Investment perspectives

Emerging market debt: The Case for Strategic Allocation

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Introduction

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 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 currency and local.

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

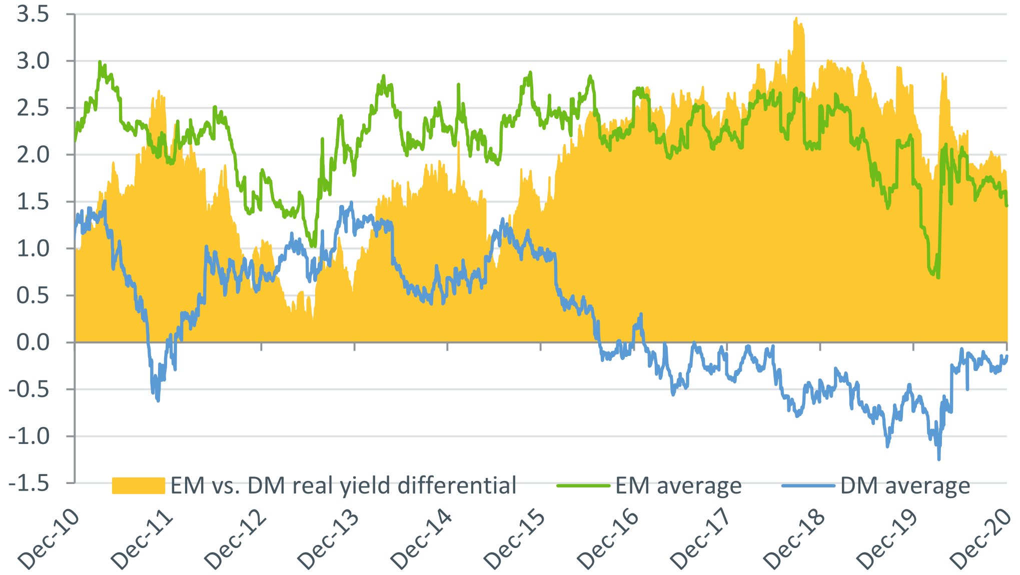
Corporate EMD has rapidly developed into a significant asset class, with 56 countries in the broad corporate index, the JP Morgan CEMBI BD. As EM economies become more integrated into global markets, liquidity continues to improve which may lend support to credit quality overall. Many EM corporates are 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 $29.6tn, or 25% of the global fixed income universe. It is on track to grow, to reach $45tn by 2025, equating to approximately 29% of global fixed income, the vast majority of which sit outside the major benchmarks[1]. 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 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%[2]. 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 1).

Chart 1: 10-Year Real Rates: EM vs DM

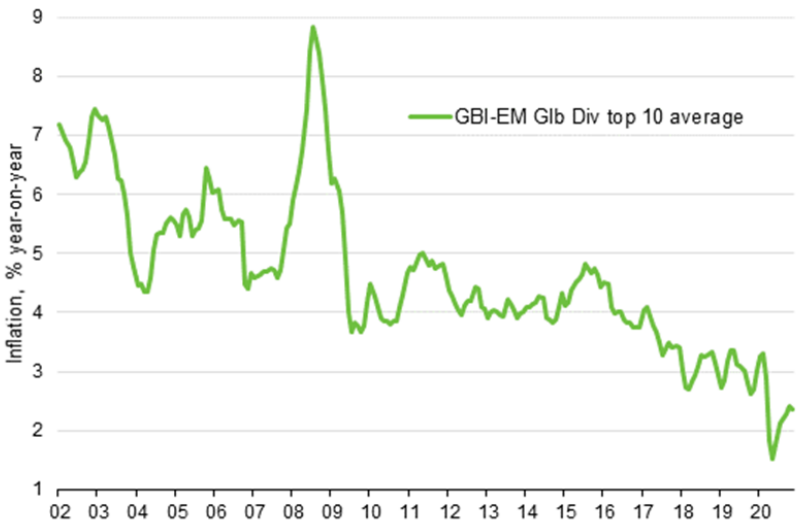


Source: Bloomberg, Amundi

[1] Ashmore, The EM Fixed Income Universe Version 9.0, August 2020
[2] Stone Harbor, EMD Outlook 2021

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 2). 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%, not substantially higher than the 2% target of the US. Many EM governments have also greatly improved their fiscal discipline.

Chart 2: GBI-EM Global Diversified Index Top 10 Average Countries' Inflation Change, Year-on-Year

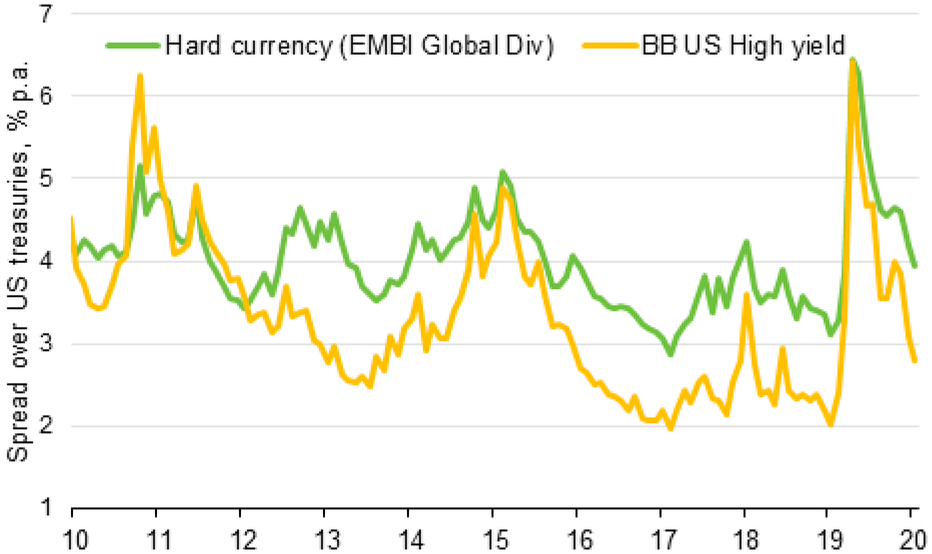


Source: Bloomberg

The selloff across risk assets in March 2020 was of a magnitude larger than the Global Financial Crisis and it happened much more quickly, and 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 3).

Chart 3: JPM EMBI versus BB US High Yield Spreads over US Treasuries

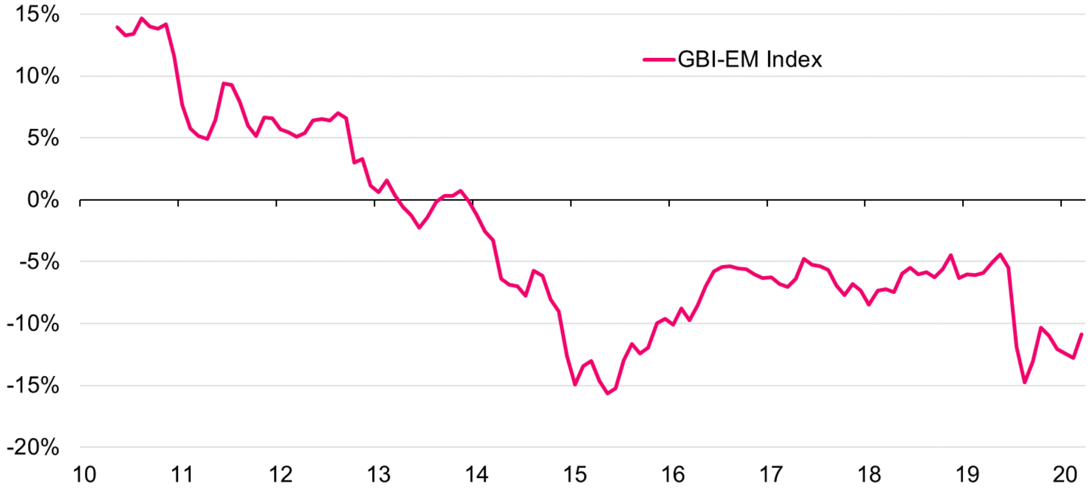


Source: Bloomberg

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 4). 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 4: 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 reversion of emerging market currencies from their currently below average levels noted above.

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 supports 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, 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 QE 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.