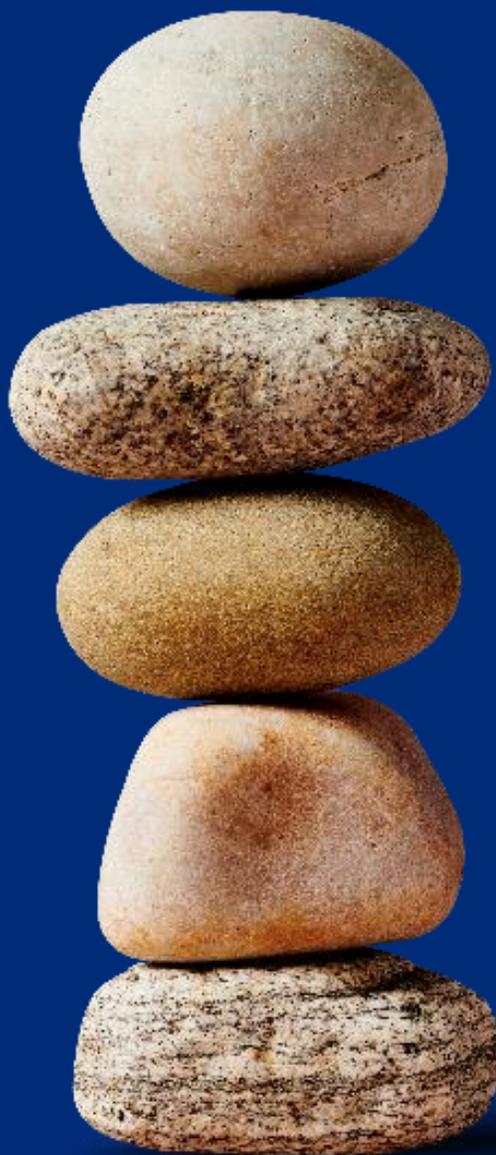


# Frontier Market Debt

Global Multi Asset Team

July 2024



# Executive Summary

Frontier market debt is characterized as bonds issued by sub EM countries as well as lower rated emerging market economies. The asset class offers a combination of potentially attractive yields and strong diversification qualities owing to idiosyncratic return drivers.

Frontier economies demonstrate robust economic growth, particularly in non-oil exporting nations. They generally exhibit current accounts in reasonable shape, resilient fiscal positions and maintain manageable debt levels. Furthermore, they are poised for strong economic growth driven by rapid industrialization, urbanization, and supportive macroeconomic policies. There is, however, a wide spectrum of outcomes with a lot of differentiators between the countries (hence the idiosyncrasy of the asset class) and plenty of political risk.

Lending to individual frontier countries has been risky due to the higher idiosyncratic risks associated with these markets including political instability, economic volatility, corruption, less well-developed financial systems and currency fluctuations. However, much of the risk is country-specific rather than linked to the global economy and can be reduced via an allocation that diversifies across countries. In our view, fundamentals are reasonable (and improving) for many of the underlying countries in the investment universe. With yields today<sup>1</sup> at historically high levels relative to emerging market debt and global high yield, frontier market debt valuations appear compelling, especially as defaults have been modest. Substantial currency devaluations have happened in some countries, but not across the asset class as a whole.

We believe that frontier market debt may be a suitable addition to multi-asset portfolios, offering the potential for higher returns while bringing diversification benefits. However, the asset class comes with idiosyncratic as well as political, currency and default risks.



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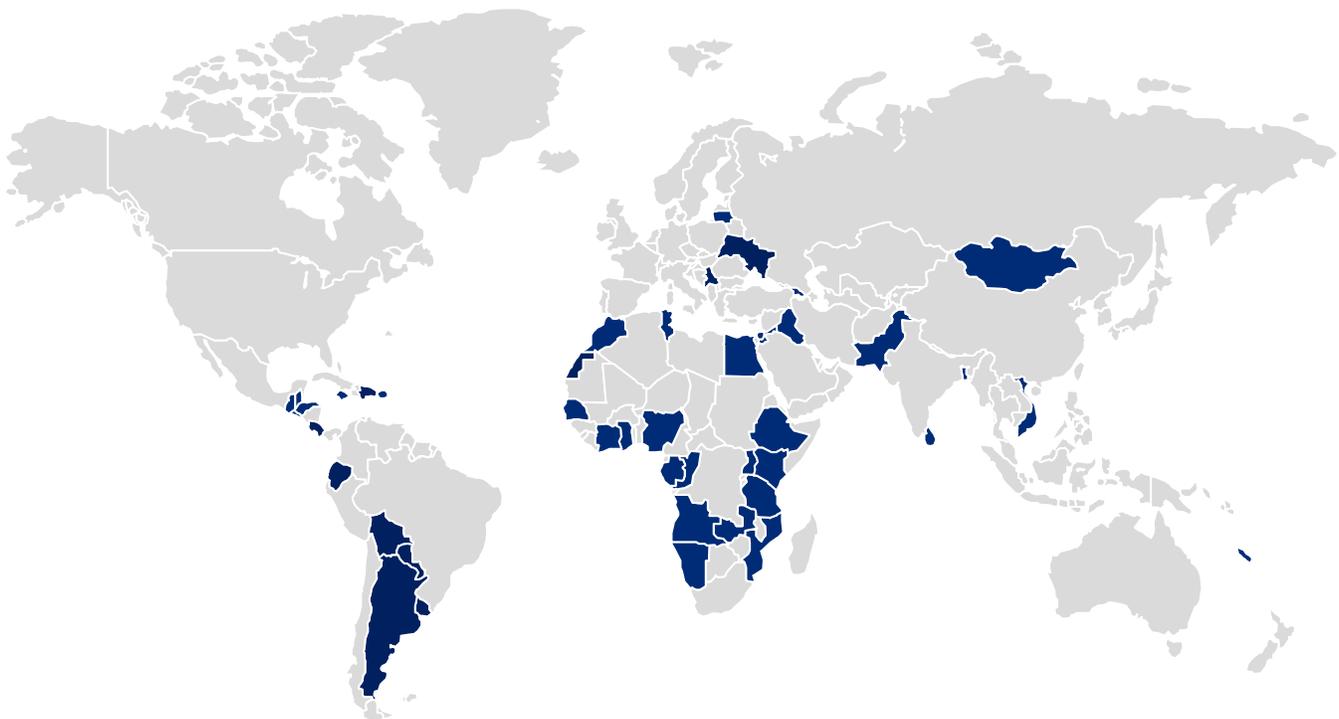
<sup>1</sup> June 2024. Source: Bloomberg, Ninety One, Mercer analysis

# An introduction to Frontier Markets

## Overview

Frontier market debt consists of bonds mainly issued by countries at an early stage of their economic and financial development. These markets are often located in Africa, parts of Asia, Eastern Europe, the Middle East, and Latin America. This stage of development mirrors the early days of emerging markets, which once stood where frontier markets are today – on the brink of dynamic growth and integration into the global financial system.

**Figure 1. Shaded represent countries considered frontier markets\***



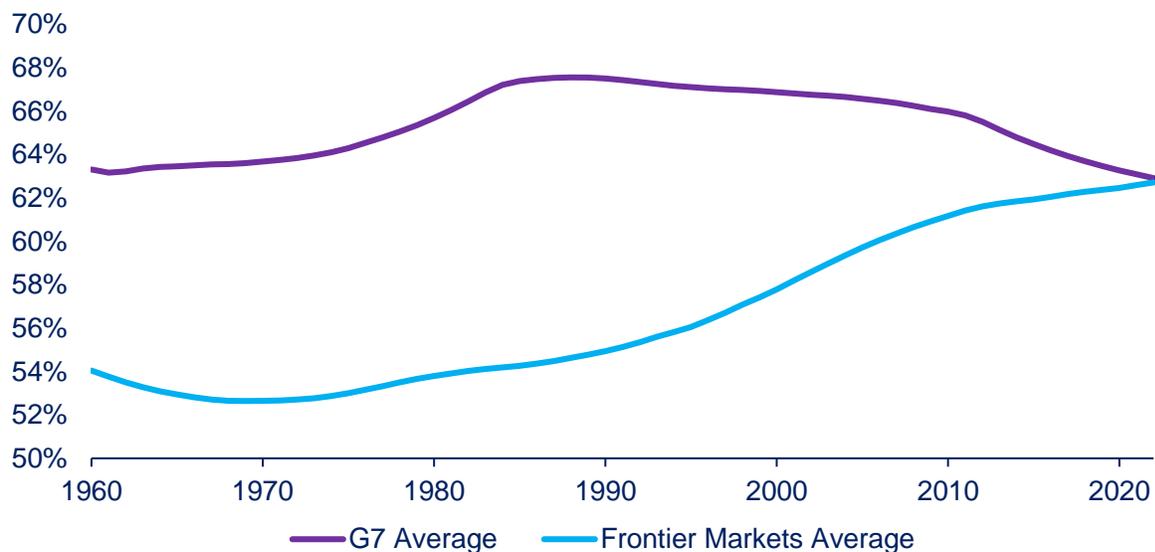
*Source: Mercer. For illustration purposes only. \*As denoted in the JP Morgan NexGem (a hard currency index for frontier market debt) and FTSE Frontier Government Bond Indices (a local currency index for market debt)*

## Yield and Growth Potential

Frontier market debt offers some of the highest yields in the fixed income universe at the time of writing<sup>2</sup> – averaging c.11% for hard currency assets and c.14% for local currency assets – a reflection of risks investors face in the event of defaults and/or currency devaluations as well as the lack of international capital flows. Yields in frontier market debt have also been impacted broadly by the rise in global bond yields since 2022.

Despite frontier market debt yields being historically high, underlying fundamentals have improved. The growth potential in frontier markets is significant. These economies are often marked by rapid industrialization, increasing urbanization, growing working age population, a substantial commodity base and more prudent macroeconomic. This economic dynamism, while not without its challenges, presents opportunities for astute investors to participate in the growth story of these countries which should lead to lower yields and deliver meaningful capital appreciation.

**Figure 2. Working age as a percentage of total population**



Source: Mercer, World Bank. December 2022. Frontier markets as defined by the JP Morgan NexGem Index (hard currency) and the FTSE Frontier Government Bond Index (local currency)

## Diversification and Low Correlation

Frontier market debt offers diversification benefits in a multi asset portfolio particularly in times of drawdowns and market stress. It exhibits a low correlation with more established asset classes, including developed market equities and bonds as well as broader emerging market debt. This is largely due to the idiosyncratic risk profile of the constituent countries with over 30 of them in the local and hard currency frontier market debt universe. For example, the average pairwise correlation within the local currency universe is 0.10

<sup>2</sup> June 2024. Source: Bloomberg, Ninety One, Mercer analysis

highlighting the idiosyncratic nature of the local currency universe. This characteristic can provide a cushion against volatility in other markets, offering a stabilizing effect on a total portfolio.

### Risks and Challenges

Investors in frontier market debt must navigate risks including political instability, economic volatility and lower liquidity. For local currency bonds, currency devaluations as well as repatriation concerns are a key risk factor. For hard currency bond investors, spread widening and potential default risks are the main risk factors.

The lessons learnt from the evolution of emerging market debt can be invaluable here. The importance of rigorous due diligence, deep understanding of local markets, and a long-term perspective are as critical in frontier markets today as they were in emerging markets in the past. This means that country and issue selection from highly skilled and experienced active managers can add value.

**Figure 3. Frontier Market Bonds Characteristics**

	EMD HC	EMD LC	FMD HC	FMD LC
<b>Yield</b>	8.4%	6.6%	10.7%	13.7%
<b>Duration (years)</b>	6.4	5.0	5.2	5.1
<b>Spread</b>	384 bps	n/a	730bps <sup>1</sup>	n/a
<b>Volatility</b>	9.2%	8.3%	13.9%	3.9%
<b>Number of countries</b>	70	16	30	14
<b>Market Cap (\$bn)</b>	1,180	3,710	109	374
<b>Max Drawdown</b>	- 26%	-19%	-44%	-14%
<b>Index</b>	JP Morgan EMBI Global Diversified	JP Morgan GBI-EM Global Diversified	JP Morgan NEXGEM	FTSE Frontier Government Bond

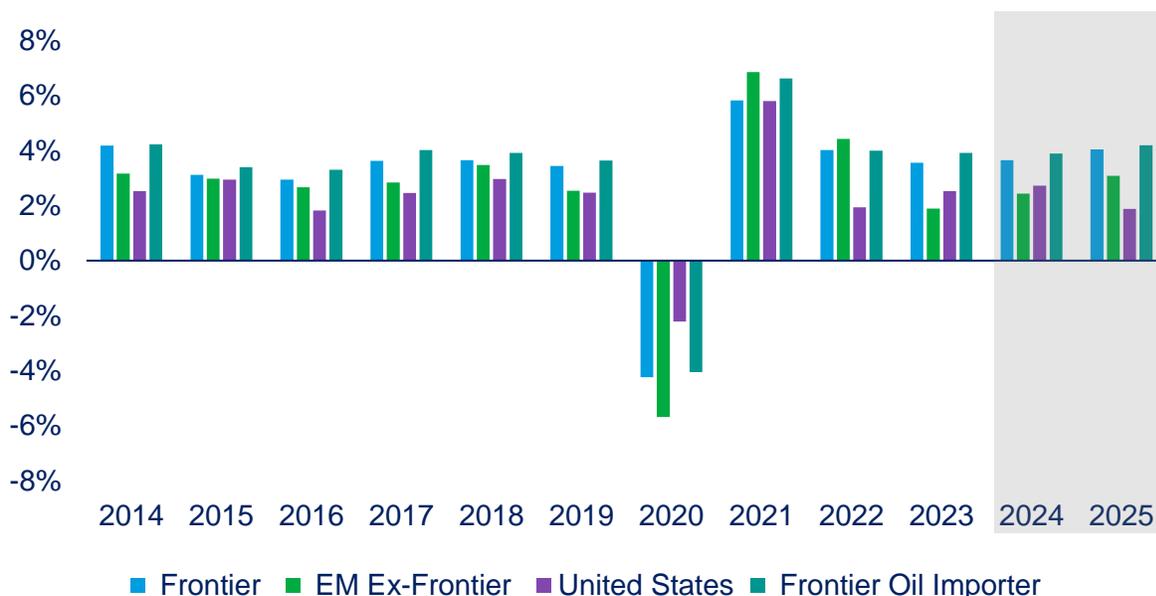
Source: JP Morgan, FTSE Russell. Mercer. Data as of May 31, 2024. Volatility and max drawdown for period Jan 2006 to May 2024, using monthly observations. Given small index sample size for FMD LC, volatility and yield data represent a portfolio of 24 equally weighted frontier local markets. Official FTSE index includes 14 countries <sup>1</sup>Spread to 5-year US treasury.

# Fundamentals

There is a wide spectrum of economies in the frontier market debt universe. For example, countries like Nigeria and Angola have substantial oil reserves, while Zambia has stores of copper; services-led economies like Bangladesh and Kenya benefit from a young workforce; Vietnam is benefiting from a burgeoning industrial sector; and countries like Rwanda are benefitting from investments into information and communication technology.

Frontier economies stand to benefit from structural reform designed to increase labour force participation and productivity. As this occurs, it should drive capital formation which in turn would lead to improving living standards, education and healthcare. The resultant pick-up in innovation and skill should drive productivity growth. All of this put together should lead to higher trend growth rates, and a lower cost of capital due to improved creditworthiness.

**Figure 4. Real GDP Growth**



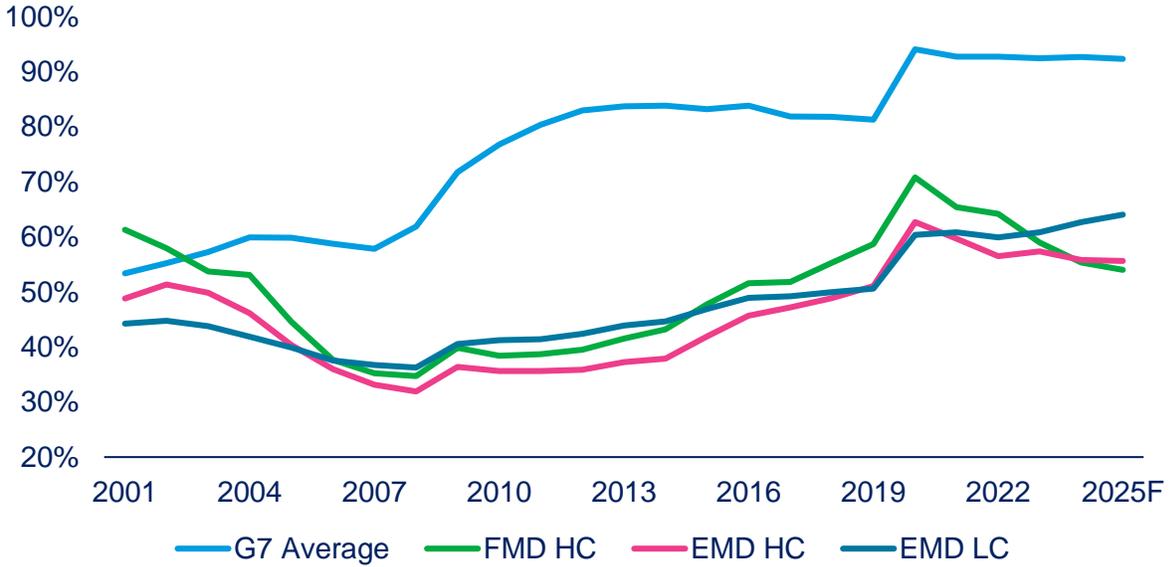
Source: IMF World Economic Outlook. Ninety One calculations April 2024. Mercer

The primary balance, which measures a country’s fiscal stance excluding interest payments, is a key indicator of its fiscal health and sustainability. Positive primary balances in frontier markets suggest a government's capacity to meet its obligations without increasing debt levels. Frontier markets primary balances are now running at levels which are consistent with bringing debt down further which improves creditworthiness. Therefore, this should lead to lower borrowing costs and increased investor confidence leading to capital inflows.

Frontier markets have diverse sources of financial flows, including foreign direct investment (FDI), remittances, and portfolio investments. While FDI and remittances provide a stable source of foreign currencies, portfolio flows can be more volatile, subject to global risk sentiment. The other key source of financing for frontier countries is via multinational &

supranational organisations such as the IMF and World Bank. Debt sustainability remains a concern in some countries, but overall debt levels remain manageable.

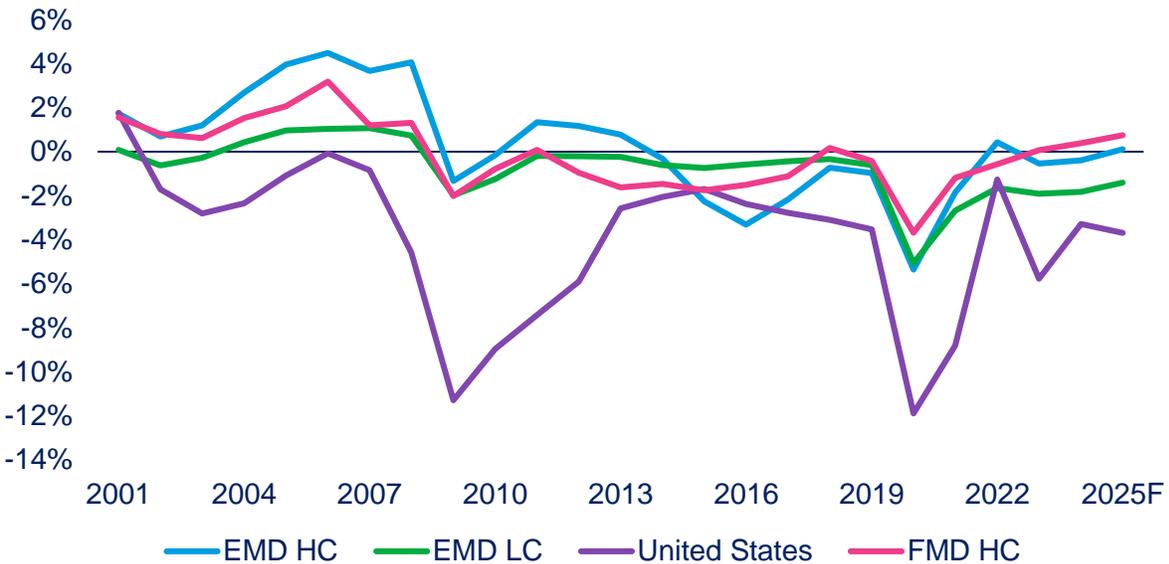
**Figure 5. Debt to GDP**



Source: Haver, IMF World Economic Outlook. Ninety One calculations April 2024. Mercer

Emerging and frontier central banks were one of the first to start raising interest rates as inflation spiked in their economies in 2021. Due to this, many have seen inflation fall back with growing slowing and this has allowed central banks to start cutting rates. The gentle rate cutting cycle should continue, providing a further tailwind to growth.

**Figure 6. Primary Deficit as % of GDP**



Source: Haver, IMF World Economic Outlook. Ninety One calculations April 2024. Mercer

Importantly, cutting rates does not necessarily lead to weaker currencies in frontier markets. Interest rate differentials should remain broadly intact as developed market central banks have broadly started to cut interest rates. Moreover, where the aim of rate cuts is to stimulate growth when inflation is near target, it could be seen as a positive, attracting international flows.

Furthermore, supranational organisations like the IMF are willing to lend on non-commercial terms as well as assist with any restructuring. This has meant that haircuts on defaults have historically been manageable, and losses are more than compensated by the higher yields on offer.

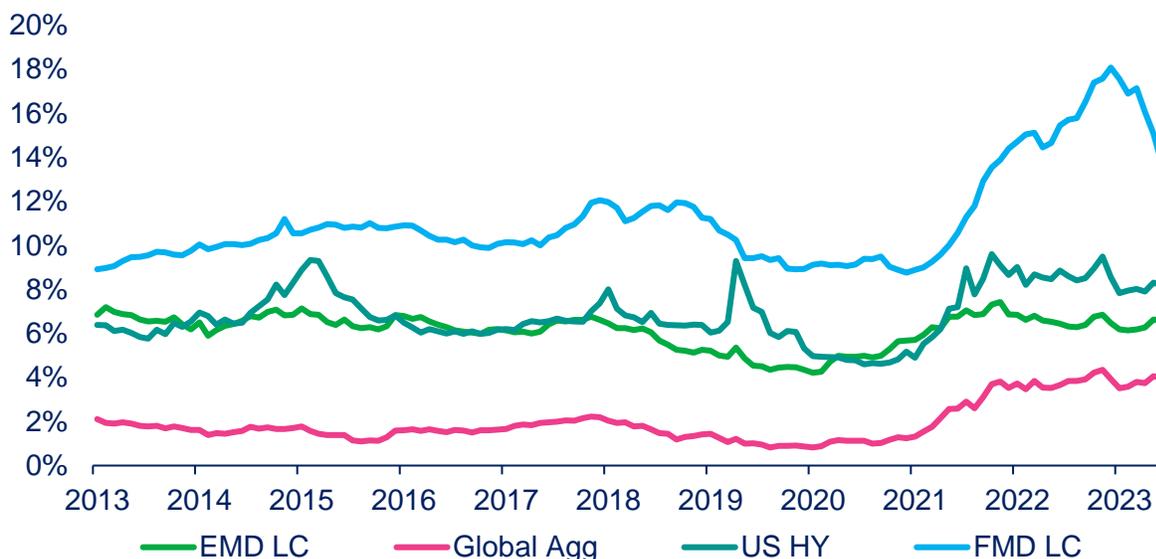
It is important to understand the currencies of frontier countries especially when investing in local currency bonds. One of the ways to measure the currencies is to look at the real effective exchange rates (“REER”). There is a premium in frontier local markets where on average investors are paid a rate well above what would be implied by inflation and interest rate differentials especially when compared to more developed emerging markets. This premium exists due to lower levels of market development & saving and increased levels of idiosyncratic risk.

China’s increasing presence as a major lender and investor in frontier markets should not be overlooked. Chinese financing, often directed towards infrastructure projects, has become a significant source of capital. However, there have been some issues with the most recent being the restructuring of Zambian debt where China sought a multinational status while lending on commercial terms. Eventually, a common agreement was reached under the G20 Common Framework which was a significant milestone. China’s role in future restructurings remains a key risk.

# Valuations

Local currency frontier market debt yields represent a compelling opportunity as they are far above their historical range and emerging market counterparts. They also offer a higher yield than US high yield bonds due to the higher risks.

**Figure 7. Yields remain high for local currency frontier markets**



Source: Bloomberg. Ninety One calculation. Representative indices shown. EM LC = JPM GBI-EM Global Diversified, Global Agg = BBG Global Aggregate, US High Yield = Bloomberg US High Yield Corporate, Frontier LC Index = Portfolio of 24 equal weighted frontier local markets. Mercer

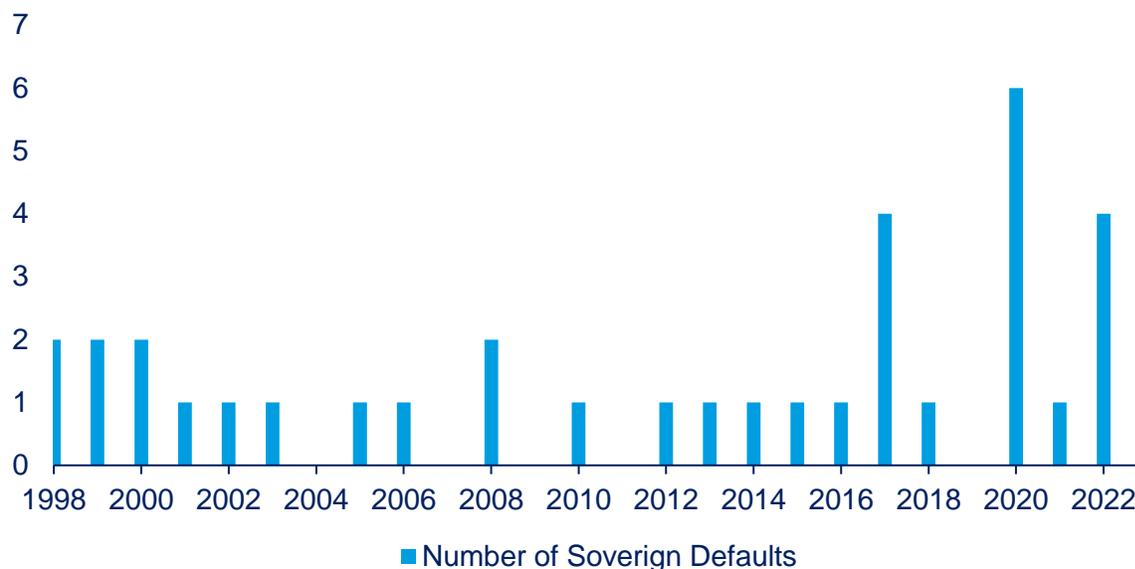
Historically, frontier market debt defaults have been rare (Figure 9). Governments can have incentives to not default on their obligations as it restricts future access to global capital markets. That being said, the asset class is not immune to defaults and while defaults happen, they are rare and recovery rates are high. Currency devaluations may also occur and a recent example of this was in Ghana in 2022 when the Cedi depreciated by 55% due to domestic and external challenges.

**Figure 8. Impact of defaults**

	Average Default Rate	Average Recovery Rate
<b>Frontier Market Debt</b>	3.6%	38%
<b>Emerging Market Debt</b>	1.7%	42%
<b>US High Yield</b>	3.4%	41%

Source: Bloomberg, Global Evolution, Mercer calculations. Averages since 2001 to 2022. US HY recoveries exclude Russia in 2022

**Figure 9. Historic Defaults in Frontier Markets**



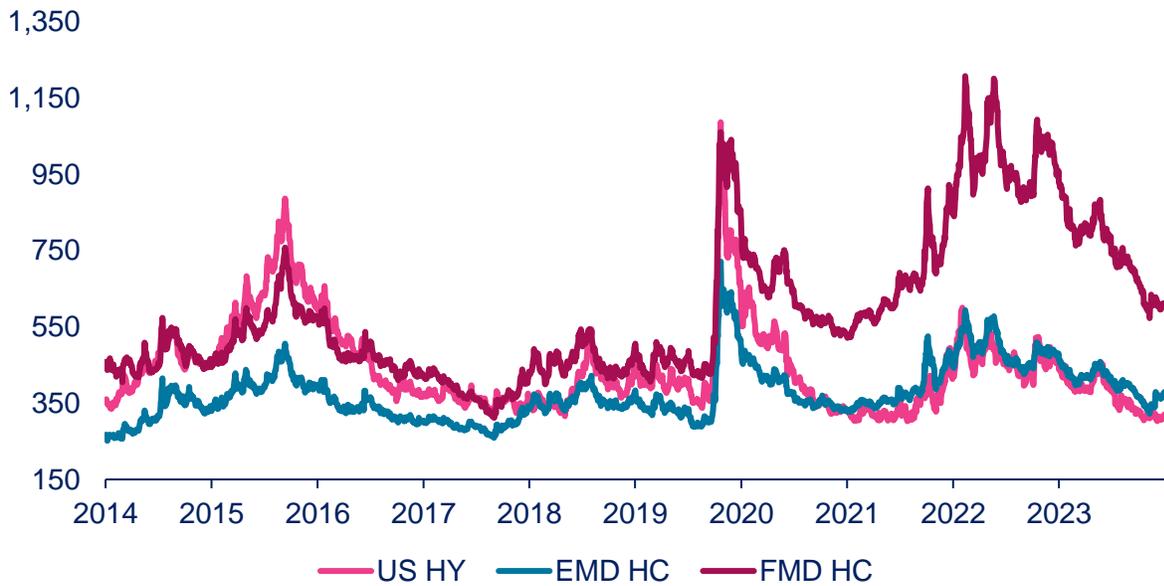
Source: Global Evolution analysis, Mercer. December 2023

Defaults have picked up in the universe since Covid, largely due to the impact of the pandemic on frontier economies. However, this was a one-off global phenomenon where the world ground to a halt. Since then, global trade has resumed and default rates in the frontier universe are expected to converge back to pre-covid levels.

Spreads on hard currency frontier market debt are wide compared to history as well as compared to broader hard currency emerging market debt and developed markets high yield corporates. US high yield corporate spreads are at their 5<sup>th</sup> percentile (meaning 95% of the time spreads were higher than current levels) while broad hard currency emerging market debt spreads are at the 56<sup>th</sup> percentile and hard currency frontier market spreads are at their 66<sup>th</sup> percentile.

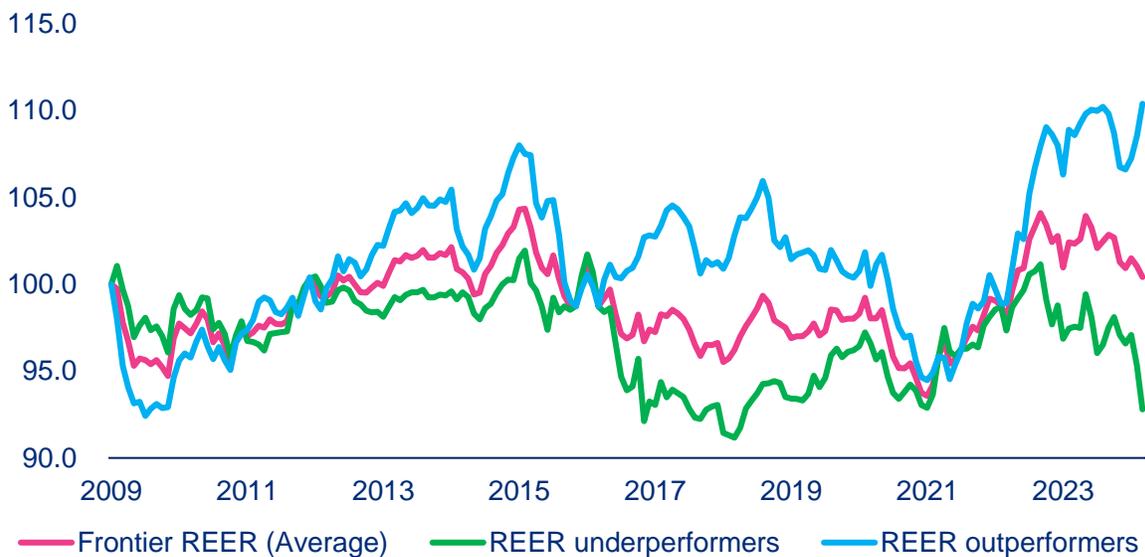
Another source of return for local currency investors is via appreciation in the currency. Today, from a cyclical perspective, the REER in several frontier markets is exceptionally low and investors should expect returns to be boosted as the REERs in these economies normalise back towards average. Positive structural changes to external accounts may further support improvement in REERs. Yields on local currencies also offer some protection against devaluation and in practice we do not expect to capture the full yield given the cushion that is built in. Ultimately the attractive carry is not dependant on currencies having to appreciate over the short to medium term. As long as currencies remain stable investors are able to collect on the differential.

**Figure 10. Spreads over treasuries (bps)**



Source: Bloomberg. Ninety One calculation. Mercer. Dotted line represents the average over the period.

**Figure 11. Frontier Real Effective Exchange Rates**



Source: Bloomberg. Average is constructed using 21 liquid frontier market REERs. Ninety One calculation. Mercer

In summary, valuations look cheap as investors have been attracted by rising government bond yields, leading to some frontier countries trading at distressed levels while their fundamentals remain solid. The broad universe offers an attractive premium when considering that there were no defaults in 2023 and no major defaults are expected in 2024.

# Historical Data Analysis

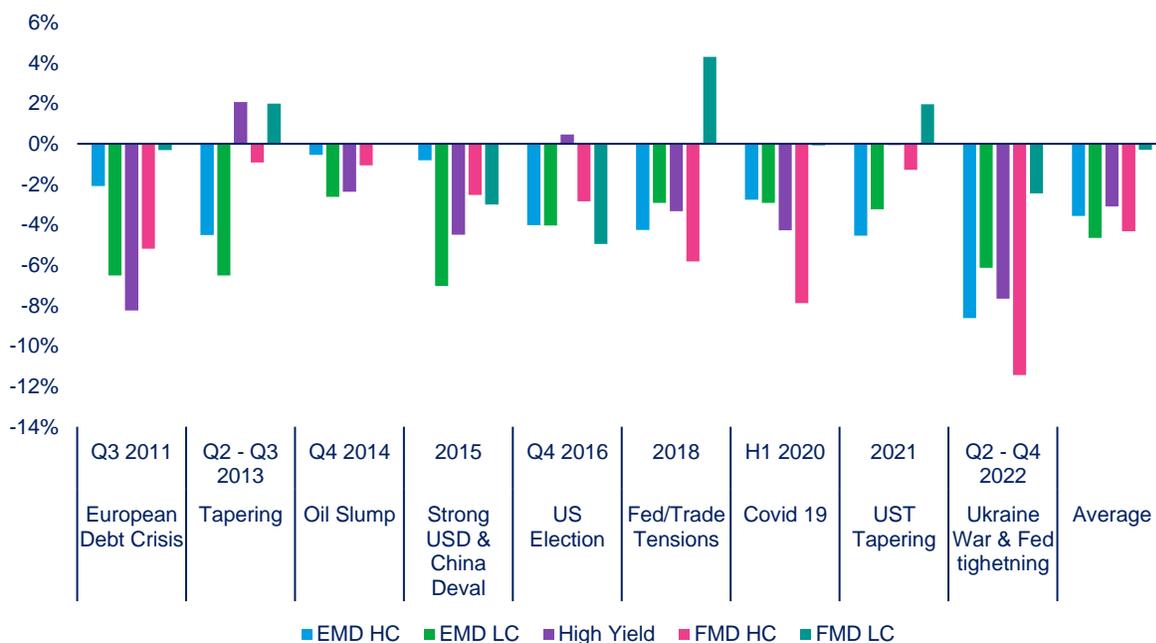
Frontier market debt has the ability to offer higher return potential over the long term compared to other risk assets. While doing so with improved risk/reward due to the idiosyncratic risk profile of the asset class. However, there is considerable risk involved with investing in frontier economies. Some is across the asset class such as political risk as well as currency risk for local currency investors and other risks come from idiosyncratic nature of individual countries which is heightened by a concentrated portfolio.

**Figure 12. Risk and return characteristics**

	Return (pa)	Volatility (pa)	Sharpe
<b>FMD Hard Currency</b>	6.8%	13.9%	0.35
<b>FMD Local Currency</b>	3.5%	3.9%	0.39
<b>EMD Hard Currency</b>	5.0%	9.2%	0.33
<b>EMD Local Currency</b>	3.6%	8.3%	0.19
<b>Global High Yield</b>	6.1%	10.2%	0.41
<b>Global Aggregate</b>	2.1%	6.1%	0.03

Source: Thomsons Reuters Datastream, JP Morgan, NinetyOne, Mercer Calculations from Jan 2006 to May 2024. FMD LC is portfolio of 24 equal weighted frontier local markets.

**Figure 13. Drawdown Analysis**



Source: Thomsons Reuters Datastream, JP Morgan, NinetyOne, Global Evolution. Mercer Calculations from 2006 to 2023. FMD LC is portfolio of 24 equal weighted frontier local markets.

Figure 14. Correlation analysis

	EMD HC	EMD LC	High Yield	Global Agg	MSCI EM	MSCI ACWI	Small Cap	FMD HC	FMD LC
EMD HC	1.00	0.74	0.83	0.69	0.71	0.70	0.67	0.89	0.36
EMD LC		1.00	0.67	0.68	0.80	0.69	0.62	0.60	0.52
High Yield			1.00	0.53	0.80	0.83	0.83	0.85	0.33
Global Agg				1.00	0.51	0.48	0.42	0.46	0.43
MSCI EM					1.00	0.87	0.81	0.71	0.43
MSCI ACWI						1.00	0.95	0.70	0.34
Small Cap							1.00	0.68	0.26
FMD HC								1.00	0.31
FMD LC									1.00

### Local Currency Regional Correlation

	Africa	Asia	Latin America
Africa	1.00	0.22	-0.03
Asia		1.00	0.19
Latin America			1.00

### Hard Currency Regional Correlation

	Africa	Asia	Middle East	Latin America	Europe
Africa	1.00	0.75	0.75	0.66	0.64
Asia		1.00	0.60	0.61	0.57
Middle East			1.00	0.74	0.68
Latin America				1.00	0.69
Europe					1.00

Source: Thomsons Reuters Datastream, JP Morgan, NinetyOne, Mercer Calculations from 2006 to 2023. Local currency is portfolio of 24 equal weighted frontier local markets.

Frontier markets are less well integrated into the global financial system and so offer a true diversifier to a portfolio. Adding frontier market debt can help improve portfolio efficiency when added to a broad portfolio of developed market equities and bonds. Diversification matters most in periods of drawdown to help protect a portfolio. Local currency markets have shown to be a true diversifier in periods of drawdown as on average they have fallen a mere 0.3% over key market drawdowns over the last decade.

Moreover, investors can potentially benefit from the breadth of geographical exposure in the frontier market debt universe. The average pairwise correlation across the various countries in the local market universe is 0.10 which highlights that while frontier market debt is not correlated to broad markets, it is also lowly correlated within itself.

## Key risks

**Political and Economic Instability:** Frontier countries often face a higher degree of political and economic instability than more emerging and developed countries. This can include unstable governments, corruption, frequent regulatory changes, and conflicts. Political risks can lead to unpredictable economic environments, characterized by high inflation, currency volatility, and inconsistent growth trajectories.

**Liquidity Risk:** Frontier market investments typically exhibit lower levels of liquidity compared to those in developed markets due to the smaller size of the market. This reduced liquidity can lead to challenges in buying or selling large positions without affecting market prices. However, the liquidity has improved over the last decade and should continue to improve as investors discover the asset class.

**Currency Risk:** Investing in frontier markets local currency bonds involves exposure to local currency fluctuations, which can significantly impact investment returns. For foreign investors, the devaluation of the local currency against their home currency can erode investment gains or exacerbate losses. Additionally, the inability to repatriate capital due to local foreign exchange (FX) markets being closed should also be considered. Currency risk in frontier markets is often heightened due to less stable economic conditions and less effective monetary policies.

**Default Risk:** Countries can default; however, investors are well compensated by higher yields (wider spreads). In the event of default, recovery rates have also been reasonable in the past. There were no frontier market debt defaults in 2023 and no significant issuer is expected to default in 2024. Although investing in frontier markets has some unique risks given the nature of the asset class, the risk premiums on offer have historically sufficiently compensated investors.

**Implementation risk:** We see two avenues for investors to access this opportunity. It could be done via utilising broad emerging market debt allocations where managers allocate to frontier market debt off benchmark, or it could be implemented via allocating to specialist frontier market debt managers. We believe that investors with an unconstrained opportunity set should aim to implement via specialist managers, however, this should be done through a risk controlled, multi manager approach to avoid concentration risk.

## Conclusion

Frontier market debt presents a compelling investment case for investors seeking to idiosyncratic return drivers to their portfolio. These markets, characterized by higher yielding and often smaller economies with less mature capital markets, can offer attractive yields and have high economic growth potential. Despite the complex and nuanced nature of this market segment, frontier market debt bears resemblance to the early days of emerging market debt, where higher yields compensated for higher risks and attracted investors willing to navigate uncertainties for potentially higher returns. Just as in those early days, there is a wide spectrum of outcomes for investors and the key to success is picking the winners and avoiding the losers.

From a fundamental perspective, the growth potential in frontier markets is significant and is expected to outpace developed and emerging markets. Valuations seem attractive with yields close to 14% in local currency bonds and spreads over 600 basis points on hard currency bonds<sup>3</sup>. International markets are opening back up providing a supportive technical backdrop for the asset class. We think investors should take note.



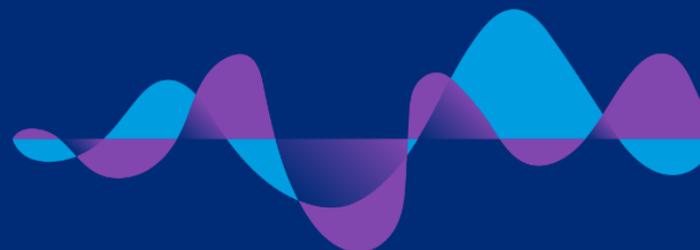
**Fahad Badar**  
**Senior Multi Asset Analyst**  
Global Economics and Dynamic Asset Allocation

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G-563815