Commentary
Emerging Markets

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COVID-19: What It Means For Emerging Market Debt Investors

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Emerging Market Debt (EMD) investors are justifiably rattled by the market volatility of the past few weeks as questions about the spread of COVID-19 (coronavirus) and its impact on economic conditions and markets have dominated headlines. Adding to EM Debt volatility is the oil price war triggered by the breakup of the OPEC+ alliance; the price of crude oil is down 52% this year (as of March 16). Here, we take stock of the market action so far and consider what it means for investors in Emerging Market Debt.

DM Monetary Policy Easing Positive for EM Assets

Developed Market (DM) central banks have moved swiftly to provide monetary policy support. The Federal Reserve (Fed) took decisive action by reducing the Fed funds rate to essentially zero and announcing an extensive bond buying programme. In Europe, the Bank of England reduced the policy rate by 50bps, while the European Central Bank (ECB) announced a comprehensive stimulus package.

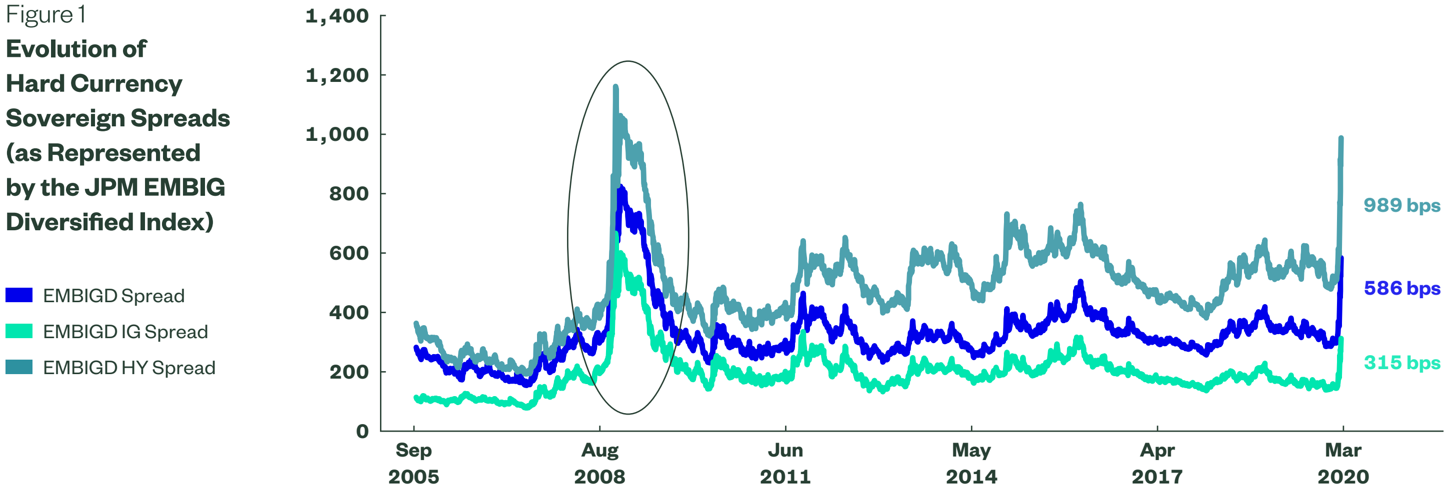
Historically, when DM central banks — and particularly the Fed — have provided aggressive monetary policy support EM assets have subsequently rallied strongly and attracted solid inflows. For instance, the Fed's Quantitative Easing (QE) announcement in November 2008, and subsequent expansion in March 2009, was followed by strong performance for both EMD Hard Currency and Local Currency. EMD Hard Currency (HC)[1] was up 29.8% in 2009 and 12.2% in 2010, while EMD Local Currency (LC)[2] was up 22% in 2009 and 15.7% in 2010. While in 2009 there were other forces in place driving performance — including cheap valuations, a weak US dollar, a 78% oil price rally — the Fed's monetary policy was also a clear factor.

A Good Entry Point?

While markets are still assessing the impact of COVID 19 and EMD has sold off along with other risk assets (EMD HC: -11.3% and EMD LC: -13.1% year-to-date as of March 16)[3] we believe that an attractive entry point will develop in an asset class that had started to look expensive at the end of last year.

After a strong year in 2019, EMD valuations had started to look less appealing in 2020, particularly among EMD HC assets. However, the recent correction has changed this dynamic. As of March 16, the spread on the JP Morgan EMBIG Diversified Index (the EMBIG) had widened by 297 bps year-to-date, driven by the High Yield sub-index that has increased by an astonishing 502 bps. EMD high yield has been targeted, partially due to concerns over the capacity of less-developed nations to deal with an epidemic, but also because many are also commodity exporters suffering from subdued China demand. Oil exporters then suffered a double whammy as oil prices sold off sharply after Saudi Arabia launched a price war. Consequently, EMD sovereign spreads reached their widest levels since the Global Financial Crisis (GFC) in 2008. (Figure 1).

Figure 1
Evolution of Hard Currency Sovereign Spreads (as Represented by the JPM EMBIG Diversified Index)



Source: State Street Global Advisors, JP Morgan, Bloomberg Finance LP., as of March 16, 2020. Past performance is not a guarantee of future results.

Wide EMD HC Spreads Offer Significant Tightening Potential

EMD HC performance is driven by two key drivers — US Treasuries and EMD spreads. While EMD spreads have had a large negative contribution year-to-date, the US Treasury rally through March 9 has softened the blow. The 10-year US Treasury reached an all-time low of 0.32% on March 9 — a hugely supportive move for EMD HC performance. Spread-widening, however, has been exacerbated by the oil price crash, leading to negative year-to-date returns.

Continued volatility in EMD spreads in the short term is still likely, whereas the potential for a further US Treasury rally is limited. However, over the medium term, we believe spreads have significant potential to tighten from what are their widest levels in a decade, especially if oil prices recover. It is important to note, though, that spread tightening from highly distressed levels tends to happen quickly, as in 2009, and therefore the time is now to prepare to move quickly. The key risk to EMD HC returns would likely come from stabilsation of US Treasury yields in the medium term.

EM FX Undervaluation to Support EMD LC in the Medium Term

EM Local Currency performance has three key drivers — the foreign exchange (FX) component, the rates component and the price component. EM rates have provided a positive contribution so far this year as EM central banks have maintained an easing bias. Some, such as the People's Bank of China (PBOC) and the Central Bank of Thailand, have already provided stimulus to tackle the economic impact of coronavirus.

The rally in EM rates has not been enough to offset the negative bond price action and the sell-off of EM FX against the US dollar — even after the dollar weakened following the Fed's rate cuts. As the US dollar is driven by safe haven flows (which increase its value), and by Fed monetary policy easing (which reduces its value), further volatility of EM FX versus the US dollar in the short term seems likely.

However, EM FX remains undervalued versus the US dollar and has the potential to recover once the COVID-19 crisis dissipates. According to our proprietary fair value model, the currencies in the JP Morgan GBI-EM Global Diversified Index (the GBI-EM) were almost 6% undervalued versus the US dollar at the end of 2019; as of March 16, they were undervalued by almost 15% (Figure 2). Furthermore, additional monetary policy stimulus by the Fed could drive more US dollar weakness, which would be positive for EM FX and EMD LC.

Figure 2
EM FX* Valuation vs US Dollar (Based on SSGA's Fair Value Currency Model)

Source: Bloomberg, State Street Global Advisors calculations, as at March 16, 2020.
Estimate of fair value versus the US dollar as of 16 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. *EM currencies included in the JPMorgan GBI-EM Global Diversified Index.

On the rates side, EM central banks have space to further cut policy rates. With the collapse in oil prices, EM inflation is likely to remain on a downward trajectory as long as EM FX weakness passthrough doesn't counter this. Overall, as COVID-19 takes a toll on EM growth, EM central banks are likely to maintain an easing bias, which is positive for EMD LC in the medium term.

Finally, even if the price component of return has started to make a negative contribution in recent weeks due to the broader risk asset sell-off, it is important to note that local currency bonds have a large local investor base which is likely to see through the current turmoil and stay the course. Therefore, while there might still be some downside potential, it is likely to be more limited.

EMD Still More Attractive than DM Fixed Income

As DM central banks have cut aggressively policy rates and investors have piled into "safe haven" securities, DM Fixed Income offers little in the way of carry to investors. The yield-to-worst on the US Agg Index was 1.72% as of March 16 and 0.47% for the Euro Agg Index. For comparison, the yield-to-maturity on the GBI-EM GD Index has jumped to 5.64% from 5.22% at the end of 2019 and to 6.67% from 4.91% on the EMBIGD index.

EM Fundamentals Relatively Strong

While the economic impact of COVID-19 is yet to be fully determined, on a historical comparison basis, EM fundamentals are relatively strong; there has been a considerable improvement of both current account and budget balances since early 2013. For instance, just before the taper tantrum in Q1 2013, the average current account balance of the countries in the GBI-EM GD Index was close to -2.0% — at the end of 2019 that figure was -0.2%. EM public debt as a percentage of GDP was 50% at the end of 2019, while it was 90% and 100% in Europe and the US, respectively.[4] Furthermore, EM central banks have relatively more scope for policy stimulus than their DM counterparts, where zero or even negative base rates are common.

As the COVID-19 epidemic tests the health systems of EM countries and their ability to contain it, the main risk to EM economies is any protracted economic impact from the outbreak and/or a lengthy oil price war materially affecting EM fundamentals and ability to service debt.

Conclusion

Continued volatility seems likely in the near term as the world learns more about COVID-19 and its impact on the global economy. This COVID-19 induced sell-off, exacerbated by the crash in oil prices, has resulted in a repricing of EMD valuations. Yet, we see many elements for a recovery in EMD asset prices in the medium term. Specifically, substantial DM Central Bank policy support, the potential for a weaker US dollar driven by US monetary policy easing, and an eventual recovery in oil prices. We believe EMD continues to have an important role in a diversified portfolio.

Endnotes

1 EMD HC performance is represented by the JP Morgan EMBI Global Diversified Index.

2 EMD Local Currency performance is represented by the JP Morgan GBI-EM Global Diversified Index.

3 EMD HC performance is represented by the JP Morgan EMBI Global Diversified Index; EMD LC performance is represented by the JP Morgan GBI-EM Global Diversified Index.

4 Source: International Monetary Fund.

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* This figure is presented as of March 31, 2020 and includes approximately $51.62 billion 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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