Insights
Fixed Income

Emerging Market Debt Outlook
Opportunities Amid Uncertainty

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2024 is already shaping up to be a year of considerable uncertainty. The first quarter has given us a taste of that with a sharp reversal of expectations for the US economy and the monetary policy plan of the Federal Reserve. This matters for emerging market debt because the type of economic landing that unfolds in the US and the Fed rate action will heavily influence its fate this year.

In hard currency sovereign debt, high yield stands to benefit the most if there are fewer-than-expected US rate cuts and it is also set to be supported by positive idiosyncratic stories in the distressed space. In local currency debt, local rates have been driving performance over the past five quarters and are likely to be more sensitive to the broader macro backdrop and to be negatively impacted should the Fed adopt a shallower rate-cutting cycle. In addition to the impact of the Fed and the US economy, we also consider the likely effects of elections, heightened geopolitical risks, and China's ongoing difficulties on the prospects for EM debt this year.

What Drove Emerging Market Debt in 2023?

Through much of 2023, there were two key macro themes that markets focused on but didn't get right — the US economy proved more resilient than anticipated and subsequent Federal Reserve (Fed) monetary policy stayed hawkish for longer, while the expected tailwind of China's reopening from its zero-covid policy was overestimated. These themes affected EM debt to varying degrees — Fed policy remained a key driver of EM returns whilst China's woes had less of a direct impact on EM fixed income markets. There were EM-specific themes that were important for EM debt returns: EM disinflation was an important factor in local currency returns, while in the hard currency space, high yield spreads, and the distressed names in particular, outperformed.

Key Themes for EM Debt in 2024

The US Economy and the Fed: Could We See a Repeat of 2023?

In the first quarter of 2024, the US economy continued to surprise with its resilience, proving that US exceptionalism is still very much in place. This led to significant readjustment of expectations around Fed monetary policy. Having rallied strongly in the final quarter of 2023, US Treasuries have given up some of those gains as markets are now expecting only three cuts in 2024, compared to seven projected at the start of the year.

Our base case economic scenario is one of "soft landing" where the Fed cuts rates for the first time in June and follows that with three or four more reductions before the end of 2024. This would present a so-called Goldilocks environment for EM debt where EM spreads and FX remain supported while lower Treasury yields and a weaker US dollar add further to EM debt returns.

While the prospects of recession seem unlikely at this juncture, it is worth considering what a shallower Fed cutting cycle and a "no-landing" outcome could mean for EM returns. Stronger US growth should be positive for risk assets, but it could actually have a negative effect if it means that the Fed cuts rates by a lot less than anticipated — or perhaps doesn't even cut at all this year. The impact that resilient US growth coupled with "higher for longer" rhetoric from the Fed had on EMD and other risk assets in the third quarter of 2023 was negative — the S&P500 was down over 10% from end of July to end of October, while the EMBIG and GBI-EM indices were down over 5% and over 6%, respectively. It was only in November, when the Fed signaled a pause in rate hikes that EMD returns tipped into double-digit territory, largely due to the rally in US Treasuries and US dollar weakening. We could possibly see a similar pattern reemerge — only this year we have the additional complication of US elections in November, an event that could bring more uncertainty to the outlook for US rates and the dollar.

Many EM Elections in 2024 but US Election Key for EMD

2024 is an election "super year" but some elections matter more than others. Even though elections invariably bring uncertainty and volatility into markets, the impact from EM elections on broader index returns has generally been well contained and this seems likely to remain the case.

The election that is most likely to have a broad-based impact on EM is the US presidential election. A Trump win is clearly a risk to EM; after Trump's 2016 victory, EM markets experienced a mini tantrum — rates sold off and the US dollar strengthened. However, the negative impact is unlikely to be as strong this time around. For one, the surprise element is significantly lower. Even so, a Trump win could have an inflationary effect through protectionist economic policies, higher tariffs, and looser fiscal policy — this would lead to higher US Treasury yields and a stronger US dollar, neither of which is good for EM debt. During Trump's presidency, EM faced higher volatility due to the near-constant threat of sanctions and higher tariffs, and there is little reason to believe a second Trump term would be much different.

China's Difficulties — Less Material for EM Debt Investors

The end of China's covid restrictions at the start of 2023 was expected to deliver a reopening bounce as had been seen elsewhere. Instead, the reality was underwhelming and even if official growth figures for 2023 were within expectations, and stimulus announcements have been made, negative news flow from the country has continued. However, it is important to note that the impact from China's woes has been felt primarily within EM equity markets, with fewer ripples being seen across EM fixed income markets. In local currency debt, where China represents 10% of the flagship JPM GBI EM Global Diversified index, the impact of the country's difficulties on overall index performance has been muted. This is because Chinese bonds are low yielding (approx. 2.3% vs. 6.5% for the index) and typically exhibit low volatility levels; the Chinese yuan is a managed currency, thus limiting the volatility of Chinese local currency bonds. In hard currency debt, China accounts for 4% of a well-diversified index of 70 countries and Chinese quasi-sovereign bonds are investment grade rated; their impact on the overall index performance in the past year — when spread-tightening was driven by lower quality high yield credits — has also been minimal.

Hence, China's impact on EM debt returns remains indirect in nature, through its influence on global growth and demand for commodities. Although China didn't come back with roaring demand for commodities, this has actually been beneficial for EM debt during this cycle because it kept EM inflation in check.

Heightened Geopolitical Risk — Impact on EM Debt Returns

Geopolitical risk has been on the rise over the past three years, with the invasion of Ukraine by Russia and the Israel-Hamas conflict at the forefront of a changed landscape. Concerns regarding China-Taiwan tensions, which have been simmering for years, have also mounted in recent months. The perception of heightened geopolitical risk is further intensified by the prospect of a second Trump presidency, given his vocal lack of support for NATO.

However, when it comes to geopolitical risk and the outlook for EM debt, one should distinguish between the headlines and the implications for EM returns. There are some lessons we can draw from recent events — specifically, geopolitical risk has a broad-based impact on EM returns only when it leads to a extended risk-off period in the markets such as that witnessed in the case of Russia and Ukraine. When Russia invaded Ukraine, EM suffered not so much due to the direct impact on the countries involved, but more significantly due to the indirect result of higher commodity prices, the sharp spike in inflation, and the steep rate hiking cycles. By contrast, the Israel-Hamas conflict has had a more limited impact on EM returns as it has thus far remained regional and relatively contained.

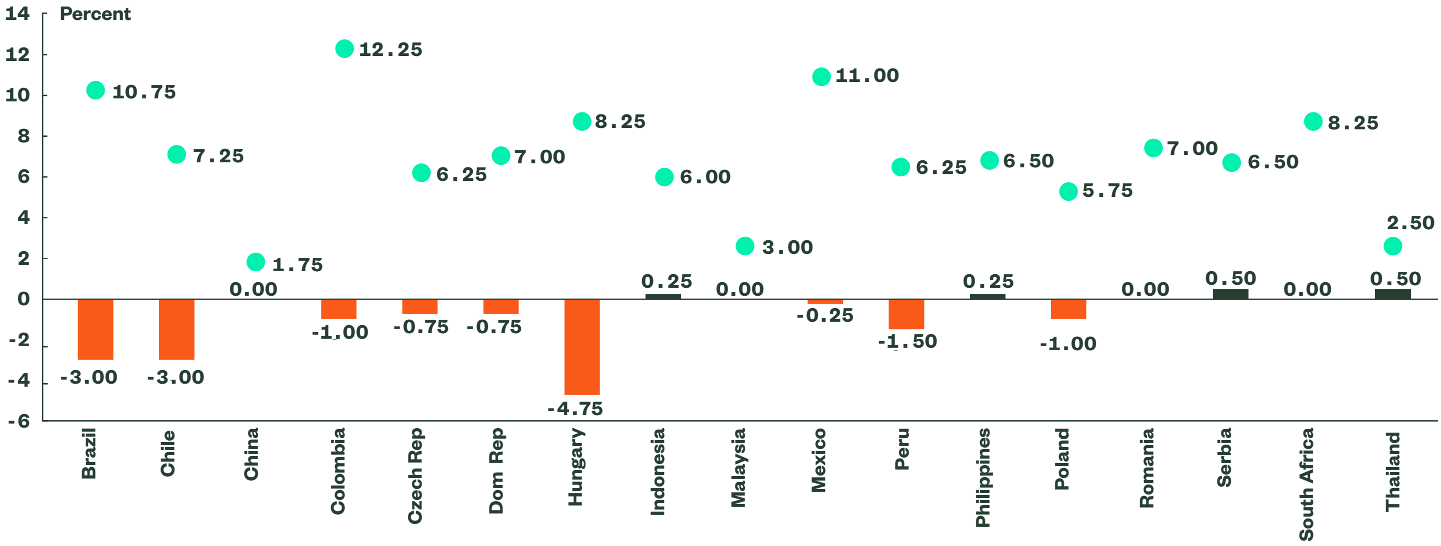
EMD Outlook: EM Specific Performance Drivers are Evolving

The main EM specific themes that drove performance in the past five quarters were EM disinflation, which supported local rates, and high yield (HY) spread tightening, which supported hard currency spreads. While they still have potential to add to EM returns, it is important to recognize that they have already played out to some extent. Moreover, EM rates are likely to be a lot more sensitive to the broader macro backdrop and the type of Fed rate-cutting cycle that develops, while the high yield restructuring stories are by their nature idiosyncratic and less dependent on the macro landscape.

Local Currency Debt — EM Central Banks Can Cut Further, But The Fed Matters

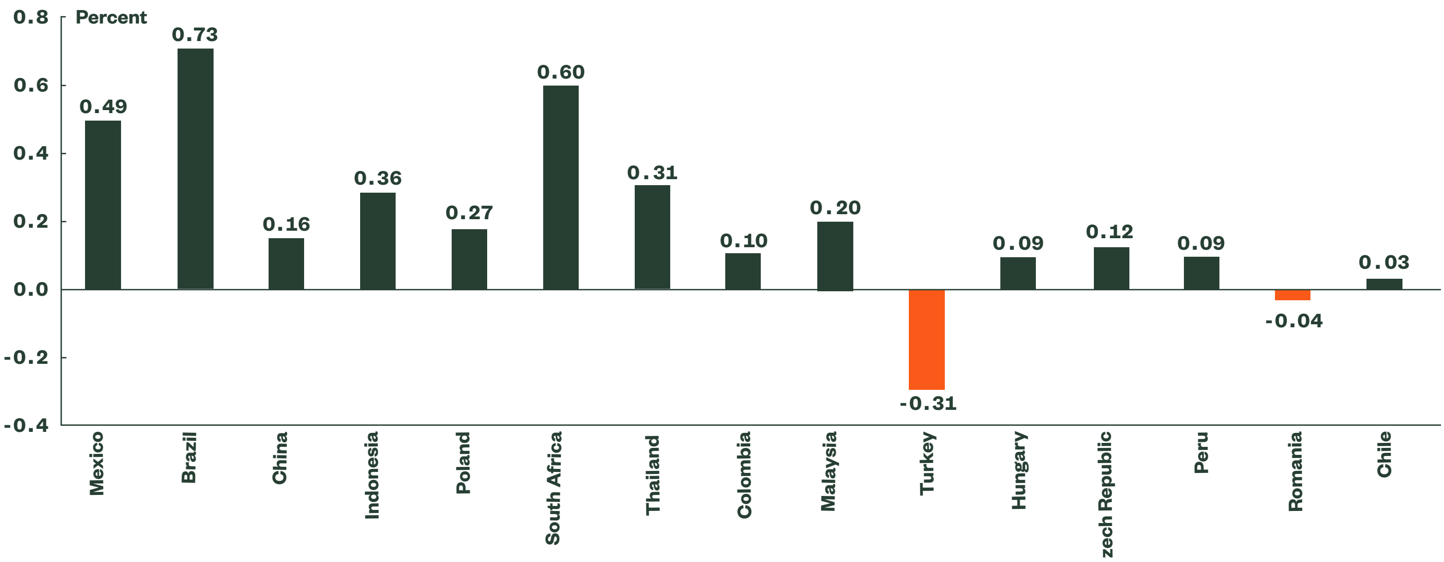
Within the local currency space, the majority of EM central banks have started to cut rates, following the lead set since last summer by Latin America (LATAM). Even so, a large number of EM central banks haven't cut rates and some have even tightened policy — these have been mostly Asian central banks, while Turkey stood out as it moved to reverse its unorthodox policies and has increased its base rate by 30%. EM real rates remain largely positive, giving EM central banks the space to start, or continue, to cut rates. However, the timing and size of the US Fed's rate cuts will matter too — a deeper-than-anticipated Fed rate cut cycle starting in June would likely allow EM central banks to make additional reductions. A shallower Fed rate cut cycle, on the other hand, would act as a headwind to a more substantial rally in EM rates — EM central banks would be unlikely to cut aggressively in the face of a stronger dollar and weaker EM FX, given the potential to reignite inflation pressures.

Figure 1
Plotting the Rate Actions of EM Central Banks Since July 2023



Source: State Street Global Advisors, Bloomberg Finance L.P. as of 28 March 2024. Based on countries in the JPM GBI-EM GD index, excluding Turkey.

Figure 2
Positive Real Rates Give Scope for More EM Rate Cuts



Source: State Street Global Advisors, Bloomberg Finance L.P., as of 28 March 2024; real yields are calculated as nominal yields minus inflation.

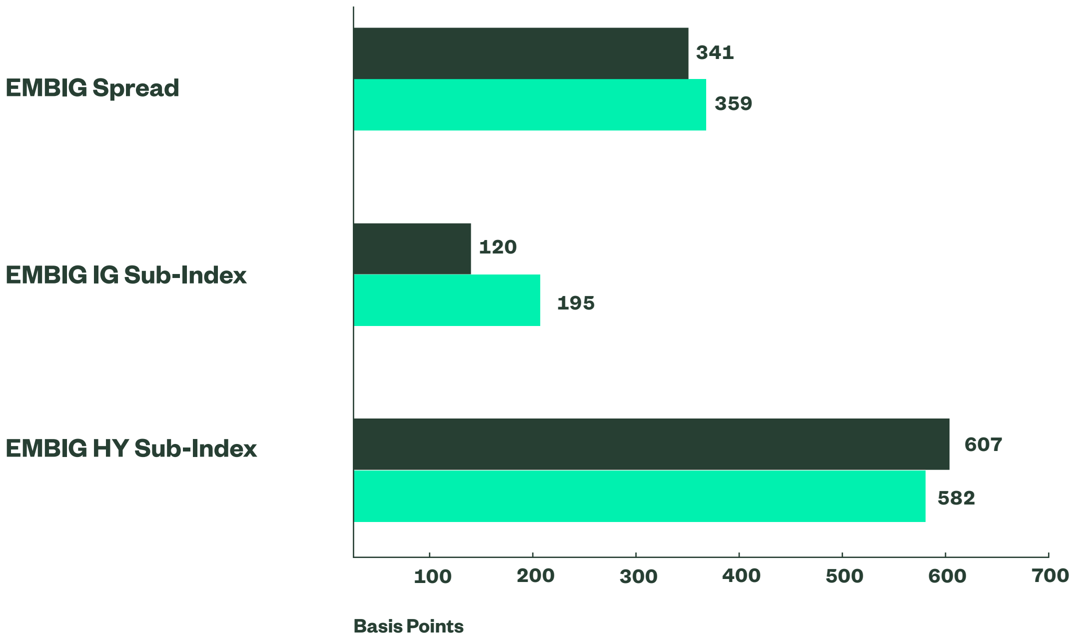
For the FX component of local currency EM returns, we expect that trading in the US dollar will be range-bound, and hence EM FX — which is typically priced against the greenback — is also likely to trade within a relatively narrow range. EM currencies remain significantly undervalued versus the US dollar (we estimate an undervaluation of over 10%, based on our purchasing power parity FX model), and this has the potential to benefit dollar-based local currency investors over the long term.

Hard Currency Debt — HY Spreads to Continue to Outperform

In hard currency debt, spreads tightened substantially through 2023; investment grade (IG) spreads are now significantly tighter than the long-term average. The improved quality of the IG sub-index justifies this move to some extent, but nonetheless IG EM spreads are starting to look expensive. High yield (HY) spreads experienced even greater tightening from the very wide levels evident in early 2023, and have been driving EM spread returns over the past five quarters. High yield spreads are now close to long-term averages, but we believe spreads of the lower quality distressed credits can tighten further. Many of these countries are in the process of restructuring their debt and have requested support from the International Monetary Fund (IMF). With Managing Director Kristalina Georgieva's first term at the institution coming to an end in November this year, we expect that she would want to see through negotiations for programs that have already started. Egypt, for example, secured an $8bn package earlier this year — significantly more than initial expectations and this contributed to the tightening spreads of the broader EM high yield sub-index.

Figure 3
EM Spreads Have Tightened Significantly; High Yield Could Tighten More

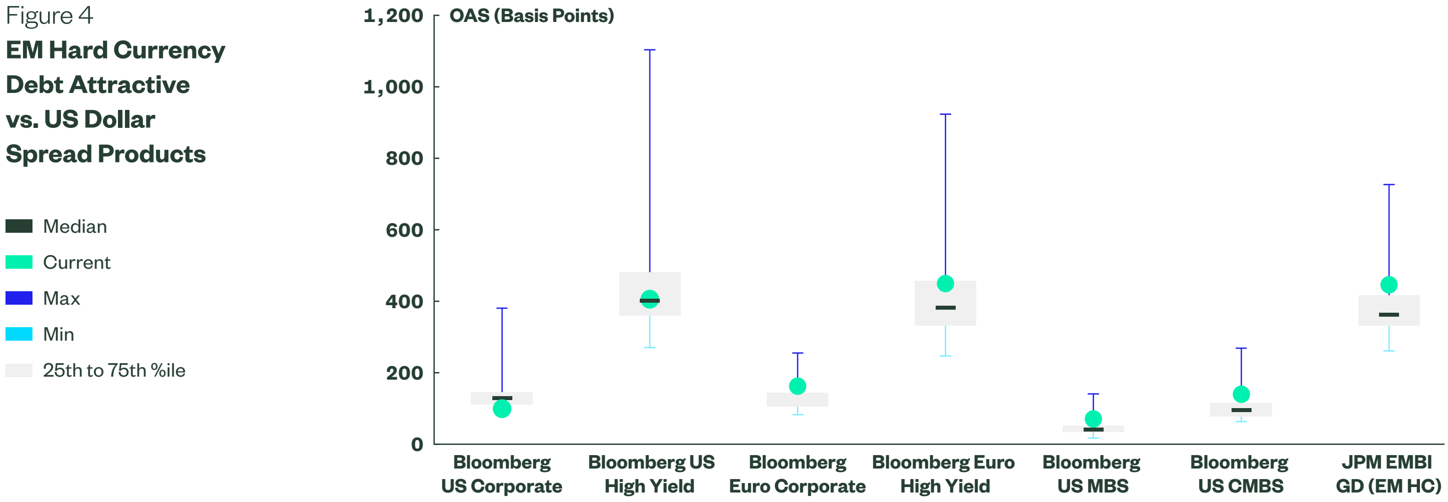
Current Spread — Basis Points (28 March 2024)
15-year Average Spread



Source: State Street Global Advisors, Bloomberg Finance L.P., JP Morgan as of 28 March 2024. Past performance is not a reliable indicator of future performance.

EM HY spreads also stand to benefit the most from a 'no landing' scenario of the US economy. In the case of a soft landing — which remains our base case — EM HY spreads would likely still fare well given the idiosyncratic stories at play, while overall hard currency debt returns will also benefit from the rally in Treasuries once the Fed starts cutting rates.

Figure 4
EM Hard Currency Debt Attractive vs. US Dollar Spread Products



Source: State Street Global Advisors, Bloomberg Finance L.P., JP Morgan as of 28 March 2024. Past performance is not a reliable indicator of future performance.

Finally, EM hard currency debt still screens attractive compared to other US dollar spread products with a yield oscillating around 8%.[1] EM hard currency sovereign debt offers attractive income — similar to US and Global High Yield but for investment grade quality. The outperformance of EM HY spreads over the past five quarters have been driven by EM idiosyncratic factors, illustrates the diversification benefits of holding EM debt as part of broader portfolios.

Endnote

1 Based on the JP Morgan EMBI Global Diversified index.

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* Pensions & Investments Research Center, as of December 31, 2022.
† This figure is presented as of December 31, 2023 and includes approximately $64.44 billion USD of assets with respect to SPDR products for which State Street Global Advisors Funds Distributors, LLC (SSGA FD) acts solely as the marketing agent. SSGA FD and State Street Global Advisors are affiliated.

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The views expressed in this material are the views of the Lyubka Dushanova through the period ended 31 March, 2024 and are subject to change based on market and other conditions.

ID2098207-6533080.1.1.GBL.RTL 0424
Exp. Date: 30/04/2025