

# Revisiting Emerging Market Debt: Brighter Days Ahead?

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After a volatile year, emerging market debt has rallied in recent months. The recovery has not been without turbulence, but there are signs that the skies are brightening as some of the headwinds that pinned back performance have eased. We consider what investors in EM debt might expect through the rest of 2023.

## In the Rear View Mirror: EMD in 2022

Taking a look back at what transpired in 2022, we can see that emerging markets were caught up in the turmoil of a volatile year. However, when we assess what impacted returns in the asset class it becomes clear that underperformance in both hard currency and local currency EM debt was driven by non-EM factors. In hard currency sovereign debt where returns can be broken down into two main drivers — spread return and treasury return — US Treasuries accounted for almost two-thirds of the underperformance, with spread widening accounting for a third. In local currency sovereign debt, the key drivers of return are foreign exchange (FX) and interest rates; FX was responsible for almost half of the underperformance, and EM FX underperformance was largely due to the strength of the US dollar.

Hence, one of the main drivers of performance in EM debt over the course of 2022 was in fact the monetary policy of the US Federal Reserve and the resulting sell-off in US Treasuries and strengthening of the US dollar.

Figure 1  
**EMD 2022  
Performance Breakdown**

Hard Currency Sovereign Debt (JP Morgan EMBIG Diversified)	2022 (USD) (%)	Local Currency Sovereign Debt (JP Morgan GBI-EM Global Diversified)	2022 (USD) (%)
<b>Total Return</b>	<b>-17.78</b>	<b>Total Return</b>	<b>-11.69</b>
Spread Return	-4.39	FX Return	-5.84
Treasury Return	-14.01	Rates Return	-5.85

Source: State Street Global Advisors, JP Morgan as of 31 December 2022. Past performance is not a reliable indicator of future performance. Index returns reflect capital gains and losses, income, and the reinvestment of dividends. Performance returns for periods of less than one year are not annualized.

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Of course, there were also EM-specific factors that contributed to underperformance. The war in Ukraine was a tail risk that materialized and it obviously affected not only emerging markets but also global markets through the commodity channel.

There was also a notable slowing in Chinese growth. China has long been the growth engine for EM and the world, and it registered real GDP growth of 3% in 2022 — one of the lowest prints in its modern history. The country's zero-COVID policy combined with a sharp downturn in the real estate sector were among the main culprits for this outcome.

Finally, the sharp increase in refinancing costs along with a still-significant debt overhang from the COVID-induced crisis exposed the more vulnerable EM issuers in hard currency and some of them had to restructure their debt.

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## Looking Forward: Prospects for Remainder of 2023

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While 2022 was painful, this leaves us with an improved outlook for the asset class this year. Even though volatility is likely to remain a feature of 2023, albeit with less intensity if one believes that most of the sell-off in US Treasuries has already occurred and most of the US dollar strength narrative has already played out, this removes two of the key headwinds that weighed on the asset class through last year. Furthermore, with COVID-related lockdowns in the rear-view mirror, there could be additional tailwinds from pent-up demand.

For the first three months of 2023, both hard and local currency EM debt have registered positive returns of 1.86% and 5.16%, respectively.<sup>2</sup> Moreover, January saw a return of inflows into the asset class, particularly for hard currency debt, after a year of unprecedented outflows.

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## Hard Currency Debt Outlook: All About the Carry

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We believe that the main argument in favor of hard currency debt this year is its carry. With a yield hovering around 8.5% for the flagship JP Morgan EMBI Global Diversified Index (EMBIG), we think that the asset class offers attractive compensation for income-seeking investors.

Investors have concerns about the potential impact on EM spreads should a US recession materialize and more broadly about the impact of risk-off episodes such as the turmoil in the banking sector seen in March. EM spreads are correlated with global risk sentiment and sold off during this period. During volatile periods like this, however, the market dynamic is generally one where risk assets sell off and so-called 'safe haven' assets rally — this is exactly what happened in March when the sell-off in EM spreads was offset by a rally in US Treasuries. We believe that this dynamic will mitigate the impact on EM hard currency performance over the course of the year even if we see further volatility in spreads.

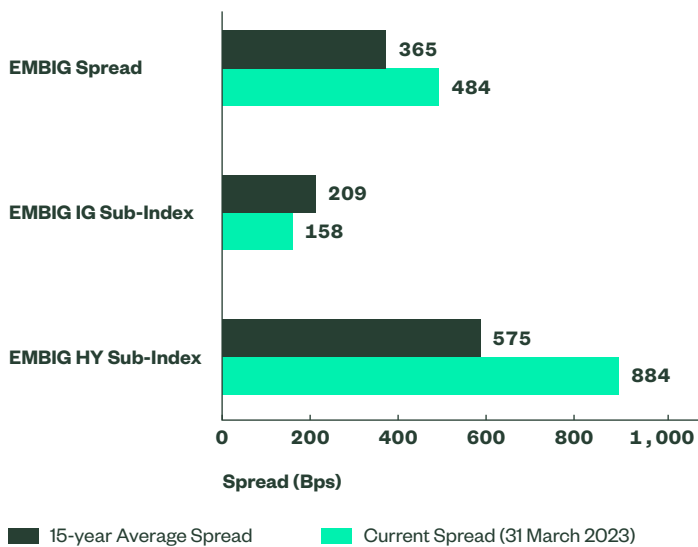
It should also be noted that in the hard currency debt universe, the high yield issuers that comprise 48% of the broader JP Morgan EMBI Global Diversified Index have driven the overall index spread wider. This is illustrated in the chart on the left side of Figure 2 which compares the current spread of the EMBIG index and its investment grade (IG) and high yield (HY) sub-indices to their respective 15-year average spreads. The good news is that most of the vulnerabilities have already been exposed and priced in. Zambia and Sri-Lanka were among the countries to start debt-restructuring procedures in 2022 whilst a number of other countries including Tunisia, Ghana and Egypt sought IMF support; this increased risk has already been reflected in the EMBIG high yield spread that has widened significantly more than the long-term average.

Finally, we expect that hard currency debt is also going to be supported by favorable technicals. With 10-year US Treasury yields hovering between 3–4%, most issuers are likely to sit on the sidelines whilst bonds are refinanced via other channels; the possibility of another year of negative net supply would serve as a positive technical backdrop.

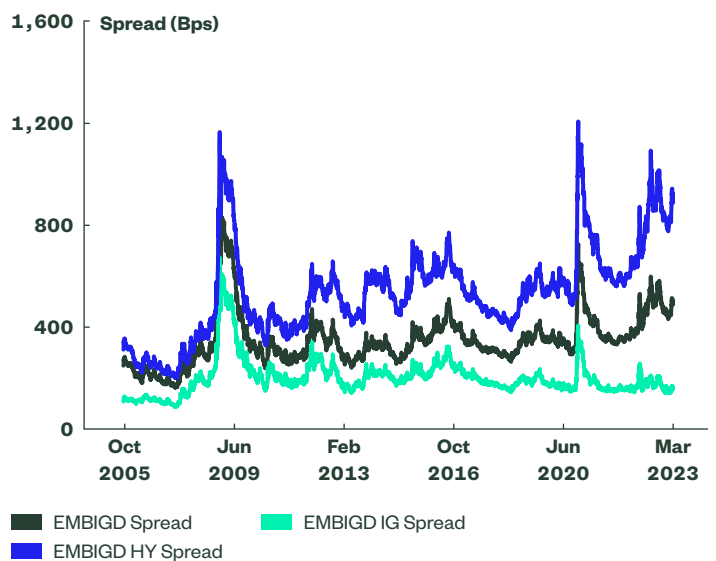
Figure 2

### Hard Currency Sovereign Spreads

Hard Currency Sovereign Spread (31 March 2023) vs 15-Year Average



Historical Hard Currency Sovereign Spreads



Source: State Street Global Advisors, JP Morgan, Bloomberg Finance L.P., as of 31 March 2023. Past performance is not a reliable indicator of future performance.

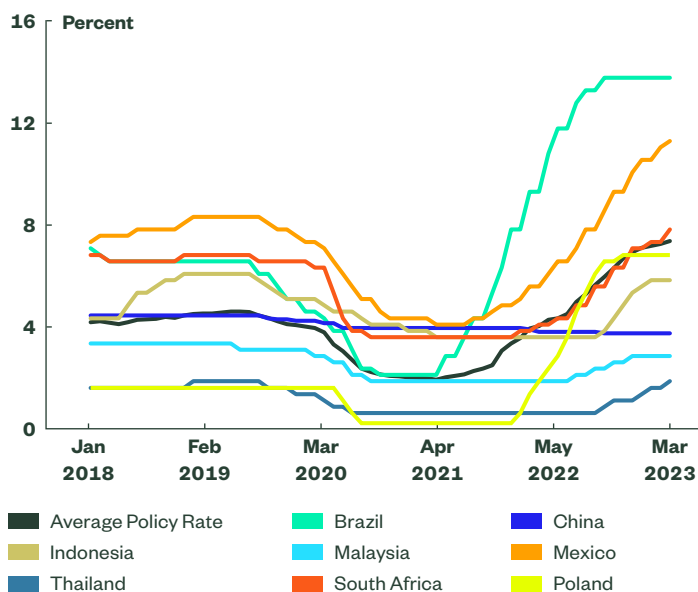
### Local Currency Debt Outlook: Catalysts for Local Rates to Outperform

In local currency EM debt, there are catalysts for local rates to outperform this year. EM central banks have been ahead of the curve, having started to hike rates in the second half of 2021 — more than half a year ahead of the Fed. As a result, we are now seeing EM inflation peaking — as illustrated in the chart on the right-hand side of Figure 3. Some EM central banks have already paused their hiking cycle and are expected to start cutting policy rates in the second half of 2023, thus creating a favorable backdrop for EM rates to outperform.

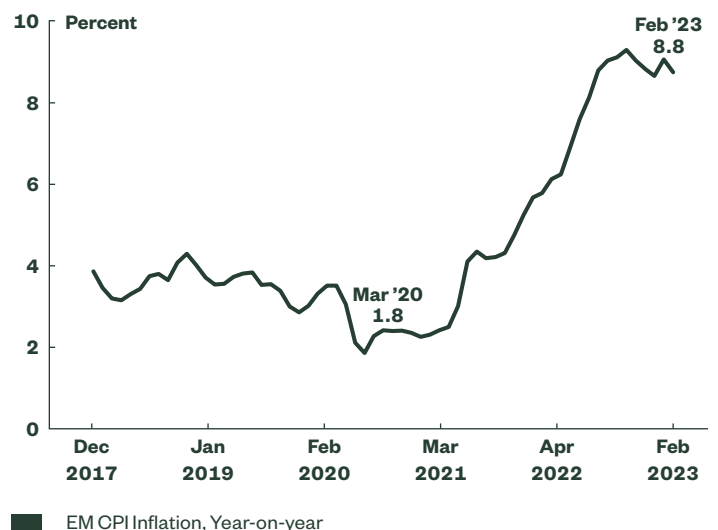
Figure 3

### EM Central Bank Policy and Inflation

EM Central Bank Policy Rates



EM CPI Inflation YoY



Source: State Street Global Advisors, Bloomberg Finance LP as of 31 March 2023. \*Note: Weighted average policy rate is based on the weights in the JPM GBI EM Global Diversified Index, with the exception of Uruguay. As of 31 March 2022, Russia is no longer part of the JPM GBI-EMGD Index.

Source: State Street Global Advisors, Bloomberg as of 28 February 2023. Weighted average CPI inflation is based on the weights of the JPM GBI EM Global Diversified Index.

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According to our Purchasing Power Parity FX model the currencies in the JPM GBI EM Global Diversified Index remain significantly undervalued versus the US dollar on an aggregate basis (-11% as of March 2023) as has been the case for the past two years. However, we believe this is mostly a reflection of the US dollar's strength; relative to other currencies (such as the euro), EM FX has been fairly priced or slightly undervalued over the past year. A weakening trend in the US dollar would further support EM local currency returns; however, it seems more likely the US dollar will remain volatile through 2023, driven by US monetary policy and market sentiment. Therefore we expect that the greatest source of performance in local currency debt will come from the rates side.

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## The Benefits of an Indexed Approach

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We believe that our indexed approach in Emerging Market Debt is suitable to this type of highly volatile market environment because it provides investors with a reliable and efficient exposure to the beta of emerging markets. Our investment process in EMD is focused on minimizing the tracking error versus the index but also on minimizing the cost of implementation. We also seek, where possible, to add value within tight risk limits by exploiting micro inefficiencies that arise in the market.

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## Endnote

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- 1 Source: State Street Global Investors as of 31 March 2023.
  - 2 Source: JP Morgan EMBIG Diversified Index (Hard Currency) and JP Morgan GBI-EM Global Diversified Index (Local Currency).

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\* Pensions & Investments Research Center, as of December 31, 2021.

<sup>†</sup> This figure is presented as of December 31, 2022 and includes approximately \$58.60 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. Please note all AUM is unaudited.

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