Insights
Emerging Markets

10 June 2020

What's Next? EM Debt Perspectives

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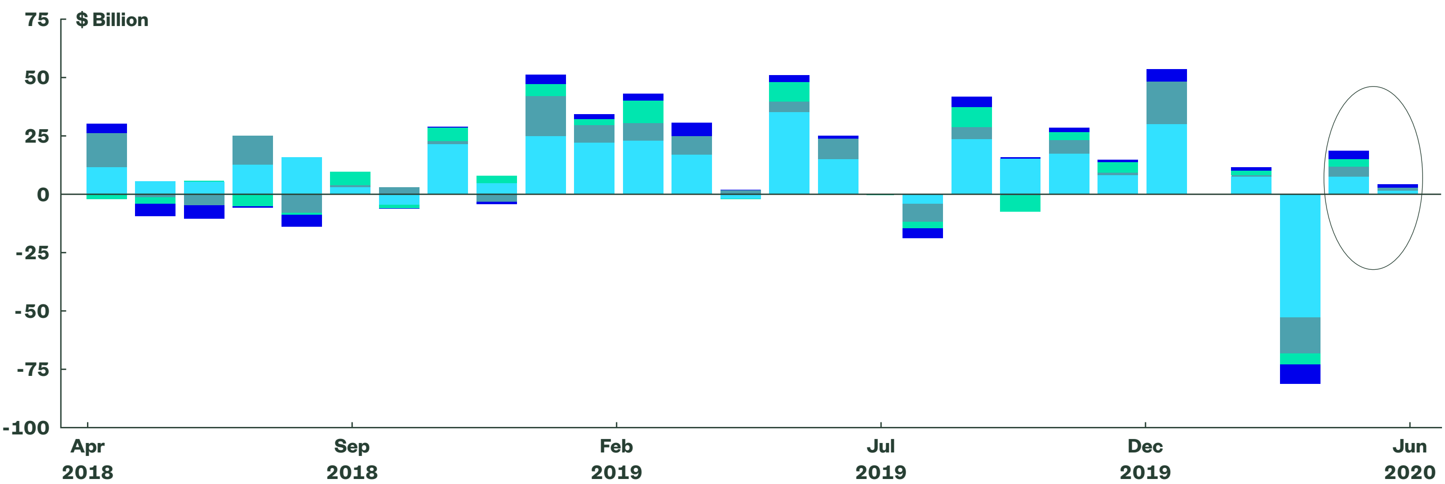
Emerging markets have not experienced the humanitarian crisis that many feared as the pandemic spread. This has enabled EM assets to recover something reflected particularly in the recovery of emerging market debt. As these concerns around the COVID-19 threat abate, investor attention has refocused on potential opportunities in EMD. But not all segments of the market will hold the same appeal.

Emerging Market Flows — Capital Returning

The impact of the coronavirus outbreak was initially felt earliest in developed markets but hit emerging markets hardest following its spread from China. And while there has been a strong recovery by EM assets in tandem with global financial markets recently, the period has left its mark and significant challenges persist. As the virus spread and the crisis unfolded it is estimated that the there were outflows of almost $100 billion from EM assets in the first quarter. Both the speed of the decline and the scale of outflows were more extreme than other periods since (and including) the global financial crisis. As Figure 1 illustrates, there has been some reversal of those flows.

Figure 1
Tentative Signs of Returning Flows



Source: Bloomberg Finance LP, National Sources, IIF as at 31 May 2020.

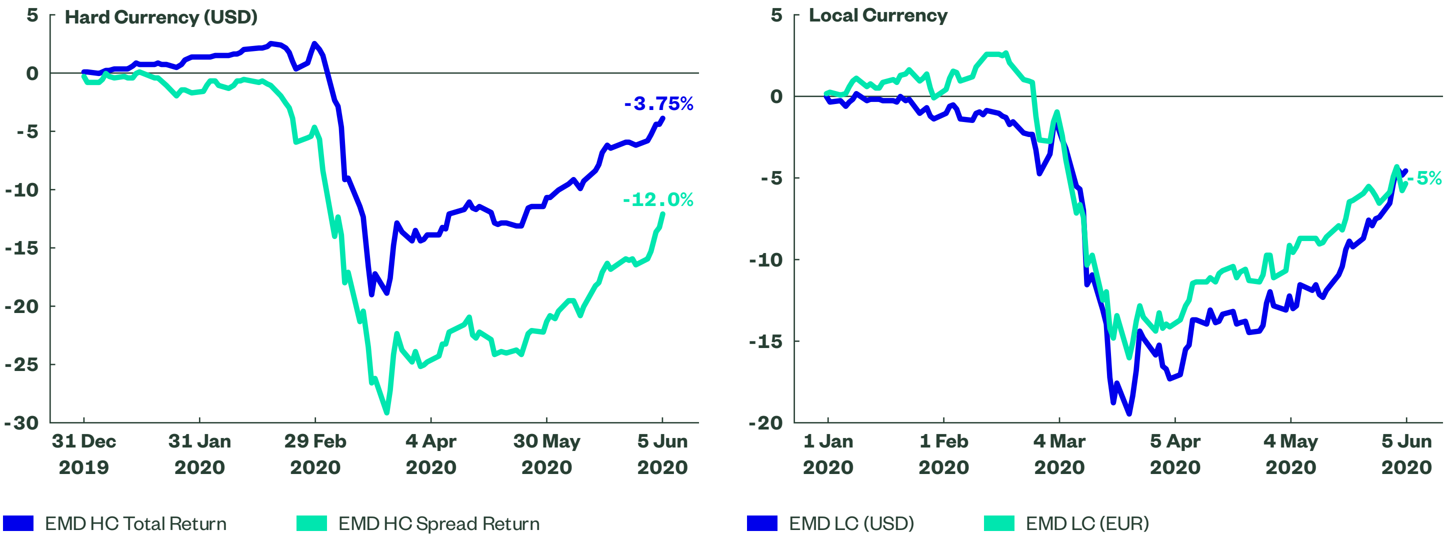
EM Debt Returns Recover, But Concerns Persist

After a steep COVID-driven decline in EMD values, a strong and admittedly surprising recovery has followed. Uncertainty about the nature of the pandemic and how emerging markets might cope had initially weighed heavily on sentiment. Given poor living conditions and population densities in large cities where access to fresh water can be challenging, a major concern was that the health crisis could turn into a humanitarian crisis. However, the worst fears did not materialise and EM Asia, in particular, has contained the virus exceptionally well; EM countries in Europe have also done reasonably well in this regard. But worries persist about Latin America, where lockdowns are being eased even in countries where infection rates are still rising.

Looking at Figure 2, we can see the scale of the market reaction, but the subsequent rebound has surprised many observers. The chart on the left shows that the year-to-date losses by Hard Currency debt was scaled back from about -20% to less than -4% by early June. The green line reflects the spread performance — removing the US Treasury effect, the decline was closer to -30%, followed by a recover to -12%.

The chart on the right details the performance of Local Currency EM debt and a similar narrative is evident there.

Figure 2
Both Hard and Local Currency EMD Recover



Source: JP Morgan as 4 June 2020. Past performance is not a guarantee of future results.

EMD Valuations — Mixed Prospects

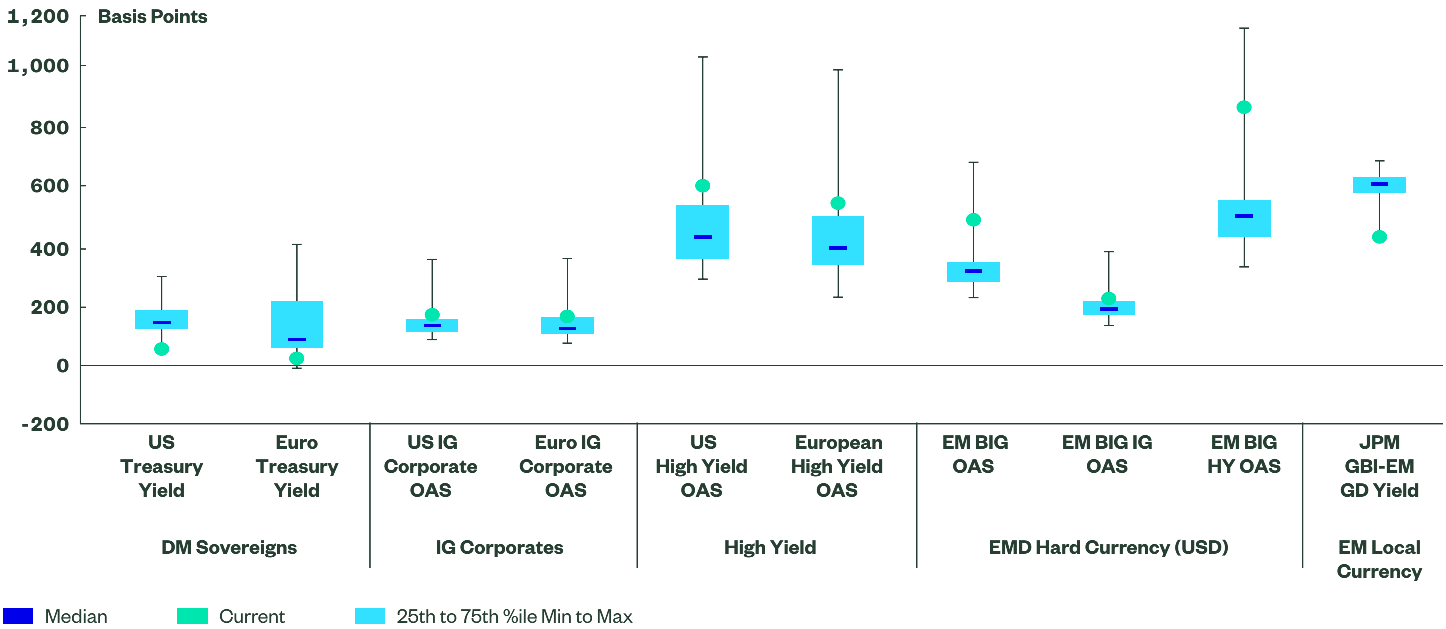
In terms of valuation, local currency EM yields have rallied and declined to new lows. Through 2019, there was a considerable decline in bond yields amid a recovery from Fed related pressure in 2018. Recent COVID-related turbulence has eased and the downtrend has reasserted itself. Supporting that yield descent has been the broad containment of inflation and macro policies that underpinned that progress.

The latest crisis will invariably deliver disinflationary effects across the globe including for local currency economies of emerging markets. Local bond markets have seen yield declines to new lows driven by these deflationary effects and the significant monetary policy response. Hard currency markets, on the other hand, given their weaker credit profiles and foreign borrowing, are less attractive; here, spreads remain wide, reflecting the significant challenges that some countries face in the near term.

Figure 3 provides a broad snapshot of valuations across developed and EM debt markets. It's of little surprise to see US and Euro Treasury yields close to all-time lows, given policy rates at zero and massive central bank quantitative easing. Over on the other side of the chart, EM local currency yields are also at the aforementioned record lows. This can be justified somewhat on a real yield basis and reflects market confidence in prudent macro policies and easier monetary policies and also importantly their ability to fund themselves given their large local investor bases. Another factor that should not be overlooked is currency valuations, given the relative weakness in recent times.

Hard currency EM valuations are more mixed. While investment grade EMD spreads look attractive, and are likely to be a safer source of yield the same cannot be said for the high yield segment; here, HY spreads and risks remain significantly elevated. This is a concern as they face into debt restructuring challenges which will continue to be difficult for some of these weaker sovereigns.

Figure 3
LC EMD Yields Hit Record Low
(10 Years to May 2020)



Source: Bloomberg Barclays Indexes and JP Morgan as at 29 May 2020.

HC EMD — Weak Stay Weak, Strong Stay Strong

Within the hard currency EMD universe, there are countries running short of options. Their debt is trading at distressed levels and debt restructuring is an increasingly likely scenario for some. A number were already struggling before the impact of COVID-19 hit — Argentina, Venezuela and Lebanon, to name three — but it is likely that these latest developments not only make their restructurings inevitable but also more severe. The 10 countries in most difficulty make up about 5% of the universe and account for about $77b of outstanding debt. Holders of this debt will realise a capital loss as they structure and the implications of these events are likely to weigh on market sentiment for some time.

There has been a better narrative within the investment grade part of the HC EMD landscape, where recovery has been more justified. A lot of the HC borrowers in this space tend to be Middle Eastern and the snapback in oil prices has eased concerns considerably.

Ultimately, it has been a case of weaker countries remaining weak and potentially having to restructure and stronger countries weathering the challenges better.

Considerations in Allocating to EM

For investors reassessing their allocations in EMD, we have set out a simple table (Figure 4) that aims to highlight the pros and cons of local currency and hard currency options. At the present time, the arguments for local currency are the stronger of the two; the merits include higher credit quality and a large local investor base that is happy to invest without currency risk, thus underpinning demand. EM currencies were undervalued coming into this crisis and have since become even more undervalued — this has proved to represent an attractive entry point in the past. Governments with local currency borrowings are more likely to have better fundamentals and less vulnerabilities, which allows for greater flexibility around policy and ultimately retaining investor confidence.

At present, hard currency borrowers typically have weaker underlying credit ratings and are vulnerable to USD dollar strength, which effectively increases the cost of debt repayments and their ability to borrow affordably at such elevated yields. Moreover, the additional return benefit they have enjoyed from US Treasury yield declines has effectively been exhausted. Investors also must consider the impact of debt restructuring that will result in a permanent capital loss.

Following the recovery in EMD assets from their recent lows, we see greater justification and support for EMD local currency valuations, while hard currency investors will continue to encounter challenges going forward.

Figure 4
EMD Allocation Considerations

Strategy	Supports	Concerns
Local Currency	Higher Credit Quality (IG) Large Local Investor Base Declining Inflation/Real Yields Undervalued Currencies Low Allocations	COVID Challenges (Brazil) Low Bond Yields (4%)
Hard Currency	Wide Spreads/Valuations Diversification	Weaker Credit Quality (HY) Foreign Currency Debt Restructurings Low US Treasury Yields

Source: State Street Global Advisors as at 10 June 2020.

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ID228145-3117603.1.2.GBL.INST 0620
Exp. Date: 30/06/2021