White Paper
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The Case for Allocating to Emerging Market Debt

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Executive Summary

Emerging market debt (EMD) is a versatile asset class. It offers equity investors risk mitigation potential with modest return dilution. For fixed income investors willing to move out on the risk spectrum, EMD still presents a significant yield pick-up opportunity. There has been a notable rise in indebtedness in some countries and, now more than ever, investors need to be comfortable with headline and idiosyncratic risk, look beyond average index level metrics, and be mindful of individual issuer risks. Emerging markets were certainly not immune to the global yield reset of recent quarters. However, with broad EM yields now at significantly higher levels in absolute terms and an increasing number of EM central banks cutting rates, a growing, albeit guarded, case has emerged for consideration of the asset class in investors' portfolios.

Key Points

- **Yield Enhancement** Emerging market debt still provides an attractive yield pick-up relative to developed market bonds.
- **Diversification Benefits** The low correlation and higher growth factor exposures of EMD assets provide diversification benefits for global bond and equity investors.
- **Evolving Fundamentals** While emerging economies offer relatively strong growth, China faces a more subdued growth trajectory with implications for its neighbours.
- **Rate Cycle** Some EM central banks may be ahead of their advanced economy peers in the rate cutting cycle and offer potential outperformance opportunities.
- **Higher Volatility/Drawdown and Idiosyncratic Risks** Investors need to be aware of the potential higher volatility and drawdowns as well as the idiosyncratic risks associated with EM assets.

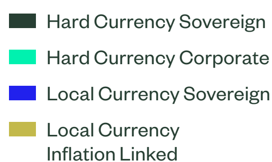
Emerging Market Debt Overview

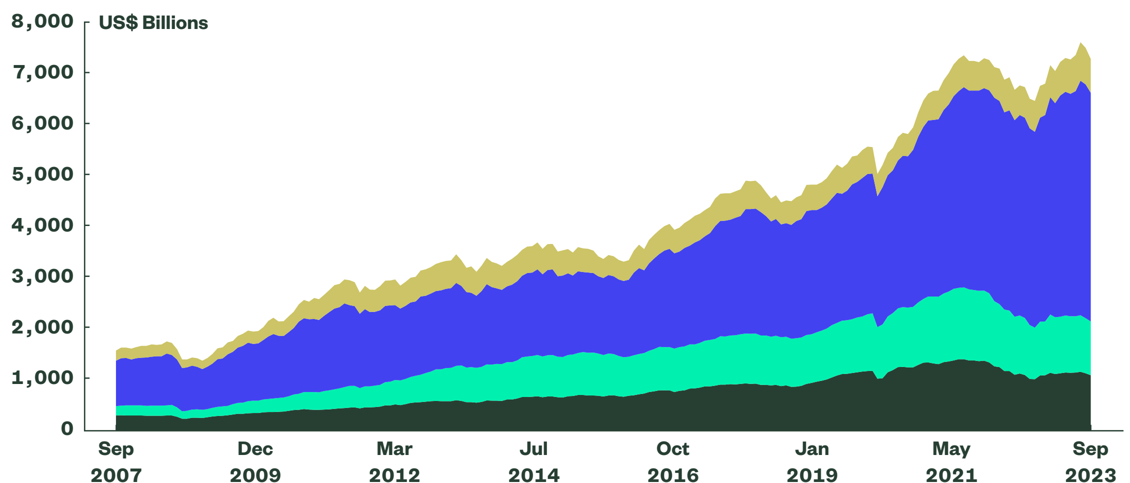
- Emerging market debt has evolved into a significant multi-trillion dollar segment of the global bond market in recent years.
- There are three broad investible EMD segments: hard currency sovereign, hard currency corporate, and local currency sovereign — each with its own distinct characteristics.

Fast Growing Market, Improving Liquidity

Over the past two decades, the EM debt market has grown significantly. Our focus is on the investible universe based on the established bond indices most followed by institutional investors in hard currency sovereign and corporate debt and in local currency debt. Based on our estimates, this market of index-eligible securities stood at about US$7.3 trillion at the end of September 2023. We think this makes it too big a market for global investors to ignore.

Figure 1
The Growth of Emerging Market Debt (Sep 2007–Sep 2023)





Source: State Street Global Advisors, JP Morgan, Barclays as of 30 September 2023.

In line with the market's rapid growth, there has also been an improvement in trading liquidity which has helped to bring trading costs down. The cost of trading in hard currency EM debt, as represented by bid-ask spreads, is now close to pre-pandemic levels and meaningfully lower than the cost of trading US high yield bonds, although not as low as those for US investment grade bonds. The cost of trading local currency sovereign EM debt has remained very stable and is lower than that of US investment grade bonds.

Characteristics of Emerging Market Debt Assets

Hard currency (HC) sovereign, hard currency corporate, and local currency (LC) sovereign are the three broad investible segments for EM debt investors. Hard currency sovereign and corporate indices are predominantly comprised of US dollar-denominated bonds issued by emerging market governments and companies, respectively, while LC sovereign indices include local currency denominated debt issued by emerging market governments.

The key characteristics of the three EMD assets are illustrated in Figure 2 alongside those of global aggregate bonds, global high yield (HY) bonds and global equities for comparison purposes. Some of the main differences across EMD assets include:

Mix of IG/HY with Different Levels of Quality The three EMD segments offer varying degrees of credit quality exposure. This differs from the global aggregate bond universe which is made up entirely of investment grade (IG) bonds, while global high yield (HY) bonds consist of 100% sub-investment grade bonds. Of the three EMD segments, local currency sovereign EMD has the highest proportion of bonds with an investment grade rating (75%), while hard currency sovereign EMD has the lowest proportion (51%).

Local Currency EMD Less Diversified Hard currency sovereign and hard currency corporate debt are quite diversified by country and region. By way of contrast, local currency sovereign debt is relatively concentrated — the representative index contains only 19 countries, with the largest 10 accounting for 84%.

Currency and Rates Risk Hard currency sovereign and corporate exposures are typically USD-denominated with risks driven mainly by movements in US interest rates/yields and EM sovereign and corporate credit risk. Euro-based investors therefore have the additional consideration of US dollar fluctuation. Local currency sovereign debt is sensitive to movements in local rates and currencies relative to the euro, along with the credit risk of the underlying sovereigns.

Figure 2

Key Characteristics of EMD Assets, Global Aggregate Bonds and Global High Yield Bonds

	Hard Currency Sovereign EM Debt	Hard Currency Corporate EM Debt	Local Currency Sovereign EM Debt	Global Aggregate Bond (Hedged[1])	Global High Yield Bond	Developed Markets Equity	Emerging Markets Equity
Index	JP Morgan EMBI Global Diversified	JP Morgan CEMBI Broad Diversified	JP Morgan GBI-EM Global Diversified	Bloomberg Global Aggregate	Bloomberg Global High Yield	MSCI World	MSCI Emerging Markets
Investment Universe	68 countries	63 countries	20 countries	71 countries	111 countries	23 countries	24 countries
Currency	USD	USD	20 EM currencies	27 currencies[1]	6 currencies	14 currencies	24 currencies
Regional Split (%)							
Asia Pacific	18	42	40	26	4	9	78
Europe	15	7	21	26	20	18	2
Latin America	33	24	30	1	13		9
Middle East & Africa	34	27	9	1	13	0	11
North America				44	49	73	
Other Supranational				2	1		
Index Rating*	IG Credit Rating Ba1/BBB-	IG Credit Rating Baa2/BBB-	IG Credit Rating Baa1/BBB+	IG Credit Rating Aa2/AA3	Sub-IG Credit Rating Ba3/B1	N/A	N/A
IG/Sub-IG Split (%)	51/49	58/42	75/25	100/0	0/100	N/A	N/A
Yield to Worst (%)	8.36	7.23	6.32	3.84	9.2	N/A	N/A
Dividend Yield (%)	N/A	N/A	N/A	N/A	N/A	2	3.26
Duration (Yrs)	6.76	4.17	5.04	6.76	3.87	N/A	N/A
Key Risk Drivers	US Treasuries and EM Sovereign Spreads	US Treasuries, Sovereign and EM Corporate Spreads	Local Rates and Local Currencies	Local Rates, Currencies and Corporate Spreads	Local Rates, Currencies and Corporate Spreads	Develop Market Beta and Currencies	Emerging Markets Beta and Currencies

Source: State Street Global Advisors, JP Morgan, Bloomberg, MSCI, Factset as of 30 June 2023.
* J.P. Morgan use the middle rating of Moody's, S&P and Fitch. If only two of the agencies rate a security, then the most conservative (lowest) rating will be used. If only one rating agency rates a security, that one rating will be used. Where there are no security level ratings, an issuer rating may be used to determine index classification.
[1] Global Aggregate exposure is assumed to be currency hedged for euro investors. Past performance is not a reliable indicator of future performance.

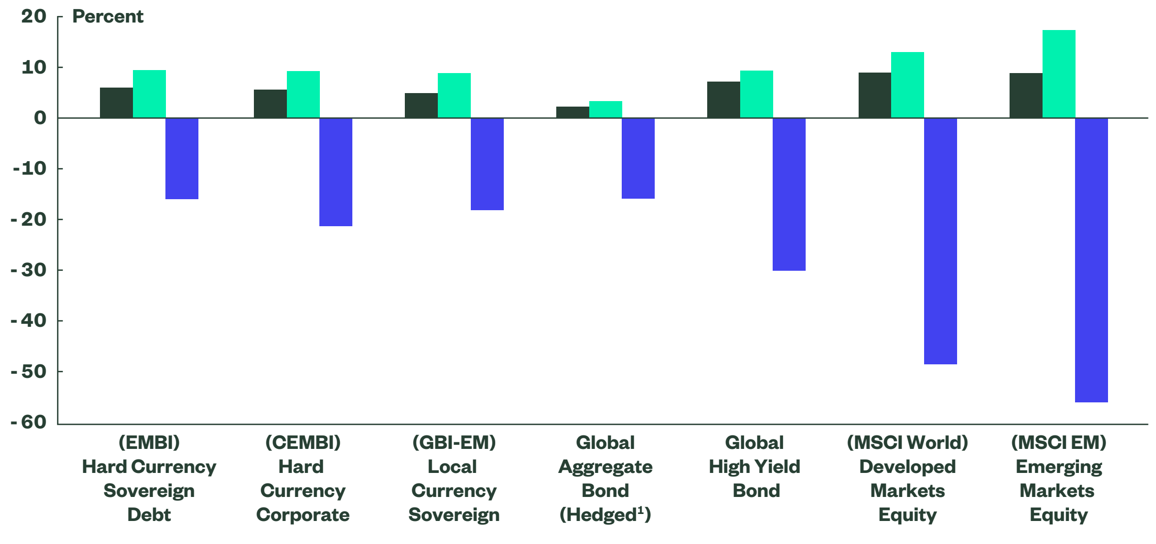
Emerging market debt provides a relatively attractive yield enhancement opportunity compared to investment grade bonds. While yields are lower than those of high yield bonds, the average credit ratings are higher. As shown in Figure 2, the main EM segments had yields ranging from 6.3 % to 8.4% at the end of June 2023, which was between one and a half and two times that of global aggregate bonds, and somewhat lower than that of global high yield bonds.

Hard currency corporate and local currency sovereign benchmarks have investment grade ratings that, depending on the rating agency, are between four and six notches below global aggregate bonds, with noticeably shorter average index duration. By contrast, the average rating of hard currency sovereign debt varies between speculative and investment grade depending on the rating agency while its duration is in line with that of global aggregate bonds. We believe that higher yields with equal or lower duration than aggregate bonds, and better ratings than high yield bonds, offer an attractive combination to both bond and equity investors.

Return/Risk Profile of EMD: Between Investment Grade Bonds and Equities

The long-term returns and risks of hard currency sovereign, corporate, and local currency sovereign EM debt have historically been somewhere between those of global aggregate bonds and global equities (Figure 3). This is not surprising given that EMD assets comprise both investment grade and speculative grade bonds and are exposed to what is typically a more pronounced business cycle.

Figure 3
Historical Returns and Risks of Fixed Income and Equity Assets (EUR) (Jan 2003–Sep 2023)

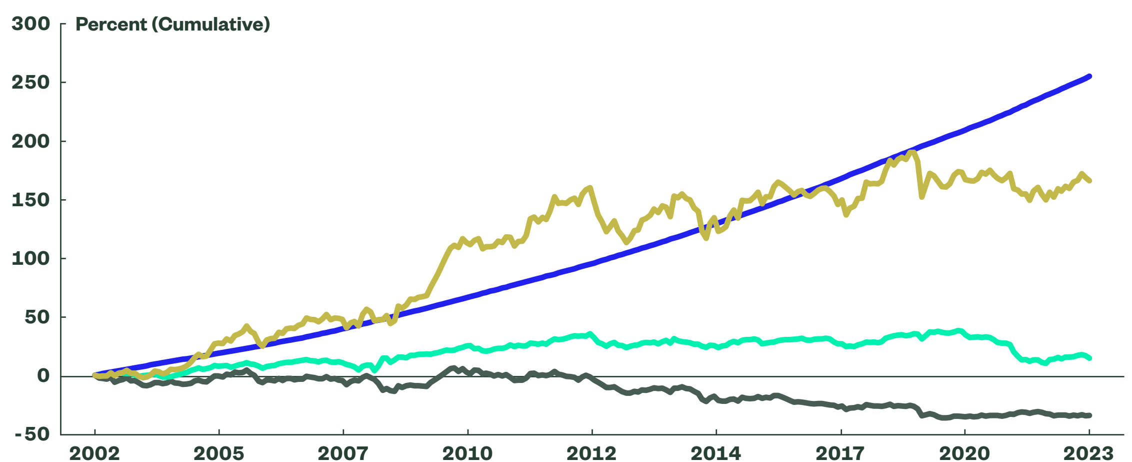


Source: State Street Global Advisors, JP Morgan, Bloomberg, MSCI, as of 29 September 2023. Data: JP Morgan EMBI Global Diversified index for Hard Currency EM Sovereign, JP Morgan CEMBI Broad Diversified index for Hard Currency EM Corporate, JPM GBI-EM Global Diversified index for Local Currency EM Sovereign, MSCI World index for MSCI Developed World, MSCI Emerging Markets index for MSCI EM returns, Bloomberg Global Aggregate for Global Aggregate and Bloomberg Global High Yield for Global High Yield. All index returns are gross total returns in EUR. Past performance is not a reliable indicator of future performance. [1] Global Aggregate exposure is assumed to be currency hedged for euro investors. Index returns are unmanaged and do not reflect the deduction of any fees or expenses. Index returns reflect all items of income, gain and loss and the reinvestment of dividends and other income as applicable. Please note that the return components are expressed in local currency terms.

Income and FX Drive EMD Local Returns

In Figure 4, we decompose local currency EM debt total returns to highlight contributions from the various return components on a cumulative basis. Not surprisingly, income (returns from coupons) is the dominant driver of returns over time, with some contribution from price (returns from changes of the bond's face value or principal) as the rates move up and down. However, returns can be significantly impacted by the foreign exchange (FX) component (returns from EM currency movements relative to the euro). Prior to 2008, EM currencies were generally flat against the euro and FX did not contribute to the total return of local currency sovereign debt. Since 2012, the return contributions from the FX component have been mostly negative. An assessment of the fair value or otherwise of EM currencies is a key consideration for euro-based investors when investing in local currency sovereign bonds. We take a closer look at EM currency exposure on page 15.

Figure 4
Decomposition of Local Currency Returns for JP Morgan GBI-EM Global Diversified Index for Euro Investors (Dec 2002–Sep 2023)



Source: State Street Global Advisors, JP Morgan, as of 29 September 2023. Index returns are unmanaged and do not reflect the deduction of any fees or expenses. Index returns reflect all items of income, gain and loss and the reinvestment of dividends and other income as applicable. Past performance is not a reliable indicator of future performance.

Benefits of Allocating to Emerging Market Debt

- Low correlation and higher growth factor exposures provide diversification benefits for both bond and equity portfolios.
- By blending EMD segments, investors can generate relatively attractive returns while reducing the risk profile compared to holding a single EMD asset.

Diversification Benefits for Bond and Equity Portfolios

The long-term correlations between EM debt and global aggregate bonds or global equities have been modest. This indicates the potential diversification benefits of adding EMD to a global bond or global equity portfolio (see Figure 5). For global aggregate bond investors, EM hard currency corporate and local currency sovereign debt have provided compelling diversification opportunities given their low historic correlations. Hard currency corporates offer a lower duration and higher credit exposure, while local currency sovereigns provide a more direct local rates and currency profile. From a global equity investor's perspective, all three EM debt segments provide broadly similar diversification benefits.

Figure 5
Asset Correlation Based on EUR Returns Jan 2003–Jun 2023

	EM HC Sovereign Debt	EM HC Corporate Debt	EM LC Sovereign Debt	MSCI All Country World Equity	MSCI World Equity	MSCI Emerging Market Equity	Global Aggregate Bonds (Hedged)	Global High Yield Bonds
EM HC Sovereign Debt	1.00	0.93	0.71	0.52	0.52	0.42	0.41	0.85
EM HC Corporate Debt	0.93	1.00	0.60	0.47	0.47	0.36	0.27	0.84
EM LC Sovereign Debt	0.71	0.60	1.00	0.57	0.53	0.65	0.34	0.63
MSCI ACWI	0.52	0.47	0.57	1.00	0.99	0.79	0.09	0.68
MSCI World	0.52	0.47	0.53	0.99	1.00	0.73	0.08	0.69
MSCI EM	0.42	0.36	0.65	0.79	0.73	1.00	0.12	0.55
Global Aggregate (Hedged)	0.41	0.27	0.34	0.09	0.08	0.12	1.00	0.19
Global High Yield	0.85	0.84	0.63	0.68	0.69	0.55	0.19	1.00

Source: State Street Global Advisors, JP Morgan, Bloomberg, MSCI, as of 30 June 2023. Data: JP Morgan EMBI Global Diversified index for Hard Currency EM Sovereign, JP Morgan CEMBI Broad Diversified index for Hard Currency EM Corporate, JPM GBI-EM Global Diversified index for Local Currency EM Sovereign, MSCI All Country World index for MSCI ACWI, MSCI World index for MSCI Developed World, MSCI Emerging Markets index for MSCI EM returns, Bloomberg Global Aggregate for Global Aggregate and Bloomberg Global High Yield for Global High Yield.

Allocating to Emerging Market Debt on a Forward-Looking Basis

Before considering the benefits of an emerging market debt allocation in multi-asset portfolios we first explore EM debt as a standalone allocation. The primary question facing prospective EM debt investors is how to allocate across the three main segments. A range of outcomes exists depending on an investor's objectives and constraints — from a minimum volatility combination to a maximum risk-adjusted return portfolio, with others along the spectrum. In the table below, we set out some illustrative blends of emerging market debt to help highlight the attributes and trade-offs of holding the different combinations.

Figure 6
Blended EMD Strategies

Strategy	Description
EMD Blended 1	33% EMD HC Sovereign + 33% EMD HC Corporate + 33% EMD LC Sovereign
EMD Blended 2	25% EMD HC Sovereign + 25% EMD HC Corporate + 50% EMD LC Sovereign
EMD Blended 3	50% EMD HC Sovereign + 50% EMD LC Sovereign
EMD Blended 4	50% EMD HC Sovereign + 50% EMD HC Corporate

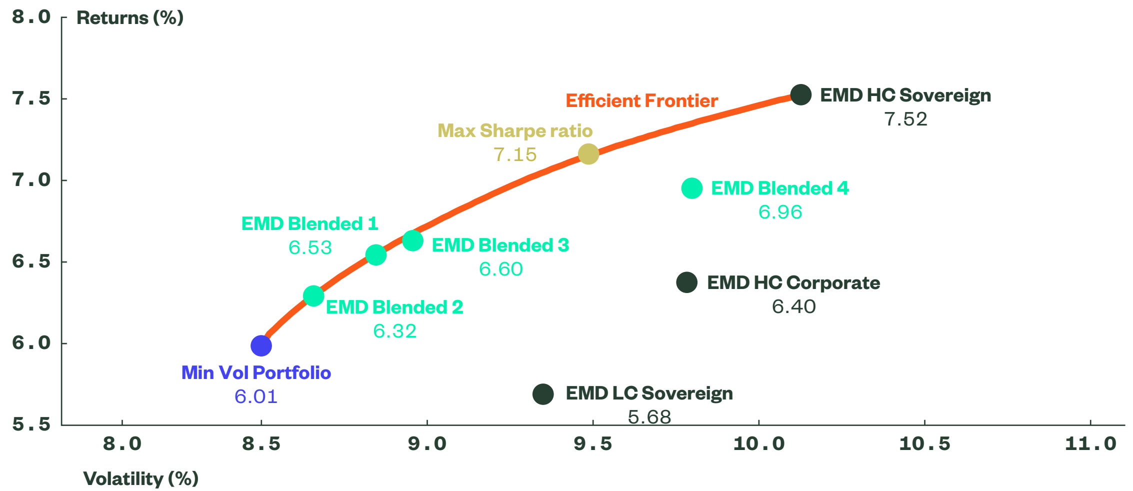
Source: State Street Global Advisors. For illustrative purposes.

In Figure 7, we present our long-term expected return and risk estimates for hard currency sovereign, local currency sovereign and corporate EMD, as well as the four blended strategies outlined above. Our long-term fixed income return forecasts incorporate the current yield-to-worst of the respective bond segments, adjusted insofar as the local currencies are at a discount or premium to fair value versus the euro. Our long-term fixed income risk estimates are based on historic standard deviation but with a modest uplift to adjust for a somewhat suppressed historic volatility outcome.

Investors have enjoyed very attractive historic returns from the EMD assets under consideration here. We expect this to continue, albeit at a more moderate level. The recent rise in yields across all three segments certainly offers investors a more tempting entry point, but somewhat stretched currency valuations may well temper returns. For euro investors in the hard currency debt segments, an overvalued US dollar presents a slight headwind and will partially offset today's more generous yield levels. Investors in local currency debt face a similar dilemma — higher starting yields today are a distinct plus, but a generally undervalued euro now removes what was previously a tailwind due to an undervalued EM currency basket.

Blending the EMD segments can provide relatively attractive returns while reducing a portfolio's risk profile compared to holding a single EMD exposure. Moreover, blends that include local currency debt (Blends 1, 2 and 3) have relatively lower volatility compared to a hard currency only blend. This is due to the FX component, which results in superior diversification benefits.

Figure 7
Optimal Portfolios Based on Blended Expected Returns, Risks and Correlations



Source: State Street Global Advisors, JP Morgan as of 30 June 2023. The expected returns for each individual segment are derived from yield to worst for the respective bond segment. There is no adjustment for potential default losses. Local currency returns are adjusted insofar as they are at a discount or premium to fair value. Volatility and correlation data are based on the historical monthly performance data of the respective bond segment from 31 December 2002 to 30 June 2023. The above expected returns are estimates based on certain assumptions and analysis. There is no guarantee that the estimates will be achieved. Returns and risk metrics for the blended strategies, minimum volatility and maximum Sharpe ratio portfolios were achieved by mathematically combining the actual performance data of EMD HC Sovereign expected return and volatility, EMD HC Corporate expected return and volatility and EMD LC Sovereign expected return and volatility. The performance assumes no transaction and rebalancing costs, so actual results will differ. Past performance is not a reliable indicator of future performance.

Impact of EMD Allocation on Fixed Income Portfolios

Using long-term historical return and risk metrics, we first assess the impact on the return and risk of a global bond portfolio by replacing 15% of the global aggregate (euro hedged) bond exposure with a blend of EMD assets.

As illustrated in the following table (Figure 8), this 15% allocation to emerging market debt, equally split across EM HC Sovereign, EM HC Corporate, and EM LC Sovereign would have led to an increase in both portfolio returns and volatility, and actually improved the Return/Risk ratio and maximum drawdown modestly.

Investors with a higher return target and level of risk tolerance could make a larger EMD allocation to their portfolio to increase their return/risk metric.

Figure 8
Impact on Fixed Income Portfolios

	Return (%)	Volatility (%)	Return/Risk	Max Drawdown (%)
Global Aggregate	2.26	3.29	0.69	-15.88
Global Aggregate + EM Debt	2.79	3.46	0.81	-14.26
Difference	0.53	0.17	0.12	1.63

Source: State Street Global Advisors, JP Morgan, Bloomberg Finance L.P., as of 29 September 2023. Returns and risk metrics were achieved by mathematically combining the performance data of the Bloomberg Global Aggregate Index and an equalweighted basket of JP Morgan EMBI Global Diversified index (Hard Currency Sovereign), JP Morgan CEMBI Broad Diversified index (Hard Currency Corporate) and JPM GBI-EM Global Diversified index (Local Currency Sovereign) in an 85%/5%/5%/5% weight. The performance assumes no transaction and rebalancing costs, so actual costs will differ. Past performance is not a reliable indicator of future performance.

Impact of EMD Allocation on Equity Portfolios

In addition to assessing the impact on a global fixed income portfolio, we also look at how a blend of EMD assets could affect a global equity portfolio. In Figure 9, we calculate the long-term historical return and risk of a global equity portfolio when we replace 15% of the global equity exposure with a combination of EMD assets. This modest 15% allocation to emerging market debt, equally split across EM HC Sovereign, EM HC Corporate, and EM LC Sovereign, would have enhanced the risk profile of an equity book with marginal return dilution.

Figure 9
Impact on Global Equity Portfolios

	Return (%)	Volatility (%)	Return/Risk	Max Drawdown (%)
MSCI ACWI	8.76	13.15	0.67	-48.43
MSCI ACWI + EM Debt	8.35	11.94	0.70	-43.34
Difference	-0.40	-1.22	0.03	5.09

Source: State Street Global Advisors Bloomberg, MSCI, as of 29 September 2023. Returns and risk metrics were achieved by mathematically combining the performance data of the MSCI ACWI and an equal-weighted basket of JP Morgan EMBI Global Diversified index (Hard Currency Sovereign), JP Morgan CEMBI Broad Diversified index (Hard Currency Corporate) and JPM GBI-EM Global Diversified index (Local Currency Sovereign) in an 85%/5%/5%/5% weight. The performance assumes no transaction and rebalancing costs, so actual costs will differ. Past performance is not a reliable indicator of future performance.

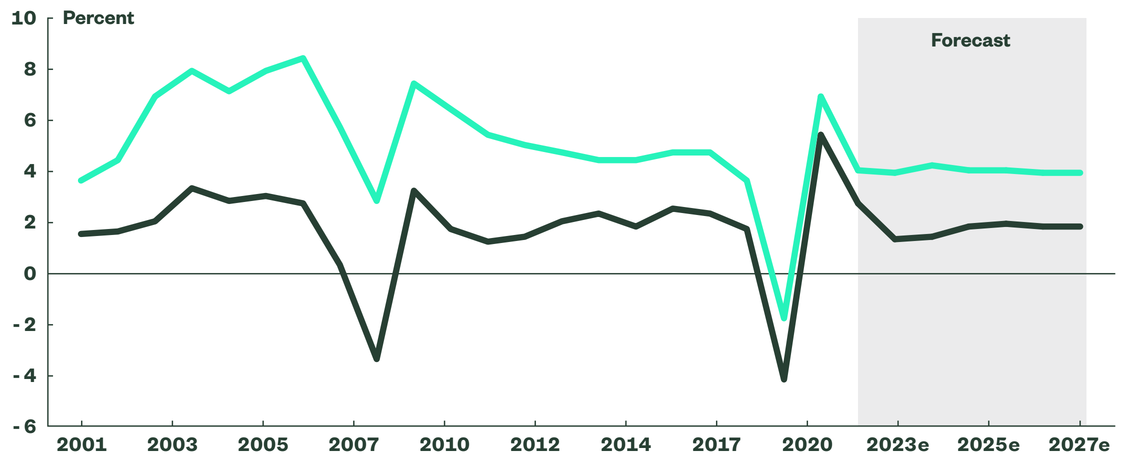
Fundamentals Underpin Case for Local Currency Emerging Market Debt

- Emerging market economies are expected to deliver superior growth relative to their advanced market counterparts in the coming years. While Asia remains a key driver of growth, China's recent experience serves as a reminder of the challenges facing even those with more policy options.
- Real policy rates vary enormously by country but it is notable that EM central banks responded quickly to the inflation dynamic and are now cutting rates or, generally speaking, are well positioned to cut rates assuming the disinflationary trend continues.

Emerging Market Countries: Higher Growth but Divergent Prospects

The world economy is slowing, with growth forecast to be well below historic averages in both 2023 and 2024. The slowdown is more pronounced in advanced economies, however, and emerging markets have generally remained quite resilient and are expected to remain the key contributor to global growth. According to the International Monetary Fund (IMF), advanced economy GDP is expected to increase by 1.4% in 2024, while emerging economy output should expand by 4.0% — both of these forecasts are potentially liable to revision in the coming quarters, although they nonetheless underline a resumption of higher growth in emerging markets. This trend of superior growth in emerging markets is not new — it's been a feature of the world economy since the turn of the millennium. However, the scale of the superior growth appears to be declining and, according to IMF forecasts, looks to be converging towards a slightly lower, but still impressive, favourable gap of about two percentage points (Figure 10).

Figure 10
Real GDP Growth (Annual % Change)



Source: State Street Global Advisors, International Monetary Fund as of October 2023. The above forecasts are estimates based on certain assumptions and analysis made. There is no guarantee that the estimates will be achieved.

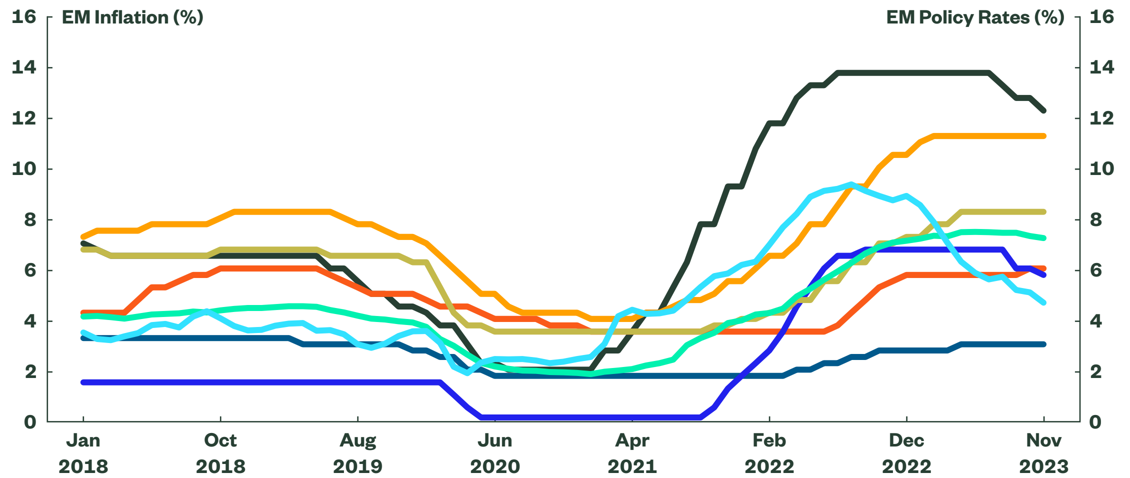
While aggregate EM growth projections are robust, it's important to recognise divergences at regional and country level. Emerging and Developing Asia is expected to deliver growth averaging 5% in 2023 and 2024 and this region is clearly the main growth engine for broad EM prospects. However, this masks a clear slowdown in China, where authorities are tackling significant challenges in its property market that threatens to weigh more heavily on weak consumer confidence. India, on the other hand, should see growth of more than 6% for 2023 and 2024, according to the IMF. Economic output in both Emerging Europe and Latin America is forecast to remain stable but somewhat subdued at around 2.25% in both years. Divergent trends are also evident across countries within these regions. Hungary and Poland are the outliers in Europe, with growth forecasts well below trend and behind regional peers in 2023 before rebounding in 2024. Regional heavyweights Brazil and Mexico shore up Latin American output with growth of over 3% in 2023 followed by a significant deceleration in Brazil during 2024.

Distinct differences are also obvious on the inflation front. Several Asian nations are experiencing subdued consumer price inflation with disinflation evident in China, India, Malaysia and Thailand. A similar picture emerges in many Latin American countries with inflation forecast to ease further in 2024. While on the right path more progress in needed in a number of the larger Central and Eastern European economies in particular. Investors in local currency debt will naturally want to focus on the disparities among the benchmark heavyweights: China, Thailand, Malaysia, Brazil and Mexico are making good progress while Poland and Hungary have more to do.

Real policy rates have risen considerably in many of the larger emerging market countries over the past two years and the consequent easing in inflation through 2023 has been a welcome development. Against this backdrop, markets have begun to price in rate cuts and this adds a favourable tailwind to local currency emerging market debt (Figure 11). Nonetheless, potentially higher-for-longer rates across advanced economies may make rate cuts in emerging markets a complicated task as declining interest rate differentials can undermine currency stability and in turn fuel higher inflation.

Figure 11

EM Central Bank Rates Peak as EM Inflation Decelerates

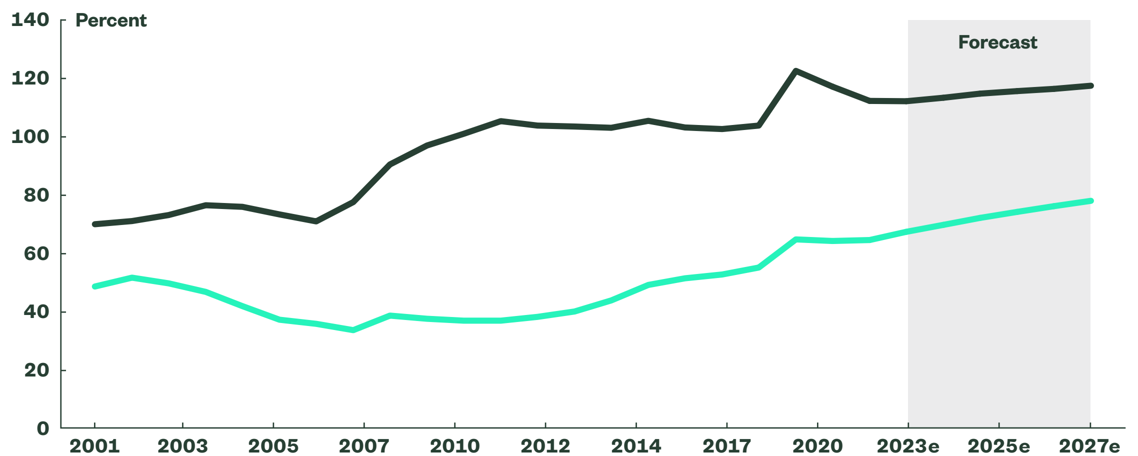


Source: Bloomberg Finance L.P., as of 30 November 2023.

The significant build-up of public debt is a critical point for investors in emerging markets (Figure 12). In its October 2023 Fiscal Monitor, the IMF noted that "global public debt is now substantially higher, and it is projected to grow considerably faster than in pre-pandemic projections". General Government Gross Debt for emerging markets is forecast at 68% of GDP on average in 2023 and rises to 78% of GDP on average by 2028. This is a substantial increase considering the metric stood at 56% in 2019 before the pandemic. A look behind the averages is once again instructive: given its weight and expanding stock of debt China drives a substantial part of the increase with it debt projected to reach 104% of GDP by 2028 according to the IMF, whereas India's debt is expected to decline slightly from its 2023 level of 82% to 81% by 2028. With India set to join JP Morgan's Government Bond Index-Emerging Markets (GBI-EM) index suite on a phased basis from June 2024 this is a welcome diversifier for investors, although it does further increase the benchmark's allocation to Asia.

Figure 12

General Government Debt as % of GDP



Source: State Street Global Advisors, International Monetary Fund as of October 2023. The above forecasts are estimates based on certain assumptions and analysis made. There is no guarantee that the estimates will be achieved.

Idiosyncratic and Contagion Risks a Fixture of EM investing

Idiosyncratic (or country specific) risk is often cited as something to watch for when investing in emerging markets. As individual countries pursue their domestic policies there is no guarantee that those policies align with what investors consider orthodox. Turkey's central bank has at times followed a monetary policy that few investors would regard as conventional and this has had significant implications for currency and market risk. Russia's ejection from benchmarks following its invasion of Ukraine was a shock to the system, but also another timely reminder of the more extreme idiosyncratic risks within the emerging market debt universe. Despite China's policy latitude, the country's property market woes and its accelerated and sustained debt build-up mark it out as a candidate prone to headline and idiosyncratic risk.

Contagion is another aspect of EM debt investing to keep in mind. When one EM country runs into difficulties there is an expectation that others are likely to follow. Sometimes this originates from common factors such as exposure to currency and commodity price shocks — this is particularly the case among the commodity importers or those more open economies with a more leveraged exposure to international trade. Emerging markets are also susceptible to swings in investor confidence and broad risk appetites even though a sharp change in sentiment may have no bearing on an individual country's economic fundamentals.

Despite these vagaries it is important to recognise the progress and reforms made in emerging markets over the last 20 years — many countries have liberalised their capital markets (allowing for more market-oriented currency regimes), established independent central banks, and built up foreign currency reserves.

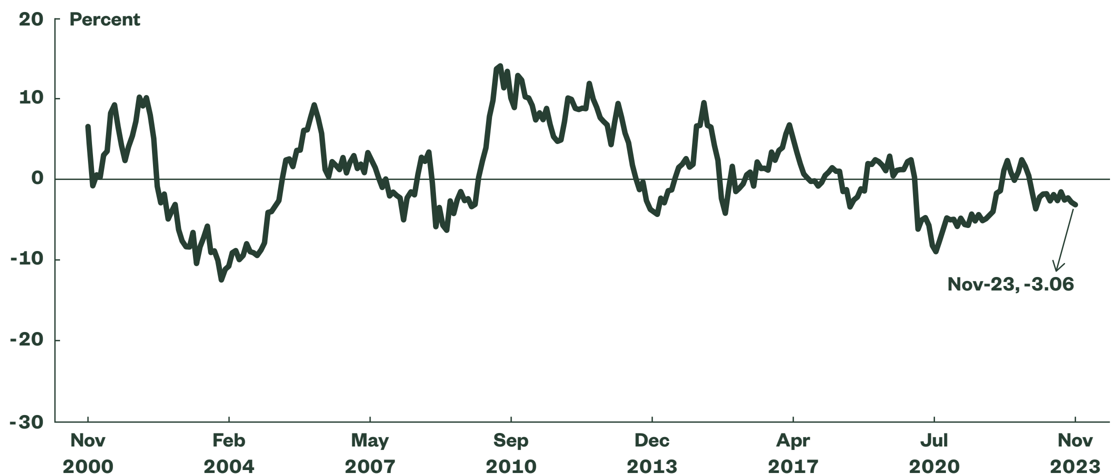
Local Currency Emerging Market Debt — The FX Component

As noted, income return tends to be the dominant driver of total returns over time. That said, foreign exchange rate movements against the euro have been a significant return and risk driver for investors in local currency EMD. Due to a long-term historical negative return contribution from the FX component and high EM currency volatility, it has been less beneficial for euro-based investors to incorporate local currency EMD into a global portfolio relative to hard currency sovereign EMD.

On the other hand, we have observed that the performance of local currency EMD is correlated to the valuation of EM currencies versus the euro. Historically, a good time to invest in EMD has been when EM currencies have been attractively priced (undervalued) against the euro. Investing in local currency EM debt during periods when EM currencies are overvalued has typically resulted in poor returns for investors as the subsequent currency depreciation can wipe out bond gains.

The recent weakening of the broad basket of EM currencies has coincided with a weakening of the euro, so EM currencies (as a basket) are now close to fair value relative to the euro (Figure 13). The substantial rise in yields in recent times may make this immaterial for some investors, while others may want the added comfort of a potential currency tailwind — for the latter, opportunities may arise should poor sentiment towards EM lead to renewed weakness or should the euro experience a rebound.

Figure 13
EM Currency Over/ Undervaluation Versus the Euro



Source: State Street Global Advisors, Bloomberg Finance, L.P., as of 30 November 2023. Past performance is not a guarantee of future results. Historic estimate of fair value versus euro to 30 November 2023 — valuations above 0% imply overvalued and below imply undervalued. The calculation is based on the currency weight of the JP Morgan GBIEM Global Diversified total return index. This information should not be considered a recommendation to invest in a particular currency. It is not known whether EM currencies will be profitable in the future.

The Bottom Line

Emerging market debt, like many other asset classes, faces a challenging environment as some of the world's major central banks hold firm in the fight on inflation despite the appearance of some fractures in an already slowing world economy. Superior growth prospects versus those of advanced peers need to be seen in the light of rising debt burdens and perhaps a somewhat constrained policy response from China, complicated by an ongoing war in Ukraine and conflicts in the Middle East. Much of this has been priced in to debt markets with yields now substantially higher than they were just a couple of years ago. We may well be at an uncomfortable juncture with more bouts of volatility likely as the inflation and policy response picture is far from complete. But for strategic investors with the resources and risk appetite, the potential rewards from investing in emerging market debt are attractive.

As with most bond investments, income tends to be the dominant driver of returns over the medium to long-term. In the short term, however, currency fluctuations can drive return variance in hard currency and (more so) in local currency EM debt. Assessing the fair value of those local currencies can help investors manage that risk — allocating to the asset class where the currencies are trading close to, or below, fair value can help build a buffer into the investment decision.

Finally, we note the versatility of emerging market debt — its low correlations with global equities and global bonds makes it a welcome addition for both global equity and debt investors.

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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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