

Schroders



# Schroders Emerging Markets Lens: Emerging Market Debt

## Strategic Research Unit

May 2023

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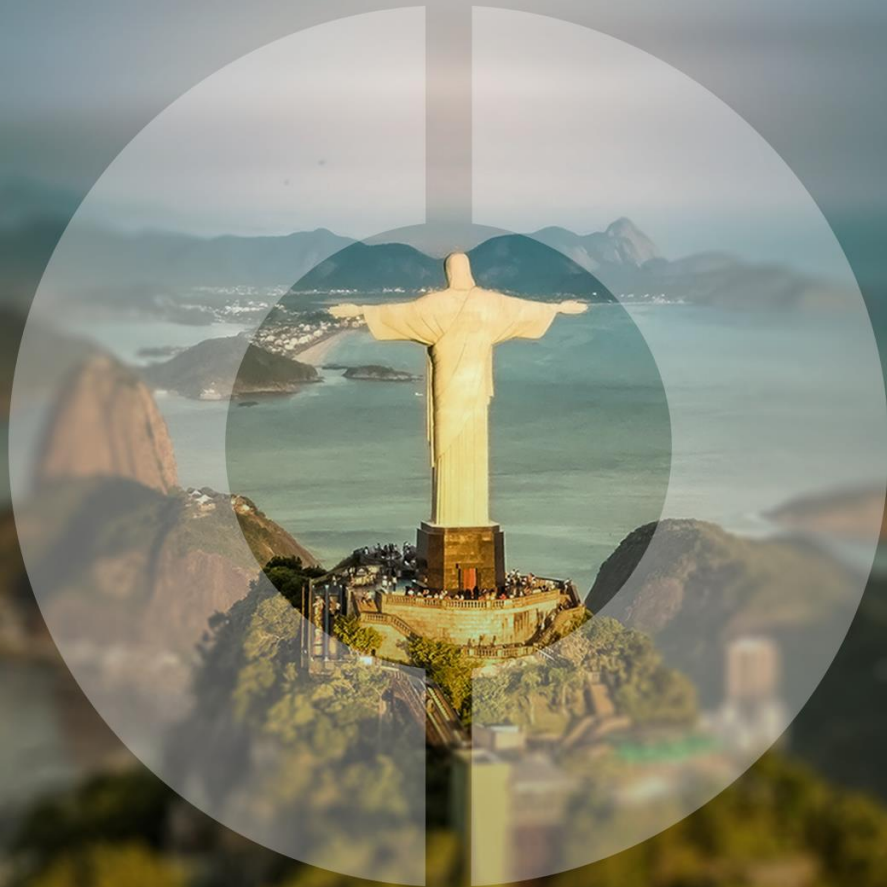
# Summary

## Hard currency emerging market debt (EMD):

- The hard currency EM bond index yield is elevated relative to its long term history.
- This is entirely down 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, both the IG and HY spreads are 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. However, EM inflation is now falling and could provide some relief.
- There are undervalued **currencies** in all three EM regions. The degree of value in EM currencies varies significantly.



## Emerging market debt: hard currency

# Summary: hard currency emerging market debt

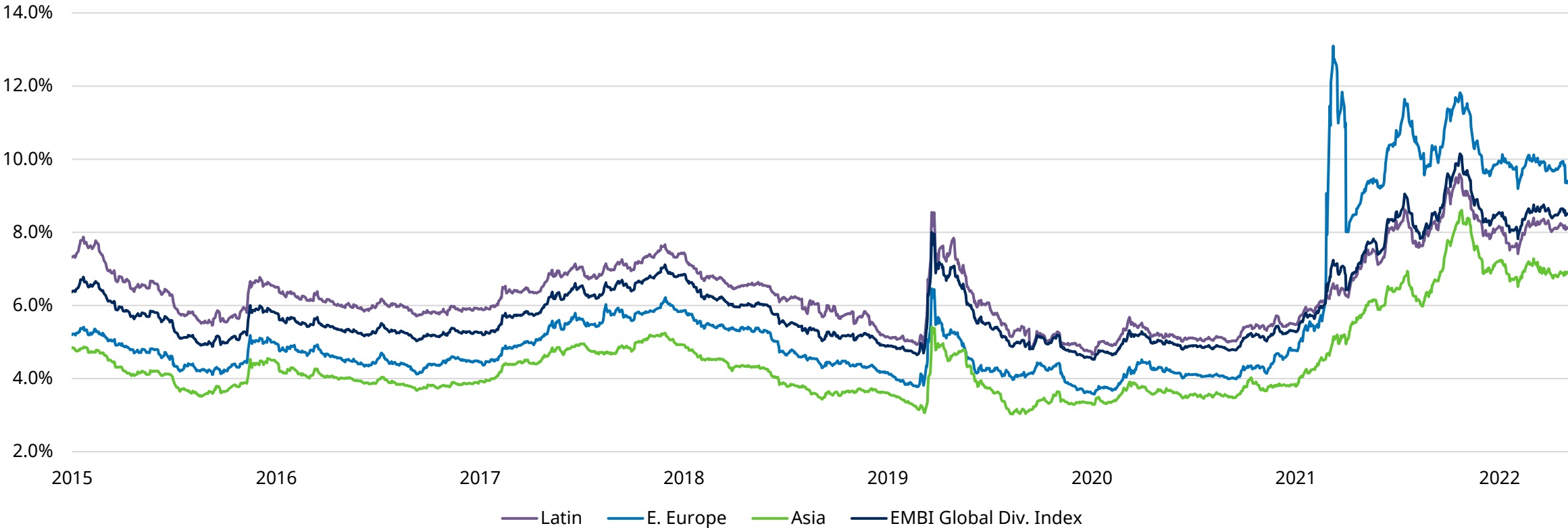
- The hard currency sovereign EMD index yield is well above its long term history.
- In sovereign EMD, the spread dispersion between countries remains wide. In general, commodity exporters and larger countries are doing fine, while some commodity importers and smaller countries continue to feel the pain.
- 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 30 April 2023.  
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# EM hard currency index yield is elevated relative to history

This is despite some moderation from a peak last October

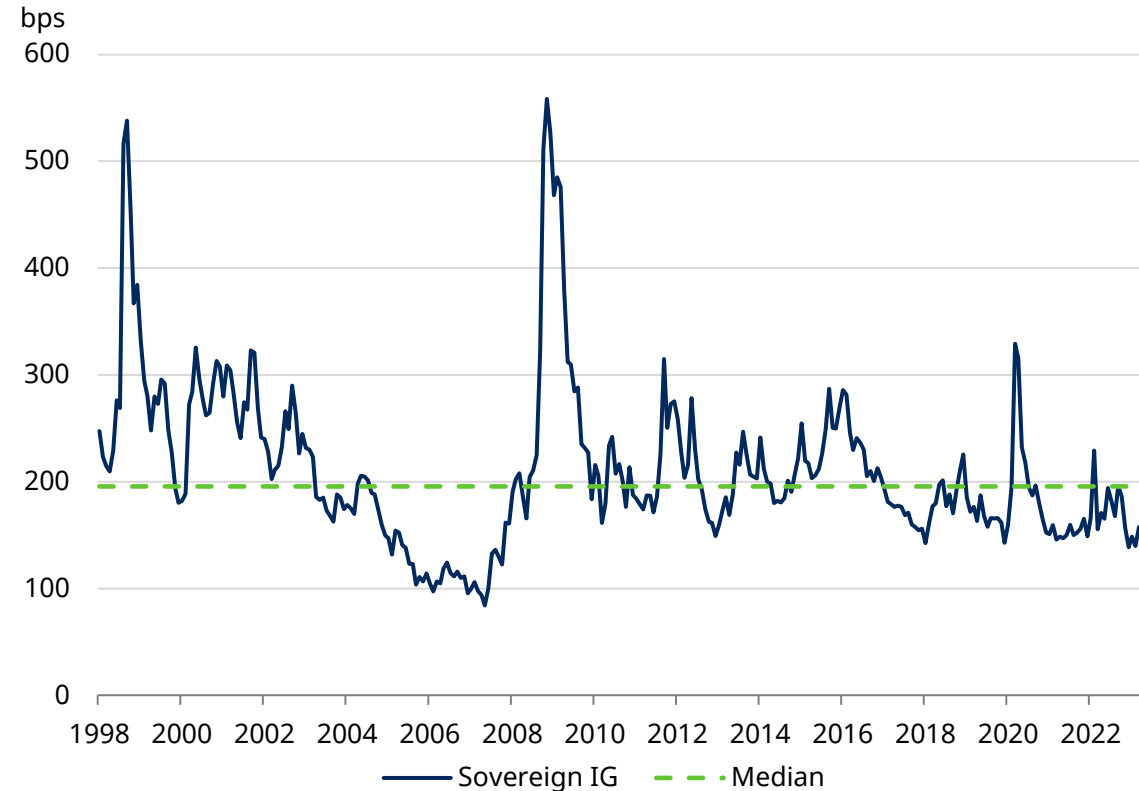
## Hard currency sovereign EMD regional index yield



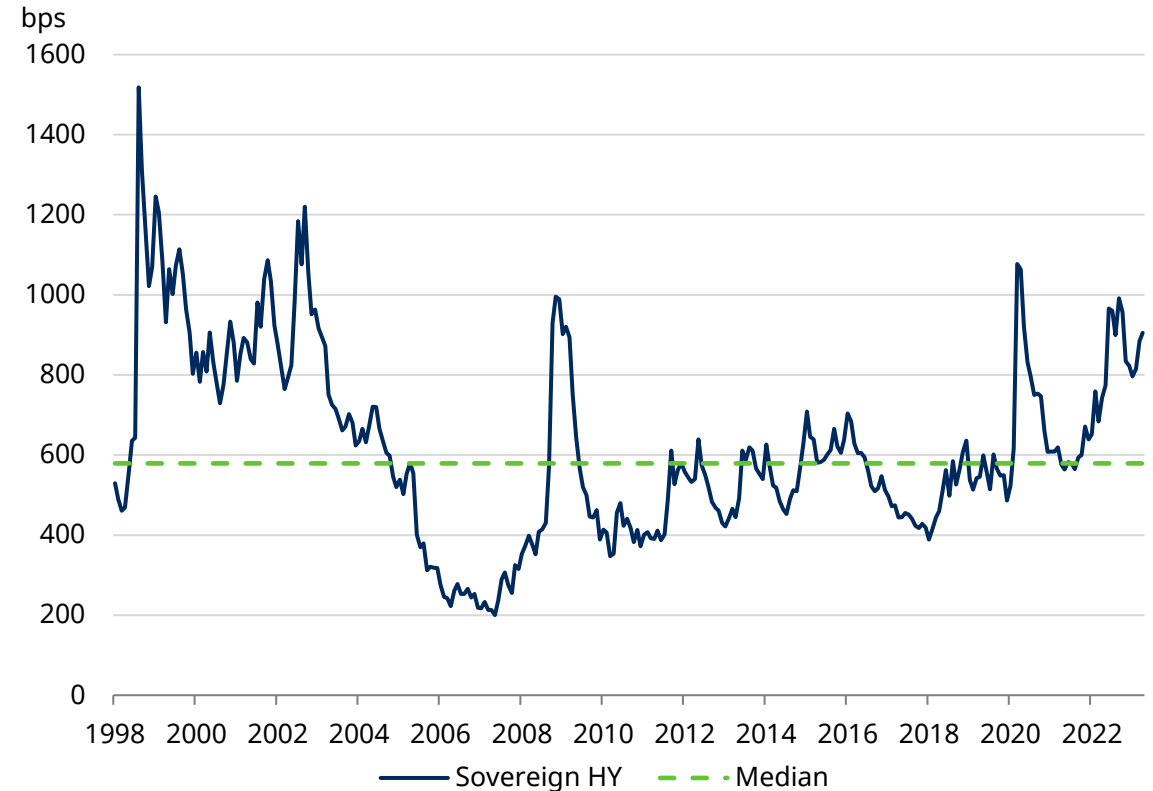
Russia was removed from all JP Morgan EMD indices from 30 April 2022.  
Source: Schroders, JP Morgan. Data as at 2 May 2023. Please see relevant disclaimers on page 36.

# Valuation of hard currency sovereign EMD

## Hard currency sovereign EMD IG spread



## Hard currency sovereign EMD HY spread

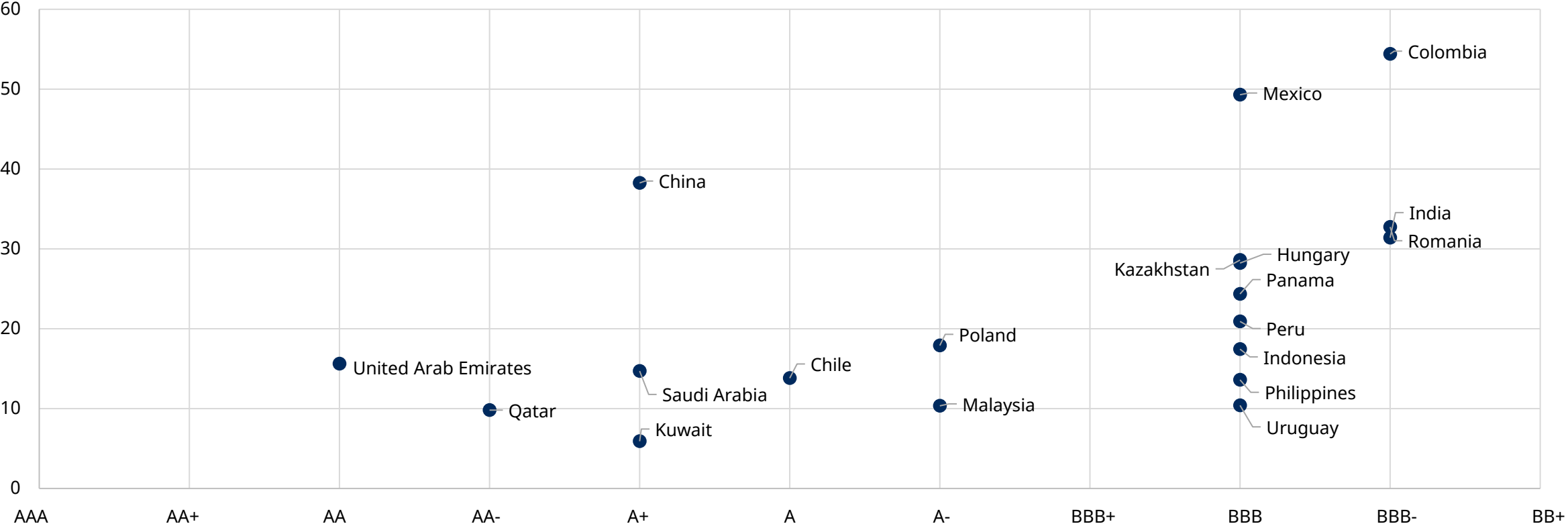


**IG spread is below the historical median; the HY spread remains elevated**

Source: Refinitiv Datastream, J.P. Morgan. Data as at 30 April 2023. Please see relevant disclaimers on page 36.

# Duration adjusted spreads of IG countries

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



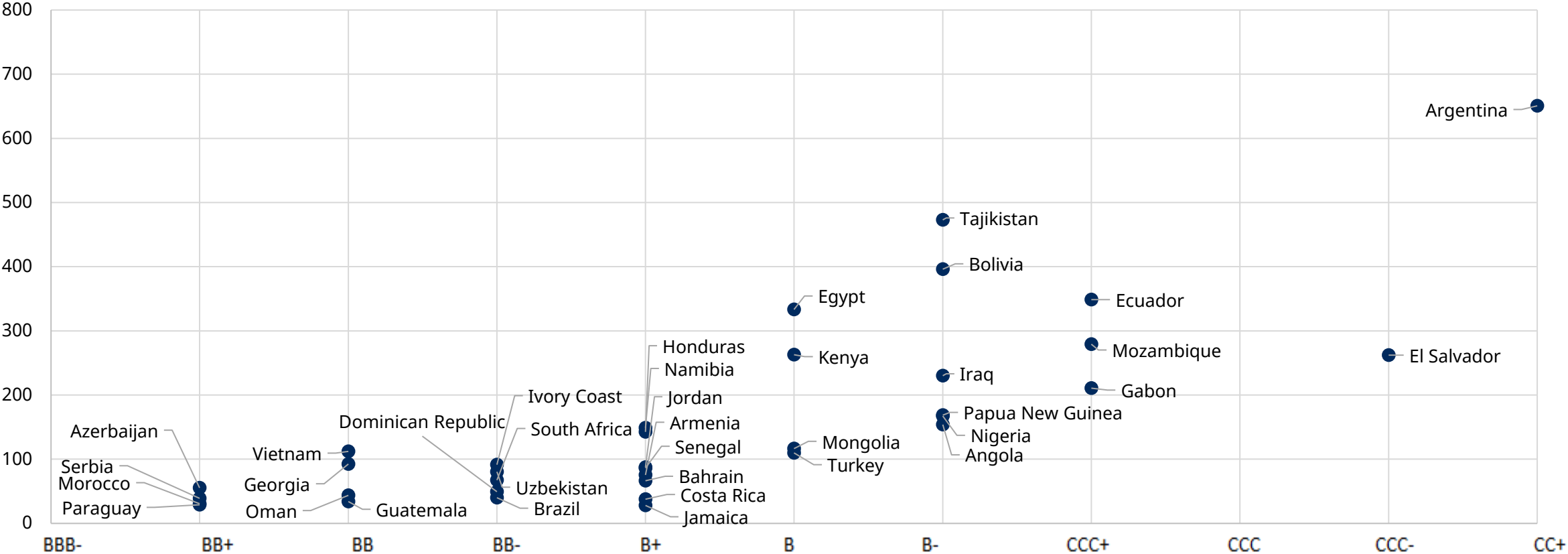
<sup>1</sup>The JPMorgan EMBI Global Diversified Index includes both sovereign and quasi-sovereign bonds. The y-axis shows spread per unit of duration, in basis points. Source: Schroders, Refinitiv Datastream, J.P. Morgan. Data as at 30 April 2023. Please see relevant disclaimers on page 36.



# Duration adjusted spreads of HY countries

Significant variability between the countries

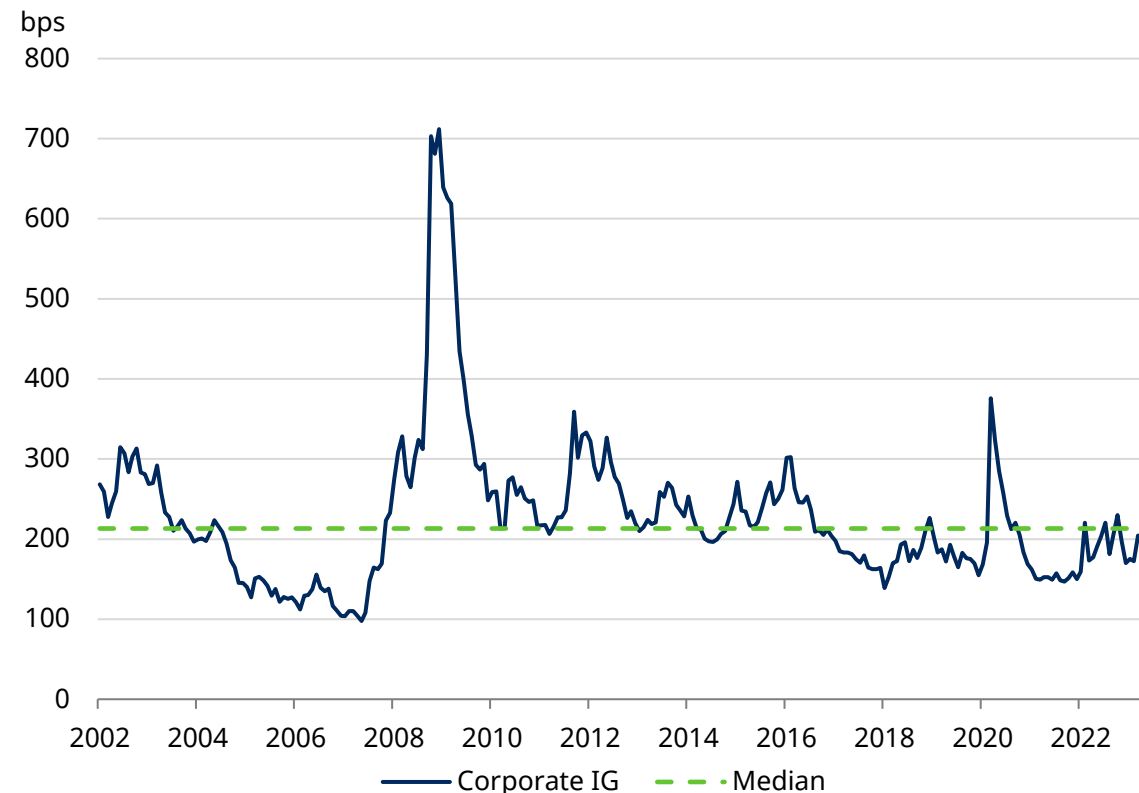
## Hard currency sovereign EMD HY: spread vs. duration vs. credit rating



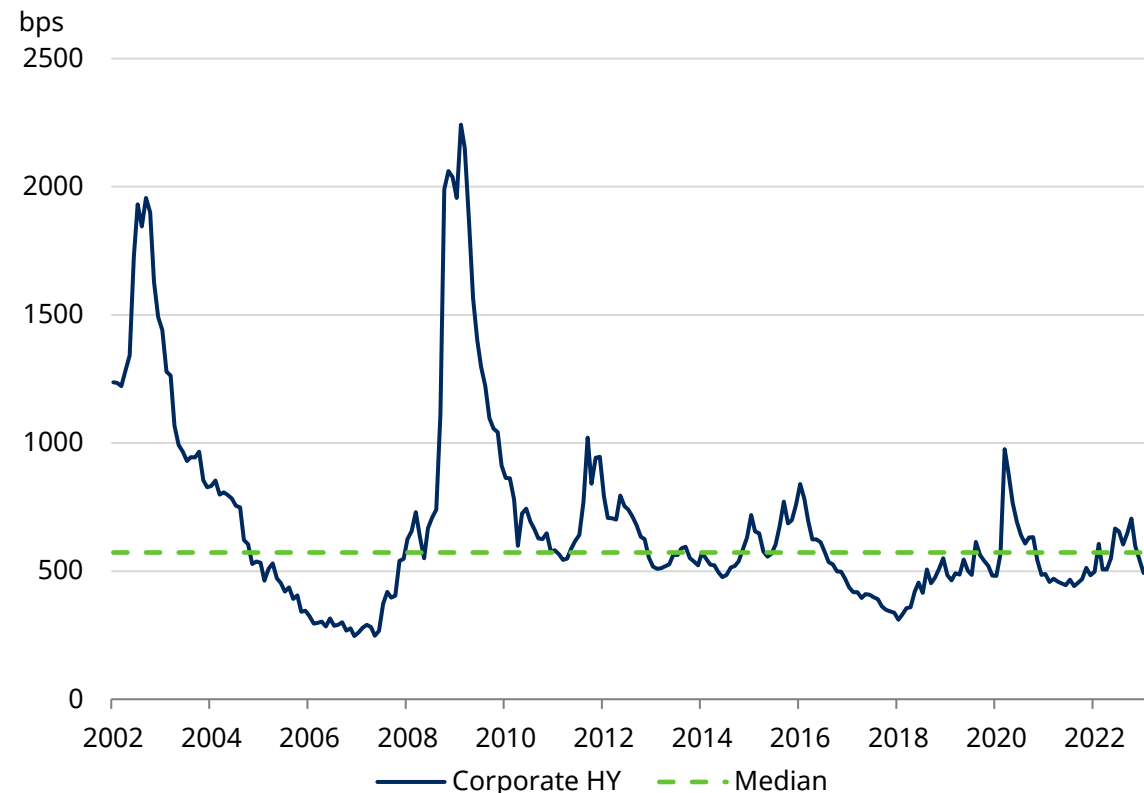
The y-axis shows spread per unit of duration, in basis points.  
 Source: Schroders, Refinitiv Datastream, J.P. Morgan. Data as at 30 April 2023. Please see relevant disclaimers on page 36.

# Valuation of hard currency corporate EMD

## Hard currency corporate EMD IG spread



## Hard currency corporate EMD HY spread



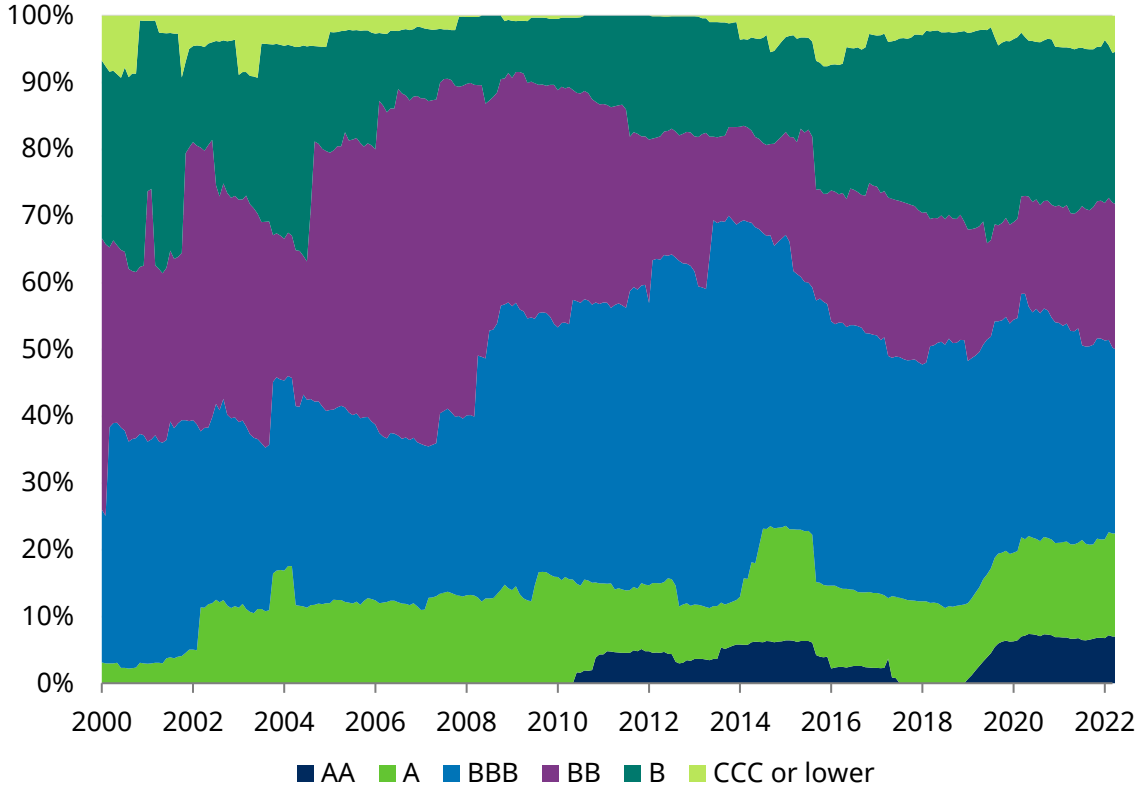
**EM IG corporate and HY spreads are close to their historical median**

Source: Refinitiv Datastream, J.P. Morgan. Data as at 30 April 2023. Please see relevant disclaimers on page 36.

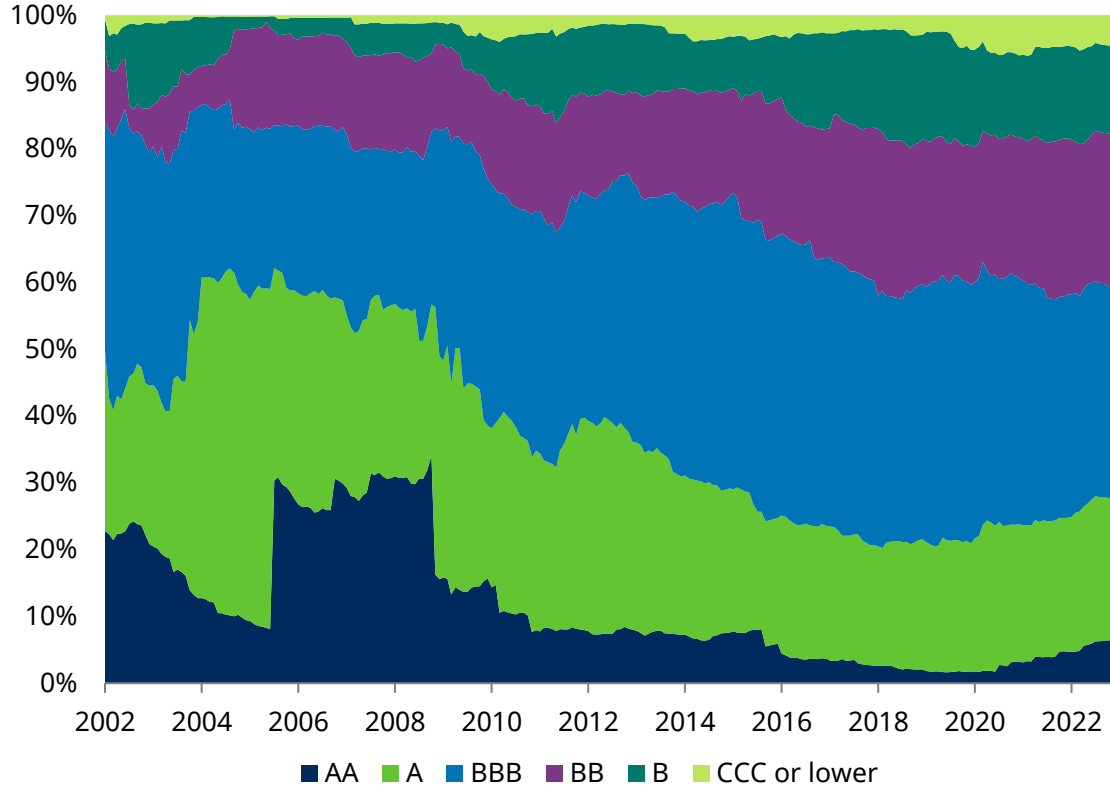
# EMD historical ratings split

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 30 April 2023. Please see relevant disclaimers on page 36.

# Characteristics of EM hard currency issuers

Hard currency corporate issuers



■ Financials    ■ Nonfinancials

Hard currency sovereign issuers



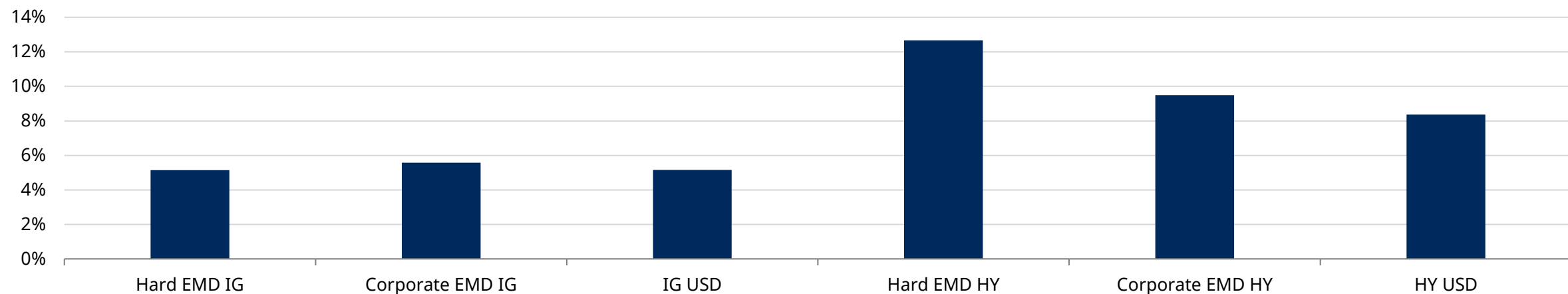
■ Sovereign    ■ Quasi Sovereign

Source: Refinitiv Datastream, J.P. Morgan. Data as at 30 April 2023. Please see relevant disclaimers on page 36.

# 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	5.1%	5.6%	5.2%	12.7%	9.5%	8.4%
Spread (bps)	148	193	140	905	581	450
Duration	8.2	5.0	7.1	5.5	3.4	4.3
Rating	A3	A3	A3	B1	B1	B1
Percentage of EMD index	52.0%	58.4%	-	48.0%	41.6%	-

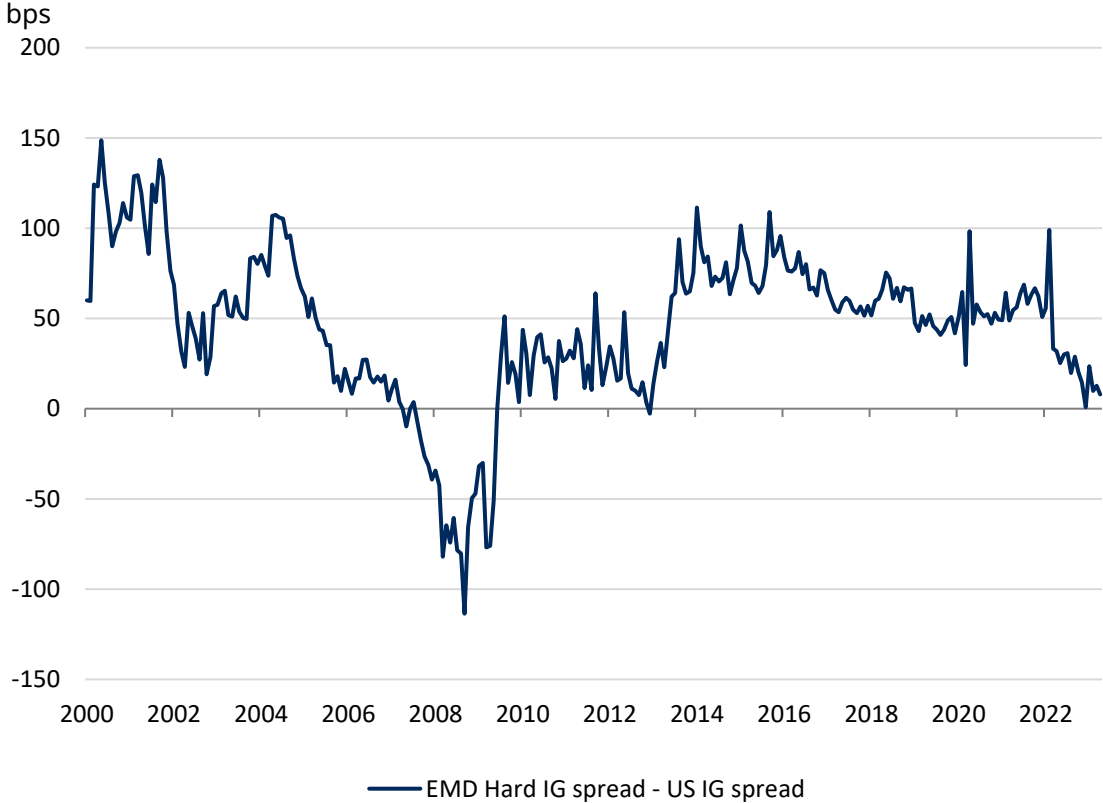
## EM vs. DM yields



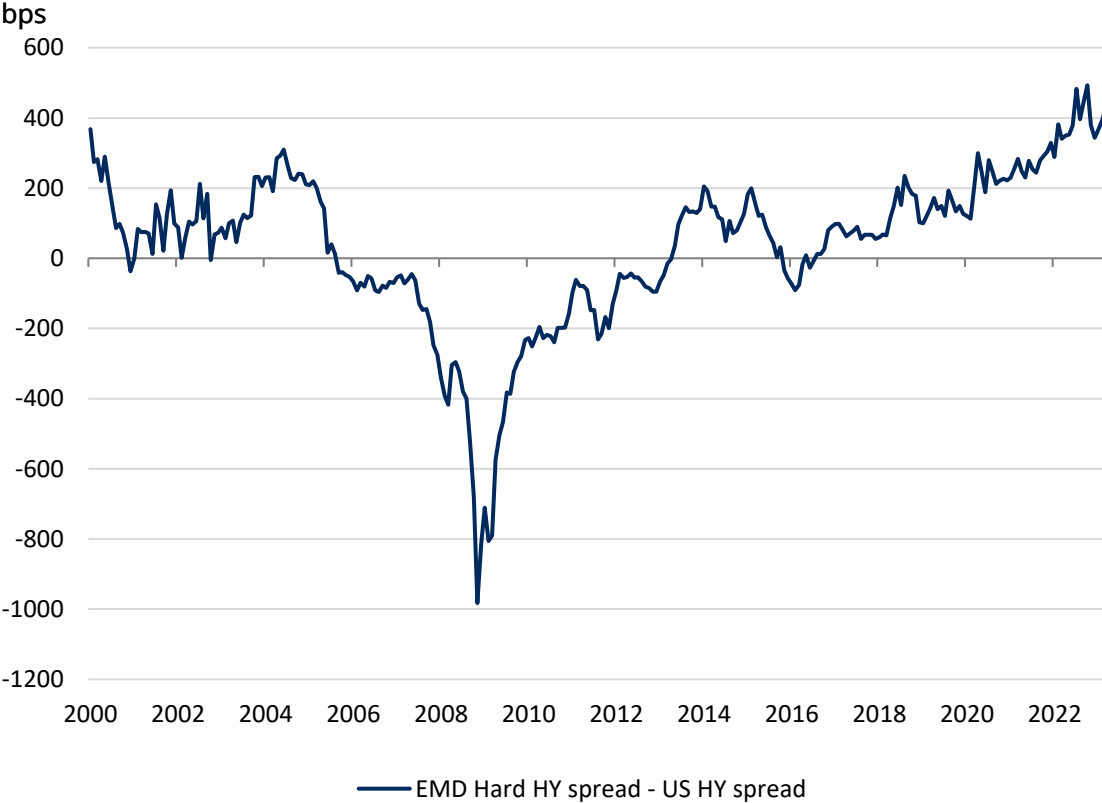
Source: Schroders, Refinitiv Datastream, ICE Data Indices, J.P. Morgan. Data as at 30 April 2023. Please see relevant disclaimers on page 36.

# EM dollar debt: sovereign EMD vs. US corporates

### Sovereign EMD IG spread minus US IG spread



### Sovereign EMD HY spread minus US HY spread

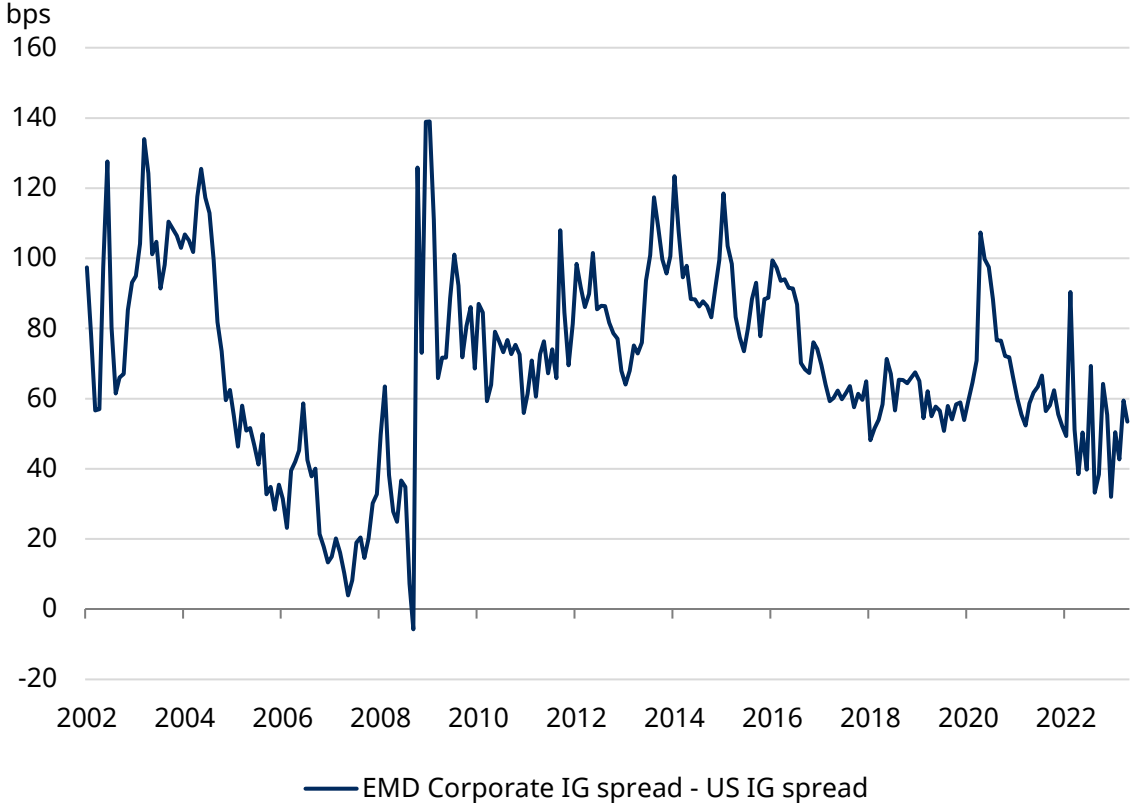


The sovereign EMD HY spread minus US HY spread is close to the top of its long term range

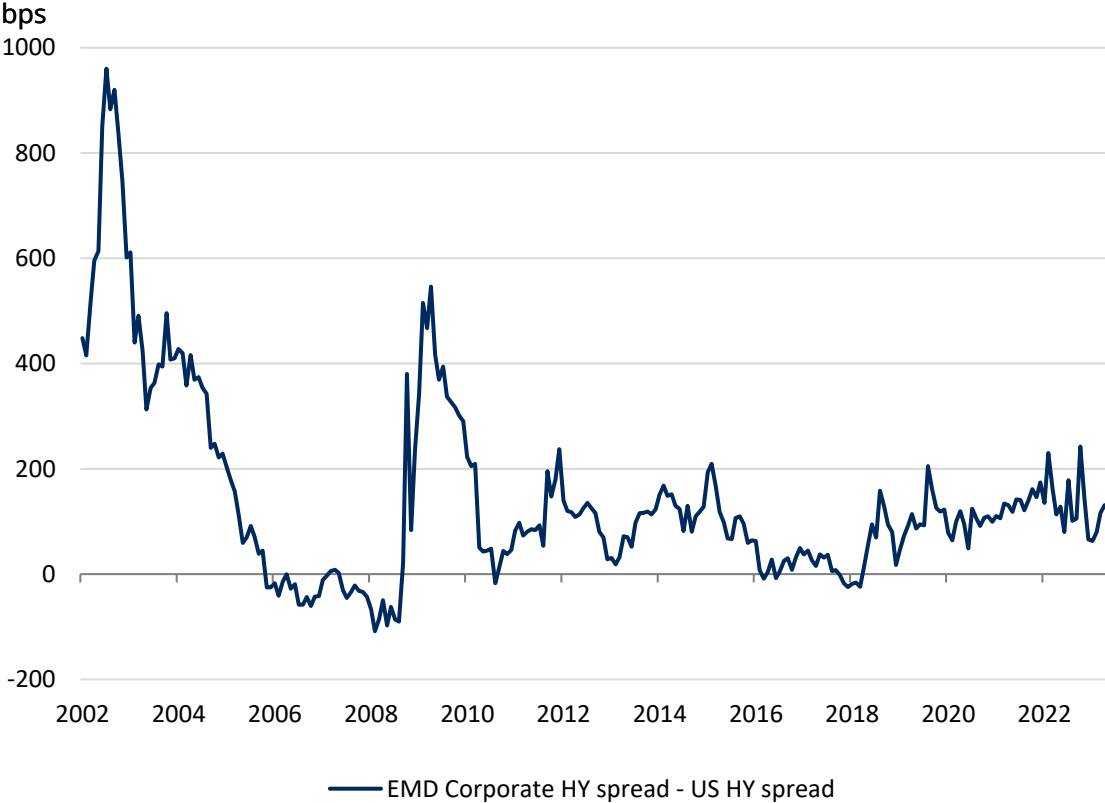
Source: Schroders, Refinitiv Datastream, ICE Data Indices, J.P. Morgan. Data as at 30 April 2023. Please see relevant disclaimers on page 36.

# EM dollar debt: corporate EMD vs. US corporates

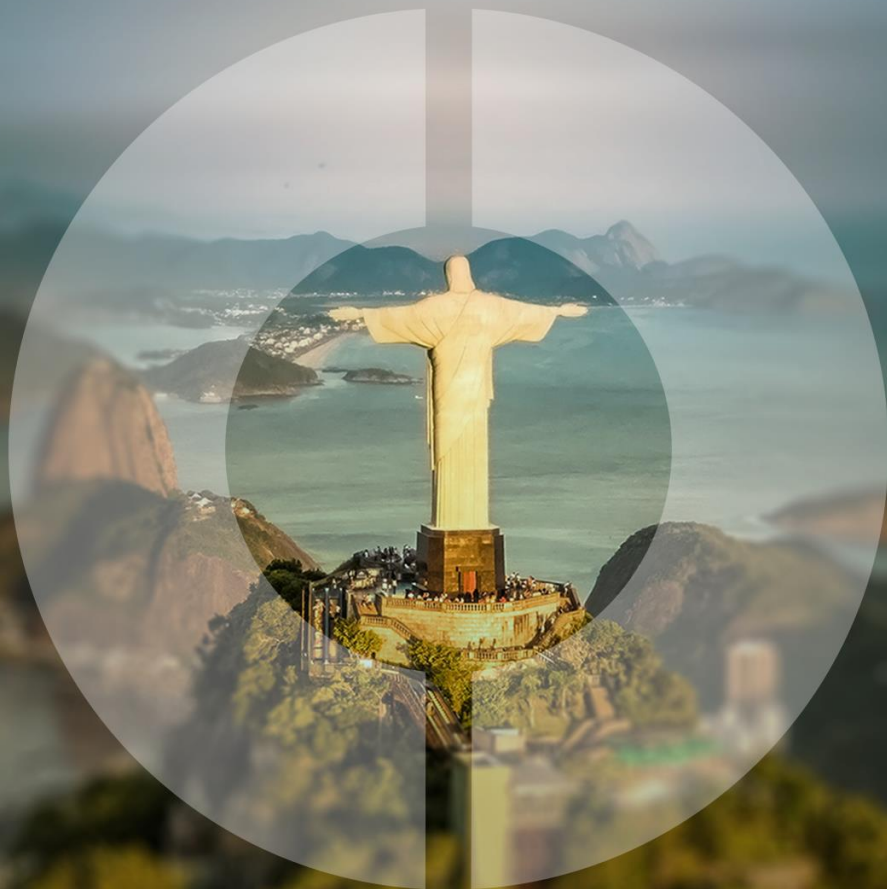
### Corporate EMD IG spread minus US IG spread



### Corporate EMD HY spread minus US HY spread



Source: Schroders, Refinitiv Datastream, ICE Data Indices, J.P. Morgan. Data as at 30 April 2023. Please see relevant disclaimers on page 36.



## Emerging market debt: local currency



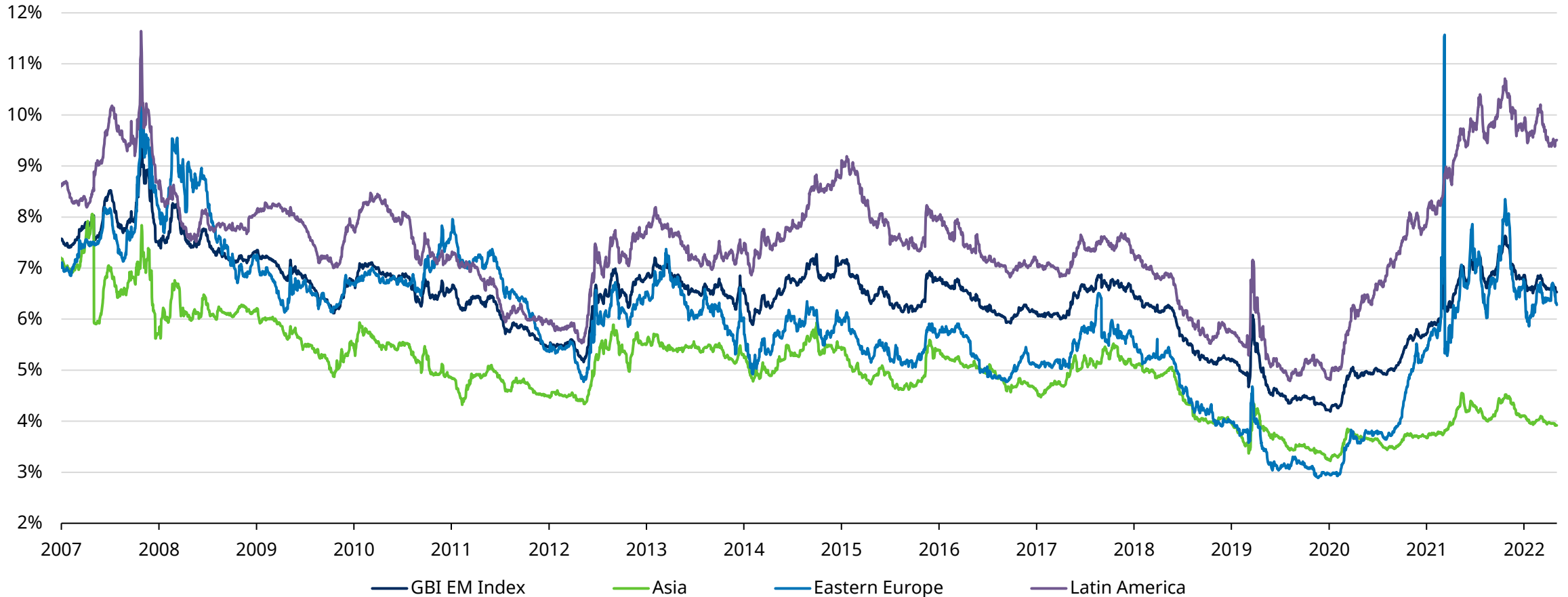
# Summary: local currency emerging market debt

- The local EM index yield is close to the top of its ten year range, sitting at 6.5% at the end of April. There is 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 everywhere ex China. However, average EM inflation (ex Turkey) has turned, and is now falling.
- 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. However, EM inflation is now falling and could provide some relief. Read more: [Falling EM inflation points to rate cuts](#)

# EM local currency index yield is 6.5%

....but this masks significant variation between regions

## Yields of EM regions

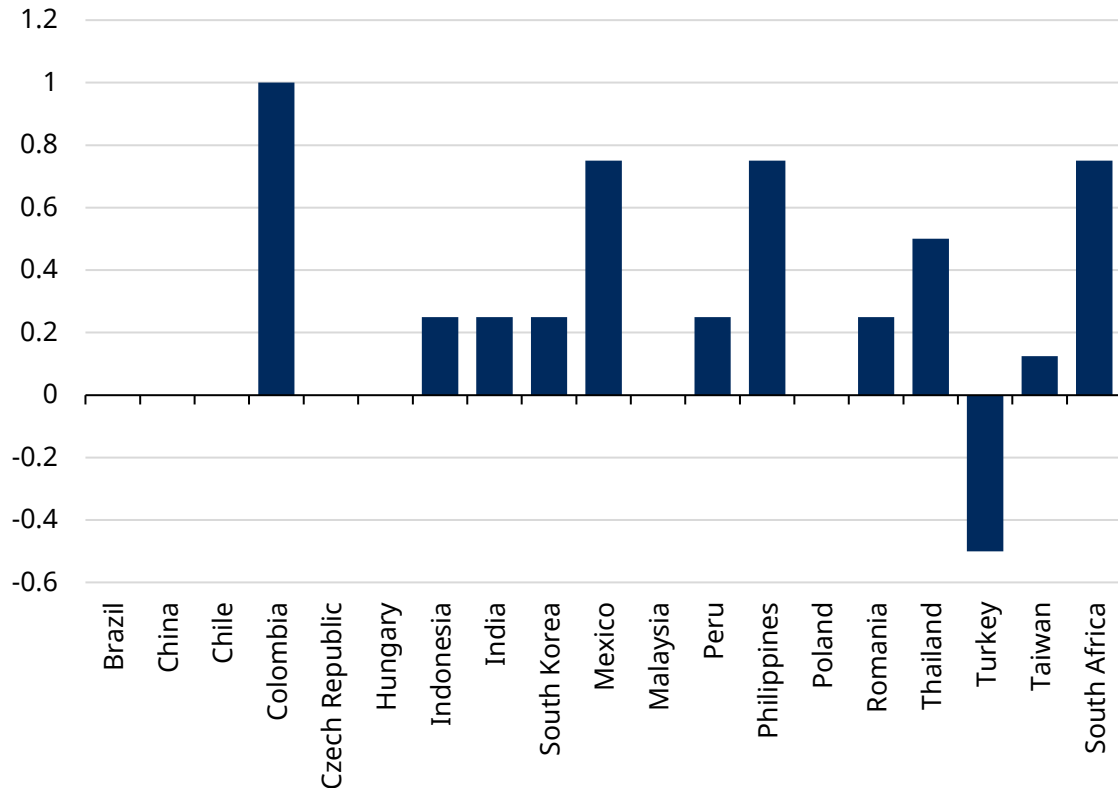


Source: Schroders, Refinitiv Datastream. Data as at 2 May 2023. Russia was removed from all JP Morgan EMD indices from 31 March 2022. Please see relevant disclaimers on page 36.

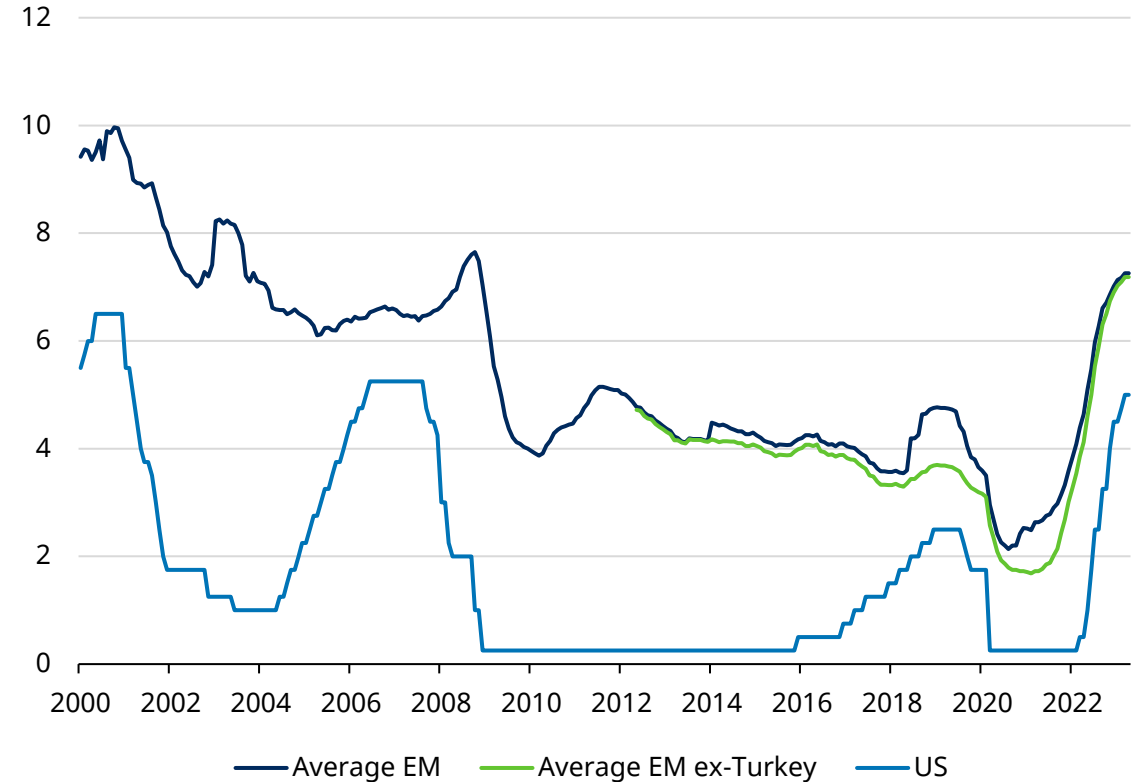
# EM policy rates

Average EM policy rate is at its highest since 2008

### Change in EM policy rates YTD (%)



### Average EM policy rate<sup>1</sup> (%)



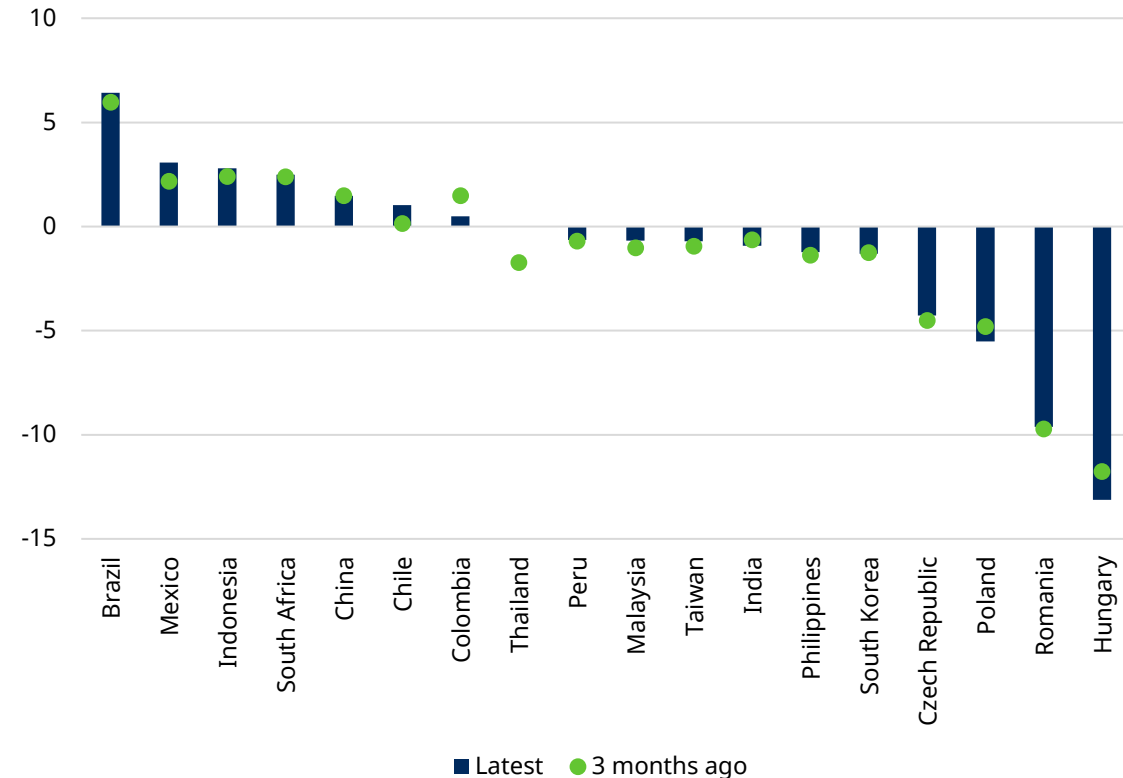
Various EM, with the exception of Turkey, have continued hiking cycles in early 2023

Source: Schroders, Refinitiv Datastream. Data as at 30 April 2023. <sup>1</sup>Based on 19 major EM countries. Please see relevant disclaimers on page 36.

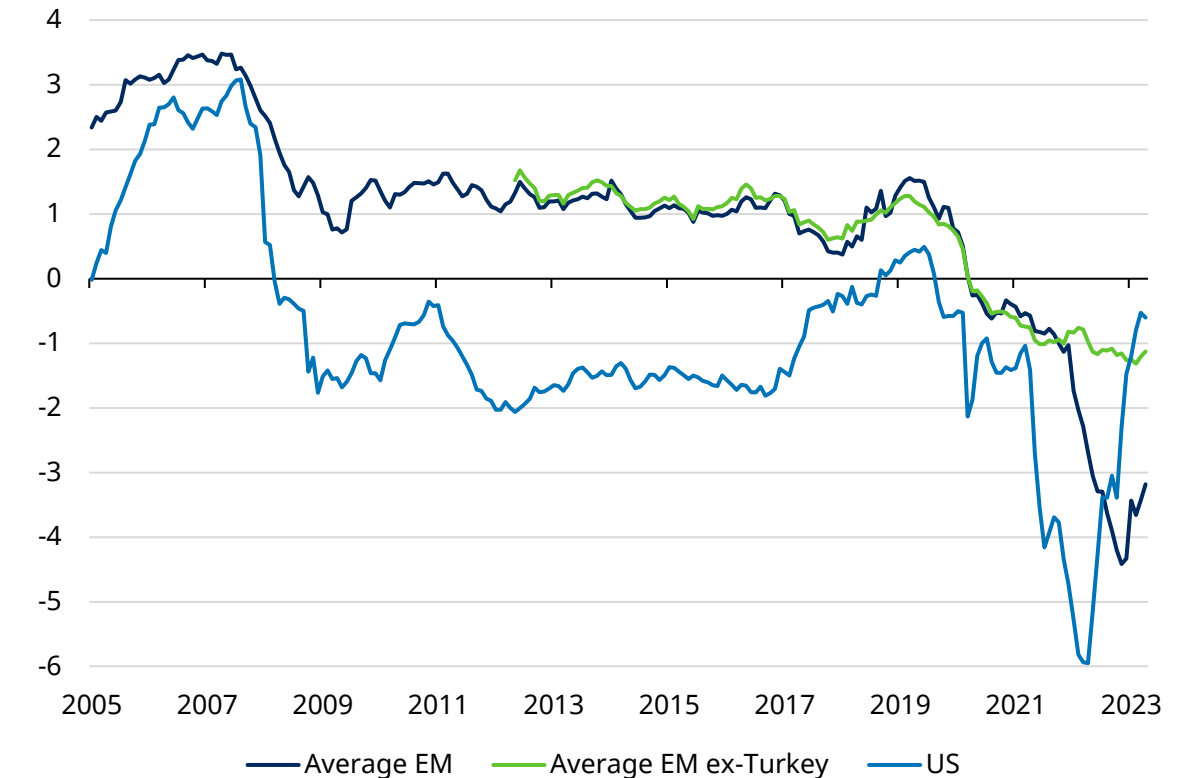
# Various EM real policy rates are still negative

...especially in Eastern Europe

## EM real policy rates (%)



## Average EM real policy rate<sup>1</sup> (%)



<sup>1</sup>Based on 19 major EM countries. Turkey has very high inflation at the moment, with the annual core inflation at 46%. At the same time, Turkey's policy rate is well below inflation at 8.5%. Hence, Turkey's real policy rate is very negative at -37.5%, skewing the EM average.

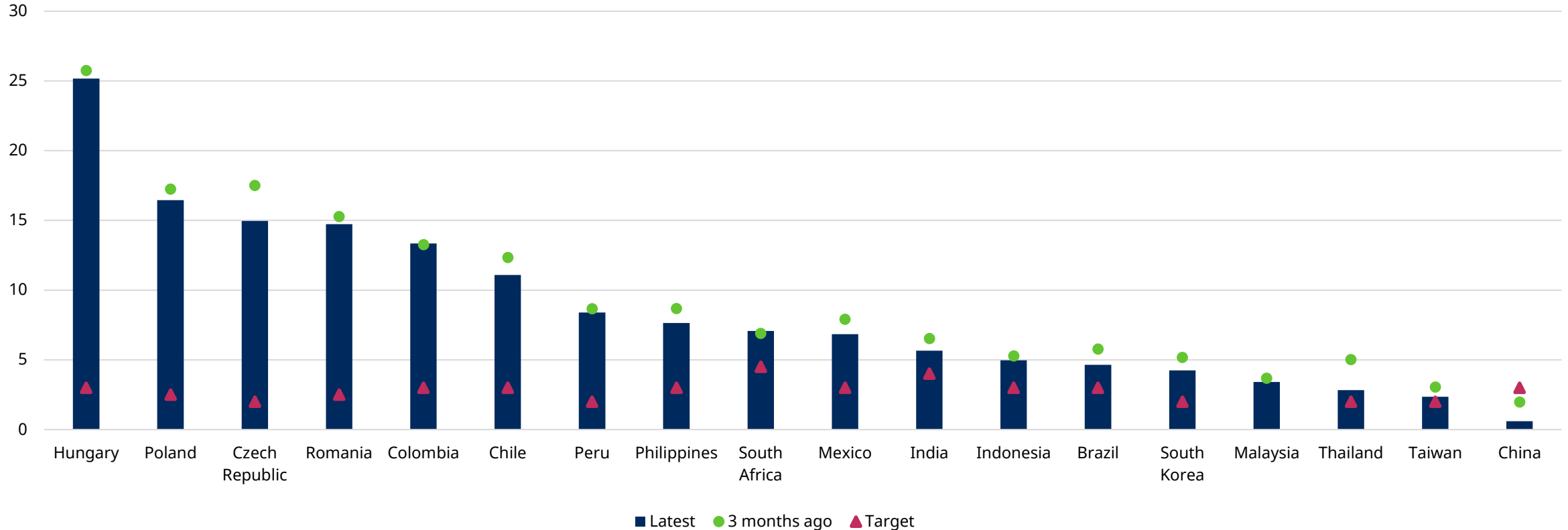
Source: Schroders, Refinitiv Datastream. Data as at 30 April 2023. Nominal policy rate minus annual core inflation.

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# EM inflation

Headline inflation is above target everywhere ex China

## Headline inflation (%)



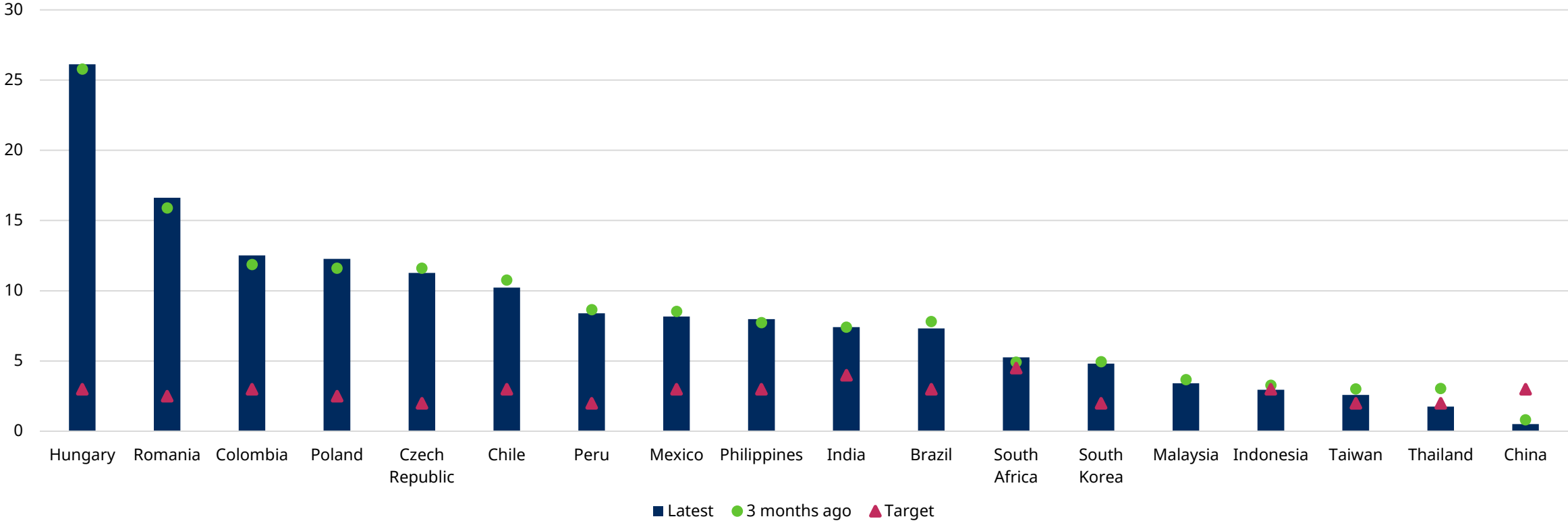
There are signs of disinflation in various EM

Turkey's annual headline inflation (44%) omitted from the figure.  
Source: Schroders, Refinitiv Datastream. Data as at 30 April 2023. Please see relevant disclaimers on page 36.

# EM core inflation

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

## Core inflation (%)

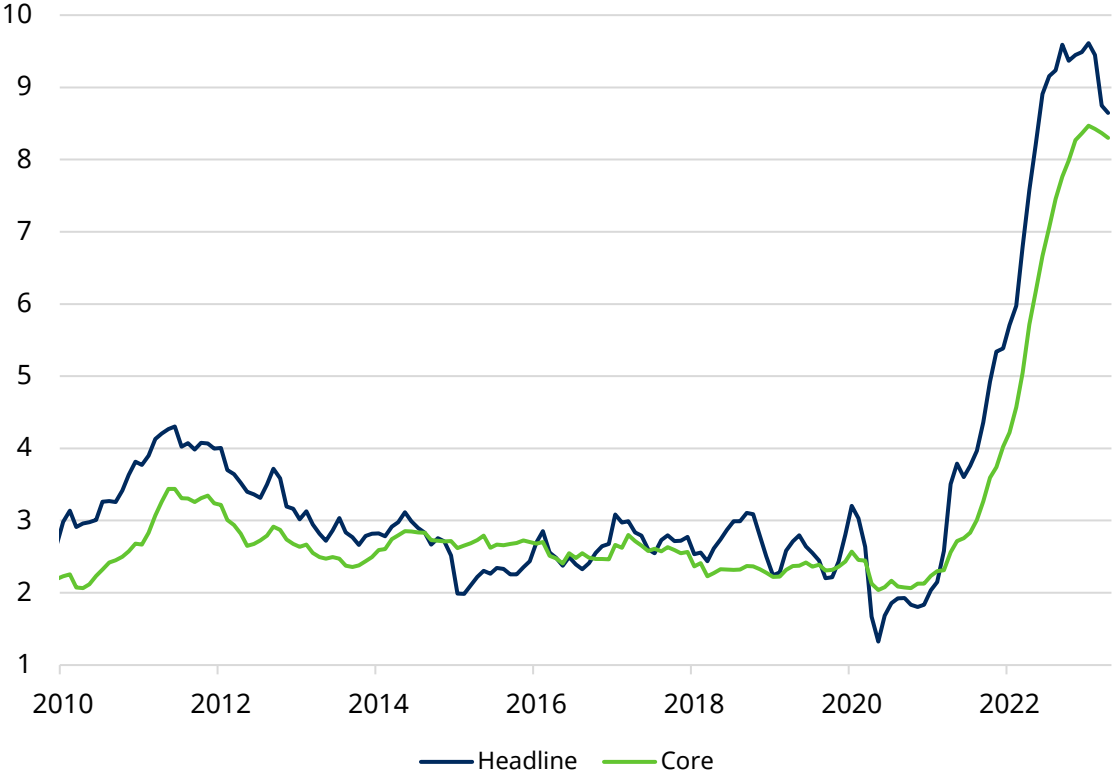


Turkey's annual core inflation (46%) omitted from the figure.  
 Source: Schroders, Refinitiv Datastream. Data as at 30 April 2023. Please see relevant disclaimers on page 36.

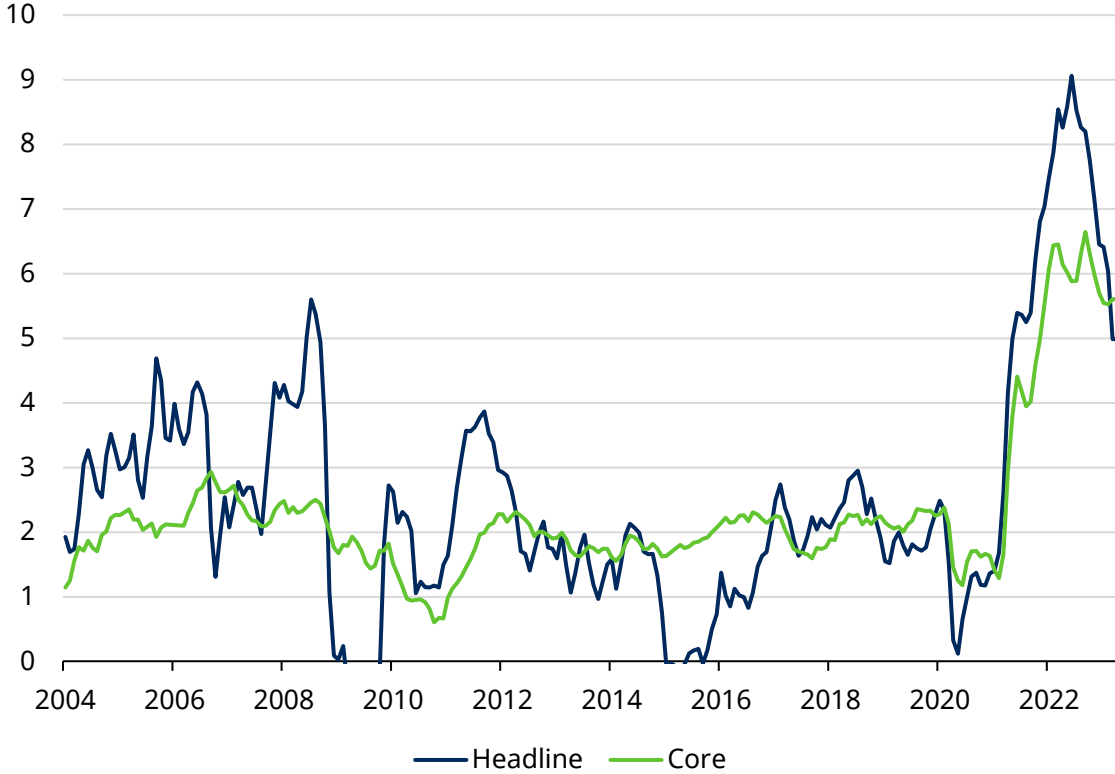
# Headline EM inflation has started to fall

...and core looks to have peaked

### Average EM inflation ex Turkey<sup>1</sup> (%)



### US inflation (%)



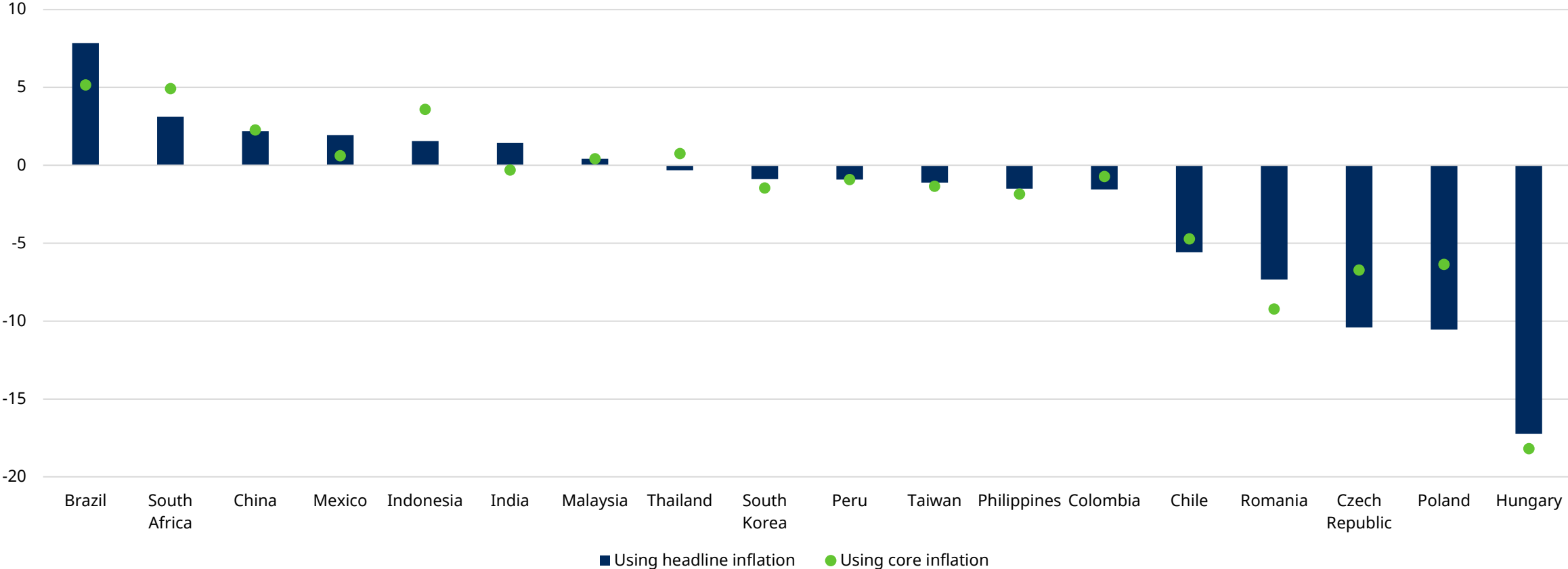
[Read more: Falling EM inflation points to rate cuts](#)

<sup>1</sup>Based 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 30 April 2023. Please see relevant disclaimers on page 36.

# 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



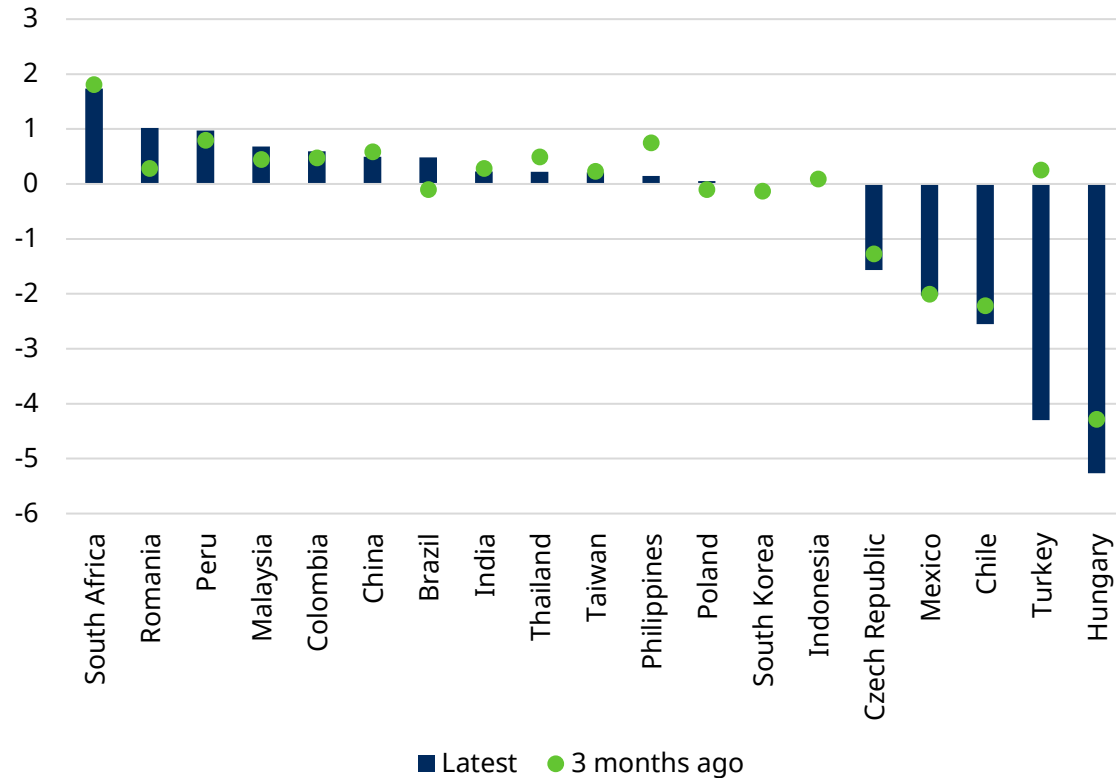
## Real bond yields are positive in Brazil and South Africa in particular

Nominal 10 year yield minus annual headline or core inflation  
Source: Schroders, Refinitiv Datastream. Data as at 30 April 2023. Please see relevant disclaimers on page 36.



# EM yield curve shape

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



## Average EM yield curve steepness (10y yield – 2y yield)<sup>1</sup>



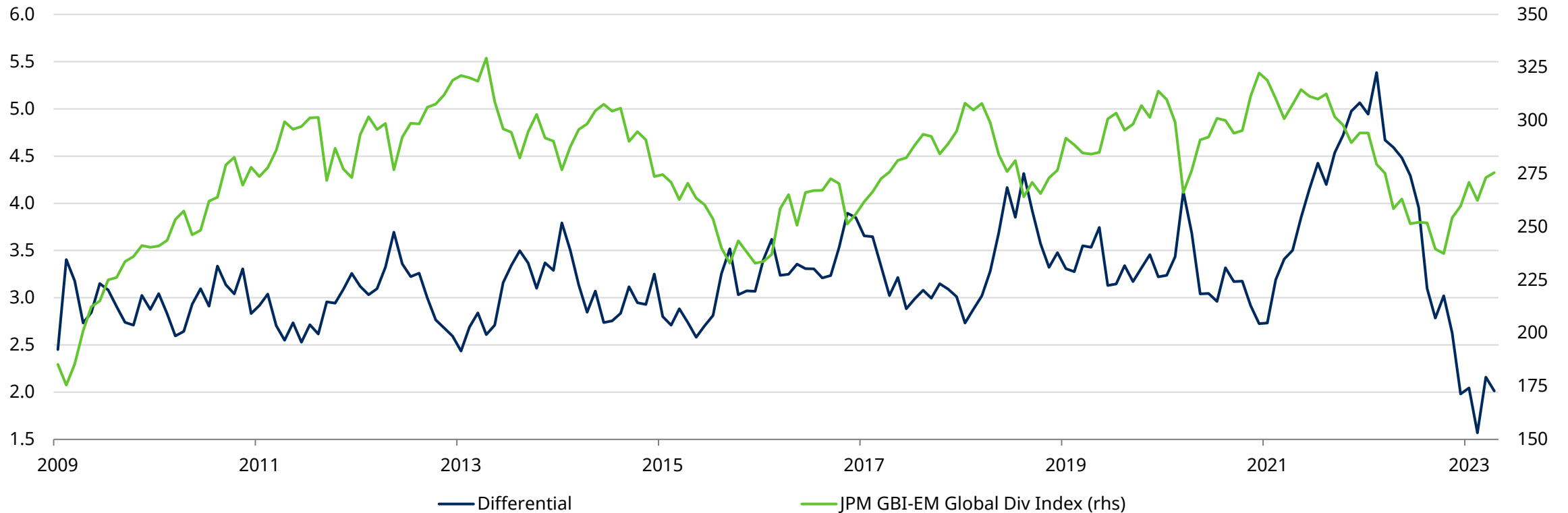
**EM yield curves have been flattening as central banks hike short-term interest rates**

<sup>1</sup>Based on 19 major EM countries.  
Source: Schroders, Refinitiv Datastream. Data as at 30 April 2023. Please see relevant disclaimers on page 36.

# 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.**

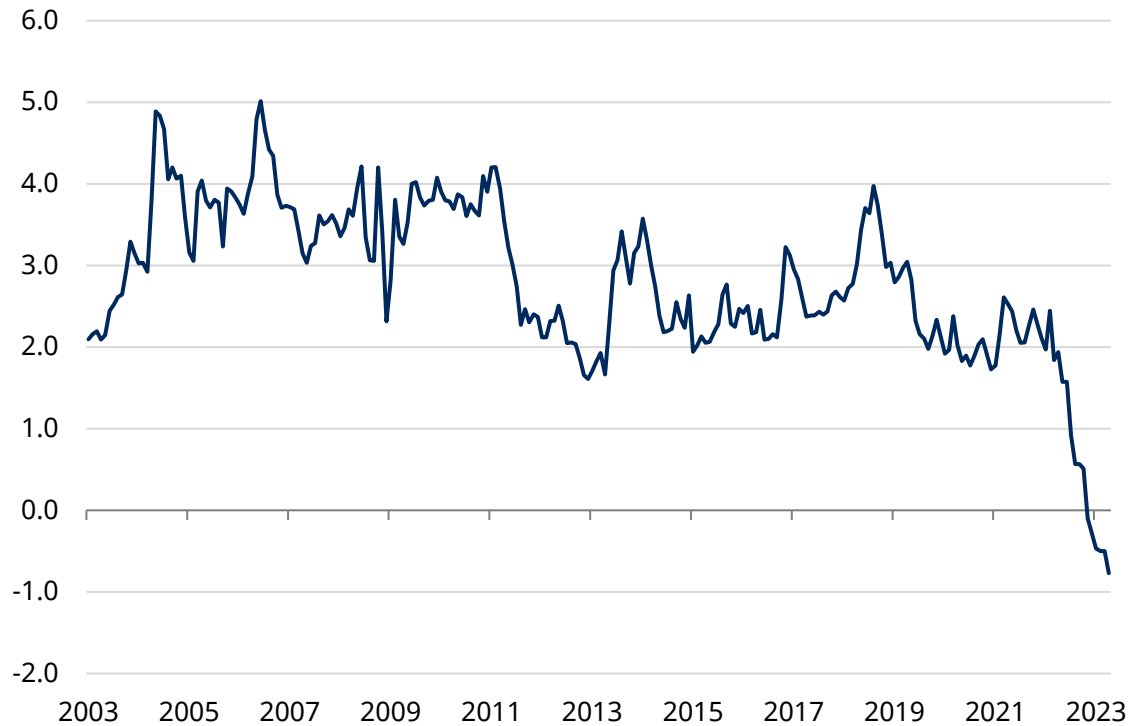
EM real yield is weighted average of individual JPM GBI-EM index nominal yields deflated by core inflation. DM real yield is 5Y government bond yields of US, UK, Euro zone, Japan deflated by core inflation, weighted by the size of individual government bond market.

Source: Schroders, Refinitiv Datastream, ICE Data Indices, J.P. Morgan. Data as at 30 April 2023. Please see relevant disclaimers on page 36.

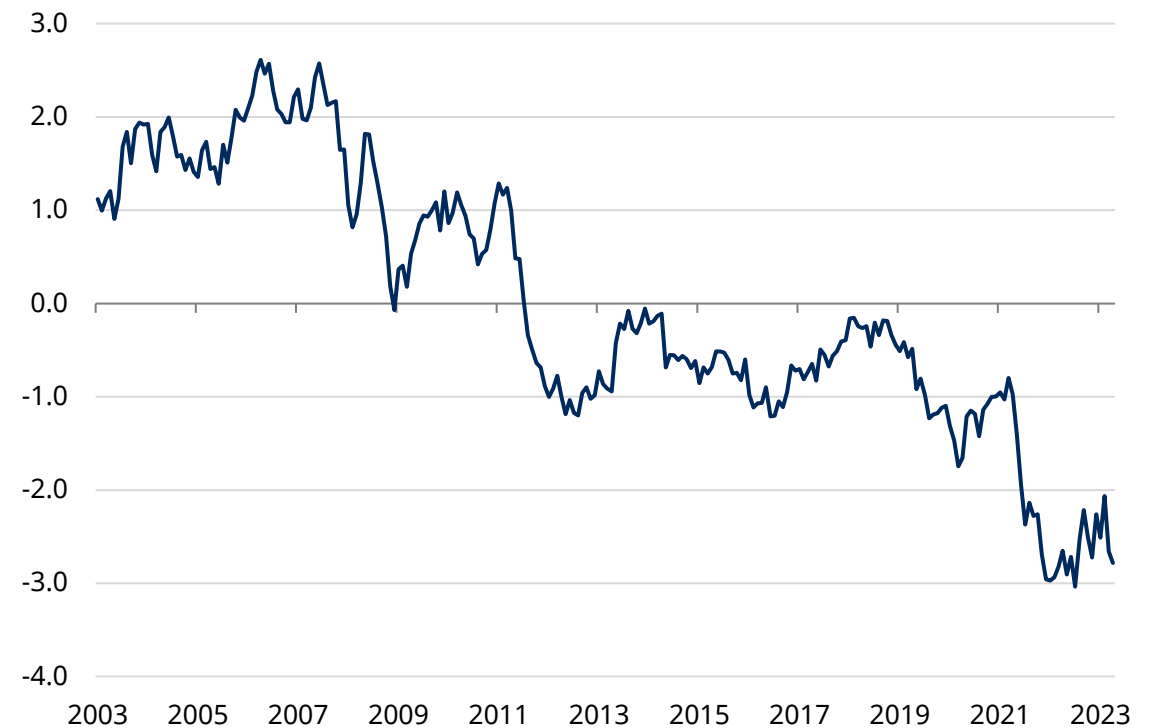
# EM and DM real yields

## Individual drivers of the real yield differential

### EM real yield (%)

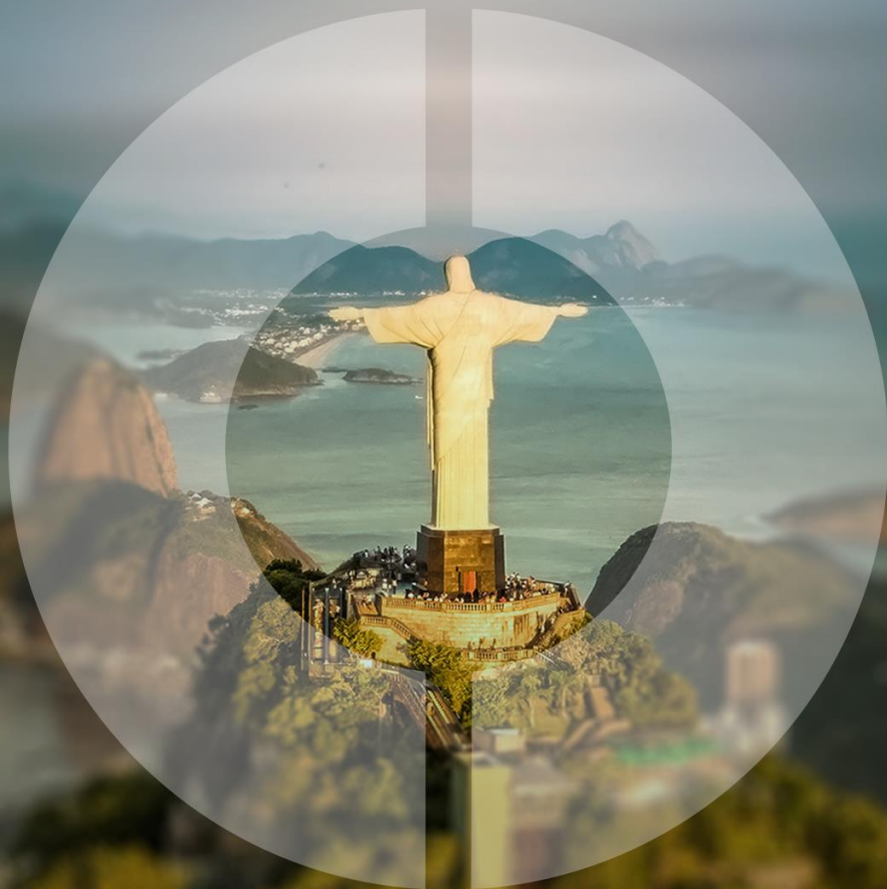


### DM real yield (%)



### EM real yield has moved into negative territory

Source: Schroders, Refinitiv Datastream, ICE Data Indices, J.P. Morgan. Data as at 30 April 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 36.



## Emerging market currencies

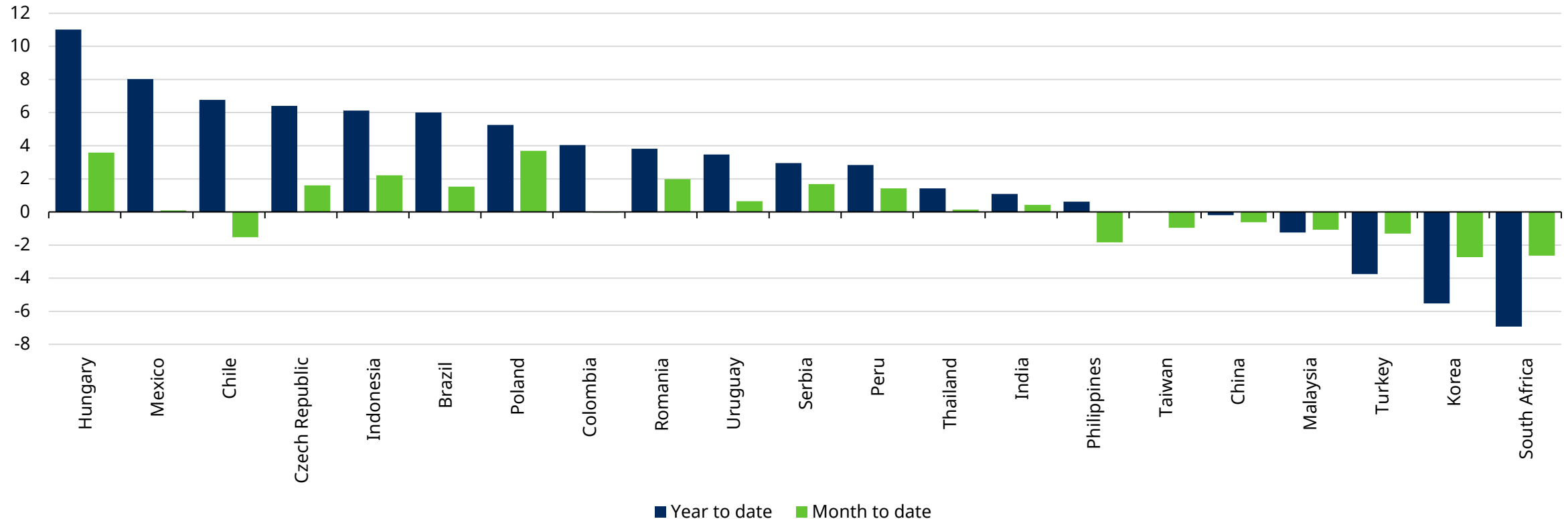
# Summary: emerging market currencies

- A majority of EM currencies have appreciated versus the US dollar 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 Romania and India are also expensive versus history. Turkey, Serbia, and South Africa are the cheapest EM currencies.
- 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 currencies have been broadly stronger YTD

## EM currency returns (%)



Eastern European and Latin currencies have seen the most appreciation YTD

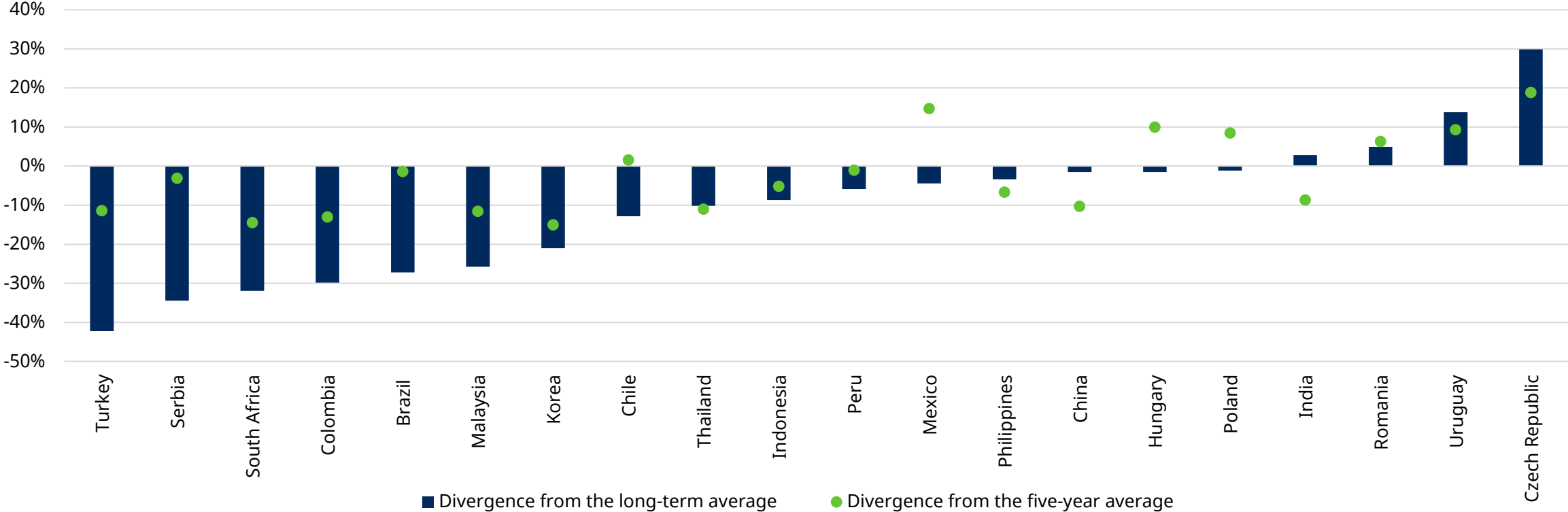
Past performance is not a guide to future performance and may not be repeated.

Source: Schroders, Refinitiv Datastream. Data as at 30 April 2023. Please see relevant disclaimers on page 36.

# EM currency value

Some currencies are significantly undervalued

## Real exchange rate: deviation from average



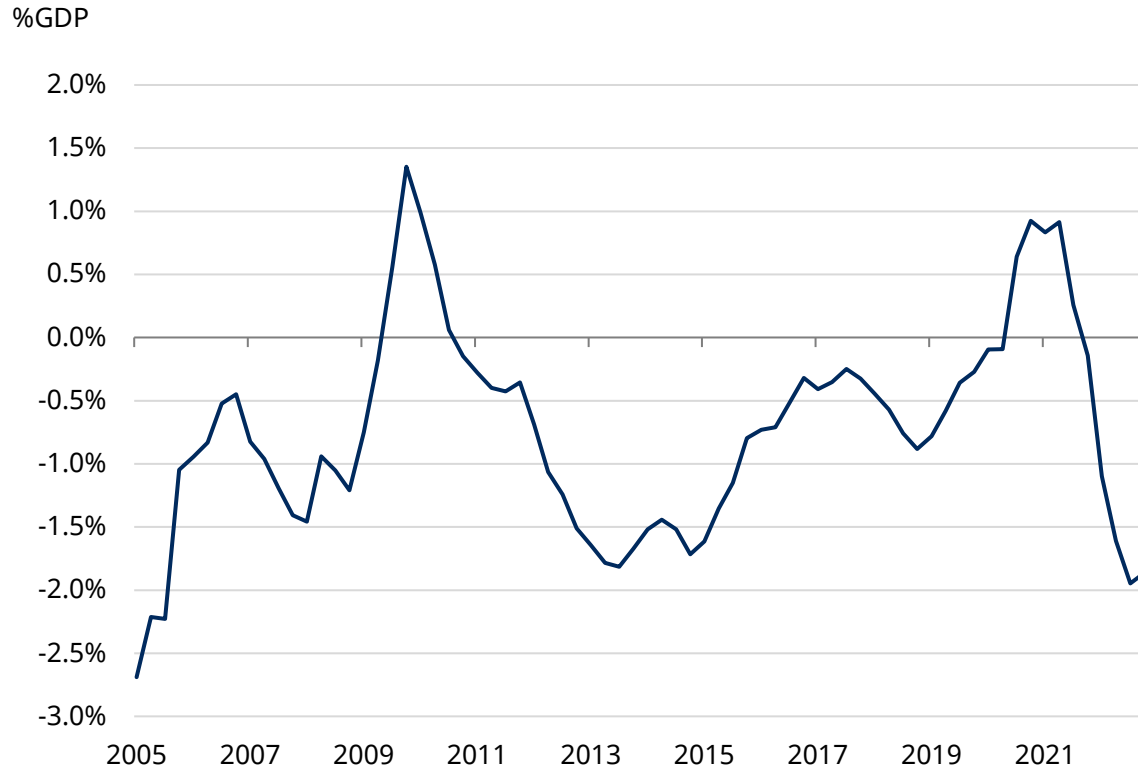
Turkey, Serbia, and Colombia have the cheapest currencies

Source: Schroders, Refinitiv Datastream. Data as at 30 April 2023. 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 36.

# EM fundamentals: current account vs. currency valuation

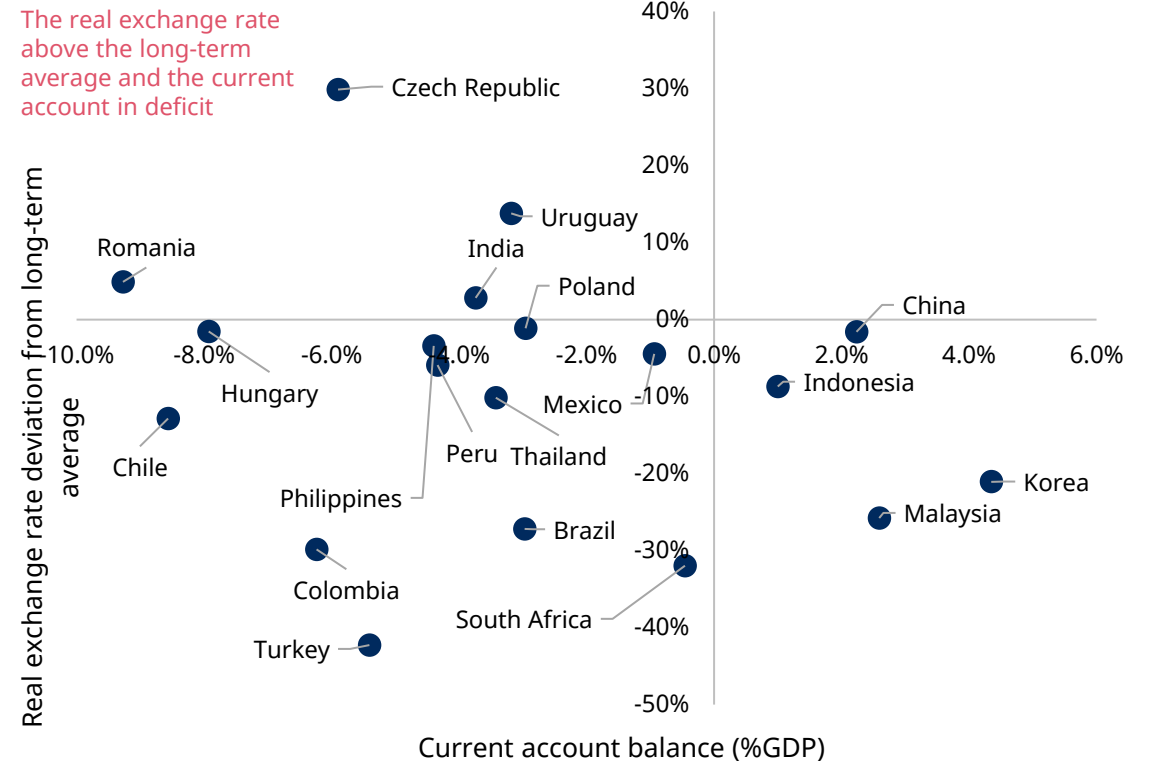
Current accounts of commodity importers have deteriorated

## Average EM current account balance<sup>1</sup>



## EM currency value<sup>2</sup> vs. current account balance

Real exchange rate deviation from long-term average



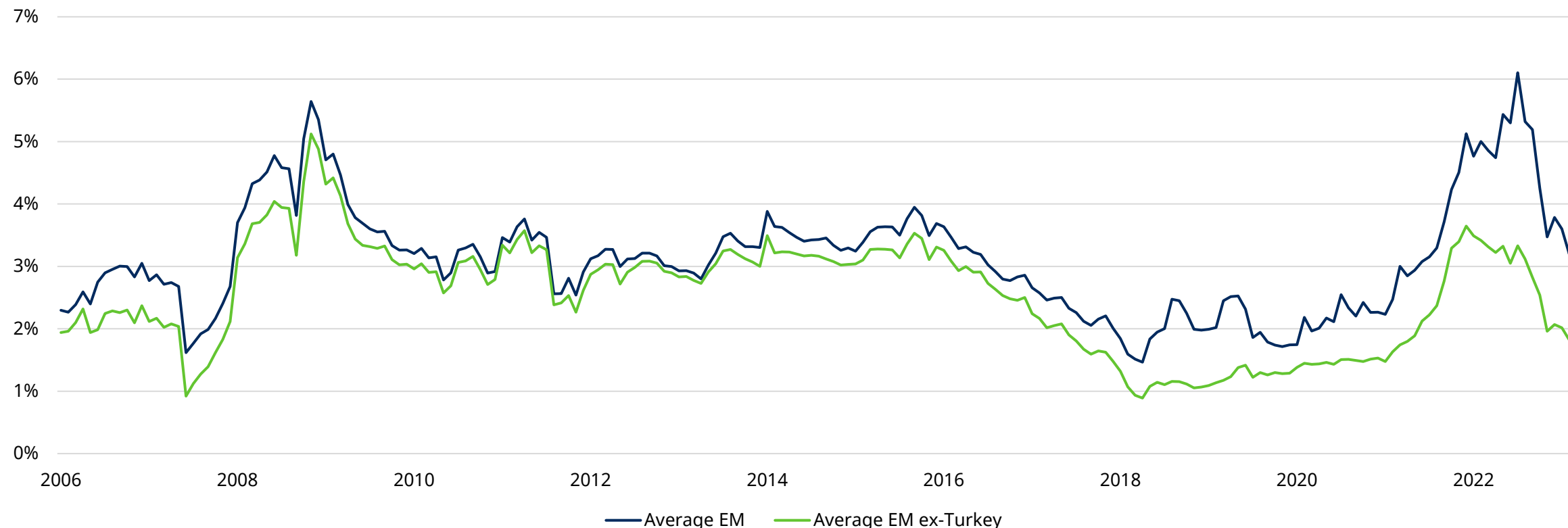
**Czech Republic, and Romania are among the most vulnerable to currency weakness**

<sup>1</sup>Based on the historical country weights of the JPM GBI-EM Global Diversified Index. <sup>2</sup>Currency 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 30 April 2023. Please see relevant disclaimers on page 36.



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

## Average EM carry<sup>1</sup>

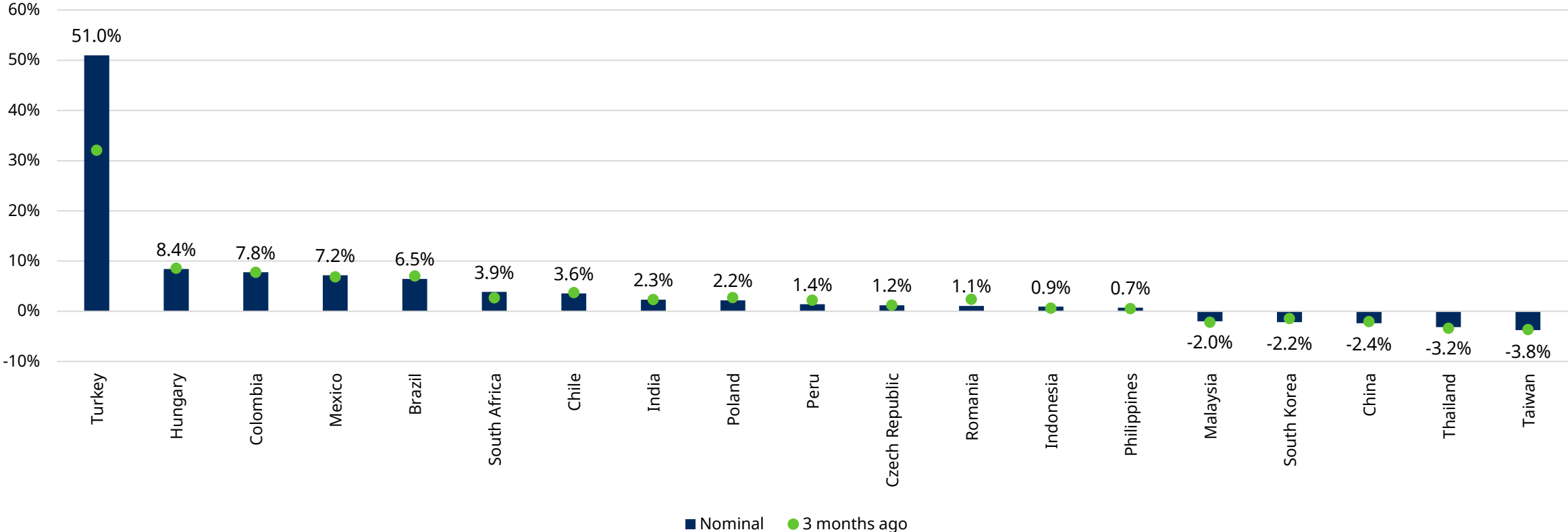


## EM ex-Turkey carry has stabilised in recent months

<sup>1</sup>The 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 30 April 2023. Please see relevant disclaimers on page 36.

# FX Carry varies significantly between the countries

## EM FX carry<sup>1</sup>



<sup>1</sup>The return of holding 1-year FX forward vs. US dollar to maturity.  
 Source: Schroders, Refinitiv Datastream. Data as at 30 April 2023. Please see relevant disclaimers on page 36.

# 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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