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EMERGING MARKETS

Flashing Yellow Light on Frontier Debt

By Craig Mellow March 3, 2018

Emerging Markets

Kenya just scraped through a presidential election whose results the losing side refuses to recognize. The nation's budget deficit ballooned to almost 9% of gross domestic product last year. The International Monetary Fund called timeout on an assistance program. So what happened when the nation of 48 million tried to borrow $2 billion on global markets two weeks ago? "There was a bun fight," says Kevin Daly, a portfolio manager for emerging market debt at Aberdeen Investments. "Our allocation was nothing."

Translated, that means Kenya had seven times the demand it needed for its bonds, and placed 10-year paper at what not so long ago would have been a normal rate for a residential mortgage, 7.25%. There was a 30-year tranche, too.

Kenya is not the only exotic sovereign credit finding favor despite the shudder that passed through world financial markets last month. Dominican Republic raised $1 billion for 30 years at 6.5%, and Belarus, $600 million on a 12-year term for 6.2%. Finance officials from Senegal are on a roadshow as we speak, with Cote D'Ivoire (which defaulted seven years ago) and Angola on tap for March. If the correction was supposed to curb risk appetite, someone missed the memo.

The volume of hard-currency bonds issued by so-called frontier markets has swelled to $140 billion today from next-to-nothing before 2008. Investors gutsy enough to get in early have been well rewarded. The Aberdeen Global-Frontier Markets Bond fund has returned 10% annually since inception in 2013, compared with 6.2% for global emerging market Eurobonds, Daly says. Default rates have been similar to those for U.S. high-yield bonds, yet frontier-debt interest rates are considerably higher.

OPINIONS ARE DIVIDED on exactly what happens next, but the length of the recent rally argues for some lightening of frontier- bond positions.

Alison Graham, who runs the frontier-only hedge fund Voltan Capital Management, sees a market flooded by newbie investors who are bound to get burned. "Pension funds are looking to eke the last few basis points out of a trade that's on its last legs," she says. "Every three years or so, something happens to these markets, and most of it is not very predictable." The Aberdeen fund went into an 18-month decline after oil prices crashed in mid-2014, for instance.

Aberdeen is steering a middle course. Daly sticks up for frontier market bonds in general. “Most investors think that this is very high risk and regimes leave their countries in a state of disrepair. That’s fake news,” he says. Yet the firm has retreated from the asset class toward relatively safer ground as yields decline. When the rally started two years ago, Aberdeen’s global emerging markets bond funds were about 11% overweight on frontier credits. That’s now 3%.

Brett Rowley, an analyst covering Africa and the Middle East for TCW, remains sanguine. “People are looking for yield, and frontier markets have certainly outperformed,” he says. “We feel very comfortable taking a deeper dive.”

One thing all the experts agree on: This isn’t investing you should try at home through passive strategies or reading the newspaper. No exchange-traded fund covers frontier bond markets, and for good reason: Get caught holding a big defaulter like Argentina in 2014, and a market- weighted portfolio can cave.

On the other hand, even the bearish Graham is still buying a few issues like local-currency paper from Nigeria and Egypt, betting that major devaluations will stabilize those nations’ volatile currencies. “The most important driver in these markets is idiosyncratic risk,” Daly says. Proceed with caution.