Commentary
Fixed Income

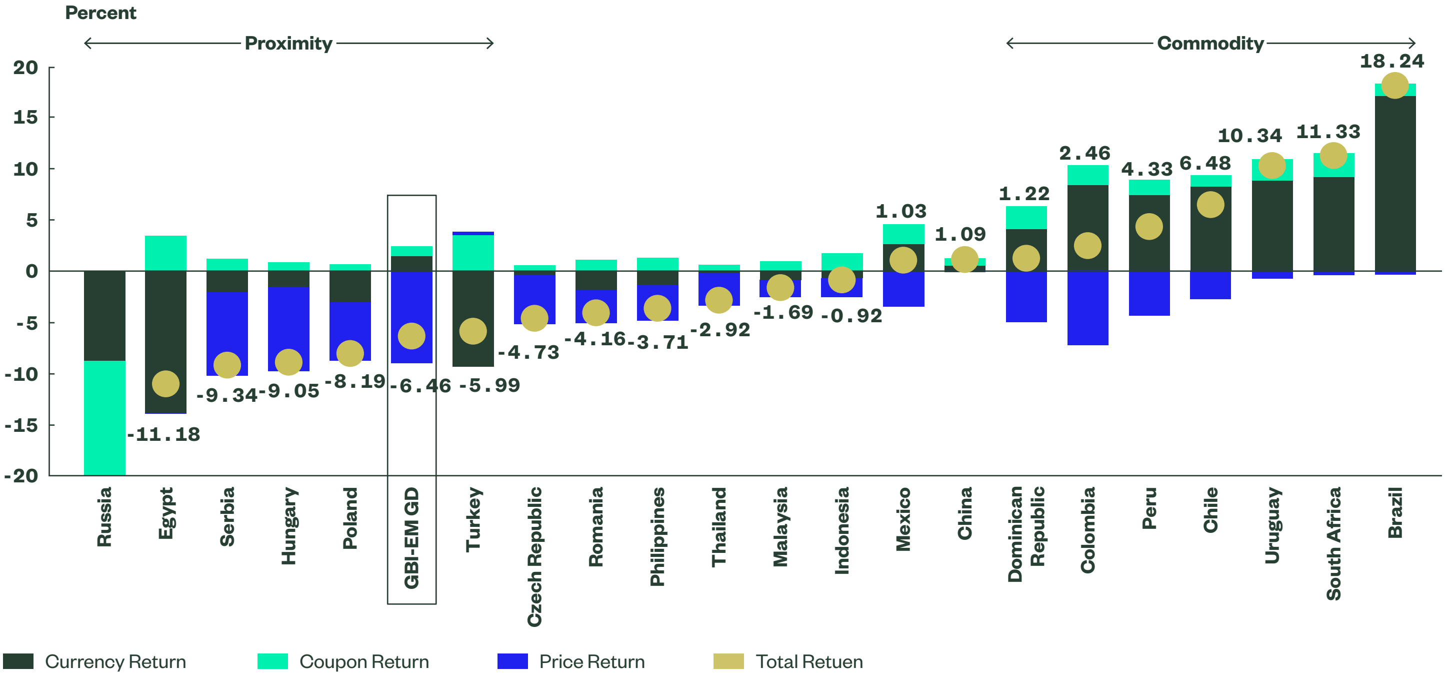
Q1 2022

Emerging Market Debt Market Commentary

Chart of the Quarter: Differentiation in EM Performance

In a quarter marked by broad risk-off moves, differentiation between EM countries with high proximity/linkages with the Russia-Ukraine War and commodity exporters became pronounced.

Figure 1
Variation of Returns in Q1



Source: JP Morgan as of 31 March 2022. Past performance is not a reliable indicator of future performance.

Quarterly Commentary — Q1 2022

Emerging markets experienced a very turbulent start to the year as Russia invaded Ukraine towards end of February, taking markets by surprise. Significant penalties on Russia swiftly followed, most notably the sanctioning of the Central Bank of Russia that prevented it accessing much of its offshore reserves. In addition, major Russian banks were cut from the SWIFT system, thereby stifling access to global capital markets. The Russian local bond market became practically inaccessible to foreign investors and ultimately led to the exclusion of Russian bonds from major fixed income indices (FTSE, JPMorgan, Bloomberg) from 31 March.

News flow around the war stoked a massive sell-off in Russian, Ukrainian and Belarusian local and hard currency bonds, with CEE (Central and Eastern Europe) markets and Turkey also impacted. In the initial weeks of March, the risk-off moves became broader across EM, mostly around supply-side concerns as Russia and Ukraine have outsized contributions to global trading in energy, wheat, and metals. These price moves and supply disruptions fueled increasing concerns about risks of a stagflationary environment developing, with EM growth forecasts revised down and inflation forecasts revised up.

In the final three weeks of the quarter, EM currencies and EM spreads stabilised somewhat to provide some respite, as differentiation in EM regions became more pronounced. In EMFX, against the backdrop of surging commodity prices, commodity exporters rallied and the sell-off was concentrated among countries that were more closely linked by proximity and other ties to the Russia-Ukraine War (see Figure 1). There was some underperformance in EM Asia on account of surging Omicron cases in China and its zero COVID policy that meant tighter restrictions on social mobility. In EM hard currency markets, a similar differentiation in spread changes was evident between commodity exporters and those having significant exposure to the war in Ukraine and a few distressed countries (such as Pakistan, Tunisia etc.).

Meanwhile, surging inflation was a consistent theme through Q1 with the February US headline CPI rising by 7.9% year-on-year, a level not seen for almost 40 years. The US Federal Reserve delivered a 25 basis point (bps) rate hike in its March 15-16 meeting and, based on the implied rate hikes priced into Fed Funds futures, the policy rate is expected to reach 2.5% by the end of 2022.[1] Uncertainty around the economic outlook led to a flattening in the US Treasury yield curve throughout Q1, with the 2s10s spread narrowing to just 4 bps by quarter-end, down from 79 bps at the end of December. But with higher real rates (after EM inflation subsides) and EM central banks staying ahead of DM counterparts in terms of policy normalisation, many EM countries seem reasonably well positioned to tackle domestic inflation and FX instability amid higher US rates. Over the course of the latest quarter, hard currency outflows totaled -$11.9bn, while local currency outflows amounted to -$2.2bn.[2]

Figure 2
Emerging Market Debt Index Returns — As of 31 March, 2022

	1m (%)	3m (%)	6m (%)	YTD (%)	12m (%)	3yrs (%)	5yrs (%)
In USD							
GBI-EM GD (EM Local Currency)	-1.53	-6.46	-8.83	-6.46	-8.53	-1.13	0.18
EMBI GD (EM Hard Currency)	-0.90	-10.02	-10.42	-10.02	-7.44	0.01	1.69
CEMBI BD (EM Corporates)	-2.55	-8.82	-9.38	-8.82	-7.25	1.97	2.83
In EUR							
GBI-EM GD (EM Local Currency)	-0.60	-4.40	-5.04	-4.40	-3.38	-0.83	-0.61
EMBI GD (EM Hard Currency)	0.04	-8.04	-6.69	-8.04	-2.22	0.32	0.89
CEMBI BD (EM Corporates)	-1.62	-6.81	-5.60	-6.81	-2.02	2.28	2.02
In GBP							
GBI-EM GD (EM Local Currency)	0.35	-3.77	-6.64	-3.77	-4.15	-1.47	-0.85
EMBI GD (EM Hard Currency)	0.99	-7.44	-8.26	-7.44	-3.00	-0.33	0.65
CEMBI BD (EM Corporates)	-0.69	-6.20	-7.19	-6.20	-2.80	1.61	1.77

Sources: State Street Global Advisors, Bloomberg, JP Morgan as of 31 March 2022. Past performance is not a guarantee of future results. Index returns reflect capital gains and losses, income, and the reinvestment of dividends. Performance returns for periods of less than one year are not annualised.

Figure 3
Key EM and Macro levels as of 31 March 2022

Item	Δ 1 Month	Δ 3 Months	Δ YTD	Current Level
GBI-EM GD Yield	-5 bps	52 bps	52 bps	6.23%
EMBI GD Yield	-20 bps	115 bps	115 bps	6.44%
EMBI GD Spread	-70 bps	31 bps	31 bps	400 bps
CEMBI BD Yield	-4 bps	110 bps	110 bps	5.68%
CEMBI BD Spread	-59 bps	19 bps	19 bps	331 bps
CDX.EM 5y	-59 bps	41 bps	40 bps	228 bps
10y UST	51 bps	83 bps	83 bps	2.34%
Dollar Index (DXY)	1.66%	2.76%	2.76%	—
DOW 30	2.32%	-4.57%	-4.57%	34678
Oil (WTI)	4.76%	33.33%	33.33%	$ 100.28

Source: JP Morgan, Bloomberg Finance L.P., as of 31 March 2022.

Local Currency Market Highlights

EM local currency debt returned -6.46% in US dollar terms in the first quarter, as measured by the JP Morgan GBI-EM Global Diversified Index. The overall weakness of the index was driven by events in Ukraine, with Russian local currency bonds detracting -4.44% from index returns. The RUB fell sharply and the sell-off in the local currency bonds saw the 10-year yield touch 16% on 25th February, at which point trading was halted in local markets. The effects were also felt in CEE countries, where FX and price returns were negative amid this sell-off. However, the strong rally in commodity prices amid supply concerns boosted the FX returns of some commodity currencies, particularly in Latin America, which resulted in overall positive EMFX returns of 1.65% over the three months to March.

Figure 4
Key Return Drivers of EM Local Government Bond Markets

GBI-EM GD (EM Local Currency)	Monthly Return (%)	3 Month Return (%)	YTD Return (%)
In USD			
Total Return (in $)	**-1.53**	**-6.46**	**-6.46**
FX Return (vs $)	1.66	1.65	1.65
Price Return (Local currency)	-3.32	-9.08	-9.08
Interest Return (Local currency)	0.14	0.97	0.97
In EUR			
Total Return (in €)	**-0.60**	**-4.40**	**-4.40**
FX Return (vs €)	2.59	3.71	3.71
In GBP			
Total Return (in €)	**0.35**	**-3.77**	**-3.77**
FX Return (vs €)	3.53	4.34	4.34

Sources: State Street Global Advisors, Bloomberg, JP Morgan as of 31 March, 2022. Past performance is not a guarantee of future results. Index returns reflect capital gains and losses, income, and the reinvestment of dividends. Performance returns for periods of less than one year are not annualised.

Figure 5
Best and Worst Performers Across EM Local Government Bond Markets in USD

Q1 2022	Country	Total Return USD (%)	Bond Return (%)	FX Return (%)	Average Index Weight (%)	Index Impact (bps)**
GBI-EM GD		**-6.46**	**-8.11**	**1.65**	**—**	**—**
Top 5 Performers	Brazil	18.2	0.9	17.2	8.8	160
	South Africa	11.3	1.9	9.2	8.8	100
	Uruguay	10.3	1.3	8.9	0.1	1
	Chile	6.5	-1.7	8.3	2.1	13
	Peru	4.3	-2.9	7.4	2.2	10
Bottom 5 Performers	Poland	-8.2	-5.1	-3.3	7.0	-57
	Hungary	-9.1	-7.4	-1.8	3.5	-31
	Serbia	-9.3	-7.2	-2.3	0.3	-3
	Egypt	-11.2	3.3	-14.1	1.1	-12
	Russia	-100.0	-100.0	-8.9	4.4	-444

Source: State Street Global Advisors, Bloomberg, JP Morgan as at 31 March 2022. Past performance is not a guarantee of future results. Index returns reflect capital gains and losses, income, and the reinvestment of dividends.
* Country and currency performance of JP Morgan GBI-EM Global Diversified Index.
** Index impact is calculated by multiplying the period average weight by total return.

Russia was the worst performer in Q1, as bonds lost all value and detracted 444 bps from the index return. The escalation of the situation along the Russia-Ukraine border worsened as President Putin recognised the independence of two breakaway Ukraine regions — Donetsk and Luhansk — on 21 February, with a full-scale invasion following three days later. The severe sanctions imposed on Russia, most notably cutting off CBR's access to its offshore reserve assets, cutting off major Russian banks from SWIFT, and stifling access to global capital markets, made the Russian local bond market almost inaccessible for foreign investors — trading activities were suspended in local markets. The RUB fell sharply, forcing the government to intervene through FX selling and imposing capital controls. The CBR raised its key interest rate from 9.5% to 20% and ordered export-focused companies to sell foreign currency in an emergency move to contain the depreciation of the ruble as well as rising inflationary concerns — February CPI inflation increased by 9.2% year-on-year (y/y). Notwithstanding some progress in peace talks between Russia and Ukraine and some agreement on a few issues, the situation continues to remain dire.

Hungary was also particularly weak, returning -9.1% in USD terms and detracting 31 bps from the index return. Consumer prices rose 7.9% y/y in Q1 '22, ahead of estimates of 7.4% and fueling expectations of more aggressive central bank rate hikes. The central bank revised its forecast for 2022 inflation to a range of 7.5%–9.8% up from 4.7%–5.1%. The 1-week deposit rate was raised by 215 bps, mostly in the aftermath of Russia's invasion, and stood at 6.15% on 31 March. The local bonds sold off amidst inflation concerns that were further exacerbated by the risks from Russia-Ukraine War.

Egypt was also one of the underperforming countries in Q1 (-11.2%), as the central bank devalued the currency by 14% and raised its main policy rates by 100 bps (overnight deposit and lending rates were revised to 9.25% and 10.25%, respectively) as a means to combat inflationary pressures arising from the COVID pandemic and the Russia-Ukraine War.

Brazil was the best performer, returning 18.2% in USD terms and contributing 160 bps to the index return. The returns were almost entirely driven by a rally in the Brazilian real. Leftist ex-President Luiz Inacio Lula da Silva, the front-runner in this year's presidential race, leaned towards the centre and expressed interest in having former Sao Paulo Governor Geraldo Alckmin as his running mate. The central bank maintained its aggressive approach to monetary policy tightening, increasing interest rates by 100bps to 11.75% in February, up from 2% about a year ago. The relatively attractive carry, cheap local stocks, and buoyant oil prices are attracting foreign inflows, while the central bank has signaled a likely slowdown in the pace of future rate increases ahead of ending the rate hike process.

South Africa also performed strongly, returning 11.3% in USD terms and contributing 100 bps to the index return. The central bank delivered a 50 bps hike in the quarter, taking the repurchase rate up to 4.25%. The market doesn't expect the central bank to hike rates aggressively, given the February inflation print of 5.7% is within the bank's target range of 3%–6%. The local currency debt attracted foreign inflows as high commodity prices provides a boost to government effort to reduce budget deficits and debt. Moody's upgraded the outlook to stable from negative.

Hard Currency Market Highlights

EM hard currency sovereign debt returned -10.02% in Q1, as measured by the JP Morgan EMBI Global Diversified Index. Both the treasury and spread components were significantly negative, with US Treasuries selling off on the back of rate hike expectations and inflationary concerns, and spreads widening due to the broader risk-off sentiment arising from the Russia-Ukraine War. In the last final weeks of Q1, spreads of a few commodity exporters rallied amidst surging commodities prices as the differentiation in the performance of commodity exporters and countries directly affected by Russia-Ukraine became pronounced.

Figure 6
Key Return Drivers of EM Hard Currency Government Bond Markets in USD

EMBI GD (EM Hard Currency)	Monthly Return (%)	3 Month Return (%)	YTD Return (%)
Total Return	**-0.90**	**-10.02**	**-10.02**
Spread Return	2.68	-4.52	-4.52
Treasury Return	-3.49	-5.76	-5.76
IG Sub-Index	-2.63	-12.38	-12.38
HY Sub-Index	0.92	-7.51	-7.51

Sources: State Street Global Advisors, Bloomberg, JP Morgan as of 31 March, 2022. Past performance is not a guarantee of future results. Index returns reflect capital gains and losses, income, and the reinvestment of dividends. Performance returns for periods of less than one year are not annualised.

Figure 7
Best and Worst Performers Across EM Hard Currency Government Bond Markets*

Q1 2022	Country	Total Return (%)	Spread Return (%)	Treasury Return (%)	Average Index Weight (%)	Index Impact (bps)**
EMBI Global Diversified		**-10.02**	**-4.52**	**-5.76**	—	—
Top 5 Performers	Lebanon	16.2	17.1	-0.8	0.2	4
	Ethiopia	9.9	13.4	-3.1	0.1	1
	Angola	3.6	9.2	-5.1	1.1	4
	Mozambique	3.2	8.7	-5.0	0.1	0
	Iraq	2.8	5.2	-2.3	0.4	1
Bottom 5 Performers	Kazakhstan	-15.2	-10.4	-5.3	2.4	-37
	Pakistan	-18.7	-15.7	-3.6	1.1	-21
	Ukraine	-51.4	-49.8	-3.1	1.7	-88
	Russia	-76.6	-76.3	-1.3	2.3	-173
	Belarus	-84.4	-84.2	-1.0	0.3	-24

Source: State Street Global Advisors, Bloomberg, JP Morgan as of 31 March, 2022. Past performance is not a guarantee of future results. Index returns reflect capital gains and losses, income, and the reinvestment of dividends.
* Country and currency performance of JPM EMBI Global Diversified Index.
** Index impact is calculated by multiplying the period average weight by total return.

Russia was one of the worst performers in Q1, returning -76.6% in USD terms and detracting 173 bps from the index return. Since hard currency bonds are traded offshore, the closure of Russian exchanges to non-local participants had less of an impact and there was also no issue of RUB convertibility. S&P Global downgraded the country's rating three times in the aftermath of the Russian invasion, from BBB- to CC, taking it further into sub-investment grade territory, mostly over uncertainties around debt repayment capabilities and technical difficulties persisting due to sanctions. Notably, Fitch and Moody's have slashed Russia's sovereign rating status below investment grade. The cost of insuring Russian government debt surged towards March-end, with credit default swaps (CDS) pricing indicating a 90% probability of default within five years.[3]

As one might expect, **Ukraine** was also one of the major underperformers, returning -51.4% in USD terms and detracting 88 bps from the index return. As Russian forces advanced on Ukraine's major cities, economic activities came to a standstill and people began to flee the country. The UN Refugee Agency has said that more than 4.2 million people have fled into neighboring countries. The yield on the September 2032 bond shot up to 21.2% as of 31 March.

Lebanon was the best performer in Q1'22, returning 16.2% in USD terms and contributing 4 bps to the index return. The rally was largely driven by Prime Minister Najib Mikati's statement that the government will begin talks with debt holders as it is currently discussing an economic recovery plan with the International Monetary Fund (IMF). The Lebanese government continues to engage with the IMF to negotiate a preliminary deal as the meetings started towards the end of March. The authorities are optimistic that they would conclude the talks by agreeing on the list of measures that the country would need to implement to pave the way for $5bn in aid and to unlock $11bn in other financial commitments made to Lebanon in the past few years.

Among the poorer performers in Q1 was **Kazakhstan**, returning -10.4% and detracting 37 bps from index returns. There was social unrest and protests against the backdrop of rising fuel prices in the beginning of the year and heavy gunfire erupted in Almaty, the nation's largest city and former capital. Russia and its allies dispatched troops to help quell the protests. The central bank raised its key rate to 13.5% in an emergency step following Russia's invasion of Ukraine. Russia is its largest trading partner and the international sanctions imposed on Russia were already taking a toll on its oil exports.

Endnotes

1 Source: Bloomberg Finance L.P., as of 31 March 2022.

2 Source: JP Morgan.

3 Source: Bloomberg, as of March 24.

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* Pensions & Investments Research Center, as of December 31, 2020.
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