Investment Perspectives

Winter 2021

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Welcome

Welcome to our 2021 Winter edition of Investment Perspectives

Traditionally, in our Winter edition of Investment Perspectives, we reflect on the highs and lows of the previous year and provide some expectations for the year ahead. 2020 is a year that will become synonymous with the global pandemic and therefore it's difficult to fully reflect and move on while we continue to be impacted by it.

This has not been the case for markets, which looked past the current disruption and touched new heights at the turn of the year. The vaccine has been an elixir for asset prices long before it began to be administered to the general population. However, if we were to focus exclusively on these market levels (without any knowledge of what has happened to global economic growth), we might believe that the global pandemic had actually had a positive impact on the global economy in 2020. However, we would argue this only highlights the growing disconnect between the two and nowhere is the comparison starker than in equity markets.

Perhaps we can take some comfort then, that historically equity markets are considered a leading indicator and therefore we can be cautiously optimistic that economic activity (and everyday life) will recover in 2021. Chris Arcari explores this in more detail in his capital markets outlook covering global economic activity and we also explore some broader investment themes in the following articles:

- Andy Green discusses the possibility of UK interest rates falling below zero and some of the practical considerations and implications for assets and liabilities of negative interest rates;
- Asad Rashid digs into the changing composition of emerging market equities and discusses the five things every emerging market equity investor needs to know; and
- Sticking with emerging markets, Penny Cochrane explores emerging market debt and provides her views on the case for a strategic allocation.

Best wishes all for 2021.

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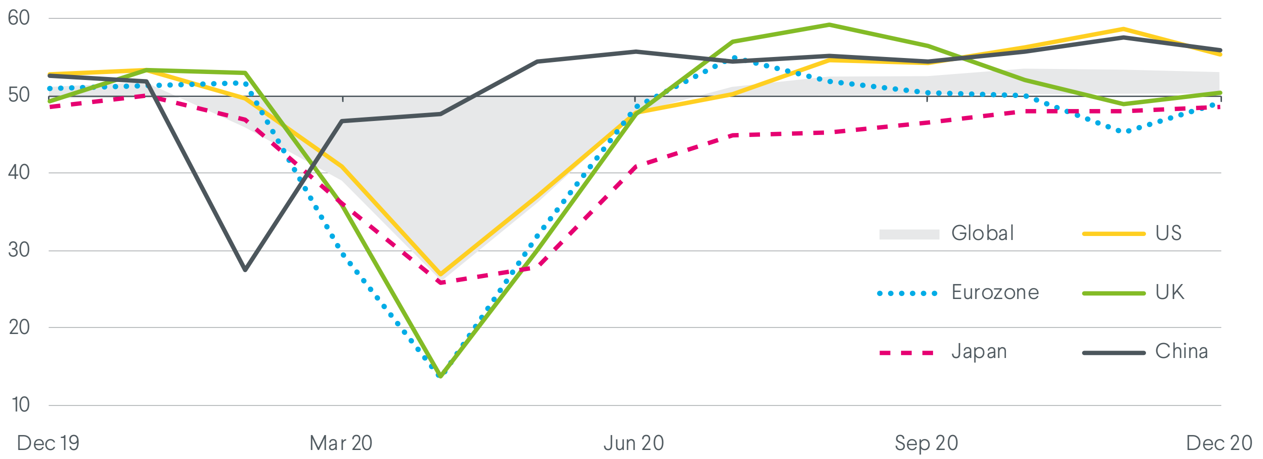
Capital markets update

Released: January 2021

Announcements of effective vaccines allowed companies and markets to put near-term economic weakness in the context of a potential end to the pandemic in 2021. Global equity markets, oil and industrial metals prices rose in concert with US treasury yields in the fourth quarter.

Despite Q3 GDP releases showing a sharp initial rebound in economic activity, output remains well below end-2019 levels in most economies. Furthermore, the global economy is set to end 2020 on a weak note after many countries, particularly in Europe and the US, re-imposed restrictions to reduce COVID-19 infections. However, PMI surveys provide little evidence of a slowdown at a global level (Chart 1).

Chart 1: Composite PMIs



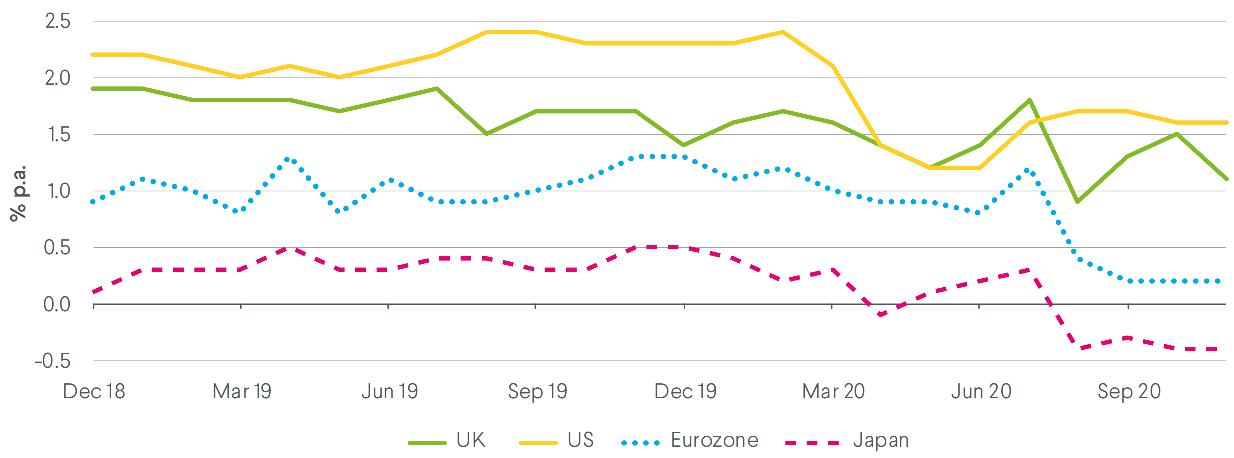
Source: Bloomberg

Eurozone and UK composite PMIs have eased since the summer, but the global equivalent remains at a level signalling expansion, supported by solid readings in the US, China and elsewhere. Even in the Eurozone and UK, both manufacturing and services have held up far better than during initial lockdowns in spring. Once again, subject to looser restrictions and facing a stronger external environment, manufacturing has been far more resilient than services, remaining at a level typically consistent with strong expansion.

Consensus forecasts a 4.2% fall in 2020 global GDP followed by a 4.8% expansion in 2021, though output in the major advanced economies is not expected to reach pre-pandemic levels until at least 2022. While vaccine developments have not altered the average projection (most forecasts already assumed social distancing would continue in to 2021 but fade over time as vaccine coverage expanded and therapies improved), we believe the risks to the outlook are now more balanced. Though cases continue to rise at a global level, it appears increasingly likely that many advanced economies could vaccinate a large proportion of their most vulnerable citizens early this year, potentially paving the way for a more permanent relaxation of restrictions.

Sterling was volatile in the fourth quarter as Brexit talks approached their conclusion. It ended the period 1.5% higher in trade-weighted terms as the EU and UK reached a trade deal enabling tariff- and quota-free movement of goods. In trade-weighted terms, the US dollar and Japanese Yen, both typically considered safe-haven currencies, fell 4.3% and 1.2% respectively, below end-September levels as economic sentiment improved.

Chart 2: Core CPI inflation



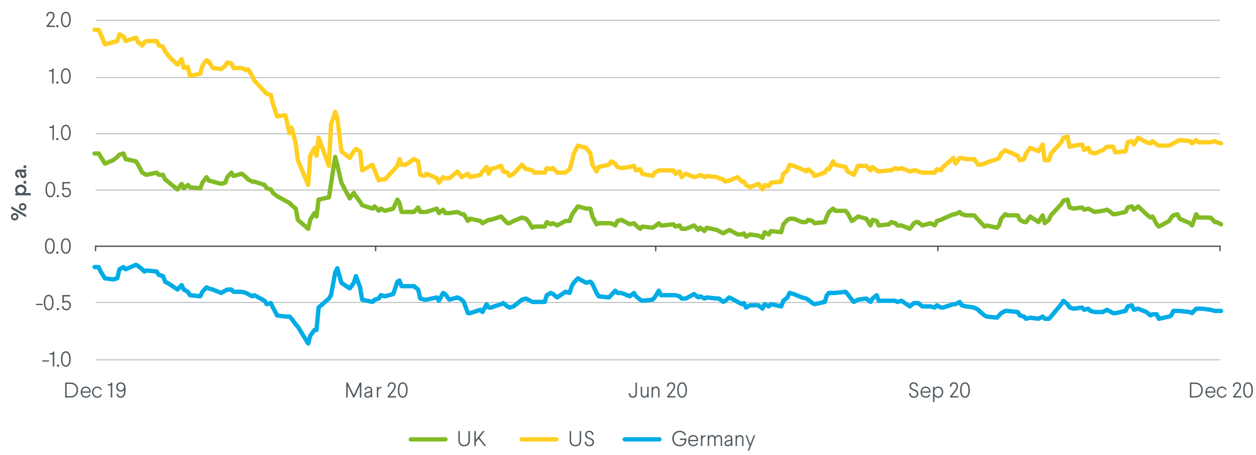
Source: Datastream

Some commentators fear the release of pent-up demand when the pandemic subsides could lead to a surge in inflation. However, most are more sanguine when GDP remains well below trend and unemployment is expected to rise. The consensus estimate is for a fall in inflation this year to be followed by a modest increase in 2021. While a sustained rise in inflation and the subsequent need to raise interest rates would represent a risk to economic recovery and asset prices, the resilience of supply during the pandemic, and a return to normality that will probably be gradual, suggest any inflation pressure will be limited and interest rates are likely to remain low for an extended period.

Government bonds

10-year US Treasury yields rose as the economy continued to recover in Q4, but UK and German equivalents were little changed as near-term economic weakness prompted their central banks to increase asset purchases. In the UK, Brexit disruption may moderate the economic rebound expected in 2021 and the Bank of England has been looking at the implications of further easing through negative interest rates. Against that backdrop, very low yields are vulnerable to a less favourable fundamental background as growth and inflation recover and less technical support, as monetary easing is replaced by short-term stability and longer-term tightening.

Chart 3: 10-year government bond yields



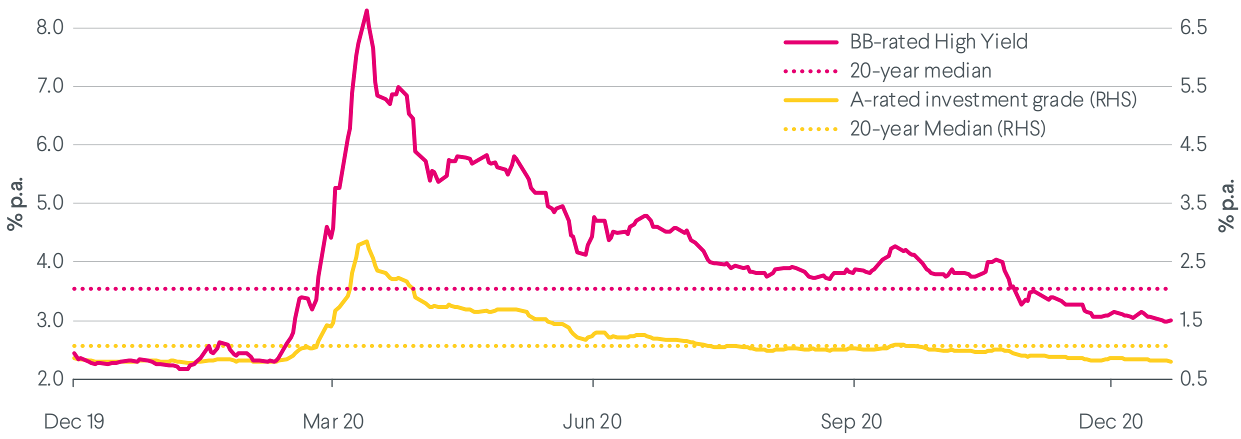
Source: Bloomberg

Despite the government's announcement that RPI will be aligned with CPIH (c.1% p.a. lower) in 2030, with no compensation for index-linked gilt holders, implied inflation actually rose at longer terms. This may suggest that markets had not only fully discounted the change but expected it might take effect earlier.

Credit

Unusually for a period of financial stress, companies have been able to raise huge amounts of debt to see them through near-term disruption. This increase in leverage, coupled with falling profits, has resulted in lower interest coverage, despite a significant decline in yields. Although default rates have risen – to 8.4% in the last 12 months to November[1] in the US high-yield market – the accommodative funding conditions have helped keep them well below the peaks of previous crises. However, it is likely defaults could remain elevated as companies lose government support.

Chart 4: Investment-grade corporate credit spreads



Source: Bloomberg

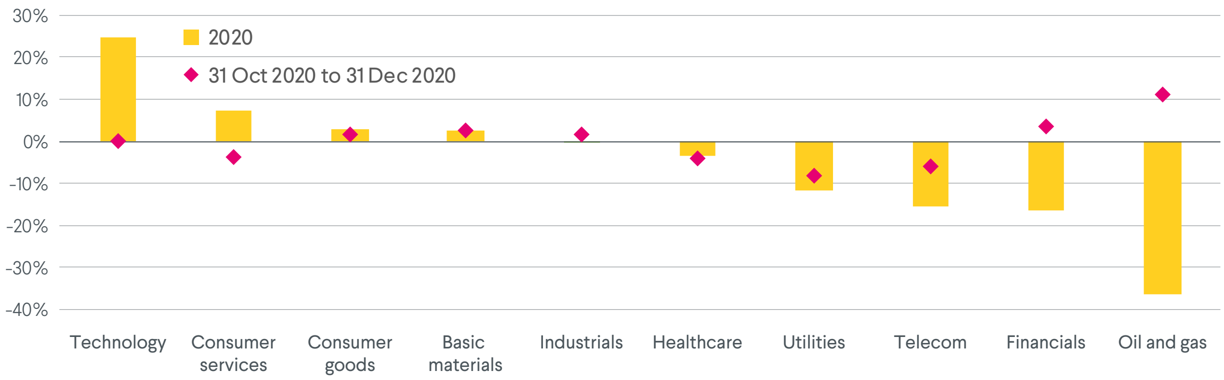
Nonetheless, global credit spreads have retraced much of the widening seen in Q1 and are now well below longer-term medians (Chart 4). Credit assets which have seen less direct policy support, such as asset-backed securities and leveraged loans, look to offer better value than similarly rated fixed-interest corporate bonds.

Equities

The pandemic-induced recession has been notable by its creation of winners and losers: "social distancing" stocks, mainly in the technology sector, have benefitted not only from their ability to grow earnings while most other stocks saw huge pressure on profits, but also from the decline in the discount rates used to ascribe a present value to their future earnings. Progress towards a vaccine has, to an extent, reversed this narrative since the start of November as cyclical sectors benefitted from improving economic sentiment (Chart 5).

1 Moody's Weekly Market Outlook issuer-weighted default rate.

Chart 5: FTSE ALL World Relative Total Return



Source: Datastream

Global equity valuations at, or near, record-high levels continue to mask stark divergences across sectors and regions. Cheaper valuations in regions such as Europe and the UK, with their higher-than-average cyclical exposures, may suggest there is further room for the value rotation to run.

However, while rises in government bond yields are limited and gradual, longer-duration growth sectors, such as technology, may well remain in favour in spite of high valuations. Vaccine rollouts should see significant pressure on COVID-19 laggards ease, but the disruption caused by the pandemic may accelerate longer-term trends. A rapid increase in technological adoption and efforts to de-carbonise the global economy would lend further fundamental support to the "winners" while weighing on old-economy cyclical sectors such as oil and gas.

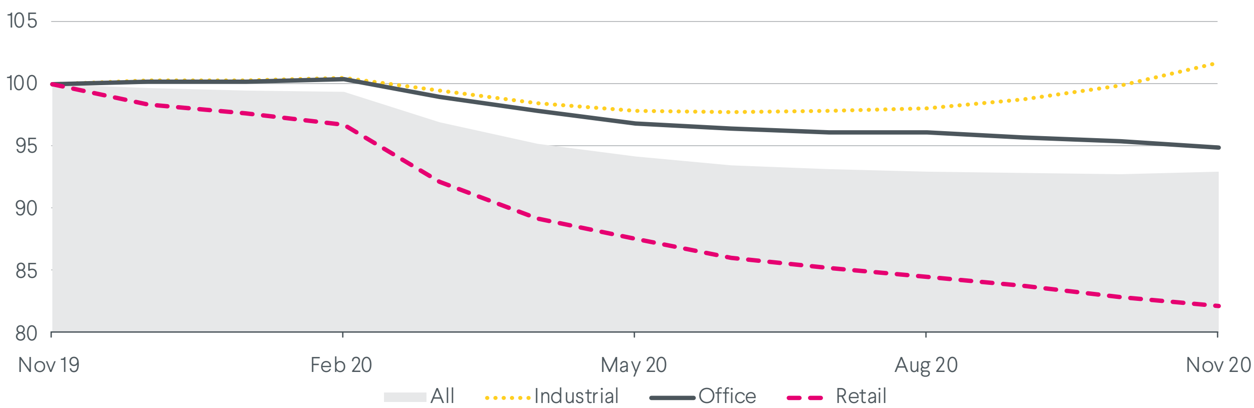
Partly as a result of this tension between current valuations and longer-term prospects, we currently have no strong regional, sectoral or stylistic preferences.

Property

The 12-month total return on the MSCI UK Property index was -1.9% to end-November, though monthly returns have been positive since July. Capital values, in aggregate, have fallen 7.1% in the year to November, predominantly due to a 17.9% fall in the retail sector (Chart 6). Retail capital values continue to fall month by month, and the decline in office values has accelerated in the last 3 months.
A recovery in industrial capital values, up 5.6% since July, highlights the continuing divergence between property sectors: the pandemic has accelerated the longer-term trend from in-store to online spending, increasing demand for logistics and warehousing facilities.

Aggregate rents have fallen 2.4% over the last year, although the month-on-month falls that have occurred since February have levelled off. Retail rents and (at a slower pace) office rents continue to fall, but annual rental growth in the industrial sector not only remains positive but rose in November. Rent collection remains a challenge for landlords; the issue was probably at its height in the initial lockdown earlier in the year, but the recent re-imposition of restrictions may limit the immediate improvement.

Chart 6: UK commercial property capital value index



Source: MSCI UK Monthly Property Index

Conclusion

Policy interventions have been instrumental in supporting economies, and vaccine developments have further boosted economic sentiment. The risks to the outlook are undoubtedly more balanced, but delays to the deployment of vaccines and the spread of COVID-19 in the intervening period remain downside risks.

Falling interest rates have supported valuations, but further monetary easing seems incompatible with the rebound in growth and earnings expected. As such, a repeated boost from large falls in interest rates looks unlikely in the years ahead and the low starting point for yields translates to a bleak outlook for government bonds. Given the compression of investment- and speculative-grade corporate bond spreads, investors may increasingly consider credit assets that have seen the least direct policy intervention, where valuations are less demanding.

Valuations in global equity markets look elevated even allowing for the likely economic rebound and earnings recovery.

A rotation into cyclical sectors is underway, but differentiation between an easing of shorter-term pressures and the acceleration of longer-term trends, both caused by COVID-19, may limit its persistence.

A balanced approach across regions, sectors and styles is preferred. The creation of winners and losers extends to property: the mix of what constitutes an optimal property portfolio will continue to change.

However, property in aggregate is likely to remain an important source of diversification and yield.

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Negative interest rates – implications and considerations

Released: November 2020

Here, we discuss the possibility of UK interest rates falling below zero and consider some of the practical considerations and implications for assets and liabilities of negative interest rates.

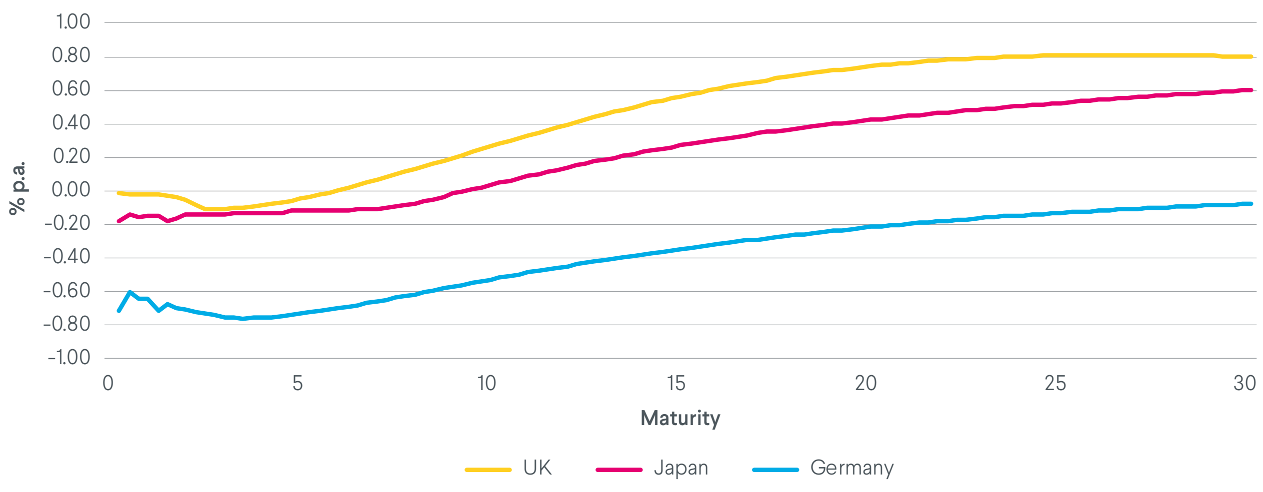
Background

With economies facing deep recessions from the economic shock caused by the COVID-19 pandemic, all measures to boost demand will likely be on the table, especially if fiscal policy was constrained by politics or the size of sovereign debt burdens. These measures include the potential for UK interest rates to go negative.

Negative interest rates were already in place in many developed economies well before the pandemic. The European Central Bank (ECB) was the first out of the traps when they lowered the deposit rate for commercial banks to -0.1% p.a. in June 2014.

Denmark, Japan, Sweden and Switzerland are countries that have all since taken policy rates negative. The ECB, Japan and Sweden deployed the policy with the aim of rekindling inflation expectations, while Denmark and Switzerland have used negative rates to halt currency appreciation and reverse massive capital inflows.

Chart 7: Nominal UK, German and Japanese government bond yield curves as at 30 September 2020



Source: ICE

The BoE cut interest rates to 0.1% p.a. in March 2020 and restarted purchases of government bonds under its Quantitative Easing (QE) programme. The tone has changed noticeably on the use of negative interest rates this year: initially described as something the Bank was not "planning or contemplating", negative interest rates are now under "active review". In fact, market expectations in November 2020 indicated that interest rates could fall into negative territory in Q3 2021.

Negative interest rates are not new

Over $15tn of nominal debt, globally, already trades with a negative yield. UK nominal gilt yields are already negative between 1 and 6 years, and in May 2020 the UK sold 3-year debt at a negative yield for the first time.

In addition, real yields have been negative in the UK for a long time.

Implications for value of assets and liabilities

The impact on assets and liabilities will, to a large extent, depend on how successful the market believes the policy will be in rekindling future growth and inflation. Based on the examples in Germany and Japan, it appears that cheap money is not enough; market participants need to have confidence in the stability of the economic environment.

If negative rates serve to entrench expectations of low growth and lead to lower long-term yields, the value placed on liabilities, including settlement costs, would increase. On top of this, increases or decreases in inflation expectations will also impact the value placed upon inflation-linked liabilities.

Based on the current situation in Germany, it is not impossible for the UK curve to shift below zero at all maturities. However, we also note that there is likely a limit on how much lower yields can fall.

All else equal and assuming a parallel shift in yield curves, negative interest rates should tend to raise all asset prices – a mathematical certainty for bonds, and in theory for other assets, as lower risk-free rates imply a higher present value of all future income. However, for credit, equity, and property – not risk-free assets – the context in which rates are being lowered will be important. If a reduction in risk-free rates is accompanied by expectations of increased defaults, a reduction in earnings or fall in rental growth, investors would demand a higher risk premium and therefore lower prices, offsetting the lower interest rates. Alternatively, lower interest rates may mean investors are willing to pay more for those assets if their view of the fundamental investment characteristics is unchanged.

Implications for hedging

The decision to hedge interest rates becomes more challenging as interest rates approach zero or become negative, especially if there may be a limit to how much lower long dated yields could go. We expect, although this cannot be for certain, that the potential for future falls in gilt yields and price appreciation may reduce as gilt yields fall towards zero. Put another way, the risks may appear more asymmetric as yields approach zero.

The asymmetry of nominal yields does not apply as readily to real yields. We already have materially negative real yields in the UK and there does not seem to be a natural lower bound to which real yields may gravitate, as long as inflation expectations are allowed to rise.

In addition to the strategic implications for hedging from negative interest rates, there are a number of practical operational considerations to be aware of.

Implications for cash and other debt assets

Money market funds

Given their short-term nature, money market funds would likely quickly experience lower, or even negative returns, especially after fees, following the introduction of negative policy rates. In anticipation of this, money market fund managers may have or be switching their fund classifications to Variable NAV (VNAV) as it may not be feasible to continue with a Constant NAV (CNAV) or low-volatility NAV (LVNAV) pricing approach in a negative interest rate environment. This does not imply a change to the underlying credit quality of the portfolio, although this is something to monitor.

VNAV funds use mark-to-market pricing, while CNAV and LVNAV funds use amortised accounting to value the underlying assets. This means that the former are more likely to experience short-term (e.g. daily) fluctuations in unit prices. This loss of capital preservation (albeit marginal) is worth noting where cash is held to meet known or potential commitments such as benefits, investment capital calls, fx or other derivative settlement or collateral calls.

Floating rate credit

The introduction of negative interest rates is not positive for floating-rate credit assets, but will not necessarily result in returns turning negative in the short-term. Floating-rate assets pay a coupon which is set in-line with a reference rate (LIBOR or SONIA) plus a credit spread. In addition to the spread potentially still providing an overall positive return, many euro and sterling denominated floating-rate credit assets (less so US) have floors to prevent returns from turning negative. In practice, even in the absence of floors, euro-denominated floating rate assets have tended to cease paying coupons rather than requiring payment from bond holders. European Residential Mortgage-Backed Securities and Collateralised Loan Obligations (CLOs) historically also include interest rates floors.

Implications for derivatives

Interest rate paid on cash collateral

Derivative positions may be collateralised using gilts or cash. Where cash is used as collateral the derivative documentation will govern the rates being paid on cash collateral. It is necessary to understand the extent of any mismatch between the cash rates that can be earned by investing the cash posted as collateral and the interest rate due on that collateral to the counterparty. Signing up to ISDA's negative interest rate protocol brings greater clarity that negative interest rates can be payable on cash posted as collateral.

Gilt repurchase or repos

Leverage of gilt positions is effectively achieved using gilt repos, i.e. borrowing cash to buy gilts, and the interest payable on that borrowing reflects the repo rate. As far as we are aware, there is generally no floor on the repo rate so it is possible for repo rates to become negative and in fact we have seen such repo rates going negative in Germany. This means that an investor borrowing to increase gilt exposure could be paid interest to borrow.

Interest rate swaps

Interest rate swaps involve one party paying/receiving a floating rate of interest (typically either LIBOR or SONIA) in return for receiving/paying a fixed rate of interest. Swap documentation should be reviewed to ensure there are no floors applying to the floating leg of a swap.

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Five things every emerging markets investor should know

Released: December 2020

Emerging markets is a term used to describe economies considered to be in a transitional phase from developing to developed economies. Apart from that one common characteristic, each of the underlying countries has its own currency, economic policy and a set of companies across different sectors which makes broad comparison across markets very difficult.

The MSCI Emerging Markets Index ("MSCI EM") is the most commonly used benchmark which solves this problem by bringing these countries and companies into a single index which adjusts for the transition from developing to developed economies over time.

This process of constant adjustment in the MSCI EM has recently resulted in one of the largest changes to the risk profile of the index since its launch. Our analysis of the two main changes (the growing weight to Chinese equities and the evolving sector composition of the index) indicates that emerging markets now offer a very different proposition to the investment opportunity in the last 10, 20 or 30 years. Based on the analysis, we have made five key observations that we believe are relevant for all investors.

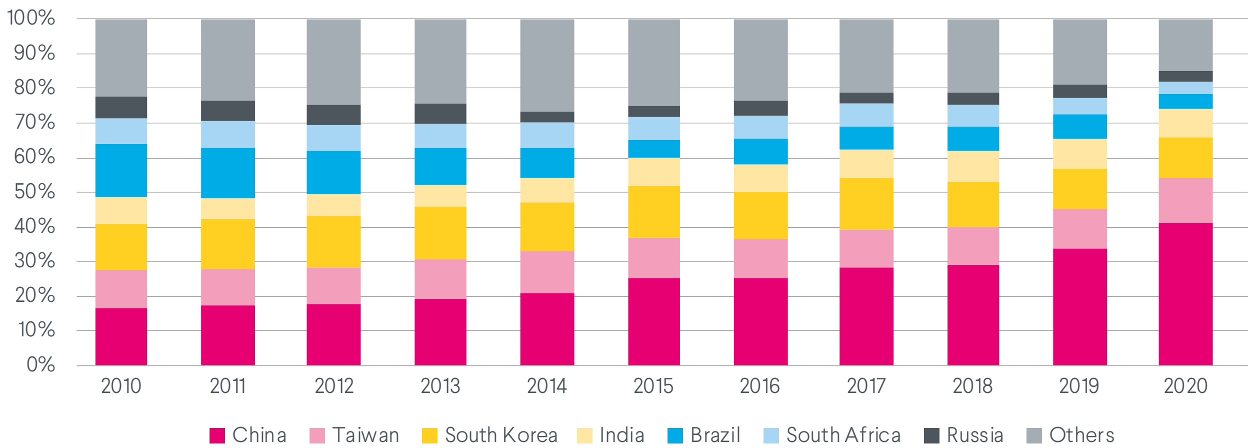
What's in an index?

The MSCI EM index has grown from 10 countries with an equity market capitalisation of $15 billion in 1988 to 26 countries with a $6.4 trillion equity market capitalisation in 2021[2].

The emerging market economies of the 1980s and 1990s were focussed on producing cheaply and selling abroad. Over time, these economies have evolved to focus more on growing internal consumption and leapfrogging the traditional path to becoming developed markets through the use of mature economic policies and technology.

This evolution has mostly been led by China, which was first included in the index in 1996 with a weight of c.0.5%. By 2010, that weighting had grown to c.14% and today stands at c.42% - making China the most heavily weighted country in the index[3].

Chart 8: The evolution of the MSCI EM Index to September 2020



Source: MSCI

2 MSCI / Acadian
3 MSCI

China and the A shares story

The increasing weight of China is understandable given it is now the world's second largest economy by GDP and the Shanghai, Shenzhen (the two mainland stock exchanges) and Hong Kong (the offshore stock exchange) markets combined are the world's second largest equity market.

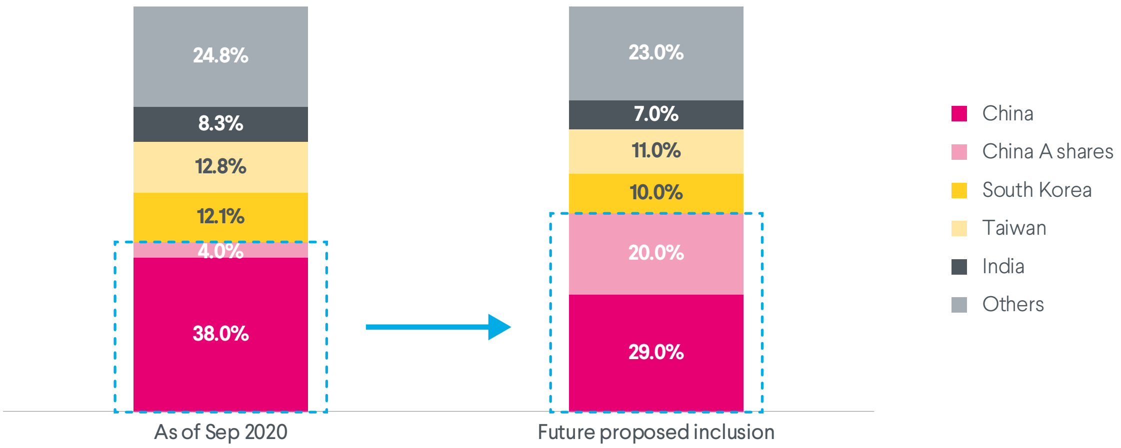
Interestingly, China's weight in the MSCI EM index is set to rise further as MSCI incorporates more China A shares into the index over the next few years[4].

China A shares are Renminbi-denominated (Chinese local currency) equity shares of China-based companies that trade on the Shanghai and Shenzhen Stock Exchanges. These shares provide access to companies that derive their earnings from China's domestic economy.

The Shenzhen Stock Exchange hosts more private companies (with nearly 50% in the information technology, consumer discretionary and healthcare sectors) while the Shanghai Stock Exchange is dominated by larger, state-owned companies in more traditional sectors such as financials and industrials.

The process of integrating these companies into the MSCI EM index was started in 2018 and now over 400 large and mid-cap A share companies comprise c.4% of the index[5]. While there are some technical issues to resolve (stock settlement periods, etc.) before more A shares are added, MSCI is expected to continue the inclusion process. Further inclusion could raise the weight of China A Shares from 4% of the MSCI EM today to 20% in the future, taking the total China weight in the index to nearly 50%.

Chart 9: China A share inclusion in the MSCI EM Index



Source: MSCI/Fidelity

As of 30 September 2020, China represents c.42% of the MSCI EM index and along with Taiwan (12.8%), South Korea (12.1%) and India (8.3%), these four markets represent c.75% of the index, with 22 other countries accounting for the remaining c.25%[6].

This is quite a change from the days when the BRICs (Brazil, Russia, India and China) were expected to become the largest emerging market economies and highlights that the index is now heavily dominated by Asian companies.

It also highlights that the country diversification of the MSCI EM is now more in line with the MSCI World Index (used to benchmark developed markets) which is heavily dominated by USA (67% of the index) and where three countries (USA, Japan and the UK) represent c.79% of the index. With both indices, our key observation is that the index is more likely to be impacted by country-specific factors in the largest constituents (China and USA respectively) than any of the other markets, reducing the country diversification benefits of investing in an index fund.

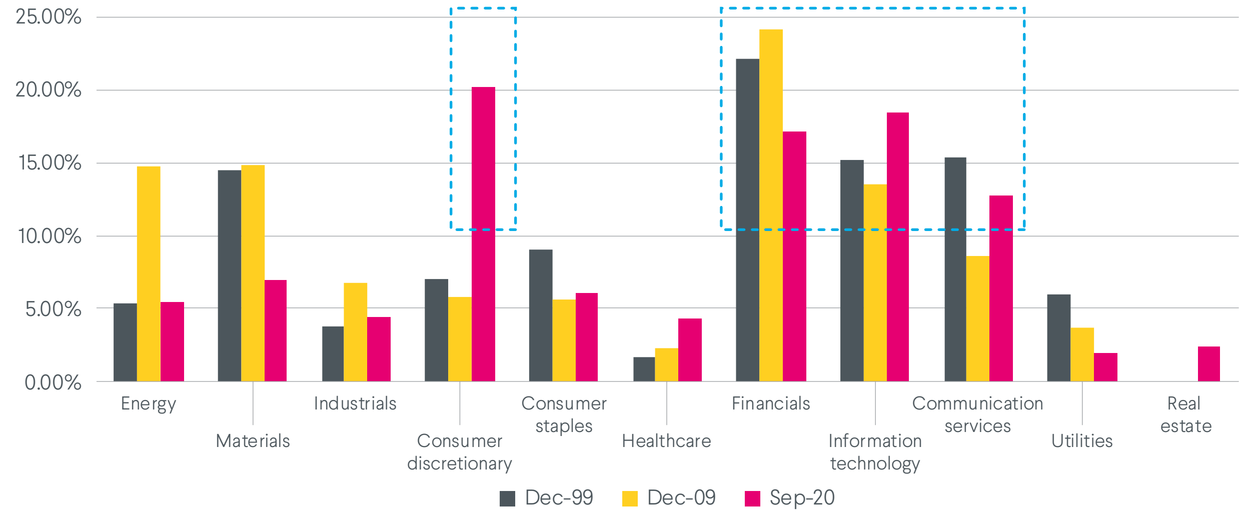
4 The initial inclusion of Chinese equities in 1996 consisted of B-shares (Domestically Listed Foreign Investment Shares) and in 2000, MSCI added Hong Kong-traded Chinese equities (Red Chips, H-shares). The process of integrating China A shares into the MSCI EM index was started in 2018.

5 MSCI

6 MSCI

How has the sector composition evolved over time?

Chart 10: MSCI EM Index sector weights over time



Source: MSCI/Fidelity

The emerging market economies of 30 years ago were a mixed collection of commodity exporters and low-cost manufacturers. As shown in the chart above, the MSCI EM index is now mostly comprised of companies in the Information Technology, consumer discretionary, financials and communication services sectors (combined weight of 67%), all of which are driven by domestic consumption or high value-add exports.

Conversely, the commodity or infrastructure-driven sectors such as the energy, materials, industrials and utilities sectors have become much less important drivers of performance.

What may come as a surprise is that several emerging market companies have seized the lead in innovation and are leapfrogging developed market companies in areas such as e-commerce, digital payments, social media platforms, renewable energy and electric vehicles.

Examples such as Alibaba (shopping and financial payments platform), TikTok (social media platform), Taiwan Semiconductor (global leader in integrated circuits), Samsung Electronics (electronics manufacturer) and Infosys (IT consulting) are but some of the names that showcase the global leadership of emerging market companies in 'new economy' sectors.

Emerging markets as a group have been filing more global patents than USA and Japan (two highly innovative economies) since 2005. China alone is home to many companies with global leadership in renewable energy production, 5G cellular network equipment and electric vehicles - technologies which are expected to form the bedrock of future societies.

We note that the technological expertise is not evenly split amongst emerging market countries, with information technology being the largest sector weight in Asia whereas financials and commodity driven sectors are more common in EMEA (Europe, Middle East and Africa) and South America. This partially explains the growing weight to Asia in the index, and the rapid growth of technology companies in Asia is only likely to increase the weight differential further.

Five things every emerging markets investor should know

The emerging markets of today offer a very different proposition to the investment opportunity in the last 10, 20 or 30 years. This leads us to make five key observations relevant to all investors:

1 Comparisons with the past are less meaningful

Given the changes to the index at both the country and sector level, evaluating historical index behaviour to guide expectations for the future has become less meaningful. In particular, the large correlation to the commodities cycle is no longer relevant given the reduced exposure to commodity and infrastructure driven sectors in the index. Furthermore, the largest countries in the MSCI EM index now run current account surpluses (e.g. China, South Korea and Taiwan), whereas in the 1980s and 1990s the largest countries generally ran deficits (e.g. Brazil, Malaysia, and Mexico).

This makes comparisons of currency volatility and reliance on foreign capital to grow (trends of the past) less meaningful.

2 The index is now more concentrated

Not only more concentrated in China, but also in the top 10 stocks. In 1998, the top 10 stocks accounted for c.16.7% of the index which has now risen to c.31%, despite the total number of stocks increasing from 958 in 1998 to 1151 today.

If the weight to China continues to rise with the incorporation of more China A shares, this could create a dilemma for some investors who either feel the asset class is no longer sufficiently diversified or those who may want to have greater control of their China exposure.

We are broadly comfortable with most investors maintaining the current allocation to emerging markets, noting that China's weight is still far below that of the equivalent weight to USA in the MSCI World Index. The alternative solution would be to opt for separate EM ex-China (or EM ex-Asia) and China (EM Asia) funds and set the weight to each allocation as desired. However, at the current time, this is a less practical solution as there are only a handful of managers who provide EM ex-China (or EM ex-Asia) equity funds.

3 Emerging market benchmarks are constantly evolving

Since the MSCI EM index was launched in 1988, there have been several reclassifications with some countries promoted to developed markets and others demoted to frontier markets.

We believe the recent evolution is a trend that is unlikely to reverse anytime soon given the faster growing demographics of Asian economies (such as China and India) and the shift from export-led to consumption-led growth.

While it is difficult to predict when China, Taiwan or South Korea (which is already classified as developed in FTSE Russell indices but not MSCI) may be promoted to the MSCI World index and which countries may replace them, the one certainty is that the investment exposures in the MSCI EM index will again change significantly at a future point in time when these promotions occur.

4 Broad generalisations about emerging markets fundamentals are inaccurate

This is not a surprise to us as few investors would group the economies of the USA, Japan and the UK (the three largest countries in the MSCI World Index) together for economic analysis. However, emerging markets have been commonly treated as a homogenous group in the past when commodity driven sectors had a larger weighting. We believe that due to the ongoing trend toward more domestically driven economies, economic fundamentals by country are becoming more dispersed, making broad generalisations about the asset class inaccurate.

5 Emerging market equities offer an attractive long-term investment

We believe an allocation to emerging market equities is attractive as a strategic long-term investment. Emerging markets, led by China, have demonstrated that they are an important engine of incremental global economic growth. The longer-term trends like urbanization and growing incomes, combined with the recent trends of global leadership in technology-led sectors, make the investment proposition more attractive than in the past.

We recognise that a one size fits all approach is not suited to emerging market allocations. We suggest that the size and investment management style (active or passive fund) decisions should take into account other factors such as current market valuations, political risk, currency risk, ESG risks, the timing of the allocation and how comfortable investors are with the growing weight to China.

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Emerging market debt: the case for strategic allocation

Released: January 2021

An investment in emerging market debt (EMD) provides access to debt issued by governments (and companies) in emerging economies.

The EMD universe can be broadly divided into three categories:

- **Local currency –** Sovereign and quasi-sovereign[7] government bonds issued in each country's own currency;
- **Hard currency –** Sovereign and quasi-sovereign bonds denominated in major international currencies, most commonly the US dollar; and,
- **Corporate debt –** Debt instruments issued by public and private sector corporate issuers issued in both hard and local currency.

Local currency

Local currency bonds are the largest component of the EMD universe. In general, emerging economies typically offer higher real interest rates than developed markets. This reflects a higher demand for capital, faster population growth, higher productivity growth and often higher central bank inflation targets and relative institutional weakness. The drivers of local currency returns are average yield, duration and currency appreciation or depreciation.

Hard currency

The EMD hard currency index comprises bonds, issued by EM countries, primarily denominated in US dollars. EM bonds denominated in US dollars typically offer a yield premium over US treasuries as compensation for taking additional credit risk. While there is no EM currency risk, there is a more explicit default risk as countries' revenues are in local currency. Therefore, the drivers of hard currency returns include default risk as well.

Corporate bonds

Corporate EMD has rapidly developed into a significant asset class, with 56 countries in the broad corporate index, the JP Morgan CEMBI BD. As EM economies become more integrated into global markets, liquidity continues to improve which may lend support to credit quality overall. Many EM corporates are global-sized players and the JP Morgan CEMBI BD is roughly 70% investment grade and 30% high yield.

As at the end of 2019, the overall EMD market was around $29.6 trillion, or 25% of the global fixed income universe. It is on track to grow, to reach $45 trillion by 2025, equating to approximately 29% of global fixed income, the vast majority of which sit outside the major benchmarks[8]. With such a large market, an allocation to EMD cannot be ignored and yet the vast majority of investors are materially underweight to the asset class. The global recovery expected over the next few years is set to be a positive for risk assets in general, and EMD in particular, is poised to perform well relative to other fixed income assets.

Yield differential

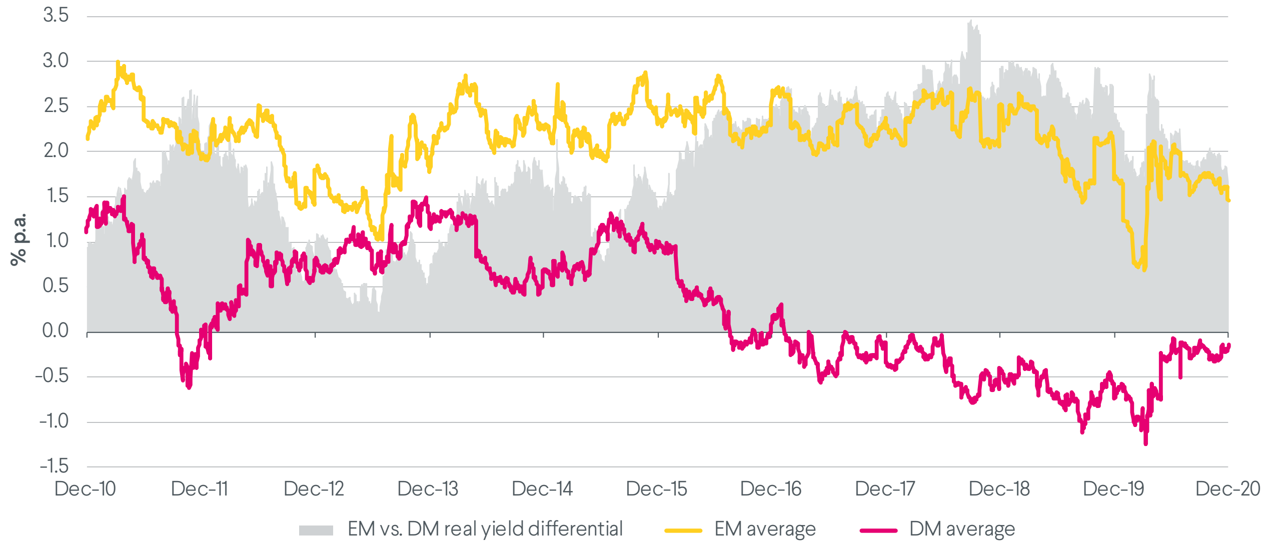
At present, nearly 90% of developed market government debt yields less than 1% p.a[9]. The average developed market 10-year real rate has been negative for the past four years, and the spread differential between emerging markets local currency rates and developed markets remains high (Chart 11).

7 A quasi-sovereign issuer is a company with 50% or more government ownership or control

8 Ashmore, The EM Fixed Income Universe Version 9.0, August 2020

9 Stone Harbor, EMD Outlook 2021

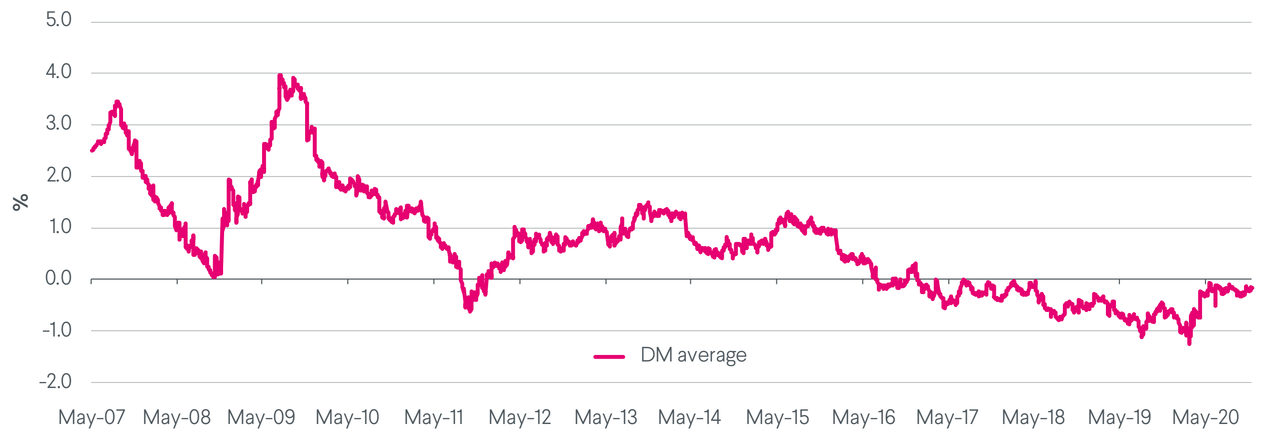
Chart 11: 10-year real rates for emerging market versus developed market government debt



Source: Bloomberg, Amundi

While nominal yields have also fallen in emerging markets, the fall in real yields has been limited by a fall in average EM inflation, which has been on a declining trend for many years (Chart 12). EM Central Banks are now largely independent and far more credible than in the past, and they are far more focused on controlling inflation with an average target of 3.5% p.a, not substantially higher than the 2% p.a target of the US. Many EM governments have also greatly improved their fiscal discipline.

Chart 12: GBI-EM Global Diversified Index Top 10 average countries' inflation change, year-on-year



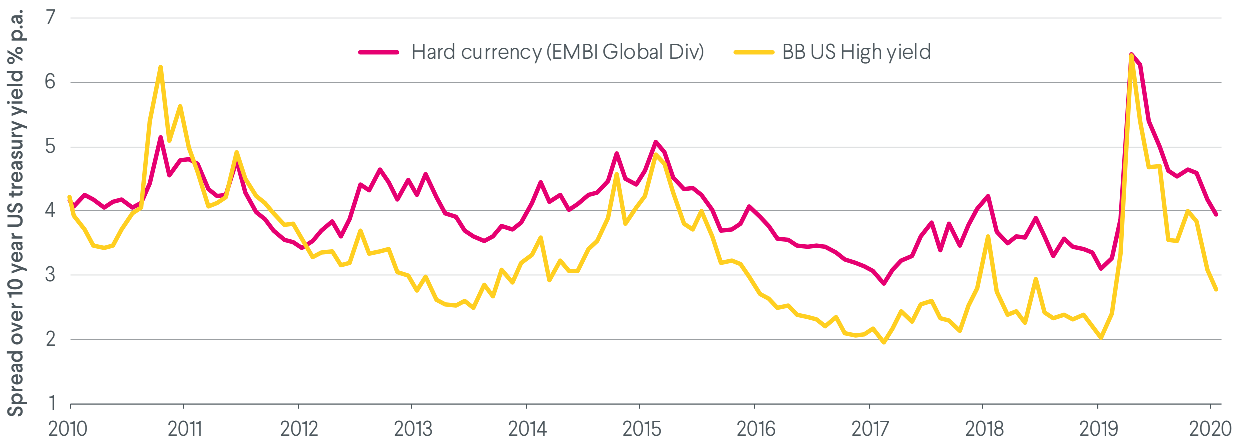
Source: Bloomberg

The selloff across risk assets in March 2020 was of a magnitude larger than the Global Financial Crisis and it happened much more quickly. EMD was no exception. However, the level of recovery in EMD, compared to the developed markets, has not kept pace. Within EMD hard currency, high yield issues experienced a more significant dislocation than investment grade.

Whereas investment grade spreads have mostly recovered, high yield spreads have lagged and the spread differential remains above average.

Relative to other fixed income assets, the EMD hard currency yield spread offers relative value versus developed market comparators. As of end December 2020, the main hard currency index, the JP Morgan EMBI Global Diversified, yielded a spread premium of 1.2% p.a. over the similarly rated US High BB index (Chart 13).

Chart 13: JPM EMBI versus BB US high yield spreads over US treasuries

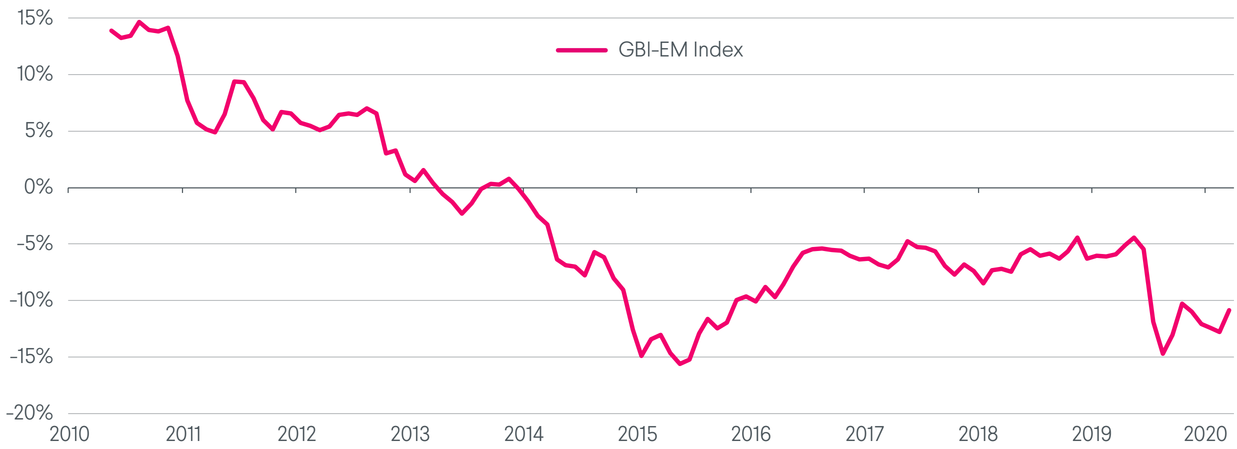


Source: Bloomberg

Currency and default risk

In addition to yields and spreads, currency appreciation or depreciation can significantly impact local currency EMD returns and the probability of default in hard currency markets. The nascent global economic recovery in the second half of 2020 led to US dollar weakness, as short-term safe haven appeal faded, and monetary and fiscal stimulus caused a deterioration in longer-term dollar fundamentals. Furthermore, following a decade-long rise in the US dollar, average real effective exchange rates suggest EM currencies, in aggregate, still look cheap versus the dollar (Chart 14). In addition to providing technical support, local currency appreciation versus the dollar leads to higher returns in dollar terms and is typically associated with stronger performance in the local currency-denominated emerging markets. In hard currency markets, a weaker dollar reduces the relative size of dollar-denominated debt burdens, reducing the probability of default.

Chart 14: GBI-EM Index real effective exchange rates relative to the 10-year average



Source: Bloomberg

Given the positive inflation differentials between emerging and developed markets, we would still expect longer-term nominal currency depreciation of emerging market currencies. However, there are a number of reasons to believe this depreciation may not be as marked as in the past and that current local currency yields provide a degree of compensation for this risk:

- Inflation differentials are much smaller than in the past: a 3.5% p.a. average emerging market central bank target versus 2% p.a. average target amongst developed market central banks. Indeed, the Fed's adoption of flexible average inflation targeting could lower this differential further in future;
- Higher productivity growth rates in emerging economies are supportive of longer-term real currency appreciation versus developed markets; and,
- The potential for reversion of emerging market currencies from their currently below average levels as noted above (Chart 14).

Of emerging market bonds, the vast majority (82%) are denominated in local currency, and there is typically concern over the level of volatility of emerging market currencies. Local currency exposure is often left unhedged for two main reasons: the cost of hedging and the expectation that there will be return from the FX exposure. However, EM currencies tend to have low levels of correlation to each other so a diversified FX exposure should be less volatile overall, and long-term investors should not be deterred by short-term FX volatility.

Conclusion

In addition to the shorter-term support the expected global economic recovery may provide, EMD may be considered an attractive strategic allocation for the following reasons:

- Structurally low real yields in developed markets will likely influence a rotation into EMD, an asset class where investors are typically underweight;
- Lower inflation than in the past means yields may offer more adequate compensation;
- Attractive EM fundamentals versus the developed markets; and
- A weaker dollar will influence investors to look to non-dollar assets that have potential to perform.

There are a few key risks to this scenario. If a global recovery does not occur as expected, likely due to further lockdowns, a slow vaccine rollout, or the vaccine proving less effective than anticipated, then this is a negative for risk assets as a whole, including EMD. In addition, a sharp increase in US yields and the dollar, like what was seen in the Taper Tantrum in 2013 over news that quantitative easing was decreasing, would represent an acute risk for EMD.

Aside from a source of meaningful return, EMD offers investors a broad diversification across a heterogeneous opportunity set. With EMD comprising one-quarter of the global bond universe, it is a strategic allocation that should not be ignored.

Given the current variables of the market, a blended active approach whereby managers have the flexibility to rotate across hard and local currency, government and corporate, to allocate to the best relative value is the approach to get the best value from such a diverse asset class.

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Market returns to 31 December 2020

	Yield % p.a.		Returns to 31 December 2020 (sterling, % p.a.)		
	30-Sep	31-Dec	1 year	3 years	5 years
EQUITIES					
Global	2.2	1.9	13.0	10.1	14.5
UK	4.6	3.4	-9.8	-0.9	5.1
Developed markets ex UK	2.0	1.8	14.6	11.3	15.2
Emerging markets	2.5	2.2	11.9	6.2	14.5
BONDS					
Conventional gilts	0.6	0.5	8.3	5.2	5.5
Index-linked gilts	-2.3	-2.4	11.0	5.6	8.4
Sterling corporate bonds	2.0	1.6	8.6	5.7	6.7
High-yield (US) *	6.1	5.0	6.2	5.9	8.4
Emerging market debt*+	4.5	4.2	5.3	5.0	7.1
UK PROPERTY	-	-	-1.0	2.8	4.4
HEDGE FUNDS *	-	-	6.4	4.0	4.1
COMMODITIES *	-	-	2.6	1.2	7.3

* Return in $ +Hard currency

Source Datastream:

FTSE All Share
FTSE World Developed ex UK
FTSE All World
FTA Govt All Stocks
FTA Govt Index Linked All Stocks
iBoxx Corporate All Maturities
BofA ML US High Yield Master II
JPM GBI-EM Diversified Composite
UK IPD Monthly
Credit Suisse Hedge Fund
S&P GSCI Light Energy

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