Private investment: The tide that lifts all boats

Emerging Markets Outlook Q3 2021

Maritza Cabezas

Triodos Investment Management

The economic rebound has materialised in most emerging countries, but there is a lot of work to be done for the rebound to translate into a sustainable recovery, particularly in the poorer countries. The pandemic has caused significant damage and the resources and funding to rebuild better societies are under strain.

In the absence of global coordination, the impact of manufacturing bottlenecks in areas such as vaccine production and renewable energy will only be the tip of the iceberg, making the recovery more fragile. Governments, private investors, and multilateral agencies will have to work together to avoid that only certain parts of the world take part in the recovery.

From rebound to sustainable recovery

According to the International Labour Organisation, the scarring from pandemic has increased funding needs for sustainable development in emerging and developing countries by 30% (USD 1.2 trillion or on average 3.8% of their GDP). Low-income countries account for the largest share of this funding gap. And this is where most of the world population lives and where basic needs are the largest.

At the same time, the post-pandemic rebound led by China and the optimistic view of growth in advanced economies is lifting commodity prices. Although positive in terms of additional revenues for commodity exporters, risks of higher inflation are creeping up slowly in emerging and developing countries. And even if these are temporary pressures, higher food prices resulting from the mix of lockdowns and increasing demand for certain staples are already threatening food security, particularly in low-income countries. According to the World Food Programme, the prices of staples in West Africa are up 40% over a five-year average.

Triodos IM, as an impact investor is seeking opportunities to support emerging and developing countries in a sustainable recovery. By investing in renewable energy, agricultural and food-related projects, as well as in financial inclusion, often in high risk countries where businesses have little access to financial services, we are contributing with projects that will support the recovery. Investing in developing countries requires a higher risk appetite and risk awareness, and a strategy to support businesses in meeting international environmental, social and governance standards. In this quarterly we present some of the challenges impact investors face in this regard.

The first half year shifting for the better...

Global economic activity has been improving. Advanced economies are expanding at the strongest post-recession pace in 80 years. Countries with fiscal space have managed to give private consumption an impulse. Trade momentum remains strong and commodity exporting countries continue riding the wave of higher prices due to the rapid growth in demand, particularly from China and the US. Low-income countries are also benefitting from official support under the Debt Suspension Initiative, which has been extended until end-2021.

The Fed's reinforced commitment to keep interest rates low for some time continued stimulating capital flows to emerging markets. At the same time, sustainable investment in emerging markets has been increasing, as more stakeholders want to see their values reflected in their investments. Countries with access to capital markets have seen flows stabilise following the outflows in the first quarter. Emerging market credit spreads are in a downward trend since May 2021. Emerging market sovereigns have increased the issuance of green and social bonds. Chile has been the front runner, followed by Poland. Kenya and Ghana have indicated their intentions to do the same.

Inflation remained relatively contained in the first half of the year with a few exceptions. Central banks concerned about inflation have started to increase policy rates. Turkey, Brazil, and Russia were the first movers. However, central banks still grappling with the virus and witnessing inflation pressures, are postponing rate hikes. Currencies remain largely stable, except for a few cases including India, Peru, and Myanmar where currencies depreciated as uncertainty increased in the past months.

...but recovery still fragile

Where vaccine rollouts have been the slowest, the pickup in economic activity has been poor. In South Asia and Sub-Saharan Africa, the continuation and even worsening of COVID-19 have curbed business activity. In the second quarter of 2021, vaccine availability remained a large obstacle, partly as a result of the slow pace in redirecting excess supplies from advanced economies to developing countries. However, after reaching a critical mass in populations vaccinated, advanced economies have recently made concrete steps to improve access to vaccination to the rest of the world.

This will be helpful for the COVAX programme, responsible for vaccines for all since the major limitation for an urgent response have been shortages in supply. According to the World Health Organisation, more than half of the poorer countries receiving doses via the COVAX-programme do not have enough supplies to sustain their vaccination programmes. The speed of vaccination is also critical to stop the emergence of more contagious variants that may require new vaccines. Currently, only 3% of the population has been vaccinated under the COVAX programme because of supply constraints and the goal is to have 20% of the population vaccinated in 92 low-and medium income countries by the end of 2021.

Besides vaccine availability, it is also important to pay attention to the health of the economies going forward. This has to do with the quality of the recovery, taking into account the differences in fiscal (debt) and external positions (current account), as well as the inflation dynamics and what this means for the sustainability of the recovery.

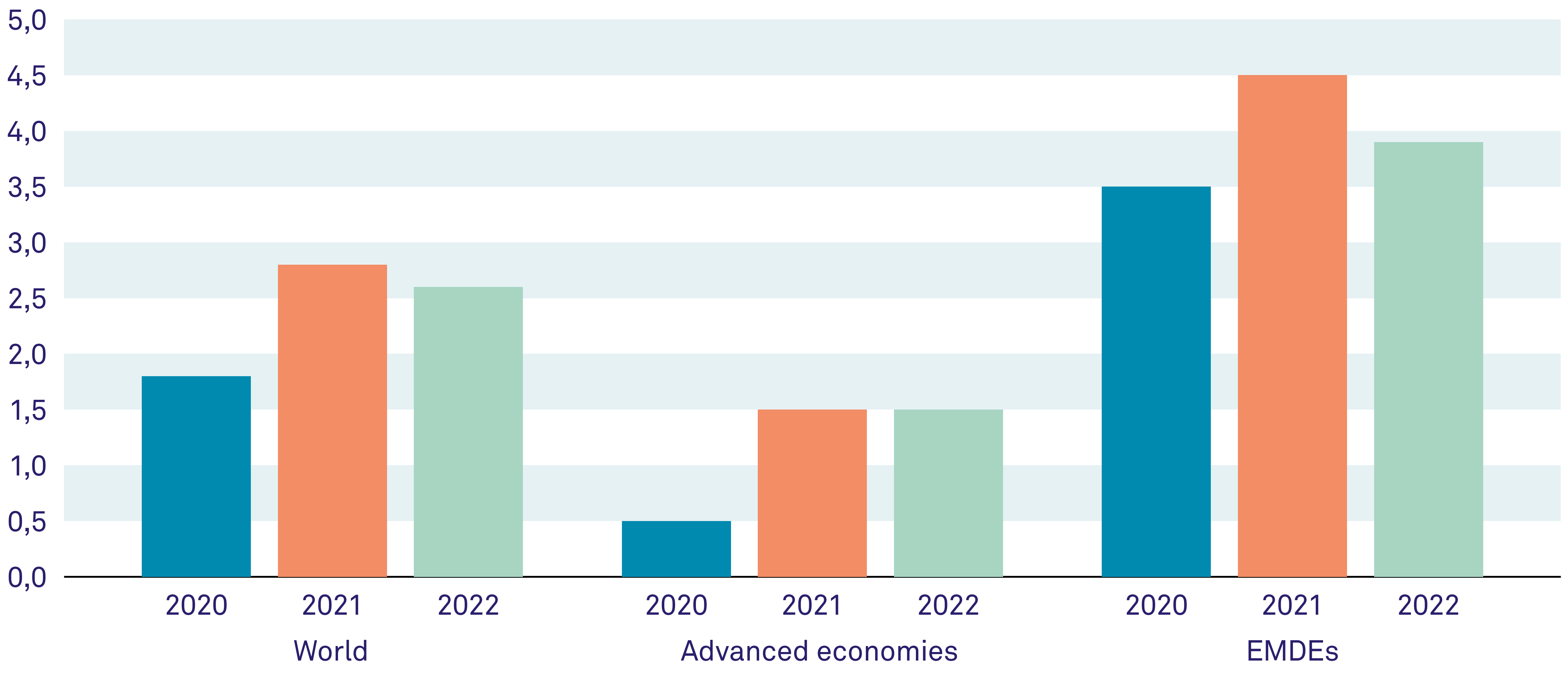
The near-term EM outlook: higher public debt and inflation ticking up

Given the costs and scarring of the pandemic it will take time for **fundamentals to improve**. However, delaying the improvement in debt and external accounts dynamics means that increasing debt service payments and upticks in inflation will be clouding the recovery. Brazil, Russia, India, China, and South Africa are expected to increase their median gross government debt to GDP, as a group, in the next couple of years from 77% in 2019 to 80% in 2022. The external picture for these countries will roughly remain the same as in 2019. Meanwhile, the declining inflation trend in emerging and developing countries in 2018-2019 has disappeared and inflation is expected to increase this year across the board. And although we see the rise in inflation as temporary, it is now particularly affecting populations with lower incomes.

Indeed, if vaccine availability is more widespread and mobility restrictions are lifted, inflation drivers should fade. Additionally, if food distribution is better coordinated, this will help reduce the pressure on food prices, particularly in countries that have not yet tamed the virus or where international prices have made importing food too expensive. Regions with a high dependency on food imports include sub-Saharan Africa and the Middle East and North Africa are experiencing the highest increases. Although countries in these regions were wrestling with food security already before the pandemic, the situation has deteriorated with the lockdowns, the supply chain disruptions and currency depreciations.

For now, inflation pressures are already limiting the maneuvering space for some central banks, as they are forced to increase interest rates to maintain their credibility in keeping inflation below their targets.

Figure 1 Inflation forecasts (in %)



Source: Consensus forecast June 2021 in 57 countries. 2020 is actual inflation rates

However, we expect most emerging market central banks to look beyond the food and energy shocks and maintain rates on hold, while monitoring the pace of their recoveries.

The long-term outlook: More private (foreign) investors needed for a sustainable recovery

For the rebound to materialise into a sustainable recovery, private (foreign) investment is more relevant than ever. The UN Sustainable Development Goals (SDGs; 17 goals agreed by world leaders in 2015) and climate targets will probably not be met if funding does not flow in a coordinated way into the right investments and if governments in the receiving countries do not improve their business environment to reduce risk premia and attract less costly capital.

According to the **World Bank**, between 119 and 124 million people were pushed into extreme poverty during the pandemic. Remote learning has remained out of reach for at least 500 million people. The drop-out rate in education in the developing world has been estimated by the United Nations at around 24 million students. The ILO has issued warnings of the loss of USD 3,7 trillion in income for global workers during the pandemic. This means that countries have fallen back on the SDGs and that additional financing is needed to avoid further delay.

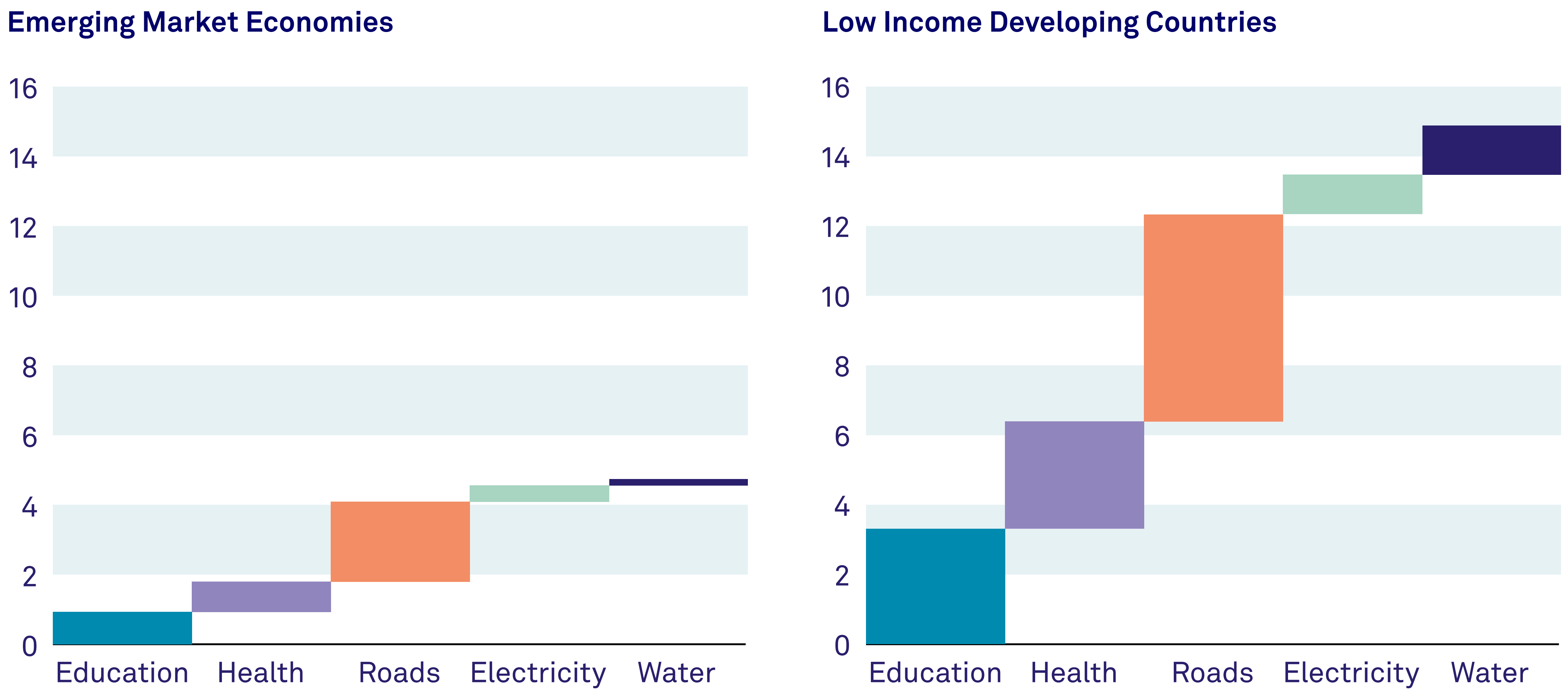
The IMF has estimated that since the pandemic, the public and private sectors together will on average have to spend some 15 percentage points of their own 2030 GDP to meet the SDGs in low-income countries (see graph). Multilateral organisations such as the IMF and World Bank have been helping to fill this gap and they have been speedy in providing emergency financing during the pandemic. Much of the funding has been channeled to health systems. But investment in other areas remains critical.

Private investment can make a significant contribution to economic growth and development. The **IMF has estimated** that in developing countries the private sector generates 90% of jobs and 60% of all investments and provides 80% of government revenues. It can also improve efficiency gains through competition and increase risk sharing between the private and public sectors.

In the past years, private investment in emerging and developing countries has been partly driven by significant monetary easing of major central banks, resulting in a tide of liquidity and the search for yield. Indeed, the gap between yields in emerging markets and advanced economies has made investing in emerging markets more attractive. This and the drive to diversify investments led to a surge of portfolio flows- defined as foreign purchases of equity and bonds. And although portfolio flows tend to be volatile, an improvement in the fundamentals of the receiving countries has made these flows somewhat stickier lately.

But the proof is in the pudding. In a low yield-low return environment in advanced economies, emerging markets became an attractive destination for investors. When central banks in advanced economies resume their path to interest rate normalisation, the resilience of investments, particularly portfolio flows will be tested. India is a good example of the vulnerability of emerging markets to volatile capital flows when the Fed announced the start of monetary tightening eight years ago. Since then India and other large emerging countries have built stronger reserves, which makes them less vulnerable to a sudden reversion of capital flows. Going forward, a country's fundamentals and long-term expected returns will only become more important. As said, fundamentals look in better shape now than in previous US tightening cycles, but there is a case for further improvement. We expect the Fed to start tapering in early 2022 and to begin the rate hike cycle by early 2023.

Figure 2 Additional spending requirement for meeting the SDGs by 2030 (percentage of 2030 GDP)



Source: IMF

Aligning private foreign investments with ESG goals

Foreign private investments in emerging and developing countries often require a high-risk appetite that not all investors have. But a higher risk appetite is now more common. In exchange for financing impact and change, as well as higher returns and diversification, the balance has been shifting towards more investments in emerging countries, particularly frontier countries. Evidence of this is the increasing participation of large asset managers, that choose to take part in strategic partnerships with developers in renewable energy in emerging markets. And specialised private equity competitors focused on impact in emerging markets are increasing in number and scope. This virtuous circle is a window of opportunity for partnerships to increase the scale and impact of investments in emerging and developing countries.

And so, gradually, the focus of investments and investor types are changing. Climate-related investments are getting more attention, while advanced economies headquartered investors have reported a significant increase. The European Investment Bank issued its first ever frontier local currency in the Georgian lari, responding to a surge in demand for higher yielding assets. Uzbekistan and Kazakhstan have become popular among investors and appetite for recently issued bonds has been strong.

But new trends involve a change in strategy across all investor types. China has been a prominent foreign investment partner in the league of the United States and France, particularly given its rapidly growing role in Africa. The gains that could be made in meeting international standards for sustainable investments from China are huge. But the road is still long and winding and there is room for improvement with China as leading investor and potential partner.

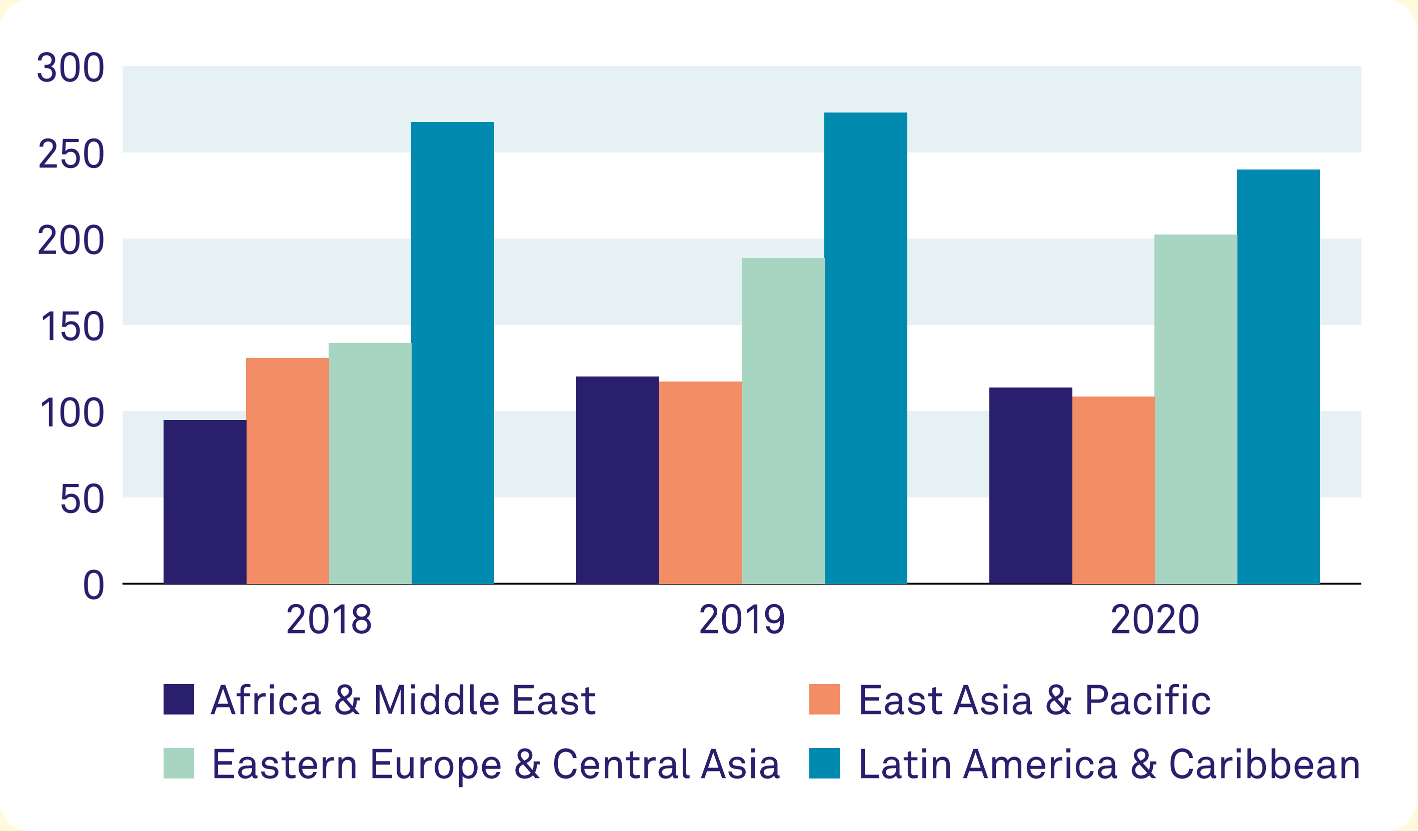
Investing in high risk countries

Countries in an early stage of the development process often have higher country risk profiles. But excluding these countries from funding would mean that they are being denied the capital they need to continue developing. This is where impact investing plays a huge role. It means giving people an opportunity to satisfy their basic needs, facilitating the transition to renewable energy and providing the means to end poverty. Undoubtedly, investing in these countries is challenging. As impact investors it is our role to be present in these countries and support the marginalised. Understanding the risks is therefore crucial to adopt the necessary mitigating actions. Appropriate due diligence, risk frameworks and the knowledge and experience of regional teams are critical to a well-managed investment process. A strategy, constant monitoring, training and impact measurement are complementary in making sure that the investment process meets the sustainability goals.

Triodos Investment Management has developed a country risk model that assesses 92 emerging and developing countries with a standardised framework. Besides the traditional macroeconomic risks, including weak current account and high public debts, ESG has been integrated in this risk assessment framework. A total of 50 indicators that influence the business environment are monitored. The environmental risk is measured by the physical and transition risks arising from climate change. Social risks include the risks of social protests, labour strikes and terrorism. Governance includes weak government effectiveness, regulatory quality, and corruption. The integration of ESG increases the awareness of some of the outside-in challenges faced by emerging markets and frontier countries. The framework also shows how these individual standards collaborate with one another. For instance, how improvements in governance measured by corruption trends, lead to less social protests and better environmental management.

From a risk management perspective, countries with stronger ESG propositions tend to be better stewards of the environment, proponents of stronger social contracts and better in providing education, health care and financial opportunities for the more marginalised, as well as guardians of the rule of law and contesters of corruption.

Figure 3 Triodos IM investments in emerging markets* (EUR million)



* Corresponds to investments from TMF, TFSF, HTF, TETEF, TFTEF and SFRE
Source: Triodos Investment Management

Figure 4 Country risk model

Data and forecasts › **Macro & ESG risks** › **Internal ratings** › **Interactive** › **Products**

Data and forecasts
- 92 EM countries
- 26 indicators including forecasts
- 25 strategic risks (composite indicators that include risks to business environment)

Macro & ESG risks
- Selection of risks critical for the business (outside-in perspective)
- Weighted according to TIM values & data quality

Internal ratings
- Consistent and comparable scores
- Clustered in six pillars with respective scores
- Allows alignment risk profile & risk appetite → funds

Interactive
- Tool allows comparison of regions, countries and scores
- Visualisation of indicators and trends

Products
- FRC approved and tenative scores for risk management
- Stress test & scenario analysis
- Probability of default (PD) & Loss given default (LGD)

The case for green investments

Emerging and developing economies currently account for two thirds of the world's population, but only one-fifth of global investment in clean energy. On a per capita basis, energy consumption in these countries is generally low, but expanding economies and rising incomes offer an opportunity. The falling costs of key clean energy technologies are also a positive incentive in terms of the accessibility for lower income households. At the same time, the shift in consumer and investor demand from fossil to renewable energy sources is now a reality.

Governments in fossil producing countries will be hesitant to lose oil-related revenues. Therefore, alternative investments to maintain the growth potential are necessary. In this sense, making capital available to emerging and developing countries in the field of renewable energy has some urgency. If the opportunity is not taken, and the energy transition falters in these countries, this will become the major fault line in global efforts to address climate change and to reach sustainable development goals. According to the **IEA, World Bank and World Economic Forum**, investments in clean energy in emerging markets are still modest and in 2020 even dropped by 8% to USD 150 billion.

Although addressing **climate change through investments** is getting more attention, the capital needed remains subdued. This is in part because many governments in emerging and developing countries continue in crisis mode. Shifting from high-carbon choices that economies have pursued in the past will require strong engagement with national governments and society. Countries will have to move fast to improve regulation and provide clearer policies for renewable investments. And investors will have to be mindful of the benefits of coordinated and unified efforts for financing renewable energy and other far reaching projects, including financial inclusion. **Triodos IM has success stories to share** and they will need to multiply if we want a better planet.

Main indicators forecasts

	GDP growth (% yoy)			**Inflation** (CPI, % yoy avg)			**Government debt/GDP** (%)			**Government balance/GDP** (%)		
	2019	2020	2021 forecast	2019	2020	2021 forecast	2019	2020	2021 forecast	2019	2020	2021 forecast
Argentina	-2.1	-9.9	3.1	52.8	40.5	46.0	99.6	81.3	79.2	-3.7	-8.4	-8.4
Brazil	1.4	-4.4	5.0	3.7	3.2	6.6	90.1	92.6	91.6	-5.9	-13.8	-7.4
Chile	0.9	-6.0	8.6	2.6	3.0	3.5	19.8	19.1	17.7	-2.8	-7.3	-6.4
China (mainland)	6.0	2.3	8.5	2.9	2.5	2.0	20.4	21.0	21.9	-4.9	-6.2	-4.1
Colombia	3.3	-6.8	7.1	3.5	2.5	3.5	57.5	50.3	46.4	-1.9	-7.5	-8.0
Hungary	4.6	-5.1	6.0	3.4	3.4	4.5	78.8	80.4	73.2	-2.0	-7.7	-7.9
India	4.1	-7.4	7.7	3.7	6.6	5.6	50.8	55.7	57.8	-4.2	-6.5	-7.5
Indonesia	5.0	-2.0	4.0	2.8	2.0	2.1	39.9	44.7	47.6	-2.2	-6.1	-5.9
Malaysia	4.4	-5.7	-1.4	0.7	-1.1	2.0	63.2	64.8	65.5	-3.5	-3.8	-6.4
Mexico	-0.2	-8.5	5.8	3.6	3.4	4.9	40.8	37.9	37.6	-1.7	-2.8	-2.3
Peru	2.2	-11.1	8.7	2.1	1.8	2.7	34.0	36.8	36.9	-1.4	-7.7	-5.7
Philippines	6.1	-9.4	5.9	2.5	2.6	4.0	54.6	52.7	53.0	-3.3	-7.5	-7.8
Poland	4.7	-2.7	4.5	2.1	3.7	4.2	58.5	61.1	60.3	-0.6	-6.9	-6.1
Russia	2.0	-2.9	3.4	4.5	3.4	5.6	16.5	17.0	18.7	2.1	-4.0	-1.4
South Africa	0.2	-7.0	4.6	4.1	3.3	4.3	76.0	72.6	74.4	-4.5	-9.9	-8.3
South Korea	2.2	-0.8	3.8	0.4	0.5	1.3	51.0	50.0	51.3	-0.5	-3.6	-0.3
Taiwan	3.0	3.1	5.8	0.6	-0.2	1.7	28.0	26.4	26.1	0.4	-0.4	0.1
Thailand	2.3	-6.2	2.1	0.7	-0.8	1.3	44.9	45.5	44.7	-1.9	-5.9	-5.3
Turkey	1.0	1.6	5.3	15.2	12.3	15.7	36.1	45.1	43.1	-2.9	-3.6	-4.4

Note: 2020 includes forecasts for some countries

Source: IMF and IHS

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With over 25 years of experience as a globally active impact investor, and as a wholly owned subsidiary of Triodos Bank, Triodos Investment Management has developed deep sector-specific insights across Energy & Climate, Inclusive Finance, Sustainable Food & Agriculture, and Impact Equities and Bonds. Offering impact solutions through private equity, debt, and listed equities and bonds, our assets under management amounted to EUR 4.9 billion as per 30 June 2020.

Investing in positive change

For more information about our impact investment strategies, please contact our Investor Relations team at:

+31 (0)30 694 2400
TriodosIM@triodos.com
www.triodos-im.com/impact-equities-and-bonds

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Maritza Cabezas
Triodos Investment Management

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Via Bertha, Utrecht

Cover photo
Kyle Glenn

Triodos Investment Management