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Investing for a world of change

# Time to take a closer look at EM hard currency debt

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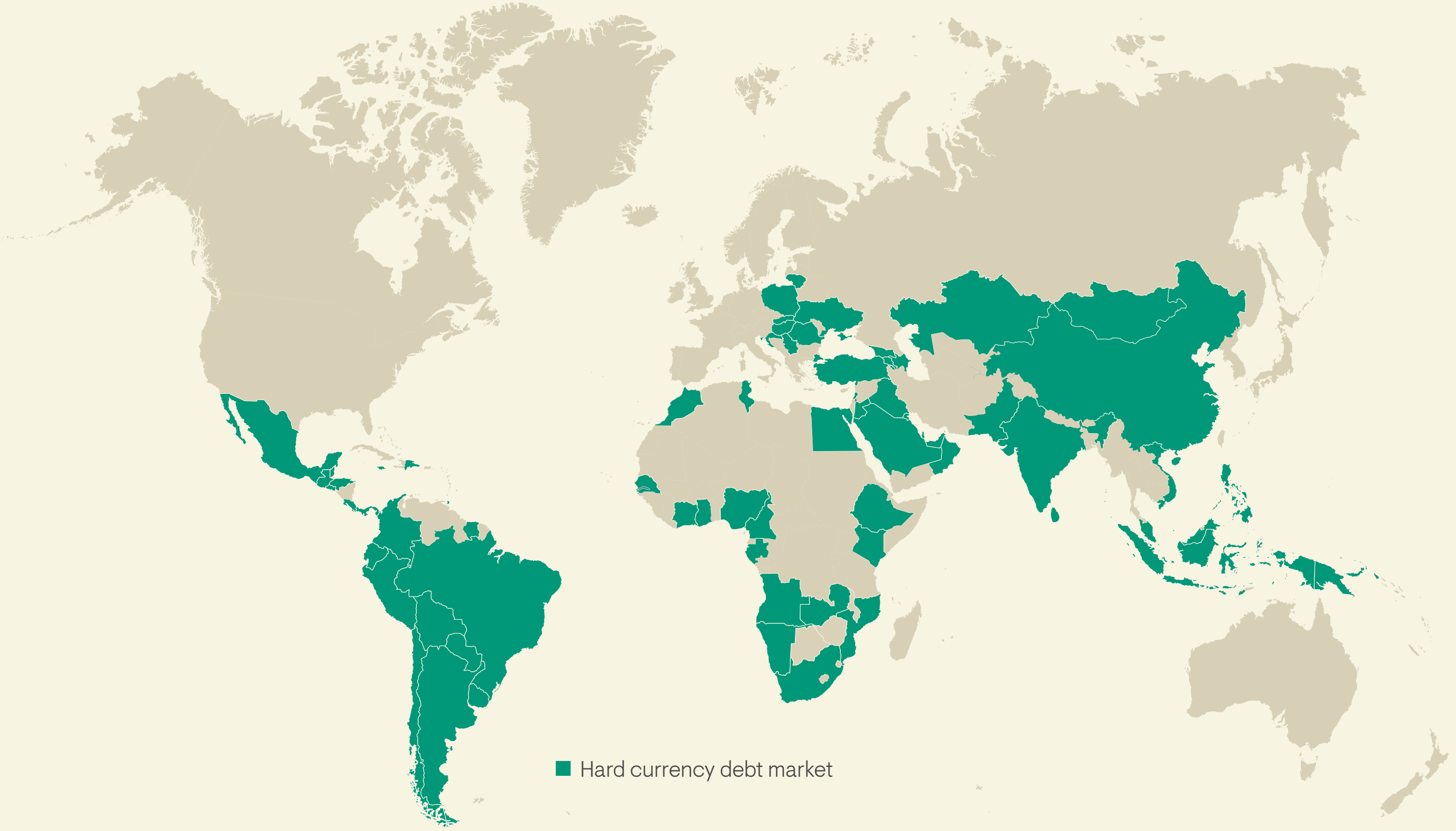
The EM hard currency debt market has grown and evolved significantly to become a broad and diversifying opportunity set. With favourable characteristics and supportive structural and cyclical dynamics, we think now is a good time for investors to take a closer look at the asset class.

## A bigger and broader opportunity set

Since the asset class was born in 1989, it has seen astonishing growth and evolution to become a valuable addition to portfolios. This is a topic we covered in a recent piece. Here are a few highlights:

- Since the Global Financial Crisis (GFC), the amount of overall debt in issuance has increased by 3.5 times, with annual growth rates above 15%.
- Over the past 10 years, a diverse array of countries have joined the flagship EM hard currency debt index, known as the JP Morgan Emerging Market Bond Index (EMBI), with the number of countries rising from 38 to 69.
- Originally dominated by Latin America, today the investment universe spans the globe. This explains its diversification properties while also bringing additional complexity and the need for investors to keep abreast of multiple dynamics and drivers.

**Figure 1: Hard currency debt markets today**




**LatAm**
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Colombia
Costa Rica
Dominican Republic
Ecuador
Guatemala
Honduras
Jamaica
Mexico
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Peru
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Suriname
El Salvador
Trinidad and Tobago
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Hungary
Kazakhstan
Lithuania
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Lebanon
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**Gulf Cooperation Council**
UAE
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Saudi Arabia

**Africa**
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Cameroon
Egypt
Ethiopia
Gabon
Ghana
Kenya
Morocco
Mozambique
Namibia
Nigeria
Senegal
Tunisia
South Africa
Zambia

**Asia**
China
Indonesia
India
Sri Lanka
Mongolia
Malaysia
Papua New Guinea
Philippines
Pakistan
Vietnam

Source: JP Morgan, Bloomberg. JP Morgan EMBI universe as at 31 August 2023.

## A rich hunting ground for active investors

A key feature of the EMBI's growth has been the increasing number of smaller markets, including countries in central Asia, Sub-Saharan Africa, and the Middle East. These smaller and often less-liquid markets are also typically under-researched by the mainstream investment community, bringing greater potential for alpha capture for those willing and able to do the necessary analysis.

This globally diverse frontier market universe is as big as the US high-yield bond market (US$1.4 trillion as at the end of 2022, according to JP Morgan). These markets offer the opportunity for investors to take meaningful – and diversified – exposure to a broad range of underlying return drivers.

With the growth of frontier markets, the number of high-yield markets within the EMBI has risen. At the same time, the index has also included more countries from the Gulf Cooperation Council (GCC) and these countries are generally of higher credit quality. The result is a greater dispersion of return outcomes, especially relating to the potential for negative credit events, which creates a rich hunting ground for active investors.

Another important consideration is that the EMBI includes '100% quasi-sovereigns'. These are companies that are 100% owned by the government, typically operating in essential industries linked to a country's natural resources, such as oil and gas or utilities. These businesses tend to have implicit (and sometimes explicit) state guarantees, meaning their ability to service debt is heavily linked to the sovereign. Representing 19% of the investable universe as at the end of August 2023, quasi-sovereigns offer diversifying characteristics and sometimes spread pickup relative to the associated sovereign debt, or interesting relative-value opportunities.

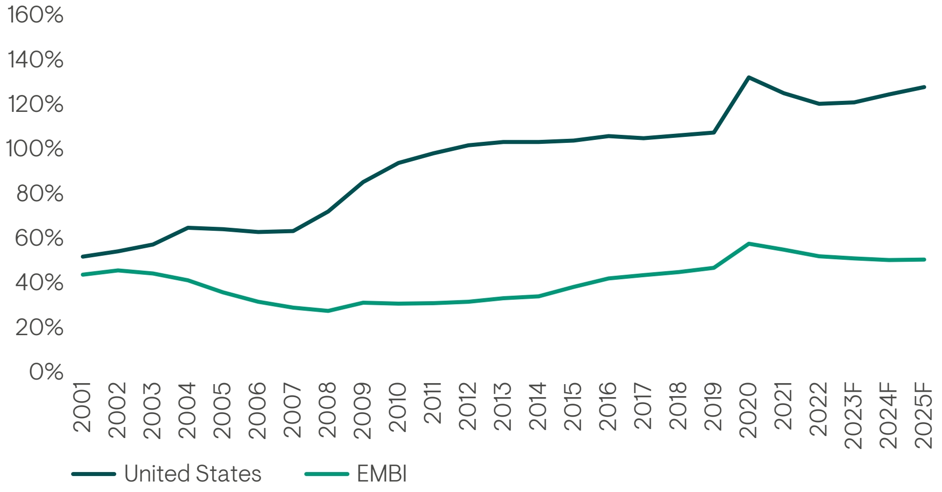
More broadly, as the investment universe has grown, coverage of it has become more challenging as it spans oil exporters and importers, regional manufacturing hubs and services-driven economies. Investors also need to keep abreast of global geopolitical trends in addition to the highly diverse set of market-specific drivers. Those with the know-how can seek to exploit the resultant mispricing opportunities in the market.

> A globally diverse investment universe offers investors the opportunity to take meaningful and diversified exposure to a broad range of underlying return drivers

## Strong fundamental foundations

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 many EM governments remaining fiscally prudent even as inflation spurred nominal growth. This has led to increasingly healthy primary fiscal balances across EM economies, as well as debt-to-GDP stabilising at modest levels.

**Figure 2: EM and US Debt to GDP**




Source: IMF, Moody's, Ninety One. EMBI weighted scores across 69 EM countries.

Funding strength is also 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. All of this points to EMs being in a good position structurally.

## Supportive dynamics

From a cyclical perspective, credit spreads on the EM hard currency debt market are above their long-run averages, creating attractive valuations, especially in high-yield markets.

From a more structural perspective, in addition to the growth premium mentioned above, given the huge amount of capital needed to finance the energy transition, the green bond market has significant growth potential, and social, sustainable and sustainability-linked bond markets along with it. In many instances, EMs are leading the way in this field to create a compelling opportunity set for investors.

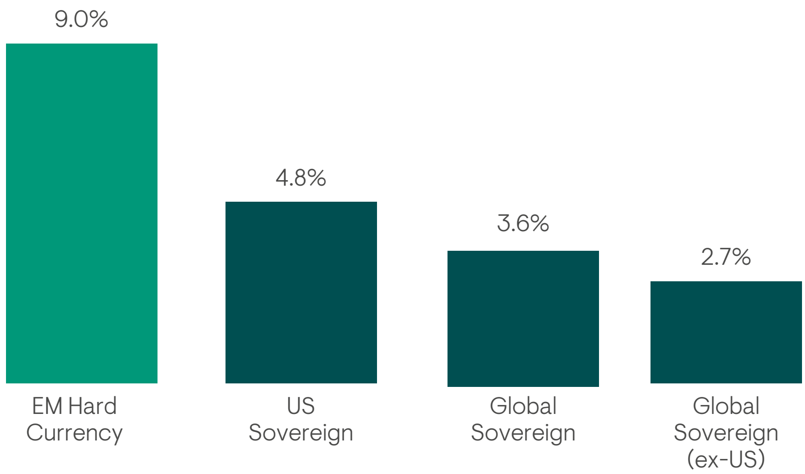
## Relevant for portfolios

Over the past 20 years, as we discussed here, EM debt has delivered attractive returns for its underlying credit quality, and robust risk-adjusted returns. EM debt has brought significant diversification benefits; unsurprisingly, hard currency-denominated debt has had a higher correlation to developed market fixed income (given the comparable underlying drivers: US Treasuries and spreads) and the correlation in local currency debt is lower. Importantly, however, the asset class offers a sufficiently high correlation to other growth fixed income asset classes that it can be considered in the same risk bucket, yet the returns are differentiated enough that it warrants analysis as a standalone allocation.

## Current valuations at attractive levels

Some EM hard currency markets are still pricing in significantly more risk than we believe is justified. Spreads remain above their long-run averages, creating attractive valuations, and we expect the asset class to benefit from peaking global rates as well as the tentative bottoming of the ratings cycle. Despite the recent rally, the asset class still benefits from a yield buffer relative to developed markets. This is particularly the case across high-yield markets.

**Figure 3: Nominal yields of EM hard currency debt versus US and global sovereign bonds**




Source: Bloomberg, JP Morgan, Ninety One, 02 October 2023. **EM Hard Currency**: JPMorgan EMBI. **US Sovereign**: JPMorgan GBI US; **Global Sovereign**: JPMorgan GBI Global; **Global Sovereign ex-US**: JPMorgan GBI Global ex-US. For further information on indices, please see the Important information section.

In addition, market positioning remains light. This, when combined with muted issuance, makes the technical backdrop (supply and demand dynamics) look compelling. As interest rate volatility declines, we expect to see more significant demand for this relatively high yielding asset class.

## Conclusion

Having experienced significant growth and evolution, the EM hard currency debt universe today offers investors access to a compelling global opportunity set and a wide range of structural return drivers. Many of the smaller markets in this investment universe are under researched, offering active investors a rich hunting ground. The positive cyclical dynamics and strong fundamentals underpinning this asset class – coupled with attractive valuations – make now a great time to consider EM hard currency debt, in our view.

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