Insights
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Emerging Market Debt: Unfulfilled Potential

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Currency volatility and the impact of COVID have led to volatile returns for emerging market debt (EMD) in 2021. However, global growth and inflation are starting to slow and concerns have lessened over an adverse market reaction to the Federal Reserve withdrawing monetary accommodation.

So risks to EM local currency debt appear to have diminished. Relatively high yields, the fact that markets have already priced a considerable degree of policy tightening, and a still-overvalued USD create some potential for returns during the remainder of the year.

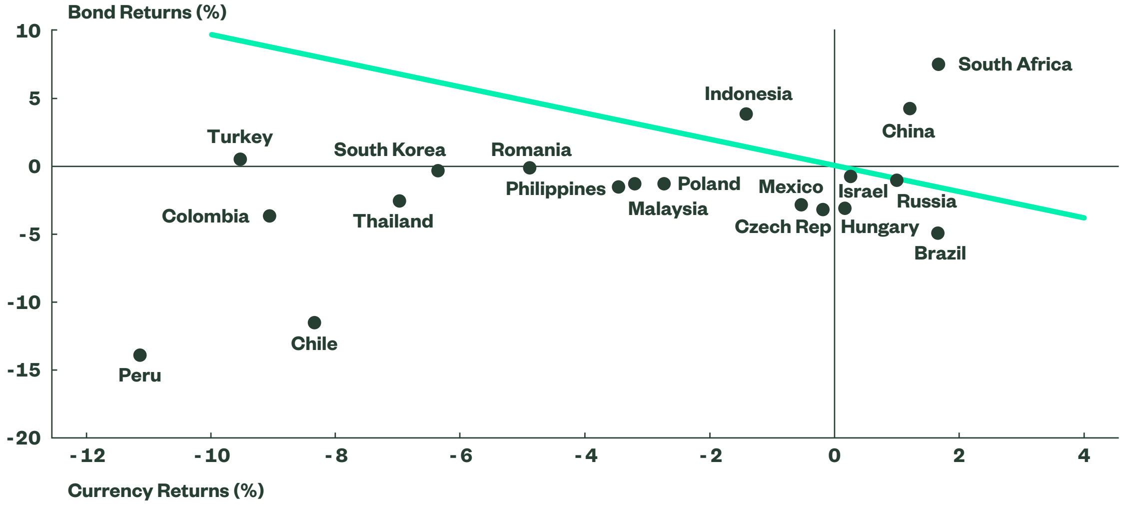
What's Driving EMD Performance?

Emerging market debt (EMD) enjoyed a positive start to 2021 amid strong global growth and optimism that COVID would be less of an issue, as investor demand for risk assets surged. EMD saw particular interest given the high yield on offer. However, the spike in Treasury yields and the rebound in the USD asked questions of the emerging markets that they did not necessarily have answers to. Against a pandemic backdrop, high inflation (which pressured central banks to raise rates) and big swings in certain currencies undermined returns.

As is often the case in EMs, performance varied significantly. Figure 1 illustrates this dispersion well, with the top performer year to date in the Bloomberg EM Local Currency Liquid Govt Index being South Africa (total return of +9.47%) and the bottom being Peru (total return of -24.45%). It is clear that currency remains a key factor in driving returns (x-axis) and, for 13 out of the 19 issuers in the Bloomberg EM Local Currency Liquid Govt Index, it has negatively affected performance.

Figure 1

Emerging Market Local Currency Debt Returns for 2021 Weighed Down by Currency Declines



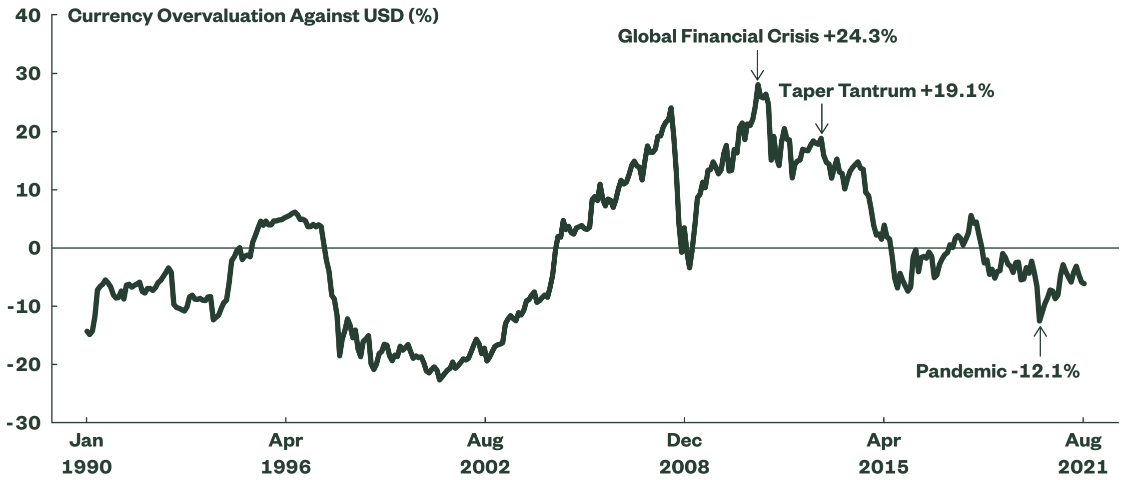
Source: Bloomberg Finance L.P. Returns are for 31 December 2020 to 31 August 2021 (not annualised). Past performance is not an indication of future results. Index returns are unmanaged and do not reflect the deduction of any fees or expenses. It is not possible to invest directly into an index.

While the Bloomberg EM Local Currency Liquid Govt Index may be down 3.0% year to date, other strategies, such as the JP Morgan Government Bond Index EM Global 10% Cap 1% Floor, have seen even worse performance,[1] largely due to greater exposure to Latin American debt.

Currency exposures will be important for funds' relative performance but the big question remains whether to expect the USD to resume its decline. Using a longer-term model of value, State Street Global Advisors estimates that the basket of currencies that make up the Bloomberg EM Local Currency Liquid Govt Index remains 5.7% cheap to the USD.[2] There may no longer be the strong consensus for USD weakness that there was at the start of 2021, but this valuation implies some potential for richening of EM FX against the USD on a longer-term basis.

Figure 2

Valuation of the Basket of Currencies that Comprise the Bloomberg EM Local Currency Liquid Govt Index vs. the USD



Source: State Street Global Advisors, as of 31 August 2021.

Living in Fear of the Taper

This cheapness of EM currencies is significant. Many investors remain cautious around what may happen when the Federal Reserve (Fed) starts to taper its asset purchases. Indeed, the 2013 taper tantrum was an unhappy time for EMD investors given the double whammy of the sharp rise in US Treasury yields and the depreciation of their currencies versus the USD. However, this currency decline was from significantly richer levels, with the State Street Global Advisors model suggesting EM currencies were more than 19% overvalued relative to the USD at that time.

A second key difference is that many EM central banks were in the course of easing monetary policy in 2013, which raised the risk of capital flight as interest rate spreads swung in favour of the USD. This is not the case in 2021, with 7 of the 19 central banks in the Bloomberg EM Local Currency Liquid Govt Index having pushed interest rates higher in Q3 2021. With Fed Chair Powell having done his best to distance the start of rate rises from the taper of bond purchases, it is likely that interest rate differentials will move increasingly in favour of EMD over the next few months.

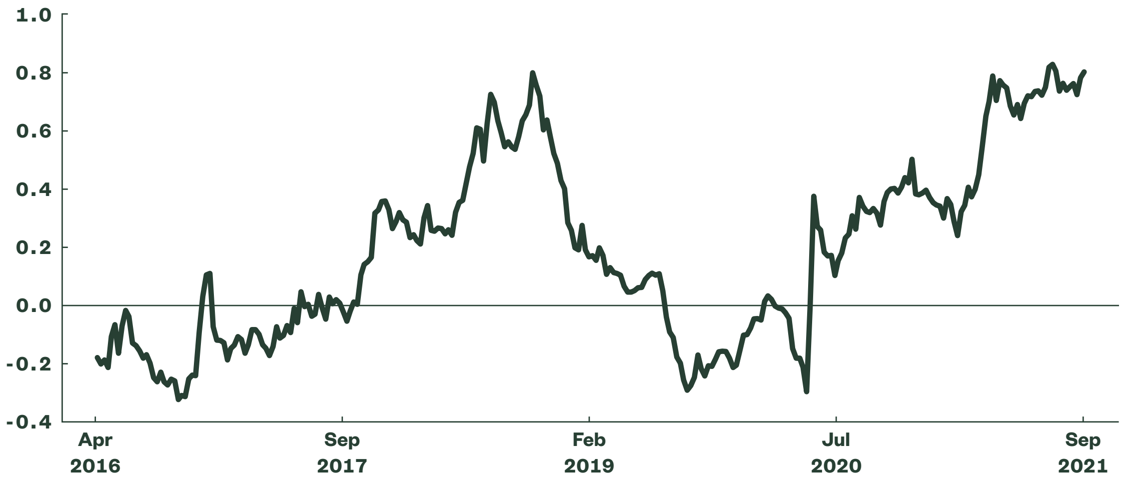
In short, the Fed's better management of the taper (so far) could act to restrain any spike in US Treasury yields and USD appreciation. Conversely, the fact that many EM central banks have already embarked on their tightening cycle should help to attract capital due to the higher yields on offer.

Central Banks Battling Inflation

A key reason for EM central banks tightening policy has been the high levels of inflation seen as a result of depreciating currencies and general global inflation pressures. This is not typically a favourable backdrop for fixed income investors, but there may be some relief in sight. The PriceStats® series run by State Street Global Markets tracks inflationary pressures in online prices in many EM countries. The year-on-year rate of change has either stabilised or started to edge lower in several of the key countries, including Brazil, South Korea and South Africa.

This hints that pressure for central banks to push rates higher could start to ease. Markets already price a high degree of tightening into the front end of the curve. Figure 3 shows the slope between the central bank rate and the 2-year bond yield weighted according to the Bloomberg EM Local Currency Liquid Govt Index. The slope remains at its steepest levels in 5 years, suggesting the market is well advanced in pricing an EM tightening cycle into the curve. Many EM central banks have been reluctant hikers, so if inflation pressures are starting to ease, and given uncertainties around the Delta variant of COVID, we could see them decelerate the pace of monetary tightening.

Figure 3
The 0–2 Year Slope of the Curve in EM Remains Steep, Suggests Considerable Monetary Policy Tightening Priced by Market



Source: Bloomberg Finance L.P., as of 31 August 2021. Weighted for the 19 central banks whose bonds make up the Bloomberg EM Local Currency Liquid Govt Index.

The rush by the market to price in tighter policy has pushed up the yield on EM bonds. For instance, the yield to worst on the Bloomberg EM Local Currency Liquid Govt Index is more than 4.6%, which is its highest since the March 2020 spike in yields. This high comes at a time of low yields in many other asset classes: the spread over US high yield is around 85–90bp, which compares to a 5-year average spread of -88bp.[3] The spread is currently close to the wides seen in 2014[4] and, while there may be economic factors driving the spread differential, it should enhance the appeal of EMD in an environment where there is investor caution regarding how tight credit spreads have become.

Positive Flows Story Dominated by China

At a headline level, we see positive investment flows for EMs. Portfolio flows data from the Institute of International Finance suggests that more than $200 billion has flowed into EMD over the first eight months of 2021. However, around half of that has gone into China debt markets. Additionally, much of the assets flowed during the first two months of the year.

Clearly, increasing rates in several EM countries, coupled with fears around the Fed's taper plan, have slowed inflows into EMD. However, the flows are expected to remain positive, largely powered by flows into Chinese debt. The backdrop for Chinese government debt continues to look positive for three key reasons:

- The FTSE World Government Bond Index will include China bonds from October 2021. This means there will be regular monthly buying of Chinese Treasuries as investors who follow that index add holdings.

- Yields on Chinese debt look comparatively attractive, with the 10-year yielding around 2.9%. This is more than 150bp above the yield on the US 10-year Treasury. While there are no expectations that the People's Bank of China (PBOC) will cut rates in the near term, the weaker recent growth dynamic has seen 10-year bond yields fall by close to 50bp in the hope that there may be easier policy at some stage.

- Chinese government bonds displayed stability during the March 2020 crisis, with price action that was consistent with relatively safer assets, such as US Treasuries, rather than getting swept up in the broader EM debt sell-off. The stability and liquidity of Chinese bonds could broaden the appeal for investors concerned over high valuations in some asset classes and the potential for increased market volatility.

Exposure to China debt is capped at 10% of the Bloomberg EM Local Currency Liquid Govt Index. Nonetheless, a steady stream of buying would help to stabilise the overall performance of EM debt.

Summary

EMs will continue to face challenges during the remainder of 2021. Some of those challenges, including higher inflation and tighter central bank policy, already look well priced into the debt markets. Others, such as an adverse market reaction to changes in US policy, are less easy to predict but look less threatening given the Fed's signalling and the overvalued nature of the USD. The potential for EM currencies to appreciate, coupled with the yield premium offered by EMD, certainly make it an interesting strategy in an environment where fixed income investors continue to face the challenges of low yields and compressed spreads.

Endnotes

1 Bloomberg EM Local Currency Liquid Govt Index returned -3.04% year to date versus -3.47% for the JP Morgan Government Bond Index EM Global 10% Cap 1% Floor.

2 Source: State Street Global Advisors, as of 31 August 2021. The estimate is based on certain analyses and assumptions. There is no guarantee that the estimate will be met.

3 Source: Bloomberg Finance L.P., as of 15 September 2021.

4 The spread of the yield to worst on the Bloomberg EM Local Currency Liquid Govt Index and the Bloomberg U.S. Corporate High Yield Bond Index reached 90bp on 13 September 2021, which was only around 5bp below the spread seen in March 2014.

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* Pensions & Investments Research Center, as of 31 December 2020.
† This figure is presented as of 30 June 2021 and includes approximately $63.59 billion 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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