Commentary
Emerging Markets

8 April 2020

COVID-19 and Emerging Markets: Taking Stock, Moving Forward

The COVID-19 pandemic represents both a serious public health and economic threat for emerging markets. The crisis has dented emerging market growth prospects and reversed years of strong performance. While the full impact of the crisis is yet to be seen, the extent of market moves thus far presents investors with opportunities to take advantage of significant undervaluation in both emerging market debt and equities.

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Emerging Market Debt: Is there Enough Priced in?

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Emerging markets started 2020 on a relative firm footing, supported by expectations of a pick-up in global and emerging market growth and a pause in the US-China trade war. The COVID-19 pandemic has, however, stopped emerging market growth in its tracks. COVID-19 represents a particularly serious public health crisis for emerging markets due to high population density, poor living conditions, lack of access to running water and weaker healthcare systems.

As well as the humanitarian challenge, COVID-19 and the social distancing measures introduced to contain its spread are taking a large economic toll, particularly on citizens who must venture out each day to earn their living. The significant decline in the oil price is another major, but unrelated, shock to those emerging markets that are net oil exporters.

Emerging market governments and central banks have tried to bolster their economies amid this threat. Regrettably, however, the financial ability of emerging markets to support their economies and their people are much weaker than developed markets. The coming months will undoubtedly be very challenging for emerging markets as they work their way through the crisis.

Emerging Market Debt Performance

It's important to differentiate between local currency and hard currency emerging market debt.

The table below compares performance of local and hard currency emerging market debt in the first quarter of 2020:

Figure 1
EMD — Local Currency

JPM GBI-EM Global Diversified Index	1Q '20 EUR (%)	1Q '20 USD (%)
Total Return	**-13.26**	**-15.21**
Currency Return	-12.20	-14.30
Price Return (in Local ccy)	-2.44	-2.44
Coupon Return (in Local ccy)	1.38	1.38

Source: JP Morgan. As of 31-Mar-20. Past performance is not a guarantee of future results.

Figure 2
EMD — Hard Currency

JPM EMBI GD Index (USD)	1Q '20 (%)
Total Return	**-13.38**
Spread Return	-21.57
Treasury Return	10.45
Investment Grade Sub-Index	-5.44
High Yield Sub-Index	-22.44

Source: JP Morgan. As of 31-Mar-20. Past performance is not a guarantee of future results.

As the tables show, in US dollar terms, emerging market debt suffered losses of between 13.4% for hard currency and 15.2% for local currency in the first quarter of 2020. Poor returns have been driven by the spread of COVID-19, the oil price collapse and the rally in the US dollar.

Diving deeper, it's clear that the vast majority of the negative performance of local currency debt has been driven by the currency effect (-14.3% in USD terms). The bond market return has remained relatively robust. This can be explained by the fact that local currency emerging market bonds tend to be larger countries like Brazil and Mexico that are better developed, with domestic bond markets driven by local investor demand. Their financial systems usually have an ecosystem of banks, insurance companies and other financial institutions that can borrow and lend freely. The currencies of these countries are also free floating.

This contrasts with emerging markets that borrow in hard currency, which tend to be less developed and economically and politically weaker. Of the -13.4% return in the first quarter of 2020, there was a +10.5% return from US Treasuries, offset by a -21.6% return from the spread widening over US Treasury bonds. With the rally in the US dollar, countries which have US dollar-denominated debt have been particularly challenged.

The current sell-off has wiped out five years of robust emerging market debt returns, while driving current valuations into new territory. While local currency emerging market debt yields have risen to 5.4%, this is quite low historically. This is a sign both that these countries have had strong fundamentals prior to the crisis and that inflation has been low, meaning local bond markets have been able to sustain lower bond yields.

In contrast, the yield on hard currency emerging market debt has spiked from around 5% to 7%, an elevated level historically. For some countries, borrowing cost are above 10%, which could make future borrowing too expensive.

Flows Have Reversed

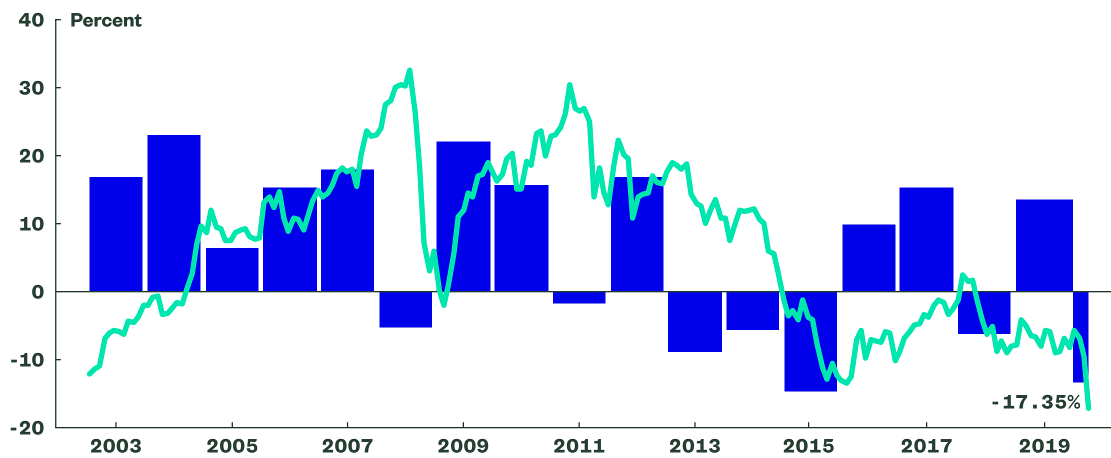
Among the main reasons for poor performance has been significant investor outflows out of emerging markets, a reversal of recent trends. Non-resident portfolio outflows in March 2020 amounted to $31 billion for emerging market debt and $50bn for emerging market equities.

The record outflows dwarf those of previous market stress periods, including the global financial crisis. The key reason is that emerging markets today make up a much larger proportion of the global financial system so flows in absolute terms are larger. These outflows explain why many emerging market currencies have performed so poorly against the US dollar, and why we have seen yields and bond spreads over Treasuries reach new levels.

Emerging Market FX: Rapid Adjustment

Emerging market currencies entered this crisis undervalued against the US dollar and they are now at an extreme level of undervaluation. The chart below shows the local currency emerging market debt excess return in blue overlaid with currency valuations from our local currency benchmark.

Figure 3
Emerging Market FX — Rapid Adjustment



Source: Bloomberg Finance, L.P., data as of 31 March 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 31 March 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.

Since 2003, local emerging market currencies have experienced significant over- and undervaluation against the US dollar, with the level of undervaluation at 17.4% as at 31 March 2020, *the largest undervaluation since*.

Historically, periods of undervaluation have been followed by strengthening of local currencies and we expect that to play out again. We believe a prudent approach for investors currently underweight emerging markets would be to invest in local currency emerging market debt while this significant undervaluation persists.

Hard Currency Debt will be Particularly Challenged

Some of the countries issuing hard currency debt are generally poorer and more exposed to this crisis from a health, humanitarian and economic perspective. Ecuador, Angola and Lebanon have all experienced negative returns of over 60% over the first quarter of 2020, driven by record spread widening against US Treasuries. These countries have balance of payments problems and have borrowed in US dollars, explaining why they are trading at distressed levels.

Emerging Market Debt Outlook

The outlook for emerging market debt remains challenging, however, there has been significant repricing which presents opportunities.

Below is a summary of the key reasons for investors to consider increasing allocations to emerging market debt:

- **Significant undervaluation** on emerging market currencies
- **Distressed pricing** on hard currency sovereign bonds
- **Some room to manoeuvre for larger emerging markets** — their current accounts have been closed, they have low inflation, good policy, younger populations and the International Monetary Fund is ready to provide assistance, if required
- **Currently, allocations to emerging markets are low,** and emerging market bond investors should consider addressing this, given the significant change in valuations relative to developed market sovereigns as the scale of their future borrowing requirements begin to be priced into markets.

2

Emerging Market Equities: Opportunity Amid Uncertainty

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The COVID-19 crisis has brought about an unprecedented amount of uncertainty into global equity markets.

The table below shows the performance of the MSCI Emerging Markets index and the difference between best and worst sector returns in March 2020 and compares it to other market shocks. These include the 9/11 attacks on the World Trade Center, the global financial crisis and the Greek debt crisis.

Figure 4
Extraordinary Times

	MSCI Index (%)	Difference (Best — Worst Sector) (%)
Sep-01	-15.40	26.90
Sep-08	-16.80	29.40
Oct-08	-26.60	21.30
Sep-11	-14.50	29.80
Mar-20	**-15.40**	**20.80**

Source: FactSet, MSCI.

The 15.4% fall of the MSCI Emerging Markets index in March is the fifth lowest monthly return in the last 25 years and is similar in scale to that following the 9/11 attacks. The sector returns spread of the index is typically 3-5%, but in March was 20.8%, the widest since the Greek debt crisis.

Risk is not Always What it Seems...

Breaking the index down by country, China has been the best-performing country in the MSCI Emerging Markets index in March, down 7%. This is counterintuitive given that the COVID-19 outbreak originated in Wuhan, China. Two large energy exporters, Qatar and Saudi Arabia have also outperformed the overall MSCI Emerging Markets index, despite the large fall in the oil price.

We can also split the MSCI Emerging Markets index into low, neutral and high-risk stocks, with risk defined as idiosyncratic stock risk. Here, we see that the worst-performing bucket are the low risk stocks. Like the country observation, this result is not necessarily what would be expected during this crisis.

Below is a matrix that splits stocks in the MSCI Emerging Markets index into two categories — risk and style. Stocks have either low, neutral or high idiosyncratic risk and are either value, neutral or growth stocks. The returns for stocks in each bucket can be calculated, as shown below for March 2020:

Figure 5
Risk is Not Always What It Seems...

Style	Risk: High	Risk: Neutral	Risk: Low
Value	-26%	-13%	-15%
Neutral	-19%	-20%	-16%
Growth	-9%	-10%	-22%

Source: FactSet, MSCI.

The worst-performing segment of the market is the high-risk value stocks, driven by poor performance of real estate, energy and financials stocks. In contrast, the best-performing segment is the high-risk high-growth stocks, including technology and healthcare companies. Investors have been drawn to these stocks, despite their high volatility and high correlation with overall market returns.

Emerging Market Equity Outlook

There is undoubtedly more downside to come in global equity markets. However, financial markets have mispriced risk and the compensation that investors receive for taking emerging markets exposure is at a record high.

When markets start to return to some semblance of normality then opportunities will abound. This could happen rapidly, following for example, news of a flattening of the rate of new COVID-19 infections and deaths, or announcement of a COVID-19 vaccine. Interestingly, China, the United Arab Emirates and other emerging markets have been among the most successful in containing COVID-19, in contrast to developed countries such as the US. China, India and other emerging market countries are also involved in trialling new COVID-19 vaccines.

Our active management approach will benefit from the dispersion of stock returns created by the crisis, enabling us to selectively invest in companies that will emerge from the crisis as global leaders. In the current volatile market environment, we also continue to maintain sufficient diversification and liquidity across our portfolios.

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ID192326-3035076.1.1.GBL.INST 0420
Exp. Date: 30/04/2021