Insights
Emerging Markets

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To the Brink and Back: Emerging Market Debt in 2020

Lyubka Dushanova
Portfolio Specialist, Emerging Market Debt

Emerging market debt (EMD) has rallied along with other risk assets, recovering a large part of the losses incurred earlier in the year. In **"COVID-19 and what it means for EMD investors"** published in April, we argued that the sell-off in March induced by the dual blow of the COVID-19 outbreak and a collapse in oil prices presented an attractive entry point into the asset class. In this update, we take stock of what has happened since then and consider whether EMD still represents an attractive investment.

Emerging Market Debt (EMD) rallies have historically tended to happen quickly and the rebound from the trough on 23 March to 30 September has been little different, with EMD Hard Currency (HC) and Local Currency (LC) returning 22.6% and 16.3%, respectively. The year-to-date outperformance of HC versus LC has been aided by sustained low US Treasury yields and spread tightening, driven by the investment grade part of the index. US Treasury returns were the largest driver of EMD HC performance in Q1 2020, but spread tightening was the key driver in Q2–Q3.

Figure 1
Emerging Market Hard Currency Debt Return Drivers

JPM EMBIG Diversified Index (in USD)	Q1 2020 (%)	Q2 2020 (%)	Q3 2020 (%)	YTD 2020 (%)
Total Return	-13.38	12.26	2.32	-0.51
Spread Return	-21.57	12.37	2.59	-9.59
Treasury Return	10.45	-0.10	-0.26	10.05
Investment Grade Sub-Index	-5.54	9.06	2.58	5.79
High Yield Sub-index	-22.44	16.57	1.99	-7.80

Source: State Street Global Advisors, JP Morgan as of 30 September 2020. Past performance is a not a guarantee of future results.

Local currency debt has also recouped some of the losses incurred earlier this year. Underperformance of EMD LC has been driven by the currency return component on a year-to-date basis, although EM FX was one of the principal drivers of positive EMD LC performance in Q2 and part of Q3.

Figure 2
Emerging Market Local Currency Debt Return Drivers

JPM GBI EM Global Diversified Index (in USD)	Q1 2020 (%)	Q2 2020 (%)	Q3 2020 (%)	YTD 2020 (%)
Total Return	-15.21	9.82	0.61	-6.32
Currency Return	-14.30	3.92	-0.24	-11.16
Price Return	-2.44	4.34	-0.46	1.33
Coupon Return	1.38	1.35	1.32	4.11

Source: State Street Global Advisors, JP Morgan as of 30 September 2020. Past performance is a not a guarantee of future results.

While it seems unlikely that the pace of the rally can be sustained, we believe there are still reasons to be constructive on the asset class.

Favourable Macro Backdrop

The level of developed market (DM) monetary policy support and the rapidity with which it was deployed was nothing short of extraordinary. Combined with equally extraordinary fiscal packages and programs, this has led to a strong rally in risk assets, as illustrated by the S&P 500 Index recovering to an all-time high in August. However, at the same time, gold also reached a new peak, indicating that while investors have been riding this liquidity-driven rally, concerns over economic fundamentals and COVID-related uncertainty remain elevated.

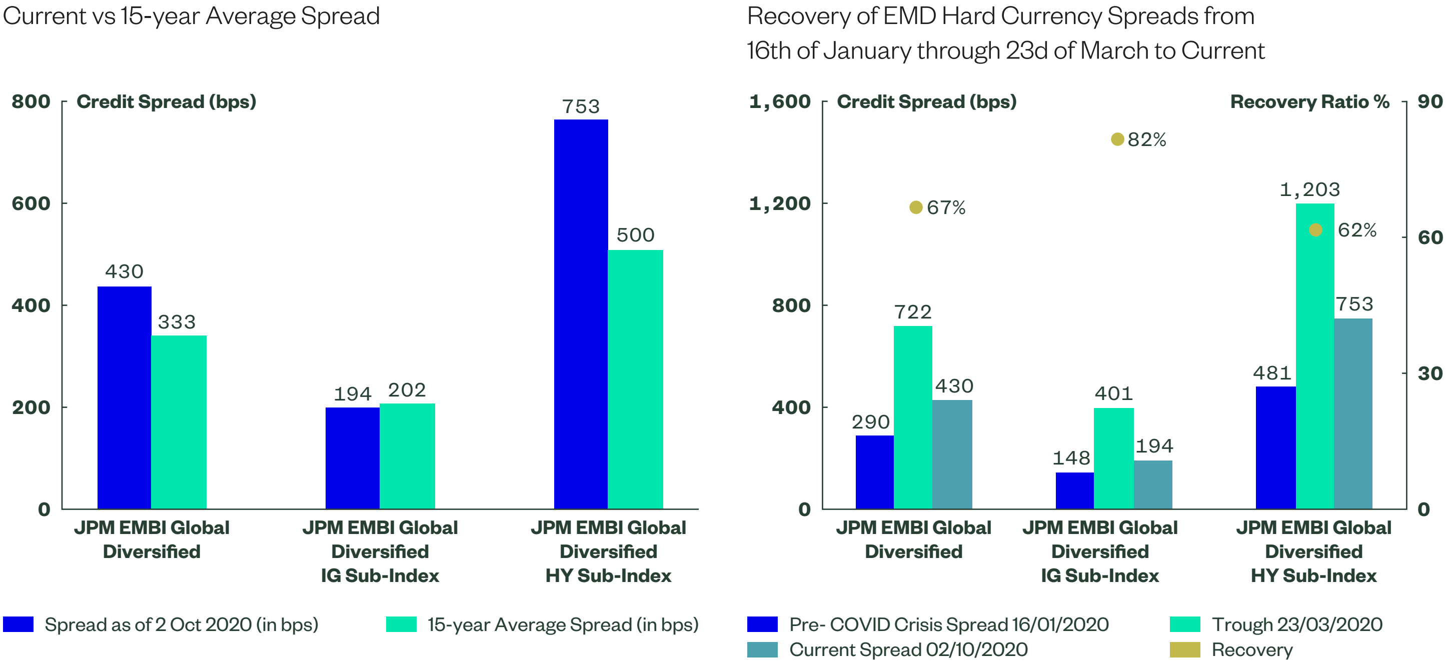
EM Debt has staged an impressive rally since March despite concerns over debt sustainability and high COVID-19 infection rates in some of the largest EM countries like Brazil, Mexico and India. While these remain valid ongoing concerns, low global and EM inflation, a weaker US dollar and a stabilisation in oil and commodity prices from the lows of early-2020 have all contributed to a favourable backdrop for the asset class.

While short-term volatility is not out of the picture, this improved macro landscape is likely to stay in place through the next few quarters and, combined with continued economic recovery and the hunt for yield, it should lend ongoing support to the asset class in the medium term.

EM Debt Hard Currency Outlook

Against a backdrop of ultra-low or even negative rates in DM, and as both the US Federal Reserve (Fed) and European Central Bank (ECB) are now buying corporate bonds, demand among investors has shifted to high-quality USD-denominated EM debt. The spread of the JP Morgan EMBIG Diversified Index has yet to return to 2020's tightest levels seen on 16 January, but by 2 October it has recovered about 67% of the widening that occurred between then and 23 March (see Figure 3). This recovery has been driven by the IG sub-index which has tightened by 82% for the same period, while the HY sub-index has lagged. The EMBIGD IG spread is now tighter than the 15-year average, but because the HY sub-index is still significantly wider, the overall EMBIGD spread is also still wider than the 15-year average.

Figure 3
Index Spreads Haven't Fully Recovered Widening Seen in March 2020



Source: State Street Global Advisors, JP Morgan, Bloomberg as of 2 Oct 2020. Past performance is not a guide to future results.

The significant tightening in EMD IG spreads and the strong performance of EMD HC in Q2 and Q3 amid continued uncertainty are raising worries about the prospects for the asset class. However, we still see good reasons to stay constructive on EMD HC.

Firstly, one of the reasons why EMD HC has yielded positive YTD results has been the remarkable rally in US Treasuries. So, the gains achieved in the latest two quarters should not be viewed as an indicator that EMD HC has no further room to run. EM spreads may still have scope to grind tighter over the next few quarters. With the Argentina and Ecuador restructurings completed, and other restructurings already priced in, there may still be positive surprises from high yield issuers, while demand for high quality IG debt is likely to remain robust as an indirect effect of QE in DM. Meanwhile, although US Treasuries, which have stabilised at historically low yield levels, represent a risk to EMD HC returns, this risk is not likely to materialise in a meaningful way soon. Even if we see short-term volatility in US Treasuries, given the Fed's latest guidance that it will maintain its policy rate near zero through at least 2023, a significant sell-off seems unlikely.

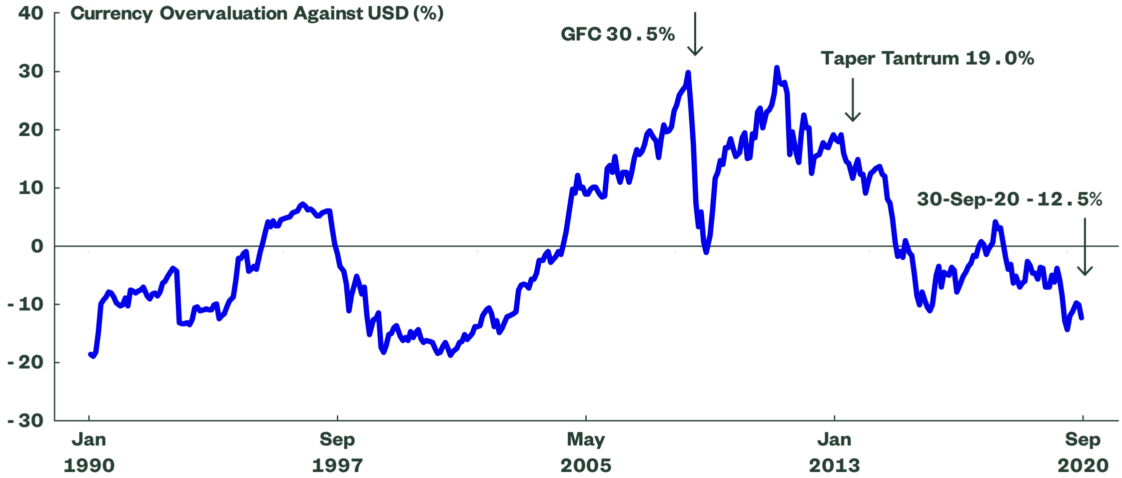
Secondly, while EM spreads have tightened significantly, particularly in IG, the hunt for yield, the relative attractiveness of EM debt and significant liquidity in the system are likely to see continued flows into the asset class, even at the expense of leaving some sectors overvalued.

EMD Local Currency Debt Outlook

Emerging market countries have responded to the COVID-19 crisis with monetary policy easing, with many also employing some form of quantitative easing (QE), albeit at a much smaller scale than their DM counterparts. This has benefited EMD LC performance where the rates component of return has had a positive contribution this year. As the COVID crisis has had a deflationary impact, low EM inflation has allowed EM central banks to keep cutting rates even in the face of FX weakness.

EM currencies sold off sharply in March and this is still the largest detractor to LC returns for the year to date. However, EM FX recouped some of those losses and has been a principal driver of positive local currency returns in Q2 and part of Q3. Still, based on our proprietary fair value model, EM FX continues to screen as undervalued versus the US dollar at an index level. While the gap has narrowed since the end of March, when we estimated that EM FX was undervalued by as much as 16%, the undervaluation still stands at about 12.5% at the end of September. This remains significant and historically, these levels of undervaluation have proved to be good entry points for achieving EM local debt returns.

Figure 4
Emerging Market Currencies Remain Significantly Undervalued Versus the US Dollar

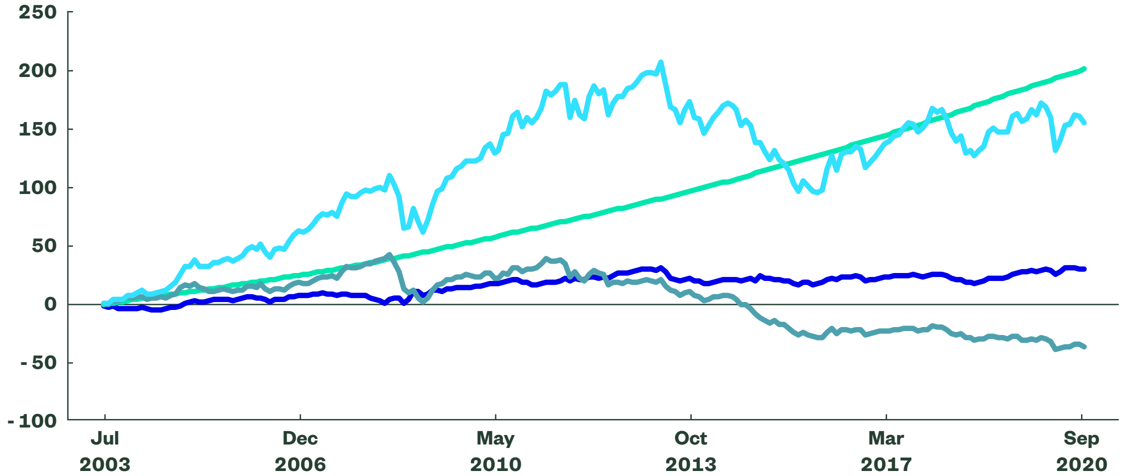


Source: Bloomberg Finance LP, SSGA Calculations as of 30 September 2020. Past performance is not a guarantee of future results. Index returns do reflect capital gains and losses, income, and the reinvestment of dividends. Performance is calculated in USD. Estimate of fair value versus the US dollar as at 30 September 2020 — valuations above 0% imply overvalued and below imply undervalued. 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. EM FX valuation is based on weights in the JP Morgan GBI-EM Global Diversified Index.

More importantly, the US dollar now seems to be in a weakening trend — this stands in stark contrast to March when USD strength, bolstered by 'safe haven' flows, proved a headwind for EM assets. The dollar has since lost one of its key pillars of support — its higher yield — while the scale of the Fed's QE program, combined with the bank's change of approach in relation to inflation, means that an argument could be made that the US dollar has come to the end of its nine-year bull run — see SSGA's article "**Shifting Gears: US Dollar on a Downward Trajectory**" for more detail.

Even though support for EM FX is less likely to come from EM central banks, which for the most part are maintaining an easing bias, EM currencies' significant undervaluation and the absence of USD strength, are both factors that are supportive to EMD LC performance. For strategic EMD investors, the largest contributor to EMD LC over the long run is the coupon and its compounding effects. Therefore, as long as EM FX is not detracting from performance, local currency debt investors would be able to earn that coupon.

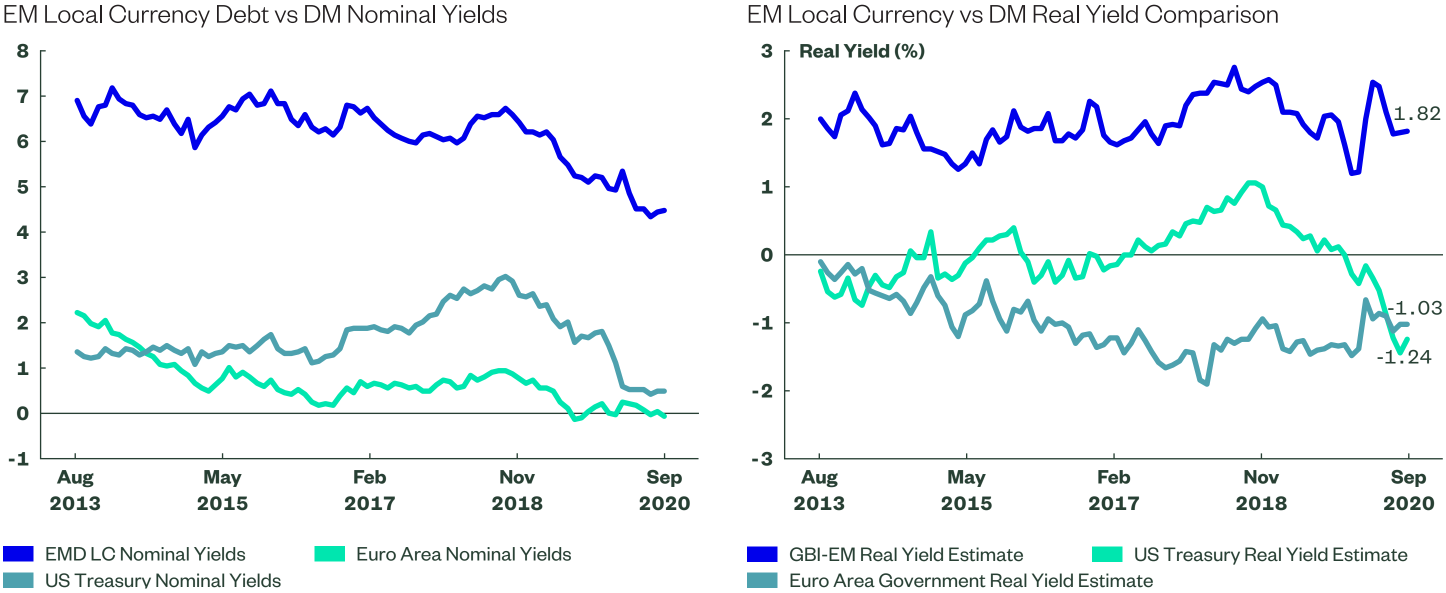
Figure 5
Coupon Principal Driver of EMD LC Returns Over the Long Run



Source: State Street Global Advisors, JP Morgan, as of 30 September 2020, for illustrative purposes only. Past performance is not a guarantee of future results. Index returns reflect capital gains and losses, income, and the reinvestment of dividends.

EM local currency yields are at all-time lows, propelled by the exceptionally low interest rates across EM countries. However, this should be viewed against a backdrop of all-time lows throughout the fixed income universe. EM local currency debt still offers positive real yields whilst other government bond real yields are firmly in negative territory. This will likely remain a pull factor for the asset class.

Figure 6
EMD LC Nominal Yields at Record Lows, Positive EM Real Yields Offer Upside Versus DM Yields



Source: State Street Global Advisors, Bloomberg Finance LP, JP Morgan as of 30 September 2020. Past performance is not a guarantee of future results.

In Conclusion: Opportunities Remain

To conclude, while both EMD HC and LC have enjoyed strong rallies since the end of March, the favourable macro backdrop, the continued economic recovery and the relative attractiveness of the asset class are all reasons for investors to stay positive on EM debt. Short-term volatility cannot be ruled out, particularly in the context of the US elections, but we believe that a potential sell-off should be viewed as an opportunity to get involved in the asset class for those who missed the rally earlier this year.

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* This figure is presented as of June 30, 2020 and includes approximately $69.52 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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Glossary

Basis point One hundredth of one percent, or 0.01%.

Bid-Offer Spread The difference between the highest price a buyer is willing to pay for an asset and the lowest price the seller will accept to sell. Bid-offer spreads are a key measure of the liquidity of an asset or security.

Emerging Market Debt (EMD) Bonds issued by governments or companies in developing countries.

Global Financial Crisis (GFC) The GFC refers to the period of extreme stress in financial markets and banking systems between mid-2007 and early-2009.

Hard Currency EMD Bonds issued by emerging market countries in currencies (such as the US dollar or euro) perceived as a more stable store of value.

High Yield Debt with generally lower credit ratings and higher yields than investment-grade bonds.

Investment Grade A fixed-income security that has a relatively low risk of default as determined by bond ratings firms.

Liquidity The ability to quickly buy or sell an investment in the market without impacting its price. Trading volume is a primary determinant of liquidity.

Local Currency EMD Bonds issued by emerging market countries in their own currencies.

Spread The difference between a securities yield and the yield on a reference security.

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