Strategy Insights | Fixed Income

Diversification, income, and total return potential: The benefits of EM local debt

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Overview

- EM local bonds offer an attractive opportunity to invest in a high yielding asset class with low correlation to US assets and potentially high total returns.
- While cyclical, EM returns have tended to mean revert based on interest rate and US dollar cycles.
- We believe EM local debt is poised to outperform over the next several years, as EM interest rates have recently adjusted higher and we expect long-term global market dynamics to lead to US dollar depreciation over the next three to five years, providing the opportunity for additional EM returns.

EM local bonds offer an attractive opportunity to invest in a high yielding asset class with historically low correlation to US assets and potentially high total returns. Over the last nearly 20 years, emerging market (EM) local bonds have returned 5.1%, almost 150% of the return of the US bond market.[1] However, over this time, EM local debt returns have been cyclical — characterized by underperformance followed by outperformance.

While returns over the next few months may be volatile, we believe current EM local bond valuations are attractive and make an allocation to the asset class worth considering.

Going forward, we believe EM local debt is poised to outperform over the next several years, based on evolving global macro conditions which should favor EM countries, and our belief that global fixed income markets tend to correct from extreme valuations and mean revert. EM returns — which can be split into interest rate and currency components — have tended to mean revert based on interest rate and US dollar cycles. On the rates side, EM interest rates have recently adjusted higher, setting up a period of potential positive performance. On the currency side, the US dollar is close to five-year highs but we believe the factors contributing to its strength are largely behind us. We expect long-term global market dynamics to lead to US dollar depreciation over the next three to five years, providing the opportunity for additional EM returns.

EM local debt: A versatile asset class

Emerging market (EM) local debt offers investors access to the attractive growth dynamics typically associated with the EM asset class. It offers significant yield enhancement to fixed income investors willing to raise their risk tolerance somewhat, and offers equity investors risk mitigation potential for a modest sacrifice of returns.

As seen in Figure 1, EM local debt offers greater opportunity for diversification compared to US dollar-denominated EM debt and US high yield — two typical choices for yield pick-up versus traditional US core fixed income. With low correlation to both US stocks and bonds, exposure to EM local debt can potentially improve portfolio diversification for both equity and fixed income investors.

Figure 1: Low correlations to both US stocks and US bonds

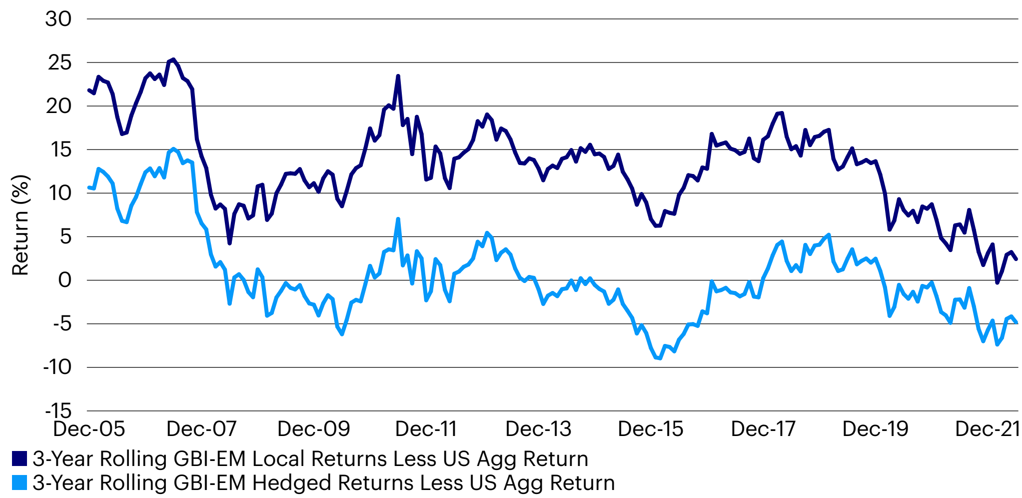
Historical correlations	US stocks	US bonds	US Treasuries
EM local debt	0.59	0.33	-0.02
EM USD debt	0.67	0.53	0.12
US high yield	0.80	0.38	-0.06

Source: Morningstar. Data from June 30, 2017 to June 30, 2022. EM Local Debt is the J.P. Morgan GBI-EM Global Diversified Index. EM USD Debt is the JPM EMBI Global Diversified Index. US High Yield is the Bloomberg High Yield Corporate Index. US Stocks is the S&P 500 Index. US Bonds is the Bloomberg US Aggregate Index. US Treasuries is the Bloomberg US Treasuries Index.

High income while waiting for interest rate reversion

From January 1, 2003 to June 30, 2022, the J.P. Morgan GBI-EM Global Diversified Index returned 5.1%, compared to a 3.4% return on the Bloomberg US Aggregate Bond Index. But returns have been cyclical, characterized by periods of underperformance followed by periods of outperformance, as returns have tended to mean revert. As shown in Figure 2, after periods of underperformance, the yield differential, or spread, between EM and US bonds has historically risen to levels that lead to outperformance over the subsequent two to three years.

Figure 2: Relative performance of EM local debt vs US bond market

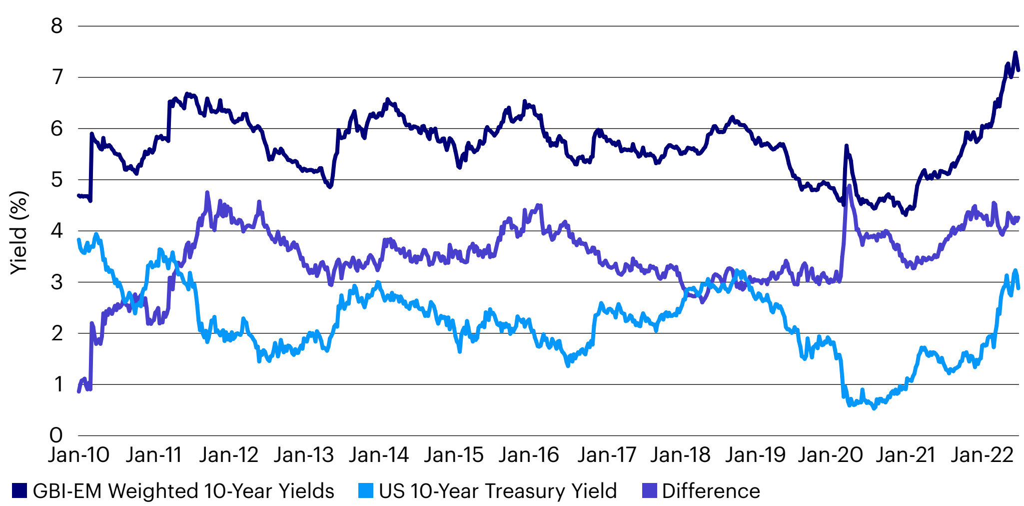


Source: Bloomberg L.P. Data from Dec. 30, 2005 to June 30, 2022. GBI-EM is the J.P. Morgan GBI-EM Global Diversified Index. The US Agg is the Bloomberg US Aggregate Bond Index. **Past performance is not a guarantee of future results.**

Potential for high total returns: Part 1 — Attractive EM local debt yields

Recent underperformance of EM interest rates is the result of central bank tightening in most EMs beginning in 2021, resulting in bond price declines. But these policy decisions have resulted in very high nominal interest rates that are now available to investors. EM local bonds currently yield around 7% on average, around 400 basis points more than the US 10-year Treasury, a level not seen in over a decade (Figure 3).

Figure 3: EM local bond yields are the highest in a decade



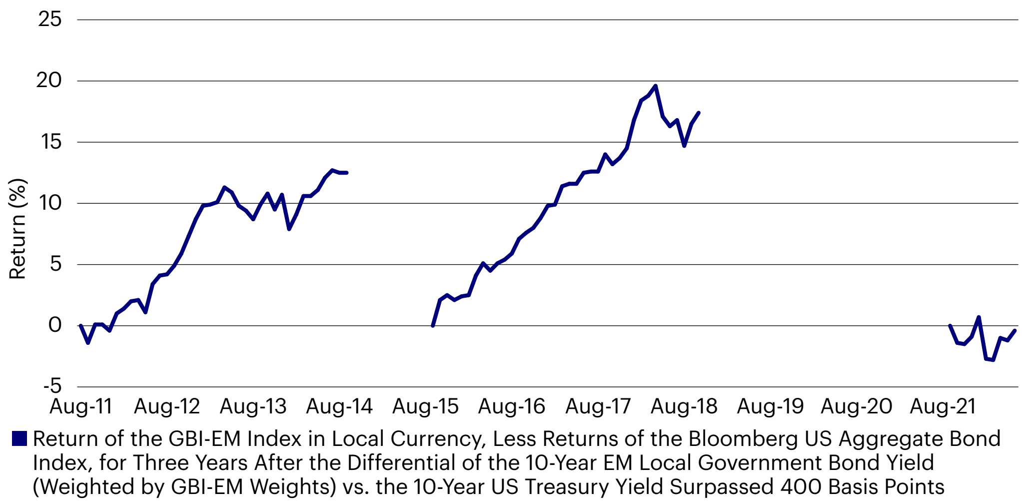
Source: Bloomberg L.P. Data from Jan. 8, 2010 to July 1, 2022. GBI-EM is the J.P. Morgan GBI-EM Global Diversified Index.

Crossing the 400-basis point threshold versus the 10-year US Treasury has historically served as a threshold for EM mean reversion, leading to EM outperformance versus the broader US bond market. This has been typically due to declining EM interest rates and a narrowing differential between EM local rates and the US 10-year Treasury yield. It is worth noting that EM local debt's current excess spread versus the US 10-year Treasury is despite a higher weight of China, a relatively low yielding market, in the benchmark, and the exclusion of Russia, a very high yielding market.

Mean reversion has historically led to EM excess returns

Figure 4 shows that periods when EM local debt yields were high versus US Treasuries have typically been followed by EM outperformance versus the broader US bond market. For example, after the yield differential widened to over 400 basis points in 2011, EM rates outperformed strongly over the next two years (Figure 4). When the yield differential widened to over 400 basis points in 2015, EM local debt outperformed in 2016 and 2017, peaking in early 2018. With the yield differential currently above 400 basis points, and yields at a decade high, we expect EM local debt to mean revert again, especially as inflation slows in both EM and the developed markets.

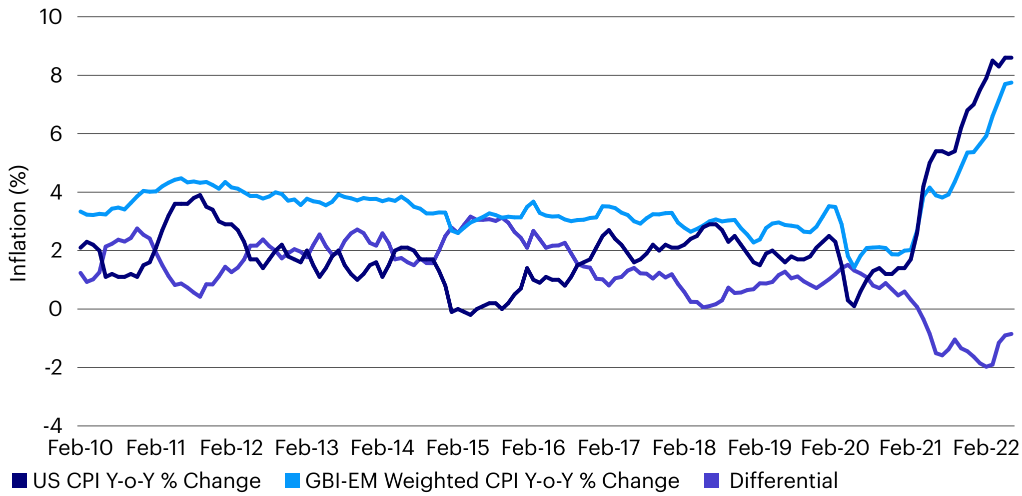
Figure 4: After periods of elevated yield differentials (historically, around 400 basis points), mean reversion and opportunities for excess return have occurred



Source: Bloomberg L.P. Data from July 31, 2011 to June 30, 2022. GBI-EM is the J.P. Morgan GBI-EM Global Diversified Index. **Past performance is not a guarantee of future results.**

Moreover, EM nominal yields are high and differentials are wide versus US interest rates, even though inflation is lower on average in EMs than in the US for the first time in a decade (Figure 5). This makes the real interest rate differential between developed and EM countries especially compelling, in our view.

Figure 5: For the first time in a decade, average EM inflation is below US inflation



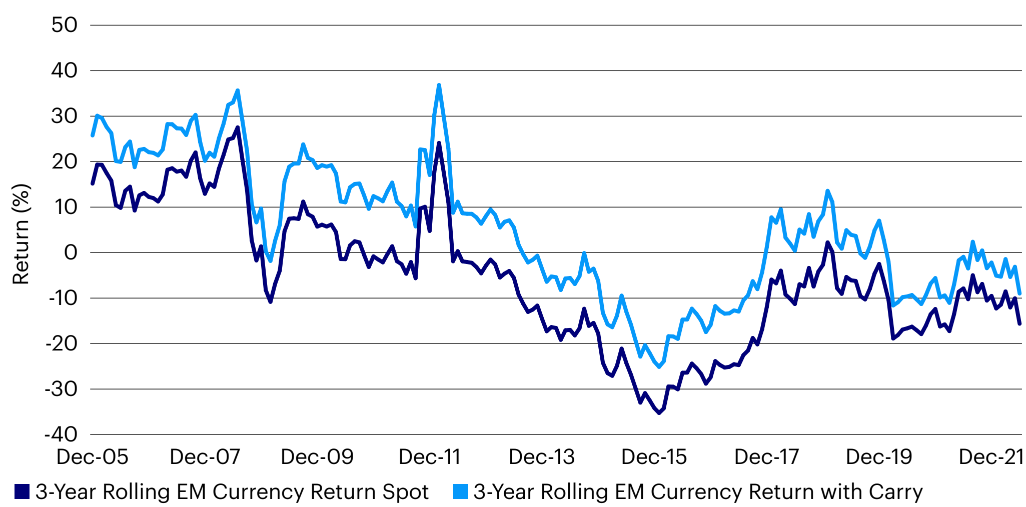
Source: Bloomberg L.P. Data from Jan. 1, 2010 to June 30, 2022. GBI-EM is the J.P. Morgan GBI-EM Global Diversified Index.

Potential for high total returns: Part 2 — EM currency appreciation

The second return component is based on currency moves. EM local debt returns are partly dependent on the performance of the US dollar and tend to be higher when the US dollar is stable or weaker. While our expectation that the US dollar will mean revert is itself compelling, when combined with high EM carry and a fundamental basis for a weaker dollar over the longer term, the case for incorporating EM local exposure into a portfolio strengthens, in our view. We anticipate that, as rates markets stabilize, high US twin deficits will likely weigh on the US dollar going forward.

EM currencies are often perceived as a volatility driver. Yet the high carry available on EM local debt has historically compensated for EM currency volatility.[2] Figure 6 shows that, including carry, EM local currencies returned around 0% on a three-year rolling basis as of the end of April, compared to a spot currency return of around -10%.

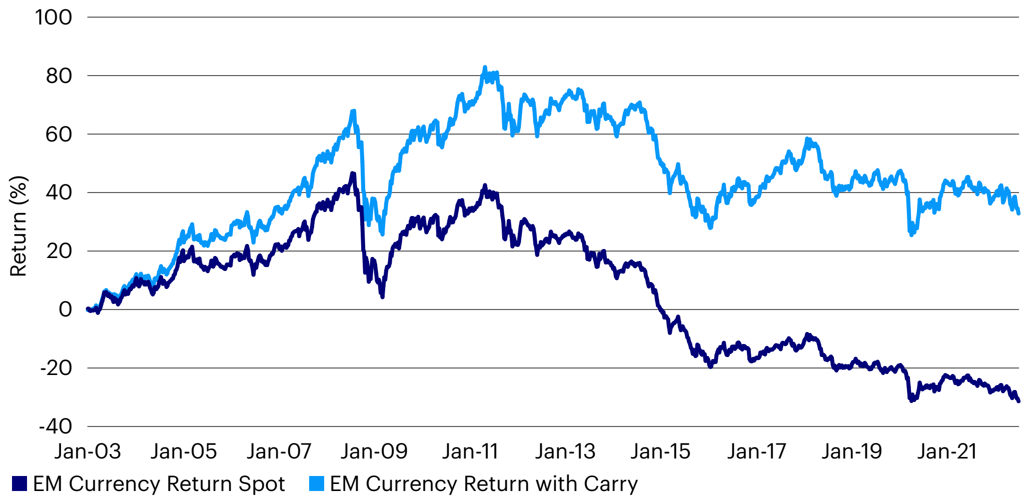
Figure 6: Extended underperformance of EM currencies has led to an overvalued US dollar and historically low EM currency valuations



Source: Bloomberg L.P. Data from Dec. 31, 2005 to June 30, 2022. **Past performance is not a guarantee of future results.**

This long period of sideways performance is clear based on the cumulative returns of EM currencies since the inception of the JPM GBI-EM benchmark in 2003 (Figure 7). Including the major drawdown of 2015 following China's slowdown and currency devaluation, EM currency returns combined with carry were around zero for the next seven years, while spot prices steadily declined.

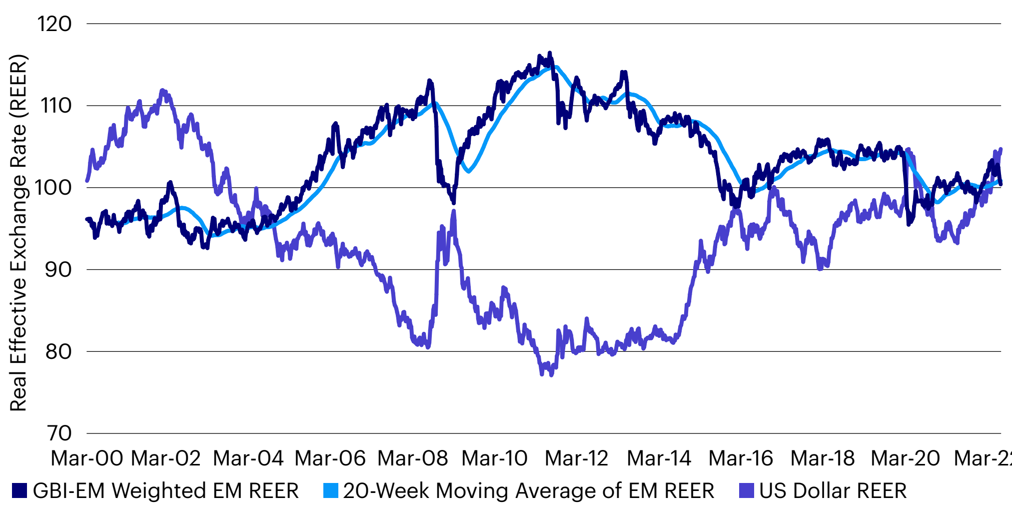
Figure 7: After the declines of 2015, EM currency returns with carry have largely moved sideways, while spot prices have declined



Source: Bloomberg L.P. Data from Jan. 1, 2003 to July 1, 2022. **Past performance is not a guarantee of future results.**

Combined with the drawdown of 2015, and without significant recovery in between, this long period of negative performance has led to a high valuation of the US dollar and historically low valuations for EM currencies. On a real effective exchange rate basis (REER), EM currencies overall are close to their lowest valuations since 2004, while the US dollar is near its highest valuation (Figure 8). This is despite the introduction of China into the index, with a weight of around 10% and a stronger currency than those it replaced, in particular, Russia (prior to the invasion of Ukraine).

Figure 8: On a real effective exchange rate basis (REER), EM currencies overall are near their lowest valuations since 2004, while the US dollar is near its highest valuation



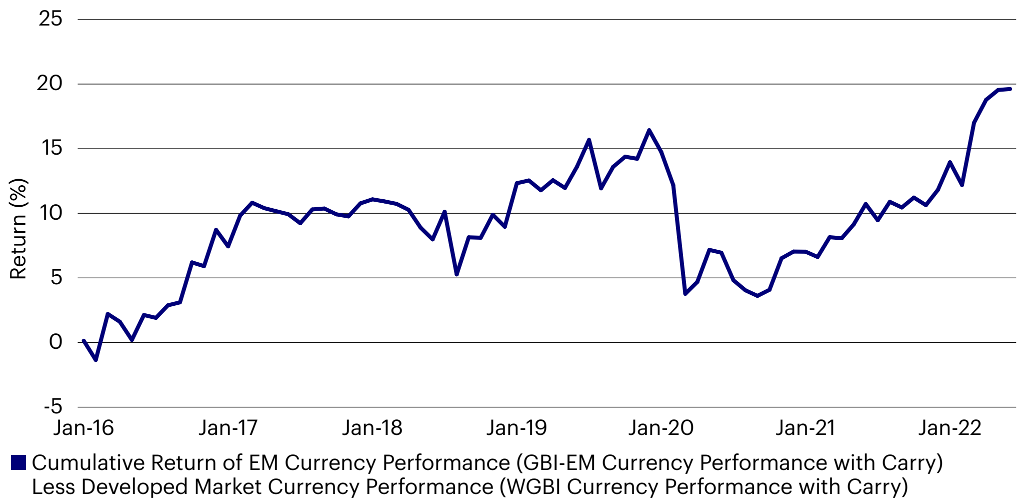
Source: Bloomberg L.P. Data from March 1, 2000 to July 1, 2022. GBI-EM is the J.P. Morgan GBI-EM Global Diversified Index.

EM currencies have performed well against developed market currencies

The performance of EM currencies is a relevant metric for US dollar-based investors, but it is important to note that the recent period of US dollar strength has not been driven primarily by EM currency weakness, but rather by weakness in other developed market currencies. This is shown by the performance of EM currencies funded from other developed market currencies other than the US dollar.

Since March 2020 (the start of the pandemic and market collapse), EM currencies have performed well versus other developed market currencies (Figure 9). EM currencies funded through a basket of developed market currencies (ex-US) have returned 6.5% since March 2020, with a standard deviation of 4.6%, i.e., a favorable Sharpe ratio of 1.4.[3] Since the start of 2016, the return of 2.8% with volatility of 6% is excellent, given the pandemic-induced market turmoil in the first quarter of 2020.

Figure 9: Relative strength of EM currencies: Even in a period of US dollar strength, EM currency weakness has not been the driver



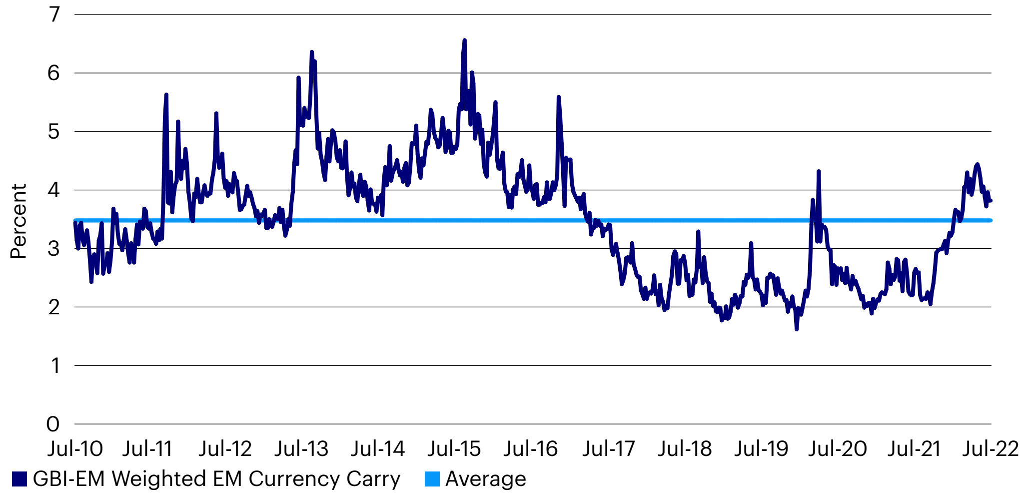
Source: Bloomberg L.P. Data from January 1, 2016 to July 1, 2022. GBI-EM is the J.P. Morgan GBI-EM Global Diversified Index. WGBI is the FTSE Non-US World Government Bond Index. **Past performance is not a guarantee of future results.**

What's next for EM rates and currencies?

Given the relative strength of EM currencies, it appears that the strength of the US dollar versus other currencies is holding EM back. In that regard, the performance of EM as an asset class will likely depend on conditions that can lead to a weaker US dollar and the presence of carry. Ultimately, we view the current elevated level of the US dollar as incompatible with global relative rate structures or the current global economic narrative. The US dollar initially appreciated on expectations that the Fed would hike more than other central banks. However, relative interest rate spreads between the US and other countries have not moved much, except versus the yen, and EM-US interest rate differentials have moved against the US dollar on average as EM countries have aggressively raised rates. The most recent leg of the US dollar rally has been driven by risk aversion based on the prospect of looming recessions in the US and Europe.

The US bond market is currently pricing in a rapid Fed tightening cycle, followed by a mini-easing cycle in 2023 on expectations that inflation will decline sharply. We believe this scenario could have two impacts: the EM-US interest rate differential should start to stabilize and perhaps move against the US, and recession fears should abate. Neither would bode well for the US dollar in the medium or long term, in our view. In the meantime, EM currency carry of nearly 4% annualized (Figure 10), is significant compensation for potential volatility of the currency market, in our view. While not at the highs of the last decade, it is still above average.

Figure 10: EM currency carry is above average



Source: Bloomberg L.P. Data from July 1, 2010 to July 1, 2022. GBI-EM is the J.P. Morgan GBI-EM Global Diversified Index.

Conclusion

Uncertainty surrounding the path of US interest rates has so far prevented markets from unlocking the value we see in EM local bond markets. However, we believe we are closer to gaining better visibility on the path of US interest rates and will start to see inflation expectations become more anchored in EM.

While EM local debt returns may be volatile over the next few months, we believe now is an opportune time to allocate to the asset class. As a strategic allocation, EM local exposure can increase portfolio diversification, given its low correlation to both US stocks and bonds. Building or adding to a position at this point may be rewarding, in our view, not only as a potential portfolio diversifier with high income, but also as a potential source of high total return.

1. Source: J.P. Morgan GBI-EM Global Diversified Index, Bloomberg US Aggregate Bond Index. Data from January 1, 2003 to June 30, 2022.
2. Carry refers to the additional return that can be achieved by borrowing in the currency of a country with a lower prevailing government bond yield in order to gain exposure to the currency of a country with a higher government bond yield. On balance, a positive net yield generates positive carry, while a negative net yield offers negative carry.
3. Source: Bloomberg L.P. Data from March 31, 2020 to July 1, 2022. EM currencies are represented by J.P. Morgan GBI-EM Global Diversified Index. Developed market currencies are represented by the FTSE Non-US World Government Bond Index.

Investment risks

The value of investments and any income will fluctuate (this may partly be the result of exchange rate fluctuations) and investors may not get back the full amount invested.

Fixed-income investments are subject to credit risk of the issuer and the effects of changing interest rates. Interest rate risk refers to the risk that bond prices generally fall as interest rates rise and vice versa. An issuer may be unable to meet interest and/or principal payments, thereby causing its instruments to decrease in value and lowering the issuer's credit rating. The values of junk bonds fluctuate more than those of high quality bonds and can decline significantly over short time periods.

The risks of investing in securities of foreign issuers, including emerging market issuers, can include fluctuations in foreign currencies, political and economic instability, and foreign taxation issues.

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