Education
Fixed Income

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Emerging Market Debt 101

Emerging market debt (EMD) is a versatile asset class, providing a potential yield pick-up opportunity for those fixed income investors willing to move out the risk spectrum. The asset class has shown historical diversification benefits through lower correlation to US bond markets.[1] However, there are important items to be aware of when considering allocating to EMD, like idiosyncratic risk, concentration risk, and currency risk.

What is Emerging Market Debt?

Emerging Market Debt represents bonds issued by countries and corporations that reside within developing economies. There can be different definitions of a 'developing economy' and which countries are included in the classification, but typical characteristics tend to be low/middle income per capita and higher growth rates than advanced economies.

EMD has three broad investable segments: Hard currency (HC) sovereign, hard currency corporate, and local currency (LC) sovereign. Hard currency sovereign and corporate indices are predominantly comprised of US dollar-denominated bonds issued by emerging market governments and corporates, respectively, while LC sovereign indices include local currency denominated debt issued by emerging market governments. There are also local currency corporates, but those are more difficult for US investors to access and invest in.

The key characteristics of the three EMD assets are illustrated in Figure 1. Some of the main differences across EMD assets include:

◊ **Mix of IG/HY with Different Levels of Quality** The three EMD segments offer varying degrees of credit quality exposure. Of the three EMD segments, local currency sovereign EMD has the highest proportion of bonds with an investment grade rating (77%), while hard currency sovereign and corporate EMD have lower proportions (51% and 56% respectively).[2]

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◊ **LC EMD Less Diversified** Hard currency sovereign and hard currency corporate debt are quite diversified by country and region. By way of contrast, local currency sovereign debt is relatively concentrated — the representative index contains only 20 countries, with the largest 10 making up 84%.[3]

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◊ **Currency and Rates Risk** The hard currency sovereign and corporate EMD assets are USD based, with risks driven mainly by movements in US interest rates and credit risk in EM sovereign and corporates. The local currency sovereign EMD asset is sensitive to movements in local rates and currencies relative to the USD, along with sovereign risk.

Figure 1
Key Characteristics of EMD Assets

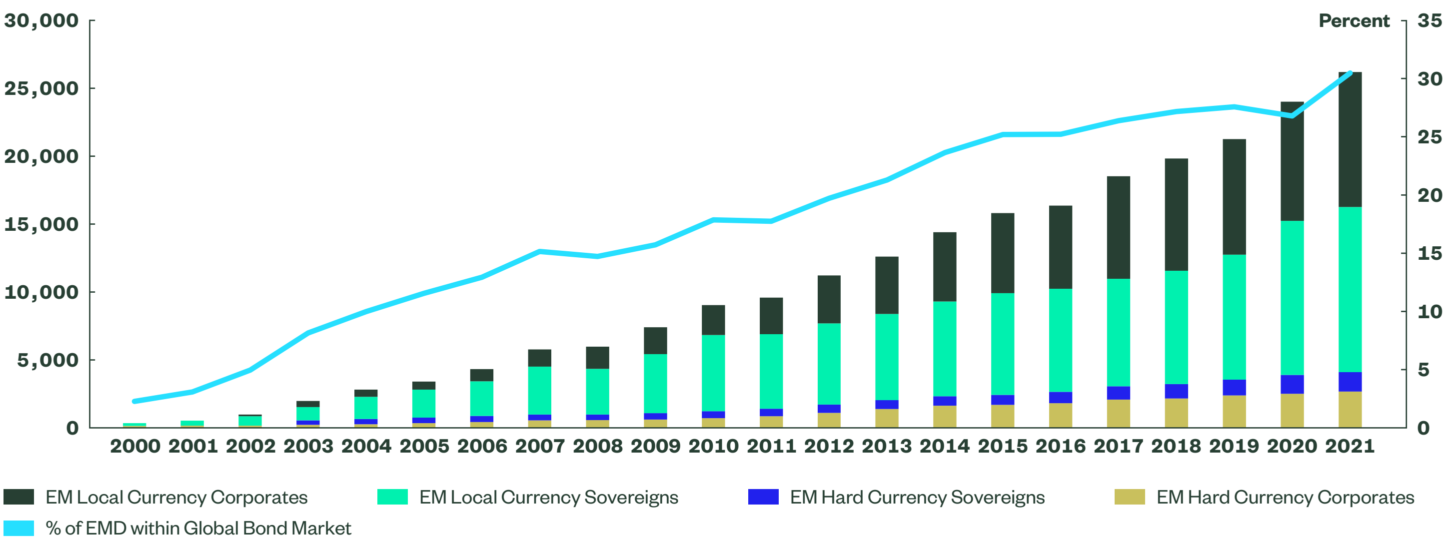
	Hard Currency Sovereign EMD	Hard Currency Corporate EMD	Local Currency Sovereign EMD
Index	JP Morgan EMBI Global Diversified	JP Morgan CEMBI Broad Diversified	JP Morgan GBI-EM Global Diversified
Investment Universe	72 countries	60 countries	20 countries
Currency	USD	USD	20 EM currencies
Regional Split (%)			
Asia	18	41	38
Europe	18	10	27
Latin America	32	24	26
Middle East & Africa	32	25	9
Top 10 Countries (%)	39	44	84
Index Rating*	Sub-IG Credit Rating Ba1/BB+	IG Credit Rating Baa3/BBB-	IG Credit Rating Baa1/BBB+
IG/Sub-IG Split (%)	51/49	56/44	77/23
Key Risk Drivers	US Treasuries & EM Sovereign Spreads	US Treasuries, Sovereign Risk & EM Corporate Spreads	The US Dollar, Local Rates & Sovereign Risk

Source: State Street Global Advisors, JP Morgan, Point, as of December 31, 2021. Hard Currency Sovereign EMD = JP Morgan EMBI Global Diversified USD Total Return Index; Hard Currency Corporate EMD = JP Morgan CEMBI Broad Diversified USD Total Return Index; Local Currency Sovereign EMD = JP Morgan GBI-EM Global Diversified Unhedged Total Return Index; *For the EMBI and CEMBI index families, we use the middle rating of Moody's, S&P, and Fitch. For the GBI-EM index family, we use the lowest rating of Moody's, S&P, and Fitch. Characteristics are as of the date indicated, are subject to change, and should not be relied upon as current thereafter.

Size of EMD Market

Over the past two decades, the total emerging market debt (EMD) market has grown significantly, surpassing $26 trillion in 2021 (based on JP Morgan estimates). Its proportion of the global bond market has also increased rapidly, rising from 2% in 2000 to over 31% in 2021. Even if we exclude EM local currency corporates, EMD accounts for 19% of the global bond market (see Figure 2).

Figure 2
EMD Market Expansion Since 2000 (in USD)



Source: State Street Global Advisors, JP Morgan, Bloomberg Finance L.P., Bank of International Settlements, as of December 2021.

Yield Enhancement

Emerging market debt provides an attractive yield enhancement option relative to investment grade bonds. Figure 3 displays the yield advantage EMD offers compared to US aggregate bonds, which have a higher index rating. EMD yields are more in line with those of high yield bonds, while enjoying higher average credit ratings. Hard currency corporate and local currency sovereign EMD assets have average investment grade ratings about 6–7 notches below US aggregate bonds, while the duration of the indices are shorter. By comparison, hard currency sovereign EMD has an average high yield rating with a modified duration slightly higher than US aggregate bonds.

Figure 3
Bond Index Characteristics

	Yield to Maturity (%)	Index Rating*	Duration
Hard Currency Sovereign EMD	9.57	Ba1/BB+	6.58
Hard Currency Corporate EMD	7.94	Baa3/BBB-	4.25
Local Currency Sovereign EMD	7.31	Baa2/BBB	4.84
US Aggregate Bond	4.75	Aa2/AA	6.20
US High Yield Bond	9.30	B1/B+	4.20

Source: State Street Global Advisors, JP Morgan, Bloomberg Finance L.P., as of September 30, 2022. Hard Currency Sovereign EMD = JP Morgan EMBI Global Diversified USD Total Return Index; Hard Currency Corporate EMD = JP Morgan CEMBI Broad Diversified USD Total Return Index; Local Currency Sovereign EMD = JP Morgan GBI-EM Global Diversified Unhedged Total Return Index; US Aggregate Bond = Bloomberg US Aggregate USD unhedged total return index; US High Yield Bond = ICE BofA US High Yield unhedged total return index. *For the EMBI and CEMBI index families, we use the middle rating of Moody's, S&P, and Fitch. For the GBI-EM index family, we use the lowest rating of Moody's, S&P, and Fitch. Characteristics are as of the date indicated, are subject to change, and should not be relied upon as current thereafter.

Portfolio Diversifier

The long-term correlations between EMD assets and US aggregate bonds have been modest, signifying potential diversification benefits when adding EMD to a bond portfolio (see Figure 4). For US aggregate bonds, local currency sovereign EMD has provided the strongest diversification benefits with the lowest historical correlation due to its lower duration and higher credit exposure relative to the other two EMD assets. Unlike the two hard currency EMD assets, it does not have an explicit link to US bonds and its EM currency exposure acts as a further diversifier.

Figure 4
Asset Correlations Based on USD Returns Jan 2003–Sept 2022

	Hard Currency Sovereign EMD	Hard Currency Corporate EMD	Local Currency Sovereign EMD	US Aggregate Bond	US High Yield Bond
Hard Currency Sovereign EMD	1.00	0.92	0.80	0.62	0.10
Hard Currency Corporate EMD	0.92	1.00	0.73	0.54	0.08
Local Currency Sovereign EMD	0.80	0.73	1.00	0.40	0.09
US Aggregate Bond	0.62	0.54	0.40	1.00	0.19
US High Yield Bond	0.10	0.08	0.09	0.19	1.00

Source: Morningstar, as of September 30, 2022. Hard Currency Sovereign EMD = JP Morgan EMBI Global Diversified USD total return index; Hard Currency Corporate EMD = JP Morgan CEMBI Broad Diversified USD total return index; Local Currency Sovereign EMD = JP Morgan GBI-EM Global Diversified USD unhedged total return index; US Aggregate Bond = Bloomberg US Aggregate USD unhedged total return index; US High Yield Bond = ICE BofA US High Yield unhedged total return index. **Past performance is not a reliable indicator of future performance.** Index returns are unmanaged and do not reflect the deduction of any fees or expenses. Index returns reflect all items of income, gain and loss and the reinvestment of dividends and other income as applicable.

Risks

The emerging market debt sector is generally more volatile than core bond segments such as investment grade corporate bonds. With this higher volatility comes a tendency to incur higher drawdowns in challenging market environments.

Idiosyncratic (or country specific) risk is a key consideration when investing in emerging markets. This is coupled with the possibility that when one country runs into difficulties, there is potential for contagion, which causes others to follow. It is important to recognize however the progress and reforms in emerging markets over the last 20 years — many countries have liberalized their capital markets (allowing for more market-oriented currency regimes), established independent central banks and built up foreign currency reserves. Thus, the hurdle today is higher for idiosyncratic risk to create contagion across the broader emerging market universe.

Emerging markets are nevertheless sensitive to swings in risk sentiment and more susceptible to external economic and geopolitical shocks. More than ever, investors need to look beyond the broad benchmark characteristics — average credit rating, average duration etc. — which tell us very little about the individual issuers in the index. Russia's ejection from benchmarks following its invasion of Ukraine was a shock, but also a timely reminder to consider country exposures and concentration risk within EM debt.

Many emerging markets are export oriented, with trade accounting for a meaningful proportion of economic growth. As global trade is largely funded in US dollars, emerging market economies are sensitive to movements in the dollar relative to their local currencies. When the dollar is weaker and global trade/growth is strong, countries and companies may seek cheaper funding (as local currency rates are generally higher than dollar rates). At the same time, foreign investors looking for higher growth and yield opportunities drive inflows into local markets.

Foreign exchange (FX) volatility and trends also play a significant role in the risk profile of local EMD. As seen in Figure 5, the value of local currency EMD generally trends in the same direction as EM currencies. In fact, movement of EM currency explains approximately an 80% of Local Sovereign EMD returns. Additionally, movement in the US dollar has the potential to impact returns of local EMD because after the debt matures, which is denominated in foreign currency, it must be converted back into US dollars, which adds currency risk. This suggests that taking a view on emerging market currencies, or a view on the US dollar, is an important consideration for USD-based investors when investing in local currency sovereign bonds.

Figure 5
Local Currency Sovereign EM Debt versus EM Currency Returns Oct 2012–Sept 2022

Source: Bloomberg Finance L.P., 10/31/2012 to 09/30/2022. Sovereign Local Currency Sovereign EMD = Bloomberg EM Local Currency Government Diversified Index. EM Currency = MSCI Emerging Markets Currency Index. **Past performance is not a reliable indicator of future performance**. Index returns are unmanaged and do not reflect the deduction of any fees or expenses. Index returns reflect all items of income, gain and loss and the reinvestment of dividends and other income as applicable.

Endnotes

1 State Street Global Advisors, JP Morgan, Point, as of December 31, 2021. See Figure 4 for details.

2 State Street Global Advisors, JP Morgan, Point, as of December 31, 2021. Hard Currency Sovereign EMD = JP Morgan EMBI Global Diversified USD Total Return Index; Hard Currency Corporate EMD = JP Morgan CEMBI Broad Diversified USD Total Return Index; Local Currency Sovereign EMD = JP Morgan GBI-EM Global Diversified Unhedged Total Return Index.

3 State Street Global Advisors, JP Morgan, Point, as of December 31, 2021. Local Currency Sovereign EMD = JP Morgan GBI-EM Global Diversified Unhedged Total Return Index.

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Glossary

Credit Spread Difference in yield between a US Treasury bond and a debt security with the same maturity but of lesser quality.

R-squared A statistical measure that indicates how much variation of a dependent variable is explained by the independent variable is a regression model.

Yield Income produced by an investment, typically calculated as the interest received annually divided by the investment's price.

Yield to Worst An estimate of the lowest yield that you can expect to earn from a bond when holding to maturity, absent a default. It is a measure that is used in place of yield to maturity with callable bonds.

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International Government bonds and corporate bonds generally have more moderate short-term price fluctuations than stocks, but provide lower potential long-term returns.

Diversification does not ensure a profit or guarantee against loss.

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