

Schroders



Schroders Emerging Markets Lens: Emerging Market Debt

Strategic Research Unit

June 2023

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Summary

Hard currency emerging market debt (EMD):

- The hard currency EM bond index yield is elevated relative to its long term history.
- This is due to the elevated spread on the high yield (HY) sovereign index. The spread on the investment grade (IG) sovereign market is below its historical average.
- In the corporate market, the IG and HY spreads are relatively close to average levels.

Local currency EMD:

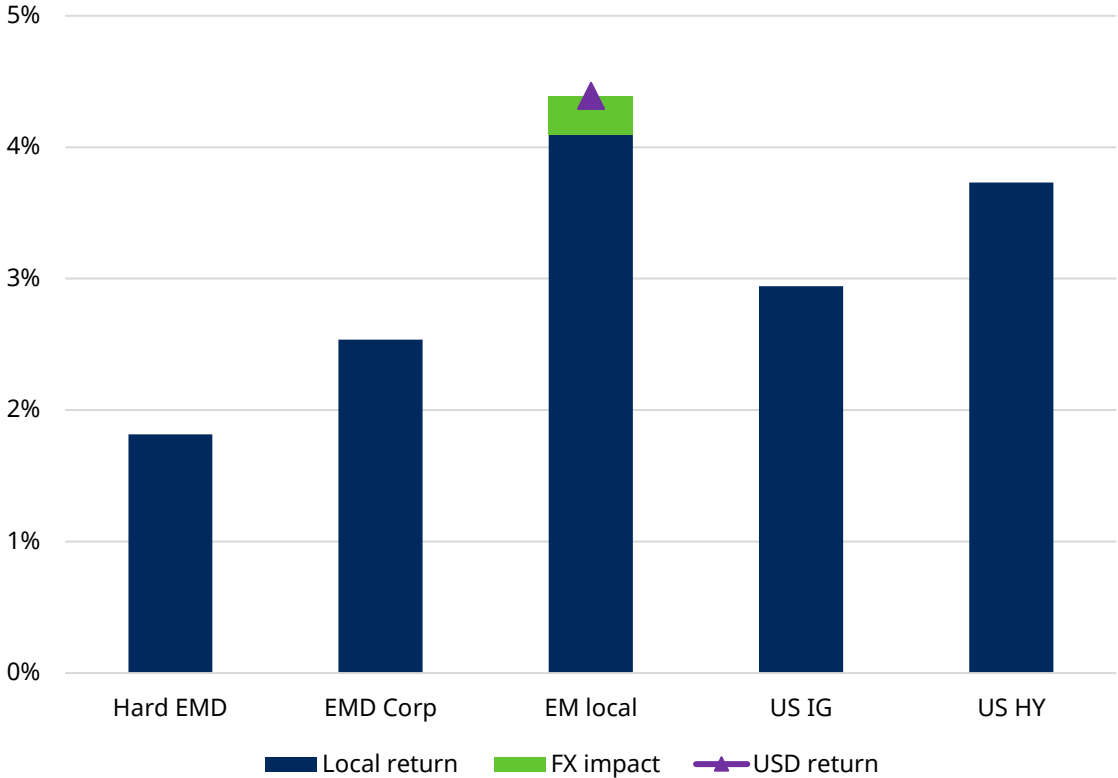
- The real yield pickup over developed market (DM) bonds has fallen to a very low level. This is primarily due to the sharp decrease in EM real yields in the past 12 months, as inflation has increased by more than nominal yields. EM inflation is now falling though, and could provide some relief.
- The average local EM yield curve is now inverted (downward sloping).
- There are undervalued **currencies** in all three EM regions. The degree of value in EM currencies varies significantly.

Source: Schroders, Refinitiv Datastream, JP Morgan, Schroders Strategic Research Unit. Data as at 31 May 2023.
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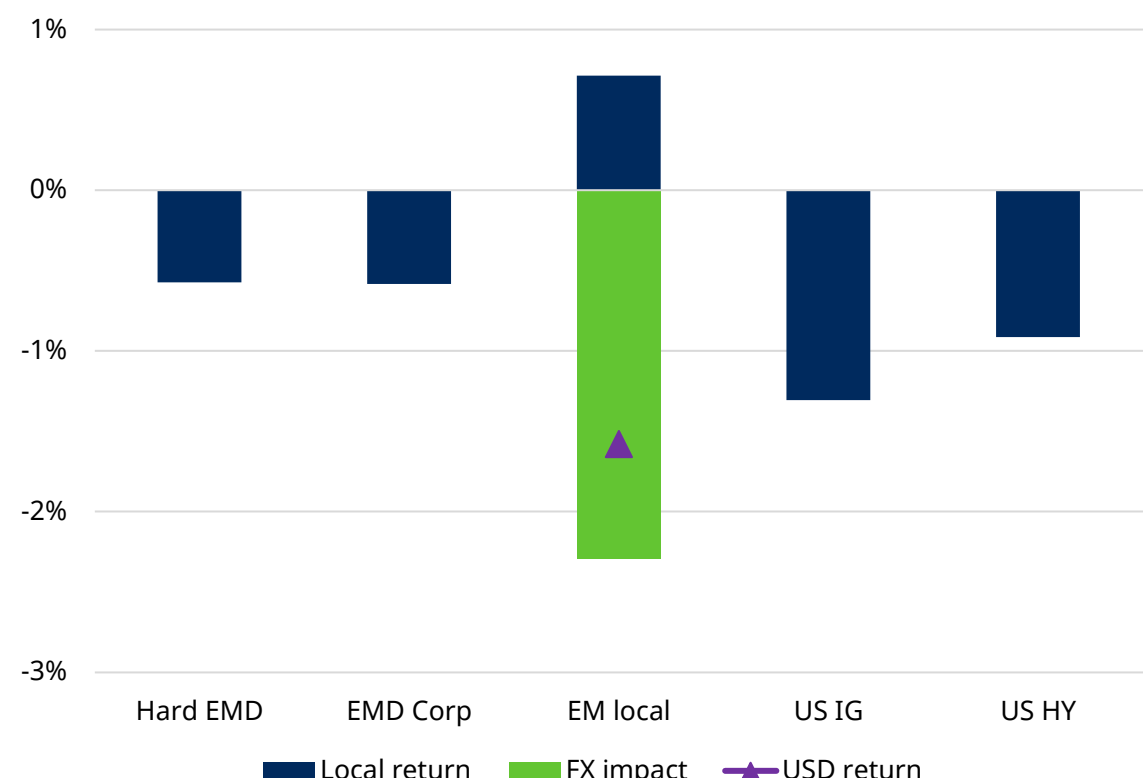
EMD came under pressure in May, but remains positive YTD

Local EMD continues to lead YTD

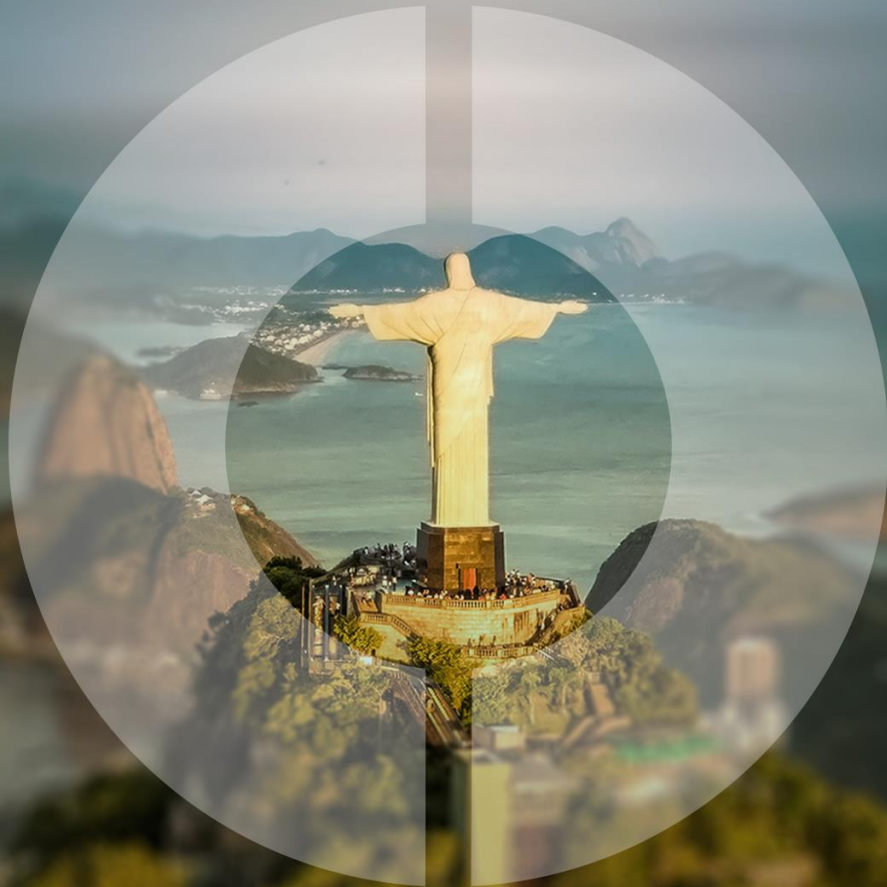
Total return YTD



Total return May



*Local currency = US dollar for all apart from local EMD which is in the relevant local EM currency
 Source: Schroders, Refinitiv Datastream, JP Morgan, Schroders Strategic Research Unit. Data as at 31 May 2023.
 Please see relevant disclaimers on page 37.



Emerging market debt: hard currency

Summary: hard currency emerging market debt

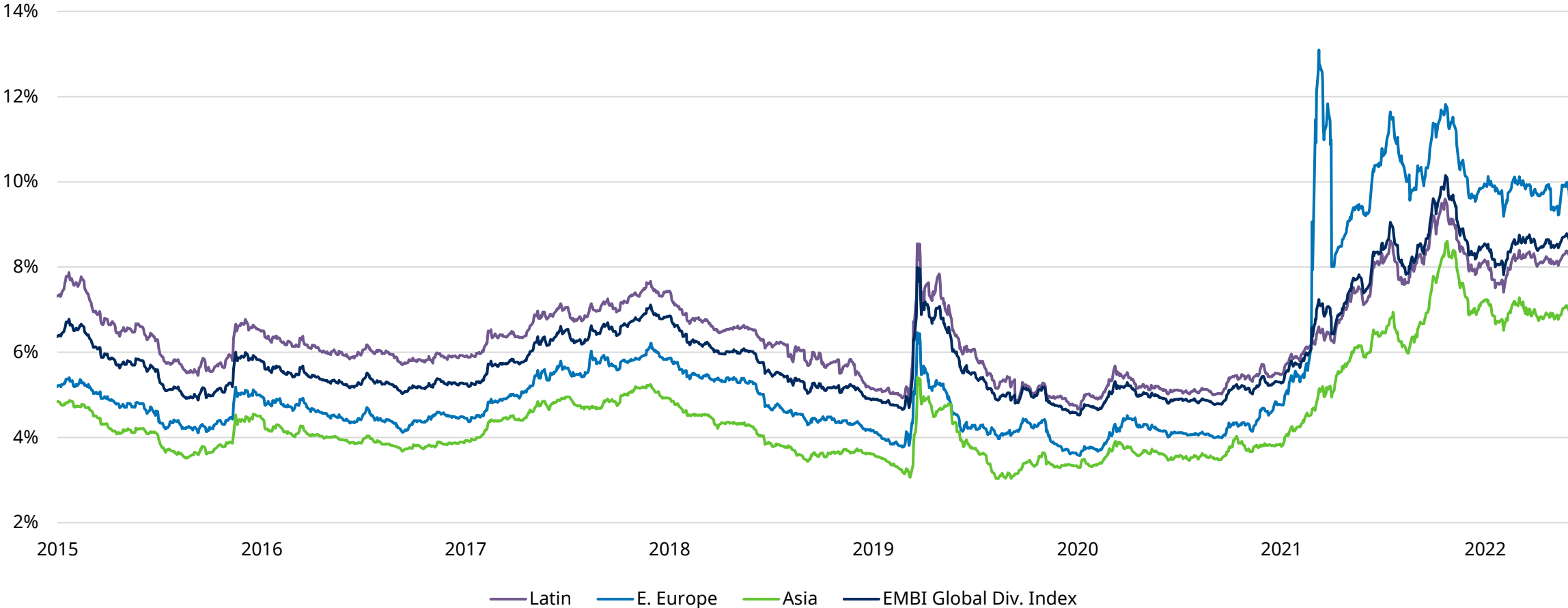
- The hard currency sovereign EMD index yield is well above its long term history.
- In sovereign EMD, the spread dispersion between countries remains wide. Larger countries and commodity exporters in general are doing fine, but some commodity importers and smaller countries are feeling the pain.
- The rise in US yields through 2022 increased the cost of debt for EM issuers. The sovereign HY index spread remains at an elevated level. The IG spread is below its historical median.
- In corporate EMD, the high yield (HY) index spread and the IG spread are close to their historical medians.
- Credit quality has worsened since the pandemic. This has been compounded by the challenges seen in 2022 for issuers included in major sovereign and corporate EMD benchmarks.

Source: Schroders, Refinitiv Datastream, JP Morgan, Schroders Strategic Research Unit. Data as at 31 May 2023.
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EM hard currency index yield is elevated relative to history

Despite some moderation to 8.5% from a peak of over 10% last October

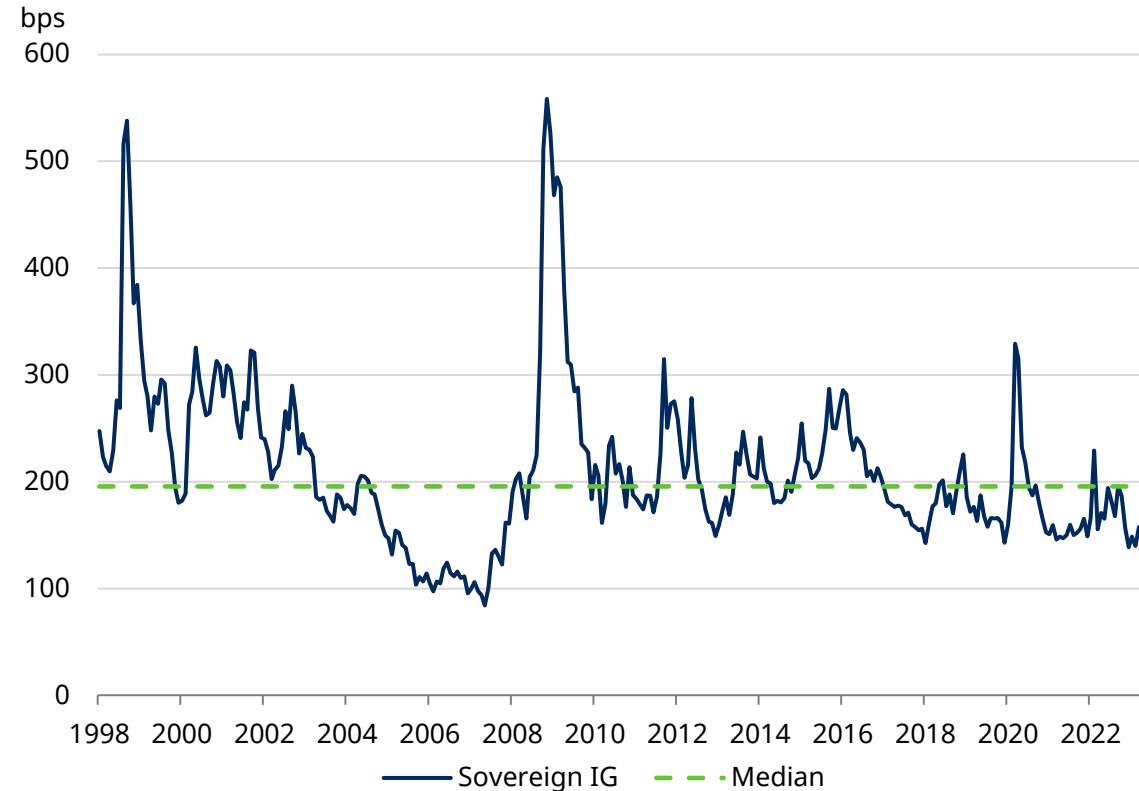
Hard currency sovereign EMD regional index yield



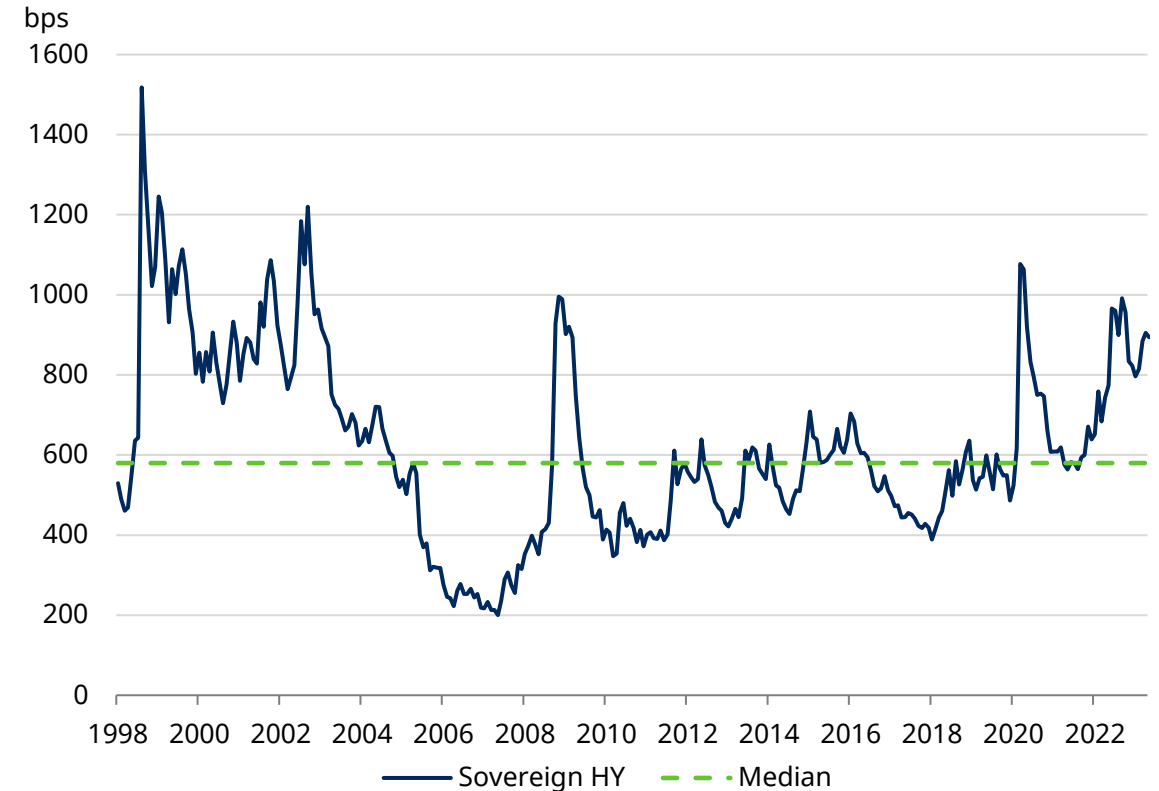
Russia was removed from all JP Morgan EMD indices from 31 March 2022.
Source: Schroders, JP Morgan. Data as at 2 June 2023. Please see relevant disclaimers on page 37.

Valuation of hard currency sovereign EMD

Hard currency sovereign EMD IG spread



Hard currency sovereign EMD HY spread

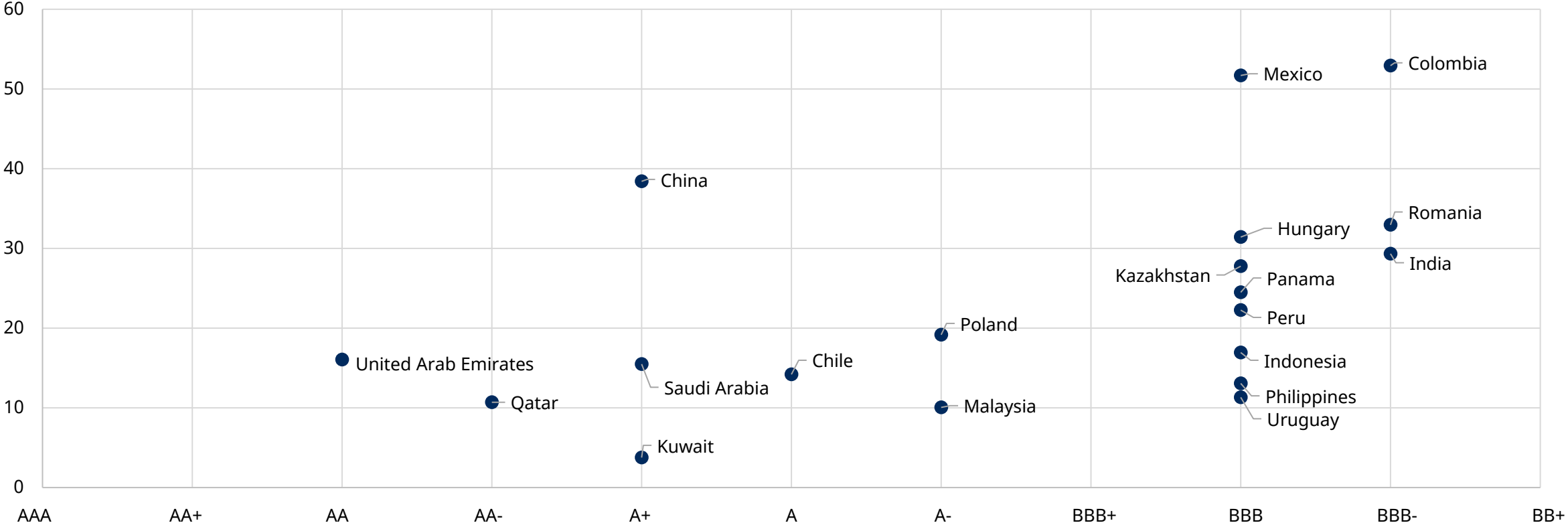


IG spread is below the historical median; the HY spread remains elevated

Source: Refinitiv Datastream, J.P. Morgan. Data as at 31 May 2023. Please see relevant disclaimers on page 37.

Duration adjusted spreads of IG countries

Hard currency sovereign EMD IG: spread vs. duration vs. credit rating

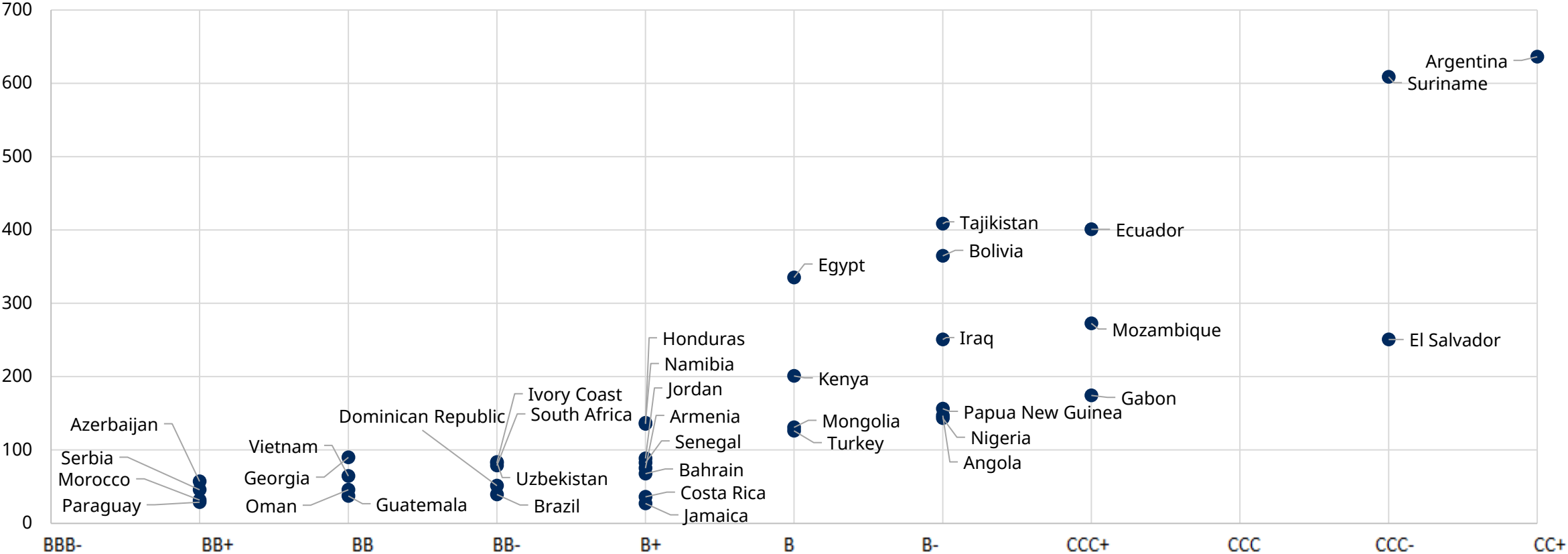


¹The JPMorgan EMBI Global Diversified Index includes both sovereign and quasi-sovereign bonds. The y-axis shows spread per unit of duration, in basis points. Source: Schroders, Refinitiv Datastream, J.P. Morgan. Data as at 31 May 2023. Please see relevant disclaimers on page 37.

Duration adjusted spreads of HY countries

Significant variability between the countries

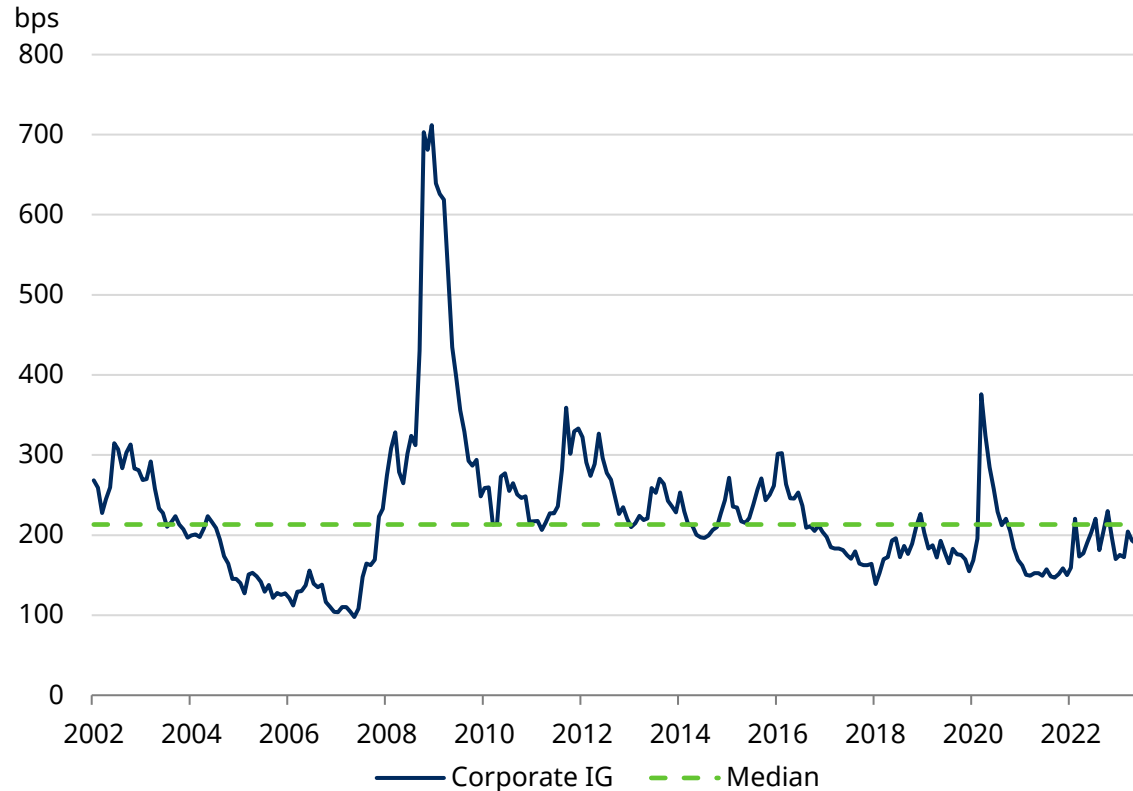
Hard currency sovereign EMD HY: spread vs. duration vs. credit rating



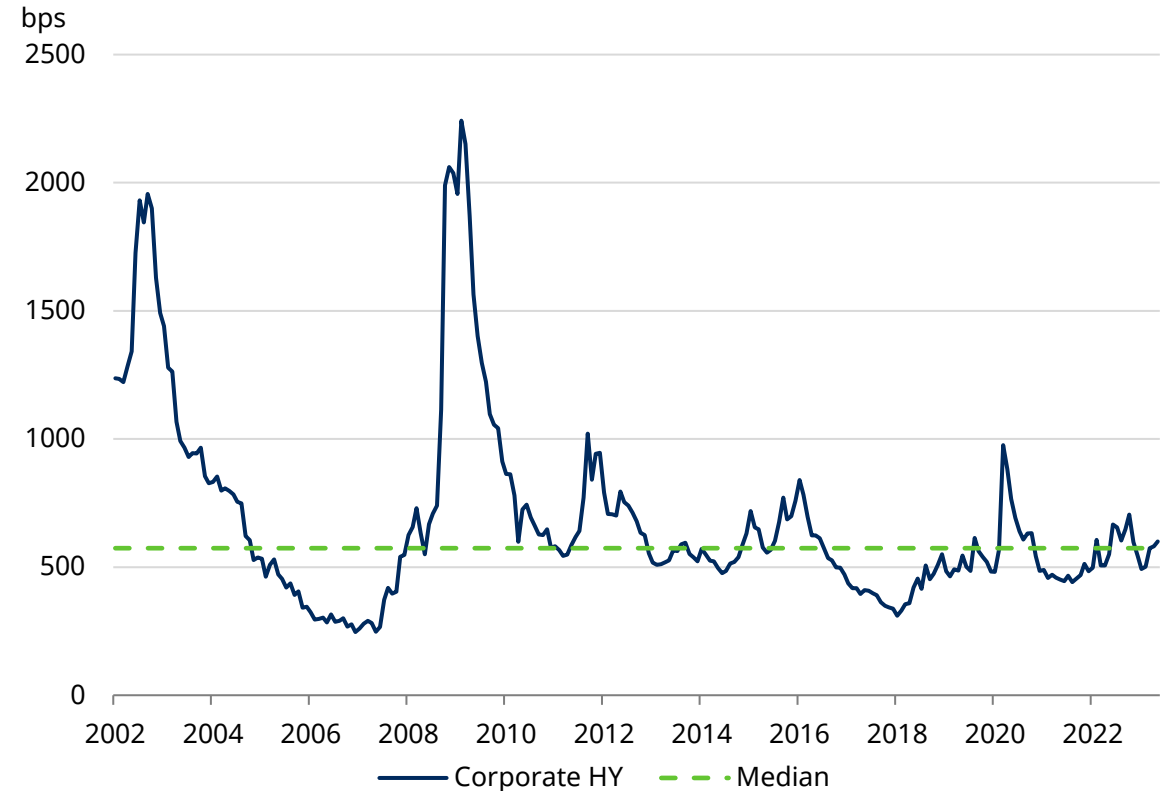
The y-axis shows spread per unit of duration, in basis points.
 Source: Schroders, Refinitiv Datastream, J.P. Morgan. Data as at 31 May 2023. Please see relevant disclaimers on page 37.

Valuation of hard currency corporate EMD

Hard currency corporate EMD IG spread



Hard currency corporate EMD HY spread



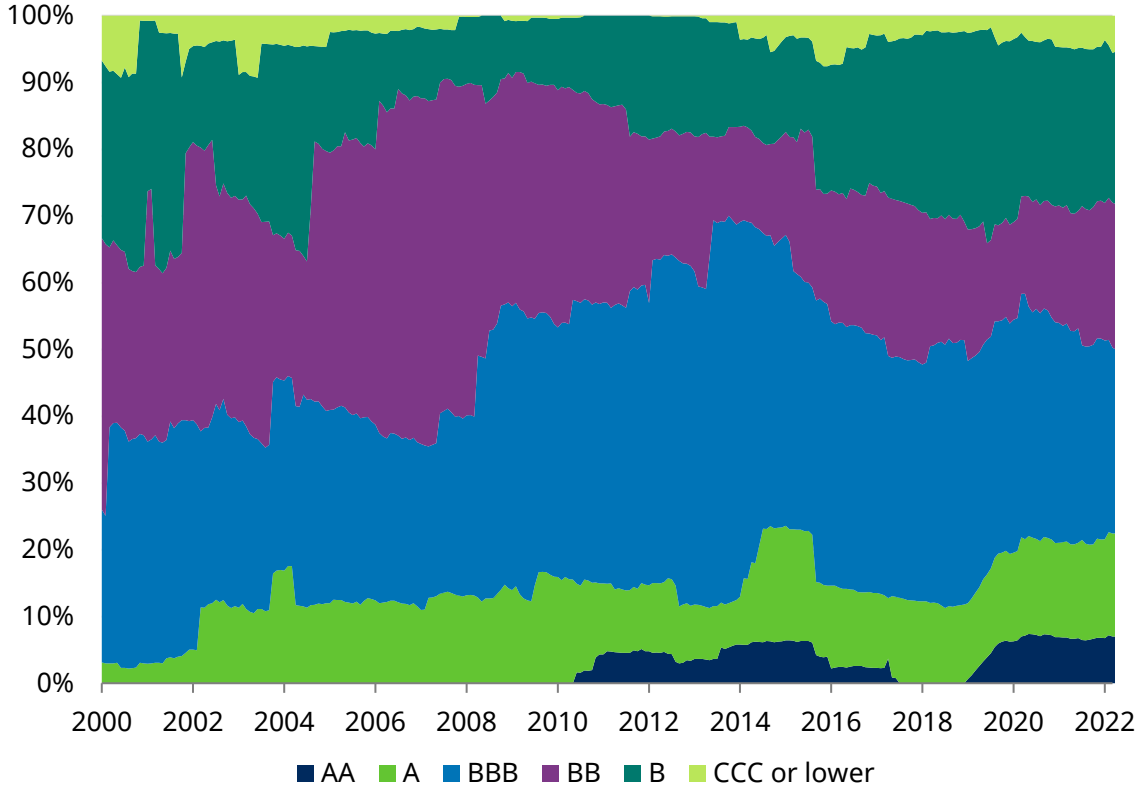
EM IG corporate and HY spreads are close to their historical medians

Source: Refinitiv Datastream, J.P. Morgan. Data as at 31 May 2023. Please see relevant disclaimers on page 37.

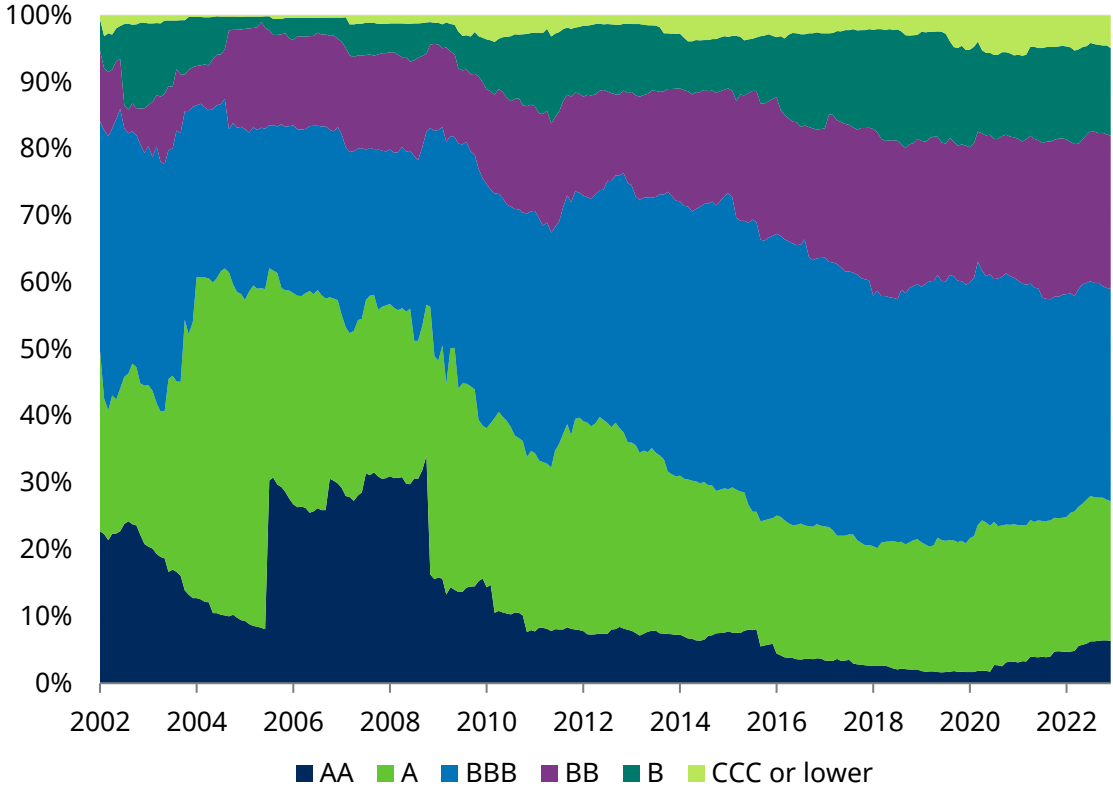
EMD historical ratings split

Share of IG bonds has fallen in the sovereign and corporate indices in the last 10 years

Sovereign EMD ratings split



Corporate EMD ratings split



Source: Schroders, J.P. Morgan. Data as at 31 May 2023. Please see relevant disclaimers on page 37.

Characteristics of EM hard currency issuers

Hard currency corporate issuers



■ Financials ■ Nonfinancials

Hard currency sovereign issuers



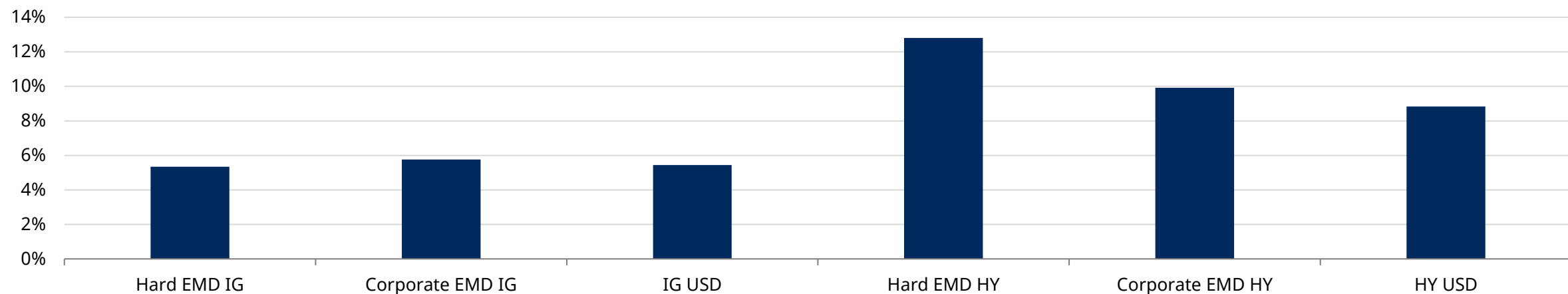
■ Sovereign ■ Quasi Sovereign

Source: Refinitiv Datastream, J.P. Morgan. Data as at 31 May 2023. Please see relevant disclaimers on page 37.

Hard and corporate EMD offer a spread pick-up over equivalent rated US corporate debt

	Hard EMD IG	Corporate EMD IG	IG USD	Hard EMD HY	Corporate EMD HY	HY USD
Yield	5.3%	5.8%	5.4%	12.8%	9.9%	8.8%
Spread (bps)	148	189	142	894	600	469
Duration	8.0	4.9	7.1	5.4	3.3	4.3
Rating	A3	A3	A3	B1	B1	B1
Percentage of EMD index	52.1%	58.3%	-	47.9%	41.7%	-

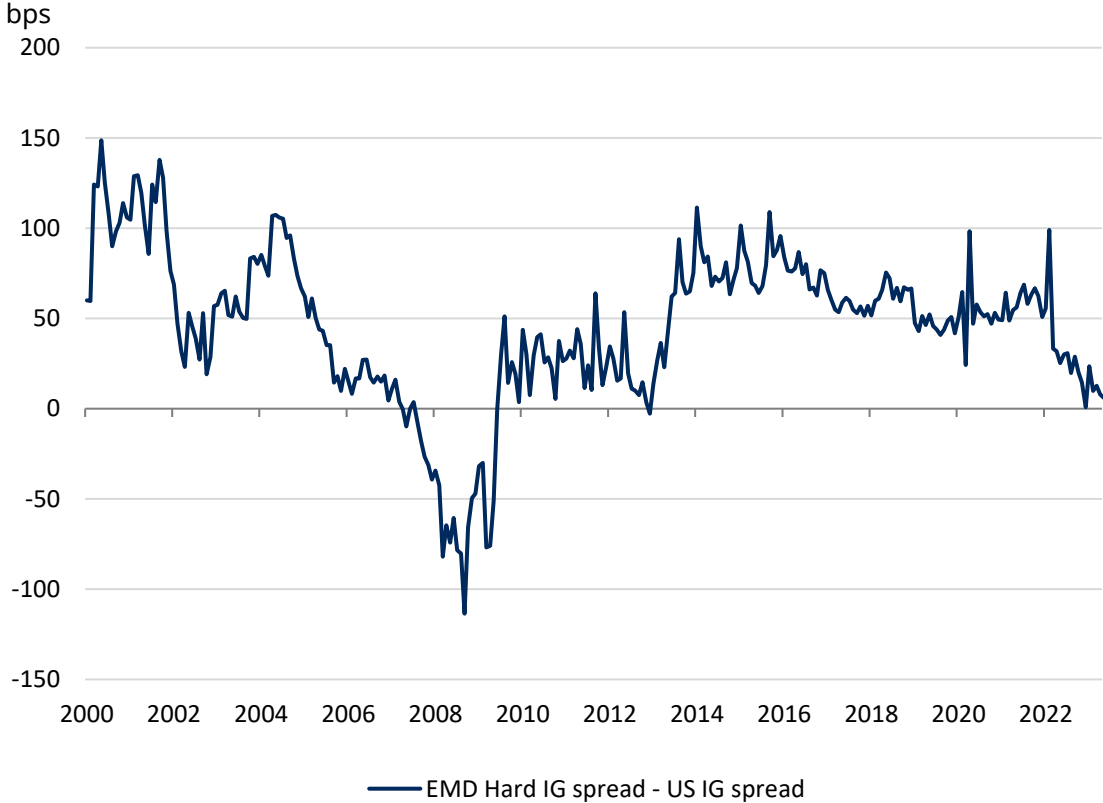
EM vs. DM yields



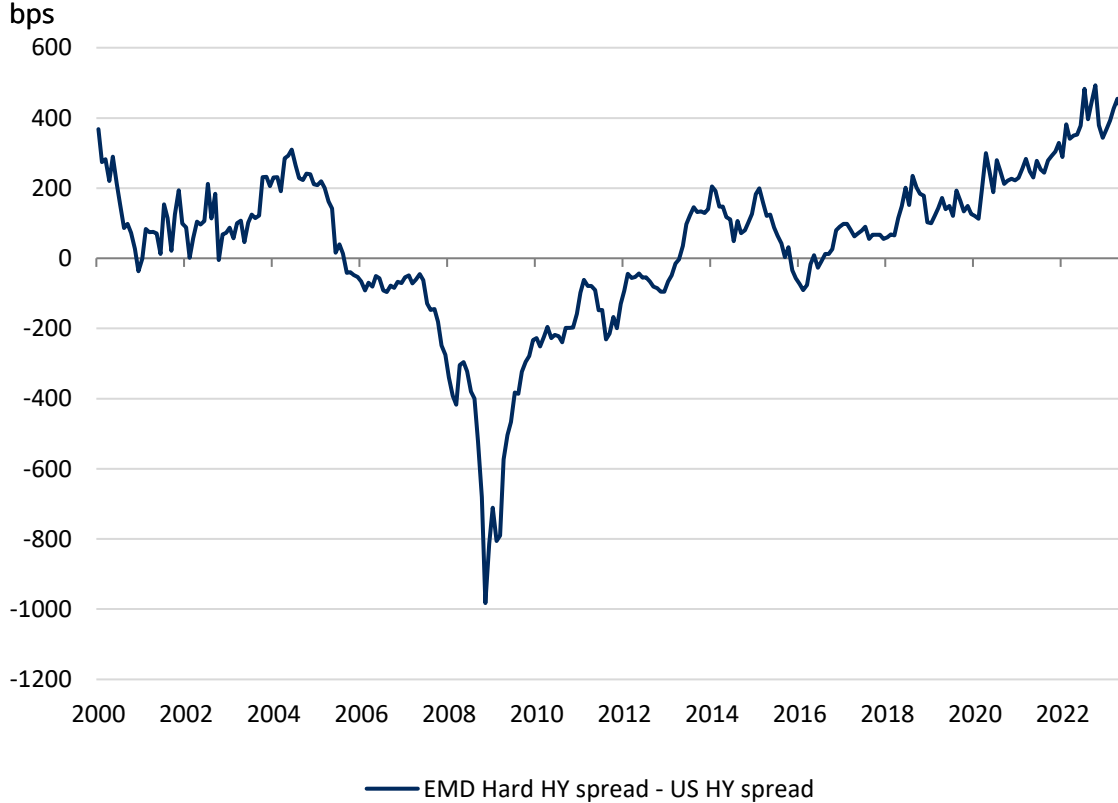
Source: Schroders, Refinitiv Datastream, ICE Data Indices, J.P. Morgan. Data as at 31 May 2023. Please see relevant disclaimers on page 37.

EM dollar debt: sovereign EMD vs. US corporates

Sovereign EMD IG spread minus US IG spread



Sovereign EMD HY spread minus US HY spread

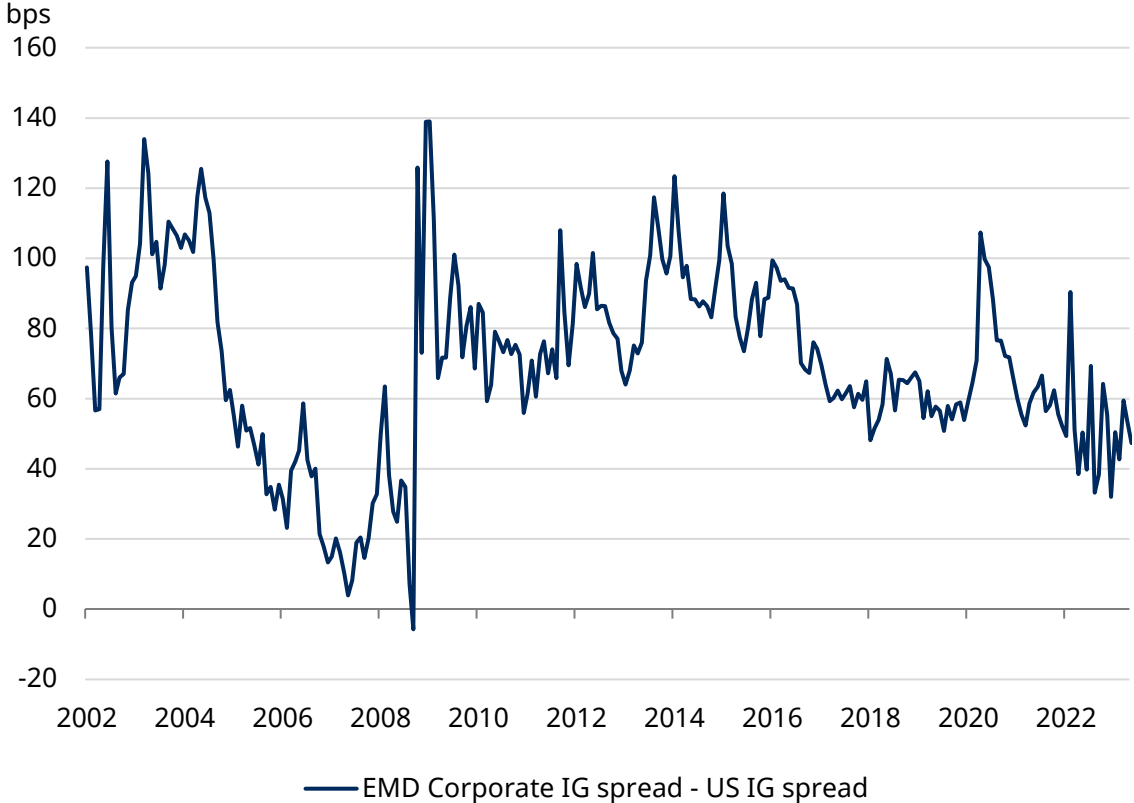


The sovereign EMD HY spread minus US HY spread is close to the top of its long term range

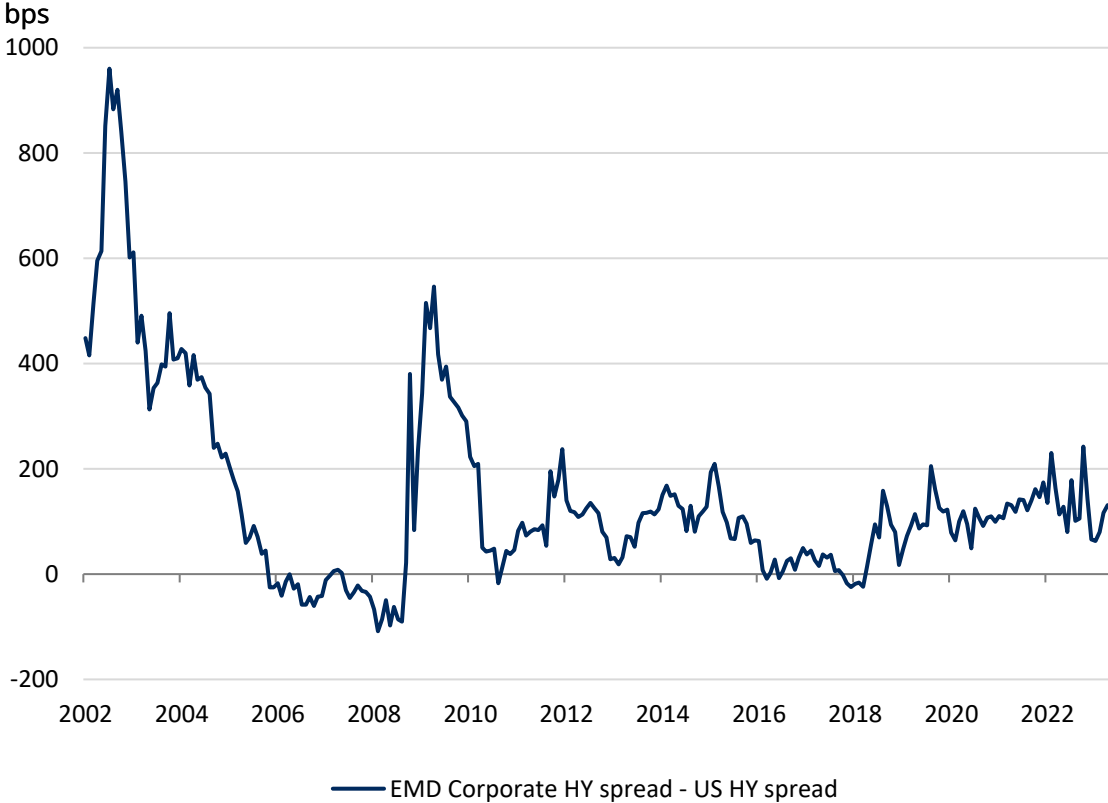
Source: Schroders, Refinitiv Datastream, ICE Data Indices, J.P. Morgan. Data as at 31 May 2023. Please see relevant disclaimers on page 37.

EM dollar debt: corporate EMD vs. US corporates

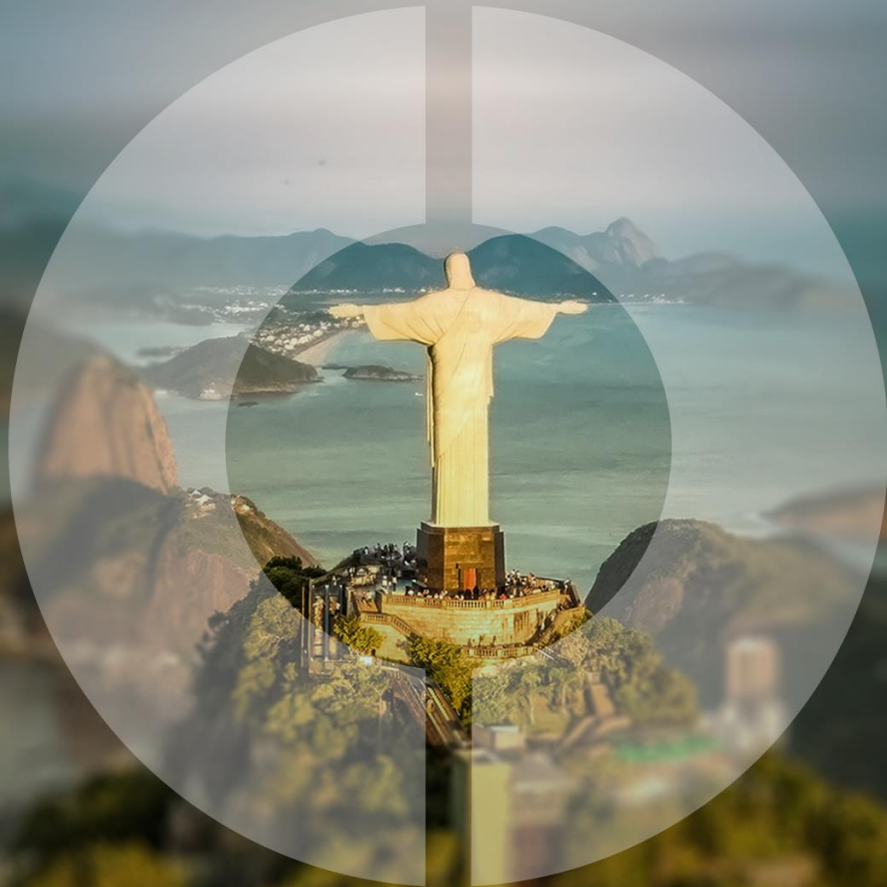
Corporate EMD IG spread minus US IG spread



Corporate EMD HY spread minus US HY spread



Source: Schroders, Refinitiv Datastream, ICE Data Indices, J.P. Morgan. Data as at 31 May 2023. Please see relevant disclaimers on page 37.



Emerging market debt: local currency

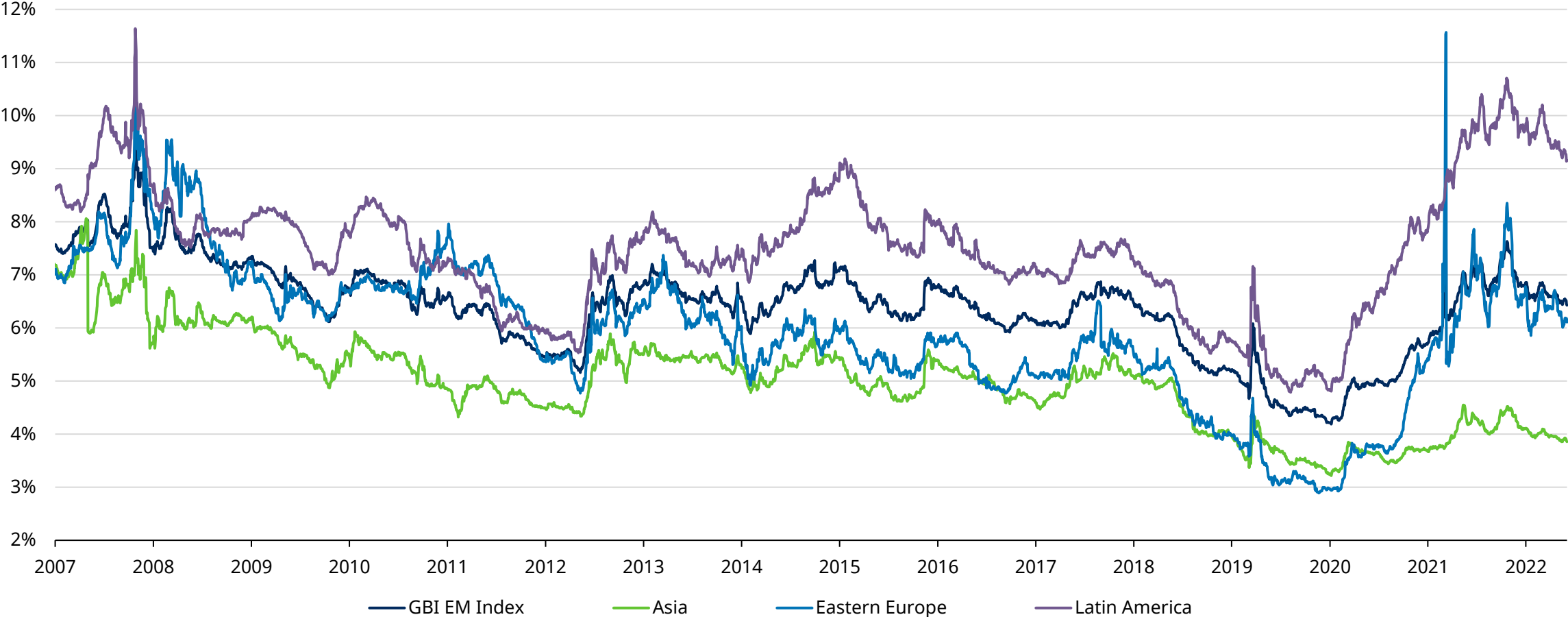
Summary: local currency emerging market debt

- The local EM index yield is close to the top of its ten year range, but this masks significant variation between regions.
- Various EM central banks have continued rate hiking cycles in 2023. The average EM policy rate is at its highest level since 2008.
- Headline and core EM inflation remain above target almost everywhere ex China. However, average EM inflation has turned, and is now falling.
- The average local EM yield curve is now inverted (downward sloping).
- The real yield premium of EM over DM is at the bottom-end of its post-GFC range. This is primarily due to the sharp decrease in EM real yields over the past 12 months, as inflation has increased by more than nominal yields. EM inflation is now falling though, and could provide some relief.

Source: Schroders, Refinitiv Datastream, JP Morgan, Schroders Strategic Research Unit. Data as at 31 May 2023. Please see relevant disclaimers on page 37.

EM local currency index yield is 6.4%

Yields of EM regions



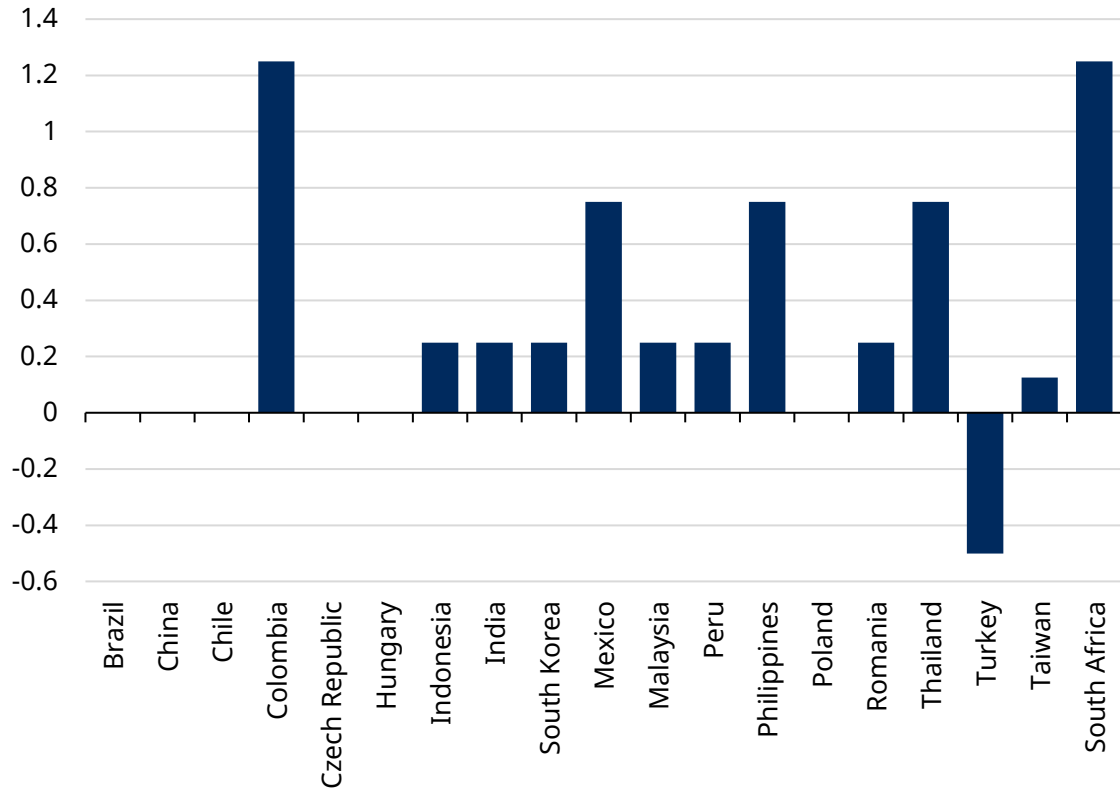
Yields vary significantly by region, and are notably higher in Latin America relative to the EM index

Source: Schroders, Refinitiv Datastream. Data as at 1 June 2023. Russia was removed from all JP Morgan EMD indices from 31 March 2022. Please see relevant disclaimers on page 37.

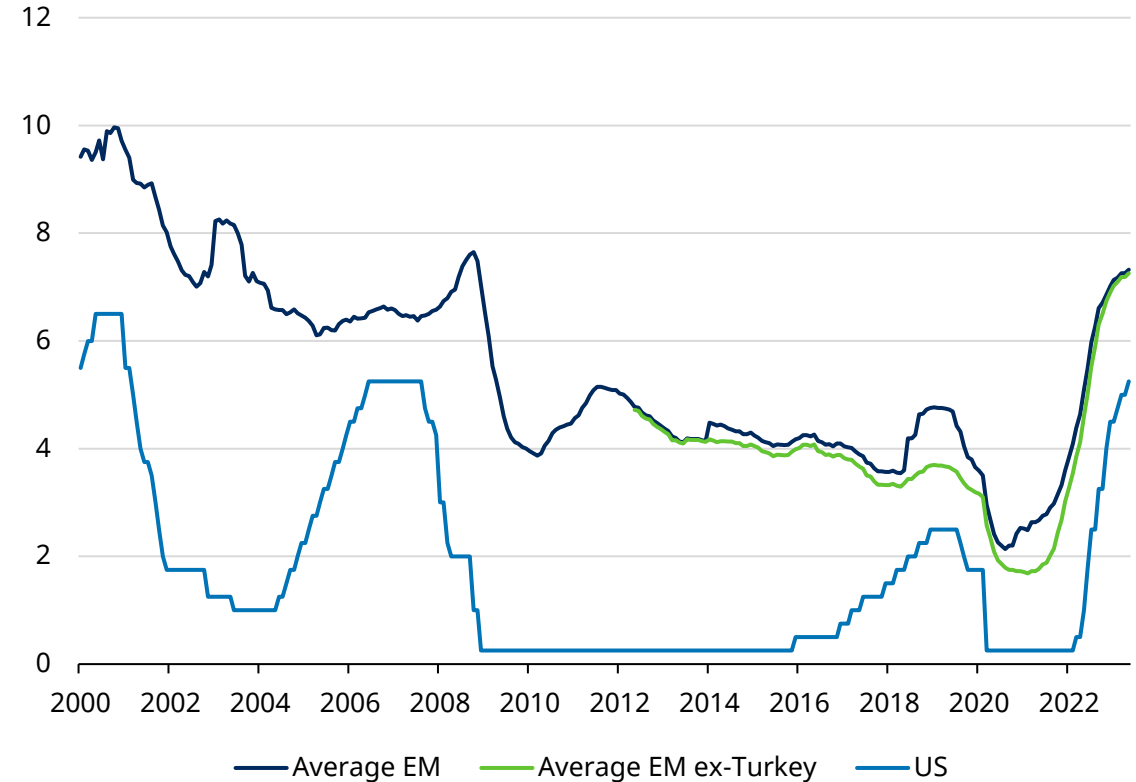
EM policy rates

Average EM policy rate is at its highest since 2008

Change in EM policy rates YTD (%)



Average EM policy rate¹ (%)



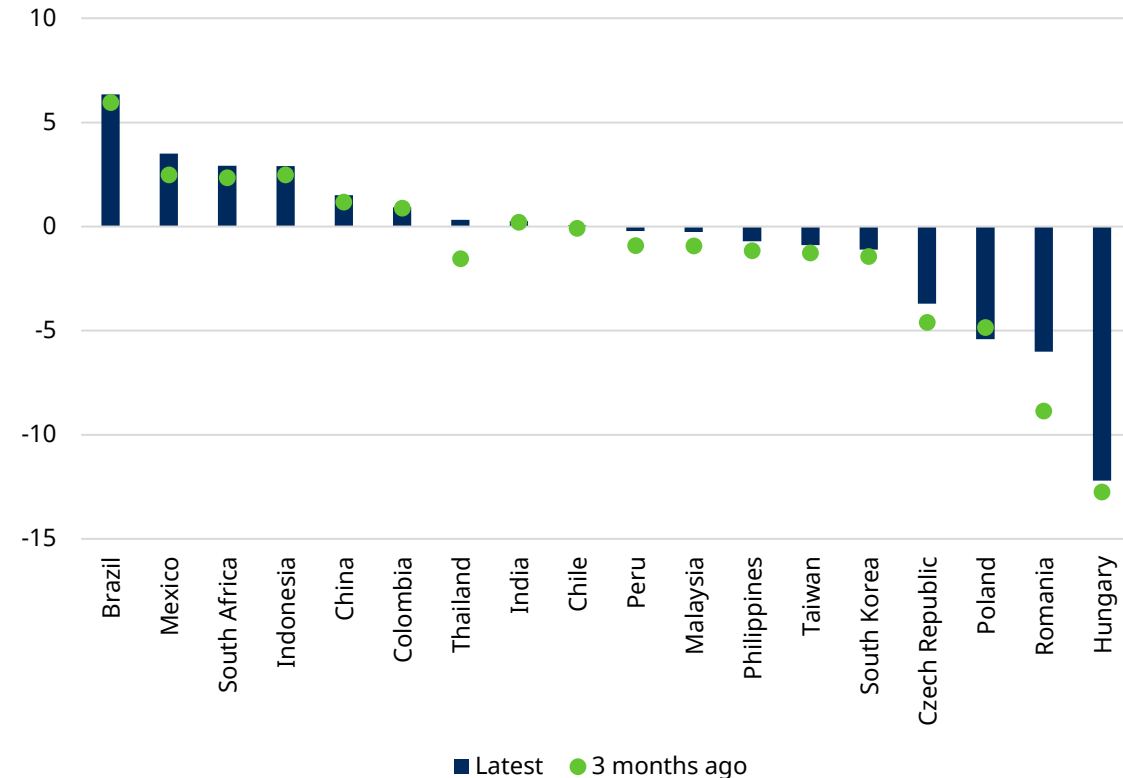
Various EM, with the exception of Turkey, have continued hiking cycles in early 2023

Source: Schroders, Refinitiv Datastream. Data as at 31 May 2023. ¹Based on 19 major EM countries. Please see relevant disclaimers on page 37.

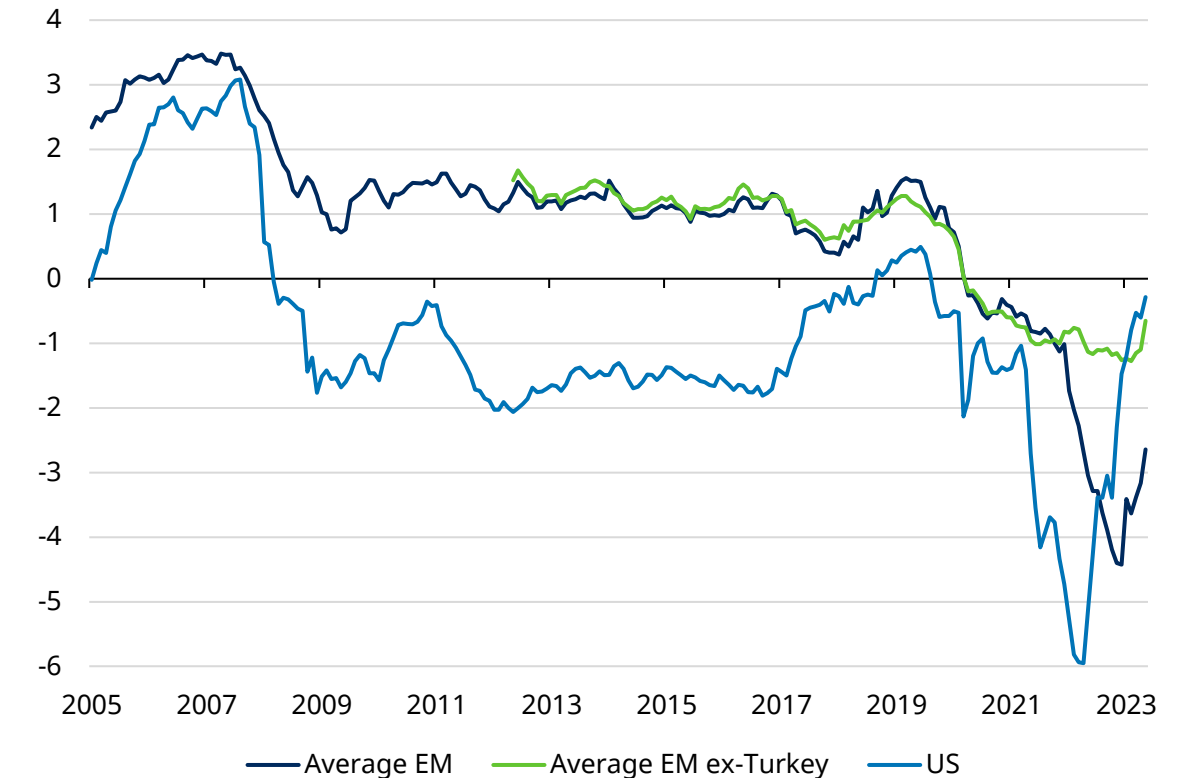
Various EM real policy rates are still negative

...especially in Eastern Europe

EM real policy rates (%)



Average EM real policy rate¹ (%)



¹Based on 19 major EM countries. Turkey has very high inflation at the moment, with the annual core inflation at 47%. At the same time, Turkey's policy rate is well below core inflation at 8.5%. Hence, Turkey's real policy rate is very negative at -38%, skewing the EM average.

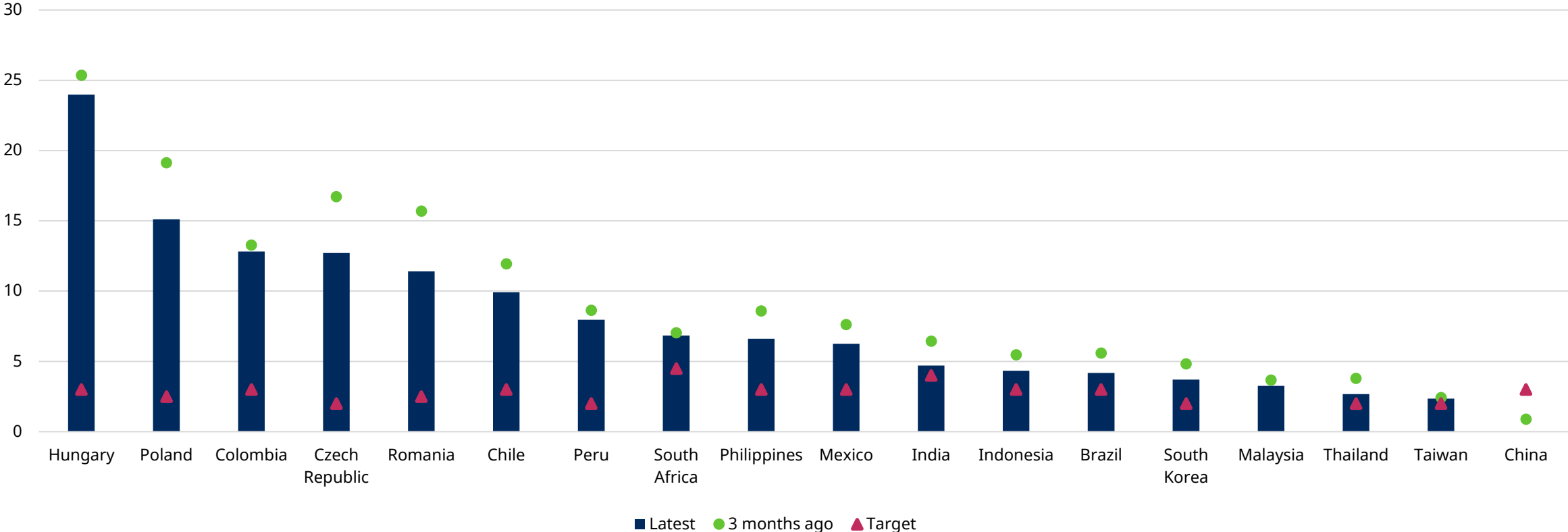
Source: Schroders, Refinitiv Datastream. Data as at 31 May 2023. Nominal policy rate minus annual core inflation.

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EM inflation

Headline inflation is above target everywhere ex China

Headline inflation (%)



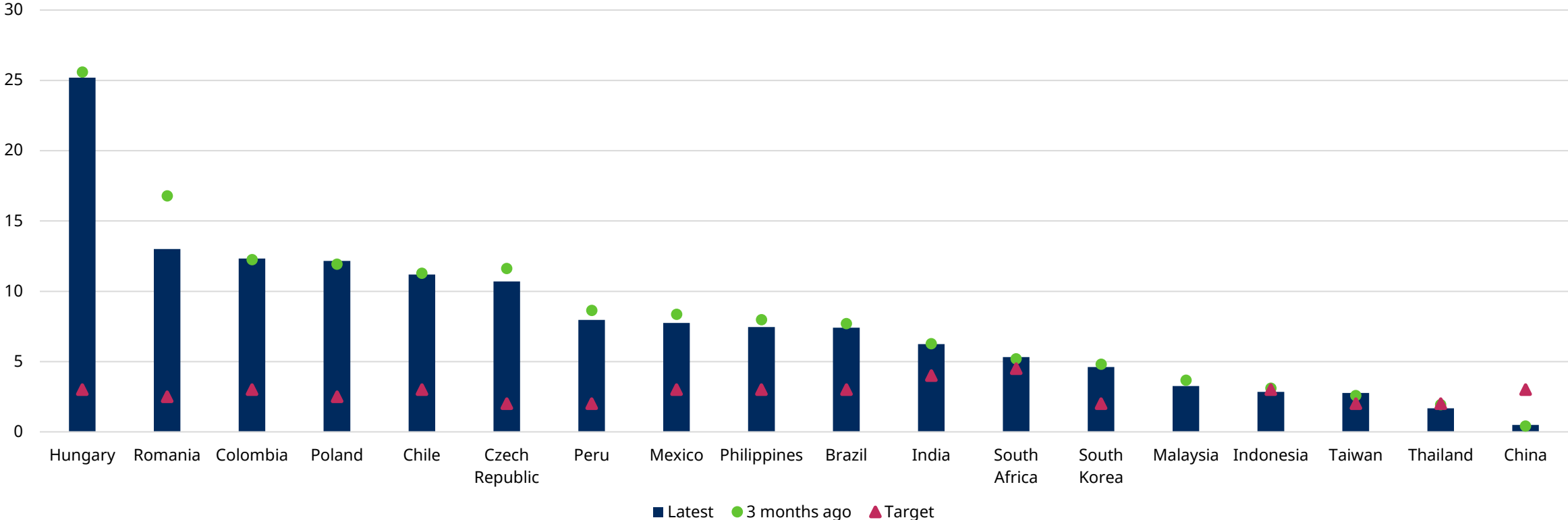
There are signs of disinflation in various EM

Turkey's annual headline inflation (40%) omitted from the figure.
Source: Schroders, Refinitiv Datastream. Data as at 31 May 2023. Please see relevant disclaimers on page 37.

EM core inflation

Core inflation is also above target in EM ex China, Thailand, and Indonesia

Core inflation (%)

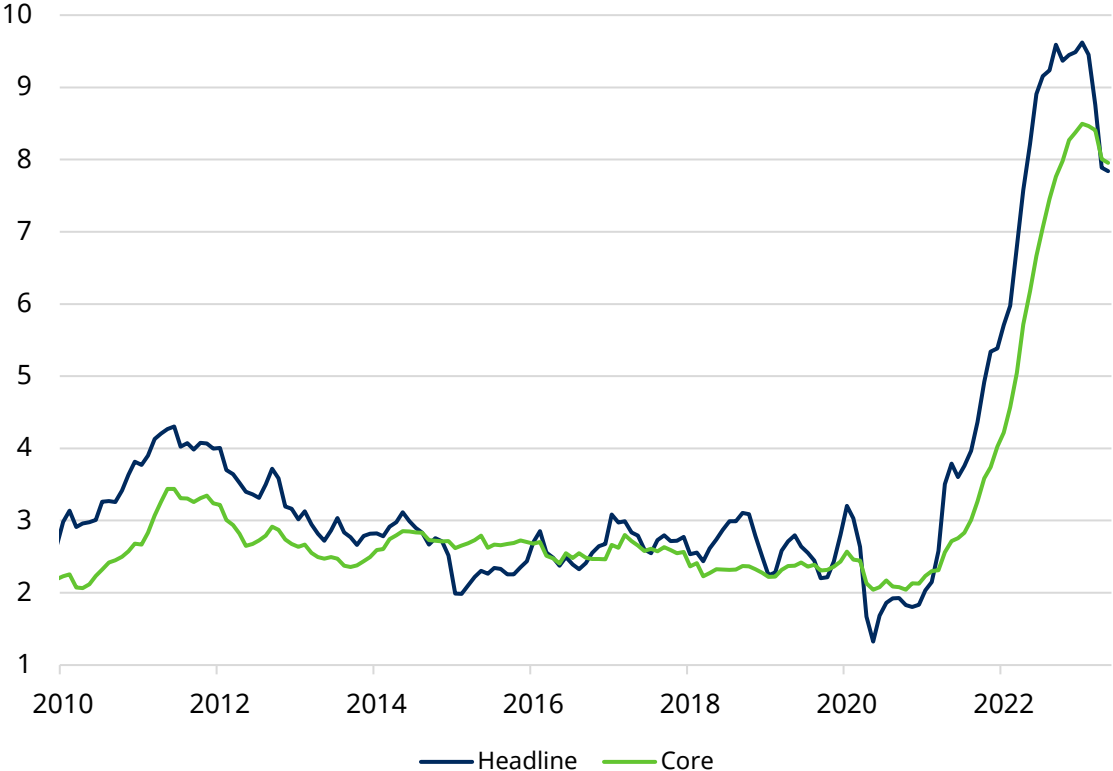


Turkey's annual core inflation (47%) omitted from the figure.
 Source: Schroders, Refinitiv Datastream. Data as at 31 May 2023. Please see relevant disclaimers on page 37.

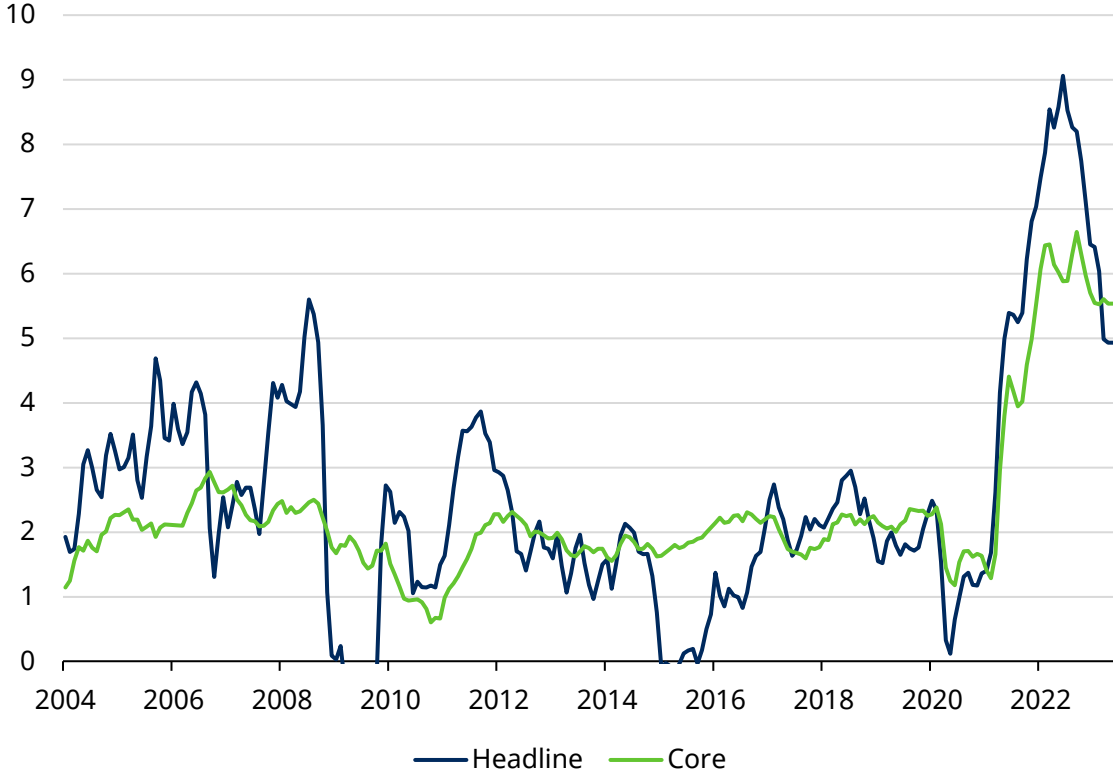
Headline EM inflation has started to fall

...and core is now coming down too

Average EM inflation ex Turkey¹ (%)



US inflation (%)



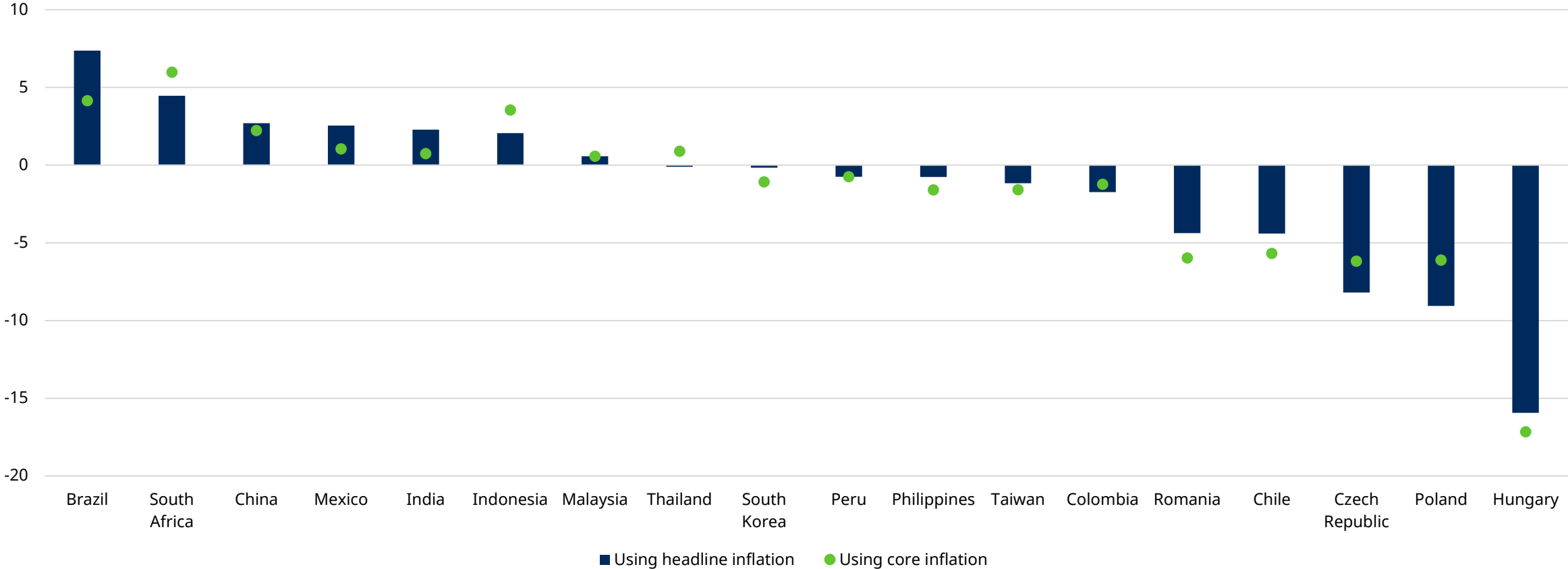
[Read more: Falling EM inflation points to rate cuts](#)

¹Based on 19 major EM countries. Turkey excluded because of significantly higher inflation in the country compared to the rest of the EM. Source: Schroders, Refinitiv Datastream. Data as at 31 May 2023. Please see relevant disclaimers on page 37.

Real bond yields are deeply negative in certain EM

EM Europe real bond yields are firmly negative relative to core inflation

Real 10 year yield

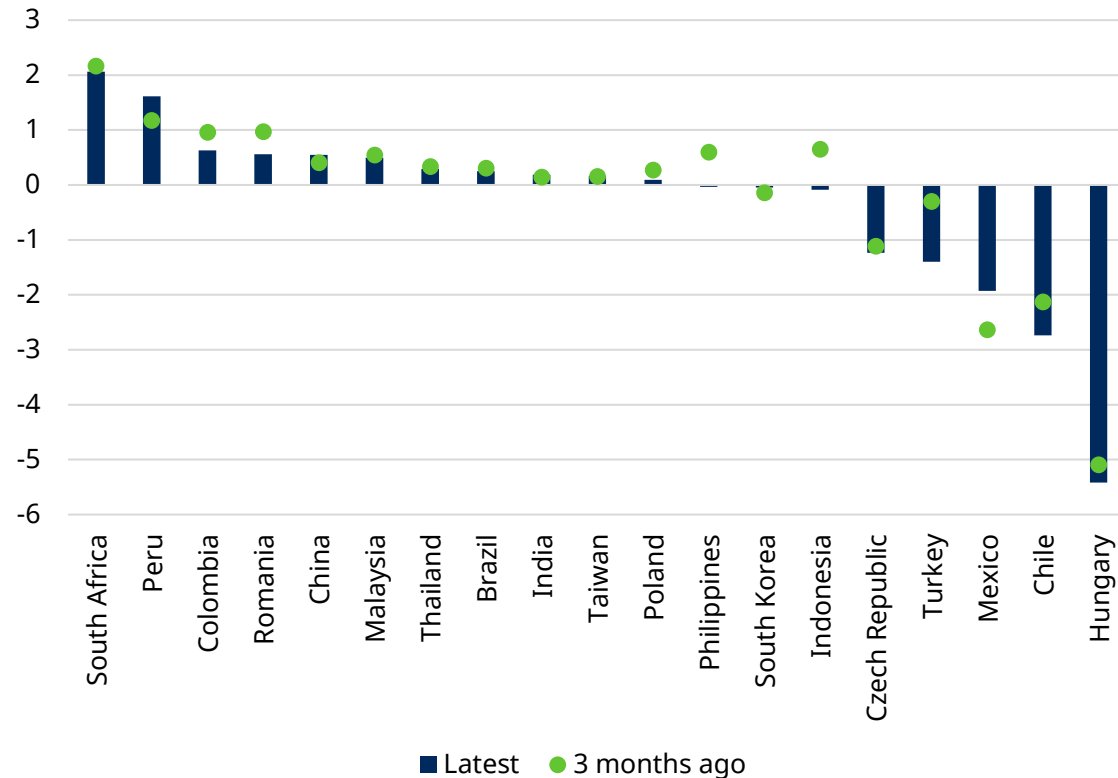


Real bond yields are positive in Brazil and South Africa in particular

Nominal 10 year yield minus annual headline or core inflation
Source: Schroders, Refinitiv Datastream. Data as at 31 May 2023. Please see relevant disclaimers on page 37.

EM yield curve shape

Yield curve steepness (10y yield – 2y yield)



Average EM yield curve steepness (10y yield – 2y yield)¹



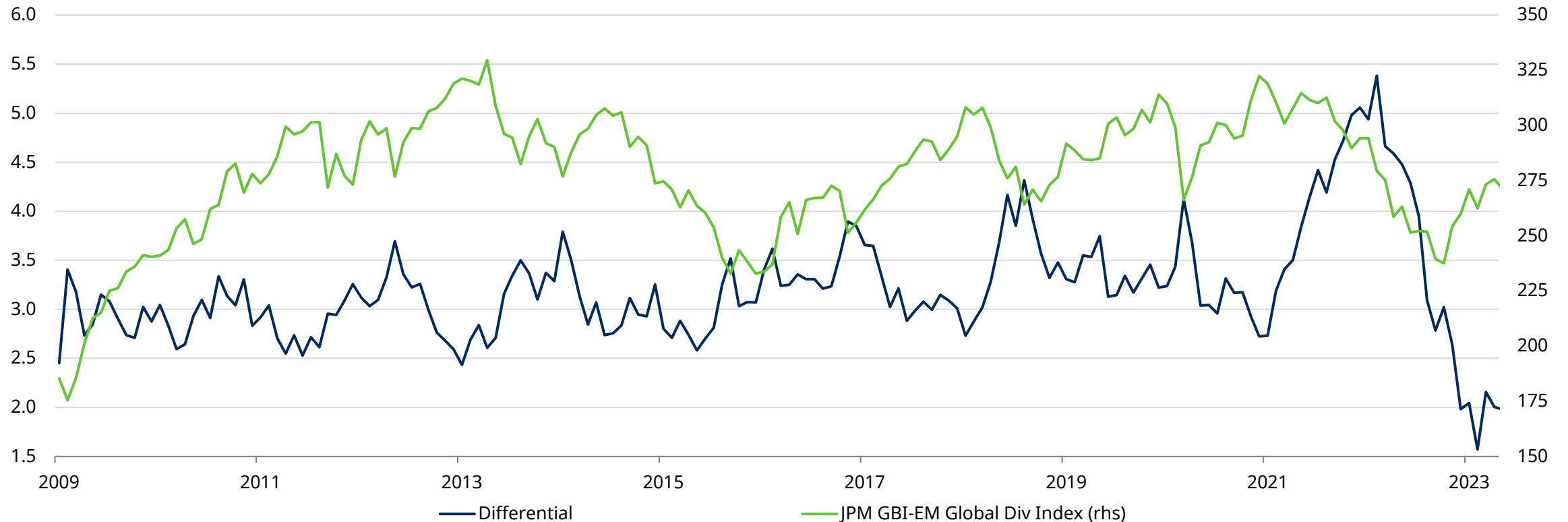
The average local EM yield curve is now inverted (downward sloping)

¹Based on 19 major EM countries.
Source: Schroders, Refinitiv Datastream. Data as at 31 May 2023. Please see relevant disclaimers on page 37.

EM/DM real yield differential

EM local currency bond valuation

EM/DM real yield differential (%)



Real yield differential has fallen to a post-GFC low

Past performance is not a guide to future performance and may not be repeated.

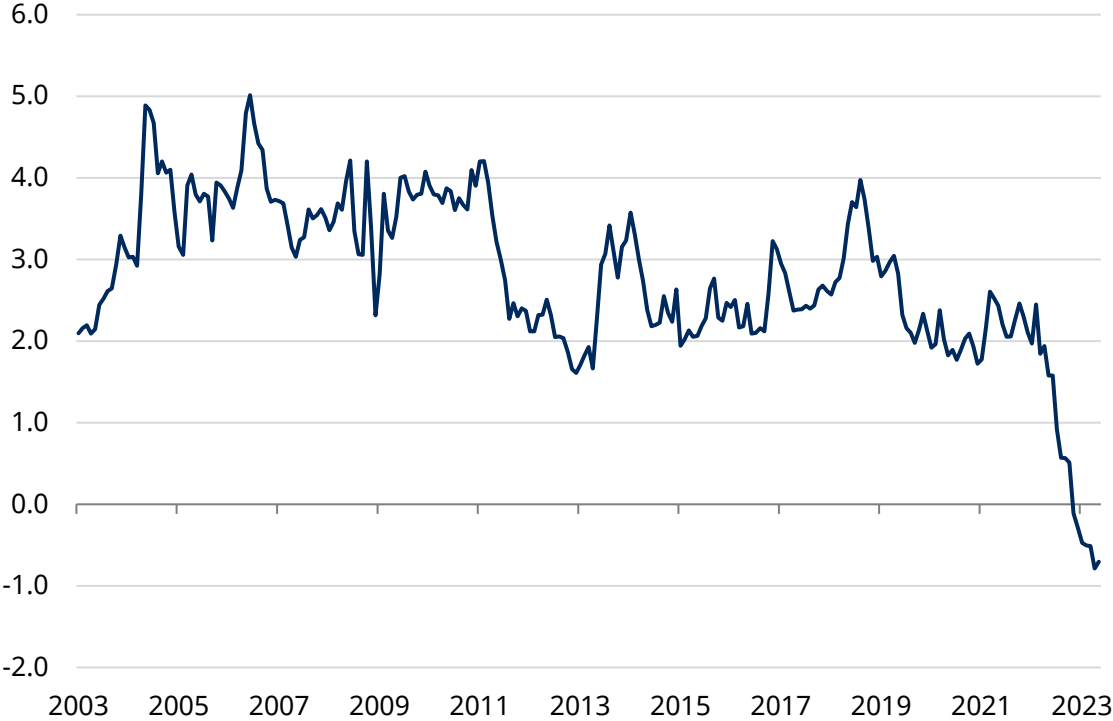
EM real yield is weighted average of individual JPM GBI-EM index nominal yields deflated by core inflation. DM real yield is 5Y government bond yields of US, UK, Euro zone, Japan deflated by core inflation, weighted by the size of individual government bond market.

Source: Schroders, Refinitiv Datastream, ICE Data Indices, J.P. Morgan. Data as at 31 May 2023. Please see relevant disclaimers on page 37.

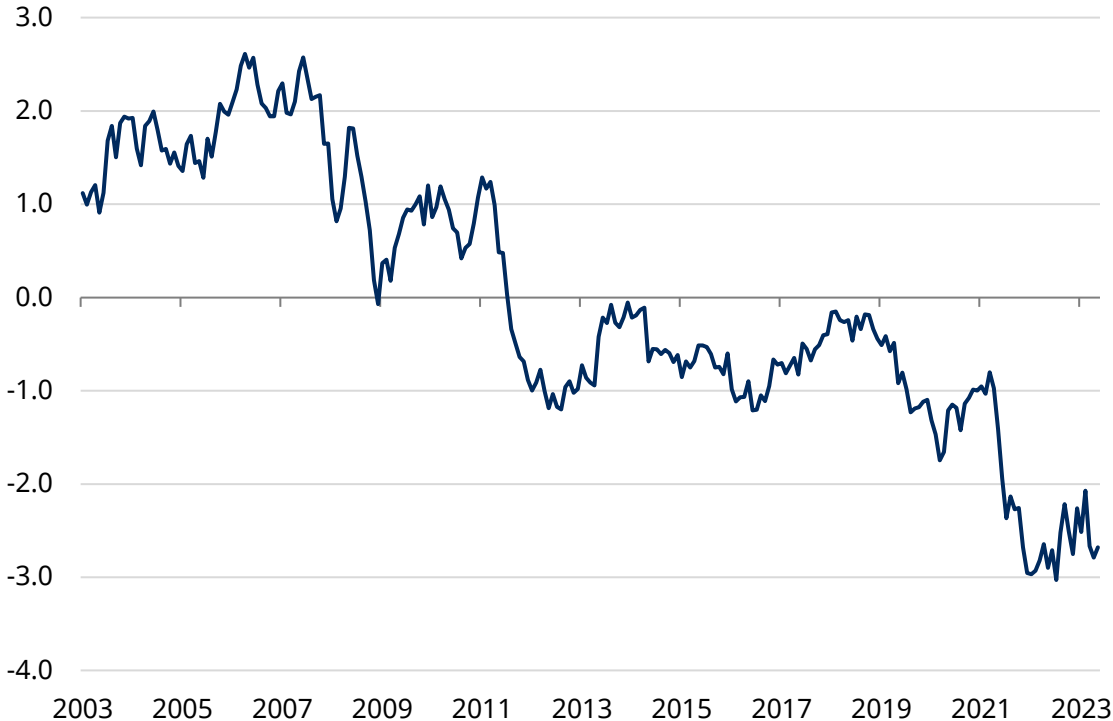
EM and DM real yields

Individual drivers of the real yield differential

EM real yield (%)

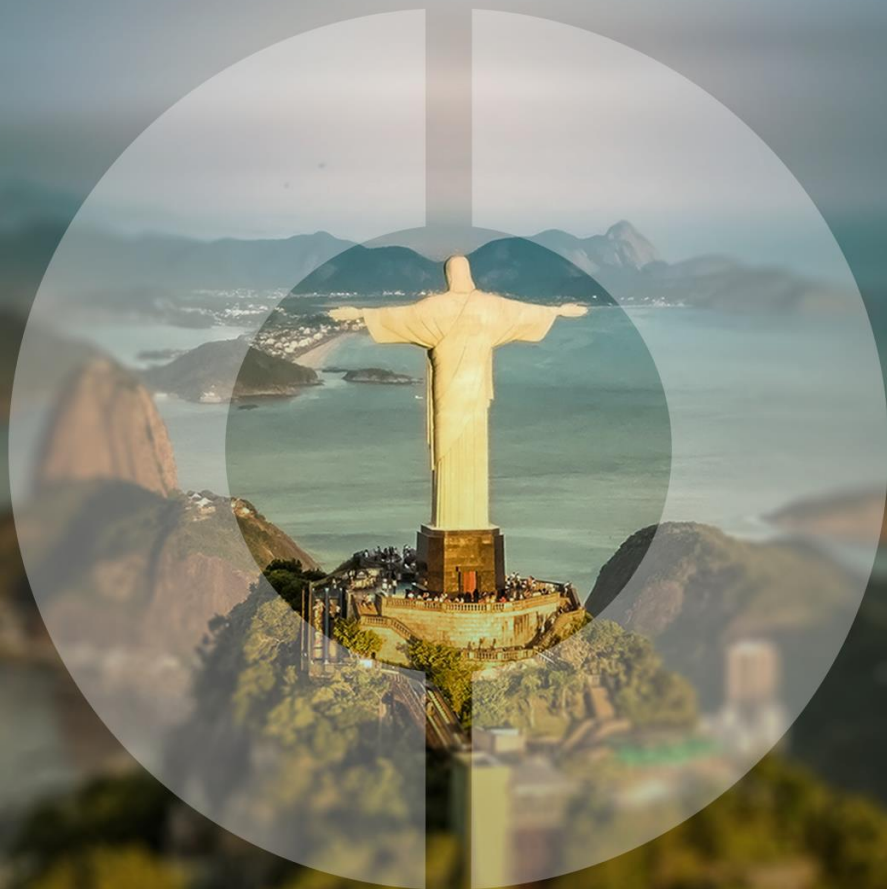


DM real yield (%)



EM real yield has moved into negative territory

Source: Schroders, Refinitiv Datastream, ICE Data Indices, J.P. Morgan. Data as at 31 May 2023. EM real yield is weighted average of individual JPM GBI-EM index nominal yields deflated by core inflation. DM real yield is 5Y government bond yields of US, UK, eurozone, Japan deflated by core inflation, weighted by the GDP PPP of each country. Please see relevant disclaimers on page 37.



Emerging market currencies

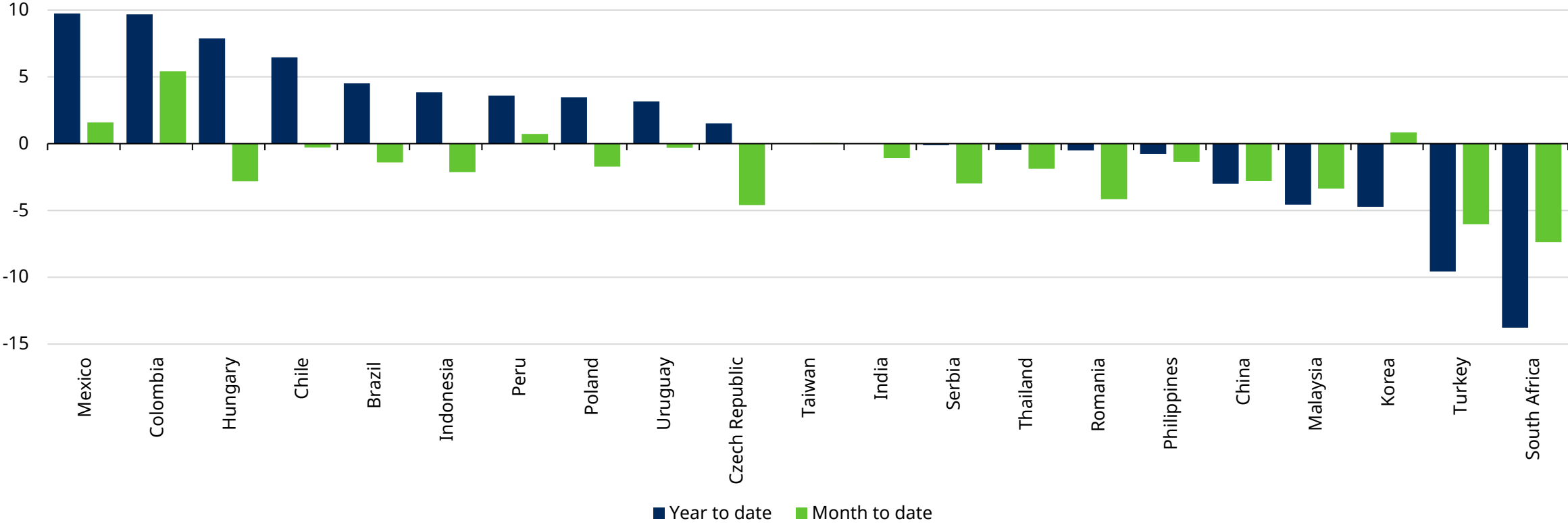
Summary: emerging market currencies

- EM currency performance versus the US dollar has been varied YTD.
- There are undervalued currencies in all three EM regions, though the degree of value in EM currencies varies significantly.
- The Czech koruna is notably above its long term and five-year averages. Currencies in Uruguay, and to a lesser extent in India are also expensive versus history. Turkey, Serbia, and South Africa are among the cheapest EM currencies relative to the long term average.
- EM FX carry, the strategy of buying higher-yielding EM currencies against lower-yielding currencies to earn the interest rate differential, made a comeback because of EM rate hikes but has faded.

EM currency performance vs US dollar

EM currency performance has been varied YTD

EM currency returns (%)



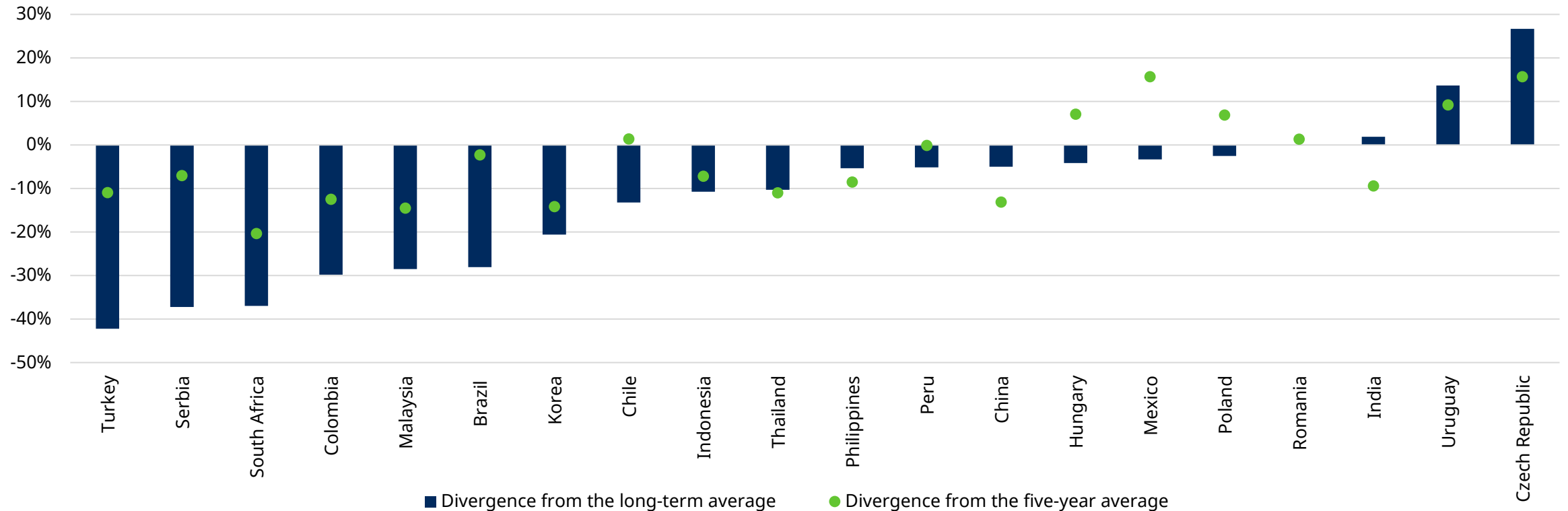
Latin currencies have seen the most appreciation so far this year

Past performance is not a guide to future performance and may not be repeated.
 Source: Schroders, Refinitiv Datastream. Data as at 31 May 2023. Please see relevant disclaimers on page 37.

EM currency value

Some currencies are significantly undervalued

Real exchange rate: deviation from average



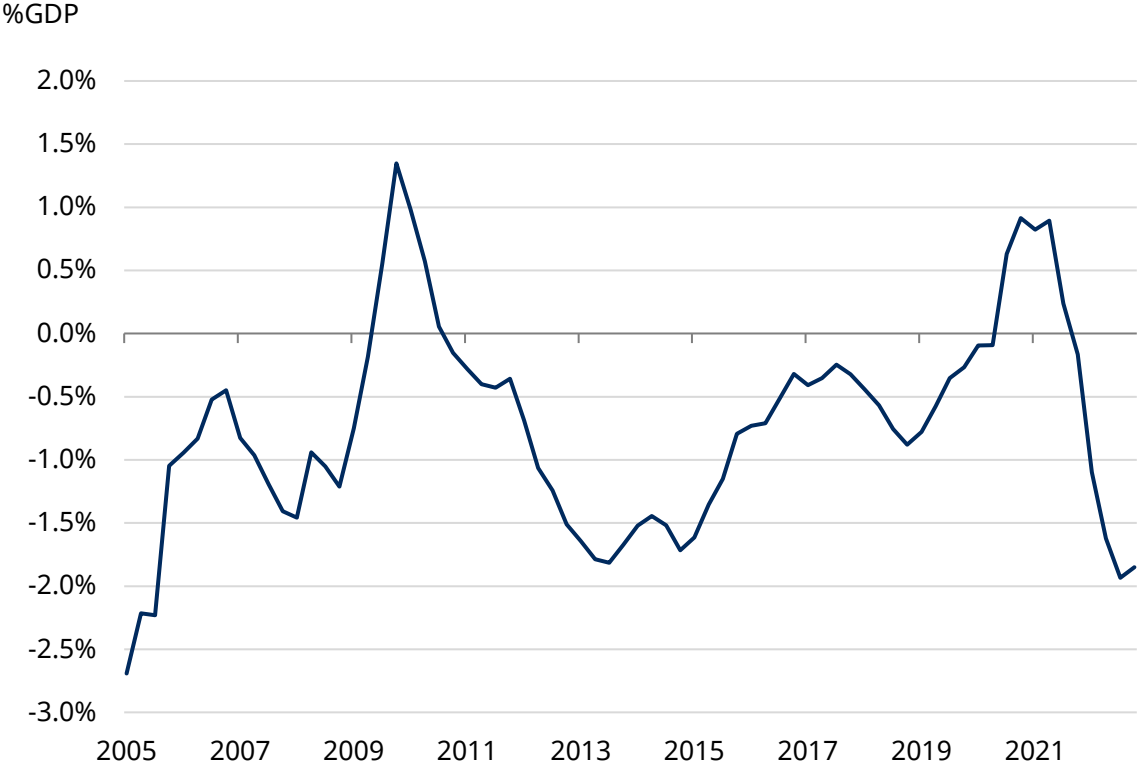
Turkey*, Serbia and South Africa are among the cheapest currencies; Czech Republic, Uruguay and India have real exchange rate above the long term average

Source: Schroders, Refinitiv Datastream. Data as at 31 May 2023. *Turkish lira has depreciated by over 11% month-to-date in June, as at 9 June. Real exchange rate is the nominal dollar exchange rate deflated by the consumer price index (CPI) of each EM country vs. US. Long-term average is since January 1995. Please see relevant disclaimers on page 37.

EM fundamentals: current account vs. currency valuation

Current accounts of commodity importers have deteriorated

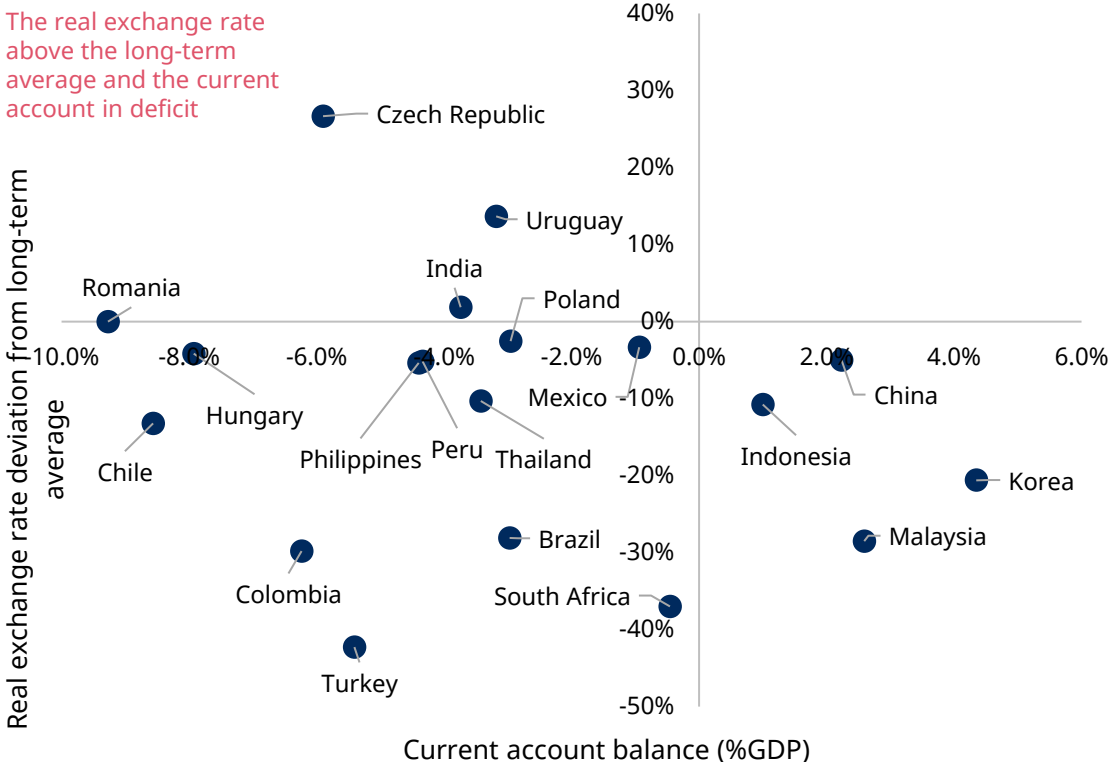
Average EM current account balance¹



EM currency value² vs. current account balance

Real exchange rate deviation from long-term average

The real exchange rate above the long-term average and the current account in deficit

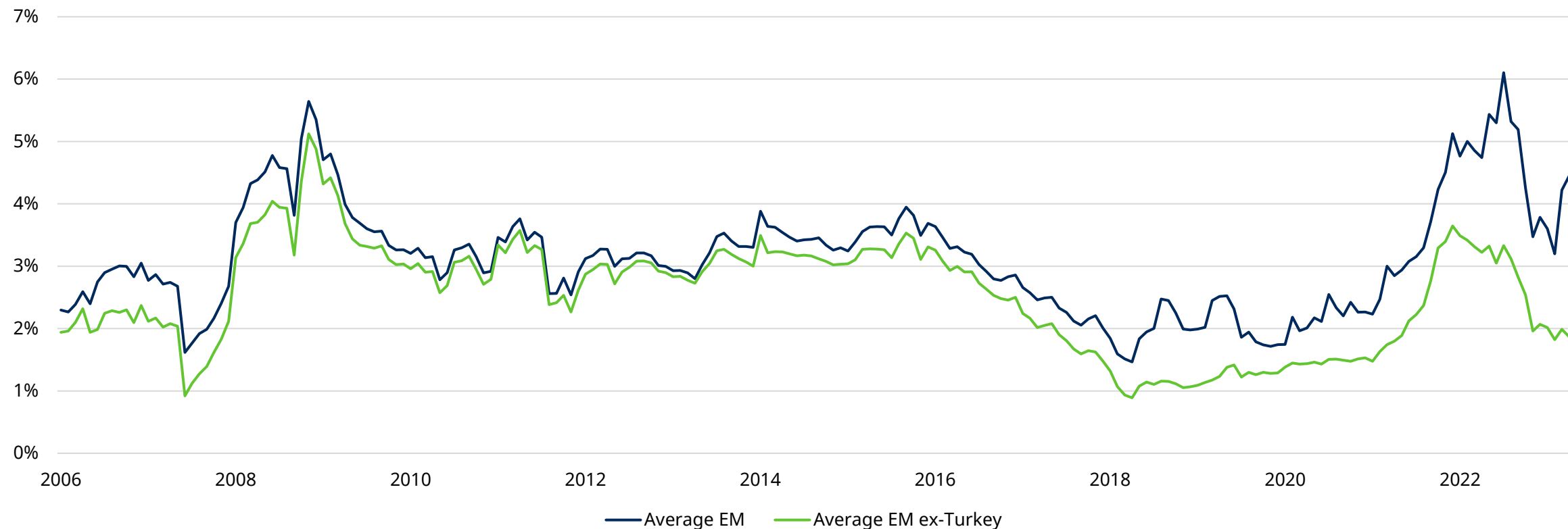


Czech Republic, Uruguay and Romania are among the most vulnerable to currency weakness

¹Based on the historical country weights of the JPM GBI-EM Global Diversified Index. ²Currency value is the deviation of the real exchange rate from the long-term average since 1995. Source: Schroders, Refinitiv Datastream. Current account data as at Q4 2022, currency value data as at 31 May 2023. Please see relevant disclaimers on page 37.

The EM FX carry trade made a comeback on the back of EM rate hikes but has faded

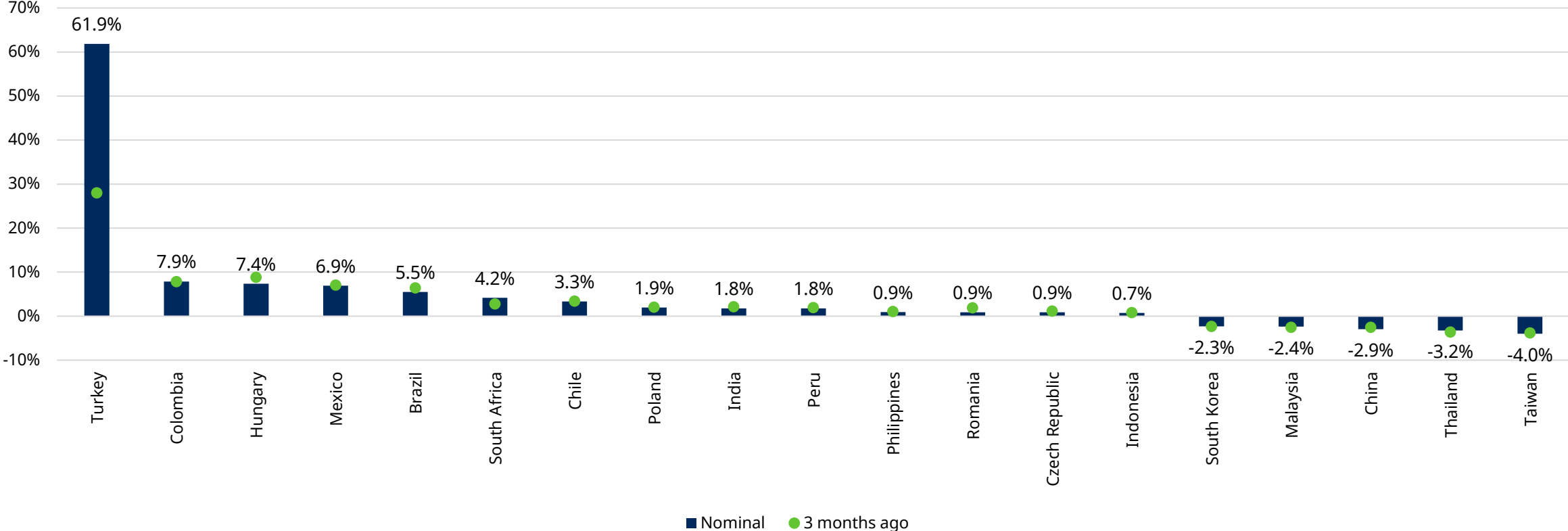
Average EM carry¹



¹The return of holding 1-year FX forward vs US dollar to maturity. Based on 19 major EM countries.
Source: Schroders, Refinitiv Datastream. Data as at 31 May 2023. Please see relevant disclaimers on page 37.

FX Carry varies significantly between the countries

EM FX carry¹



¹The return of holding 1-year FX forward vs. US dollar to maturity.
 Source: Schroders, Refinitiv Datastream. Data as at 31 May 2023. Please see relevant disclaimers on page 37.

List of indices

- **Sovereign EMD** - The JPM EMBI Global Diversified Composite Index
- **Corporate EMD** - The JPM CEMBI Broad Diversified Index
- **Local EMD** - The JPM GBI-EM Global Diversified Index

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- Any analysis or illustration of trends whether current or historical should not be solely relied upon to predict future events or results. Trends may not continue or lead to favorable investment conditions.
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