Digging deeper into emerging market debt

In this Q&A, Capital Group fixed income investment director James Blair discusses the characteristics of emerging market debt, how investors could approach investing in the asset class and the US Federal Reserve (Fed)’s policy response to the recent market volatility.

Emerging markets are heterogeneous - the broad sector obscures a lot of subtleties and the terms used can be confusing. What are the main investable emerging market debt (EMD) sectors?

Most investors recognise that EMD is a very broad asset class, but they may not be aware of the extent of that diversity. There are broadly two main categories - the hard currency and local currency markets. EM hard currency bonds can be issued by governments (sovereigns) or companies (corporates) in a major currency – generally in US dollars but also in euros. They are essentially a credit asset, typically offering a yield pick-up over US Treasuries (in the case of US dollar bonds) as compensation for taking on additional risk. They can be investment grade or high yield. Investors seek this extra yield to help cover losses that may arise from default and in some cases a liquidity premium. This spread is chiefly influenced by changes in the credit profile of the issuing entity and by global fluctuations in investor appetite for risk.

Local currency denominated bonds are mainly issued by sovereigns but can also be issued by corporations in EM countries, and they are issued in their own currency. They can be split into nominal bonds, which can have either a fixed or floating interest rate, or inflation-linked bonds where returns are tied to inflation. These are the more traditional bond markets, in that they are more interest rates-based markets rather than credit-based. Changes in domestic interest rates and shifts in the shape of the yield curve, while improving creditworthiness, is a less prominent contributor to returns. There are exchange rate considerations with local currency markets and so currency hedging decisions can be important.

This year has highlighted the breadth and differences between the different markets and countries. In hard currency bonds, there’s been a marked return difference between commodity related issuers and those with more diversified economies. The return dispersion between investment grade bonds, which have held up fairly well, and the lower rated high yield issuers, which have underperformed and are still trading at elevated credit spreads, is just as stark.
What variables do you and your team look at when assessing EMD investments?

Given the disparate nature of the EMD universe, there are a number of factors that we take into account when assessing investments in the asset class. They can generally be categorised as falling under three broad categories: fundamental factors, valuations and technical factors.

Firstly, fundamental analysis looks at the key factors driving the issuer and their economy and how these variables might change. For a sovereign issuer, you might be looking at the external funding requirements of the economy (the current account deficit + short-term debt + amortisation of medium-term debt falling due in the next 12 months) and exchange rate reserves. Then there are domestic considerations, such as the budget deficit, economic growth, inflation, etc.

Secondly, valuation analysis would consider what is priced into the sector and the issuer and how this might change over time. We would look at factors such as the price of EM debt relative to other asset classes, the EMD asset class relative to historical prices of the sector itself and within EM debt, and how bonds of similar fundamentals compare on price. We also look at pricing along the issuer’s yield curve for potential pricing anomalies.

Finally, there are the technical factors and that covers a broad range of other factors. Some of them might be the market forces for the purchase or sale of bonds, so for example if there is a large amount of new issuance, that could weigh on market pricing or changes in weights of countries in widely-followed indices, which can lead to large amounts of buying or selling. Market risk appetite is another factor - this can vary depending on the behaviour of the investors. Also, market microstructure considerations can be important, such as one that we’ve all been dealing with recently which is the impact of working from home and sell-side trading capacity, or the impact of exchange-traded funds (ETFs).

Dislocations between valuations, fundamentals and technicals can create compelling investment opportunities. We can look at some country examples. Argentina is heading into sovereign default and so clearly has weak fundamentals, but it might be the case that the USD denominated bond recovery values are higher than what is currently priced into the bonds, so some investors might buy these bonds on valuation grounds – even though they expect a default. It’s a similar situation in Ukraine – the bonds have sold off significantly and our analyst believes that some of the bonds offer decent value assuming the government manages to secure an IMF lending programme. In the current volatile environment, we might look at some local markets that have a large domestic buyer base such as China, as these markets will be less impacted by global volatility. South Africa, meanwhile, faces a double whammy of weak fundamentals and poor technical factors, as its recent downgrade meant that it was taken off the benchmark World Government Bond Index, which has triggered a huge amount of forced selling.

There’s not always a clear distinction between the three factors. Indeed, the largest single driver of returns this year has been the actions of the US Federal Reserve. It has impacted fundamental factors, it has underpinned valuations and it is providing strong technical support for credit markets.
Can you elaborate more on the Fed’s response to the shock? The actions of the Fed have had a massive ripple effect throughout the global economy and global financial markets. How do you assess that response within the EMD sector?

While we’re in the midst of a health and economic crisis, it’s thanks to large and proactive G-3 central bank measures and particularly the Fed, that we’re not also dealing with a financial crisis. The response from the Fed has been huge, but it’s also proportional to the risks being faced. We have seen interest rate cuts and quantitative easing (QE), which have been important, but there have also been a number of measures specifically to help the functioning of capital markets in US Treasuries, the repo market, the corporate bond market and even some parts of the sub-investment grade market, like supporting the ‘fallen angels’ (bonds that were previously investment grade but have been downgraded to sub-investment grade status). The Fed has been pivotal in supporting market pricing during this unprecedented time.

Do you expect the US dollar to weaken in the medium term following the large injections of liquidity and if so, how will that impact EMD?

Yes the large liquidity injections should in time lead to a weaker US dollar, but we’ll need to see a broad-based recovery in global growth before we see a decisive turn in the dollar.

A weak US dollar has generally tended to have a positive impact on EMs for several reasons. The main reason is that most EM countries meet at least part of their borrowing needs in US dollars. They do this for a number of possible reasons. EM capital markets are generally less developed than DM markets, global investors may not lend to them in their local currency and interest rates are lower in the US (although issuers will need to pay a spread over US Treasuries). When the US dollar weakens, EM countries’ external debt levels and interest payments fall, while the reverse happens when the dollar strengthens. Over the past couple of decades, EM governments have started to issue more debt in their local currency, although corporate EM debt is still predominantly issued in US dollars.

Secondly, the US dollar has tended to weaken relative to EM currencies when there has been broad-based global growth. Stronger global growth also supports commodity prices, which is another benefit to EM.

Finally, the intersection of these two factors, a lower external debt burden and broad-based growth, is very supportive for a fall in the risk premium of emerging market debt by global investors. This supports foreign direct investment flows.

Investors tend to consider EMD to be a sector that is highly leveraged to oil and other commodity prices. How fair is this characterisation?

EM as a whole is a small net commodity exporter and hence would suffer from a collapse in commodity prices, but there are large divergences between and within regions and commodity categories.
EMEA is a commodity net exporter, with the Gulf Cooperation Council, Sub Saharan Africa and Russia all major energy exporters. Latin America is also a net commodity exporter, but relies more on agricultural products and metals rather than energy. In contrast, Asia is a net importer of commodities and so is in a relatively better place to weather the current weakness in energy prices.

The countries that appear most vulnerable to weak commodity prices from a fiscal standpoint include Ecuador, Colombia, Angola and Nigeria. The oil prices that would balance the current account appear to be particularly high for Colombia and Kazakhstan. Meanwhile, countries such as India, Pakistan, Thailand, Sri Lanka, Turkey and South Africa may benefit. Very broadly, lower oil prices tend to have a net positive impact on many EM local currency issuers through lower inflation and an improvement in fiscal and external accounts, although this may be a more medium-term factor. Some diversified mining countries, such as Peru, have managed to avoid a significant downturn. Agricultural commodities have held up well, supporting Paraguay and Uruguay.

Some research suggests there has been a secular, century-long decline in real yields across the globe. How does this play into your approach in the EM debt markets?

Trend global real interest rates have been falling for a long time, and extrapolating this trend would suggest we may face sustained periods of extremely low or negative interest rates for some time. There are potential implications for this when investing across rate markets.

Firstly, with traditional fixed income assets offering low or negative yields, investors have been searching for higher-income alternatives, including EM debt. This has allowed many new countries to start issuing US dollar debt in the global capital markets, including Rwanda, Angola, Cameroon, Uganda, Ethiopia and Mozambique. Lower global interest rates have also allowed EM countries to issue debt at lower interest rates than they have done in the past. For example, when Rwanda issued debt in 2013, it did so at a rate of less than 7%, barely two decades after the 1994 genocide. EM debt levels reached 220% of GDP last year, up from 147% of GDP in 2007.¹

The impact of EM countries being able to issue more debt and at lower interest rates could be very positive. Assuming that borrowed funds go into investment into capital and other productivity-enhancing projects, this should in turn lead to higher growth rates and a faster “catch-up” to developed economies, especially given a generally younger population in many EM countries.

Of course, there is a flip side to borrowing more. It can make EM countries more vulnerable to times like we experienced in the first quarter of this year, when sudden shifts in risk sentiment drive capital outflows. Argentina had already announced its debt restructuring before the current crisis, but the last month has seen Lebanon default on payments, as well as Ecuador and Zambia announcing debt workout intentions.

¹ As at 31 March 2020. Source: Institute of International Finance
Overall, however, I would say that a lower rate environment is supportive for EM countries.

**Why should investors consider an allocation to EMD? And why now?**

It is very difficult to time the bottom of the market, but there will always be opportunities within the asset class for research-based investors. One example is currently in EM hard currency debt. Credit spreads on EM US dollar bonds remain elevated, trading at around 600bps above the risk free curve, compared to below 300bps towards the end of last year. However, this premium over US Treasuries hides two very different sub sectors. EM investment grade US dollar debt has been trading at the mid to high 300bps over US Treasuries, whereas the high yield portion has been trading at over 1000bps, which is a spread of around 250-300bps over their US dollar corporate high yield counterparts.2

Investors could benefit from having some allocation to EMD throughout the cycle. The weight can be moved up and down tactically based on factors such as risk appetite, valuations and economic growth projections, but there are a number of reasons for investing in emerging market debt over the long term.

One is that as economies mature, a long-term investor can benefit from the improvement in credit ratings as EM economies transition into a more DM-like economic structure. There is evidence for this in parts of Asia and Eastern Europe. When this happens, credit spreads on the hard currency bonds have tended to narrow. With local currency bonds, there is plenty of scope for both real and nominal bond yields to fall and converge with yields in developed bond markets as many nations are now better equipped and more willing to bear down on inflation than at any point in their history, be it through monetary policy, deregulation or labour market reform. Meanwhile, there are reasons why currency appreciation could, once again, potentially be a key source of return for local currency bonds, longer term. Emerging markets’s rising productivity and growth relative to the developed world, their improved terms of trade and their exposure to rising global commodities could serve as a magnet for investment inflows over the medium to long term.

Regardless of the investor’s approach to investing in EMD, it is worth considering diversifying according to credit rating, region, market size and economic drivers, such as for example, having oil importers as well as oil exporters in a portfolio. An active research-driven approach to the sector is key.

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2 As at 24 April 2020. Current pricing reflects volatile market period which started in February 2020. Source: JPMorgan
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