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Getting the most out of emerging market debt

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The fast view

- Emerging market (EM) debt – spanning FX, local currency, hard currency, and corporate bond markets – is a diverse investment universe underpinned by a wide range of growing economies and companies. But it is under-owned in many portfolios.
- EM fundamentals are robust and over the next few years, EM economic growth is set to outpace developed-market growth by the widest margin in a decade.
- The past year's performance reflects fundamental strength in EM, yet yields across the EM debt asset class remain high. This improves the income profile and return outlook while providing a buffer against future volatility.
- EM debt provides portfolio diversification benefits and offers active investors a rich hunting ground, given the varied behaviour of individual asset classes across the cycle and the large dispersion across markets that sit within these.
- A blended EM debt strategy allows investors to benefit from the divergent dynamics across the asset class while also capturing bottom-up selection opportunities across and within markets.

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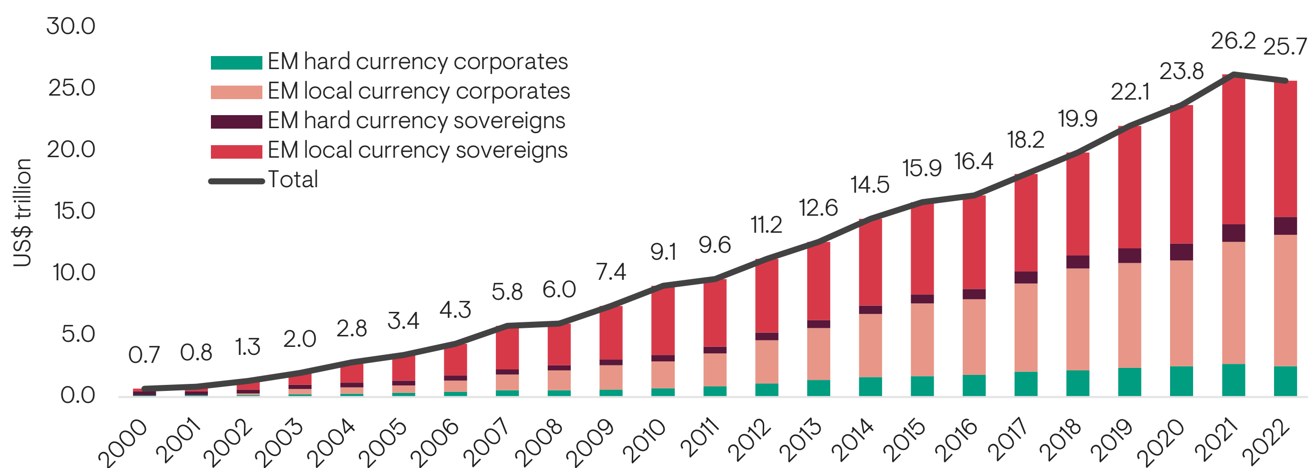
A growing asset class that is under-owned

The EM debt universe is a diverse collection of markets, encompassing a broad range of economic structures and specialisations. This includes a sub-set of less-developed 'frontier' economies – markets that are undergoing crucial changes to their economic structure, such as moving from an agriculture-driven to a services-centric economy. The EM debt market also comprises a wide range of successful corporations – many of which operate in global markets and are tapping international capital markets to help fund and grow their businesses. This makes EM debt a broad and growing opportunity set that offers a rich hunting ground for investors.

Currently spanning close to 30 local currency debt markets and 69 hard currency debt markets, the growth rate of the EM debt market in aggregate is impressive. Since 2000, the market has grown from US$0.7 trillion to US$25.7 trillion in 2022. It is clear that the EM investment universe has become too big for investors to ignore, yet foreign ownership of local currency bonds in particular stands at just 13.5%.[1] This is helpful for investors, as lower foreign ownership tends to mean that in times of market stress, there is less forced selling, and the local investor base tends to act countercyclically. It also means that in the current environment, and against the backdrop of significant recent outflows from the asset class, the technical (supply/demand) position is likely more supportive of the market.

Figure 1. A fast-growing asset class



Source: JP Morgan, Bloomberg, 31 December 2022.

Despite the rapid growth illustrated above, EM debt still has a smaller share of the global bond market than it does of global GDP and is an under-owned asset class in investor portfolios. From a more structural perspective, investment in EMs is crucial for the global transition to net zero. Given the huge amount of capital needed to finance the energy transition, the EM green bond market has significant growth potential, and the social, sustainable, and sustainability-linked bond markets along with it. This is a topic we wrote about here.

Refresher – the EM debt investment universe

EM bonds, or debt, come in a variety of forms, each with something different to offer investors. The three main types are:

- **Hard currency government bonds**: debt issued by EM governments and companies that are 100% state-owned. Denominated in US dollars (or other major global currencies, such as euros).
- **Hard currency corporate bonds**: debt issued by companies based in emerging market economies, usually denominated in US dollars (or other major global currencies).
- **Local currency corporate bonds**: a large and growing universe of debt issued by EM corporates, denominated in EM currencies, with issues typically smaller in size and less liquid than local sovereign bonds.
- **Local currency government bonds**: debt issued by EM governments that is denominated in the domestic currency of the issuer. This also gives investors exposure to the local currency, which can be hedged away if required.

A blended approach combines all of these sub-asset classes into one portfolio.

[1] JP Morgan, September 2022.

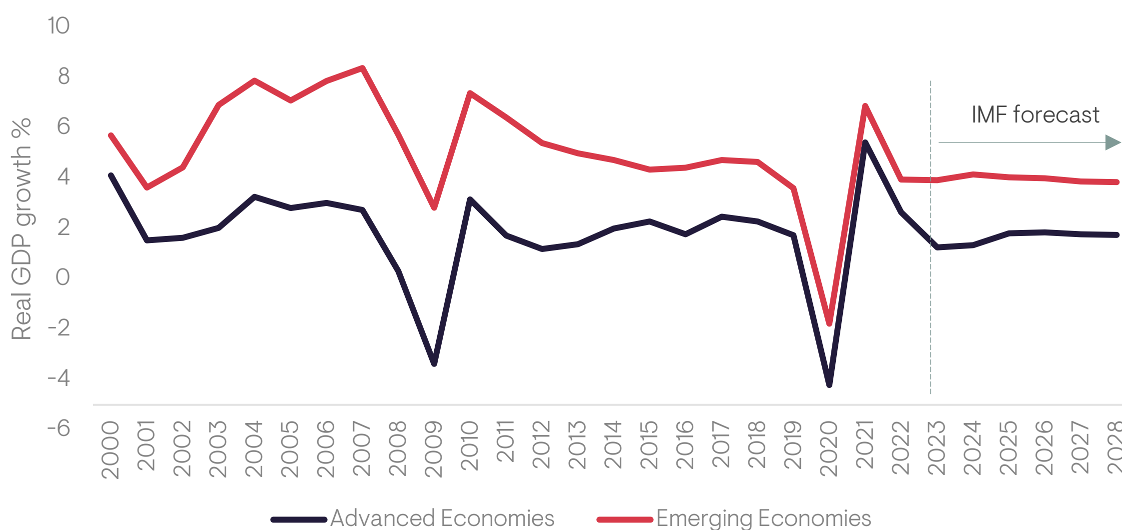
Robust fundamentals

The EM versus DM growth differential is significant

EM debt offers investors access to economies with significantly higher growth rates than many developed market (DM) economies, as demonstrated in Figure 2. Not only is the growth premium enjoyed by EMs over the last 20 years still intact, but the IMF is expecting this premium to widen to a level not seen for the last 10 years.

While the landscape driving growth has shifted somewhat over the first part of this century, the key structural dynamics that have driven higher growth in emerging markets as they move towards developed status remain in place.

Figure 2. Historic real GDP growth and forecasts



Source: IMF. July 2023.

Proactive central banks

Having learnt painful lessons from the past, when inflation began to rise as economies reopened post-COVID, EM central banks acted quickly to prevent it from spiralling out of control. This has put EM economies on a more solid footing than many of their DM counterparts, with most EMs having ended their hiking cycles and some already cutting their interest rates. As a result, EM inflation is subsiding in general, nominal GDP is rising and debt-to-GDP ratios are falling. Coupled with improved fiscal positions, the overall picture for EM seems to be robust.

We believe that this proactive EM central bank action has created attractive entry points for investors in local currency debt in markets that are at the end of their hiking or start of their cutting cycles. It also provides a more stable domestic economic backdrop for EM companies.

Support from various multilaterals

While funding challenges are not an issue for the core, larger EM economies, some frontier markets have been vulnerable - Africa is a key region that was caught by the 'sudden stop' in foreign investor flows seen in 2022, as noted here. However, the IMF has shown willingness to ensure that liquidity risks do not spiral into solvency risks for countries that are engaged in the right reforms. We also believe that current market pricing reflects these liquidity risks in most markets. Furthermore, it is not just the IMF providing support and funding – many other multilateral, regional and bilateral organisations are also providing meaningful assistance, such as the strong support Egypt is receiving from the Gulf Cooperation Council (GCC) countries.

Solid EM corporate fundamentals

Today, EM corporate debt fundamentals remain robust in aggregate. While rising costs have weighed on companies' profit margins, revenues remain resilient, and leverage levels manageable.

In a higher-rate environment, higher refinancing risks are typically a fundamental challenge for companies. But pressure on EM corporates is meaningfully lower in this cycle as most issuers have been able to pre-finance in the ultra-low interest rate regime of the past three years. This has them well-placed from a financing perspective, over the short and medium term.

Understanding EM corporates

Through time, EM companies have on average maintained better credit fundamentals than their similarly rated developed market peers, which is key to resilience during challenging macroeconomic times.

These companies often experience periods when access to long-term finance is restricted. Thus, short-term debt is a higher percentage than in developed markets, with refinancing risks historically higher. This has led to a culture among EM companies of retaining cash while containing leverage. This has been particularly evident since the COVID crisis, as many companies have pared back their expansion and capital expenditure.

Fig 3. EM vs. US and European IG net leverage

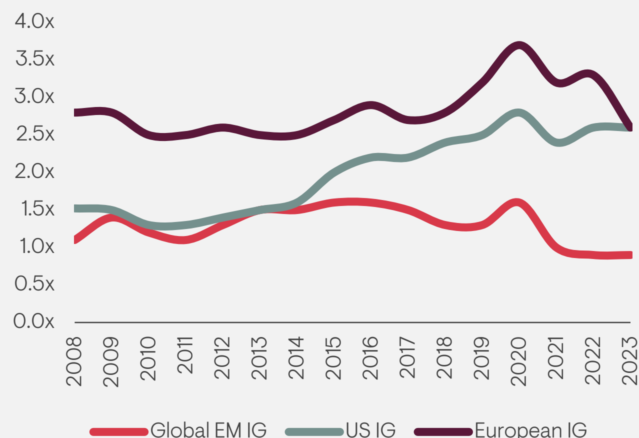
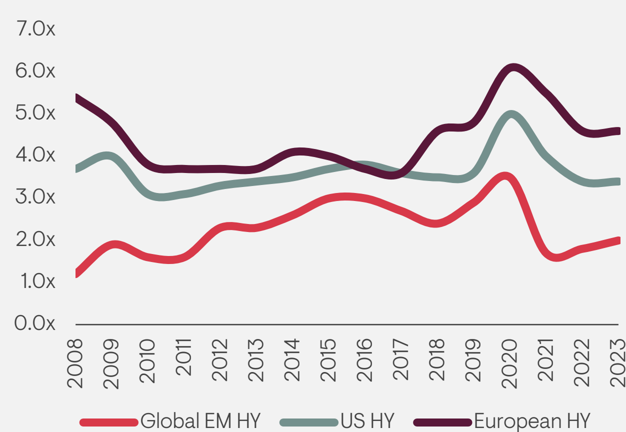


Fig 4. EM vs. US and European high-yield net leverage



Source: JP Morgan as at 31 March 2023. For further information on indices, please see the important information section.

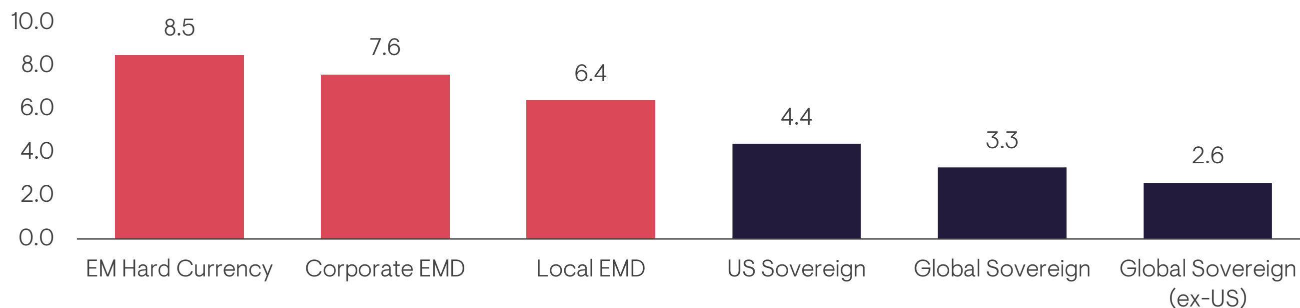
Strong fundamentals reflected in recent performance

The strong fundamentals of EMs have also meant that EM debt has been outperforming DM debt. In 2022 a blended EM debt mix (50% EM local unhedged bonds, 25% EM corporate, 25% EM hard currency sovereign)[2] outperformed the Bloomberg Global Aggregate index, with the former returning -13.4% and the latter -16.3%. This theme has continued into 2023, with the returns to 31 August being 6.1% for the same blended mix, versus 0.7% for the Bloomberg Global Aggregate. This relative performance for EMs is very encouraging - typically in periods of market weakness, EM underperforms its DM counterpart. We believe that this outperformance speaks to the structural strength of EMs now compared with previous sell-offs, reflecting factors including lower levels of US dollar debt, free-floating exchange rates, stronger current account positions and proactive central banks.

Yields remain high

One of the benefits of EM debt, and a key driver of overall returns, has been the yield pick-up it provides relative to DM debt, generating a higher level of regular income for investors. Despite recent solid performance versus DMs, the yield pick-up offered by EM sovereign bonds is still attractive. The nominal yields on various asset classes are shown below.

Figure 5. Nominal yields on various asset classes, %



Source: Bloomberg, JP Morgan, Ninety One, 31 August 2023. For further information on indices, please see the important information section.

[2] EM local unhedged = JP Morgan GBI-EM, EM Corporate = JP Morgan CEMBI, EM hard currency sovereign = JP Morgan EMBI.

While elevated yields are clearly positive from an income perspective, they have also historically been a precursor to strong future returns; with yields at current levels, the likelihood of strong subsequent returns is raised.

In the charts below, we plot yields over time, and then for each point in time we show the return recorded over the subsequent three-year period. Historically when yields spike (dark line), the subsequent three-year return (red line) has been strongly positive. This holds true for both local and hard currency returns.

Another benefit of the current high yields and wide spreads is that they provide a protective cushion against any potential near-term volatility.

Figure 6. EM hard currency yield vs subsequent 3yr return

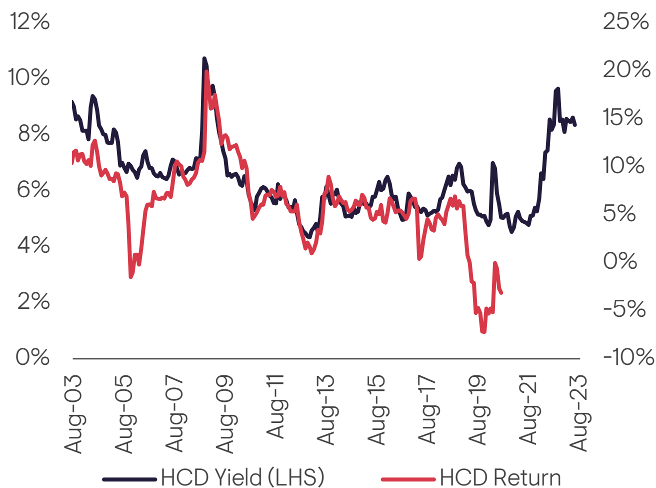
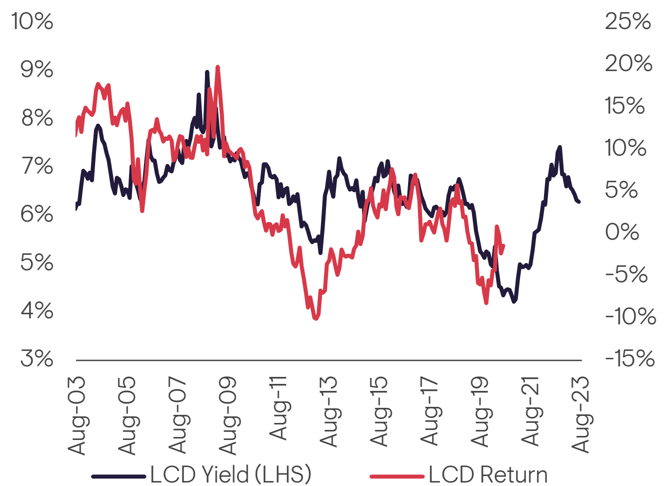


Figure 7. EM local currency yield vs subsequent 3yr return



Source: JPMorgan EMBI-GD (left chart), JPMorgan GBI-EM GD (right chart), Bloomberg, Ninety One calculations. August 2003 – August 2023. For further information on indices, please see the important information section.

A powerful source of potential alpha and diversification

Sub-asset classes perform differently through the cycle

A key benefit to investing across all EM debt asset classes is that the performance of each sub-asset class is differentiated through the broader economic and monetary policy cycle. For example, hard currency debt tends to outperform when macroeconomic conditions are strong, while the local currency market benefits from a weaker macro backdrop and benign inflation environment that is supportive of rate-cutting by central banks.

However, there are also instances – particularly at times of global market stress or large euphoric rallies – where cross-asset return correlations surge for short periods of time. These evolving environments and shifting correlations create opportunities for active investors.

Strongly differentiated returns across markets – ripe for active management

The diverse performance across the sub-asset classes over economic cycles can be further devolved into the large dispersion that occurs across markets within the same sub-asset class. The EM debt market is sufficiently diverse that idiosyncratic events and differences in national economic cycles result in very different total returns across countries in the sub-asset classes. For example, while most of the world was hiking rates in 2022 to combat inflation, China was in fact easing policy to promote growth and this reflected in positive local bond market performance.

This dispersion is illustrated in the charts below. These charts plot the best and worst annual returns for select markets and their relevant indices over the last seven years[3] and compares this with the average annual return for that same market over the same period. This dispersion highlights the potential rewards of an active bottom-up approach and is reflected in the performance active managers are able to achieve: over the past 5/10 years, the median EM debt blended active manager has outperformed their relevant benchmark by 0.99%/0.93% respectively.[4]

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[3] Seven years used to encompass an economic cycle.

[4] eVestment, Q422, USD, gross. Calculated to manager preferred benchmark and reverting to 50% JPM GBI-EM GD/50% EMBI GD where unavailable.

Fig 8. Dispersion of returns - local currency debt markets

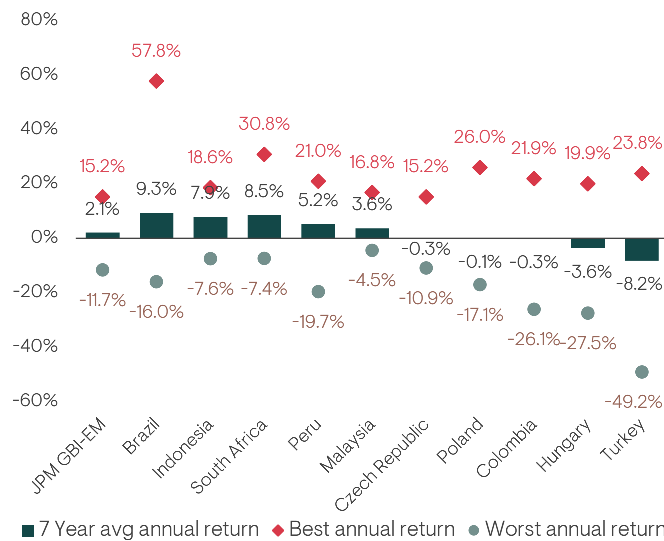
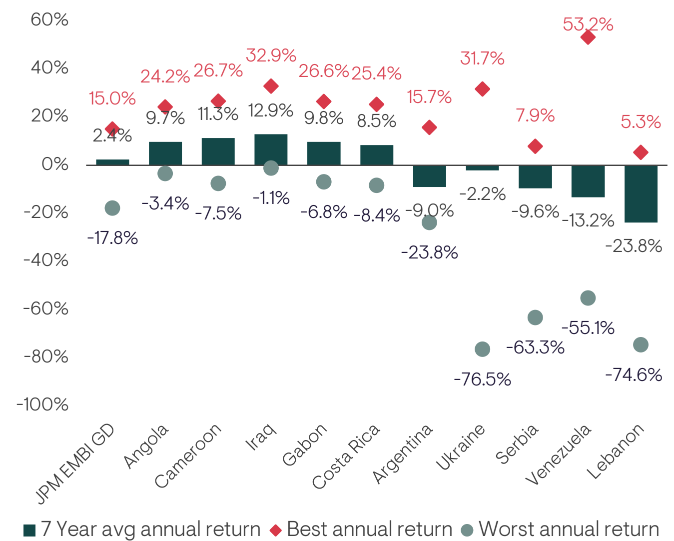


Fig 9. Dispersion of returns - hard currency debt markets



Source: JP Morgan, Bloomberg, 31 December 2022. Seven years used to encompass an economic cycle.

Smaller frontier markets are still under-researched

Although research into the larger EM economies has increased materially over recent years, many of the smaller frontier markets remain under-researched. This allows active investment managers to take advantage of market mispricings, increasing the potential for alpha capture. This is particularly true in the prevailing environment: the backdrop for the asset class is positive, but with differentiation in the outlooks of various countries across the opportunity set.

Portfolio diversification opportunity

The relatively low correlation of EM debt to DM fixed income, as seen in the table below, means that EM debt also brings significant diversification benefits and its inclusion as an allocation can improve a portfolio's efficient frontier. EM debt's return/risk profile is also compelling when compared with global DM government bonds, with the exception of local debt given the strong US dollar backdrop since the 'taper tantrum', as shown in Table 2. For more details, please see the Appendix.

Table 1. Correlations of EM blended debt with various debt and equity indices

	Blended 50/25/25*	50/50 Blend Mix**	EM Corp	EM HC Sov	EM LC Sov	BBG Global Agg	US Treasury	MSCI EM Equity	S&P 500
Blended 50/25/25	1.00								
50/50 Blend Mix	1.00	1.00							
EM Corp	0.89	0.88	1.00						
EM HC Sov	0.92	0.96	0.94	1.00					
EM LC Sov	0.97	0.73	0.77	0.81	1.00				
BBG Global Agg	0.72	0.73	0.63	0.71	0.68	1.00			
US Treasury	0.25	0.27	0.24	0.32	0.68	0.73	1.00		
MSCI EM Equity	0.83	0.82	0.74	0.73	0.82	0.58	0.09	1.00	
S&P 500	0.60	0.61	0.59	0.65	0.53	0.42	0.01	0.69	1.00

Source: JP Morgan, Bloomberg, Ninety One calculations. 31 August 2013 – 31 August 2023. Blended 50/25/25 = 50% JP Morgan GBI-EM/ 25% JP Morgan EMGIB Diversified/ 25% JP Morgan CEMBI Broad Diversified. 50/50 Blend Mix = 50% split between JP Morgan GBI-EM and JP Morgan EMBI GD. EM Corp = JPM CEMBI Broad Div. EM HC sov = JPM EMBI GD, EM LC sov = JPM GBI-EM. US Treasury = Bloomberg Barclays US Treasury.

Table 2. Annualised return and volatility of EM debt versus global sovereign bonds.

	EM local bonds unhedged	EM hard currency sovereign	EM corporate	Global DM bonds
Annualised return	4.8%	5.7%	5.4%	2.4%
Annualised volatility	11.8%	8.9%	7.6%	6.5%
Return/risk	0.41	0.64	0.71	0.37

Source: JP Morgan, Bloomberg, 31 August 2003 - 31 August 2023. EM local unhedged = JP Morgan GBI-EM, EM Corporate = JP Morgan CEMBI, EM HC sovereign = JP Morgan EMBI, Global DM bonds = JP Morgan GBI.

How to best access the EM debt opportunity?

Why blended?

While investors can access EM debt through a ‘pure’ local and/or hard currency debt portfolio, which allows them to pick top managers in each sub-asset class, this may not always be the optimal solution through a full economic cycle. Combining hard and local currency debt offers access to the full EM debt opportunity set in a single portfolio and thus for many investors, a blended approach makes sense.

A blended strategy provides the opportunity for alpha capture through: 1. top-down allocation between local and hard currency debt; and 2. bottom-up selection of the best assets in each market. It should perform well when there is dispersion in the outlook across markets, which allows for relative-value positioning.

While the ‘blended’ EM debt universe has grown significantly in recent years, it remains somewhat loosely defined. We believe that a manager of a `blended’ portfolio should allocate dynamically between asset classes with a view to outperforming a mixed local currency/hard currency debt benchmark. While our standard blended benchmark allocates 50/50 between local and hard currency debt, with 25% allocated to corporate debt within the hard currency component, ultimately the benchmark weighting should be driven by each investor’s risk tolerance and preferences. We also believe that managers of blended strategies should avoid taking excessive exposure to a single theme, country, currency, or economic outcome, and instead focus on finding high-conviction, bottom-up ideas.

Best ideas versus fund-of-funds

A seemingly obvious approach to managing a blended EMD strategy is to manage a portfolio allocating to two separate underlying funds: a hard currency debt fund and a local currency debt fund. This is what we term a ‘fund-of-funds’ approach. While this is a simple and easy-to-manage approach, we believe it has significant drawbacks, which we summarise below. Given these drawbacks, the diverse opportunity set and market inefficiencies inherent across EMs, we prefer a bottom-up-driven approach to implementing asset allocation decisions. We call this a ‘best-ideas’ approach. While asset allocation targets are still set, those targets are met by selecting individual bottom-up countries, companies, currencies, and specific bonds to buy or sell. In this way, the portfolio managers only trade a small subset of the overall portfolio (sometimes even only a handful of countries) to achieve their targets.

Fund-of-funds	Best ideas
– Allocating from one pool of assets to another involves a lot of trading across all names in the portfolio, increasing trading costs.	– Transaction costs can be meaningfully reduced, and pools of liquidity and auctions/new issues can be used to effectively meet new asset allocation targets.
– When reducing exposure to an entire asset class, the manager reduces exposure to all assets (countries or companies) in that asset allocation decision. That means it is possible (likely, even) that the overall portfolio may end up being underweight markets which are favoured by the portfolio managers.	– When reducing exposure to an asset class, the managers do not sell assets that they prefer within that asset class (e.g., the manager could move underweight local currency debt, but continue to be overweight a preferred country’s government bonds). Whatever the positioning at the asset class level, the manager can favour high-conviction markets within each asset class. This gives the portfolio the best chance of outperforming, in our view.
– It is impossible to isolate currency exposure from local bond exposure in a fund-of-fund approach. When adding (or reducing) exposure to local currency debt, both the foreign exchange (FX) and local bond (rates) exposure will increase (decrease). However, many environments demand a differentiated approach where the portfolio managers may want to be overweight FX and underweight rates (or vice versa). For example, in a high-growth environment, it would be best to be overweight FX and underweight rates.	– The manager can differentiate between currencies and local bonds in the asset allocation decision. By selecting the individual assets that are bought and sold, and whether or not the currency exposure is hedged or not, the manager can position the fund to be overweight bonds while underweight currencies (or vice versa).

Summary

Underpinned by solid fundamentals, the EM debt asset class has much to offer investors and, with historically high yields, we believe that now is a good entry point. By investing across this diverse investment universe, a blended debt portfolio provides access to the full opportunity set. Active managers that take a bottom-up approach to meet their asset-allocation objectives can pursue multiple alpha opportunities while avoiding taking excessive exposure to a single theme, country, currency, or economic outcome, and while ensuring transaction costs are kept to a minimum.

General risks: The value of investments, and any income generated from them, can fall as well as rise. Past performance does not predict future returns, losses may be made. Environmental, social or governance related risk events or factors, if they occur, could cause a negative impact on the value of investments.

Specific risks: Default: There is a risk that the issuers of fixed income investments (e.g. bonds) may not be able to meet interest payments nor repay the money they have borrowed. The worse the credit quality of the issuer, the greater the risk of default and therefore investment loss. Interest rate: The value of fixed income investments (e.g. bonds) tends to decrease when interest rates rise. Emerging market (inc. China): These markets carry a higher risk of financial loss than more developed markets as they may have less developed legal, political, economic or other systems.

Appendix: Annual returns of various indices

	EM local bonds unhedged	EM local bonds hedged	EM HC sovereign	EM corporate	Global DM sovereign
2003	16.9%	5.5%	22.2%	16.2%	14.5%
2004	23.0%	7.7%	11.6%	10.3%	10.1%
2005	6.3%	7.3%	10.3%	6.1%	-6.5%
2006	15.2%	7.2%	9.9%	6.5%	5.9%
2007	18.1%	5.0%	6.2%	3.9%	10.8%
2008	-5.2%	5.4%	-12.0%	-15.9%	12.0%
2009	22.0%	5.2%	29.8%	34.9%	1.9%
2010	15.7%	8.6%	12.2%	13.1%	6.4%
2011	-1.8%	4.5%	7.3%	2.3%	7.2%
2012	16.8%	8.9%	17.4%	15.0%	1.3%
2013	-9.0%	-4.2%	-5.3%	-0.6%	-4.5%
2014	-5.7%	3.1%	7.4%	5.0%	0.7%
2015	-14.9%	-2.2%	1.2%	1.3%	-2.6%
2016	9.9%	4.7%	10.2%	9.7%	1.6%
2017	15.2%	4.6%	10.3%	8.0%	6.8%
2018	-6.2%	0.7%	-4.3%	-1.6%	-0.7%
2019	13.5%	9.1%	15.0%	13.1%	6.0%
2020	2.7%	6.1%	5.3%	7.1%	9.7%
2021	-8.7%	-5.5%	-1.8%	0.9%	-6.5%
2022	-11.7%	-8.8%	-17.8%	-12.3%	-17.2%
2023 YTD	7.9%	4.7%	4.5%	4.2%	-0.4%
Annualised return	5.1%	3.6%	6.2%	5.6%	2.4%
Annualised volatility	11.7%	4.4%	8.9%	7.6%	6.5%
Return/risk	0.43	0.82	0.69	0.74	0.37

Source: JP Morgan, Bloomberg, 31 December 2002 – 31 August 2023. EM local unhedged = JP Morgan GBI-EM, EM local hedged = JP Morgan GBI-EM hedged, EM Corporate = JP Morgan CEMBI, EM HC sovereign = JP Morgan EMBI, Global DM sovereign = JPM GBI. All in USD.

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