Insights
Emerging Markets

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Emerging Market Debt: Cautious Optimism

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Emerging Market Debt

Emerging bond markets have enjoyed a strong rally since the sharp drawdown experienced in the teeth of the COVID crisis last year. As a result, valuations have recovered significantly even as some of the fundamentals have deteriorated — most notably on the fiscal and debt sustainability side. And while the start of 2021 has shown that smooth sailing cannot be guaranteed, there are reasons for cautious optimism.

Following the robust recovery and taking account of recent developments, it is not unreasonable that investors might question whether there is still space for emerging market debt (EMD) to advance further. The post-COVID rally has seen a strong recovery from the lows, but we still see reasons to remain constructive on the asset class. While the macro backdrop has been changing, it is still largely supportive for EM Debt. Combined with the global hunt for yield, this is likely to continue to drive flows into the asset class and thereby support performance.

The EM debt advance continued following the US elections in November and the approval of COVID vaccines. Indeed, in the last two months of 2020, buoyant markets saw the riskier parts of the asset class outperform. In hard currency (HC) EMD, high yield issuers which had lagged in the initial rebound drove this leg of the rally, while local currency EMD was bolstered by recovery in EM currencies. Although the start of 2021 has brought volatility to EMD due to the rapid rise in US Treasury yields, this has been due to expectations for even stronger US growth; despite these short-term jitters, strong US and global growth is supportive of risk assets like EM debt.

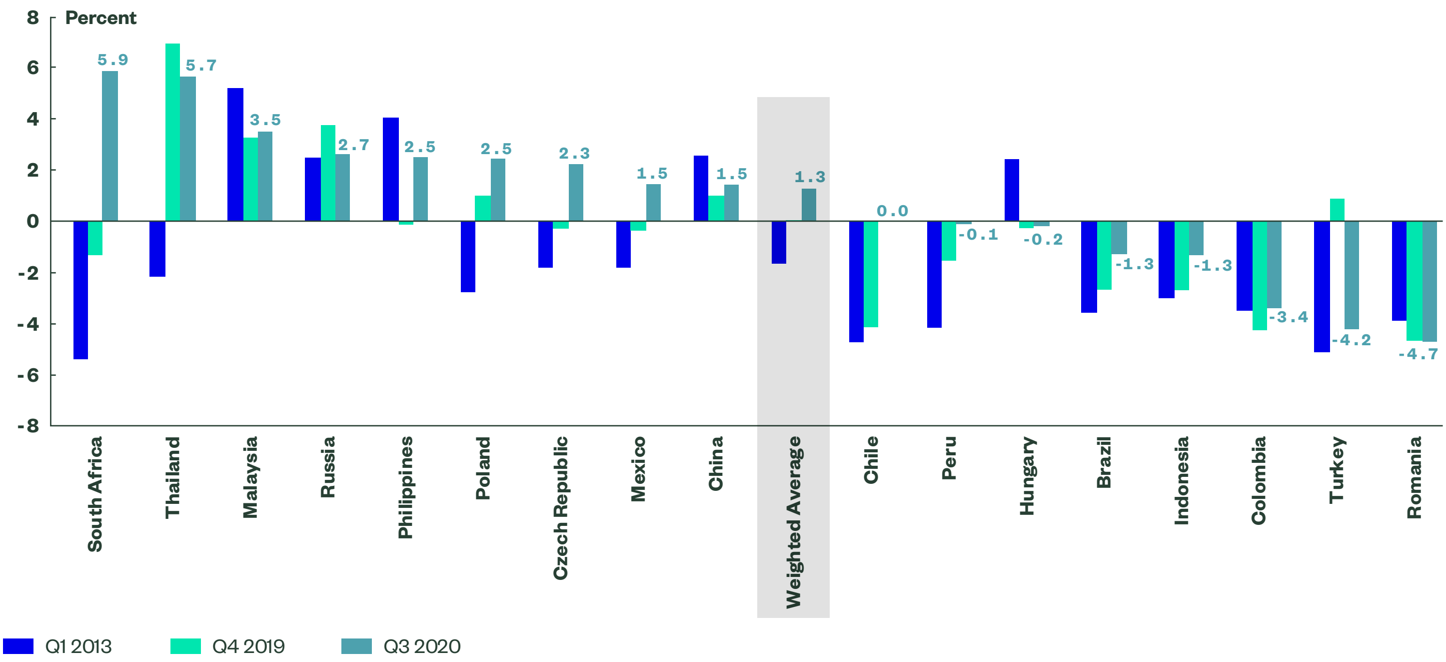
Emerging Market Fundamentals

Over the course of the last year, EM (and DM) countries have had to support their economies through quantitative and fiscal easing in order to weather the devastating effect of the COVID-induced crisis. As a result, we saw a sharp increase in debt as a percentage of GDP from already high levels. According to International Monetary Fund (IMF) data, debt-to-GDP of EM economies jumped from 53% at the end of 2019 to 62% at the end of 2020; the expectation is that debt-to-GDP for most EM countries will continue to increase over the next five years, though at a more moderate pace. While the hunt for yield and abundant liquidity due to DM quantitative easing (QE) means that the asset class is enjoying healthy flows, return to fiscal discipline and investment in structural reforms will be key in maintaining positive market sentiment once the US Federal Reserve (Fed) starts tapering QE.

More positively, EM external positions are much stronger compared to previous EM sell-offs and have improved further. For instance, just before the taper tantrum in Q2 2013, the EM countries in the JPM GBI EM Global Diversified index had a weighted average current account deficit of 1.6%. In contrast, just before the COVID-induced sell-off in March 2020, EM countries' current accounts were in balance. The external position of the same countries has improved further since then to exhibit a surplus of 1.3% (Figure 1). While this has been largely due to the sell-off in EM FX leading to a contraction in imports and the cheapening of exports, EM external vulnerabilities are less of a headwind this time, which to some extent balances out the deterioration in fiscal and debt metrics.

Finally, strong global growth and the associated continued recovery in oil prices, and commodity prices more broadly, are expected to further support EM fundamentals.

Figure 1
EM Current Account Balances as % of GDP



Source: State Street Global Advisors, Bloomberg, As of Q3 2020. All data is weighted based on the country weights of the JP Morgan GBI-EM Global Diversified Index as on the respective dates.

Outlook for Hard Currency EM Debt

The performance of hard currency EM debt in 2020 was strongly aided by the rally in US Treasuries as the COVID crisis quickly unfolded early in the year and the US 10-year benchmark yield fell from nearly 1.9% to a low of 0.5%. Entering 2021, the key risk to EMD HC was a sell-off in US Treasuries, a risk that has already materialised. A rapid rise in yields, which has seen the 10-year yield hit 1.6% in March 2021 is due to two main reasons:

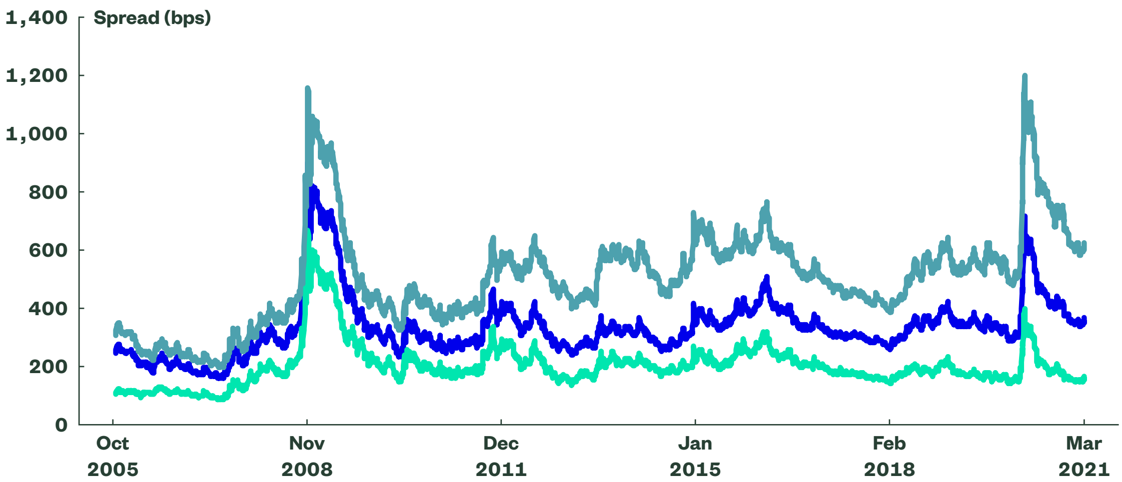
1. The larger-than-expected $1.9 trillion fiscal stimulus that the Biden administration was able to pass through Congress, combined with
2. An expected rapid roll-out of the COVID-19 vaccination program in the US following the approval of a number of successfully-tested vaccines.

Both are fuelling expectations for strong US growth, a return of inflation, and therefore the possibility that the Federal Reserve could raise rates earlier than previously expected. US Treasuries might therefore remain a headwind for EMD HC this year and are more likely to be a detractor than a contributor to returns.

For EM HC debt to deliver positive returns in 2021, spread tightening is likely to be a major factor. EM sovereign spreads have tightened considerably since March 2020, and parts of the asset class may start to look expensive, particularly on the investment grade side. The high yield (HY) segment of the index is where most of the value can be found, with spreads still significantly wider than their pre-COVID levels and the 15-year average.

However, over the coming months, investors will need to balance deteriorating fundamentals — particularly on the fiscal and debt sustainability side — against the continued hunt for yield, abundant liquidity provided by developed market central banks, and improving growth prospects. There were high default rates in the EM HC sovereign universe in 2020, with six countries in the JP Morgan EMBIG Diversified index undertaking debt restructuring, including Argentina, Ecuador, Lebanon, Zambia, Suriname and Belize. Against this backdrop, wider spreads for the high yield segment of the EMBIG index seem appropriate.

Figure 2
Hard Currency Spreads Recover From April 2020 Highs

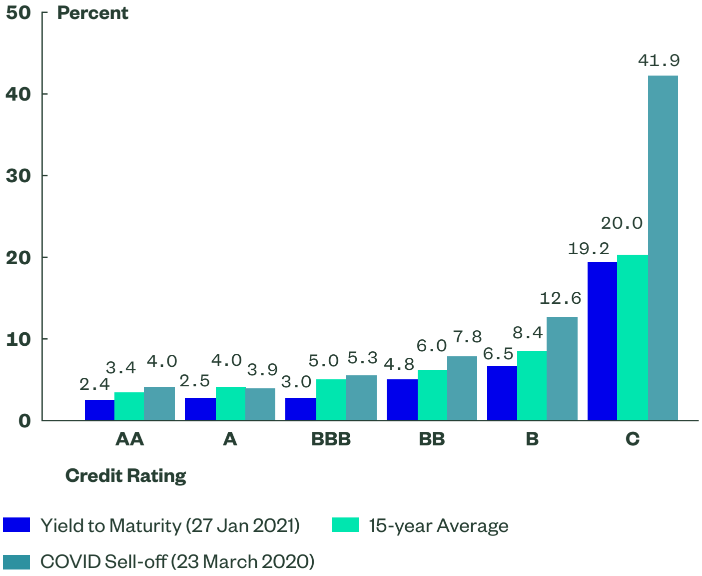


Source: State Street Global Advisors, Bloomberg, JP Morgan as of 8 March 2021. Past performance is not a guarantee of future results.

On the other hand, a closer look at EM yields (Figure 3a) reveals that they have come down to pre-COVID levels for most credit ratings. Those favourable conditions have fuelled record hard currency sovereign issuance and if EM governments can finance themselves at such cheap levels, they will surely do so. Duration has also been extended, but it is important to note that the largest duration extensions have been in the highest quality segments of the investment universe (Figure 3b).

Figure 3a

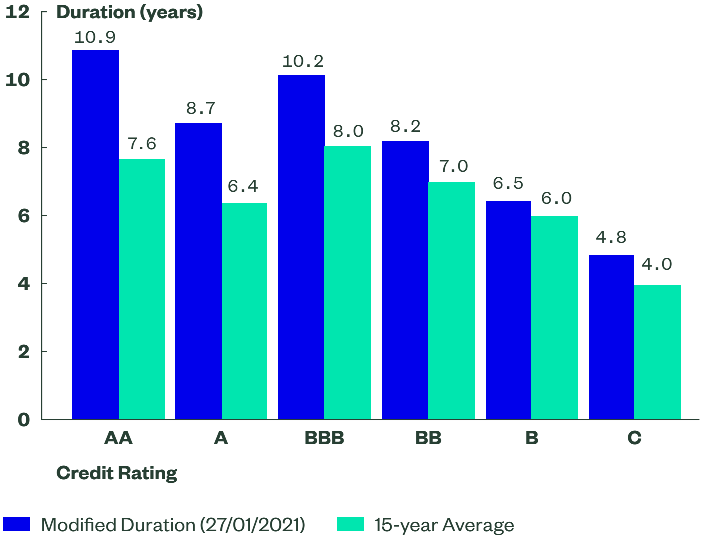
Improved Refinancing Rates for EM Economies



Source: State Street Global Advisors, JP Morgan as of 27 January 2021.
Past performance is not a guarantee of future results.

Figure 3b

Highest Quality Credits See Largest Duration Extensions

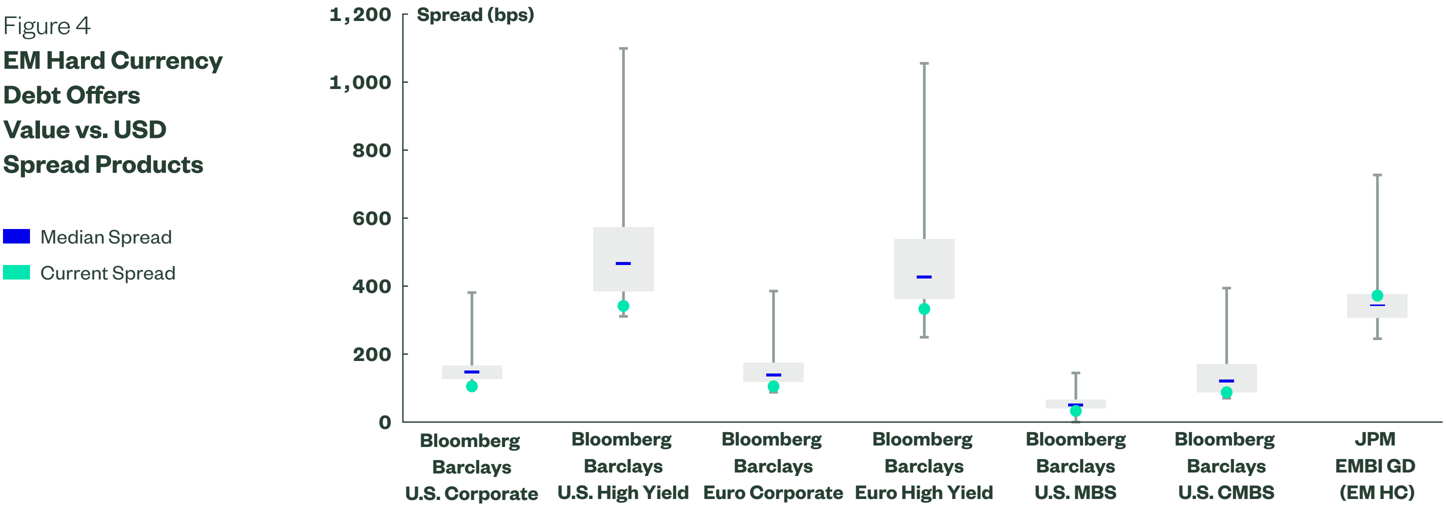


Source: State Street Global Advisors, JP Morgan as of 27 January 2021.

Even though EM spreads have tightened significantly over the past year, they are still lagging other US dollar spread products. In fact, as illustrated in Figure 4, EMD HC offers better value than most other high yielding credit markets.

Figure 4

EM Hard Currency Debt Offers Value vs. USD Spread Products



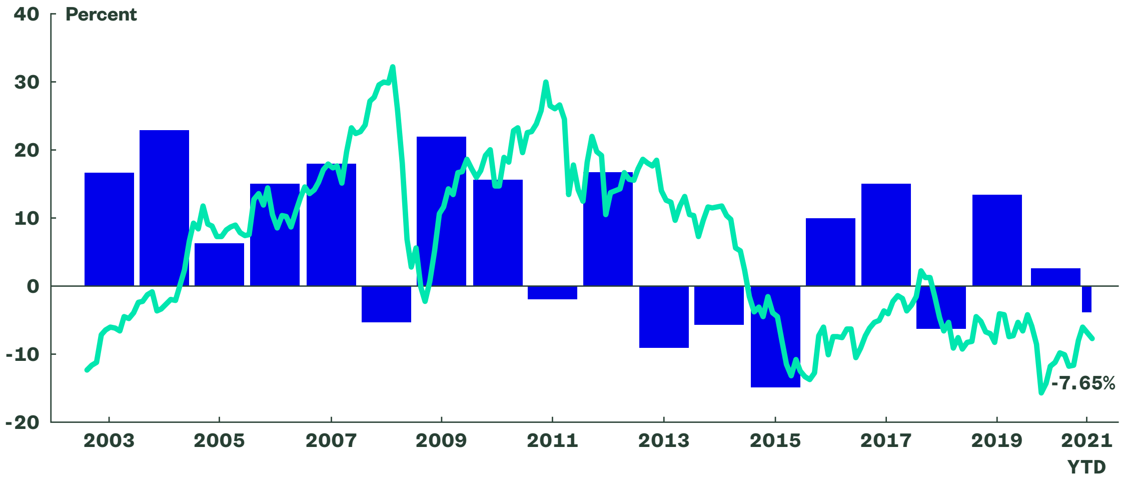
Source: State Street Global Advisors, JP Morgan as of 27 January 2021.

Local Currency EMD Outlook

Through most of 2020, EMD LC was supported by the rates component of return, though this was insufficient to compensate for the sell-off in EM currencies. However, when EM FX finally joined the rally, we saw some outstanding returns in the final quarter of 2020.

That said, EM FX remains undervalued versus the US dollar and although the undervaluation gap has narrowed, EM FX is one of the few places that we believe still offers value. We believe that this, combined with continued US dollar weakness, can support local currency debt returns in 2021. We think that the US dollar may be on a long-term depreciation trend, having lost one of its key pillars of support — its higher yield. While the US dollar strength in early 2021 has rattled markets, with US yields also picking up sharply on inflation speculation, how sustainable this is remains to be seen. The US dollar seems likely to resume its bearish trend as flows move away from 'safe haven' US dollar assets and into riskier assets like EM debt.

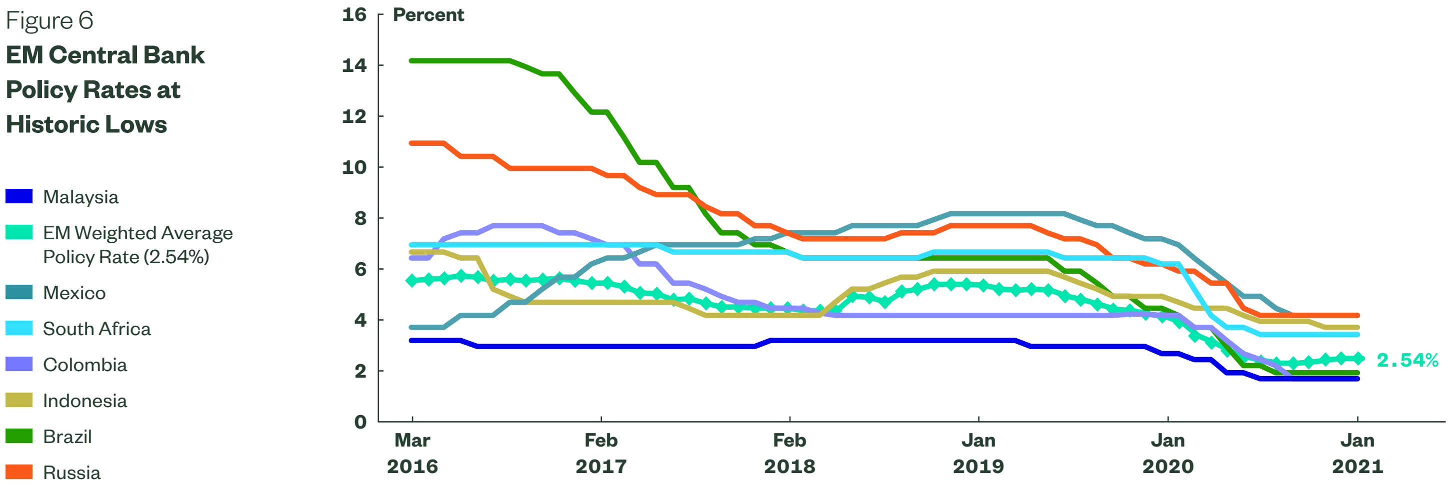
Figure 5
EM FX Undervaluation Remains Supportive of Local Currency EMD



Source: State Street Global Advisors, Bloomberg Finance, L.P., as of 28 February 2021. Past performance is not a guarantee of future results. Historic estimate of fair value versus euro to 28 February 2021 — 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.

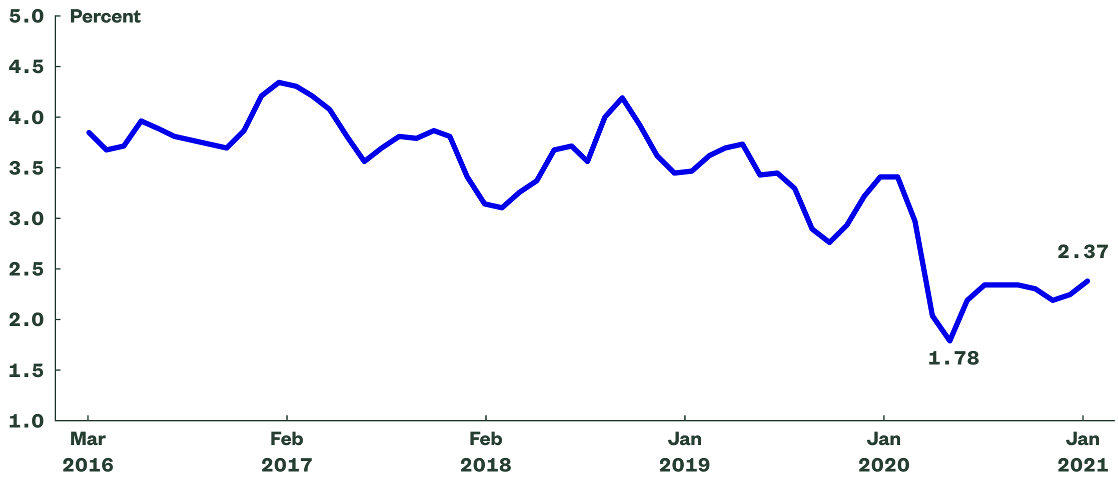
On the rates side, EM central banks cut policy rates aggressively over the course of last year with the weighted policy rate of the countries in the JPM GBI-EM GD index reaching a low of 2.4% in August; this marked an average reduction of 1.8% from the pre-COVID levels in January. While all countries in the index reduced their respective policy rate last year, some implemented steeper cuts than others. Over the coming months, most EM central banks are likely to maintain a dovish bias, although there are some exceptions — Hungary and Turkey have already hiked rates, while Brazil, which is one of the larger index constituents, is likely to follow. Although weighted average CPI inflation has increased from the lows seen in August, it is still near its historical nadir, and provides ample room for EM economies to maintain broadly accommodative policies. However, the contribution to EMD LC performance from further yield declines is limited, such that yield or carry will be the key component of bond returns.

Figure 6
EM Central Bank Policy Rates at Historic Lows



Source: State Street Global Advisors, Bloomberg Finance, L.P., as of 31 January 2021. Weighted average policy rate is based on the weights in the JPM GBI EM Global Diversified Index.

Figure 7
Historically Low EM Inflation Supportive of Accommodative Policy



Source: State Street Global Advisors, Bloomberg Finance, L.P., as of 28 February 2021. Weighted average CPI Inflation YoY based on the weights in the JPM GBI EM GD Index.

Flows into local currency markets are more likely to support the performance of the asset class this year. In 2020, flows into local currency debt lagged that of hard currency, but in the first couple of months of 2021 the two have been almost at par. With the JPM GBI-EM Global Diversified Index yielding 4.86% (as of 10 March, 2021), EM local currency debt still offers a significant yield pick-up over DM bonds, both in nominal and real terms.

In Conclusion: Evolving Outlook, Still Positive

After the strong rally enjoyed since May 2020, the backdrop for EM debt is changing. Valuations have recovered and parts of the asset class are starting to look expensive, while the macroeconomic environment is also evolving; higher US Treasury yields are expected to remain a headwind. However, there are still pockets of value in EM FX and in high yield hard currency debt, and both EMD LC and HC offer compelling yield pick-up versus other fixed income investments. The macro backdrop remains broadly supportive with abundant liquidity and the hunt for yield expected to continue to drive flows into the asset class. On the fundamental side, deterioration in debt and fiscal metrics is balanced out by an improvement in EM external positions and improving growth prospects, although EM countries will need to return to fiscal discipline and invest in structural reforms in order to enjoy positive market sentiment over the medium term.

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State Street Global Advisors serves governments, institutions and financial advisors with a rigorous approach, breadth of capabilities and belief that good stewardship is good investing for the long term. Pioneers in index, ETF, and ESG investing and the world's third-largest asset manager, we are always inventing new ways to invest.