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Emerging Markets on the Front Foot

Jason Simpson

Senior Fixed Income ETF Strategist

- Judging by the flows, many European fixed income investors have put the woes of 2022 behind them and focused on emerging market debt as one area to take on some risk — they've purchased \$950 million in EM debt ETFs through the first 26 days of the year.
- We see three main reasons why EM debt has seen so much attention: historically high yield, the potential for depreciation of the US dollar, and a turning policy cycle for several EM central banks. We believe these factors could continue to support EM debt in the coming months.

A Good Start for Emerging Markets

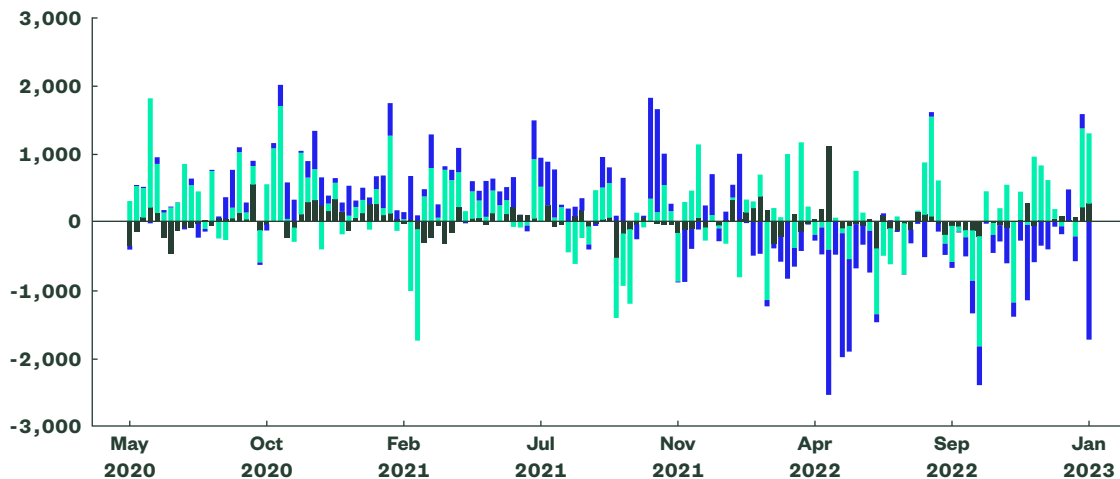
Emerging market (EM) debt has started the year strongly, with an improvement in investor risk appetite seeing market participants happy to dip a toe into EM assets once again. Returns for the Bloomberg EM Local Liquid Government Index have been robust at nearly 5% in January, which builds on a positive Q4 2022 when the index returned 8.8%.¹

After a turbulent 2022, investors have been reluctant to commit to EM debt exposures. As illustrated in the investor flows section of the [Bond Compass](#), flows into EM debt remained undeniably weak even during the performance revival of Q4. So while fast money was keen to chase the high yields on offer, it would appear that real money investors have been more cautious. However, looking at the flows data with a greater degree of granularity suggests a more nuanced story.

The chart below shows global ETF flows into EM debt split into hard currency, local currency and China local debt. What is clear is that the invasion of Ukraine in early 2022 sparked a massive outflow from Chinese debt in particular. We see a similar picture in the flows numbers produced by the Institute of International Finance,² which hinted at a big switch away from China bonds into other EM markets. Appetite for hard and local (ex-China) strategies briefly recovered mid-year before another leg higher in US Treasury yields saw another round of net selling. Q4 saw flows coming back to hard currency ETF exposures but they remained negative for China debt. The start to 2023 has seen local currency inflows gather pace alongside hard currency but China continues to suffer.

Figure 1
**Emerging Market
 Debt ETF Flows
 (All Domiciles)**

Local
 Hard
 Local China



Source: Bloomberg Finance L.P., as of 27 January 2023. Flows are as of the date indicated, are subject to change, and should not be relied upon as current thereafter.

The ongoing weakness of China bonds is potentially down to the fact that the yields on US Treasuries and most other EM debt has risen above those of Chinese bonds. While there remain some benefits to owning Chinese government bonds, such as portfolio diversification, these bonds are relatively less attractive as a source of yield.³

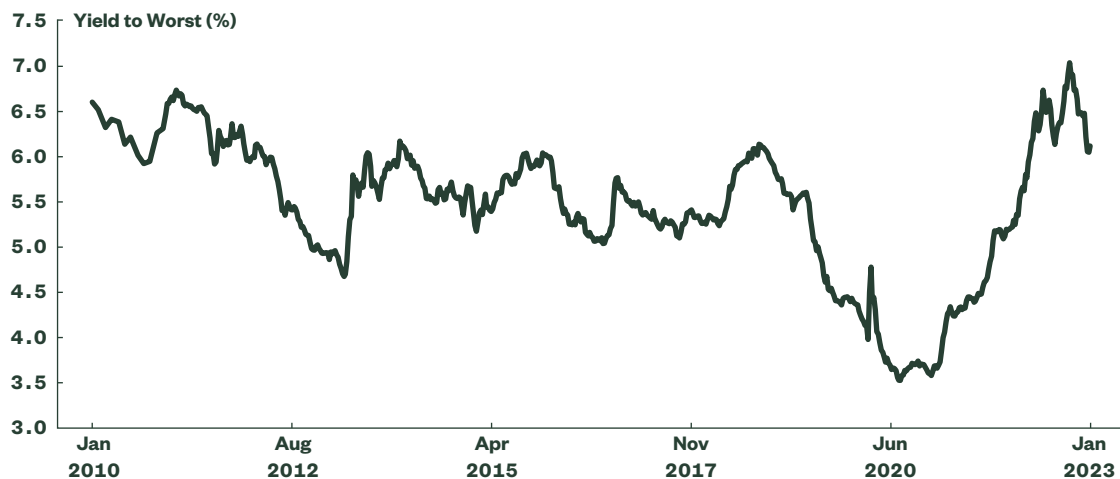
Figure 1 also highlights that a revival in local currency flows is often preceded by higher hard currency inflows. For instance, 2020 enjoyed relatively robust hard currency inflows as markets rebounded from the COVID-induced sell-off and risk appetite returned. This held until the end of Q3 2020, when the focus shifted toward local currency exposures. So the interest in hard currency strategies in Q4 2022 could make way for interest in local currency exposures if risk appetite remains firm.

**The Appeal of EM
 Local Currency Debt**

The last two weeks of flows into the end of January indicate a pick-up in interest in local currency exposures. Given the degree to which it sold off in 2022, there remains a strong case for integrating EM debt exposures into fixed income portfolios.

Yield characteristics While down off the highs, the Bloomberg EM Local Currency Liquid Index still has a yield to worst in excess of 6%. This is in line with the peaks seen during the 2013 to 2018 period and marks a dramatic repricing from lows of just more than 3.5% in 2020. With the average duration of the index having fallen during the 2022 sell-off, the yield per unit of duration, a kind of risk/reward trade-off, has also materially improved from lows of 50–60 bps of yield per year of duration to just over 100 bps.

Figure 2
**Yield at Historically
 High Levels**



Source: Bloomberg Finance L.P., as of 27 January 2023. Yield shown is the yield to worst on the Bloomberg Emerging Market Local Currency Liquid Government Index.

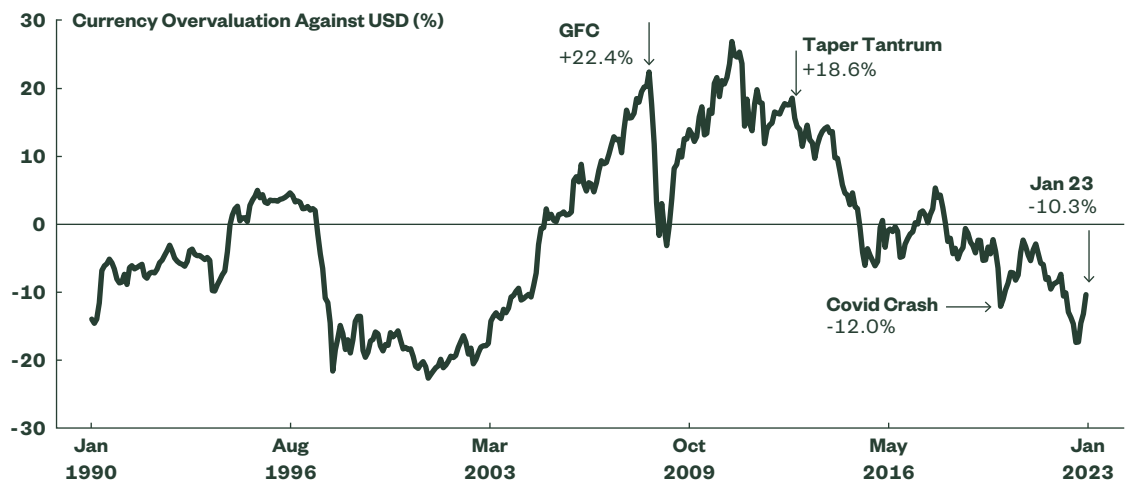
The Bloomberg EM Local Currency Liquid Government Index provides a pick-up of around 240 bps to the yield on an all-maturities Treasury fund with a similar duration.⁴ While this pick-up is below the five-year average, the fact that yields across both markets are significantly higher has driven some of the spread compression.

A significant proportion of the total return for EM now comes from the bond coupons. This accounted for 4.8% of the Bloomberg EM Local Currency Liquid Government Index returns in 2022 and is a more reliable element to return than either price or currency variations. This relatively generous coupon flow means investors can enjoy meaningful annual returns even in the (unlikely) event that bond yields remain stable and the USD steady for the foreseeable future.

Dollar Down The strength of the USD was a persistent drag on the performance of EM debt in 2022, detracting close to 11% from the return of the Bloomberg EM Local Currency Liquid Index during the first three quarters of the year. Over the course of 2022, only four of the 19 EM currencies originally in the Bloomberg EM local Currency Liquid Index actually managed to appreciate versus the USD.

The USD does appear to have peaked at the end of Q3 and has turned lower in a decisive manner. In Q4, USD weakness boosted index returns by more than 5.3% and the USD decline has continued into 2023. The flow-weighted version of the USD, the DXY, has declined more than 10% from the peak. Expectations are that it continues to decline given the high degree of overvaluation that still exists (see Figure 3).⁵

Figure 3
**USD Still Looks
Overvalued vs. EM FX**

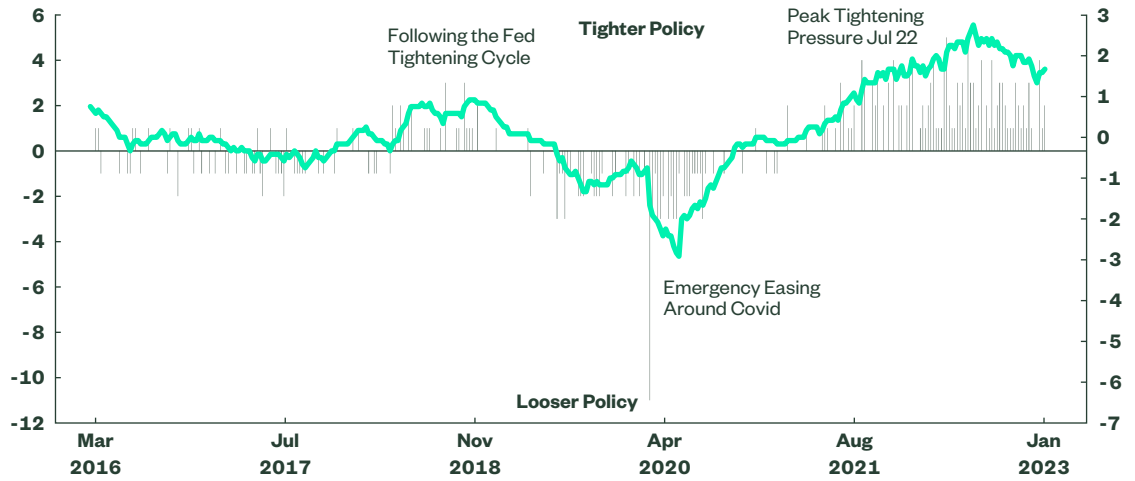


Source: State Street Global Advisors, as of 31 January 2023. The chart shows the State Street Global Advisors model of long-term value of the USD versus the currencies that make up the Bloomberg Emerging Markets Local Currency Liquid Index.

Central Bank Cycle EM central banks have reacted to mounting inflation pressures aggressively, starting the rate hike cycle in mid-2021. The upshot is that many EM central banks are at or nearing the end of their policy cycle. Most notable are Banco Central do Brasil, where political pressure for cuts has emerged since the election, and Hungary, where rates are at a lofty 13%. Others, such as the Bank of Korea and the South African Reserve Bank, have signalled that they are at or close to peak rates. Figure 4 shows a diffusion chart of rate changes by the 18 central banks that have bonds in the Bloomberg EM local Currency Liquid Index. We can see that there has been a clear deceleration in hiking momentum since late July 2022.

Figure 4
**Central Bank
 Diffusion Index**

■ Cut vs Hikes
 ■ 12w Rolling Average (rhs)

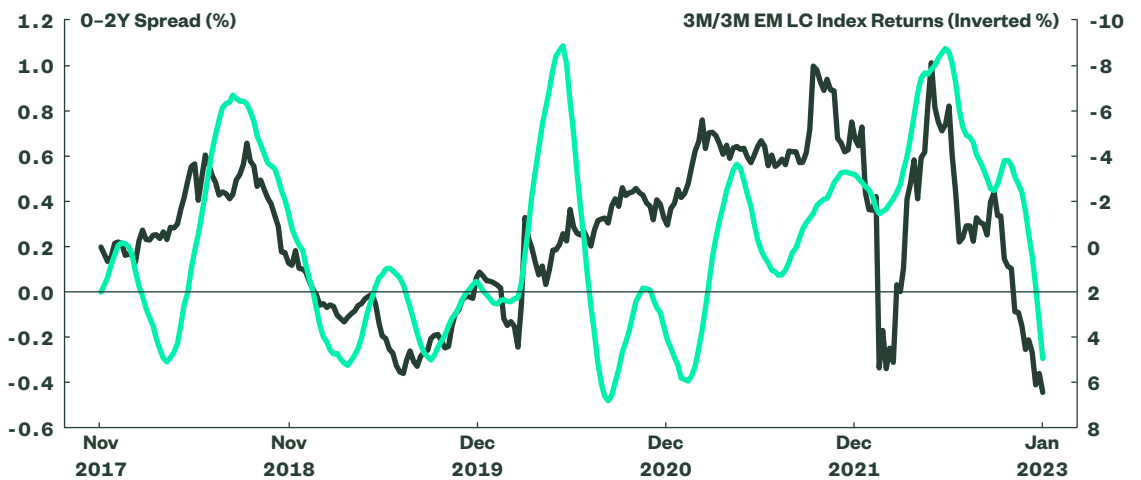


Source: Bloomberg Finance L.P., State Street Global Advisors, as of 31 January 2023. Central banks tracked are those in the Bloomberg EM Local Currency liquid Index.

The approach of the end of the cycle has had a profound effect on the yield curves of many EM nations, resulting in a dramatic flattening and, ultimately, inversion of the front-end slope. Figure 5 shows the 0 to 2-year yield spread for the markets that make up the Bloomberg EM Local Currency liquid Index and the degree to which it has flattened from its mid-2022 peak, when it briefly topped 100 bps. Historically, the flattening of the front-end slope has proven a driver of returns for EM bonds. The chart also shows the inverted 12-week/12-week change in total returns from the Bloomberg EM Local Currency Liquid Index and how a flattening in the front end is often associated with an increase in returns. The slope is clearly not the only determining factor but, in periods when it has flattened (the most notable being 2019), it has supported an improvement in returns.

Figure 5
**Swings in the Cycle
 Drive Index Returns**

■ 0-2Y Spread for Bloomberg EM LC Liquid Govt Index
 ■ Returns from the Bloomberg EM Local Currency Liquid Govt Index



Source: Bloomberg Finance L.P., State Street Global Advisors, as of 31 January 2023. 0 to 2-year slope weighted according to the market weights of the Bloomberg EM Local Currency Liquid Index.

On the Front Foot in 2023

EMs remain a tricky exposure to manage, with strong returns dependent on the persistence of current risk appetite coupled with the US avoiding a recession. The risks to global growth from a US slowdown have certainly been reduced by the re-opening of the Chinese economy, which may have eased investor concerns a little. The more rapid easing of inflation pressures in EMs versus developed markets should allow EM central banks to embark on a concerted cutting cycle.

So the outlook for the coming couple of quarters is a positive one, in our opinion, and total returns from the Bloomberg EM Local Currency Liquid Index were +4.96% for January.⁶ That return was driven by strong performances from Colombia, Hungary, Mexico, the Philippines, South Korea and Thailand, all of which provided returns of 6% or more during the month.

However, unlike Q4 2022 when the rising tide appeared to lift almost all ships, 2023 has seen a wider dispersion in returns with both Peru and Turkey suffering losses in January. This divergence underlines why country exposures are still important, even in an index. The strong gains from the Philippines and South Korea, coupled with longer duration, has meant the Bloomberg index's performance for both January and for the last quarter is ahead of the J.P. Morgan GBI-EM Global Diversified Index, which is the most widely followed EM local currency benchmark.⁷ The Bloomberg index also does not contain bonds from Egypt, which have had a tricky start to 2023. For the differences on index construction, see [EMD Local Currency: Not All Indices Are the Same](#).

Endnotes

- 1 Returns in USD terms. Source: Bloomberg Finance L.P., as of 2 February 2023. Past performance is not a reliable indicator of future returns.
- 2 For more details on the IIF numbers, see: [Gathering Momentum: Investors Move into Emerging Market Debt](#) (31 January 2023).
- 3 The 10-year China Treasury yield remained in the 2.60-2.95% range for the whole of 2022 while the yield on the 10-year US Treasury rose from 1.6% to close 2022 at 3.85%. Source Bloomberg Finance L.P., as of 31 December 2022.
- 4 Source: Bloomberg Finance L.P., as of 2 February 2023.
- 5 The USD has an overvaluation of 10.3% against the currencies that make up the Bloomberg Emerging Markets Local Currency Liquid Index as at the end of January 2023, according to the State Street Global Advisors model of long-term value.
- 6 Source: Bloomberg Finance L.P., as of 31 January 2023.
- 7 Returns from the J.P. Morgan GBI-EM Global Diversified Index were 4.29% in January 2023 and 8.45% for Q4 2022.

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