White Paper
Fixed Income

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The Case for Allocating to Emerging Market Debt

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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. The COVID-19 pandemic led to a notable rise in indebtedness in some countries and, now more than ever, investors need to be comfortable with headline and idiosyncratic risk, look beyond average index level metrics and be mindful of individual issuer risks. However, the broad move higher in yields may present a much more rewarding entry point for those investors prepared 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.
- **Evolving Fundamentals** While emerging economies offer relatively strong growth, economic scarring from the pandemic will likely extend the time required to recoup lost output.
- **Higher Volatility/Drawdown and Idiosyncratic Risks** Investors need to be aware of the potential higher volatility and drawdowns as well as the idiosyncratic risks associated with EM assets (Russia's removal from benchmarks serves as a striking reminder).

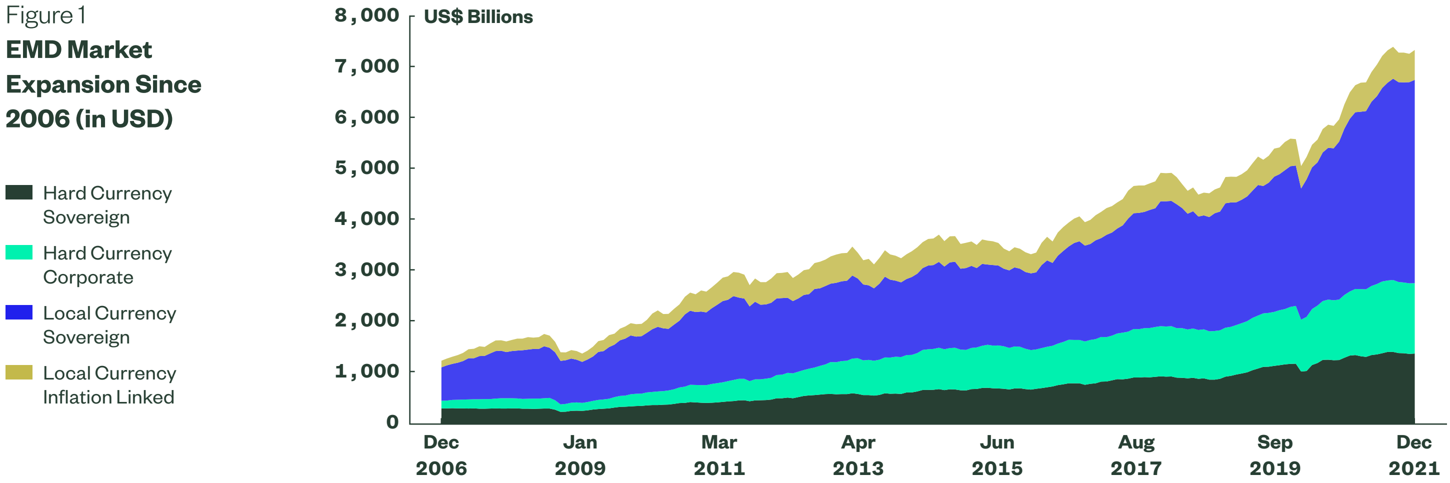
Emerging Market Debt Overview

- Emerging market debt has evolved into a significant multi-trillion dollar segment of the global bond market in recent years.
- Three broad investible EMD segments exist: 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 about US$7.3 trillion at the end of December 2021. We think this makes it too big a market for global investors to ignore.

Figure 1
EMD Market Expansion Since 2006 (in USD)



Source: State Street Global Advisors, JP Morgan, Barclays as of 31 December, 2021.

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

Hard currency (HC) sovereign, hard currency corporate, and local currency (LC) sovereign are the three broad investible segments for EM debt investors. Hard currency sovereign and corporate indices are predominantly comprised of US dollar-denominated bonds issued by emerging market sovereigns and corporates, respectively, while LC sovereign indices include 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:

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 comprises 100% investment grade (IG) bonds, and global high yield (HY) bonds which consist of 100% sub-investment grade bonds. Of the three EMD segments, local currency sovereign EMD has the highest proportion of bonds with an investment grade rating (77%), while hard currency sovereign EMD has the lowest proportion (51%).

LC EMD Less Diversified Hard currency sovereign and hard currency corporate debt are quite diversified by country and region. By way of contrast, local currency sovereign debt is relatively concentrated — the representative index contains only 20 countries, with the largest 10 making up 84%.

Currency and Rates Risk Hard currency sovereign and corporate exposures are typically USD-denominated with risks driven mainly by movements in US interest rates/yields and EM sovereign and corporate credit risk. Euro-based investors therefore have the additional consideration of US dollar fluctuation. Local currency sovereign debt 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 EMD Debt	Hard Currency Corporate EMD Debt	Local Currency Sovereign EMD 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 Global Aggregate	Bloomberg Global High Yield	MSCI World	MSCI Emerging Markets
Investment Universe	70 countries	60 countries	20 countries	73 countries	111 countries	23 countries	24 countries
Currency	USD	USD	20 EM currencies	28 currencies**	5 currencies	14 currencies	24 currencies
Regional Split (%)							
Asia Pacific	19	42	40	26	3	10	78
Europe	14	6	20	28	20	18	1
Latin America	33	25	29	1	12		7
Middle East & Africa	34	27	11	0	8	0	11
North America				42	50	72	2
Other Supranational				3	7		
Index Rating*	IG Credit Rating Ba1/BB+	IG Credit Rating Baa3/BBB-	IG Credit Rating Baa1/BBB+	IG Credit Rating Aa2/AA3	Sub-IG Credit Rating Ba3/B1	N/A	N/A
IG/Sub-IG Split (%)	51/49	56/44	77/23	100/0	0/100	N/A	N/A
Yield to Worst (%)	6.42	5.44	6.23	2.15	6.49	N/A	N/A
Dividend Yield (%)	N/A	N/A	N/A	N/A	N/A	1.84	2.53
Duration (Yrs)	7.50	4.61	5.07	7.26	4.39	N/A	N/A
Key Risk Drivers	US Treasuries and EM Sovereign Spreads	US Treasuries, Sovereign and EM Corporate Spreads	Local Rates and Local Currencies	Local Rates, Currencies and Corporate Spreads	Local Rates, Currencies and Corporate Spreads	Develop Market Beta and Currencies	Emerging Markets Beta and Currencies

Source: State Street Global Advisors, JP Morgan, Point, as of March 31, 2022.
* 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.
Characteristics are as of the date indicated, are subject to change, and should not be relied upon as current thereafter.

Emerging market debt provides a relatively attractive yield enhancement opportunity compared 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 EM debt exposures had yields around 6% at the end of Q1 2022, which was almost three times that of global aggregate bonds, and not too dissimilar to that of global high yield bonds.

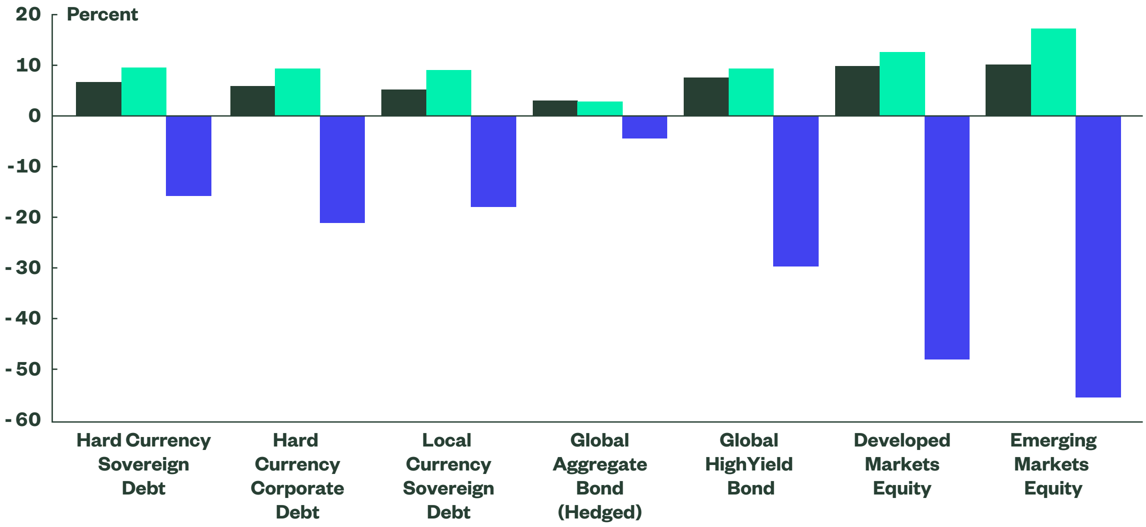
Hard currency corporate and local currency sovereign benchmarks have investment grade ratings that, depending on the rating agency, are between four and seven notches below global aggregate bonds, while the duration of the indices are shorter. By contrast, hard currency sovereign debt has speculative grade ratings on average, with a modestly 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, corporate, and local currency sovereign EM debt have historically been somewhere between those of global aggregate bonds and global equities (Figure 3). This is not surprising given that EMD assets comprise both investment grade and speculative grade bonds and their exposure to what is typically a more pronounced business cycle.

Figure 3

Historical Returns and Risks of Fixed Income and Equity Assets (EUR) (Jan 2003–Mar 2022)



Source: State Street Global Advisors, JP Morgan, Bloomberg, MSCI, as of 31 March, 2022. 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 Global Aggregate for Global Aggregate and Bloomberg 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. Index returns reflect all items of income, gain and loss and the reinvestment of dividends and other income as applicable. Past performance is not a reliable indicator of future performance.

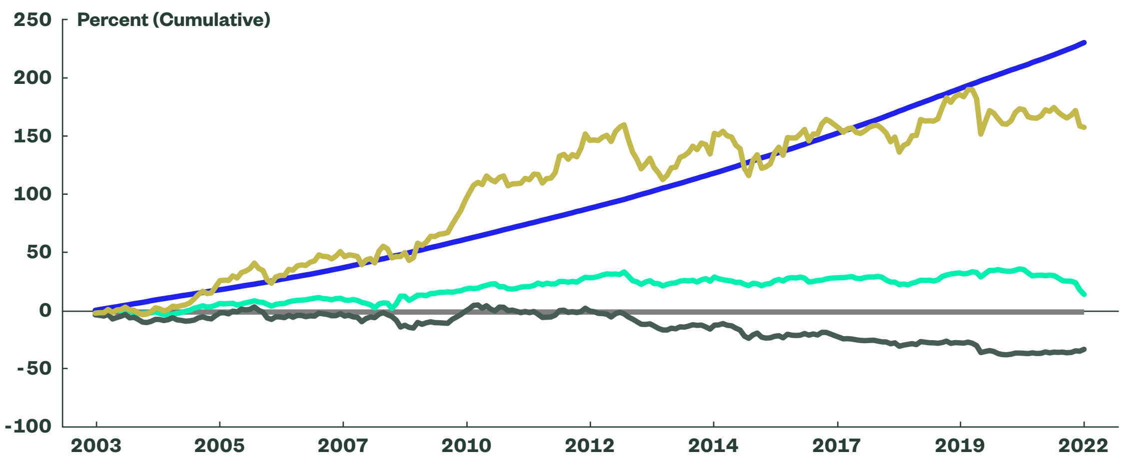
Income and FX Drive EMD Local Returns

In Figure 4, we decompose local currency EM debt total returns to highlight 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 price (returns from changes of the bond's face value or principal) as the rates move up and down.

However, returns can be significantly impacted by the FX component (returns from 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 total return of local currency sovereign debt. 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 currency exposure on page 15.

Figure 4

Decomposition of Local Currency Returns for JP Morgan GBI-EM Global Diversified Index for Euro Investors (Dec 2002–Mar 2022)



Source: State Street Global Advisors, JP Morgan, as of March 31, 2022. Index returns are unmanaged and do not reflect the deduction of any fees or expenses. Index returns reflect all items of income, gain and loss and the reinvestment of dividends and other income as applicable. Past performance is not a reliable indicator of future performance.

Benefits of Allocating to Emerging Market Debt

- Low correlation and higher growth factor exposures provide diversification benefits for both 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 EM debt and global aggregate bonds or global equities have been modest. This indicates the potential diversification benefits of adding EMD to a global bond or global equity portfolio (see Figure 5). For global aggregate bond investors, EM hard currency corporate and local currency sovereign debt have provided compelling diversification opportunities given their low historic correlations. Hard currency corporates offer a lower duration and higher credit exposure, while local currency sovereigns provide a more direct local rates and currency profile. 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 2021

	EM HC Sovereign Debt	EM HC Corporate Debt	EM LC Sovereign Debt	MSCI All Country World Equity	MSCI World Equity	MSCI Emerging Market Equity	Global Aggregate Bonds (Hedged)	Global High Yield Bonds
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	0.29	0.86
EM LC Sovereign Debt	0.70	0.60	1.00	0.57	0.53	0.65	0.32	0.63
MSCI ACWI	0.49	0.48	0.57	1.00	0.99	0.81	-0.05	0.67
MSCI World	0.49	0.49	0.53	0.99	1.00	0.75	-0.06	0.68
MSCI EM	0.40	0.35	0.65	0.81	0.75	1.00	0.02	0.55
Global Aggregate (Hedged)	0.39	0.29	0.32	-0.05	-0.06	0.02	1.00	0.13
Global High Yield	0.85	0.86	0.63	0.67	0.68	0.55	0.13	1.00

Source: State Street Global Advisors, JP Morgan, Bloomberg Finance L.P., as of 31 December, 2021. 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 Global Aggregate (euro hedged) for Global Aggregate and Bloomberg Global High Yield for Global High Yield. Index returns reflect all items of income, gain and loss and the reinvestment of dividends and other income as applicable. 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.

Allocating to EMD on a Forward-Looking Basis

Before considering the benefits of an EM debt allocation in multi-asset portfolios we first explore EM debt as a standalone allocation. The first question facing prospective EM debt investors is how to allocate across the three main segments. A range of outcomes exists depending on an investor's objectives and constraints — from a minimum volatility combination to a maximum risk-adjusted return portfolio with others along the spectrum. In the table below we set out some illustrative blends of emerging market debt to help highlight the attributes and trade-offs of the different combinations.

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

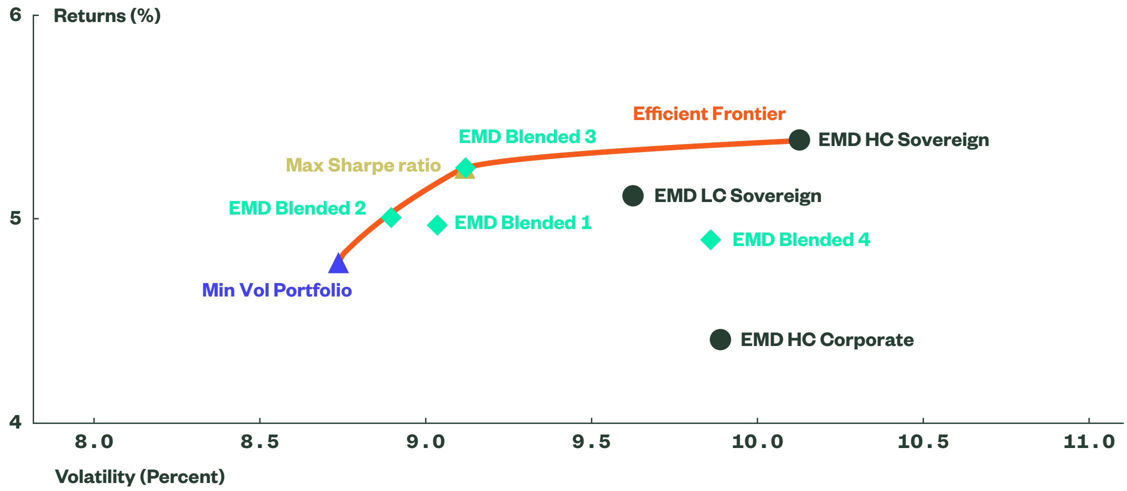
Source: State Street Global Advisors. For illustrative purposes.

In Figure 7, we present our long-term expected return and risk estimates for 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 are based on historic standard deviation but with a modest uplift to adjust for a somewhat suppressed historic volatility outcome.

Investors have enjoyed very attractive historic returns from the EMD assets under consideration here. We expect this to continue, albeit at a more moderate level. The recent rise in yields across all three segments certainly offers investors a more tempting entry point, but somewhat stretched currency valuations may well temper returns. For euro investors in the hard currency debt segments, an overvalued US dollar presents a slight headwind and will partially offset today's more generous yield levels. Investors in local currency debt face a similar dilemma — higher starting yields today are a distinct plus, but a generally undervalued euro now removes what was previously a tailwind due to an undervalued EM currency basket.

Blending the EMD segments can provide relatively attractive returns while reducing the risk profile compared to holding a single EMD exposure. Moreover, blends that include local currency debt (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, JP Morgan as of 31 March, 2022. 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 March, 2022. 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 on 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 make a larger EMD allocation to their portfolio to increase their return/risk metric.

Figure 8
Impact on Fixed Income Portfolios

	Return (%)	Volatility (%)	Return/Risk	Max Drawdown (%)
Global Aggregate	2.95	2.87	1.03	-7.37
Global Aggregate + EM Debt	3.43	3.15	1.09	-6.60
Difference	0.48	0.28	0.06	0.77

Source: State Street Global Advisors, JP Morgan, Bloomberg Finance L.P., as of 31 March, 2022. Returns and risk metrics were achieved by mathematically combining the performance data of the Bloomberg 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 on 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 affect 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	9.46	12.96	0.73	-48.43
MSCI ACWI + EM Debt	9.00	11.78	0.76	-43.34
Difference	-0.46	-1.18	0.03	5.09

Source: State Street Global Advisors, JP Morgan, Bloomberg Finance L.P., as of 31 March, 2022. Returns and risk metrics were achieved by mathematically combining the performance data of the Bloomberg 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.

Fundamentals and the Case for Local Currency EMD

- Emerging market economies are expected to deliver superior growth relative to their advanced market counterparts in the coming years, with emerging Asia being a key driver.
- Policy latitude has been eroded by pandemic-related measures, while the war in Ukraine raises fresh challenges. Additionally, real policy rates vary enormously by country but it is notable that EM central banks responded quickly to the inflation dynamic and are arguably further ahead in the interest rate cycle.

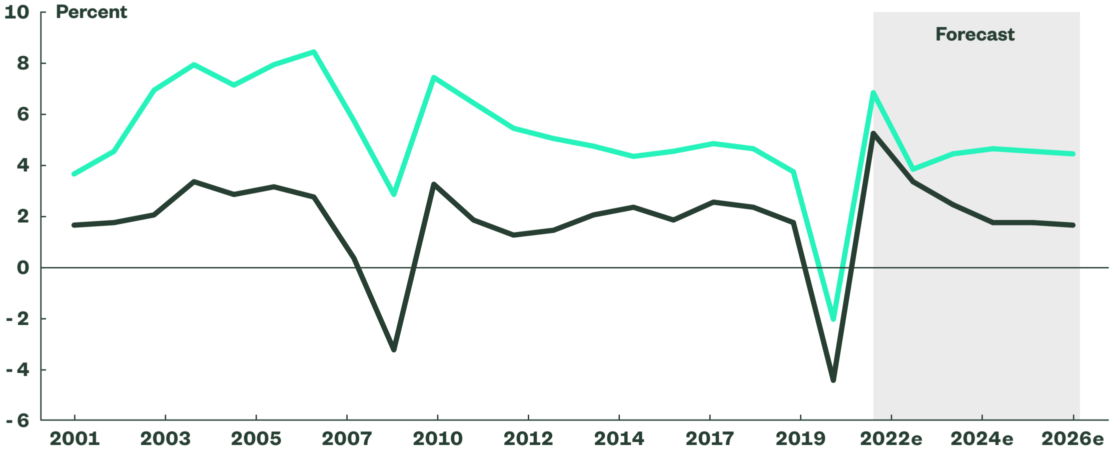
EM Countries: Higher Growth but More Debt

Emerging market economies remain key contributors to global growth. Over the last two decades they have experienced consistently stronger growth than advanced economies. According to the International Monetary Fund (IMF), advanced economy GDP is expected to increase by 3.3% in 2022, while emerging economy output should expand by 3.8% — both of these forecasts reflect significant downgrades in recent months and are potentially liable to further revisions. This growth premium of 0.5% is unusually narrow and is expected to increase to an average of 2.6% over the next four years (Figure 10).

There is a large disparity in prospects across regions, however. Emerging Asia remains the growth engine, whereas Emerging Europe is a clear laggard — unsurprising given its proximity and connections to Ukraine and Russia. Latin American and Caribbean economies' prospects lie between those two blocks. Distinct differences are obvious on the inflation front too with several Asian nations experiencing, for now at least, relatively subdued inflation. This is in sharp contrast to some Latin American and European countries that are currently seeing double-digit headline rates. It is noteworthy and reassuring that some EM central banks have responded robustly and are arguably well ahead of their advanced economy counterparts; Brazilian and Mexican authorities began raising their policy rates in March and June 2021, respectively (Figure 11). There is considerable uncertainty attached to the inflation outlook at present, but substantial moves in real policy rates should be acknowledged.

Figure 10
Real GDP Growth (Annual % Change)

Advanced Economies
Emerging Market and Developing Economies



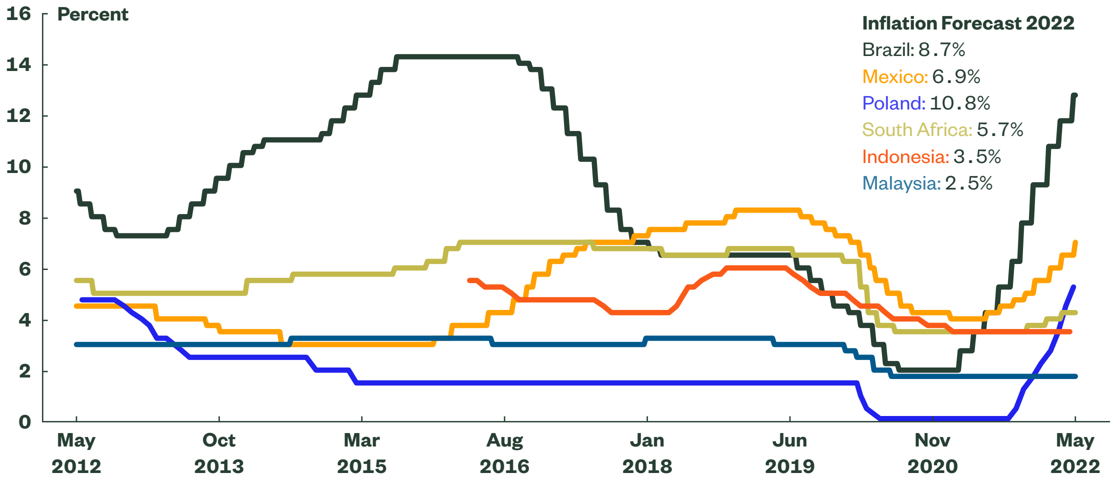
Source: State Street Global Advisors, International Monetary Fund as of April 2022. The above forecasts are estimates based on certain assumptions and analysis made. There is no guarantee that the estimates will be achieved.

The significant build-up of debt — public and private — is a critical point for EM investors (Figure 12). In its April 2022 World Economic Outlook, the IMF noted that the pandemic has led to "unprecedented increases in sovereign debt": median debt-to-GDP increased from 40% to 60% for middle-income emerging markets between 2013 and 2021. Low-income countries, which often have reduced debt-bearing capacity, have experienced a similar trend. Rising borrowing costs will clearly place a strain on the debt-servicing capacity of some countries. This is balanced by what the IMF sees as a "relatively healthy" trend in foreign exchange reserves in relation to imports across both emerging and developing economies — better than the position during the 2013 taper tantrum and the 2018 US rate tightening cycle. It's also important to note that the traditional EM sensitivity to surprise US rate hikes has changed in two key ways: first, the Fed's forward guidance removes some of the surprise element and, second, emerging markets fund much more of their requirements in local currency than in hard currency, as we can see in Figure 1 on page 4.

A number of emerging market central banks are well into their interest rate normalisation journeys as they tackle mounting inflationary pressures (Figure 11). As noted, those pressures are most evident in Latin America and Europe and have been, generally speaking, broadly absent across emerging Asia to date. This is a critical test for EM central banks in particular — a deft touch will be required to strike the right balance between growth and inflation as stagflation challenges hard-won credibility.

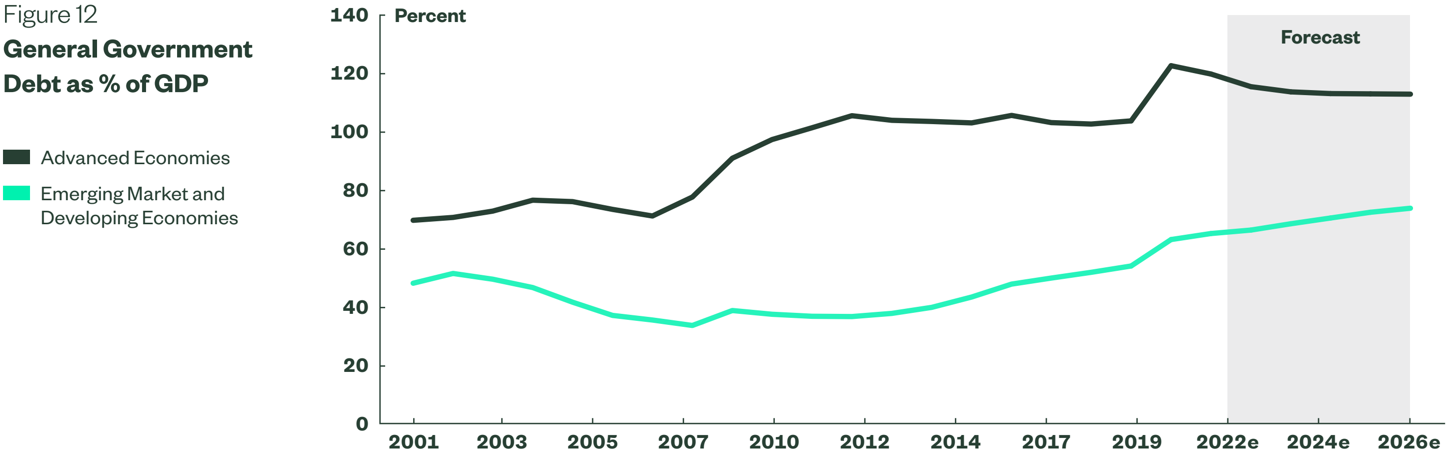
Figure 11
EM Central Banks Move to Combat Inflation (Key Policy Rates)

Brazil
Mexico
Poland
South Africa
Indonesia
Malasia



Source: Bloomberg Finance L.P., as of 13 May, 2022.

Figure 12
General Government Debt as % of GDP



Source: State Street Global Advisors, International Monetary Fund as of April 2022. 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 an expectation that others are likely to follow. While this has often been the case, it is important to recognise the progress and reforms in emerging markets over the last 20 years — many countries have liberalised their capital markets (allowing for more market-oriented currency regimes), established independent central banks and built up foreign currency reserves.

Emerging markets are nevertheless sensitive to swings in risk sentiment and more susceptible to external economic and geopolitical shocks. Russia's ejection from benchmarks following its invasion of Ukraine was a shock, but also a timely reminder of the more extreme idiosyncratic risks in EM debt. More than ever, investors need to look beyond the broad benchmark characteristics — average credit rating, average duration etc. — which tell us very little about the individual issuers in the index. We know that high food and energy prices can have a disproportionately bigger impact on low-income countries — it is a more pronounced issue for sub-Saharan African economies in the hard currency universe. In a different vein, China, typically one of the index heavyweights, deserves mention as a solid diversifier for investors but also as candidate prone to headline and idiosyncratic risk — especially given its significant debt build-up and geopolitical priorities.

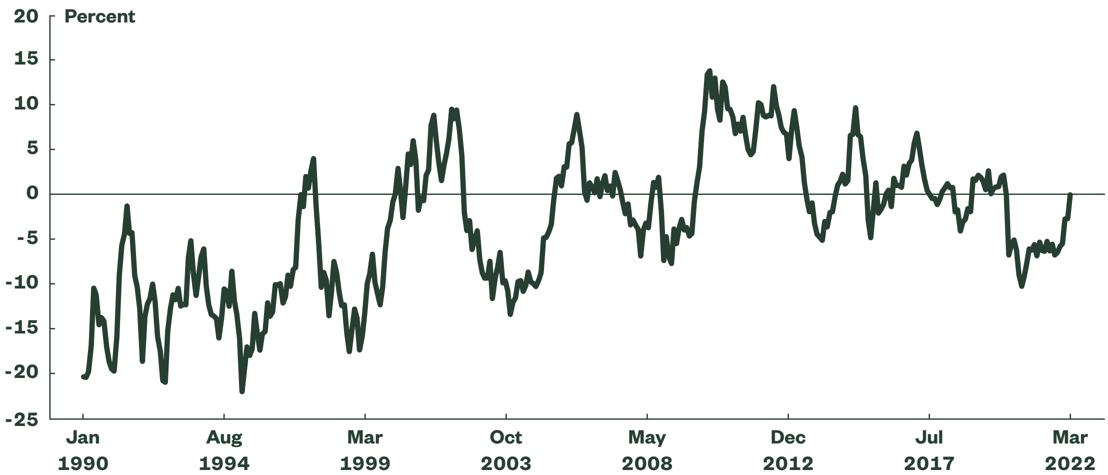
Local Currency EMD — The FX Component

As noted, income return tends to be the dominant driver of total returns over time. That said, foreign exchange rate movements against the euro have been a significant return and risk driver for investors in 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 bond gains.

The recent weakening of the broad basket of EM currencies has coincided with a weakening of the euro, so EM currencies (as a basket) are now close to fair value relative to the euro (Figure 13). The substantial rise in yields in recent times may make this immaterial for some investors, while others may want the added comfort of a potential currency tailwind — for the latter, opportunities may arise should poor sentiment towards EM lead to renewed weakness or should the euro experience a rebound.

Figure 13
EM Currency Over/Undervaluation Versus the Euro



Source: State Street Global Advisors, Bloomberg Finance, L.P., as of 31 March, 2022. Past performance is not a guarantee of future results. Historic estimate of fair value versus euro to 31 March, 2022 — 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.

Conclusion

Emerging market debt — like many other asset classes — faces the challenges of an evolving business cycle as central banks navigate a fine line between taming inflation and nurturing demand. Superior growth prospects versus those of advanced peers need to be seen in the light of rising debt burdens and pandemic-related economic scarring, complicated by an ongoing war in Ukraine. Much of this has been priced in to debt markets, with yields now substantially higher than they were a few quarters ago. We may well be at an uncomfortable juncture as more volatility likely lies ahead as the inflation/growth/policy response picture is far from complete. But for strategic investors with the resources and risk appetite, the potential rewards have become much more attractive.

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 currency and (more so) in 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.

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* Pensions & Investments Research Center, as of December 31, 2020.
† This figure is presented as of March 31, 2022 and includes approximately $73.35 billion USD 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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State Street Global Advisors Worldwide Entities

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