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# Charting a course in EM debt returns

A brief analysis of two contrasting decades suggests that asset allocators should look more closely at the asset class.

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## Two contrasting decades for EM debt

Emerging market (EM) fixed income has proven its worth in long-term investors' portfolios over the past 20 years – delivering outcomes comparable to those from developed markets (DM). Behind this, however, are two starkly different decades.

Between the start of 2003 and the end of 2012, EMs materially outperformed DMs, delivering appealing returns. This caught the attention of asset allocators, many of whom then entered the EM debt asset class with lofty return expectations – attracted by high revenue growth and resilient margins seen among quality companies in countries that were quickly building wealth. But over the subsequent decade (start of 2013 to end of 2022) the returns did not match expectations. This has left some investors questioning the role of EM beta in portfolios.

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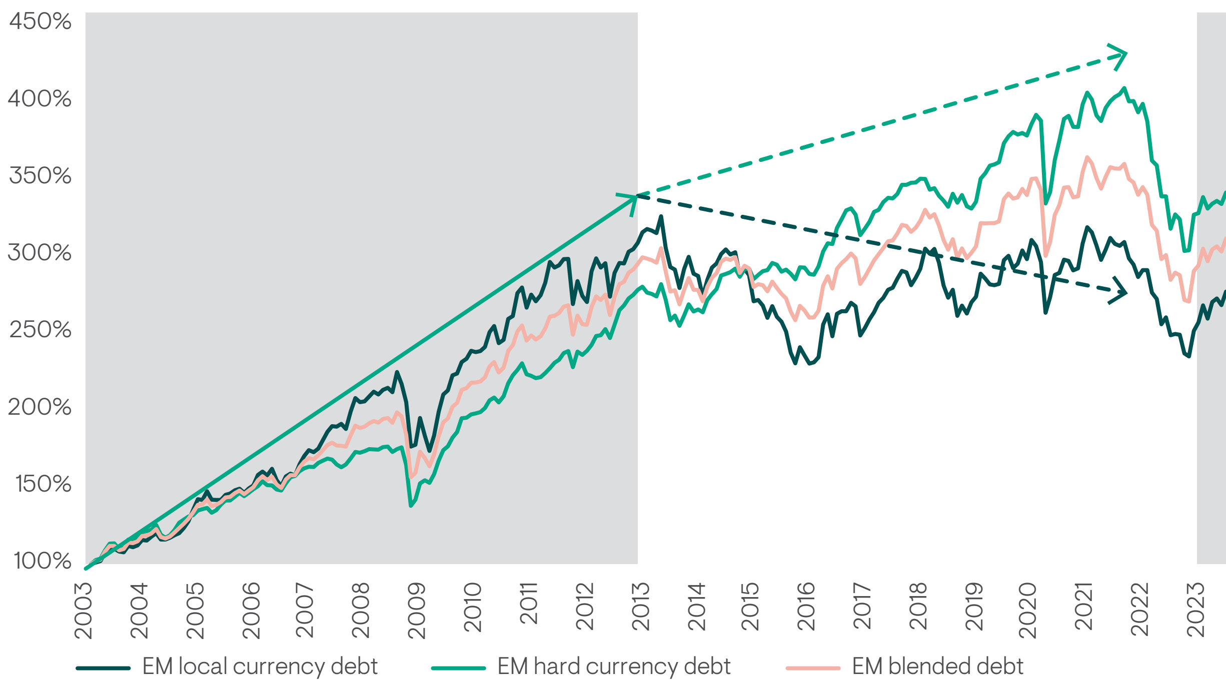
**Total return indices, rebased**




Source: JPMorgan, July 2023. LCD is JPM GBI-EM GD, HCD is JPM EMBI GD, Blend is 50% LCD/50% HCD. For further information on indices, please see the important information section.

## Diverse fortunes

The EM fixed income asset class is far from homogenous. Hard currency (mainly US dollar denominated) segments of the market – particularly corporate credit – have held their own over short and long-term periods, delivering some of the best and most consistently high Sharpe ratios among global asset classes. However, local currency debt has disappointed over the past decade. It is important, though, to disaggregate the (poor) performance of the recent inflationary period: negative headline returns were almost entirely driven by Russia's local currency debt being written to zero in the offshore market – a highly idiosyncratic geopolitical event; in contrast, in periods such as the Global Financial Crisis, EM debt performed well on a relative basis.

## The role of the US dollar

In each of the past two decades, the US dollar has been a dominant driver of EM local currency debt returns. Between the start of 2003 and the end of 2012, the US dollar weakened by over 20% relative to EMFX, providing a boost to EM local currency debt returns. On the flipside, the most recent decade has seen the US dollar strengthen by almost 30%, weighing heavily on EMFX and the overall returns delivered by the EM local currency bond investable universe. Weakness in EM spot rates against a strong dollar took a particularly heavy toll during the taper-tantrum years (2013-16) and then again in the COVID crisis (2020).

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## Not forgetting EM fundamentals

While US dollar strength has heavily influenced EM debt performance over the past decade, it's also important to acknowledge how periods of economic strength or vulnerability impacted EM. Reforms and economic strength characterised the early part of the century. We then witnessed vulnerabilities develop in the five years after the Global Financial Crisis, taking centre stage during the taper-tantrum period. Large current account deficits financed by loose global liquidity, significant foreign portfolio inflows, and weaker fiscal balances also contributed to weakness in EM debt. Crucially, though, this precipitated a significant rebalancing of EM economies, laying a foundation of resilience.

### Recent history warrants a closer look

2022 was a difficult year for fixed income total returns globally, driven by rising inflation, monetary policy tightening and higher volatility of inflation and rates. That said, relative to prior cycles, EM performance was more resilient, largely as a result of EM policymakers being ahead of the curve (in terms of more orthodox monetary policy and earlier interest rate hikes) rather than being on the back foot, as we discussed here.

More broadly, EM economies are battle-hardy and used to tough environments; it is perhaps developed market (DM) economies that are less so. If anything, in the past few years DMs have been behaving more like EMs, with markets such as US Treasuries, gilts and the Japanese currency market experiencing significant volatility. Quietly, many emerging markets have been outgrowing the EM label, as we discuss in **Blurred lines: the EM'ification of DM.**

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## Income is the ultimate driver of long-term returns

If we decompose asset class returns over the past two decades, we see that income has been the primary long-term driver. As discussed above, EMFX has added to returns over the last 20 years overall, but not in the last 10 years. In the hard currency sovereign market (EMBI), spreads have more than compensated for default losses over the longer term.

### Return sources, January 2003 to July 2023 - Local currency

| | | |
|---|---|---|
| a | Bond yield | 2.8% |
| b | EM bond capital | 0.8% |
| c = a + b | Bond return | 3.6% |
| d | EM FX yield | 3.4% |
| e | EM FX spot return | -1.7% |
| f = d + e | EM FX before dollar | 1.6% |
| g | US dollar spot return | -0.1% |
| h = f + g | EMFX return | 1.6% |
| **i = c + h** | **Total** | **5.2%** |

### Return sources, January 2003 to July 2023 - Hard currency

| | | |
|---|---|---|
| a | US Treasury yield | 2.7% |
| b | US Treasury capital | -0.2% |
| c=a+b | Duration return | 2.5% |
| d | Spread yield | 3.6% |
| e | Spread change | 0.1% |
| f=d+e | Credit return | 3.7% |
| **g=c+f** | **Total** | **6.3%** |

Source: Bloomberg, Ninety One calculations. JPMorgan GBI-EM GD, and JPMorgan EMBI-GD. Jan 2003- Jul 2023. Note that totals don't add to the asset class total due to the compounding effect between the contributing factors.

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## Where next for the asset class?

Here are the three considerations that we think are most relevant when assessing the outlook for EM debt. In each case, we see cause for optimism and potential for these factors to drive strong returns.

Firstly, EM fundamentals are improving and – based on our measures of credit vulnerability – are at their strongest levels since 2014. Fiscal strength is seeing the biggest improvement, with increasingly healthy primary fiscal balances across EM economies. Funding strength is better than in the pre-2012 period, thanks to growth in local funding markets, and external resilience is improving post-COVID on stronger basic balances (current account + FDI). While the challenging macro backdrop is weighing on headline growth in EMs, the structural growth premium of EM relative to DM remains intact and above its long-term average (although not back at the very high levels seen in the first decade we consider in this report). All of this points to EMs being in a good position structurally.

Secondly, looking across a suite of valuation metrics, the US dollar appears over-valued. Although it has moved off its recent highs, it remains at levels last seen in the early 2000s. While we are not advocating for a significant sell-off in the US dollar – or, conversely, an EMFX bull run – this headwind to EM local currency bonds looks less challenging than it has been over the past decade. We think this is likely to allow the compelling carry of EM to resume the role of key return driver.

Last but not least, from a valuation perspective, the spread pickup of EM relative to DM remains appealing. While EM spreads are below historical highs, this is justified given the relative resilience of EM fundamentals today. The recent rise in EMBI yields does not look dissimilar to the 2008-09 experience, while many local currency yields are still close to post-GFC highs. Given that yields have historically been a reliable indicator of forward-looking returns, we believe that current valuations support the case for EM debt, particularly in light of the strength of EM fundamentals.

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