White Paper
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Case for Allocating to Emerging Market Debt

Desmond Lawrence
Senior Investment Strategist
Investment Strategy and Research, EMEA

Michele Barlow
Head of Investment Strategy and Research
Asia Pacific

Jeremy de Pessemier, CFA
Senior Investment Strategist
Investment Strategy and Research, EMEA

Yichan Shu, CFA, FRM
Senior Investment Strategist
Investment Strategy and Research

STATE STREET GLOBAL ADVISORS

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Executive Summary

Emerging market debt (EMD) is a versatile asset. It offers equity investors risk mitigation potential with modest return dilution. For fixed income investors willing to move out the risk spectrum, EMD presents a significant yield pick-up opportunity as fundamentals continue to be relatively healthy, notwithstanding some notable deterioration in the fiscal backdrop during 2020. Investors need to be comfortable with headline and idiosyncratic risk, but in a low (and in some quarters, negative) yield environment, EMD offers significant potential for those investors willing to take a closer look.

Key Points

- **Yield Enhancement** Emerging market debt 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.
- **Supportive Fundamentals** Emerging economies, on average, offer stronger growth potential and lower debt burdens than their advanced counterparts despite the negative effects of COVID-19.
- **Higher Volatility/Drawdown and Idiosyncratic Risks** Investors need to be aware of the potential higher volatility and drawdowns as well as the idiosyncratic risks of EMD assets.

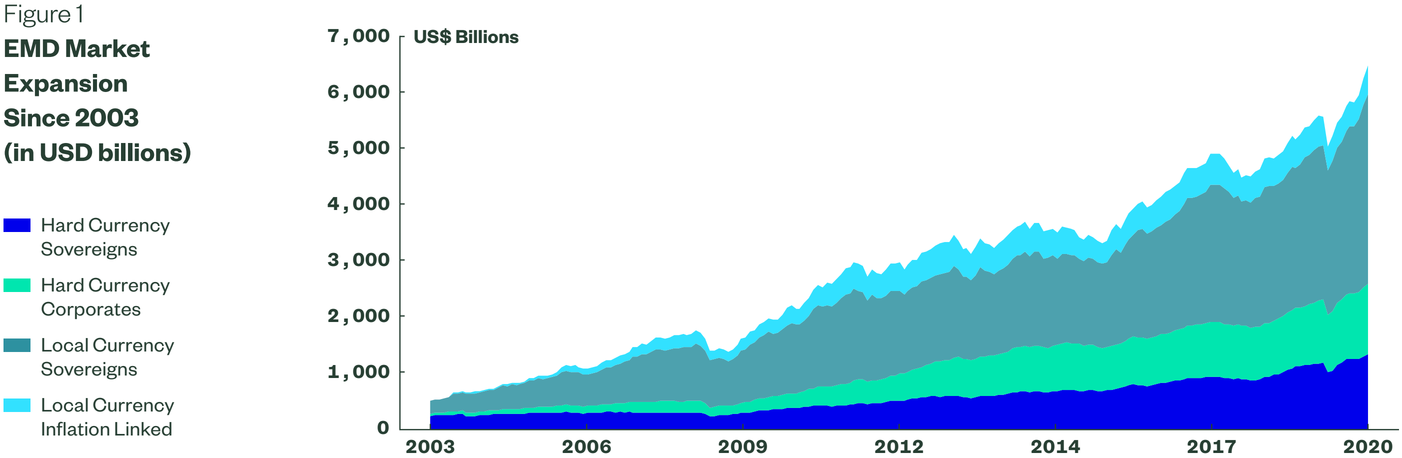
1 Emerging Market Debt Overview

- Emerging market debt has evolved into a significant multi-trillion dollar segment of the global bond market in recent years.
- Three broad investible EMD assets: 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. We focus 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 universe of index-eligible securities stood at almost US$6.5 trillion at the end of December 2020. We think this makes it too big for global investors to ignore.

Figure 1
EMD Market Expansion Since 2003 (in USD billions)



State Street Global Advisors, Barclays, JP Morgan as at 31 December 2020.

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. Over the past five years, the cost of trading in hard currency EMD, as represented by bid-ask spreads, has decreased significantly. These are now 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 EMD has remained stable and is lower than that of US investment grade bonds.

Characteristics of EMD Assets

Within the EMD universe, hard currency (HC) sovereign, hard currency corporate and local currency (LC) sovereign are the three broad investible assets for global investors. Hard currency sovereign and corporate EMD indices are predominantly comprised of US dollar-denominated bonds issued by emerging market sovereigns and corporates, while LC sovereign EMD includes 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:

1 **Mix of IG/HY with Different Levels of Quality** The three EMD segments offer varying degrees of credit quality exposure. This differs from Global Aggregate bonds which incorporate 100% in investment grade bonds, and Global High Yield (HY) bonds which consist of 100% sub-investment grade bonds. Of the three EMD assets, local currency sovereign EMD has the highest proportion of bonds with an investment grade rating (80%), while hard currency sovereign EMD has the lowest proportion (54%).

2 **LC EMD Less Diversified** Within the investment universe, hard currency sovereign and corporate EMDs are quite diversified by country and region. By way of contrast, local currency sovereign EMD is more concentrated — the representative index contains only 19 countries, with the largest 10 making up 81%.

3 **Currency and Rates Risk** The hard currency sovereign and corporate EMD assets are USD based, with risks driven mainly by movements in US interest rate and credit risk in EM sovereign and corporates. A euro-based investor also has the additional consideration of US dollar fluctuation. The local currency sovereign EMD asset 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**)	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 Barclays Global Aggregate	Bloomberg Barclays Global High Yield	MSCI World	MSCI Emerging Markets
Investment Universe	74 countries	57 countries	19 countries	71 countries	113 countries	23 countries	27 countries
Currency	USD	USD	19 EM currencies	28 currencies**	5 currencies	14 currencies	27 currencies
Regional Split (%)							
Asia Pacific	18	40	35	27	6	12	80
Europe	19	10	28	31	21	19	4
Latin America	33	26	29	1	12	–	8
Middle East & Africa	31	24	8	1	12	–	8
North America	–	–	–	39	49	69	–
Other (supranational)	–	–	–	2	–	–	–
Index Rating*	Sub-IG Credit Rating Ba1/BBB-	IG Credit Rating Baa3/BBB-	IG Credit Rating Baa2/BBB+	IG Credit Rating Aa3/A1	Sub-IG Credit Rating Ba3/B1	N/A	N/A
IG/Sub-IG Split (%)	54 / 46	58 / 42	80 / 20	100 / 0	0 / 100	N/A	N/A
Yield to Worst (%)	4.53	3.42	4.22	0.82	4.49	N/A	N/A
Dividend Yield (%)	N/A	N/A	N/A	N/A	N/A	1.85	1.98
Duration (Yrs)	8.26	4.67	5.40	7.39	4.15	N/A	N/A
Key Risk Drivers	US Treasuries and EM Sovereign Spreads	US Treasuries and EM Corporate Spreads	Local Rates and Local Currencies	Local Rates, Currencies and Corporate Spreads	Local Rates, Currencies and Corporate Spreads	Developed Markets Beta and Currencies	Emerging Markets Beta and Currencies

* For the EMBI and CEMBI index families, we use the middle rating of Moody's, S&P and Fitch. For the GBI-EM index family, we use the lowest rating of Moody's, S&P, and Fitch.
** We assume that euro investors hedge the global currency exposure.
Source: State Street Global Advisors, JPMorgan, Bloomberg Finance LP, MSCI as of 31 December 2020.

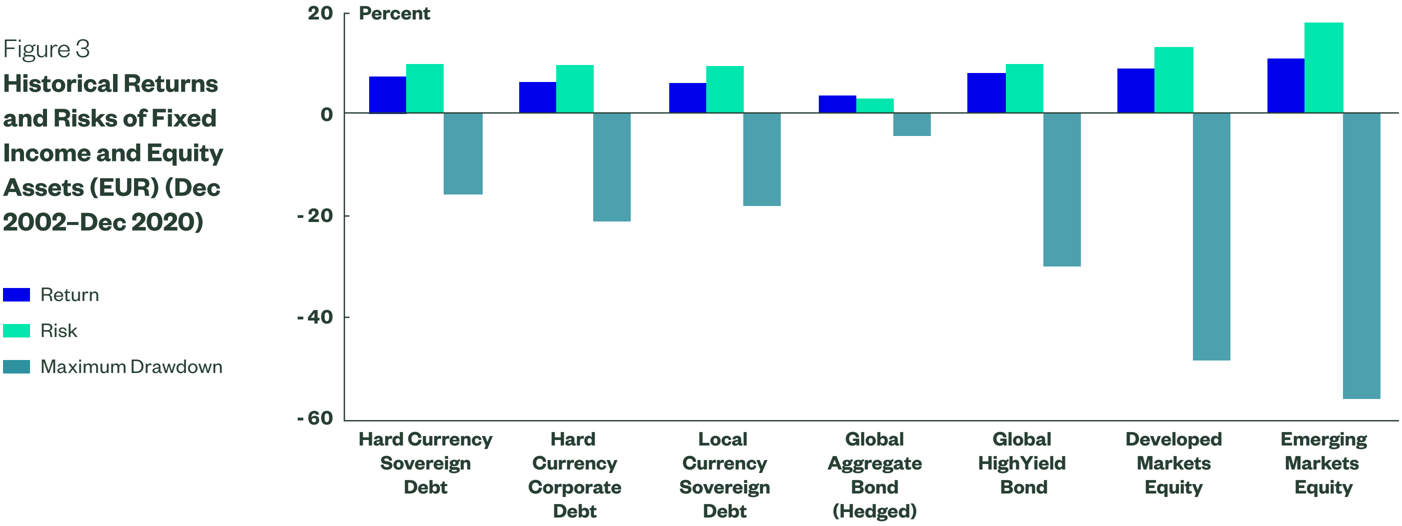
Emerging market debt provides a relatively attractive yield enhancement option relative to investment grade bonds. While yields are slightly lower than those of high yield bonds, the average credit ratings are higher. As shown in Figure 2, all three EMD assets had yields around 4% at the end of 2020, which was more than four times that of Global Aggregate bonds, and not too dissimilar to that of Global High Yield bonds.

The hard currency corporate and local currency sovereign EMD assets have investment grade ratings that, depending on the rating agency, are between three and six notches below global aggregate bonds, while the duration of the indices are shorter. By contrast, hard currency sovereign EMD has speculative grade ratings on average with a longer duration than global aggregate bonds. We believe that higher yields with (generally) lower duration than aggregate bonds, and better ratings than high yield bonds, offers 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, local currency sovereign and corporate EMD have historically been somewhere between those of Global Aggregate bonds and Global Equities (Figure 3). This is not surprising given that EMD assets are comprised of both investment grade and high yield bonds.

Figure 3
Historical Returns and Risks of Fixed Income and Equity Assets (EUR) (Dec 2002–Dec 2020)



Source: State Street Global Advisors, JP Morgan, Bloomberg, MSCI, as of 31 December, 2020. 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 Barclays Global Aggregate for Global Aggregate and Bloomberg Barclay Global High Yield for Global High Yield. All returns are gross total returns in euro terms. 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. Past performance is not a reliable indicator of future performance.

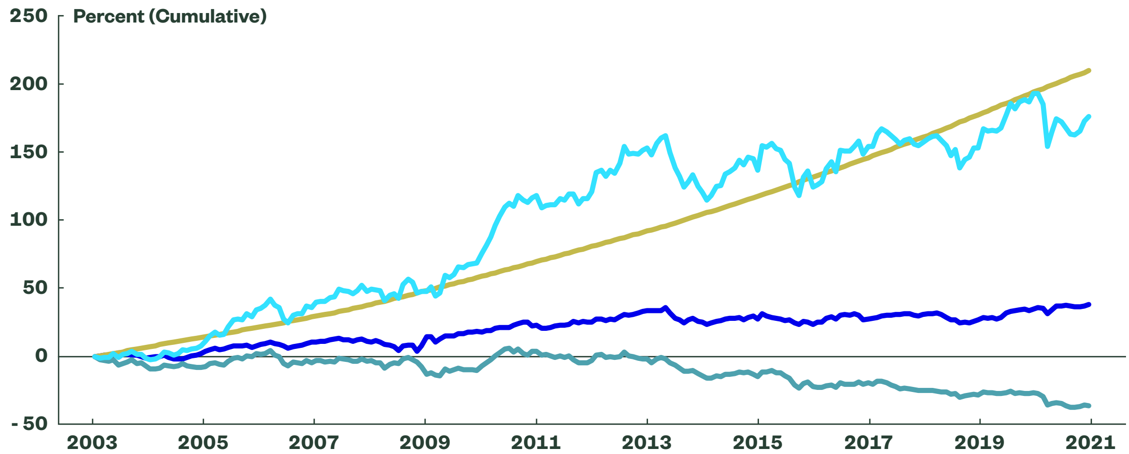
As Figure 3 illustrates, EM debt markets are generally more volatile than global aggregate investment grade bonds. With this higher volatility comes a tendency to incur higher drawdowns in challenging market environments.

Income and FX Drive EMD Local Returns

In Figure 4, we decompose local currency EM debt total returns and assess contributions from the various return components on a cumulative basis. Not surprisingly, income (returns from coupon income) is the dominant driver of returns over time, with some contribution from principal (returns from changes of the bond's face value or principal) as the rates move up and down.

However, returns can be quite significantly impacted by the FX component (returns from the EM currency movements relative to the euro). Prior to 2008, EM currencies were generally flat against the euro, and the FX component did not contribute to the local currency sovereign EMD return. 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 currencies on page 16.

Figure 4
Decomposition of Local Currency Returns for JP Morgan GBI-EM Global Diversified Index for Euro Investors (Dec 2002–Dec 2020)



Source: State Street Global Advisors, JPMorgan, as of 31 December, 2020. Index returns are unmanaged and do not reflect the deduction of any fees or expenses. Past performance is not a reliable indicator of future performance.

2 Benefits of Allocating to Emerging Market Debt

- Low correlation and higher growth factor exposures provide diversification benefits to 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 EMD assets and Global Aggregate bonds or Global Equities have been modest. This signifies the potential diversification benefits when adding EMD to a global bond or global equity portfolio (see Figure 5). For EUR hedged Global Aggregate bond investors, hard currency corporate EMD has provided the best diversification benefits with the lowest historical correlation due to its lower duration and higher credit exposure relative to the other two EMD assets. 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–Dec 2020

	EM HC Sovereign Debt	EM HC Corporate Debt	EM LC Sovereign Debt	MSCI ACWI	MSCI World	MSCI EM	Global Aggregate (Hedged)	Global High Yield
EM HC Sovereign Debt	1.00	0.94	0.70	0.49	0.49	0.40	0.39	0.85
EM HC Corporate Debt	0.94	1.00	0.60	0.48	0.49	0.35	0.30	0.85
EM LC Sovereign Debt	0.70	0.60	1.00	0.58	0.55	0.65	0.31	0.63
MSCI ACWI	0.49	0.48	0.58	1.00	0.99	0.82	-0.04	0.67
MSCI World	0.49	0.49	0.55	0.99	1.00	0.76	-0.06	0.68
MSCI EM	0.40	0.35	0.65	0.82	0.76	1.00	0.03	0.55
Global Aggregate (Hedged)	0.39	0.30	0.31	-0.04	-0.06	0.03	1.00	0.13
Global High Yield	0.85	0.85	0.63	0.67	0.68	0.55	0.13	1.00

Source: State Street Global Advisors, JPMorgan, Bloomberg Finance LP, as of 31 December, 2020. 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 Barclays Global Aggregate (euro hedged) for Global Aggregate and Bloomberg Barclay Global High Yield for Global High Yield.

Allocating to EMD on a Forward-Looking Basis

We have set out in the table below the blended emerging market debt allocations under consideration.

Figure 6
Blended EMD Strategies

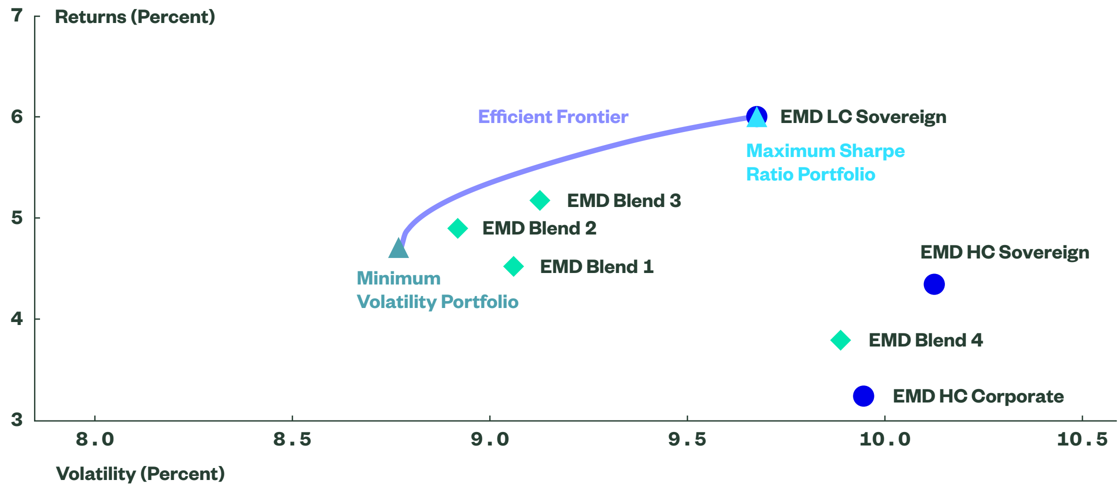
Strategy	Description
EMD Blend 1	33% EMD HC Sovereign + 33% EMD HC Corporate + 33% EMD LC Sovereign
EMD Blend 2	25% EMD HC Sovereign + 25% EMD HC Corporate + 50% EMD LC Sovereign
EMD Blend 3	50% EMD HC Sovereign + 50% EMD LC Sovereign
EMD Blend 4	50% EMD HC Sovereign + 50% EMD HC Corporate

In Figure 7, we have outlined the long-term expected returns and risks of 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, on the other hand, are based on historic standard deviation.

Based on our forward return estimates the hard currency EMD segments are expected to generate lower returns than has been the case historically while local currency EMD is expected to generate marginally higher returns than its historic return. In general hard currency returns are constrained by lower yields whereas local currency returns are lifted by an estimated discount to fair value of EM currencies versus the euro.

Blending the EMD segments can provide relatively attractive returns while reducing the risk profile compared to holding a single EMD asset. Moreover, blends that include local currency EMD (Blends 1, 2 & 3) have reduced 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, JPMorgan as of 31 December, 2020. 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 31 December, 2020. 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 to 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 maximum drawdown modestly.

Investors with a higher return target and level of risk tolerance could allocate more EMD into their portfolio to increase their return/risk metric.

Figure 8
Impact on Fixed Income Portfolios

	Return (%)	Volatility (%)	Return/Risk	Max Drawdown (%)
Global Aggregate	3.59	2.75	1.31	-4.48
Global Aggregate + EM Debt	4.06	3.06	1.33	-4.01
Difference	0.47	0.31	0.02	-0.47

Source: State Street Global Advisors, JPMorgan, Bloomberg Finance LP, as of 31 December, 2020. Returns and risk metrics were achieved by mathematically combining the performance data of the Bloomberg Barclays Global Aggregate Index 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.

Impact of EMD Allocation to 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 impact 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	8.82	13.12	0.67	-48.43
MSCI ACWI + EM Debt	8.55	11.93	0.72	-43.34
Difference	-0.27	-1.18	0.05	5.09

Source: State Street Global Advisors, JP Morgan, Bloomberg, as of 31 December, 2020. Index returns reflect capital gains and losses, income, and the reinvestment of dividends. Past performance is not a reliable indicator of future performance. Returns and risk metrics were achieved by mathematically combining the performance data of the MSCI ACWI Index 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.

3 Fundamentals Underpin Case for Local Currency EMD

- Emerging markets continue to drive global economic growth, led by China and India, with many EM countries also having considerable scope to implement fiscal and monetary measures to further support expansion.
- However, in addition to shifting trade and risk sentiment, emerging markets also face a significant challenge in tackling the coronavirus pandemic and its wide-ranging implications.

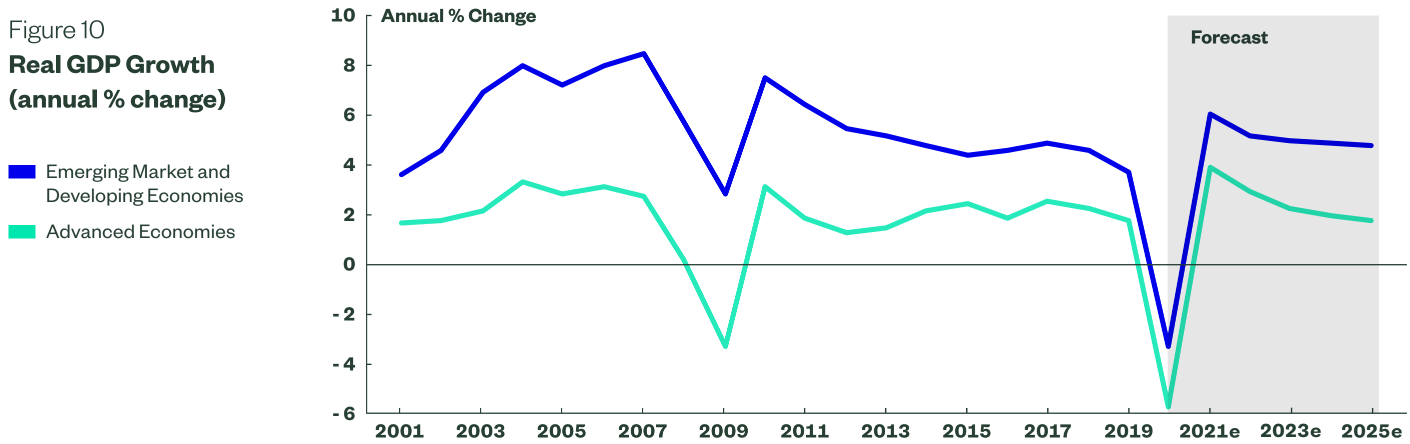
EM Countries: Higher Growth, Lower Debt

Emerging market economies remain key drivers of global growth. Over the last two decades, they have experienced consistently stronger growth than the more developed economies. According to the International Monetary Fund (IMF), advanced economy GDP is expected to increase by 3.9% in 2020, while emerging markets should expand by 6.0%. This growth premium, which bottomed at 1.9% in 2015, is expected to increase to an average of 2.7% over the next four years (Figure 10).

However, it is worth noting that much of emerging market growth is currently being driven by China and India, as a number of the other major EM economies (including Brazil, Russia and Mexico) have rebounded less vigorously from the pandemic than the advanced economies. Excluding China and India, output growth is estimated to be in line with advanced economies in 2021 before reverting once more to a premium of 1.4% on average over the next four years, according to IMF forecasts.

Figure 10

Real GDP Growth (annual % change)



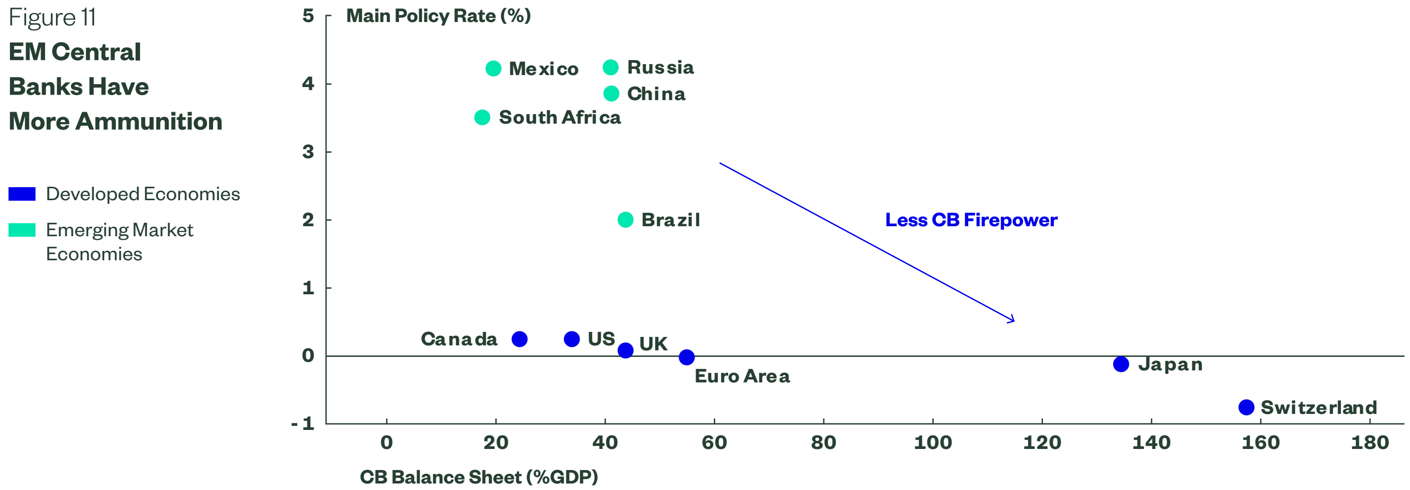
Source: State Street Global Advisors, International Monetary Fund as of October 2020. The above forecasts are estimates based on certain assumptions and analysis made. There is no guarantee that the estimates will be achieved.

In its October 2020 World Economic Outlook, the IMF noted that "Exceptional uncertainty surrounds the baseline [projection]". In particular, the report notes downside risk related to coronavirus: a surge in the virus that's difficult to contain, new variants, rapidly rising infections and deaths before vaccines are widely available. While emerging markets remain vulnerable to trade and risk sentiment, they entered the COVID crisis in significantly better shape than in previous sell-off episodes. Furthermore, the sharp EM currency decline led to an improvement of current account balances (on average), which is supportive of EM external positions — at least in the short term.

While EM central banks followed their DM counterparts in cutting policy rates and providing monetary policy support in 2020, they still have relatively more ammunition to lower rates if inflation trends remain benign (Figure 11).

Figure 11

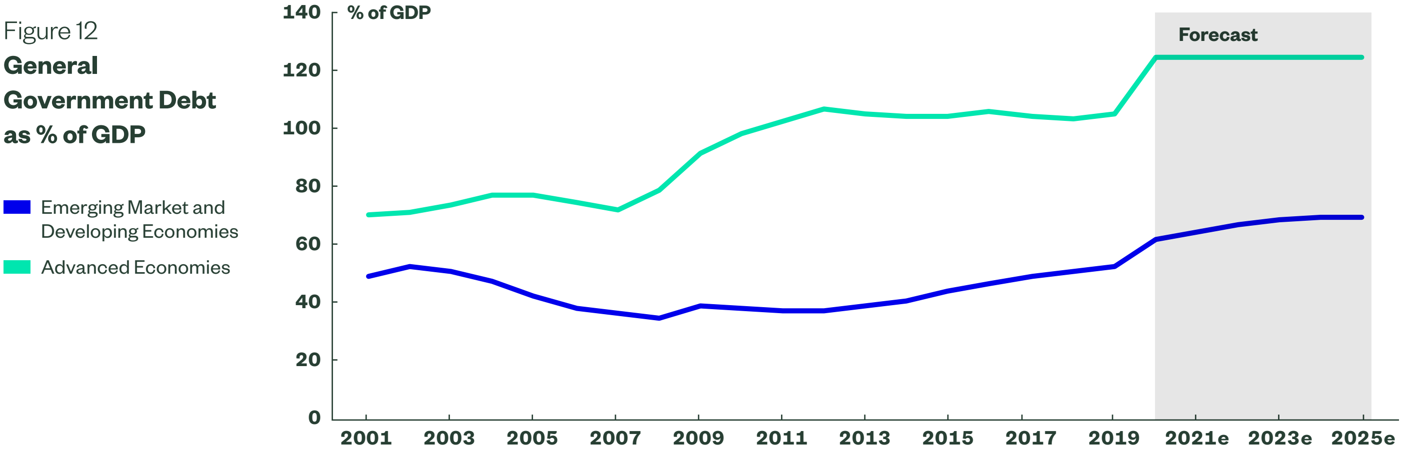
EM Central Banks Have More Ammunition



Source: State Street Global Advisors, Trading Economics as of 31 December, 2020.

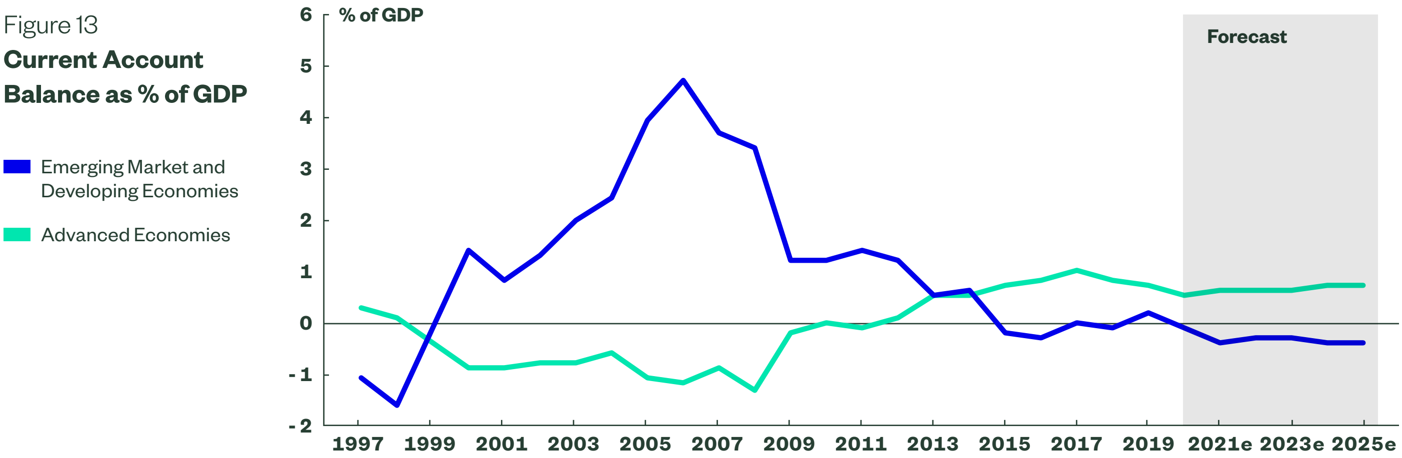
External vulnerabilities across emerging markets have reduced over the last 10 years as the number of countries running fiscal and current account deficits is now much lower, foreign exchange reserves are higher, and foreign currency-denominated debt now accounts for less of the total exposure. In 2020, EM economies recorded a sharp increase in average government gross debt as a percentage of GDP and the IMF forecasts that this may increase in the medium term. However, the level should remain far below that of advanced economies (see Figure 12). And while average current account deficits as a percentage of GDP are likely to deteriorate in the coming years, they are forecast to be within 1% of GDP (see Figure 13). Positive growth trends and favourable market conditions should help support EMD over the medium term.

Figure 12
General Government Debt as % of GDP



Source: State Street Global Advisors, International Monetary Fund as of December 2020. The above forecasts are estimates based on certain assumptions and analysis made. There is no guarantee that the estimates will be achieved.

Figure 13
Current Account Balance as % of GDP



Source: State Street Global Advisors, International Monetary Fund as of December 2020. 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 are Still Present

Idiosyncratic (or country specific) risk is often cited as something to watch for when investing in emerging markets. This is usually because when one country runs into difficulties, there is the expectation that others are likely to follow. While this has often been the case, we think that the hurdle today is higher for idiosyncratic risk to create contagion across the broader emerging market universe.

While EMD investors need to comfortable with its sensitivity to swings in risk sentiment and global macro external shocks, we believe the contagion risks are lower than in the past. There have been significant changes in emerging markets over the last 20 years with many countries liberalizing their capital markets (allowing for more market-oriented currency regimes), establishing independent central banks and building up foreign currency reserves. Overall, countries have generally been improving their balance sheets.

There have been notable instances of country-specific issues in recent years. In 2018, Argentina and Turkey experienced significant crises that saw both countries' currencies plunge and interest rates spike. This idiosyncratic risk partly explained the underperformance of emerging market debt relative to investment grade bonds in 2018. In 2020, the impact of the pandemic on economically important exports, tourism and remittances contributed to six countries (Argentina, Lebanon, Ecuador, Suriname, Belize and Zambia) in the emerging market universe defaulting and/or restructuring their debt. However, the debt of EM countries with investment grade ratings rallied in the aftermath of COVID-driven weakness, illustrating that investors are increasingly better informed about developing economies and differentiating between higher and lower quality sovereigns — contagion was largely limited to those mentioned countries with particular difficulties.

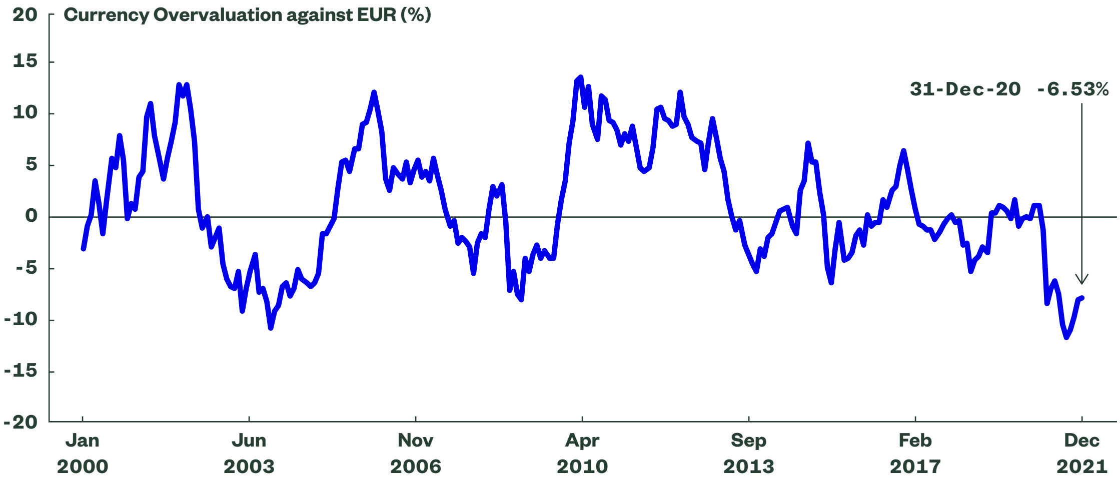
Local Currency EMD — The FX Component

As noted, income return tends to be the dominant driver of EMD returns over time. That said, foreign exchange rate movements of EM local currencies against the euro have been a big return and risk driver for 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 devaluation can wipe out any bond gains.

Today, EM currencies (as a basket) are undervalued relative to the euro. This makes it a relatively good entry point to invest in local currency emerging market debt. However, to benefit from the currency return potential there would need to be a period of euro weakness/EM currency appreciation. The challenge is in timing the run.

Figure 14
EM Currency Over/ Undervaluation Versus the Euro



Source: State Street Global Advisors, Bloomberg Finance, L.P., as of 31 December, 2020. Past performance is not a guarantee of future results. Historic estimate of fair value versus euro to 31 December, 2020 — valuations above 0% imply overvalued and below imply undervalued. The calculation is based on the currency weight of the JP Morgan GBI-EM 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.

Conclusion

Emerging market debt offers investors a relatively attractive growth exposure at a time when advanced economies may struggle to maintain their trend rate of growth. Emerging market economies typically have superior growth dynamics and significantly lower debt burdens relative to their advanced economy counterparts. Furthermore, emerging market economies have significant capacity for policy response by EM central banks should it be required in the coming years.

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 and (more so) 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 EM debt — its low correlations with global equities and global bonds makes it a welcome addition for both global equity and debt investors.

Contributors / Contacts

Altaf Kassam, CFA,
Head of Investment Strategy and Research, EMEA

David Furey
Head of Fixed Income Portfolio Strategists, EMEA

Lyubka Dushanova
Portfolio Specialist
Emerging Market Debt

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Abu Dhabi: State Street Global Advisors Limited, ADGM Branch, Al Khatem Tower, Suite 42801, Level 28, ADGM Square, Al Maryah Island, P.O Box 76404, Abu Dhabi, United Arab Emirates. Regulated by the ADGM Financial Services Regulatory Authority. T: +971 2 245 9000. **Belgium:** State Street Global Advisors Belgium, Chaussée de La Hulpe 120, 1000 Brussels, Belgium. T: 32 2 663 2036. F: 32 2 672 2077. SSGA Belgium is a branch office of State Street Global Advisors Ireland Limited. State Street Global Advisors Ireland Limited, registered in Ireland with company number 145221, authorised and regulated by the Central Bank of Ireland, and whose registered office is at 78 Sir John Rogerson's Quay, Dublin 2. **Dubai:** State Street Global Advisors Limited, DIFC Branch, Central Park Towers, Suite 15-38 (15th floor), P.O Box 26838, Dubai International Financial Centre (DIFC), Dubai, United Arab Emirates. Regulated by the Dubai Financial Services Authority (DFSA). T: +971 (0)4-4372800. **France:** State Street Global Advisors Ireland Limited, Paris branch is a branch of State Street Global Advisors Ireland Limited, registered in Ireland with company number 145221, authorised and regulated by the Central Bank of Ireland, and whose registered office is at 78 Sir John Rogerson's Quay, Dublin 2. State Street Global Advisors Ireland Limited, Paris Branch, is registered in France with company number RCS Nanterre 832 734 602 and whose office is at Immeuble Défense Plaza, 23-25 rue Delarivière-Lefoullon, 92064 Paris La Défense Cedex, France. T: (+33) 1 44 45 40 00. F: (+33) 1 44 45 41 92. **Germany:** State Street Global Advisors GmbH, Brienner Strasse 59, D-80333 Munich. Authorised and regulated by the Bundesanstalt für Finanzdienstleistungsaufsicht ("BaFin"). Registered with the Register of Commerce Munich HRB 121381. T: +49 (0)89-55878-400. F: +49 (0)89-55878-440. **Ireland:** State Street Global Advisors Ireland Limited is regulated by the Central Bank of Ireland. Registered office address 78 Sir John Rogerson's Quay, Dublin 2. Registered Number: 145221. T: +353 (0)1 776 3000. F: +353 (0)1 776 3300. **Italy:** State Street Global Advisors Ireland Limited, Milan Branch (Sede Secondaria di Milano) is a branch of State Street Global Advisors Ireland Limited, registered in Ireland with company number 145221, authorised and regulated by the Central Bank of Ireland, and whose registered office is at 78 Sir John Rogerson's Quay, Dublin 2. State Street Global Advisors Ireland Limited, Milan Branch (Sede Secondaria di Milano), is registered in Italy with company number 10495250960 - R.E.A. 2535585 and VAT number 10495250960 and whose office is at Via Ferrante Aporti, 10 - 20125 Milano, Italy. T: +39 02 32066 100. F: +39 02 32066 155. **Netherlands:** State Street Global Advisors Netherlands, Apollo Building, 7th floor Herikerbergweg 29 1101 CN Amsterdam, Netherlands. T: 31 20 7181701. SSGA Netherlands is a branch office of State Street Global Advisors Ireland Limited, registered in Ireland with company number 145221, authorised and regulated by the Central Bank of Ireland, and whose registered office is at 78 Sir John Rogerson's Quay, Dublin 2. **Switzerland:** State Street Global Advisors AG, Beethovenstr. 19, CH-8027 Zurich. Registered with the Register of Commerce Zurich CHE-105.078.458. T: +41 (0)44 245 70 00. F: +41 (0)44 245 70 16. **United Kingdom:** State Street Global Advisors Limited. Authorised and regulated by the Financial Conduct Authority. Registered in England. Registered No. 2509928. VAT No. 5776591 81. Registered office: 20 Churchill Place, Canary Wharf, London, E14 5HJ. T: 020 3395 6000. F: 020 3395 6350.

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