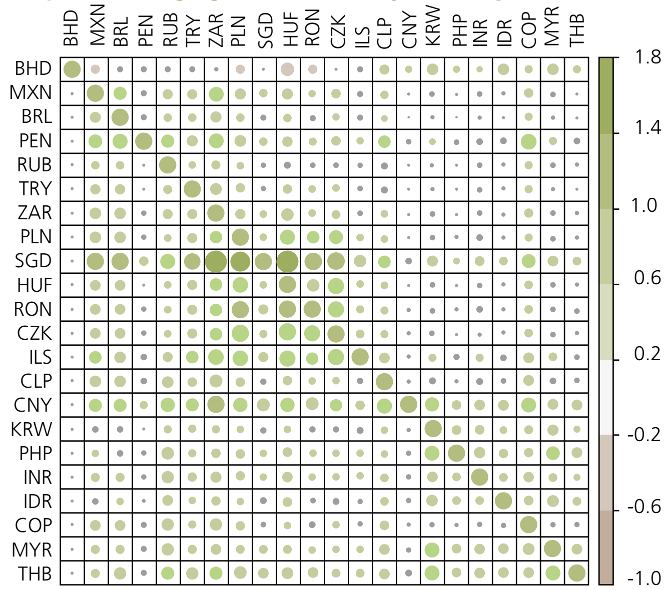
Beta

It is not only betas between frontier and different asset classes as well as frontier and traditional local currencies which look very attractive. When looking at betas between different currencies in the frontier universe, we see values close to zero (excluding almost Euro-linked currencies like Bulgarian lev or Serbian dinar) which indicate idiosyncratic drivers for each and every currency (Graph 11). This is also a clear difference when comparing against the traditional emerging market currency universe where betas between currencies are clearly higher across the market, revealing similar return drivers for the whole asset class (Graph 12).

Graph 11: Frontier market currency betas (against USD)[6]



Graph 12: Emerging market currency betas (against USD)[6]



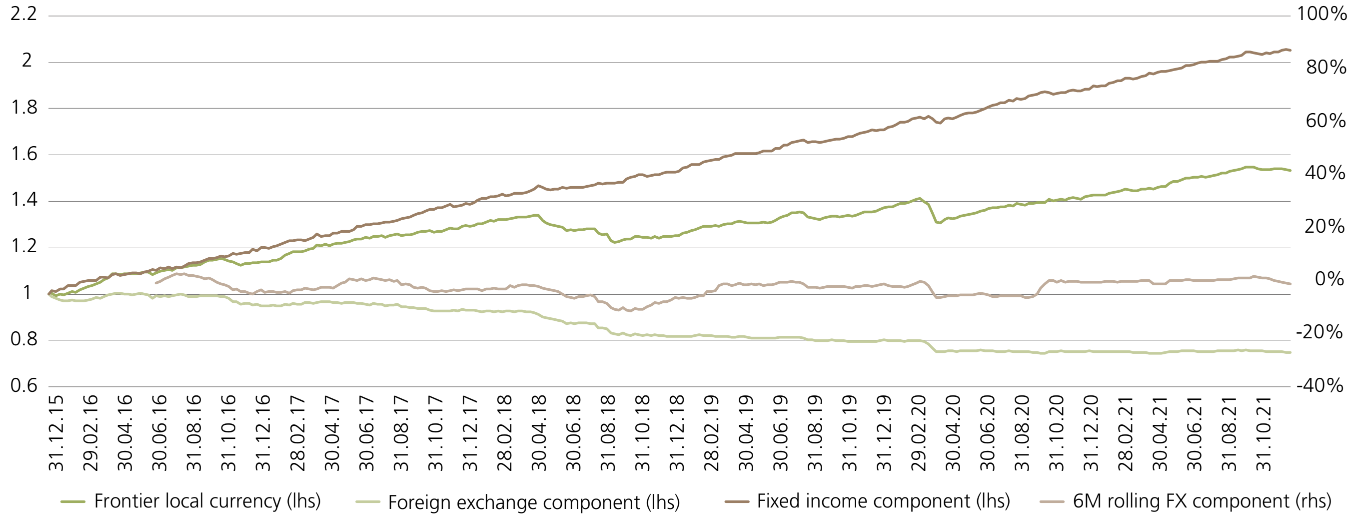
[6] The size and the colour of the bubble determine the beta. For example, a big green bubble means highly positive beta and a big brown bubble means highly negative beta. The smaller the bubble the lower the beta.
Weekly data 31.12.2009–30.11.2021
Source: LGT Capital Partners, Bloomberg

At the same time, frontier market local currency debt has highly attractive risk-adjusted return expectations due to a mostly domestic investor base as well as country specific and idiosyncratic performance drivers. All this, combined with relatively high nominal/real yields and lower currency volatility, offers very attractive long-term investment opportunities.

As can be seen in Graph 13, the main return driver for the local currency frontier debt is the fixed income component, which is providing positive and stable long-term returns (>10% p.a.). At the same time, it can be seen that the currency component is having stable but negative returns over this period, which is driven by typically higher realized frontier country inflation and which usually happens in cycles based on higher dependency on few commodities (both exports and imports).

Frontier economies offer an attractive real yield pick-up relative to emerging and advanced economies. Decades of low productivity growth and ultra-expansionary monetary policies have depressed yields in global fixed income markets. Frontier economies offer relief against the dearth of opportunities in the form of some of the world's highest real yields – adjusted for the higher inflation risk in some of these markets. When comparing developed market real yields with 10-year maturity (US -1.0% and Germany -2.5%) against some of our long-term strategic investments in frontier countries like Egypt (+9%), Ghana (+13%), Kenya (+6%), Uganda (+13%) and Uzbekistan (+4%) the difference is huge. The same can be said for the nominal yield space, where some frontier countries like Uganda and Ghana still provide yields above 15% compared to below 2% in the US and even negative yields in Germany.

Graph 13: Frontier local currency return decomposition over time. (For illustrative purposes only; similar strategy managed by the team in the past; in USD gross of fees; based on an approximation)



	2016[7]			2017[7]			2018[7]		
	Total	FX	FI	Total	FX	FI	Total	FX	FI
Frontier local currency	**13.9%**	-4.9%	19.7%	**13.7%**	-2.1%	16.2%	**-3.2%**	-12.1%	10.2%
Emerging market local currency	**9.9%**	0.5%	9.3%	**15.2%**	5.8%	8.9%	**-6.2%**	-9.1%	3.2%

	2019[7]			2020[7]			2021 YTD[7]		
	Total	FX	FI	Total	FX	FI	Total	FX	FI
Frontier local currency	**9.7%**	-2.2%	12.2%	**3.9%**	-6.1%	10.6%	**7.4%**	-0.8%	8.2%
Emerging market local currency	**13.5%**	1.0%	12.4%	**2.7%**	-5.2%	8.4%	**-10.2%**	-7.1%	-3.3%

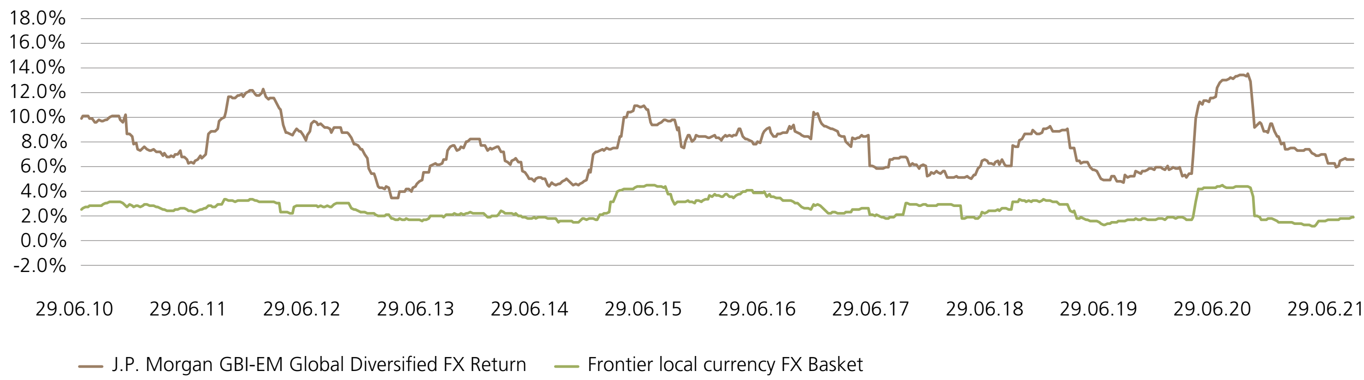
[7] Weekly data 31.12.2015 – 30.11.2021
Source: LGT Capital Partners, Bloomberg.
Past performance is not a guarantee, nor an indication of current or future performance. Returns may increase or decrease as a result of currency fluctuations.

Liquidity and volatility

A few common misunderstandings about frontier market local currency debt instruments are liquidity and risk (e.g. volatility) issues. In contrast to more traditional and developed emerging markets (Brazil, Mexico, Peru, etc.) where international investors are usually substantial holders of local currency debt (up to 50%), frontier local currency fixed income markets are dominated by local investors, and foreign participation is traditionally very low (<10%). Consequently, there will be fewer investors with a short-term investment horizon and panic mentality (i.e. "tourists") involved, and during times of higher global uncertainty local investors are seeing their domestic frontier local currency debt markets as their natural choice of safe haven. These aspects will increase liquidity and also dampen volatility during global stress environments. Obviously, all frontier markets differ from each other somehow by market structure, but it is important to understand who the liquidity providers are (pension funds, insurance companies, asset managers, corporates, etc.) as well as active global and local counterparties. However, historically, frontier market currencies have lower realized volatility than currencies in more traditional emerging markets (Graph 14).

Most of the frontier currencies are traditionally quoted against the US dollar as with more traditional emerging market currencies. Importantly, and contrary to common perception, however, frontier market currencies tend to be less volatile than their emerging market counterparts. This is primarily due to the fact that frontier currencies are not drawing short-term investors (i.e. hot-money speculators) and that hardly any frontier market currency is used as a global risk-proxy during times of heightened global uncertainty.

Graph 14: Emerging market and frontier market local currency volatilities (in USD; 1 year rolling)[8]



[8] Weekly data 29.06.2010–30.11.2021
Source: LGT Capital Partners, Bloomberg, JPM

Defaults and devaluations

Historically speaking, local currency debt seldom defaults or gets restructured, but it is pure myth that these events wouldn't exist at all. During the last few decades there have been examples of such cases (Venezuela 1998, Russia 1998, Ukraine 1998, Ecuador 1999, Argentina 2001 and 2019, and Jamaica 2010 and 2013). Overall, local currency sovereign defaults are a lot less frequent than they are in external debt as issuers do not face a currency mismatch between revenues and liabilities in times of crisis. Excluding some exceptions (Argentina, Ecuador, Sri Lanka, Venezuela, Zambia, etc.), the amount of public net external debt (% of GDP) in frontier countries is not substantial as quite a few of these countries have not even entered public external markets yet but have rather used other avenues for external funding (bilateral, multinational, etc.). Some emerging and frontier countries have used currency devaluation as a way of improving competitiveness as devaluation tends to improve a country's trade balance, making domestic goods in foreign markets more attractive. But at the same time, currency devaluation increases the prices of imported goods and thereby increases domestic inflation. From an investment perspective, during devaluation cycles, some countries devalue several times, depending how much currency weakness has been priced in before the actual event. There have been plenty of events where currency devaluation has been smaller than expected, which has benefited investments in local currency. Traditionally, countries have devalued their currencies more often based on global macro trends and uncertainties – as can be seen in Graph 15 when the devaluation cycle picked up during the global financial crisis (2008 – 2009) and negative energy price developments (2014 – 2016 and 2018).

Graph 15: Frontier currency historical devaluations[9] in 1-year period (against USD)

Data 31.12.2000 – 30.11.2021
Source: LGT Capital Partners, Bloomberg

[9] Devaluation: 5% permanent weakening in one day or 15% on five days. During devaluation cycles, some countries may devalue several times.

How we invest in frontier market local currency debt

Research and investment universe

As the asset class is – by its very nature – still developing, not all markets remain investable. Instead, the universe is evolving all the time, requiring a high degree of experience and market cultivation capabilities typically associated with active investors like ourselves. LGT Capital Partners' ("LGT CP") frontier market research universe consists of close to 140 countries, where availability of data is broadly covered by official sources like the IMF, the World Bank, the UN, and Freedom House to name just a few. Of those 140 frontier countries, we have currently identified more than 85 countries as investable either through cash government bonds, bonds issued by AAA-rated suprational lenders in local frontier market currencies, or derivatives. During our more than 15-year tenure of investing in frontier economies, we have had exposure in over 50 local currencies. Usually, the first investments into frontier countries are either in AAA-rated supranational bonds or derivatives format as local financial markets are starting to develop and there might be barriers of entry (regulation, taxation, custody accounts, etc.) for the investments.

Philosophy and strategy

LGT CP is an active emerging and frontier market debt portfolio manager. Our investment philosophy is focused on long-term decision-making and is based on a country selection approach that is grounded in fundamental and macroeconomic analysis. The country selection process is a combination of backward- and forward-looking data analysis which utilizes both quantitative and qualitative approaches. Our investment horizon is typically long – for example 5+ years on a country level – as we focus on selecting countries which are developing positively on economic, environmental, social and governance perspectives ("E+ESG") on the long-term horizon. Our approach is very much non-benchmark driven and we are targeting better risk-adjusted absolute returns rather than pure relative performance against a chosen benchmark. Typical risk characteristics of our philosophy are lower volatility and high tracking-error in order to deliver high risk-adjusted total returns.

At the core of our investment strategy is the country selection model, classifying countries into a number of investment sub-categories based on their economic, environmental, social and governance status, and direction and pace of the development. In our country selection process less weight is given to the current level (i.e. ranking) and more weight is allocated to the direction and magnitude of the development, both in backward- and forward-looking data analysis. Countries are also compared against their own peer groups based on several different indicators and not against the whole emerging market universe. ESG is an integrated part of the process when selecting suitable countries for long-term investments. Country selection is enriched by shorter-term assessments (engagement with local and global institutions, co-operation with independent parties, internal research and high-frequency data). The country selection process is validated with several other tools (classification and clustering) and indicators. Our strategy excludes all investments into corporate risk (even quasi-sovereign and government guaranteed) and focuses investments on sovereign cash government bonds, AAA-rated supranational issuance in frontier market local currencies, and derivatives (forwards, non-deliverable forwards, and options).

Engagement

Pursuing active ownership is an integral part of LGT CP's sustainable investment approach[11]. We actively engage with the countries and issuers that we invest in. We are convinced that over the long term, a well-developed relationship between a country and issuer and its investors can lead to increasing bondholder value and superior returns. LGT CP has the fiduciary responsibility to influence countries and issuers of securities in the most favorable way for their investors, society, and other relevant stakeholders.

LGT CP monitors countries and issuers on relevant ESG related matters, including strategy, financial and non-financial performance and risk, social and environmental impact and governance. Where LGT CP considers that there is a need for a dialogue with the country or issuer, or that it could influence a country's or issuer's ESG behavior positively, it starts an engagement process.

Additionally, LGT CP uses its relationships to monitor and gain further insight into relevant matters that are used for the ESG analysis of these countries and issuers. We acknowledge the value of the increased insight and understanding of countries and our issuers that we obtain from our engagement activities. To ensure the systematic feedback from our engagement activities is fed into our investment decision-making, we systematically track and share all engagement activities.

We are convinced that our broad network gives us a competitive advantage over our peers and creates added value for our investors. Over the last 15 years, we have established a broad network consisting of numerous local and global institutions and we appreciate this close cooperation and ongoing dialogue. This covers both local institutions like central banks, debt offices, different ministries, independent advisors and banks as well as global institutions like the IMF, the World Bank, the UN, the IFC, the EBRD, etc. We consider this approach as very important in terms of engagement/sustainability as well as in validating the data used in our country selection model.

ESG

ESG factors have always been a key component in our investment process, and the team continuously refines and verifies its established tools and processes in order to provide attractive risk-adjusted returns over the long term. The team intends not only to further strengthen the ESG approach of its strategies, but also to ensure transparent reporting on ESG performance.

LGT CP wants to emphasize the role of environmental factors, which do not only consist of risk-related aspects with regard to climate change. The aim is to also monitor and measure factors such as biodiversity and the use of natural resources. It is our belief that the sustainable use of natural resources has a positive long-term impact on a country's economy.

The team has a long history of cooperating with supranational AAA-rated institutions. A key element of bonds issued by these multinational institutions is the focus on solving concrete problems with a sustainable angle. This mechanism allows capital from the private sector to be effectively allocated into projects in various countries that have a measurable positive impact.

The aim of using supranational bonds is to gather financing for some dedicated projects in order to achieve the sustainable development goals of the particular country. Furthermore, we can positively contribute and have a measurable impact in a certain country which otherwise might be excluded from our investable universe. For example, we have participated in financing the reconstruction of the infrastructure in Haiti, supported women entrepreneurship in Armenia, financed projects related to the economic growth in Uzbekistan and strengthened the resilience and sustainable livelihood of poor households in Myanmar through the UN's Livelihoods and Food Security Fund. LGT CP's intention is to measure and report the success rate of the projects and investigate the achieved results in a country.

Frontier market local currency debt in emerging market debt portfolios

We see that the frontier market local currency debt asset class should be the core component of every long-term emerging market debt investor's portfolio, together with traditional emerging market debt hard currency bonds. The dynamics of traditional emerging market local currency debt have changed since the beginning of the twenty-first century and have become more speculative. Hence, the risk-adjusted return of frontier market local currency debt is more attractive. We see the traditional local currency market more as a tactical component in an investor´s portfolio that can be used to boost the return of the emerging market debt portfolio when the market conditions are favorable.

The diversification effects and the risk and return drivers of the asset class offer investors something that the traditional emerging and advanced economies cannot. Frontier economies offer access to some of the world's fastest growing economies, growing working-age populations, and rapidly urbanizing societies. The return drivers of frontier market economies are more country specific and idiosyncratic. Correlations and betas between the countries are much lower in the frontier universe than in the traditional emerging markets.

The risk-adjusted return and other risk characteristics of an emerging local currency frontier market are very attractive. The historical volatility of the asset class has been less than 3% in the long term (in USD) and the long-term strategic return expectation is more than 8% (gross of fees) p.a. This is based on the relative high running yield (more than 10%) and the average weakening of frontier currencies of about 3–4% p.a. against the US dollar.

The pandemic and frontier market debt

Sovereign and external debt levels in frontier and emerging economies have grown steadily over the past decade and surged further in the wake of the pandemic. For example, government debt ratios in frontier markets are now estimated to have risen to roughly 60% on aggregate, which is on par with the more established emerging markets, despite a better ability to serve creditors by the latter.

Even before the outbreak of the pandemic recession, some frontier economies that were already resting on precarious macroeconomic foundations, and which had limited abilities to expand borrowing (such as Argentina, Ecuador or Zambia), subsequently defaulted on their international liabilities. However, most frontier markets did not, partly due to past efforts to improve macroeconomic resilience and partly due to global debt relief efforts for low-income countries such as the World Bank/IMF-backed Debt Service Suspension Initiative and the G20 Common Framework for debt burden relief.

While these initiatives have helped to temporarily ease the financing constraints and free up scarce money to spend on fighting the health crisis, solvency and liquidity concerns could resurface once the schemes end – currently set to happen in December 2021. As the initiatives only cover the poorest 73 low- and lower middle-income countries, about one third of developing economies – that account for roughly two thirds of the total debt services at risk – need to address liquidity concerns on their own.

Hence, debt sustainability concerns will continue to pose a key challenge to frontier market investors beyond the pandemic. While countries will differ in their debt-carrying capabilities, due to differing debt service costs and currencies of debt denomination, economies that return to their pre-Covid levels of real growth rapidly and manage to stabilize depreciating exchange rates are likely to do better in the process. A sustained rebound in external demand and continued generous liquidity conditions in global financial markets are equally instrumental to help manage debt sustainability, as is an economy's ability to generate growth via the undertaking of quality investments in physical and human capital in the mid- to long-term.

Nevertheless, for many frontier economies, debt vulnerabilities will likely remain elevated over the next couple of years. In essence, they are only likely to fall to pre-pandemic levels after 2024/2025 according to a recent working paper of the United Nations Development Programme. Against this backdrop, investors should continue to reserve a considerable amount of time to strenuously evaluate liquidity and solvency conditions when allocating in frontier markets or outsource the task to investment specialists entirely.

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