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Bond basics: Emerging market debt explained

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What is an emerging market?

The World Bank defines emerging markets (EMs) as economies with "low to middle per capita income"[1] relative to their developed market peers.

Prior to the early 2000s, most of these economies depended largely on funding in a currency other than their own. Today, many of these countries have grown significantly and become more stable, allowing them to issue debt denominated in their local currencies. Over the past 20 years, the EM debt market has rapidly expanded, surpassing USD 24 trillion in 2020 (with roughly 85% in local currency and 15% in external currency), and it now accounts for over 25% of the global bond universe, up from just 2% in 2000[2]. This is largely attributed to the amount of foreign investment into the market as well as local demand stimulated by domestic growth.

Often, these are economies which are transitioning towards a more modern, developed economy. Common characteristics of EM economies include low per capita income, rapid growth, high instability and high production levels. Today, EMs make up roughly 70% of the world's GDP growth[3]. EM countries can vary drastically in size and while many are tiny relative to their developed market peers, some EMs—such as China, India, Indonesia and Brazil—rank among the largest economies in the world.

For investors, investments in EM countries can offer attractive risk-adjusted returns as well as growth and diversification benefits[4]. Investing in EM bonds can give investors exposure to equity-like returns with fixed income-like volatility patterns. There are various sectors within EMs to choose from which we will explore in this explainer.

Types of emerging market bonds

EM bonds can be categorised into the following areas:

- **External sovereign debt** – bonds issued by EM countries, denominated in non-local currency

  External (or "hard currency") sovereign debt refers to government bonds issued by EM countries in major currencies which are widely seen as being more stable than EM currencies, such as US dollars or euros. These bonds tend to be less volatile than local-currency bonds, as there is less exposure to local currency risk. Therefore, investors can take advantage of the attractive spread premiums EM debt typically offers relative to US Treasuries, with less volatility. External debt is often repaid in US dollars. EM governments earn tax revenues in their local currency, so if the dollar appreciates, this can increase their cost of repayment, which could pose a credit risk.

- **Local debt** –bonds issued by EM countries and companies in local currency

  Local debt refers to bonds issued by EM countries and companies in their local currency and this is one of the largest sectors of EM debt markets. These bonds are usually more volatile due to the link to local currency, and returns can vary hugely depending on the country. The performance of these bonds is largely driven by views on local inflation and interest rates.

  These bonds tend to be relatively uncorrelated to developed markets and can offer more attractive returns and diversification in a portfolio. There is, however, also an element of embedded risk premium in local bonds—especially in longer-dated maturities—which can be impacted by changes in credit fundamentals.

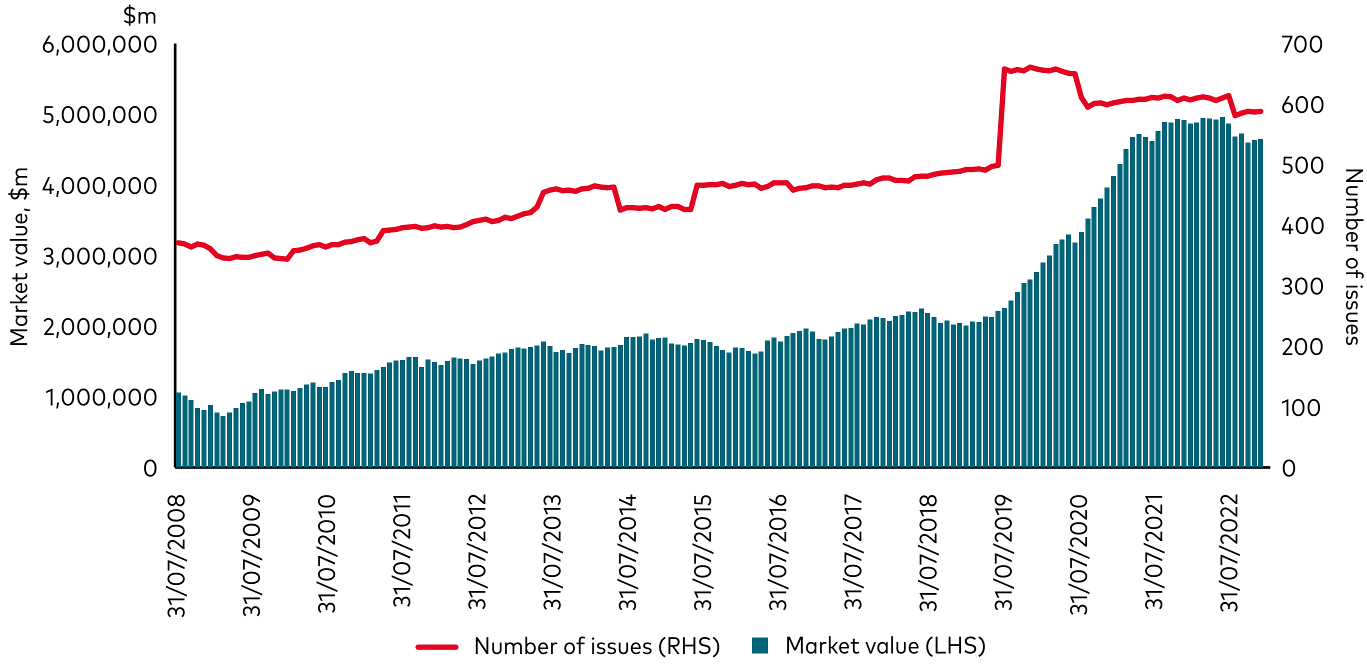
1 Source: Antoine W. Van Agtmoel of the International Finance Corporation of the World Bank), https://www.igi-global.com/, 31 October 2022.

2 Source: https://corporatefinanceinstitute.com/resources/knowledge/economics/emerging-market-economy/

3 Source: State Street Global Advisors Emerging Market Debt Enhancing a Global Bond Portfolio White Paper, March 2022.

4 Source: Morningstar Direct, 1 October 2002 to 31 October 2022. JP Morgan EMBI Global Index shows similar returns versus the MSCI ACWI Index, and similar volatility to the Bloomberg Global Aggregate Bond Index.

Size of EM local-currency government bond market 2000 to 2022, in US dollars



Source: Bloomberg EM Local Currency Government market value in USD and number of issues, as at 31 August 2022.

As local markets have become more advanced, these countries are turning more towards domestic bond issuances and the local market has therefore grown significantly over the years, as shown in the chart below.

- **External corporate debt** – corporate debt issued in hard currency (typically US dollars)

  External corporate debt refers to bonds issued by EM corporate issuers in hard currency. These corporates often have higher credit ratings than local sovereigns, as the rules around the repayment of these bonds falls under foreign laws (usually US or UK), and they therefore offer a lower risk profile. In addition, these bonds are exposed to the risk of US dollar appreciation, which refers to the cost of servicing the bond rising. However, some corporates—such as oil exporters—earn revenues in foreign currency, meaning they may be better equipped to withstand currency fluctuations.

The emerging market risk landscape

Owing to the underlying characteristics of EM countries, EM bonds typically entail certain risks:

- **Political risk**
  EM countries are often subject to more unstable political conditions than developed markets. This can mean they have less developed institutions and looser regulatory frameworks than in developed peers, and the risk of civil unrest is often higher. EM countries can also be more exposed to the risk of sanctions—such as those imposed by the West on Russia after its invasion of Ukraine—which can impair a country's ability to repay debt or trade.

  A volatile political environment can create uncertainty around economic policies which, when combined with the "headline risk" associated with elections and related unrest, can impact asset prices.

- **Market and currency risk**
  EM countries are subject to local economic factors, such as inflation, which can influence monetary policy and in turn exchange rates. These can be volatile, not least because a large number of EM economies are reliant on commodity exports, which are subject to global supply and demand dynamics. Further, food and other volatile items account for a larger share of the inflation baskets in EM economies. As inflation rises, interest rates often increase to combat the high inflation, which can negatively affect total returns. Conversely, as inflation falls, interest rates are expected to come down, which is likely to increase total returns.

- **Credit risk**
  Hard currency bonds are issued under the regulatory regime of the country from which that currency derives. For example, US dollar- or pound sterling-denominated bond defaults are handled by courts of law in the US and UK respectively. However, local bonds are typically issued under local regulation and so defaults are managed by local courts. In theory, this means that a foreign investor has less legal protection on investments in local bonds, and that is partly where the additional risk premium arises. That said, because of the generally heavy ownership of local bonds by domestic banks or pension funds, governments are generally reluctant in practice to impose aggressive restructuring on local bonds, even if some of them are held by foreign investors.

- **Liquidity risk**
  EM bond markets are typically less liquid than those in developed markets, for several reasons. First, EM countries are usually smaller issuers, and the EM market tends to attract fewer market participants than more developed markets. This can increase trading costs for investors in two ways: 1) the investor is likely to get unfavourable prices through higher bid-ask spreads, and 2) investors may face higher broker commissions due to the added complexity of trading EM bonds. However, liquidity in EM debt markets has improved over the past two decades, particularly as some of these economies open up to the West more. This is particularly true in the local EM bond market, as this has seen greater issuance than the external debt market in recent years.

  Today, EM local bonds make up an increasing share of broad-based bond market indices, such as the Bloomberg Global Aggregate Bond Index[5]. This is due in part to the fact that these bonds have more liquidity than in the past. However, of the EM local bond issuer countries that are still not in broad-based bond market indices, many still offer investors good value. This is why the choice of an EM bond index can have a significant impact on long-term performance and diversification.

  Liquidity risk in the corporate EM debt market tends to be slightly higher than that of the external or local bond markets as this sector forms a smaller share of the EM bond universe.

The emerging market opportunity

Investing in EM debt offers some exciting advantages relative to developed market bonds, including diversification and the potential for higher returns in your portfolio. EM bonds can offer high risk-adjusted returns, often with performance similar to equities and a risk level similar to that of fixed income[6].

EM historical return profile

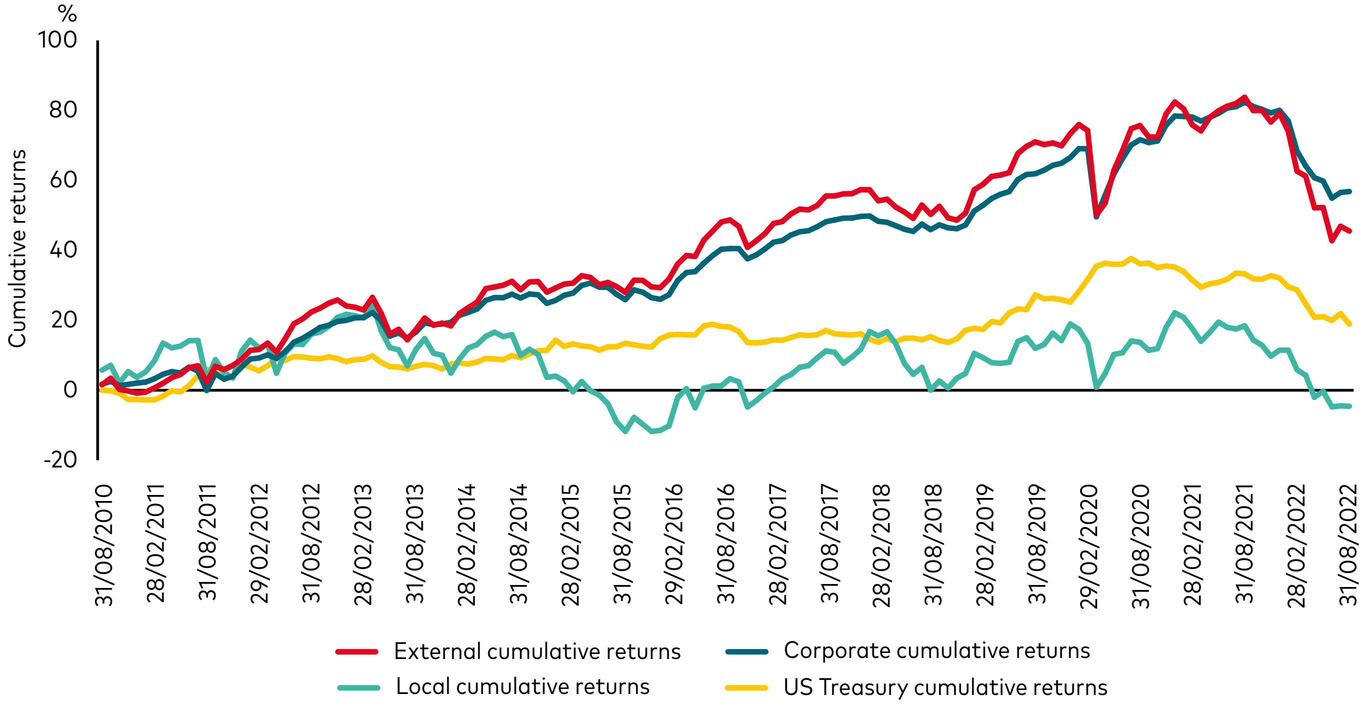
Because of their risk profile, EM bonds typically have wider spreads—and therefore higher yields—than those in developed markets. As at the end of September 2022, the J.P. Morgan EMBI Global Diversified Sovereign Index yielded 9.57% compared with 3.70% for the broad Bloomberg Global Aggregate Bond Index[7]. Therefore, by investing in EM bonds, investors can be compensated for the higher risks involved, as the chart below shows.

5 EM countries comprised approximately 2.4% of the Bloomberg Global Aggregate Bond Index as at 31 October 2012 and 11.7% as at 31 October 2022.

6 Source: Morningstar Direct, 1 October 2002 to 31 October 2022. JP Morgan EMBI Global Index shows similar returns versus the MSCI ACWI Index, and similar volatility to the Bloomberg Global Aggregate Bond Index.

7 Yield to maturity per Bloomberg, as of 30 September 2022.

Historical returns of asset classes since 2010



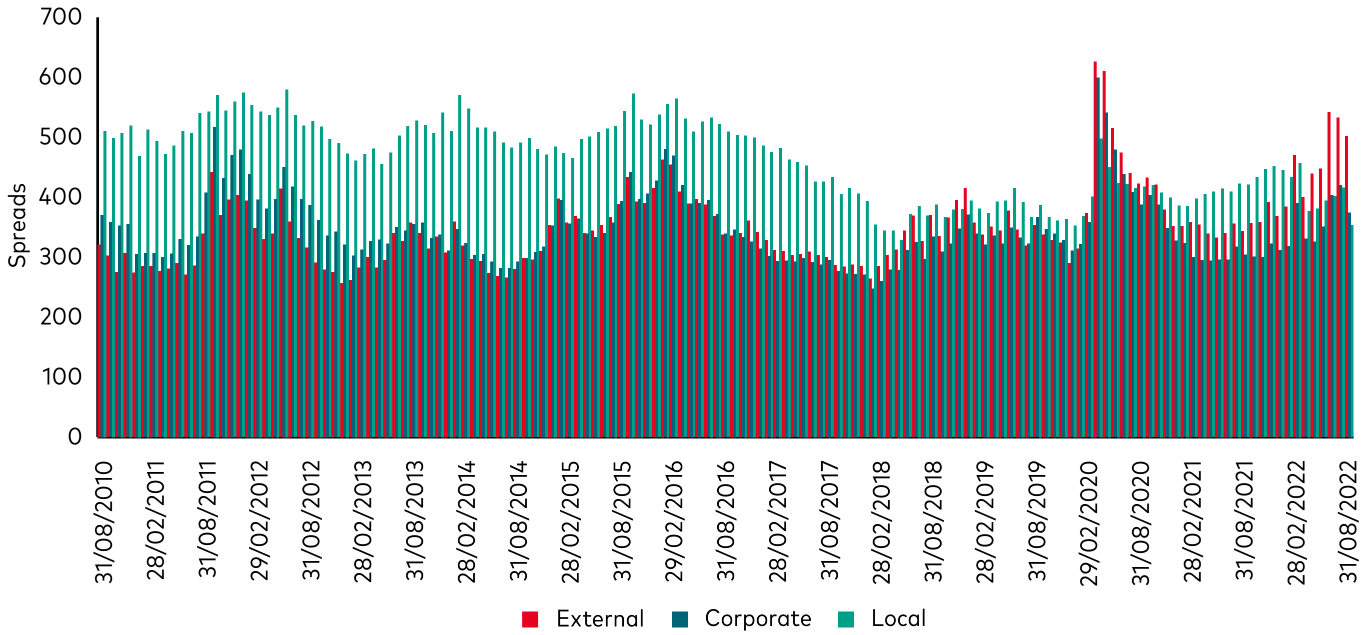
Source: Bloomberg, as at 31 August 2022. Indices shown are: J.P. Morgan EMBI Global Diversified Composite Index, J.P. Morgan Corporate EMBI Broad Diversified Composite Index, J.P. Morgan GBI-EM Global Diversified Composite Unhedged USD Index, Bloomberg US Treasury Index. Returns are in USD and calculated on a total return basis.

Past performance is not an indicator of future results.

EM local-currency bond returns have become slightly less favourable relative to US Treasuries in recent years because of the steady strengthening of the US dollar, but EM debt remains a diversification lever within a portfolio.

The chart below shows the yield spreads of external, local and corporate EM bonds relative to US Treasury bonds over the past 12 years.

External, local and corporate EM bond spreads



Past performance is not an indicator of future results.

Source: Bloomberg, as at 31 August 2022. Notes: 'External' refers to the J.P. Morgan EMBI Global Diversified Sovereign Spread, 'Corporate' refers to the J.P. Morgan CEMBI Diversified Broad Composite Blended Spread, 'Local' refers to the J.P. Morgan GBI-EM Global Diversified Composite Yield to Maturity. External refers to hard-currency emerging market debt.

As the chart illustrates, credit spreads peaked during the onset of the Covid-19 pandemic, highlighting the "flight to quality" we tend to see during distressed periods which increases the risk premium versus US Treasury bonds. More recently, spreads widened in response to Russia's invasion of Ukraine in early 2022.

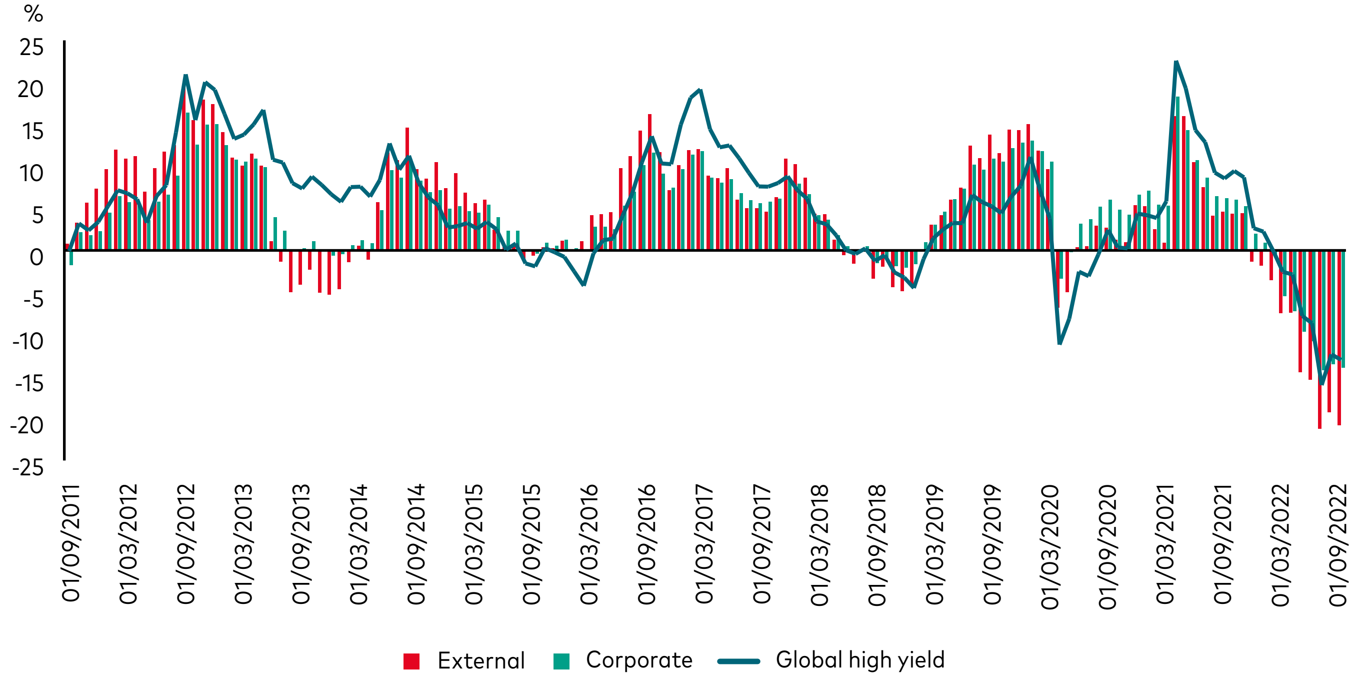
Correlation to other markets

EM debt returns are often inversely correlated to those in many developed market asset classes, meaning EM bonds can act as a strong diversifier, especially in portfolios which have a US focus.

But EM debt—particularly the external and corporate markets—also tends to be highly correlated to global high-yield bonds, as illustrated in the chart below.

However, EMs are more diversified than high-yield, given the wide range of economies they include. For example, the EM universe contains major oil-exporters such as Saudi Arabia and Qatar as well as countries like Argentina and Brazil, whose economies are more reliant on the export of food commodities. Because of this variety, the returns across EMs may differ depending on market conditions - but by holding an EM bonds allocation, investors can achieve similar returns to high-yield debt, with more diversification.

Annualized returns for EM external and corporate bonds vs global high yield



Source: Bloomberg one-year annualised monthly returns. Notes: 'External' refers to the J.P. Morgan EMBI Global Diversified Composite, 'Corporate' refers to the J.P. Morgan Corporate EMBI Broad Diversified Composite Index Level and 'Global high yield' refers to the Bloomberg Global High Yield Total Return Index Value Hedged USD, from 30 September 2011 to 31 August 2022. Returns are in USD and calculated on a total return basis.

Past performance is not a reliable indicator of future returns.

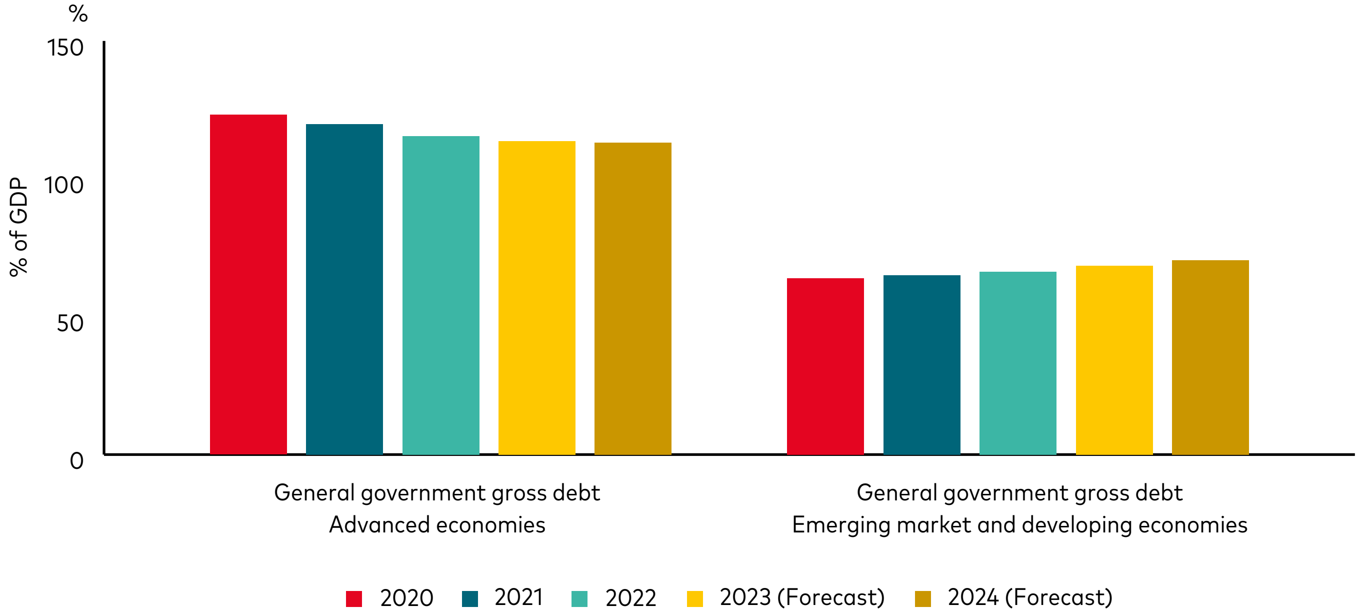
Another advantage of investing in EM debt relative to high-yield bonds is that debt recovery rates tend to be higher with governments than with corporate issuers. When a company defaults on its debt, this can often happen suddenly and in a disorderly fashion, making it difficult for investors to receive their investments – governments, however, are usually more accountable when it comes to honouring their obligations. Moreover, early warning signs of governments in distress are usually more apparent than is the case with corporates, as we have seen with Sri Lanka since 2020.

Corporate fundamentals

From a fundamentals perspective, EM corporates can appear healthier than their developed market counterparts in some respects. For example, EM countries often have a lower debt to GDP ratio, as most developed markets have historically enjoyed longer periods of lower interest rates, which has made them more willing to issue debt. In 2021, the average debt to GDP ratio for emerging markets was 63.4%, compared to 121.6% for advanced economies[8]. The same can also be seen for government debt, as illustrated in the chart below.

8 International Monetary Fund, Monetary and Financial Statistics, as at 31 December 2021.

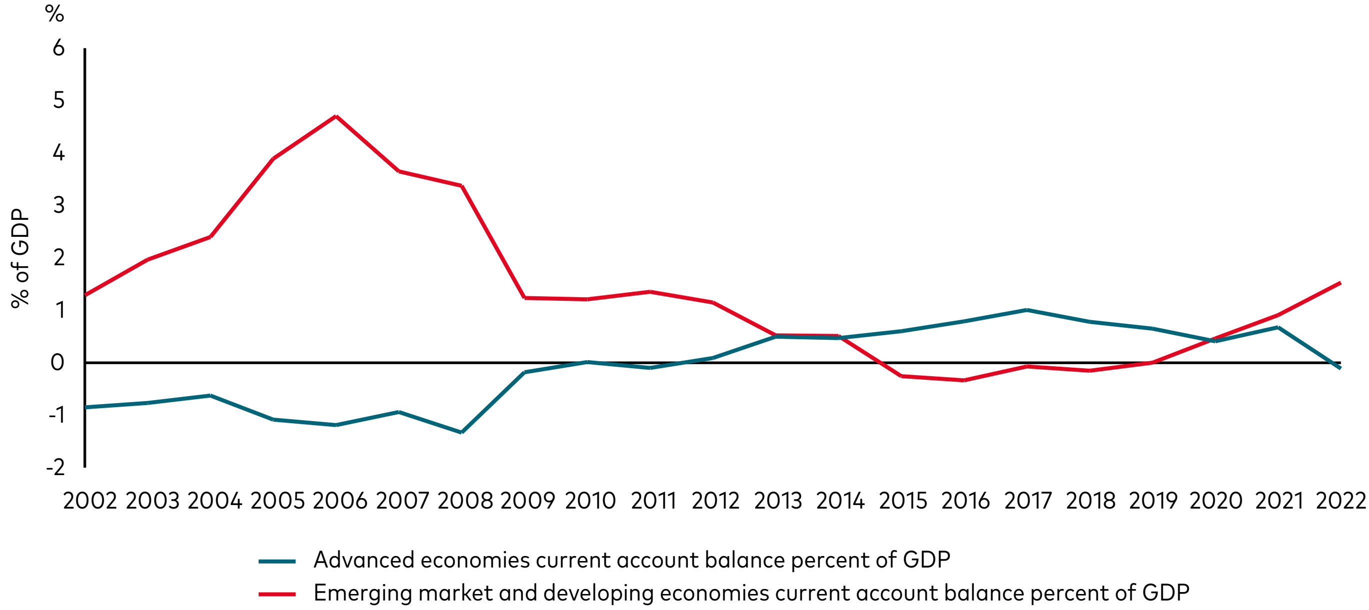
Government gross debt to GDP across advanced and emerging markets



Source: International Monetary Fund, World Economic Outlook Database, April 2022.

Additionally, many EM countries enjoy robust current account and fiscal balances, especially commodity-exporting nations—such as Brazil and Saudi Arabia—who have benefitted from rising commodity prices in recent years. The chart below shows the net current account balance as a percentage of GDP over time for developed and EM economies.

Current account balance across advanced and emerging markets



Source: International Monetary Fund, World Economic Outlook Database April 2022. Advanced economies used as a measure of developed countries, emerging market and developing economies used as a measure of Emerging Markets. Current account balance as % of GDP from 2002-2022.

What are frontier markets?

Even within EMs, the diversification opportunities are vast. For example, investors can incorporate some "frontier markets" in their portfolio, which have become more prominent in both hard currency and local issuance. These are less developed EMs, and they are typically more volatile and have weaker fundamentals than more established EM issuers. Examples of frontier EMs include Angola and Uganda. Frontier countries tend to offer even more yield potential than established EMs, while presenting an additional diversification element, as their risks are usually more idiosyncratic and uncorrelated to the wider EM market and global macroeconomic conditions. Local institutions traditionally represent the largest investors in frontier markets, rather than foreign investors. For these reasons, frontier markets can provide additional opportunities to generate alpha through relative value in an active portfolio. However, due to liquidity constraints, these would typically be a smaller part of the overall portfolio relative to that made up of more established EM issuers.

Why invest in emerging market debt?

EM bonds can offer investors diversification benefits and higher return potential than developed bond markets, and EMs represent a fast-growing share of global GDP. While EM economies carry their own set of risks, yields are higher than those in developed markets to compensate investors for this risk. Further, during distressed periods, the higher likelihood of restructuring and recovery can create attractive openings for active managers with the right approach. In summary, EM debt can provide ample opportunities to employ active strategies to exploit the risk premia and generate alpha within a bond portfolio.

Investment risk information

The value of investments, and the income from them, may fall or rise and investors may get back less than they invested.

Past performance is not a reliable indicator of future results.

Some funds invest in emerging markets which can be more volatile than more established markets. As a result the value of your investment may rise or fall.

Funds investing in fixed interest securities carry the risk of default on repayment and erosion of the capital value of your investment and the level of income may fluctuate. Movements in interest rates are likely to affect the capital value of fixed interest securities. Corporate bonds may provide higher yields but as such may carry greater credit risk increasing the risk of default on repayment and erosion of the capital value of your investment. The level of income may fluctuate and movements in interest rates are likely to affect the capital value of bonds.

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