Emerging markets fixed income: reasons for optimism

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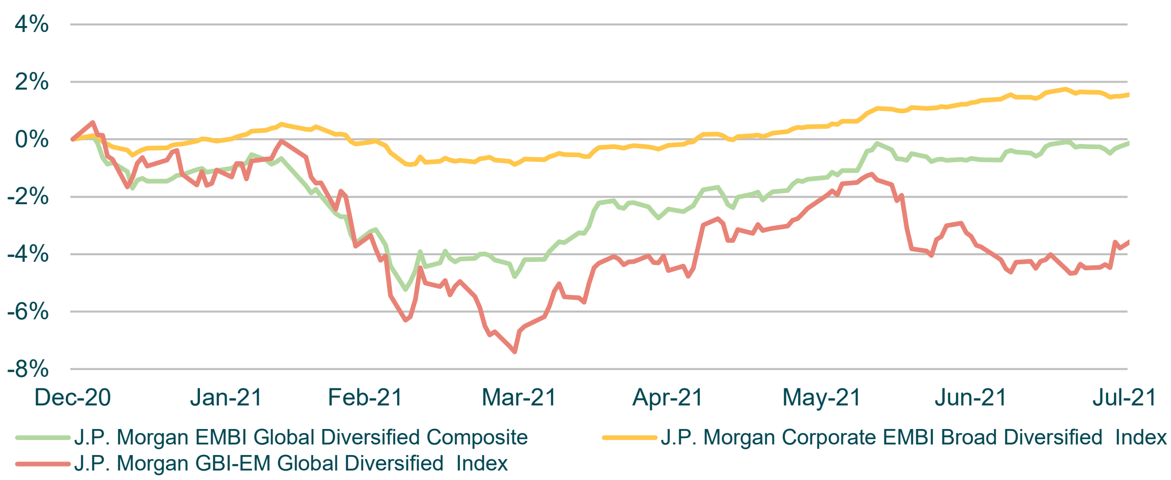
- After staging an impressive rebound in performance during the second half of 2020, investment returns on emerging markets (EM) debt have stalled in 2021 to date.
- Despite remaining uncertainty over fresh COVID-19 outbreaks and new variants, and with one eye on bond valuations, we examine whether conditions could now be ripe for investment returns among EM debt to play catch-up with the good performance seen in other risky asset classes.
- While EM credit spreads have continued to tighten overall, there are areas of value still to be uncovered, in our view. We believe EM debt valuations compare favourably to most other fixed income markets, and are now increasingly being supported by an improving global economic environment and several macroeconomic indicators that appear to be heading in the right direction for EM debt.

After staging an impressive rebound in the second half of 2020, the performance of emerging market debt assets stalled during the first half of 2021, as a fairly solid second quarter could not make up for a weaker opening quarter. A strengthening US dollar and a rise in borrowing costs (benchmarked by US Treasury yields) weighed on returns in the asset class (see Figure 1). The lower duration nature of EM corporate bonds helped this segment of the market to outperform during the first half of the year, whereas government bonds, especially those in local currency, fared the worst. Local currency assets rallied in April and May, but hawkish tones from the US Federal Reserve's June meeting led to renewed selling pressure, as the US dollar strengthened.

Returns over July and August to date (18 August, the date of writing) have so far proved to be mixed for EM debt with local currency assets underperforming due to a broad weakening of emerging market currencies versus the US dollar, while hard currency assets have registered a small positive return, helped by flattening of the US Treasury yield curve.

Figure 1. Performance of EM debt in 2021 to date (total return %)



Past performance is not a guide to future performance.

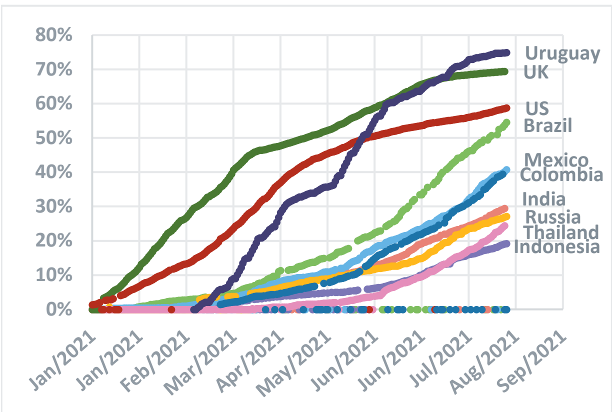
Source: M&G, JP Morgan, 30 July 2021. Returns expressed in US dollars.

As the health of the global economy continues to improve, and with the COVID-19 threat seemingly in retreat across many well-vaccinated nations (with some way to go in some emerging markets, admittedly) could we now be at a turning point for the asset class? We do not wish to downplay risks from the slow vaccination rollout in emerging markets so far (compared with most developed markets), but we do see several reasons for optimism for the asset class going forward.

Reasons to be constructive on EM debt for the remainder of 2021

Economic growth in emerging markets has rebounded and remains very robust. The latest International Monetary Fund (IMF) projections are forecasting 6.3% growth this year and 5.2% in 2022 for EM economies[1]. Interestingly, the IMF also anticipates a slightly more balanced growth outlook; growth projections for Asia have been downgraded slightly in the IMF's July outlook from a very high base in April – largely as a result of knock-on effects from India's recent severe COVID-19 experience – and increased in other regions, especially in Latin America. This outlook appears to be supported by the latest vaccination data (see Figure 2) which shows vaccination rates quickly improving in much of Latin America compared with parts of Asia[2]. As vaccination take-up increases and nations learn to adapt to the virus, we think the chances of further virus-induced growth shocks should subside substantially.

Figure 2. Share of population who received at least one dose of COVID-19 vaccine

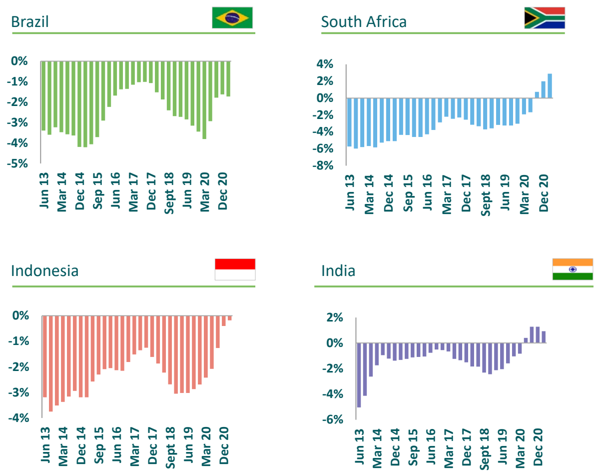


Source: Ourworldindata.org

Global demand and supply imbalances during the COVID-19 crisis actually had the effect of improving **current account balances** for many emerging nations, with some reaching their strongest levels in many years (see Figure 3).

Healthier current account balances make emerging market nations less dependent on foreign capital inflows and less susceptible to further bouts of market volatility, which we think should help support EM currencies.

Figure 3. Current account dynamics in selected EM countries



Source: M&G, Bloomberg, March 2021 (latest data available).

EM currencies (as measured by the currency component of the JP Morgan's GBI EM Global Diversified index) are down by more than 3% on a year-to-date basis (to 18 August) and seem undervalued to us. After the global financial crisis of 2007-2009, strong and persistent inflows into emerging market debt caused many EM currencies to appreciate in value and the US dollar to fall to historic lows. This time around, however, flows into EM local currencies have been more muted and, while the US dollar has depreciated from its pandemic highs, it remains significantly more expensive than it was during the period from 2011 to 2014. In our view, EM currencies could present investors with investment opportunities over the medium term.

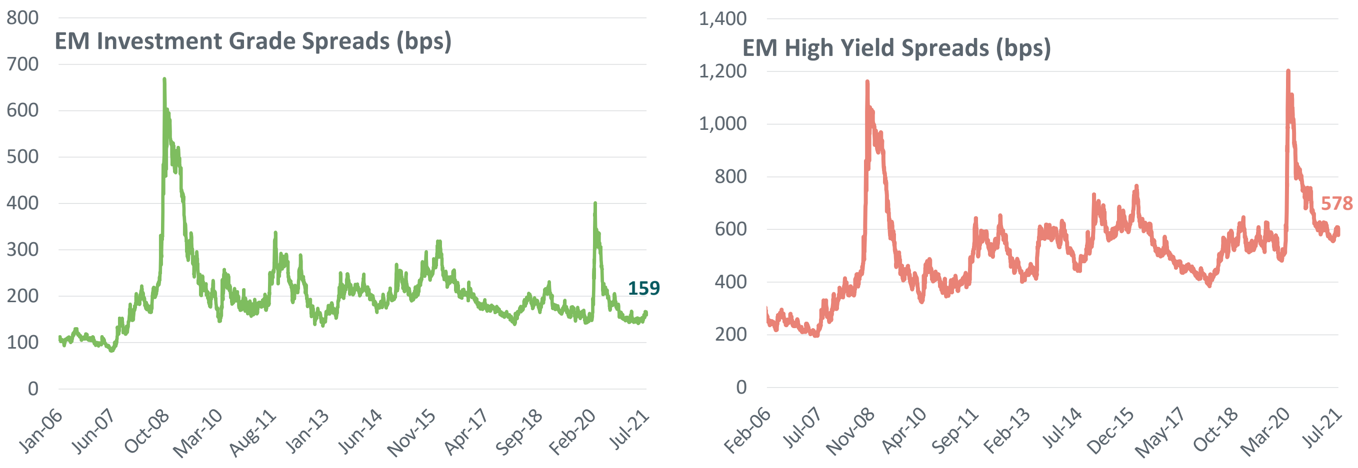
While early talk of **monetary policy** tapering is clearly under way in the US, we expect the Federal Reserve (Fed) to remain accommodative moving forward, especially given that policymakers have committed to an "average inflation targeting" framework. Many EM central banks have pre-emptively hiked interest rates ahead of the Fed. Among the 15 largest EM central banks, six have already hiked rates at least once this year. June alone saw the largest number of rate hikes since 2011 (Brazil, the Czech Republic, Hungary, Mexico, and Russia all increased interest rates), helping to reduce risk from inflation and

[1] IMF's World Economic Outlook (July 2021 update).

[2] Source: ourworldindata.org.

[3] Analysis from JP Morgan's EM Corporate 2021 Midyear Outlook.

Figure 4. EM hard-currency sovereign credit spreads – Investment grade vs high yield



Source: JP Morgan Indices, 31 July 2021

making their currencies more attractive to foreign investors.

EM inflation has accelerated in recent quarters as economies have reopened and commodity markets have rebounded. However, our view is that **EM inflation should remain fairly contained**. Many emerging nations still have a lot of spare capacity in their economies and should have the flexibility to close output gaps, even well into 2022, in our view. EM central banks have gained greater credibility over the last decade or so, and many have already demonstrated their willingness to hike rates, supporting our view. Much of the pricing pressure we have seen in emerging markets recently appears to be temporary, driven by what we believe to be transitory factors, supply bottlenecks and base effects in the data. We believe it should even out in the long term. Indeed, recent price data from JP Morgan has indicated that food price inflation has started to stabilize recently.

Despite the shock to the global economy in the past 18 months, EM companies currently offer relatively **healthy credit metrics**, in our view. Recent analysis has shown that net leverage among EM companies deteriorated only slightly during 2020 and is still significantly lower than that of developed market companies[3]. Furthermore, according to the same source, among higher-yielding EM corporates, the coverage ratio (a measure of how easily a company can use its cash flow to pay interest on its outstanding debt) is now higher than that of their high yield peers in the US for the first time since 2013. Against this backdrop, we expect relatively low default rates (approximately 2% to 3%) in the high yield segment of the EM corporate bond market in 2021. A healthier outlook for EM corporates is something that we think should appeal to investors worried about the potential for EM bond market volatility and interest rate sensitivity.

EM debt has seen a very strong recovery in terms of **credit spreads**, with the investment grade cohort (both sovereign and corporate bonds) almost back to pre-pandemic levels. However, investment grade sovereigns are arguably now weaker credits overall than they were before the pandemic hit, given the increase in debt burdens that most countries have experienced. In our view, this is no longer being reflected in investment grade spread spreads (see Figure 4, left-hand side chart). However, we believe the higher-yielding sovereign bond market still offers attractive value on a selective basis (see Figure 4, right-hand side chart).

In July, the International Monetary Fund (IMF) approved an allocation of **Special Drawing Rights (SDR)** worth the equivalent of US$650 billion, with the aim of boosting pandemic-hit economies. Emerging market countries stand to receive $275 billion in total. This is the largest SDR allocation in the history of the IMF, with the last one coming during the global financial crisis in 2009. We think it is a positive move and will provide a very welcome boost to the finances of some countries, supporting the investment case for emerging and frontier market sovereign debt in particular.

Summary

In summary, we think economic growth among EM nations will continue to strengthen, boosted by expanding vaccination programmes that should help improve both sovereign and corporate issuer fundamentals. At the same time, output gaps in many EM nations are expected to keep inflation under control, and healthy current account positions are likely to mitigate the potential effects of US tapering, in our opinion. Whilst we do not downplay the risks posed by the ongoing COVID-19 battle, including risks from as yet undiscovered variants, the above factors give us reasons for optimism for the asset class over the remainder of 2021. However, given differences in the relative speeds of vaccination availability and take-up, and speed of reopening, we could see an increasingly differentiated macroeconomic picture across emerging market countries. We therefore think it is crucial that investors continue to adopt a flexible, actively managed approach in the asset class.

Please remember that investments in bonds are affected by interest rates, inflation and credit ratings. It is possible that bond issuers will not pay interest or return the capital. All of these events can reduce the value of bonds held by a fund.

Investing in emerging markets involves a greater risk of loss due to greater political, tax, economic, foreign exchange, liquidity and regulatory risks, among other factors. There may be difficulties in buying, selling, safekeeping or valuing investments in such countries.

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