Insights
Fixed Income

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Emerging Market Debt:
In Anticipation of a Landing

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Emerging market debt (EMD) investors face some unusual dynamics heading into year end. After a period of decoupling between US and emerging market central banks, will the resilience of the US economy mark the return of the data-driven Fed as the dominant driver of EMD returns?

At the start of the year, markets were focused on two macroeconomic themes: the US economy and China's reopening. However, neither of these panned out in line with consensus expectations.

In the US, although there was a healthy debate around what kind of landing the economy would make, the consensus seemed to be that there would be some sort of landing in the second half of the year. Approaching year end, however, the US economy continues to surprise with its resilience, leading markets to re-evaluate their stance. As a result, we have seen both the dollar and US Treasury yields trend higher.

As for China, high expectations about the country's move away from its zero-COVID policy gave way to disappointment later in the year as the Chinese economy failed to deliver and the stimulus provided was largely regarded as inadequate.

In addition to the surprising resilience of the US economy and the surprising weakness of China's economy, there are other aspects that are quite unusual about these late-cycle dynamics that investors should be cognizant of when considering EMD.

Firstly, emerging market (EM) monetary policy has, at least for the time being, decoupled from that of the US Federal Reserve Board (Fed). As we have previously discussed, EM central banks started their hiking cycles ahead of the Fed. As a result, EM inflation already peaked in the fourth quarter of 2022, giving EM central banks ammunition to start cutting rates this year. This is quite unusual because EM central banks tend to follow the Fed and especially those in Latin America, which were the first ones to hike in this cycle and are now among the first to cut.

Secondly, EM spreads have appeared — and continue to appear — attractively valued, while other comparable US dollar (USD) spread products like US high yield appear a lot more expensive. Hence, EM sovereign spreads, particularly high yield sovereign spreads, have also diverged from other spread products due to the different dynamics driving them.

A Changing Backdrop

In the first half of the year, EMD performance was driven by EM-specific factors, including spreads in hard currency debt and local rates in local currency debt. The US dollar and US Treasuries were for the most part also supportive to EM performance. However, as these themes have played out to some extent and as a US recession looks increasingly unlikely this year, we are entering again into a more volatile and uncertain environment, one in which a data-driven Fed is likely to be once again the dominant force driving EMD returns.

Where Does That Leave Us?

As expected at the start of the year, the fact that EM central banks were ahead of the curve with their hiking cycles meant that EM inflation peaked a lot earlier than in the US, back in the last quarter of 2022, and has been on a steady downward trend since then.

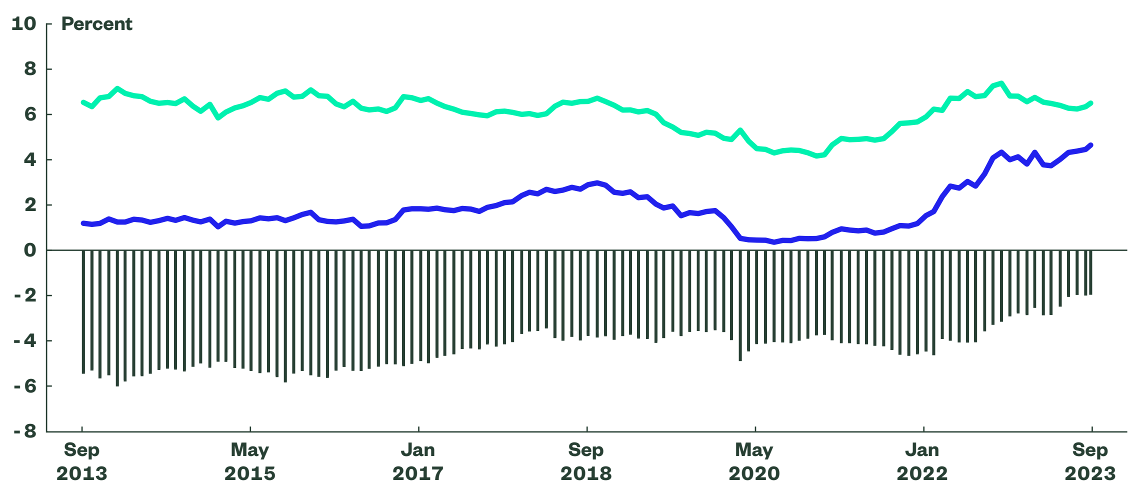
Consequently, EM central banks (with the exception of Turkey) have been broadly sounding a more dovish tune, with some of them already starting to cut their policy rates, and even more aggressively than initially expected. The rate-cutting race has been driven by Latin America's central banks — specifically Brazil and Peru. They were also joined by Poland, although the rate decision there appeared to be more politically driven.

The picture for local currency debt, however, has become a lot more complex compared to the beginning of the year, when market expectations for a landing of the US economy in the second half led to a weaker dollar and lower treasury yields.

Firstly, because EM monetary policy has decoupled from the Fed (at least for now), the differential between the yield of the JPMorgan Government Bond Index-Emerging Markets Index (GBI-EM) and that of US Treasuries is the lowest it has been for 15 years. Importantly, this is not because EM local rates have rallied too much — rather, it is because US rates have not. As a result, being short the dollar, at least in the short term, is going to be difficult. In the past three months, we have seen a resurgence in the dollar, which has not only eaten away at local currency returns but also may be posing a risk to EM inflation. In addition, the spike in oil prices since June 2023 is another factor that has the potential to cloud the outlook for EM inflation. How long can EM central banks cut rates if the recent bout of dollar strength and spike in oil prices are here to stay? Eventually, monetary policies will have to converge — either because Treasury yields finally rally (i.e., we eventually get a US recession) or because EM central banks are stopped out of their rate-cutting cycles.

Figure 1
The Differential Between EM Local Currency Yields and US Treasuries is at 10-year Low

- Difference
- GBI EM Yield
- US Treasury Index



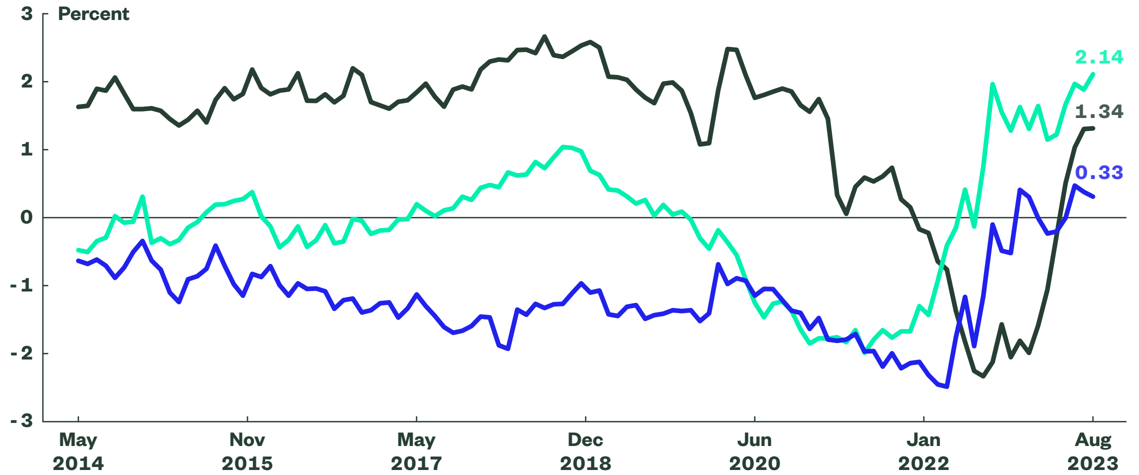
Source: JP Morgan, BAML, Bloomberg as of September 2023. Past performance is not a reliable indicator of future performance.

In defense of local currency debt, real yields have now emerged positive for some of the largest index constituents and for the broader GBI-EM Index. Even though the real yield of the GBI-EM Index is still below that of US Treasuries, it offers a healthy pick-up versus euro area real yields. Also, and perhaps more importantly, positive real yields for some of the largest constituents of the index offer protection for EM currencies.

The strong dollar will continue to be a head-wind for USD-based investors in local currency debt; however for sterling and euro-based investors, emerging market currencies and, by extension, local currency debt offers a more attractive proposition given the resilience of EM foreign exchange against these fiat currencies. Fed monetary policy divergence has buoyed the greenback again this summer, but this exceptionalism has been limited to the USD.

Figure 2
Emerging Market vs. Developed Market Real Yields

- GBI-EM Real Yield Estimatey
- US Treasury Real Yield Estimate
- Euro Area Sovereigns Real Yield Estimate



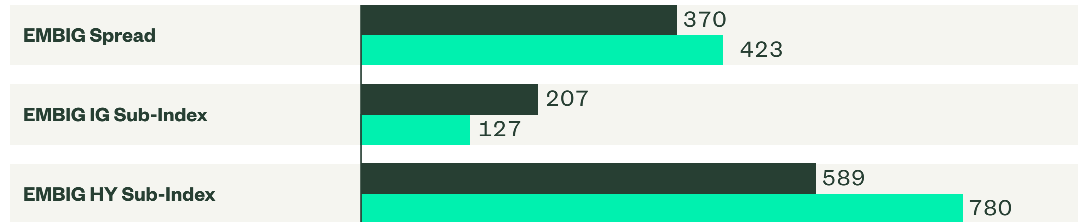
Source: State Street Global Advisors, JP Morgan, Bloomberg as of 31 August 2023. Past performance is not a reliable indicator of future performance.
EMD LC Real Yields = GBI-EM GD country weighted average of (nominal yields minus inflation). US real yields = Generic Inflation Indexed United States 5 Year Government Bond yield.
Euro Area real yields = Generic France 5 Year Government Inflation Indexed bond yield.

Hard Currency Sovereign Debt

Hard currency sovereign debt performance has been driven by sovereign spread tightening, and particularly tightening in the high yield segment. As noted at the start of the year, this is where the value was and still is, and in the absence of a US recession, emerging market high yield spreads have delivered.

Figure 3
The High Yield Segment is Driving the Wideness in the Overall EM Sovereign Debt Index

- 15-year Average Spread
- Current Spread (27 September 2023)



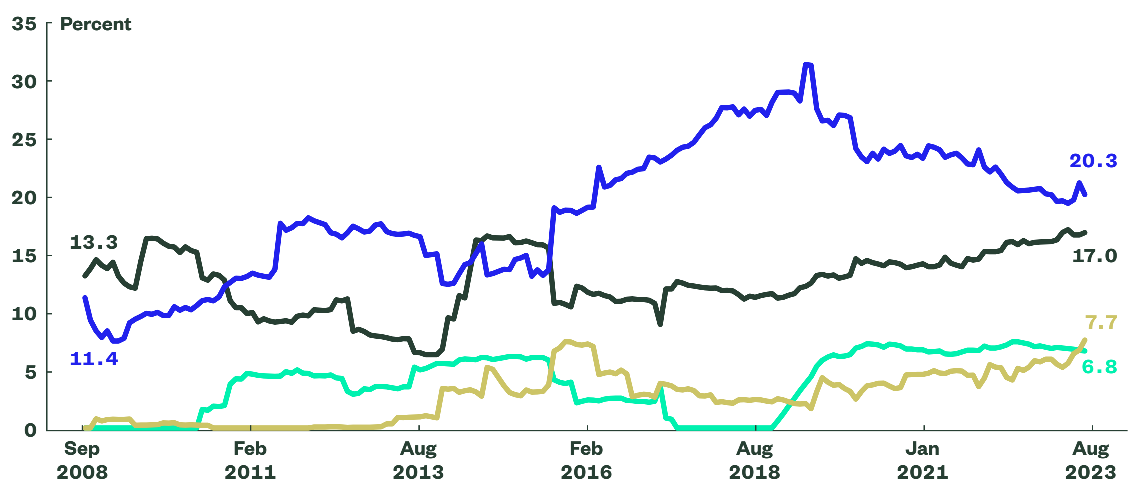
Source: State Street Global Advisors, Bloomberg, JP Morgan as of September 27, 2023.

High yield spreads still stand significantly wider than their long-term average, driving the overall JP Morgan EMBIG Global Diversified Index (the EMBIG Index) spread wider while investment-grade spreads are actually now tighter than the long-term average.

This should not be taken at face value, though. Comparing the current spread to the long-term average is not necessarily a like-for-like comparison, because the credit rating composition of the index has changed over time. More specifically, in high yield the proportion of the lowest-rated credits has increased, while in investment grade the proportion of the highest-rated credits has increased. Although the trend is similar, the reasons are different. In high yield, the proportion of B and C-rated credits has increased because countries have been downgraded. To that end, it is also important to specify that countries that default are not removed from the EMBIG Index. So as countries default and restructure their debt, something that has occurred at a higher rate over the past couple of years, the proportion of C-rated credits has naturally increased.

By contrast, in investment grade the proportion of AA-rated credits has increased due to the addition to the index of highly-rated Gulf countries and they have also been among the largest issuers over the past few years. For example, 15 years ago, AA and A-rated issuers comprised only 13% of the index while today they comprise 24% and represent nearly half of the investment grade issuers in the EMBIG Index. Consequently, the investment grade sub-index has received a quality upgrade and, even though investment grade sovereign debt looks expensive compared to the historical spread, this is probably somewhat justified due to the higher quality of the investment grade sub-index today.

Figure 4
The Proportion of Both the Highest-Rated and Lowest-Rated Credits in the JPM EMBIG Index Has Increased Over Time



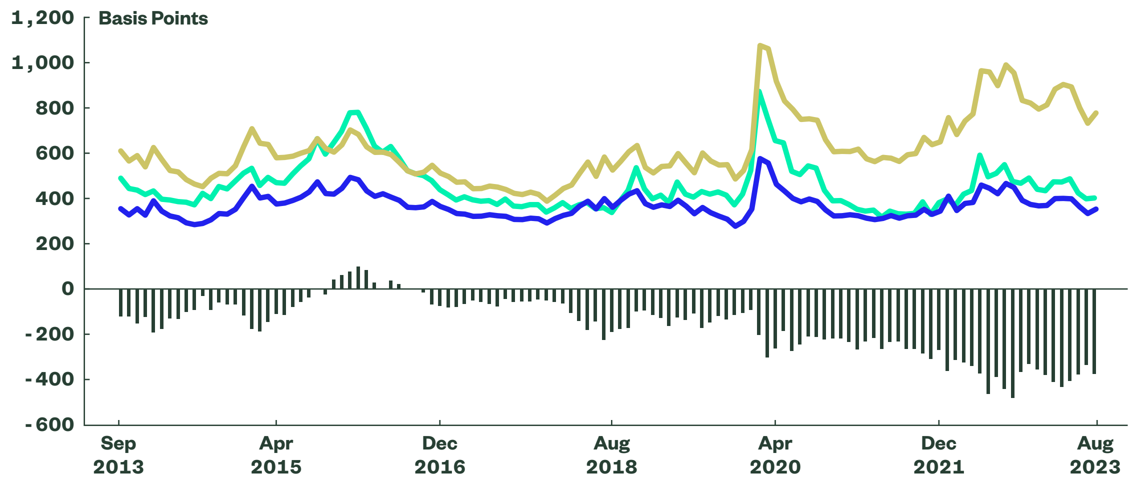
Source: State Street Global Advisors, JP Morgan as of August 2023.

In high yield, even though it is unlikely we'll see a return to the long-term average, there is still some potential for spreads to tighten. Vulnerable EM countries were exposed over the course of 2022 when refinancing rates increased sharply; these countries are already in the process of restructuring their debt and hence the negative news has already been priced in. Even though lower-rated credits now comprise a greater proportion of the high yield sub-index, they have outperformed this year and still have the potential to drive high yield spreads tighter.

As a high-yielding dollar spread product, EM sovereign debt is often compared to US high yield. So it is interesting to note that the spread between the EMBIG high yield sub-index and the BAML US High Yield Index is at some of its widest levels for the past 10 years, highlighting the diversification benefits that EM sovereign debt can offer as part of broader portfolios. In fact, the broader EMBIG Index offers a yield of approximately 8.5%, which is very much in line with the yield offered by US high yield credit, with the difference that EM sovereign debt is investment-grade rated.

Figure 5
EM High Yield Sovereign Spreads Have Diverged Sharply From US High Yield Credit Spreads

- Differential US High Yield — EM Sovereign High Yield
- US High Yield
- HC Sovereign
- HC Sovereign High Yield



Source: JP Morgan, BAML, Bloomberg as of September 2023. Past performance is not a reliable indicator of future performance.

The technical picture is also supportive of EM sovereign debt, with limited net new issuance and almost no activity in the high yield space. On a regional basis, we expect primary activity to be most prominent in the Middle East region.

That said, US Treasuries are likely to come back as a key driver of performance in EM hard currency debt as the markets reassess expectations for the US economy and Fed monetary policy.

Conclusion

For the first half of 2023, EMD enjoyed a favorable backdrop in which local rates rallied and spreads tightened, while US Treasuries and the dollar were for the most part a tailwind. However, as we approach the last quarter of the year, the surprisingly resilient US economy seems to be running out of runway for landing in 2023. As a result, we are back into a familiar place where a data-driven Fed has become once again the dominant driver of EM returns. Against this backdrop of heightened volatility and uncertainty, hard currency sovereign debt looks more attractive because EM spreads still offer value and, in the absence of a US recession, have the potential to tighten further. In local currency debt, the strong dollar is clouding the short-term outlook — not only because of its direct impact on EM currency returns, but also indirectly because of its impact on EM inflation.

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* Pensions & Investments Research Center, as of December 31, 2022.
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