Insights
Fixed Income

Q1 2020

Emerging Market Debt in Charts — 2020 Outlook

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Low yield in developed market bonds remains a key issue for investors. In this environment, we see the potential for stronger relative returns in emerging market debt, particularly local currency bonds. Heading into 2020, a mix of supportive factors could drive this asset class.

Economic Growth Differential

We believe US economic outperformance will continue, although the outperformance gap between the US and other regions may start to shrink. Europe continues to lag due to cyclical and structural problems, but a catalyst could trigger improvement, especially in the second half of 2020. Emerging markets (EM) will be critical contributors to global growth; that said, we expect economic performance in EM to be highly variable.

Meanwhile, the growth differential in aggregate remains and, at 4.6% in 2020 versus 1.9% for developed markets, is expected to widen versus 2019. This growth differential is helping foster higher yields in these regions, which is helpful for carry and potentially calls for an appreciation in the overall EM currency basket.

Figure 1
State Street Global Advisors Economic Projections

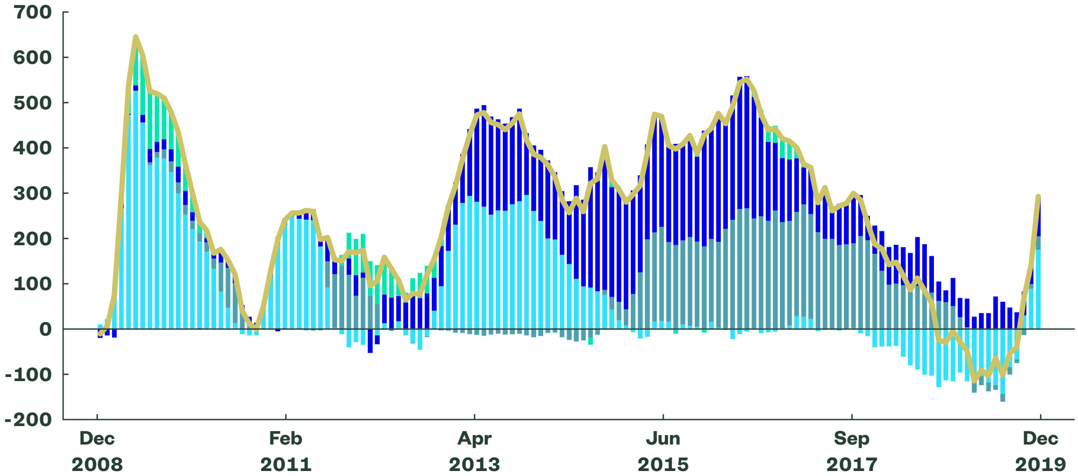
Real GDP Growth	2018 (%)	2019 (%, projected)	2020 (%, projected)
World	3.6	3.2	3.5
Advanced Economies	2.2	1.9	1.9
US	2.9	2.3	2.1
Eurozone	1.8	1.2	1.3
Japan	0.8	1.1	0.9
UK	1.4	1.4	1.6
Australia	2.8	1.8	2.5
Canada	1.8	1.6	1.7
Developing Economies	4.5	4.0	4.6
China	6.6	6.1	5.9

Source: 2018=national databases. 2019 and 2020 projections=State Street Global Advisors Economics Estimates/Projections, as of 20 December 2019. Actual results may differ from these projections.

Accommodative Central Bank Policies in Developed and Emerging Markets

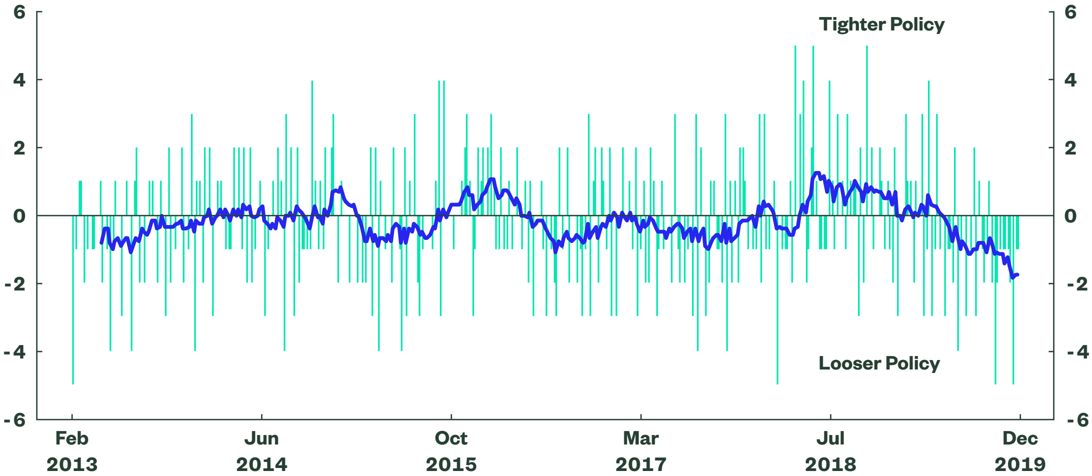
As announced by the US Federal Reserve and the European Central Bank, balance sheet expansion is resuming in an effort to prop up and expand the cycle further. Against this backdrop, the lower inflation environment in EM has allowed many EM central banks to ease financial conditions by cutting rates.

Figure 2
G4 Central Banks Balance Sheets Evolutions — Rising Liquidity Tide
Global Central Bank Balance Sheets (3mma, bn USD)



Source: Bloomberg Finance L.P., as of 31 December 2019.
BoJ=Bank of Japan, BoE=Bank of England, ECB=European Central Bank, Fed=US Federal Reserve Bank, 3mma=3-month moving average.

Figure 3
Emerging Market Central Banks Policy Diffusion Index



Source: State Street Global Advisors, Bloomberg Finance L.P., as of 27 December 2019. EM Central Bank policy diffusion index — weekly, based on the central banks of the 20 markets included in the Bloomberg Barclays Emerging Market Local Currency Liquid Government Index (this includes Argentina, which left the index at end August 2019).

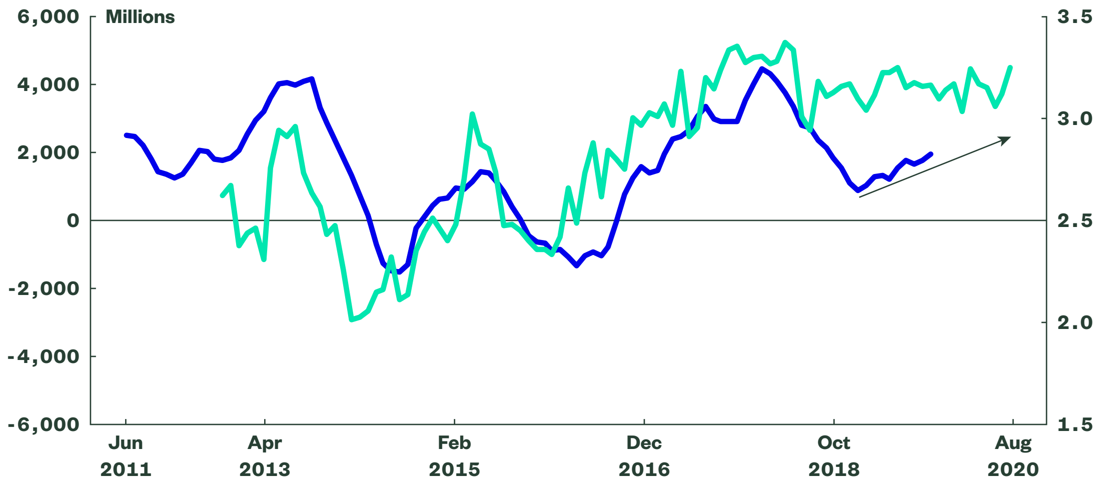
Weaker Inflation Leads to Increased Real Yield Differential and Supports Investor Flows

Investor flows into EM debt often trail the change in real yield differential between emerging and developed markets. We have seen recent falls in inflation in EM, from a peak of close to 10% in October 2018 to close to 6%, based on PriceStats data. This has greatly helped the real yield differential versus developed markets. What's more, the differential has continued to increase over the past few months, and flows have started to return to the asset class (through both mutual funds and ETFs). However, the recent increase in inflation globally could affect this real yield differential, in which case we may see a slowdown of these flows.

Figure 4
EM Debt Flows and Real Yield

EMD Fund Flows (12m Monthly Average) — LHS

EMD DM Real Yield Differential — 12m Lead — RHS



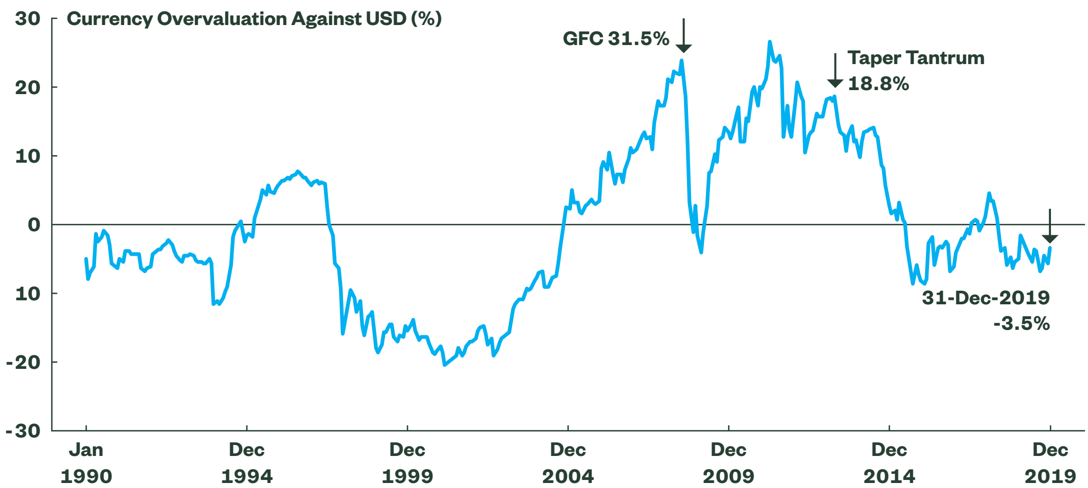
Source: State Street Global Advisors, Morningstar Direct, Bloomberg Finance L.P., as of 31 October 2019.

Currency Undervaluation vs. Long Term

Currency performance has been a drag in some countries in the index over the past 12 months. Whether it is due to idiosyncrasies, such as Argentinian peso devaluation or social upheaval in Chile, or even as a reaction to the trade war with China, many currencies now appear undervalued versus the US dollar (USD).

The below graphs highlight the return decomposition (Figure 6) of the various countries in the Bloomberg Barclays Emerging Market Local Currency Liquid Government Bond Index. Meanwhile, we can see that the basket remains 3.5% undervalued versus the USD, based on fair value models from State Street Global Advisors. Should the growth differential rebound as China dynamises its economy and brings with it some EM countries, or if the reign of the greenback supercycle fades, then the currency appreciation potential becomes a key performance tailwind.

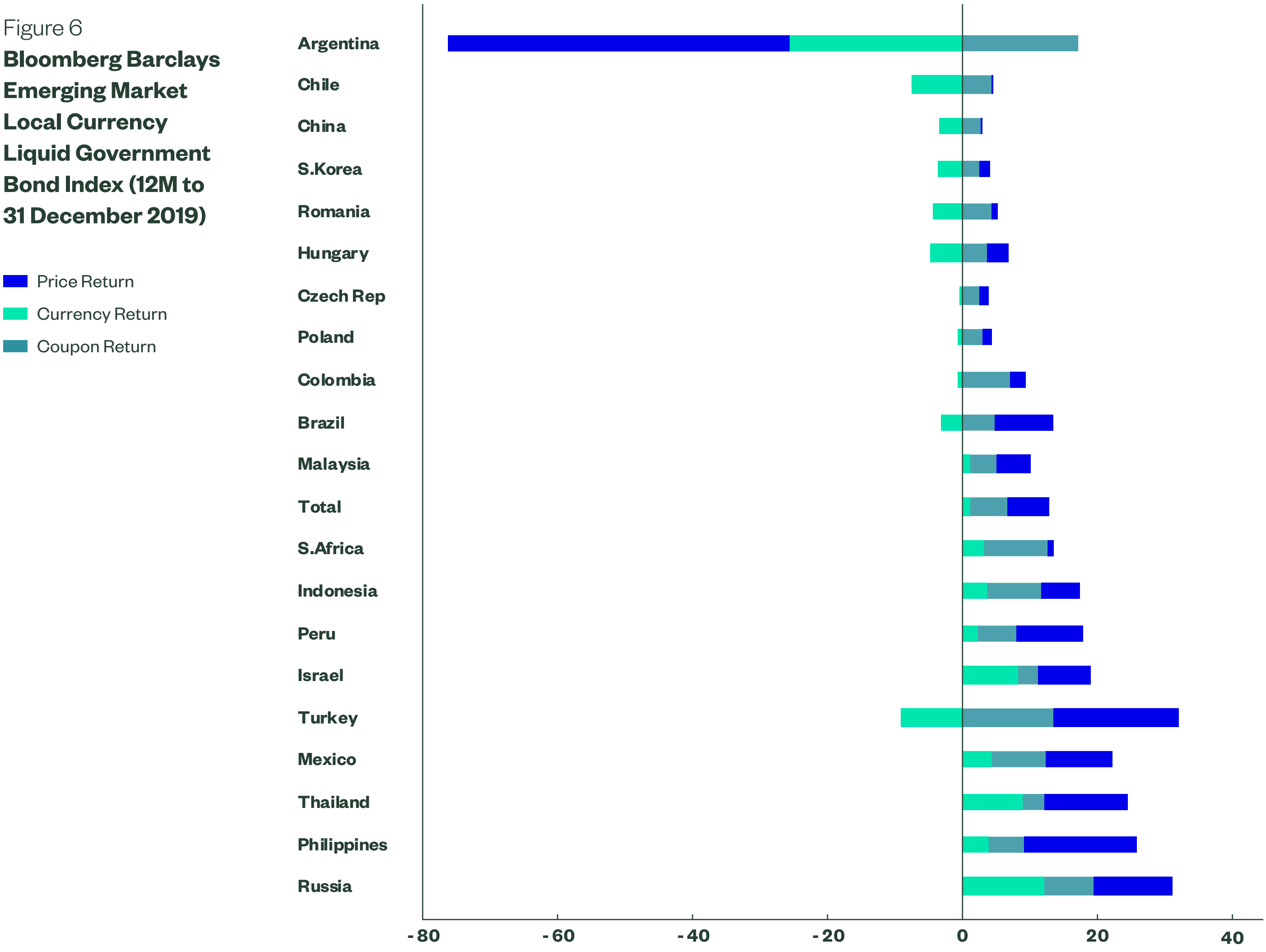
Figure 5
State Street Global Advisors Currency Valuation Model



Source: State Street Global Advisors, as of 31 December 2019. Data shown is as of the date indicated and subject to change. Past performance is not a guarantee of future results.

Figure 6

Bloomberg Barclays Emerging Market Local Currency Liquid Government Bond Index (12M to 31 December 2019)



Source: State Street Global Advisors, as of 31 December 2019. Data shown is as of the date indicated and subject to change. Past performance is not a guarantee of future results.

Time to Start Hedging the EUR/USD on Your EMD Local Currency Exposure?

The cost of hedging EM currencies has often been considered too onerous and a potential negation of the mere concept of investing in such strategies. If rates have been cut across many markets (Turkey serving as a poster child with close to 900bps of cuts in 12 months), the rates differential versus negative rates, in EUR in particular, remains quite high. Hedging the Bloomberg Barclays Emerging Markets Local Currency Liquid Government Index back to EUR would cost circa 3.7% (as of 2 January 2020) on an annual basis. In other words, close to the yield to worst of the index (4.4%).

Meanwhile, from a logistical standpoint, a number of these markets are only accessible via non-deliverable forwards (NDFs), which need to be collateralised under EMIR regulation. This would create a drag on a fund that hedges all EM currencies directly via a share class and would further eat into return potential. Based on the currency distribution of the index, close to 50% of the index would be hedged using NDFs.

Figure 7
Bloomberg Barclays Emerging Markets Local Currency Liquid Government Index
Currency Weights and Annualised Hedging Costs Back to EUR

Local Currency	Weight (%)	Spot	Outright 1 Month	Days	Annualised (%)	Weighted Cost (%)
BRL	10.00	4.50	4.52	31	3.42	-0.34
KRW	10.00	1297.54	1299.65	31	1.89	-0.19
IDR	9.00	15551.83	15616.35	31	4.82	-0.43
MYR	8.24	4.58	4.58	31	1.41	-0.12
THB	8.66	33.76	33.78	31	0.59	-0.05
MXN	8.95	21.13	21.28	31	7.82	-0.70
ZAR	6.22	15.67	15.76	31	7.05	-0.44
PLN	5.88	4.26	4.26	31	2.09	-0.12
RUB	5.40	69.09	69.50	32	6.58	-0.36
COP	3.20	3679.99	3691.05	31	3.49	-0.11
ILS	3.88	3.86	3.87	31	0.52	-0.02
PHP	2.98	56.82	57.02	31	4.03	-0.12
CZK	2.56	25.41	25.46	31	2.19	-0.06
TRY	2.44	6.67	6.73	31	10.90	-0.27
PEN	2.10	3.71	3.72	31	3.44	-0.07
HUF	2.13	330.02	330.16	31	0.49	-0.01
CNY	5.00	7.79	7.82	31	3.17	-0.16
CLP	1.67	843.51	845.06	31	2.14	-0.04
RON	1.70	4.78	4.80	31	3.84	-0.07
ARS	0.00	67.03	69.74	31	46.91	0.00

Source: State Street Global Advisors, Bloomberg Finance L.P., as of 2 January 2020. Characteristics are as of the date indicated and should not be relied upon as current thereafter.

However, one of the key reasons for investing in local currency EM debt, in the current environment, is for the currencies to appreciate versus USD. Historically, a weakening USD has often led to flows into EM FX and EM bond exposures. In such situations, a EUR-based investor may not benefit from the full performance potential of the asset class. For this reason, we believe investors stand to benefit from hedging against a potential weakening of USD versus EUR while capturing the EM currency appreciation versus USD.

The short rate differential is around 2.2% currently. However, the cost of hedging has receded as the Fed cut rates in 2019 and may simply be taking a pause before cutting further in the race to the bottom launched by developed central banks (ECB, SNB, BoJ). Thinking in terms of insurance costs, this equates to a 0.2% premium to hedge against a potential move of more than 5% in the EUR/USD pair.

Indeed, based on the State Street Global Advisors currency valuation model, at 1.11 the EUR was circa 9% undervalued versus USD on a long-term basis. It is hard to predict a return to fair value within a certain horizon, but the risk appears skewed to the downside, and hedging that risk may be necessary in order to enjoy the full potential of an EM local bond allocation.

Figure 8
Currency Valuation Heatmap

Foreign Currency (%)

Base Currency (%)	AUD (%)	CAD (%)	CHF (%)	EUR (%)	GBP (%)	JPY (%)	NOK (%)	NZD (%)	SEK (%)	USD (%)
AUD	0.00	0.80	24.80	-0.20	-8.60	-15.80	-24.20	2.80	-29.80	8.80
CAD	-0.80	0.00	23.80	-1.00	-9.30	-16.40	-24.80	1.90	-30.40	7.90
CHF	-19.90	-19.20	0.00	-20.00	-26.80	-32.50	-39.30	-17.70	-43.80	-12.90
EUR	0.20	1.00	25.00	0.00	-8.40	-15.60	-24.10	2.90	-29.70	8.90
GBP	9.40	10.30	36.60	9.20	0.00	-7.90	-17.10	12.40	-23.20	19.00
JPY	18.70	19.70	48.20	18.50	8.50	0.00	-10.00	22.00	-16.70	29.10
NOK	31.90	33.00	64.70	31.70	20.60	11.10	0.00	35.60	-7.40	43.50
NZD	-2.70	-1.90	21.50	-2.80	-11.00	-18.00	-26.20	0.00	-31.70	5.80
SEK	42.50	43.70	77.90	42.30	30.30	20.00	8.00	46.50	0.00	55.00
USD	-8.10	-7.30	14.80	-8.20	-16.00	-22.60	-30.30	-5.50	-35.50	0.00

-43.80 77.90

Undervalued Currencies   Overvalued Currencies

Source: State Street Global Advisors, as of 31 December 2019.

What are the Risks to this Outlook?

There remain idiosyncratic challenges. The risk of a Moody's downgrade of South Africa could limit the attractiveness of ZAR-denominated sovereign bonds on an FX-unhedged basis. Meanwhile, Asian debt remains exposed to the trade war. Social upheavals in Chile and Latin America are also potential threats that could further weaken their currencies. But so far, we have seen that the overall EM local currency complex has remained resilient, posting a 1.13% currency return in USD terms in 2019 based on the Bloomberg Barclays EM Local Currency Liquid Index.

Beyond trade, elevated EM debt levels and the path of US real rates will also be important. Past instances of US real rates rising in excess of 20 basis points have historically driven EM FX sell-offs of 1.5% or more.[1] While this is not the current base case, it has the potential to be one of the grey swans in 2020.

Nevertheless, these risks may be partly mitigated by abundant global central bank liquidity, as highlighted in this document. Advanced economies are already set to maintain accommodative policy, and easing in developing nations will add to a supportive environment for EM debt. There have been rate cuts in Brazil, Mexico and Turkey given contained inflation, and relatively high real rates could allow further easing to support growth.

When it comes to implementation, State Street Global Advisors and the SPDR Strategy & Research team have highlighted the need to consider the risk of a strengthening base currency versus USD. The other key element is to know your index and its evolution, as discussed in the next section of this paper.

Know Your Index

Index rules vary from one provider to the other. In some cases this variance could lead to differences in the interpretation or definition of certain regions. In the fixed income space, and EM debt in particular, there are different approaches to country inclusion rules.

For investment vehicles like ETFs, understanding this difference can in turn present opportunities when using a fund that follows one index or another. Bond indices aim to include and weight the appropriate markets, instruments and issues that reflect the opportunities available to investors. Indices typically only include securities that investors can trade — into or out of — at short notice and for which firm prices exist.

Figure 9
EM Debt Indices — Country Breakdowns

	Bloomberg Barclays EM Local Currency Liquid Government Bond Index		JP Morgan EM-GBI Global Diversified 10% Cap 1% Floor		JP Morgan EM-GBI Global Diversified Index	
	Market Value (%)	# Constituents	Market Value (%)	# Constituents	Market Value (%)	# Constituents
Total	**100.00**	**533**	**100.00**	**214**	**100.00**	**220**
Israel	3.88	14	–	–	–	–
South Africa	6.22	13	10.00	13	9.47	13
China	5.00	151	–	–	–	–
Indonesia	9.00	38	10.00	28	10.00	28
Malaysia	8.24	62	5.73	23	6.15	23
Philippines	2.98	25	–	–	0.19	2
South Korea	10.00	50	–	–	–	–
Thailand	8.66	26	9.44	15	9.50	15
Czech Republic	2.56	13	3.77	10	3.69	10
Hungary	2.13	12	3.89	11	3.85	11
Poland	5.88	16	9.08	14	8.97	14
Romania	1.70	15	2.97	12	2.69	12
Russia	5.40	21	8.80	20	8.85	20
Turkey	2.44	20	3.83	16	3.77	16
Dominican Republic	–	–	–	–	0.17	2
Mexico	8.95	16	10.01	16	10.00	16
Brazil	10.00	14	10.01	11	10.00	11
Chile	1.67	8	3.03	6	2.77	6
Colombia	3.20	9	5.81	11	6.24	11
Peru	2.10	10	3.63	8	3.53	8
Uruguay	–	–	–	–	0.16	2

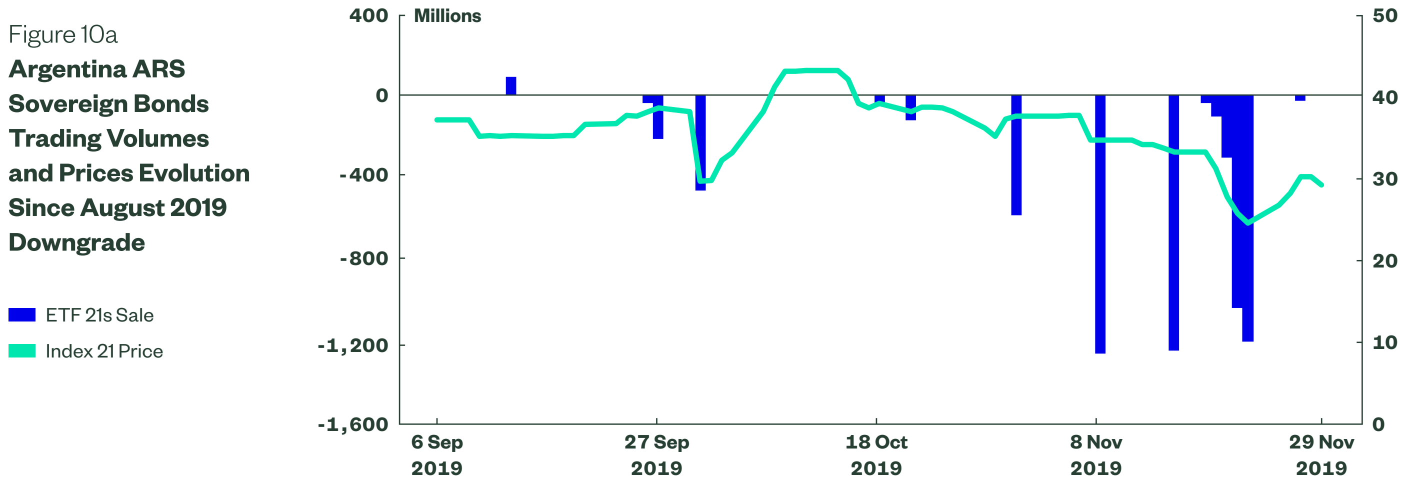
Source: State Street Global Advisors, Bloomberg, JP Morgan, as of 31 December 2019. Data are as of the date indicated, subject to change, and should not be relied upon as current thereafter.

Indices can differ from each other, however, and sometimes significantly. As a recent example, Argentina local currency sovereign bonds were excluded from the Bloomberg Barclays indices at August month-end rebalancing following the S&P rating downgrade to selected default. In the meantime, ARS-denominated bonds (2021, 2023, 2026) left the JP Morgan indices at steep losses (average trading on these bonds was around 25–30 cents) through the end of November.

This meant that ETFs, and other indexed and active vehicles, had to find an exit strategy in a more challenged market. Having set quality rules can help to partially protect against such events. That's a real-world example of why the index rules matter.

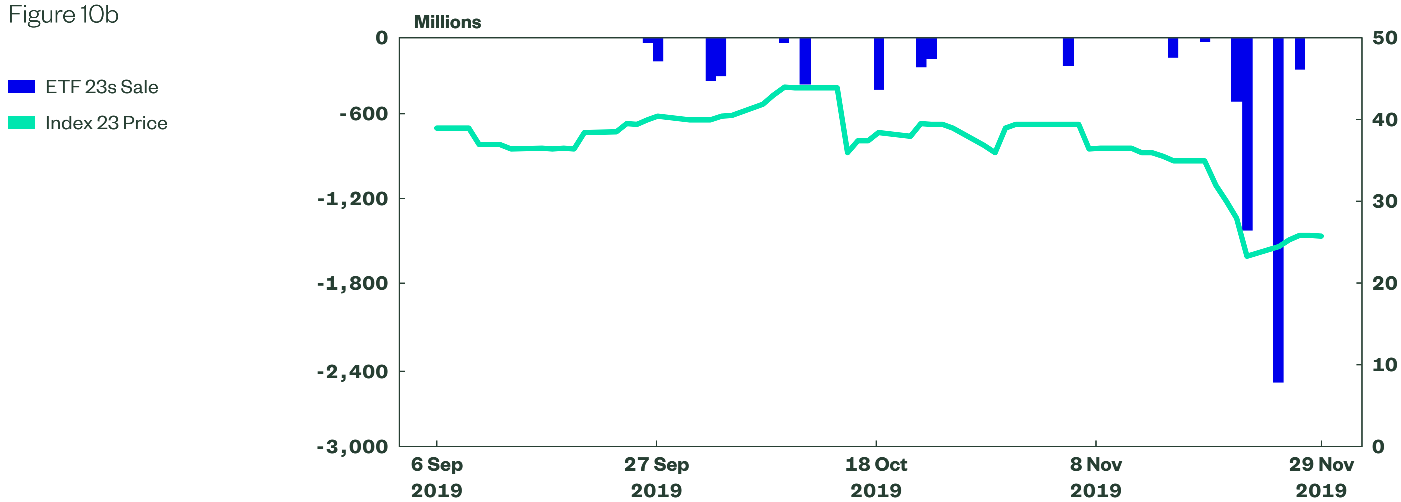
The below charts show the bond-by-bond trading activity of the two largest ETFs tracking JP Morgan indices with floored indices. These floored indices resulted in higher weight for Argentina than in the parent index. We can see the impact of ETF selling activity on each bond price going into the exit from the JP Morgan indices.

Figure 10a
Argentina ARS Sovereign Bonds Trading Volumes and Prices Evolution Since August 2019 Downgrade



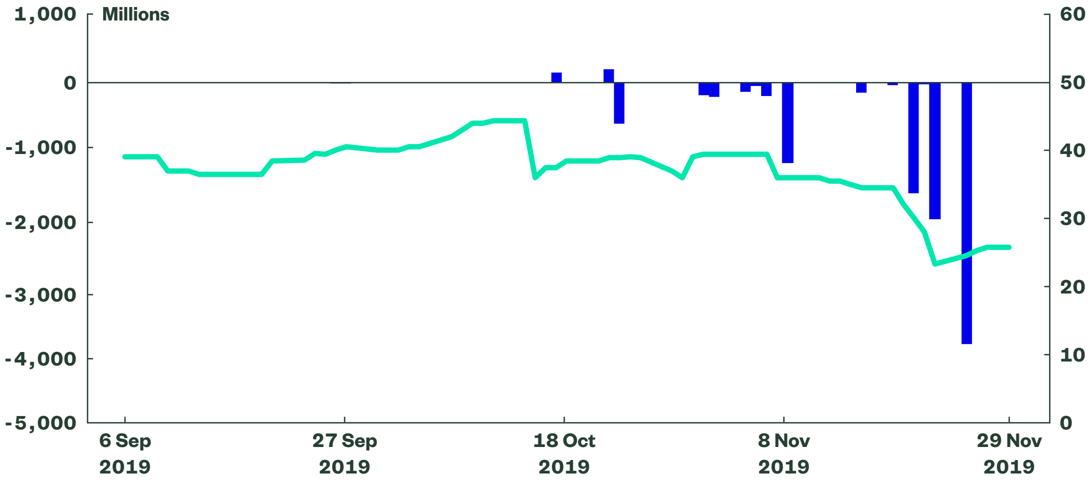
Source: State Street Global Advisors, Bloomberg Finance L.P., as of 29 November 2019.

Figure 10b



Source: State Street Global Advisors, Bloomberg Finance L.P., as of 29 November 2019.

Figure 10c



Source: State Street Global Advisors, Bloomberg Finance L.P., as of 29 November 2019.

Playing China's Inclusion

Since the March 2019 rebalancing, Chinese bonds have entered the Bloomberg Barclays Index family. In the meantime, JP Morgan announced in Q3 2019 the entry of Chinese bonds starting in Q1 2020. Once fully integrated into the indices, Chinese local currency sovereign bond weights will reach 10% of the Bloomberg Barclays EM Local Currency Liquid Government Bond Index. As at the end of December 2019, Chinese bonds amounted to 5.0% of the index. Inclusion is being staged over a 20-month period.

While US-China trade tensions continue, in the last few weeks China has moved to ease lending rates, and some strategists (e.g. Citi) expect further policy actions in 2020. When China nominal policy rate easing starts feeding through to M2 (money supply) growth, we may see a more pronounced inflection point for improved EM risk-taking.

In summary, index rules are the first element investors should understand when considering indexed strategies via ETFs. Indeed, when comparing the Bloomberg Barclays index with the various JP Morgan indices with 10% caps and 1% or 3% floors, the long-term performance has been better and has lower volatility, as per the table below.

Figure 11

Risk-Adjusted Returns — Select Emerging Market Debt Local Currency Indices

12/31/2019	Annualised Return (%)			Annualised Volatility (%)			Sharpe Ratio		
	Barclays EM Local Currency Liquid Government Index (%)	JPM EM GBI Global Diversified 10% Cap 1% Floor (%)	JPM EM GBI Global Diversified (%)	Barclays EM Local Currency Liquid Government Index (%)	JPM EM GBI Global Diversified 10% Cap 1% Floor (%)	JPM EM GBI Global Diversified (%)	Barclays EM Local Currency Liquid Government Index	JPM EM GBI Global Diversified 10% Cap 1% Floor	JPM EM GBI Global Diversified
Last 12 months	13.15	12.56	13.47	7.97	10.04	9.71	1.36	1.02	1.15
Last 3 years	7.42	6.70	7.03	7.73	9.52	9.33	0.73	0.52	0.56
Last 5 years	3.16	2.73	2.78	9.44	10.84	10.84	0.21	0.14	0.15
Since May 2011	1.51	0.75	0.54	10.32	11.50	11.53	0.07	0.00	-0.02

Source: Bloomberg Finance L.P, Bloomberg Finance L.P., as of 31 December 2019. Past performance is no guarantee of future results. **It is not possible to invest directly in an index. Index performance does not reflect charges and expenses associated with the fund or brokerage commissions associated with buying and selling a fund. Index performance is not meant to represent that of any particular fund.**

Conclusion

We believe EM local currency debt is set to extend gains in early 2020, as contained trade war fears and ample liquidity sustain investors' hunt for yield. A number of accommodative elements, from long-term growth to carry, real yield and currency appreciation, provide an environment that EUR investors should consider. However, investors looking to invest in this space may want to hedge the EUR/USD cross, as any upside surprise could limit the potential of EM debt local currency returns.

Fund Details

	SPDR Bloomberg Barclays Emerging Markets Local Bond UCITS ETF (Dist)	SPDR Bloomberg Barclays Emerging Markets Local Bond UCITS ETF (Acc)
ISIN	IE00B4613386	IE00BFWFPY67
Share Class Currency	USD	USD
Primary Ticker (Xetra)	SYBM GY	SPFA GY
Other Tickers	LSE: EMDD LN (USD), EMDL LN (GBP) Borsa Italiana: EMLD IM SIX Swiss Exchange: EMDL SE Euronext Paris: EMLD FP	SIX Swiss Exchange: EMDA SE
TER (%)	**0.55**	**0.55**
Index Name	Bloomberg Barclays EM Local Currency Liquid Government Bond Index	Bloomberg Barclays EM Local Currency Liquid Government Bond Index
Index Tickers	BECLTRUU	BECLTRUU
No. Index Constituents	533	533
Portfolio Construction	Physical — Sampled	Physical — Sampled
Income Treatment	Distributing (in or around January/July)	Accumulating
Dealing Models Available	Cash/In-Kind	Cash/In-Kind
Cash Subscription	Yes	Yes

Source: State Street Global Advisors, as of 31 December 2019. **Some of the products are not available to investors in certain jurisdictions. Please contact your relationship manager in regards to availability.**

Endnotes

1 Source: Bloomberg News, as of 5 December 2019.

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