Insights
Fixed Income

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EMD Outlook

In the Eye of the Storm

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The outbreak of war in Ukraine has upended broad financial market expectations that were built on improving economic activity in a post-pandemic world. The fallout from Russia's invasion on emerging market debt has been significant with diverging performance depending on proximity to the warzone and exposure to commodities. But EM bonds now arguably offer greater value than they have for some time and the higher yields and undervalued currencies present return-seeking investors with a potentially attractive entry point.

At the start of 2022, emerging economies were already facing a challenging backdrop: high EM and global inflation along with looming policy reversal including quantitative tightening (QT) by major developed market (DM) central banks — and the US Federal Reserve in particular — were expected to have a negative impact on the performance of EM bonds. Exacerbating these has been Russia's invasion of Ukraine — what had been widely viewed as a tail risk at the beginning of the year has unfortunately materialised, and once again emerging markets are caught in the eye of the storm. What is different this time is that the Russia-Ukraine War is having far broader implications beyond the countries directly affected by it.

Russia-Ukraine War: Three Ways it Affected EMD

1. Impact on Russia and Ukraine

From an economic and financial markets standpoint, Russia and Ukraine are unsurprisingly most impacted by the war. Following its invasion of Ukraine, Russia was subjected to unprecedented economic and financial market sanctions. Events spiralled down extremely fast, with credit rating agencies downgrading Russian sovereign debt below investment grade status within days of the invasion and withdrawing ratings altogether within a month. Pre-war, Russia represented 6.8% of the JPM GBI-EM Global Diversified Index and 3.12% of the JPM EMBIG Diversified.[1] Its weighting fell to 1.8% and 0.95%, respectively, at the end of February 2022 before it was eventually excluded from JP Morgan's indices at the end of March at close to zero value. Meanwhile, an increasing number of companies and some countries have actively moved to completely sever commercial ties with Russia.

The impact on Russian assets has been dramatic with both local and hard currency Russian sovereign debt losing over 90% of its value. Russia's currency fell sharply, losing 40% of its value between 25 February and 7 March before rebounding to pre-invasion levels by the end of April. This was partially due to Russia's central bank imposing capital controls and implementing an emergency rate hike from 9.5% to 20.0%, which it then trimmed back to 14.0% by the end of April. The ability to trade the rouble at all had been heavily restricted, making it subject to manipulation by the central bank.

Ukrainian assets were also severely negatively impacted — the country's hard currency debt, which is part of the JPM EMBIG Diversified index, has lost more than half of its value in the year to date. Furthermore, the planned addition of the country's local currency debt to the GBI-EM indices at the end of March was put on hold.

The economic fallout for both countries is of course significant. The International Monetary Fund (IMF) estimates that Russia's GDP will contract by 8.5% in 2022 and that Ukraine's GDP will shrink by 35%. But the longer-term economic consequences are also dire — Russia's economic isolation, particularly vis-à-vis the West, is likely to deepen and the country may never regain its place as one of the most important exporters of various commodities. Furthermore, its positive current trade surplus masks that imports will plummet due to sanctions which will restrict industrial production and domestic consumption significantly. As for Ukraine, it will take years to re-build the economy, the financial cost of which has been estimated by Ukraine's Prime Minister to be in the region of $600bn.

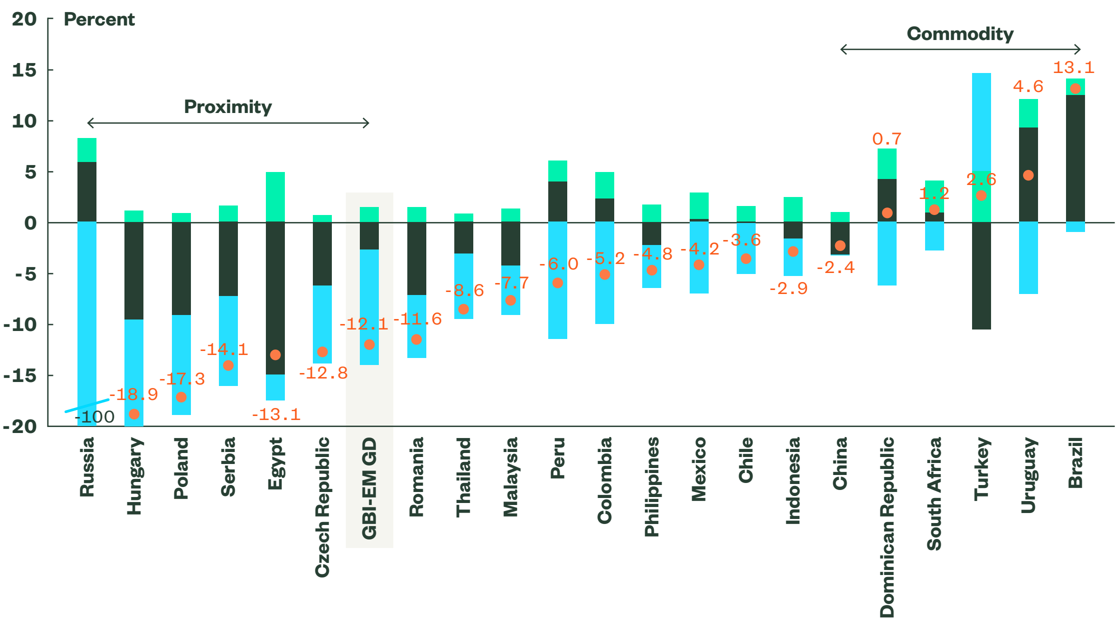
2. Spillover Effect on Neighbouring Countries

The Russia-Ukraine conflict has also had obvious spillover consequences for the neighbouring Caucasus and Central and Eastern Europe regions, which have most links with Russia and Ukraine and are particularly reliant on Russian energy.

The spillover effect was particularly evident in the currency performance of countries in Central and Eastern Europe that are included in the JPM GBI-EM GD index. As illustrated in Figure 1 Hungary, Poland, Serbia, Czech Republic and Romania bore the brunt of the underperformance to end of April this year. These countries were affected not only because of their trade exposure to Russia and dependency on Russian gas, but also because of their exposure to developed Europe where growth prospects have been seriously threatened by the war in Ukraine. Furthermore, most of these countries are commodity importers, meaning they've also been hit by the sharp price increases across the commodity spectrum.

Figure 1
EM Returns Driven by Proximity to War and Commodity Prices

Currency Return
Coupon Return
Price Return
Total Return



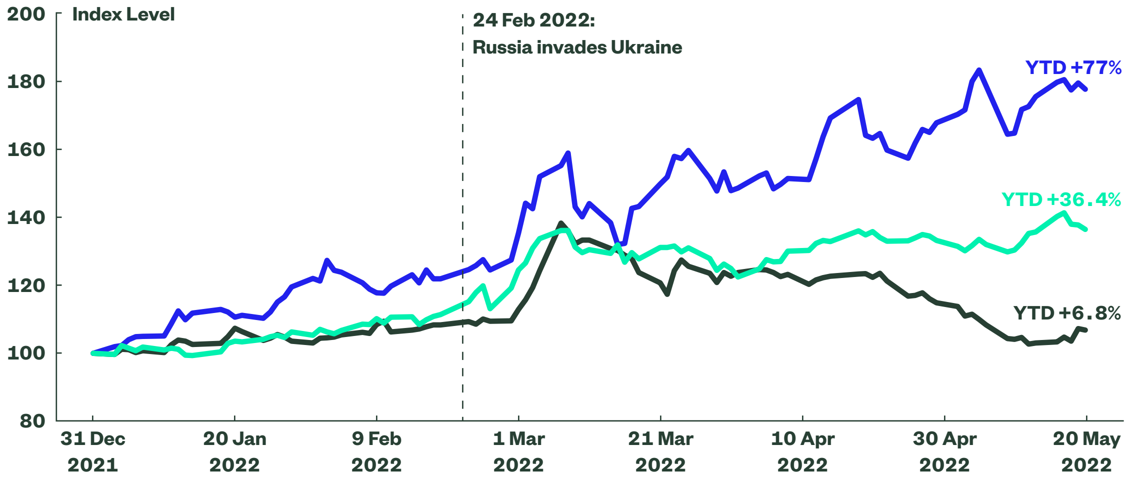
Source: JP Morgan. As of 29 April 2022. Total return breakdown for GBI-EM Global Diversified Index.
Past performance is not a reliable indicator of future performance. Index returns reflect capital gains and losses, income, and the reinvestment of dividends.

3. The Global Impact

The effects of the war are not confined to those countries in close proximity to the fighting. Russia is a key exporter of energy, metals and agricultural commodities, while Ukraine is a significant exporter of some industrial metals and agricultural commodities — particularly wheat and corn. Since the breakout of war, commodities have rallied sharply: energy prices have seen the largest gains with the Bloomberg energy commodities sub-index gaining 77% in 2022 (up to 20 May); the Bloomberg grains sub-index is up 36% and the Bloomberg industrial metals sub-index is up 6.8% over the same period. Although prices eased back from the initial spike seen in the immediate aftermath of the invasion, further flare-ups are still possible.

Figure 2
War in Ukraine Driving Commodity Prices

- Bloomberg Industrial Metals Sub-index (zinc, aluminium, copper, nickel)
- Bloomberg Grains Sub-index (soyabean, corn and wheat)
- Bloomberg Energy Sub-index (crude oil, unleaded gasoline, natural gas, eating oil)



Source: State Street Global Advisors, Bloomberg Finance L.P., as of 20 May 2022.
Past performance is no guarantee of future results. Index returns reflect capital gains and losses, income, and the reinvestment of dividends.

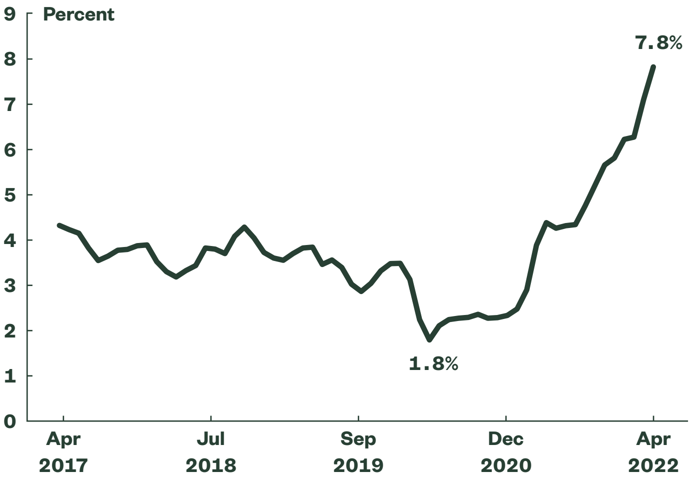
In addition to the rally in commodities, the Russia-Ukraine War has reminded us once again that we live in a world of highly-integrated global supply chains where a disruption in one region can result in broader supply chain disruptions; combined with commodity price increases, this is adding fuel to the inflationary pressures already present before the war began. In this way, the Russia-Ukraine conflict has really exacerbated some of the negative headwinds that were causing concern in the back end of 2021.

Macro Clouds Darken

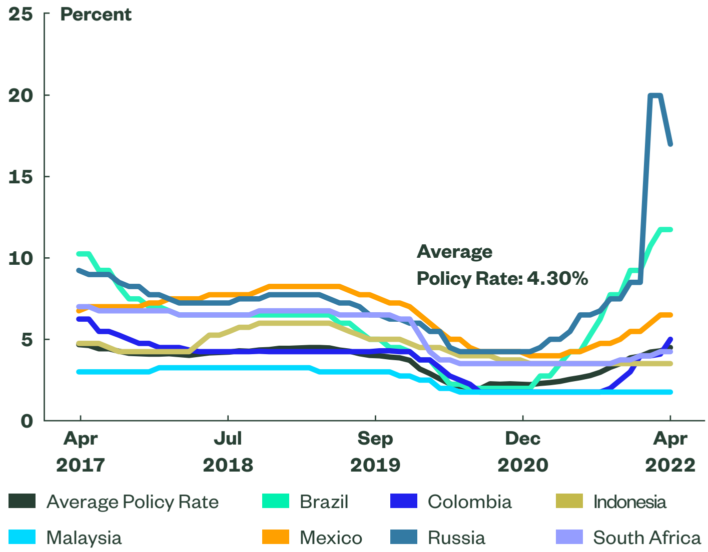
The sharp spike in global and EM inflation that started last year prompted both DM and EM central banks to reassess their monetary policies. The Fed started tapering its quantitative easing (QE) programme in November 2021, while most EM central banks had already begun increasing their policy rates from the middle of 2021. The Russia-Ukraine War has led to higher inflation still; as illustrated in Figure 3, the weighted average CPI (consumer price index) inflation of countries in the JPM GBI-EM Index reached 7.8% at the end of April — the highest level in over five years and a very sharp increase from the low of 1.8% seen less than two years ago.

Figure 3
Central Banks Move to Combat Inflation

EM CPI Inflation YoY



EM Central Bank Policy Rates

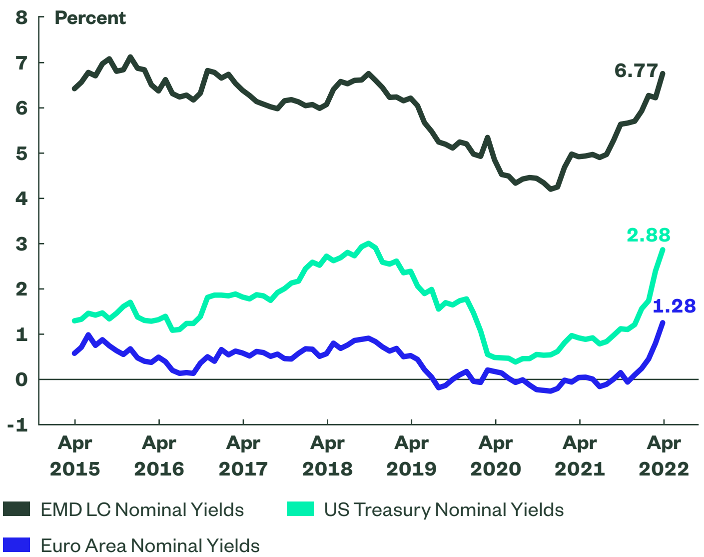


Source: State Street Global Advisors, Bloomberg Finance L.P., as of 29 April 2022.
Weighted average policy rate is based on the weights in the JPM GBI EM Global Diversified Index.
Weighted average CPI Inflation YoY based on the weights in the JPM GBI EM Global Diversified Index with the exception of Peru.
Note: As of 31 March 2022 Russia is no longer part of the JPM GBI-EM GD Index.

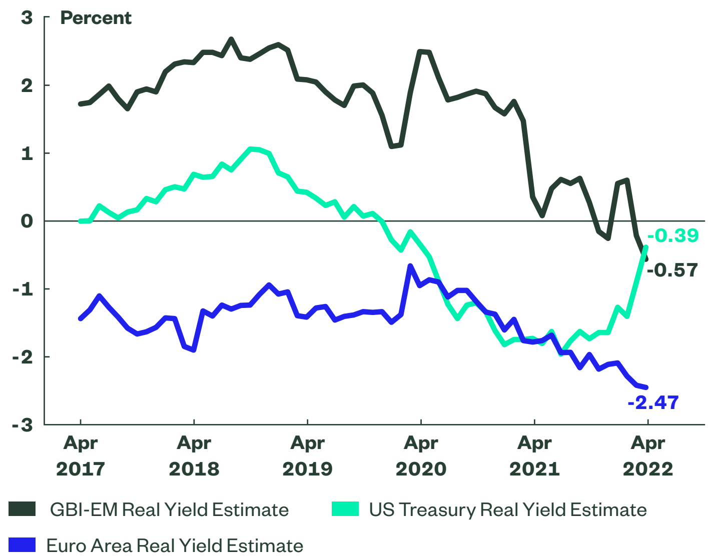
EM central banks are facing a difficult balancing act between combating ever-higher inflation and bolstering sluggish growth that had only started to recover following the COVID-19 pandemic. Despite the fact that many have accelerated monetary policy tightening, on average they have found themselves behind the curve given the rapid spike in inflation — the average real yield of the countries in the JPM GBI-EM Index plunged into negative territory despite nominal yields increasing. Meanwhile, the increase in US real yields has made EM local currency debt less attractive on a relative value basis and signals tightening liquidity. (See Figure 4).

Figure 4
EM Real Yields Turn Negative Even as Nominal Yields Rise

EM LC Debt vs DM Nominal Yields



EM LC Debt vs DM Real Yields



Source: State Street Global Advisors, JP Morgan, Barclays, as of 30 April 2022. Past performance is not indicative of future returns. EMD LC nominal yields = yield of the JPM GBI-EM GD Index. Euro Area nominal yields = Bloomberg Barclays Euro Aggregate Treasury Index yield. US Treasury nominal yields = Bloomberg Barclays U.S. Treasury Index yield.

Stagflation Concerns Mount

Stagflation, which was already identified as a key risk to EM at the start of the year, has become an even greater concern. According to the International Monetary Fund's (IMF) April update, growth of emerging and developing economies is expected to average 3.8%[1] in 2022 against inflation of 8.7%. This represents a downgrade to its growth outlook in January, when it forecast growth of 4.8%, and an upgrade to its inflation projection. As evident in Figure 1, commodity currencies and commodity exporters are generally benefitting from the increase in commodity prices, although the net effect of the Russia-Ukraine War is a stagflationary environment that is a negative overall for EM returns.

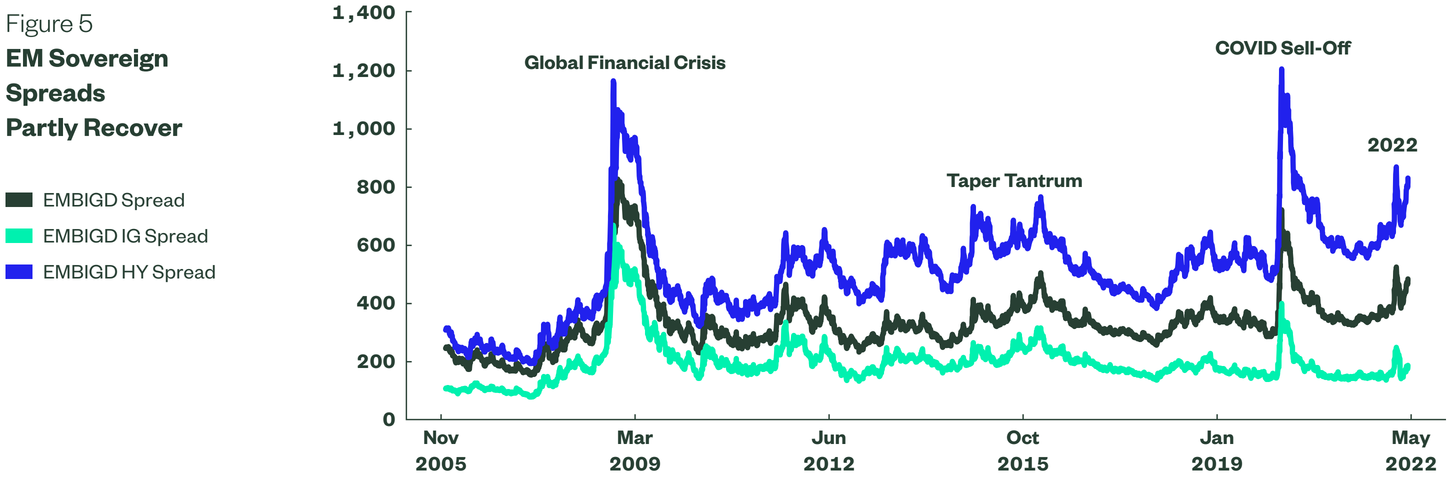
The Fed has also brought forward the tightening of its monetary policy with an aggressive hiking cycle expected to take place over the course of 2022. This in turn has led to a sharp repricing of US Treasury yields, with the 10-year yield moving above 3% in early May — an increase of over 150bps since the beginning of the year. More importantly, two-year yields have also sold off to reach a high of nearly 2.7% in April — there was a temporary inversion of the 2s10s yield curve in early April, a development which is typically a sign of impending US recession.

Unfortunately for EM, China is unlikely to save the day this time; the country's zero COVID policy has resulted in both supply chain disruptions and weaker growth. The 4.4% Chinese growth rate forecast by the IMF for 2022 is a far cry from previous Fed tightening cycles when strong Chinese growth and roaring demand for commodities supported broader emerging markets. One bright spot is that Chinese stimulus may result in an upside growth surprise with China being one of the few major economies that is easing its monetary policy.

EMD Hard Currency

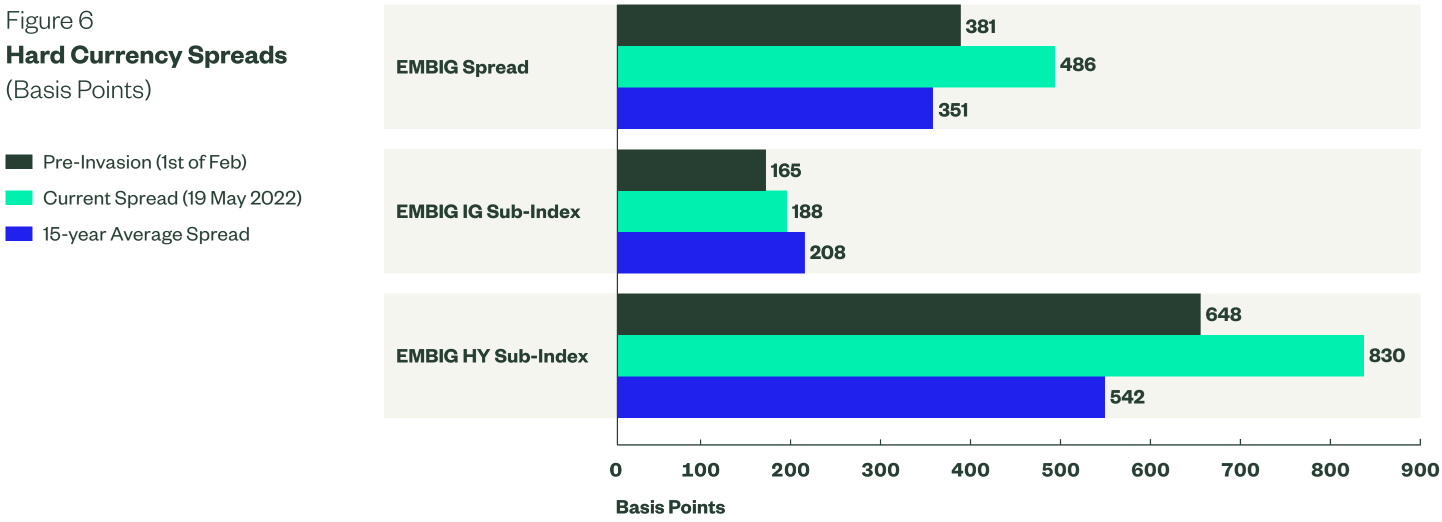
EM sovereign spreads widened significantly following Russia's invasion of Ukraine with some of the widest levels seen on the 8 of March when the EMBIG spread widened by 159bps since the start of the year. The sharpest widening was seen in the High Yield subindex, where the spread increased by 222bps; investment grade spreads, which were starting to look expensive at the end of 2021, widened by 103bps. Spreads then tightened somewhat before widening again, with the net effect being that the overall EMBIG spread is significantly wider than the 15-year average. Most of the widening comes from the High Yield subindex but investment grade spreads also offer more value than they did when we began 2022. (See Figures 5 and 6).

Figure 5
EM Sovereign Spreads Partly Recover



Source: State Street Global Advisors, Bloomberg Finance L.P., JP Morgan, as of 20 May 2022. Past performance is not a reliable indicator of future performance.

Figure 6
Hard Currency Spreads
(Basis Points)

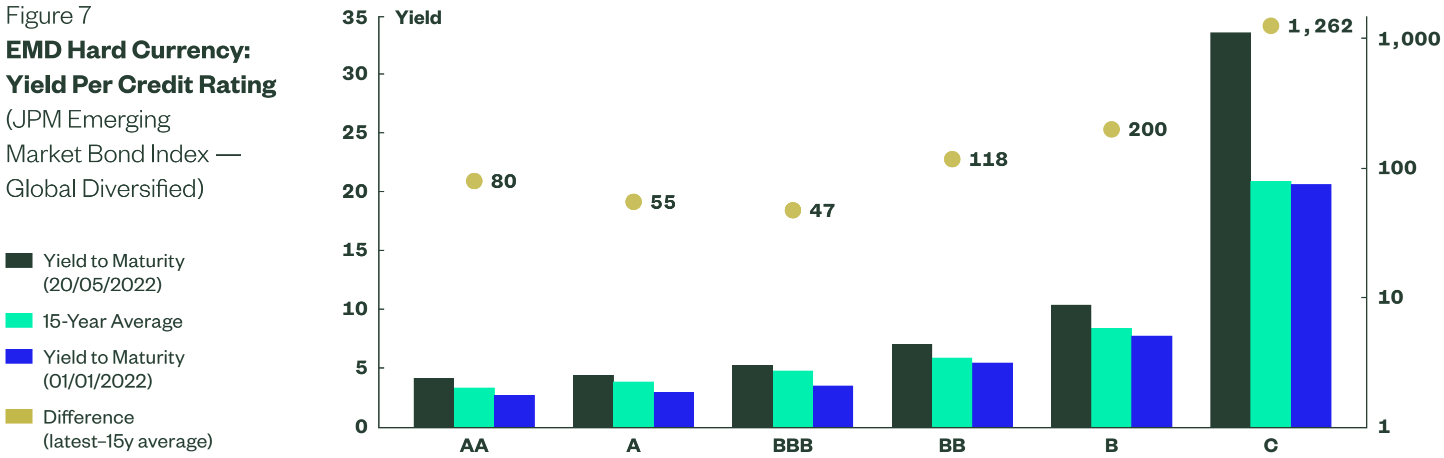


Source: State Street Global Advisors, Bloomberg Finance L.P., JP Morgan as of 20 May 2022. Past performance is not a reliable indicator of future performance.

High yield EM bond spreads have remained wider than their long-term average since the onset of the COVID crisis when emerging economies were forced to take on a significant amount of additional debt. Although this crisis propelled a number of debt restructurings, the overall impact at an index level has been minimal. Moreover, the ultra-low refinancing costs in the aftermath of the COVID crisis had put debt sustainability concerns at bay — until now. The Russia-Ukraine War hit EM with higher refinancing costs at a time when fundamentals haven't had the chance to recover. This, combined with a possible Russian sovereign default and with Sri Lanka's decision to not service its US dollar debt until debt restructuring is completed, does not bode well for risk appetite for EM high yield debt. But how worried should we be about refinancing risk?

Looking at the breakdown of EM yields relative to credit rating, we can see that EM yields have increased across the board compared to their level at the end of last year and compared to the 15-year average (Figure 7). However, the largest increases versus the 15-year average have taken place in the B and C credit rating' buckets. The highest increase has taken place in the C credit rating where yields are 12 percentage points higher than the long-term average — however, C-rated debt represents only 4% of the EMBIG Index. The next highest increase is seen in the B credit rating where yields are currently 200bps higher than the long-term average; B-rated debt represents 17% of the index. The smallest yield increases are seen in the AA, A and BBB buckets, which altogether represent more than 50% of the index.

Figure 7
EMD Hard Currency: Yield Per Credit Rating
(JPM Emerging Market Bond Index — Global Diversified)



Source: State Street Global Advisors, JP Morgan as of 20 May 2022. Past performance is not a reliable indicator of future performance.

AA*	A	BBB	BB	B	CCC and Below
United Arab Emirates	China	Hungary	Colombia	Armenia	Lebanon
Qatar	Kuwait	Indonesia	Morocco	Bahrain	Sri Lanka
	Chile	Kazakhstan	Paraguay	Honduras	Argentina
	Saudi Arabia	Mexico	Serbia	Jamaica	Gabon
	Malaysia	Panama	Azerbaijan	Jordan	Maldives
	Poland	Peru	Georgia	Namibia	ElSalvador
		Philippines	Trinidad	Rwanda	Ethiopia
		Uruguay	Vietnam	Senegal	Mozambique
		Croatia	Brazil	Bolivia	Tunisia
		Romania	Dominican Rep	Costa Rica	Ukraine
			Guatemala	Egypt	Suriname
			Ivory Coast	Kenya	Zambia
			Oman	Mongolia	
			S.Africa	Nigeria	
			Uzbekistan	Turkey	
				Angola	
				Barbados	
				Ecuador	
				Ghana	
				Iraq	
				Pakistan	
				Papua New Guinea	
				Tajikistan	

* Index rating is the average rating provided by S&P, Moody's & Fitch.

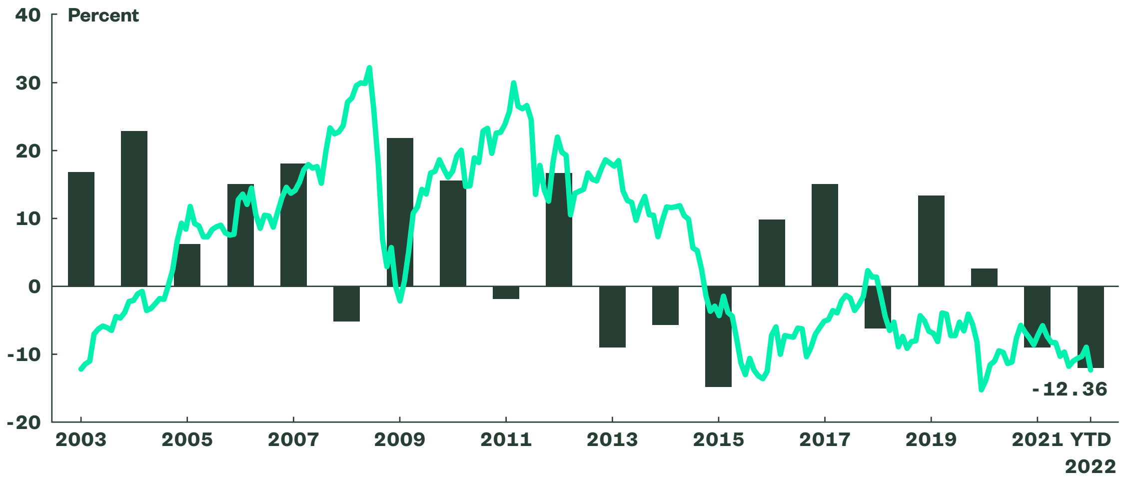
The combination of sharp US Treasury sell-off and spread-widening has led to substantial underperformance of EM hard currency (HC) debt. On a more positive note, the worst of US Treasury repricing may be behind us and spreads are more attractive than they have been for a while, potentially paving the way for better performance ahead. Also, with EM HC yields at 7.7% in May, EMD HC is becoming attractive again for income-seeking investors given the handsome compensation on offer for the risk they are taking. For comparison, US High Yield[2] debt had a yield to maturity of 7% at the end of April and Global High Yield[3] is at par with the EMBIG index; yet only 50% of the EMBIG index is accounted for by high yield, with the remainder being investment grade debt.

EMD Local Currency

US dollar strength has accelerated further this year, which is doing little to help EM FX recoup its undervaluation versus the greenback. At the same time, EM rates have sold off as a result of EM central bank monetary policy tightening leading to underperformance by EM local currency debt (Figure 8).

Figure 8
EM FX Undervalued, But Renewed USD Strength Could Hinder Rally

JPM GBI-EM Global Diversified Index — Total Return (USD %)
EM FX Over/Undervalued vs USD (%)



Source: State Street Global Advisors, Bloomberg, JP Morgan, as of 29 April 2022. 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 of 29 April 2022 — 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. Composite valuation based on weights of the JPM GBI EM Global Diversified Index.

A sustainable rally in EM appears difficult in the face of US dollar strength and stagflation. The US dollar index (DXY) — a measure of the US dollar versus a basket of currencies — has increased by 7.8% since the beginning of 2022[4] and may remain well supported as the Fed proceeds with monetary policy tightening and as global market uncertainty supports demand for so-called 'safe haven' currencies. Market turns are notoriously difficult to pinpoint in EM, but given current levels of currency undervaluation and already-projected Fed rate hikes a lot seems priced in here already.

Although earlier than developed market counterparts to begin raising policy rates, it appears that EM central banks are still behind the curve given the spike in inflation; hence, the rates component of return may remain under pressure in the short term. For EM local currency to perform, we will need to see signs of inflation rolling over, US dollar strength subsiding and a better outlook for EM growth. These factors are quite dependent on how the Russia-Ukraine War evolves and therefore remain uncertain. However, as we know from experience oftentimes in EM, it is when the skies are darkest that the dawn is approaching.

Uncertain Outlook but Silver Linings Exist

The outlook for EM remains highly uncertain as it is closely tied to the evolution and outcome of the Russia-Ukraine War, which is having a wide-ranging impact on global markets, rather than just the countries directly involved. The net effect has been higher inflation and lower growth with further havoc in commodity markets still possible. This is adding further fuel to inflation and applying downside pressure on growth.

Intensifying macro headwinds and geopolitical risk have stifled demand for EM debt, but even in the midst of this perfect storm there are some silver linings for the asset class. Both EMD LC and HC offer better value than they have for some time. For investors willing to live with short-term volatility, this could prove to be a good entry point into the asset class. Moreover, yields at an index level for both EMD LC and HC are at their highest levels in a decade, making the asset class highly attractive for return-seeking investors.

Endnotes

1 Source: JP Morgan as of 31 January 2022.

2 Based on Bloomberg US High Yield Index.

3 Based on Bloomberg Global High Yield Index.

4 Source: Bloomberg, as of 20 May 2022.

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- Build from breadth
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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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Increase in real interest rates can cause the price of inflation-protected debt securities to decrease. Interest payments on inflation-protected debt securities can be unpredictable.

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