



Schroders Emerging Markets Lens: Emerging Market Debt

Strategic Research Unit

December 2022

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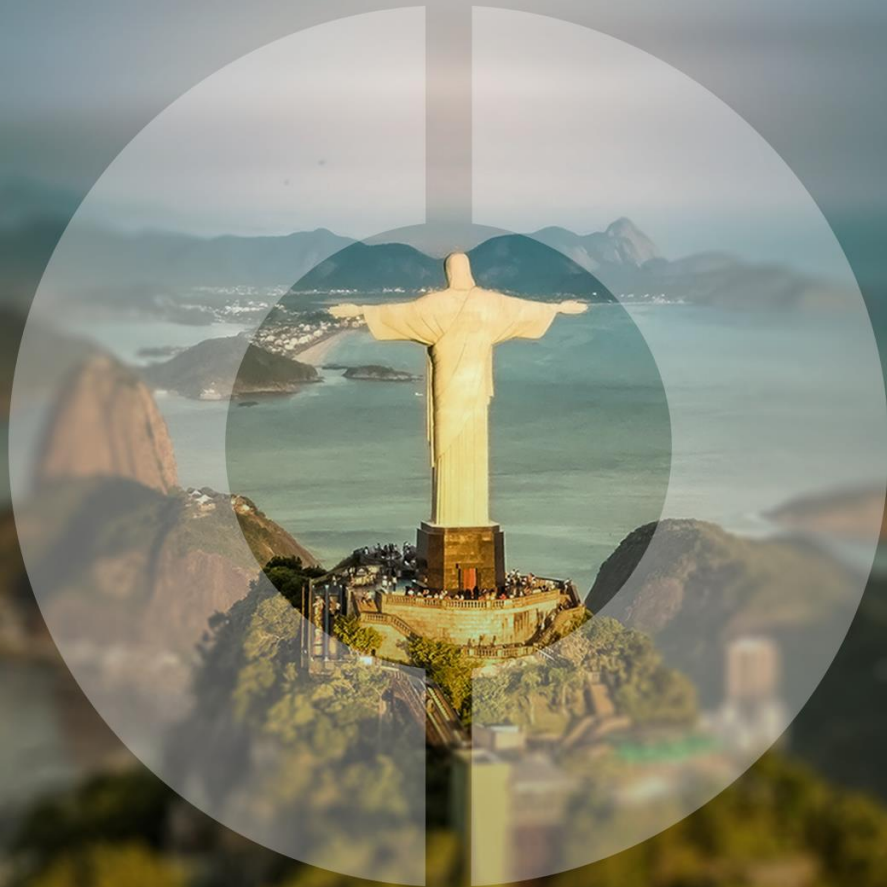
Summary

Hard currency emerging market debt (EMD):

- Despite a -1.2% fall in November, the hard currency sovereign EMD index yield remains elevated. This year's rise in yields has been driven by a combination of higher credit spreads and higher treasury yields.
- The spread of the investment grade (IG) sovereign index is now below its historical median while the IG corporate index is close to its median.
- The spread of the HY sovereign index is still elevated, despite declining in the past month. The high yield (HY) corporate index spread has moved close to its historical median.

Local currency EMD:

- The local currency EM index yield fell by -0.6% in November, but is still up 1.1% YTD, as at 5 December.
- However, the real yield pickup over developed market (DM) bonds has collapsed towards the bottom end of its post-GFC range. This is because of the sharp decrease in EM real yields this year, as inflation has increased by more than nominal yields.
- There are undervalued **currencies** in all three EM regions. On average, Latin American currencies are the cheapest, whereas Asian currencies have the least appealing value.



Emerging market debt: hard currency

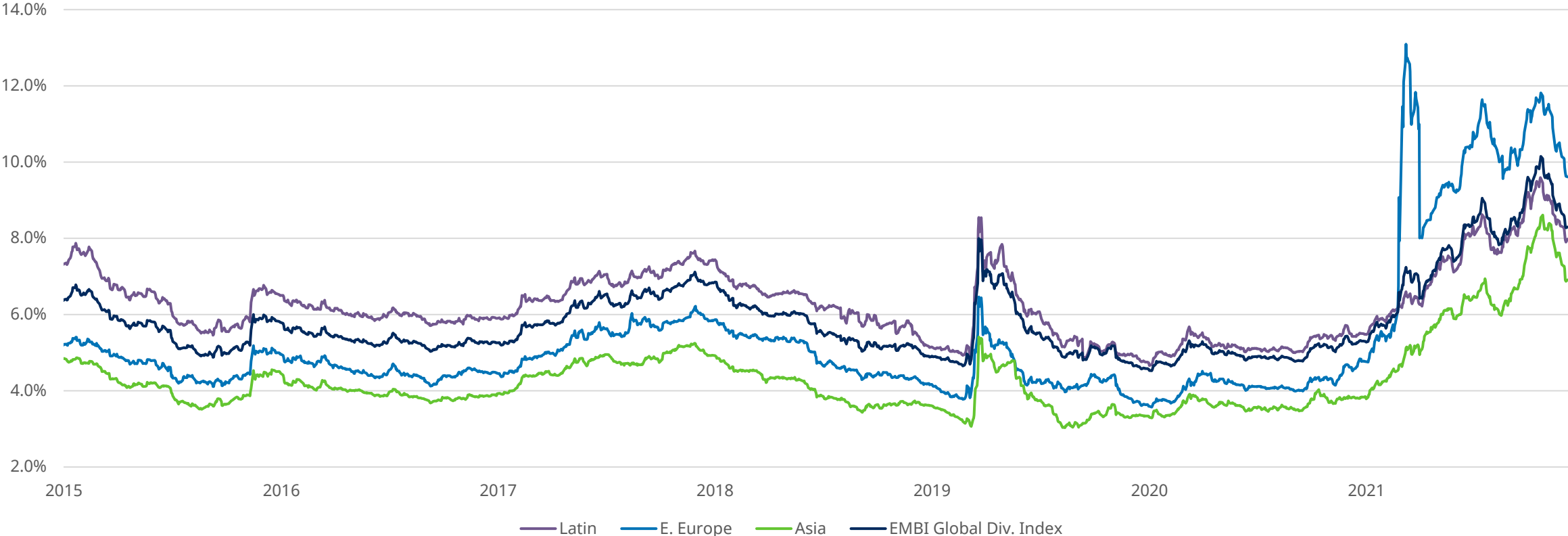
Summary: hard currency emerging market debt

- The hard currency sovereign EMD index yield fell -1.2% in November, as it recorded its strongest monthly performance since 1998.
- High energy prices post Russia's invasion of Ukraine, global growth concerns, and ongoing tightening in financial conditions have created a challenging macroeconomic backdrop for EM assets this year. The hard currency sovereign EMD index yield has risen 3.0% YTD, as at 5 December.
- In sovereign EMD, the spread dispersion between countries remains wide. While most commodity exporters and larger countries are doing fine, some commodity importers and smaller countries are feeling the pain.
- Higher US yields have increased the cost of debt for EM issuers and the sovereign HY index spread remains at an elevated level. The IG spread is below its historical median.
- In corporate EMD, the corporate high yield (HY) index spread and the IG spread are both close to their historical median.
- Credit quality has worsened since the pandemic for issuers included in major sovereign and corporate EMD benchmarks.

EM hard currency index yield has increased by 3.0% YTD

....despite a -1.2% fall in November.

Hard currency sovereign EMD regional index yield

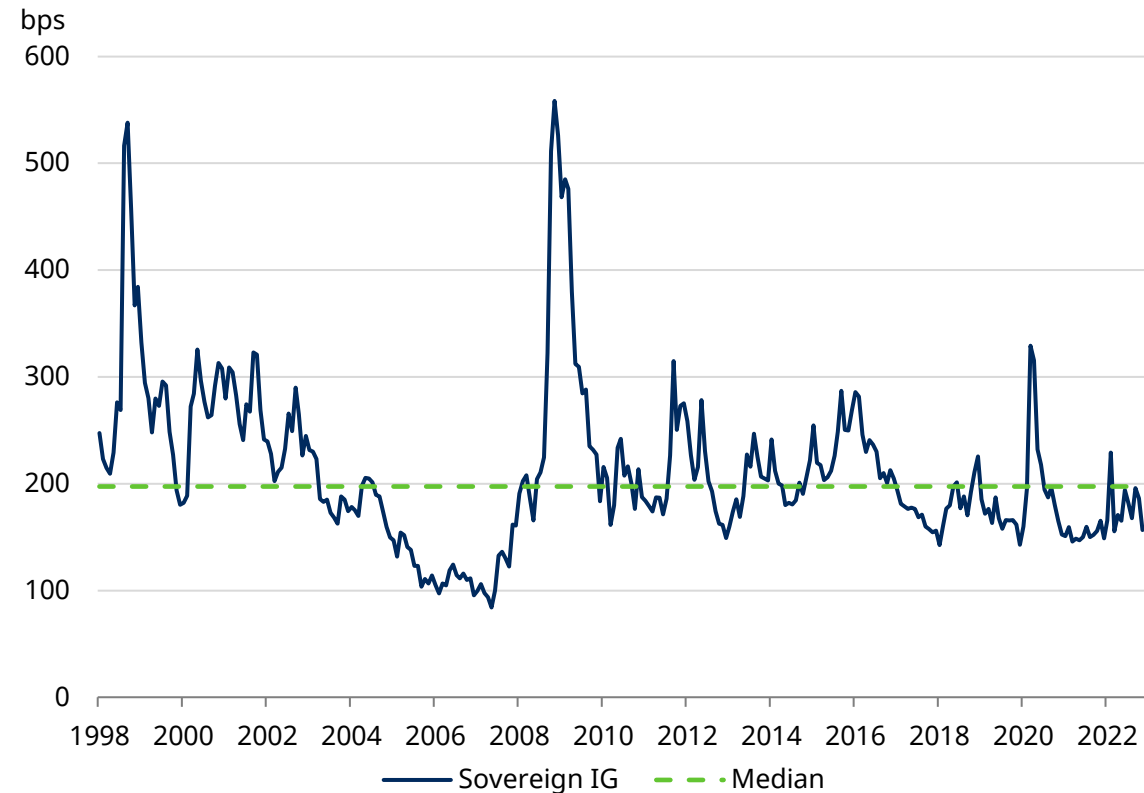


YTD yields have risen in all three regions, led higher by Eastern Europe

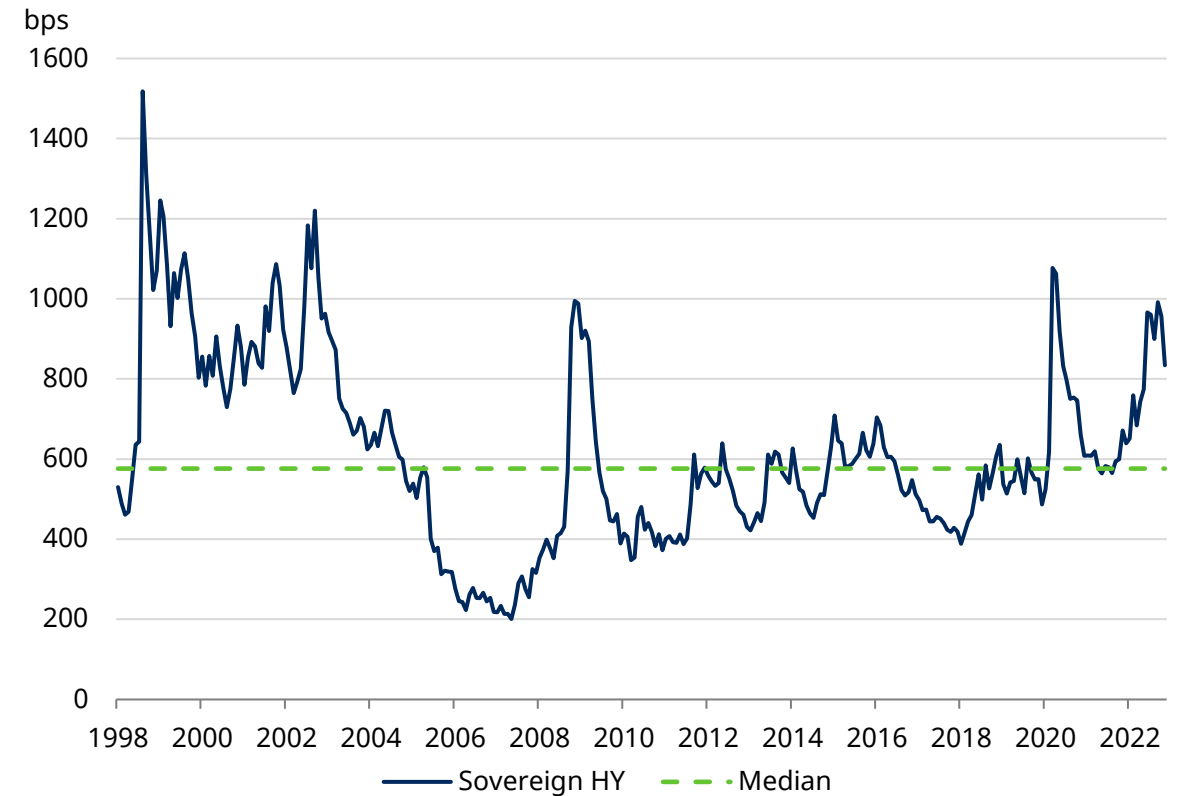
Russia was removed from all JP Morgan EMD indices from 31 March 2022.
Source: Schroders, JP Morgan. Data as at 5 December 2022.

Valuation of hard currency sovereign EMD

Hard currency sovereign EMD IG spread



Hard currency sovereign EMD HY spread

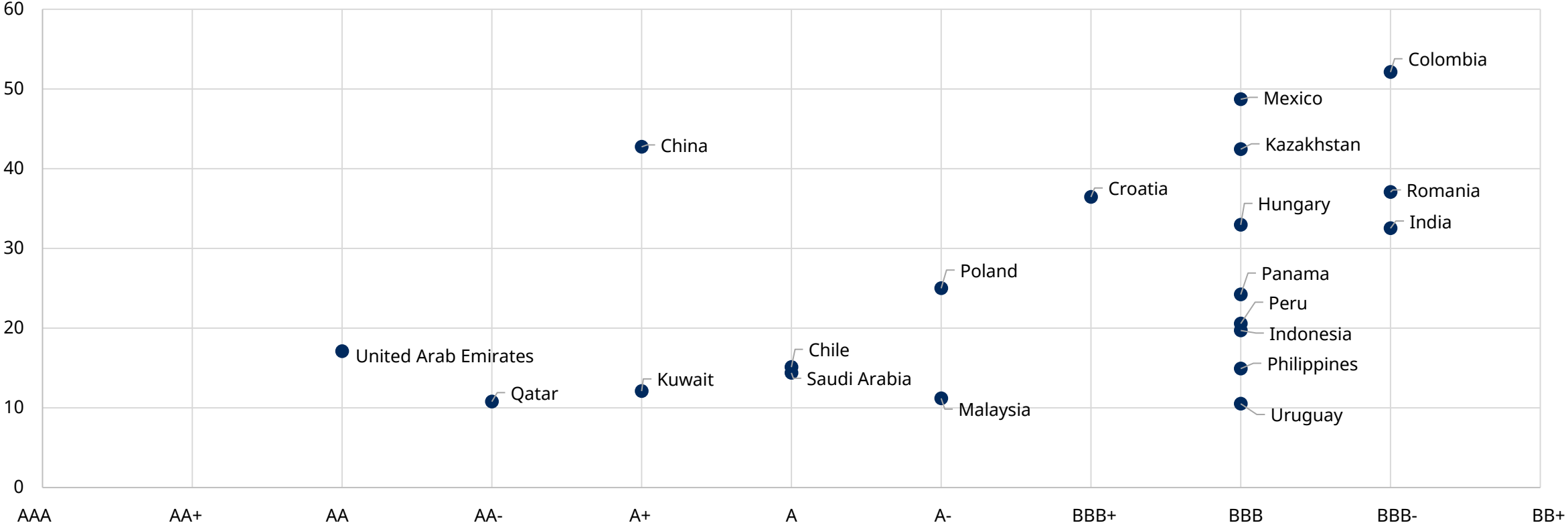


IG spread is below the historical median but the HY spread remains elevated

Source: Refinitiv Datastream, J.P. Morgan. Data as at 30 November 2022.

Duration adjusted spreads of IG countries

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

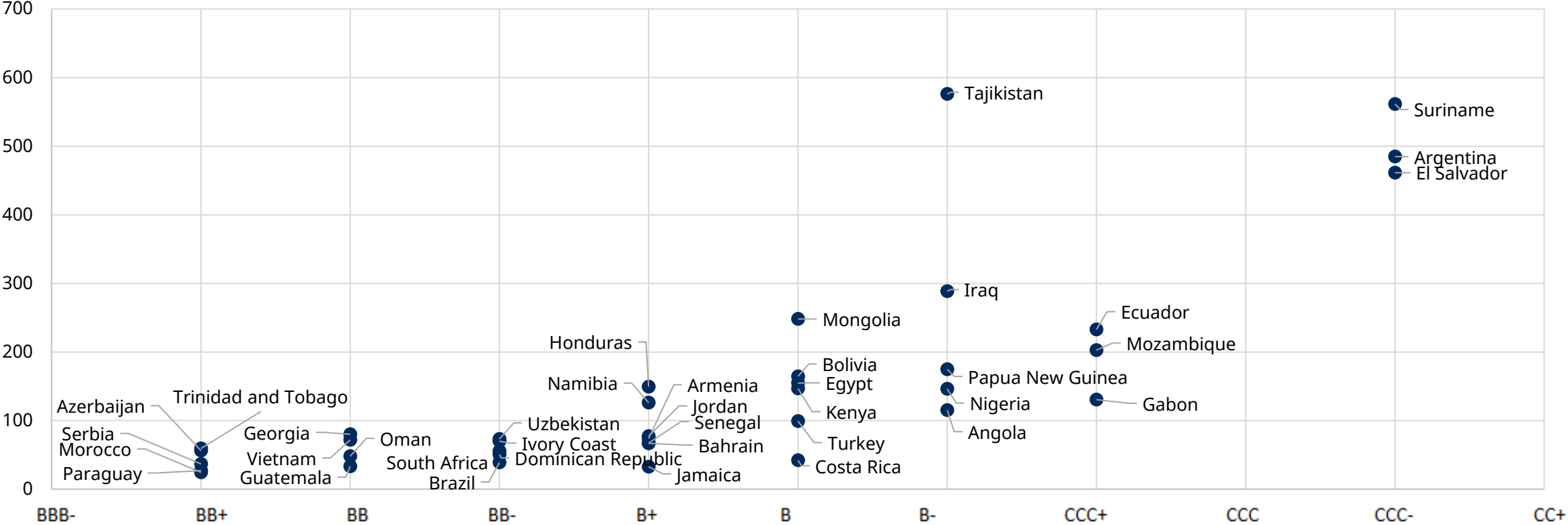


¹The JPMorgan EMBI Global Diversified Index includes both sovereign and quasi-sovereign bonds. Source: Schroders, Refinitiv Datastream, J.P. Morgan. Data as at 30 November 2022.

Duration adjusted spreads of HY countries

Significant variability between the countries

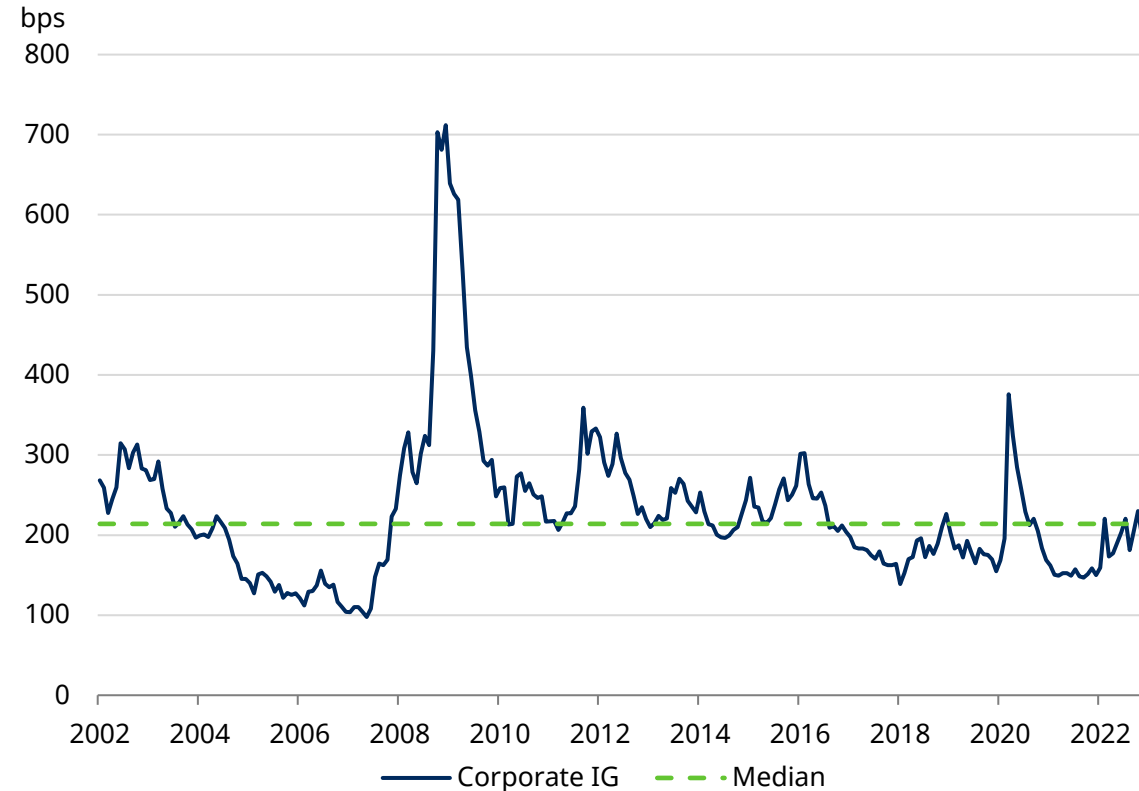
Hard currency sovereign EMD HY: spread vs. duration vs. credit rating



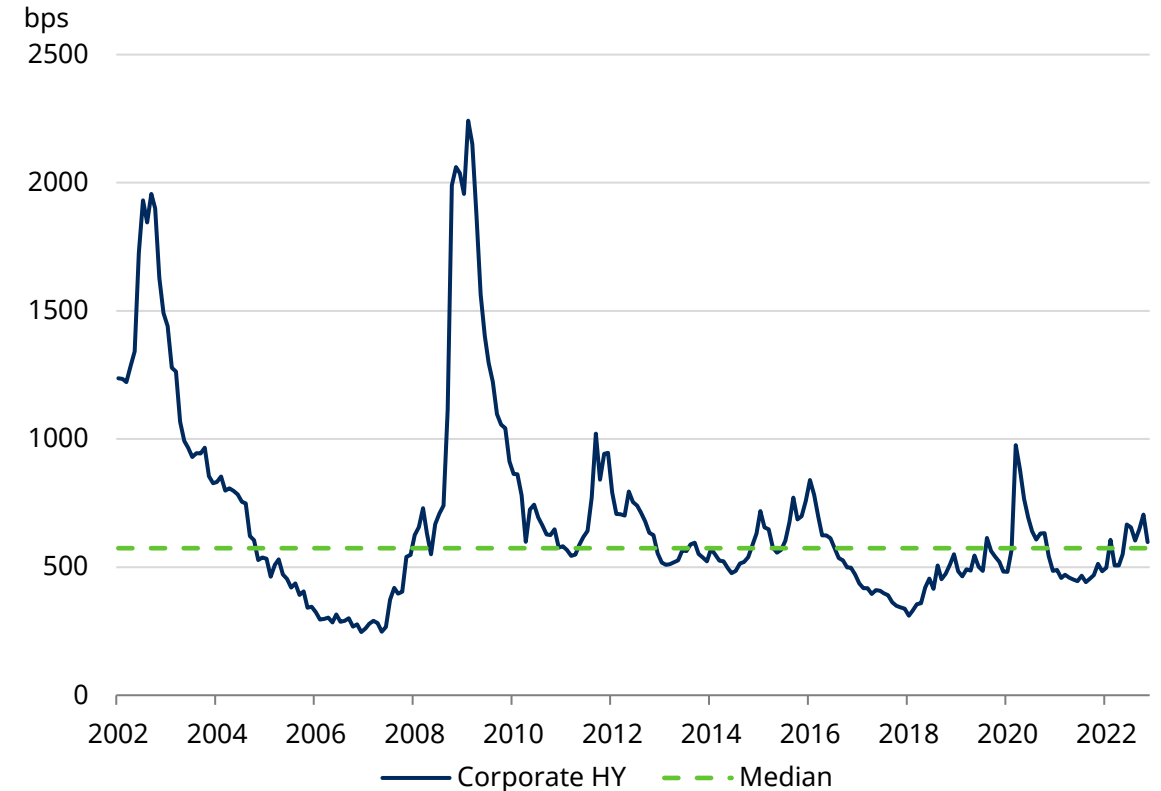
Source: Schroders, Refinitiv Datastream, J.P. Morgan. Data as at 30 November 2022.

Valuation of hard currency corporate EMD

Hard currency corporate EMD IG spread



Hard currency corporate EMD HY spread



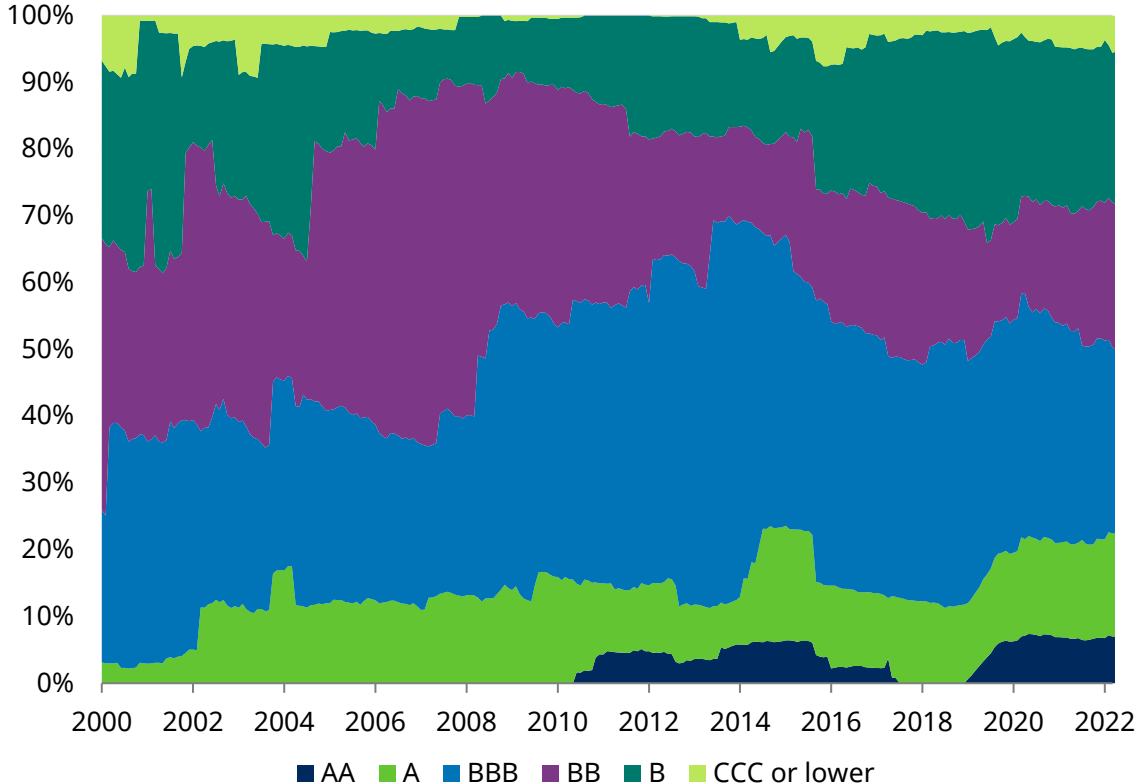
EM HY and IG corporate spreads are close to the historical median

Source: Refinitiv Datastream, J.P. Morgan. Data as at 30 November 2022.

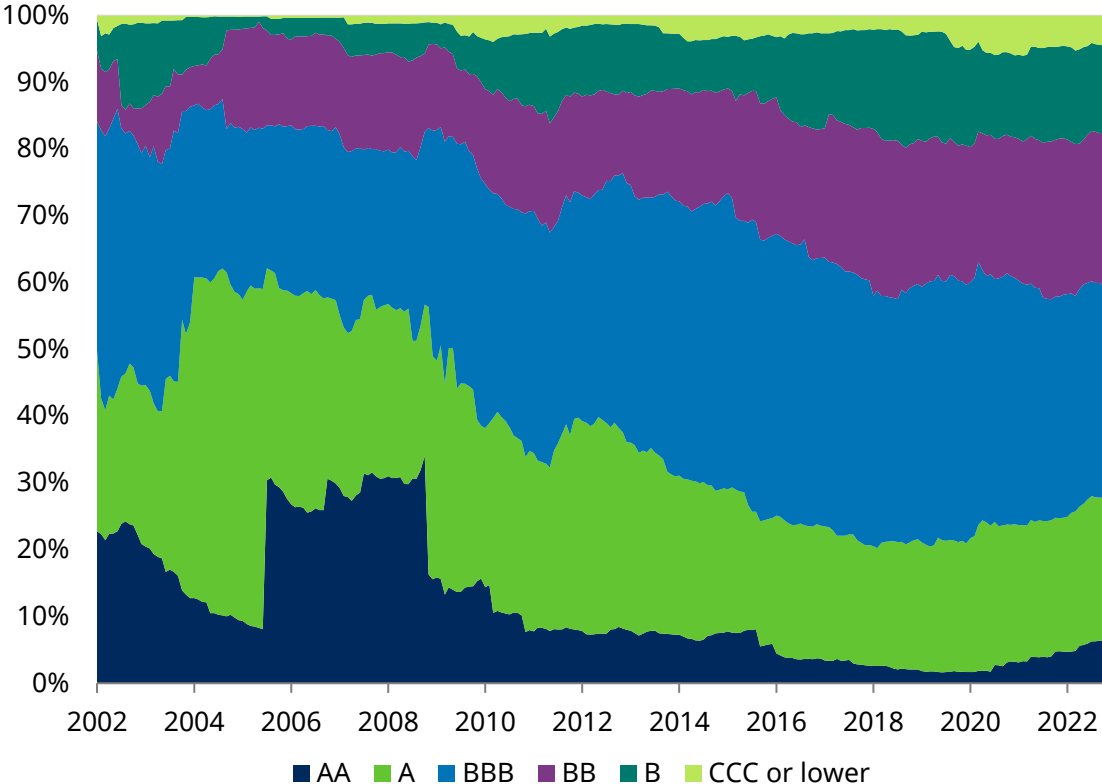
EMD historical ratings split

The share of IG bonds has fallen in both sovereign and corporate index in the last 10Y

Sovereign EMD ratings split



Corporate EMD ratings split



Source: Schroders, J.P. Morgan. Data as at 30 November 2022.

Characteristics of EM hard currency issuers

Hard currency corporate issuers



■ Financials ■ Nonfinancials

Hard currency sovereign issuers



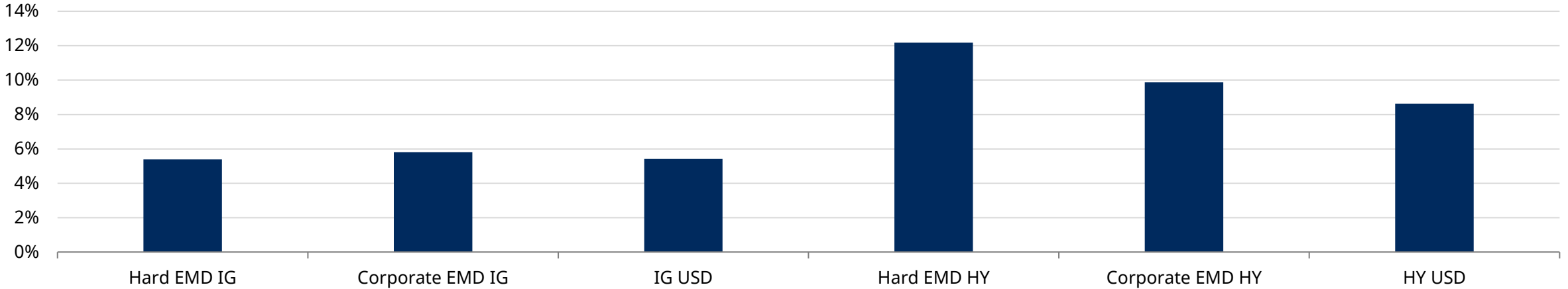
■ Sovereign ■ Quasi Sovereign

Source: Refinitiv Datastream, J.P. Morgan. Data as at 30 November 2022.

Hard and corporate EMD offer a spread and yield 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	5.4%	5.8%	5.4%	12.2%	9.9%	8.6%
Spread (bps)	2.6%	3.0%	2.6%	9.4%	7.1%	5.8%
Duration	157	197	142	834	598	455
Rating	8.0	4.9	7.2	5.6	3.4	4.6
Percentage of EMD index	A3	A3	A3	B1	B1	B1

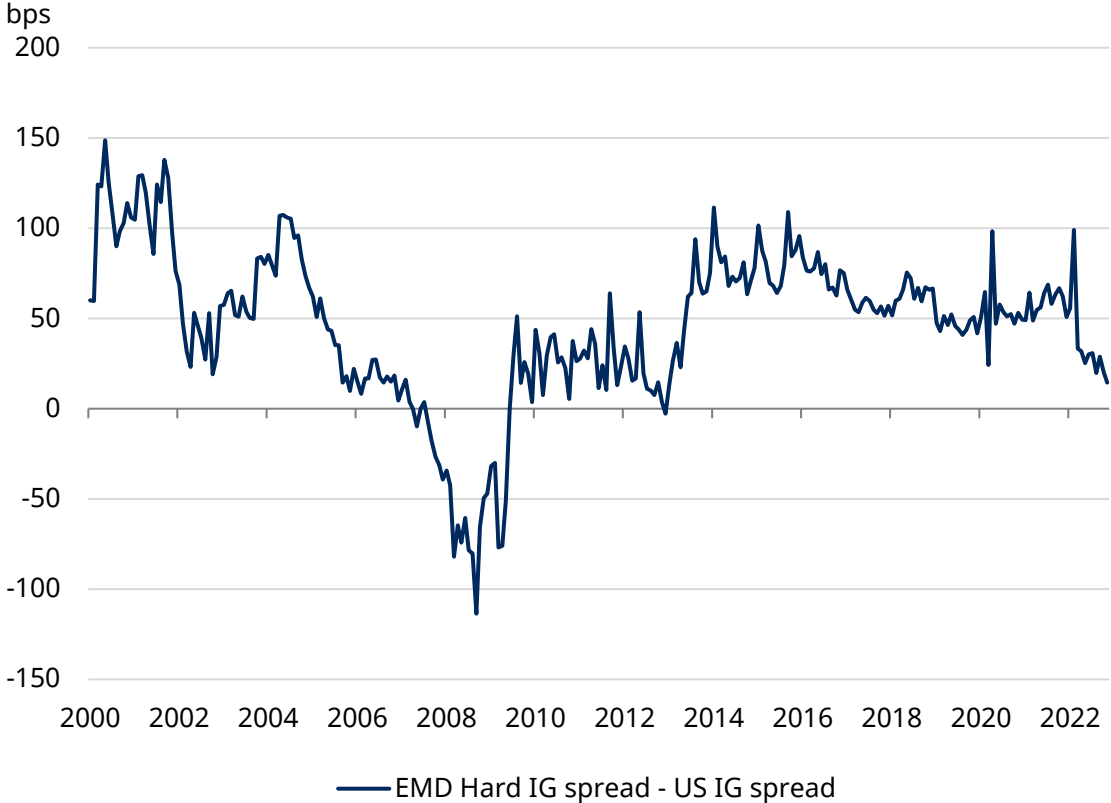
EM vs. DM yields



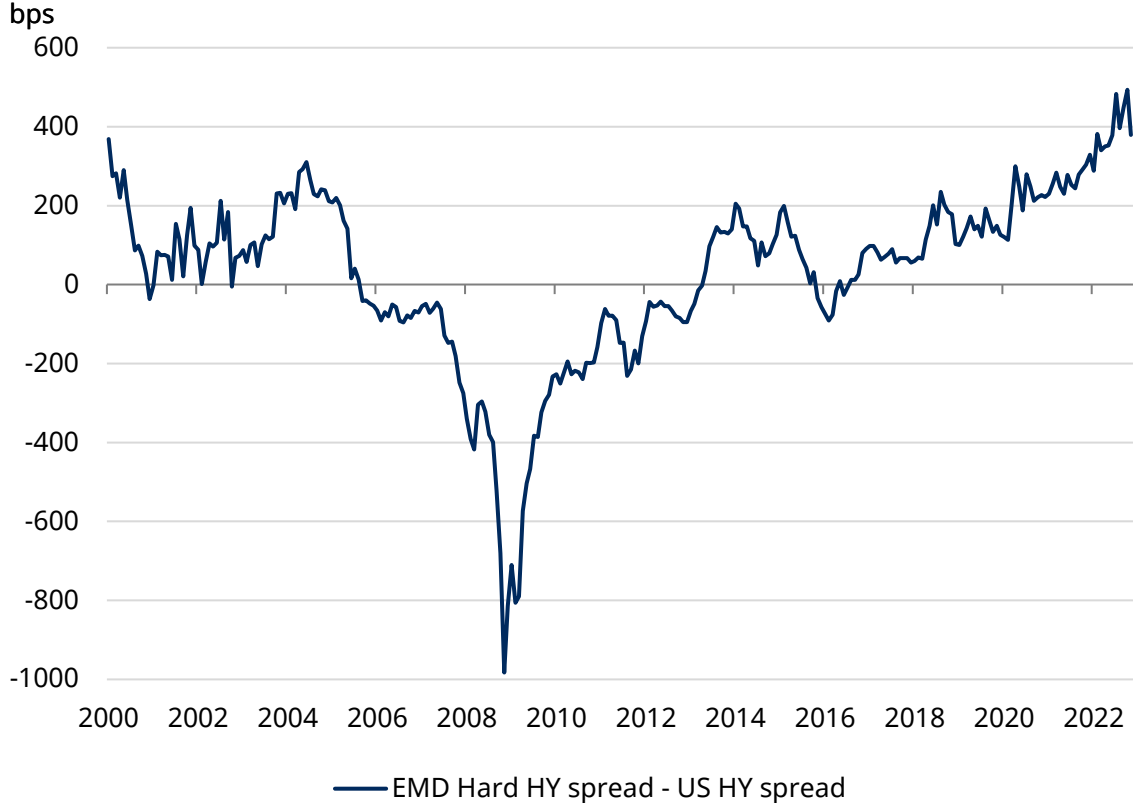
Source: Schroders, Refinitiv Datastream, ICE Data Indices, J.P. Morgan. Data as at 30 November 2022.

EM dollar debt: sovereign EMD vs. US corporates

Sovereign EMD IG spread minus US IG spread



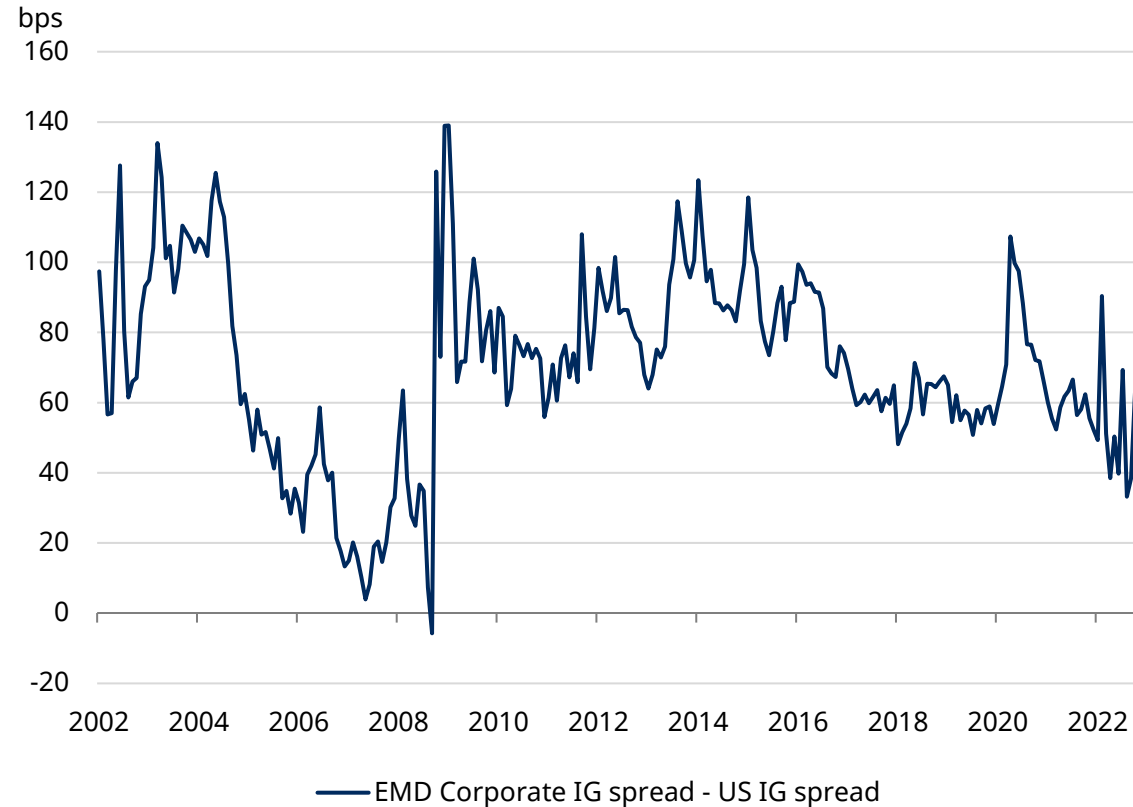
Sovereign EMD HY spread minus US HY spread



Source: Schroders, Refinitiv Datastream, ICE Data Indices, J.P. Morgan. Data as at 30 November 2022.

EM dollar debt: corporate EMD vs. US corporates

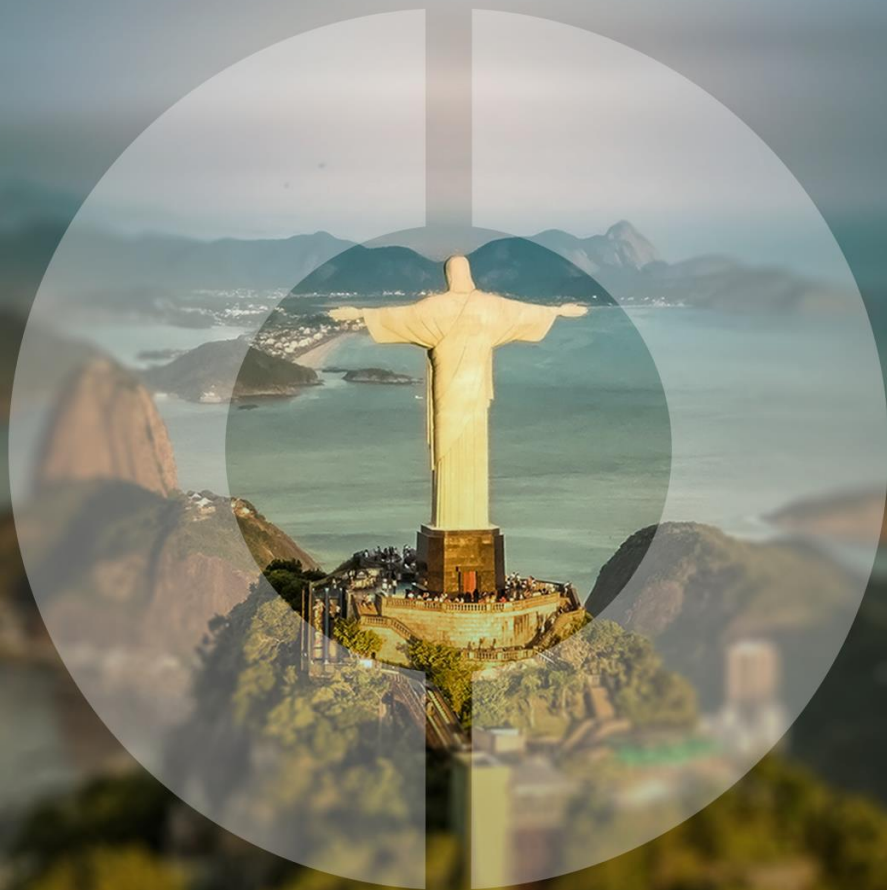
Corporate EMD IG spread minus US IG spread



Corporate EMD HY spread minus US HY spread



Source: Schroders, Refinitiv Datastream, ICE Data Indices, J.P. Morgan. Data as at 30 November 2022.



Emerging market debt: local currency

Summary: local currency emerging market debt

- The index yield fell -0.6% in November, its largest monthly down move since 2015. Softer inflation data and signs that the pace of Fed rate rises may have peaked fuelled risk appetite, while US dollar weakness was beneficial.
- Despite this monthly move, the index yield remains up 1.1% YTD as at 5 December, with yields in all three regions climbing higher, most notably in Latin America and Eastern Europe.
- Most EM central banks ex China and Turkey have been tightening policy this year, and the average policy rate is now at its highest level since 2008.
- EM inflation remains above target everywhere ex China. However, there are signs of disinflation in certain markets such as Brazil, as well as in select Asian EM.
- The real yield premium of EM over DM has collapsed towards the bottom-end of its post-GFC range. This is because of the sharp decrease in EM real yields this year, as inflation has increased by more than nominal yields.

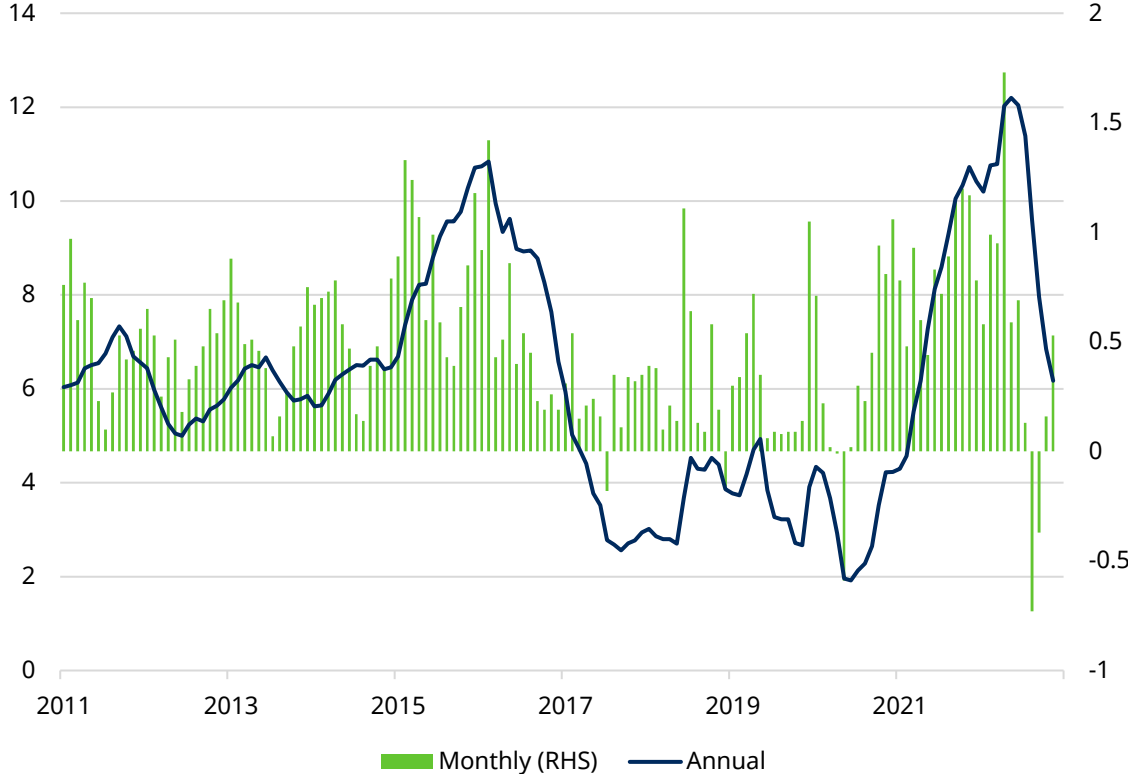
Ongoing sign of easing inflation in early hikers

Inflation has slowed in Brazil, but post-election policy uncertainty has lifted yields

Brazil 10 year yield



Brazil IPCA-15 CPI (%)

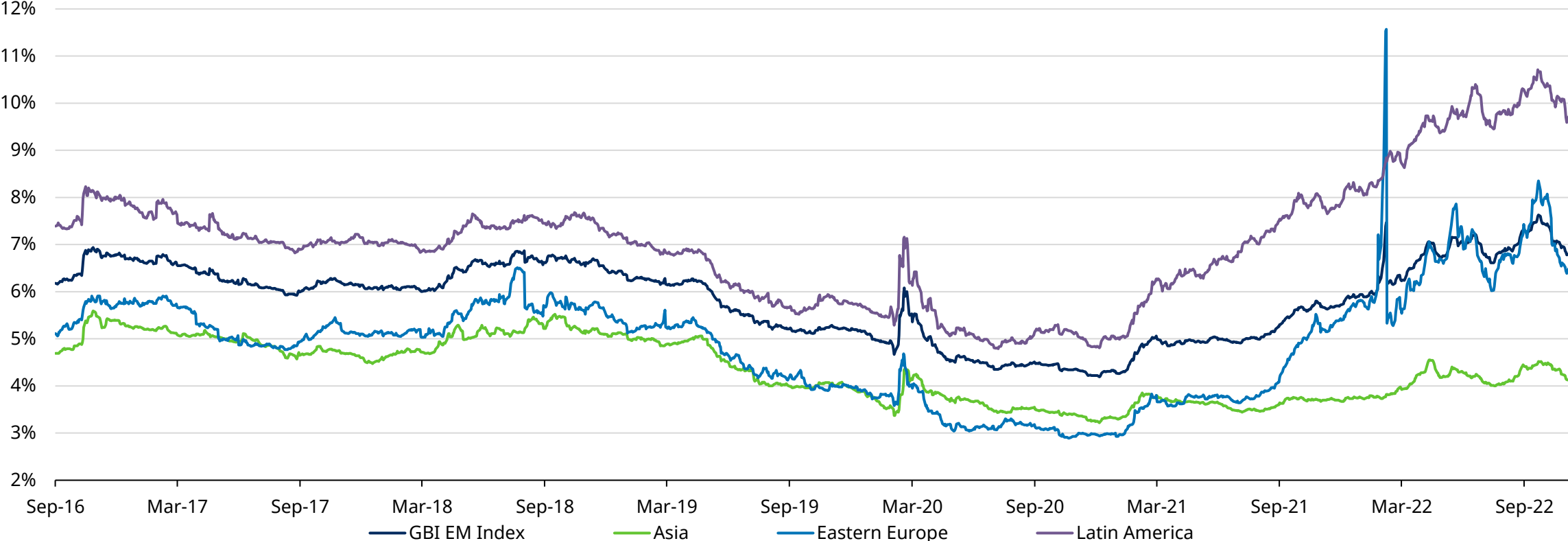


Brazil’s central bank held its policy rate in October, having hiked to 13.75% from 2.0% in early 2021

Source: Schrodgers, Refinitiv Datastream. Data as at 5 December 2022.

EM local currency index yield has increased 1.1% YTD

Yields of EM regions

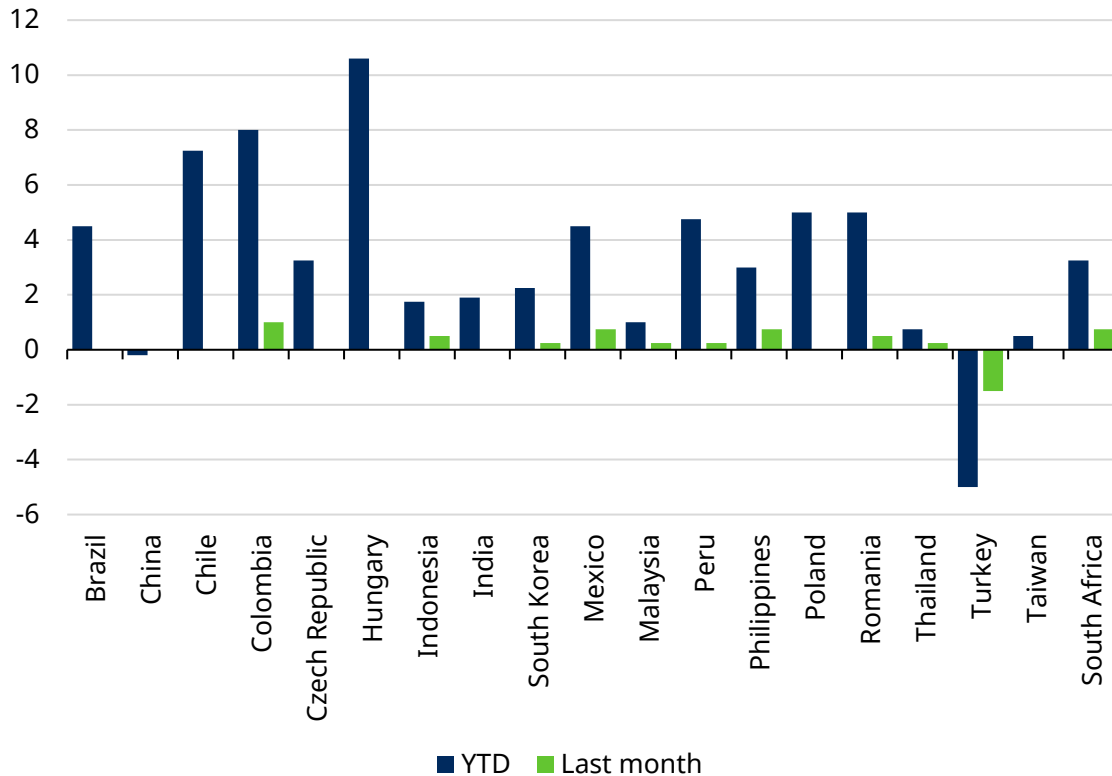


Source: Schroders, Refinitiv Datastream. Data as at 5 December 2022. Russia was removed from all JP Morgan EMD indices from 31 March 2022.

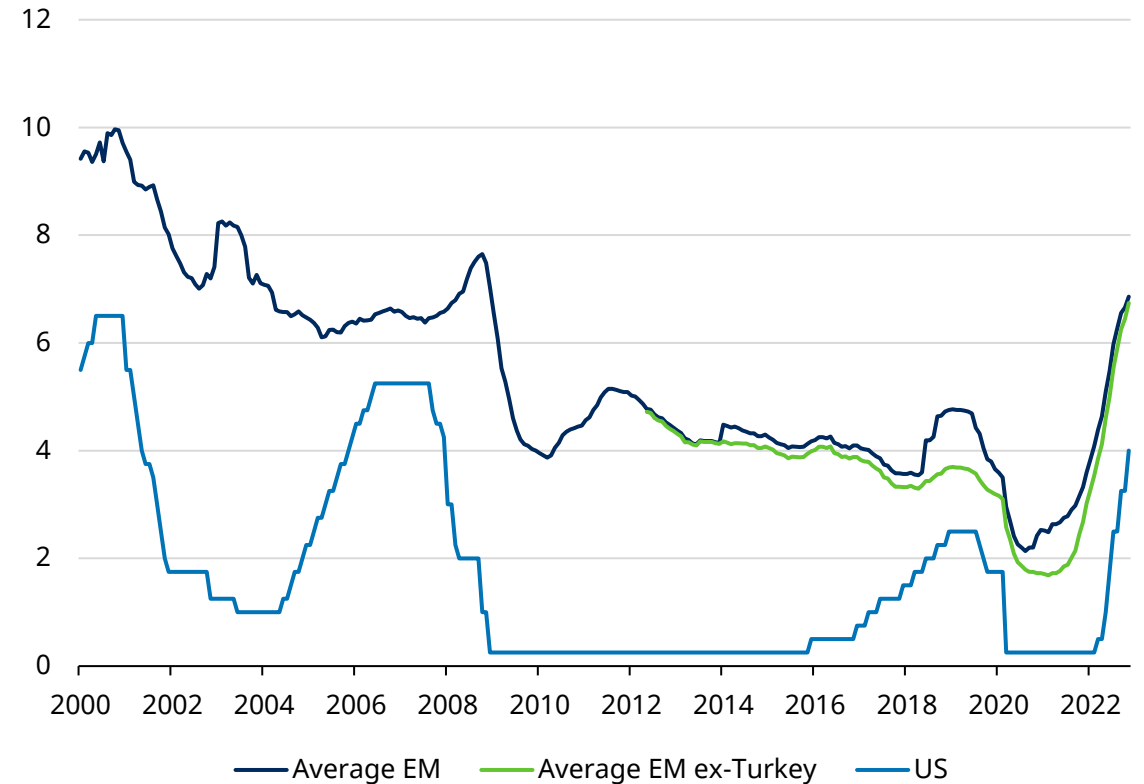
EM policy rates

Average EM policy rate is at its highest since 2008

Change in EM policy rates in 2022 (%)



Average EM policy rate¹ (%)

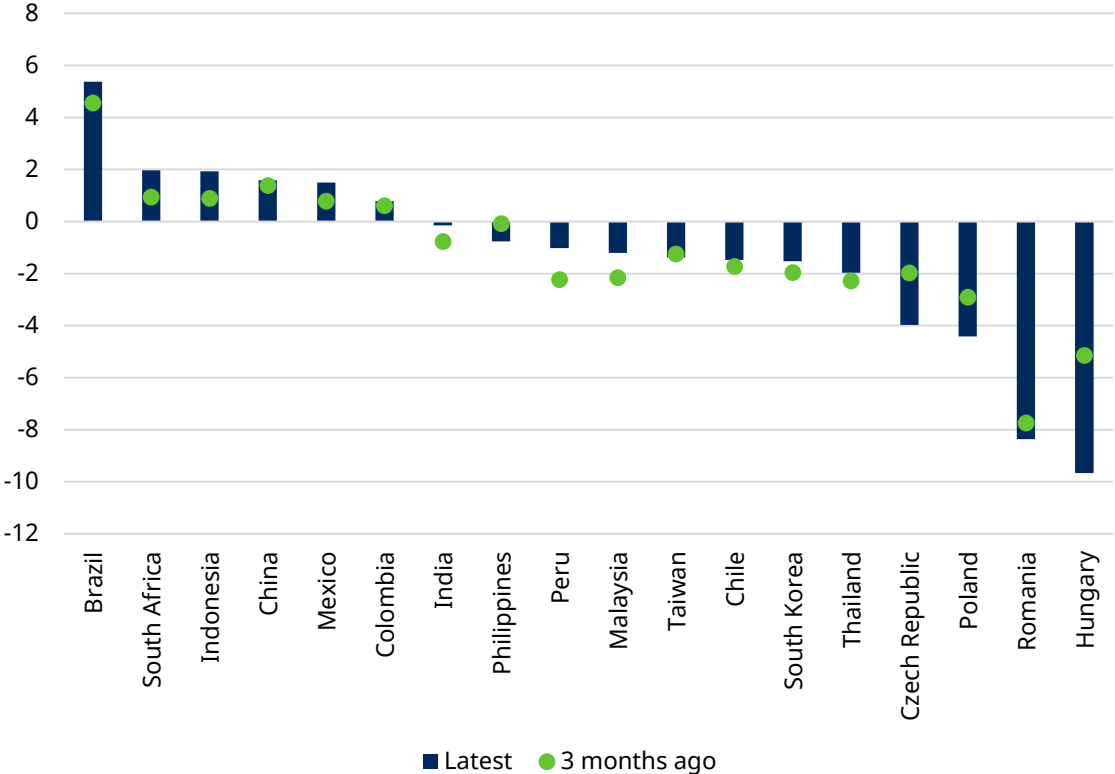


EM central banks ex Turkey and China have hiked interest rates in 2022

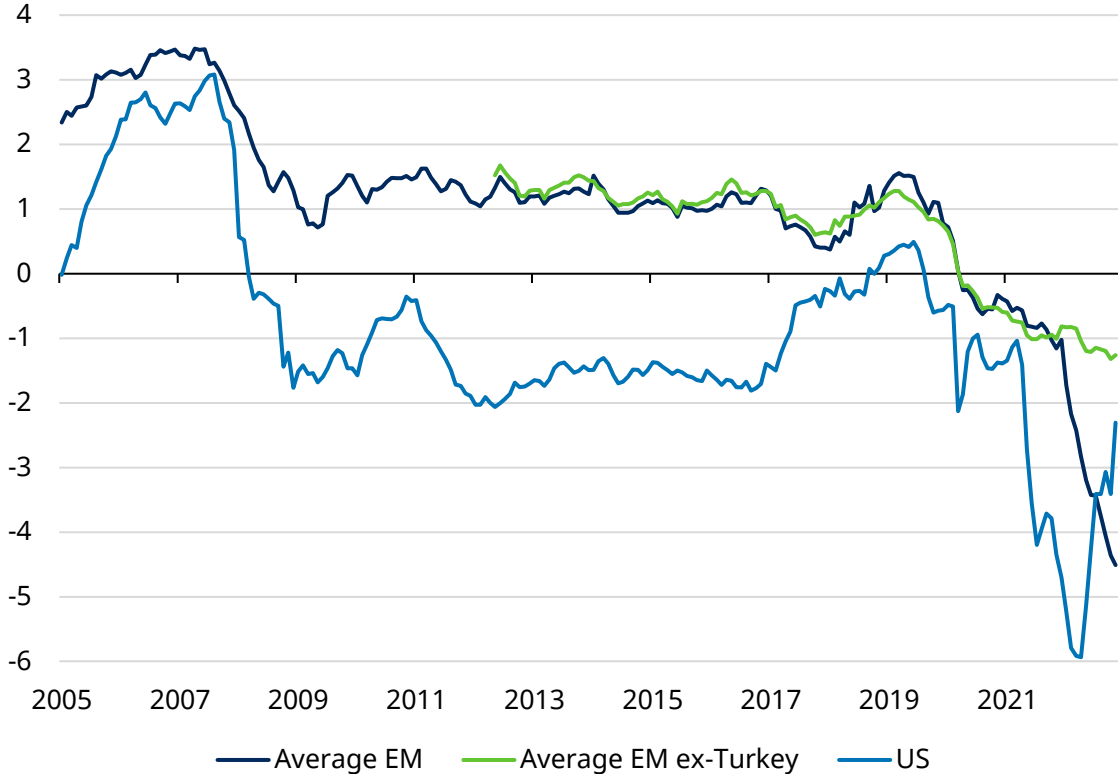
Source: Schroders, Refinitiv Datastream. Data as at 30 November 2022. ¹Based on 19 major EM countries.

EM real policy rates are still mostly negative

EM real policy rates (%)



Average EM real policy rate¹ (%)



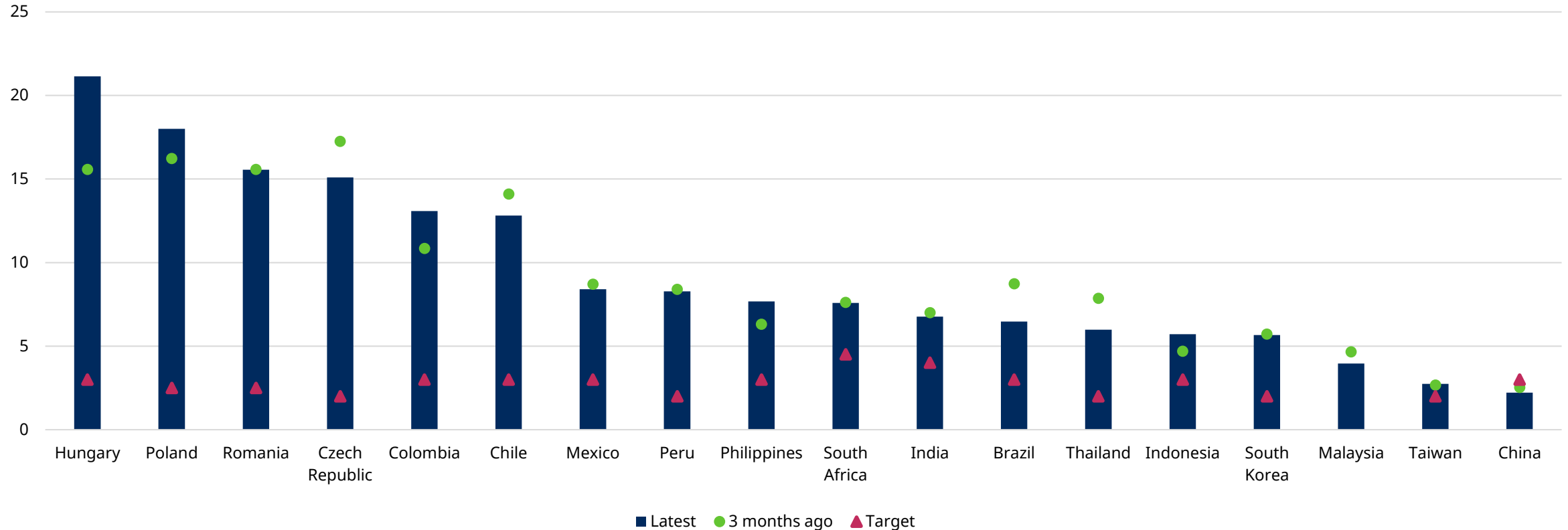
¹Based on 19 major EM countries. Turkey has very high inflation at the moment, with the annual core inflation at 59%. At the same time, Turkey's policy rate is well below inflation at 14%. Hence, Turkey's real policy rate is very negative at -45%, skewing EM average.

Source: Schroders, Refinitiv Datastream. Data as at 30 November 2022. Nominal policy rate minus annual core inflation.

EM inflation

Headline inflation is above target everywhere ex China

Annual change in headline inflation (%)



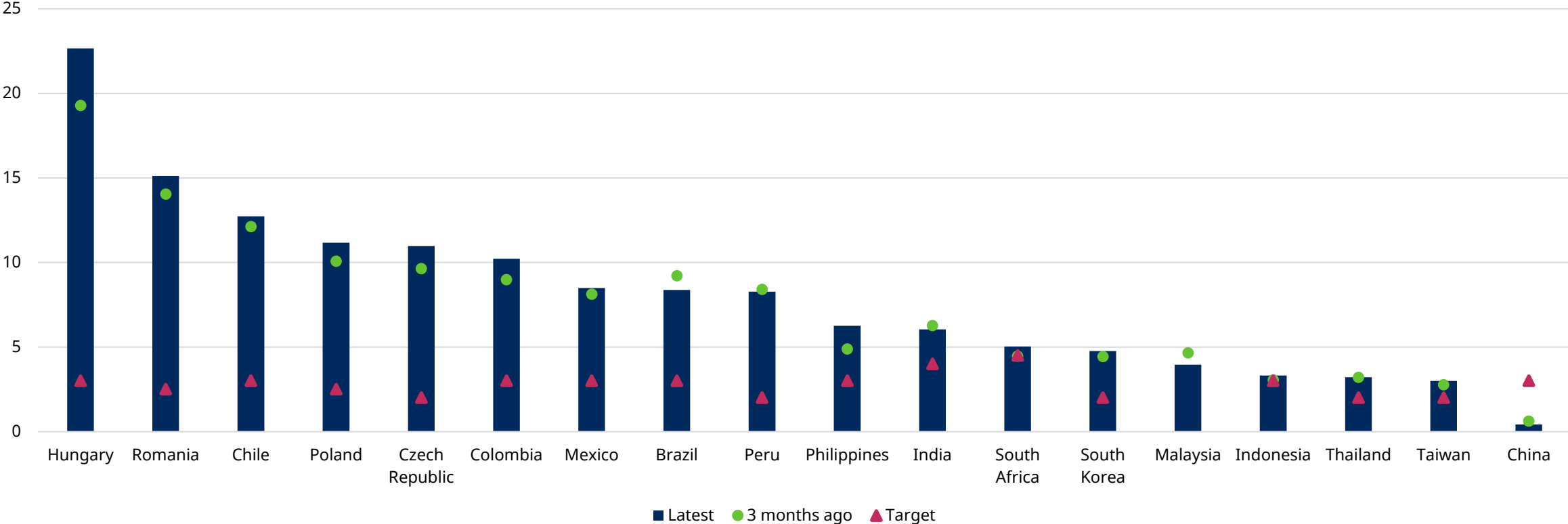
Inflation in EM Asia has been comparatively muted so far

Turkey's annual headline inflation (83%) omitted from the figure.
Source: Schroders, Refinitiv Datastream. Data as at 30 November 2022.

EM core inflation

Core inflation is also very elevated in most EM

Annual change core inflation (%)



Turkey's annual headline inflation (62%) omitted from the figure.
Source: Schroders, Refinitiv Datastream. Data as at 30 November 2022.

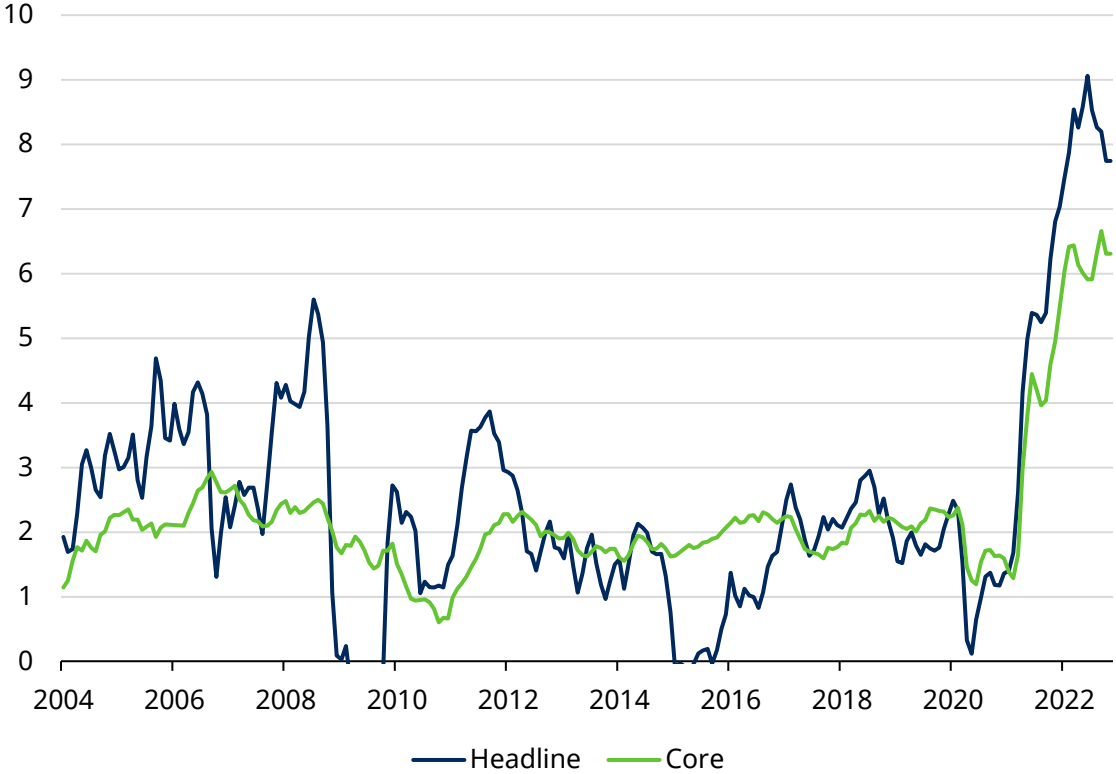
Is EM inflation peaking?

Headline US inflation looks to have peaked, is EM inflation also set to moderate?

Average EM inflation ex Turkey¹ (%)



US inflation (%)

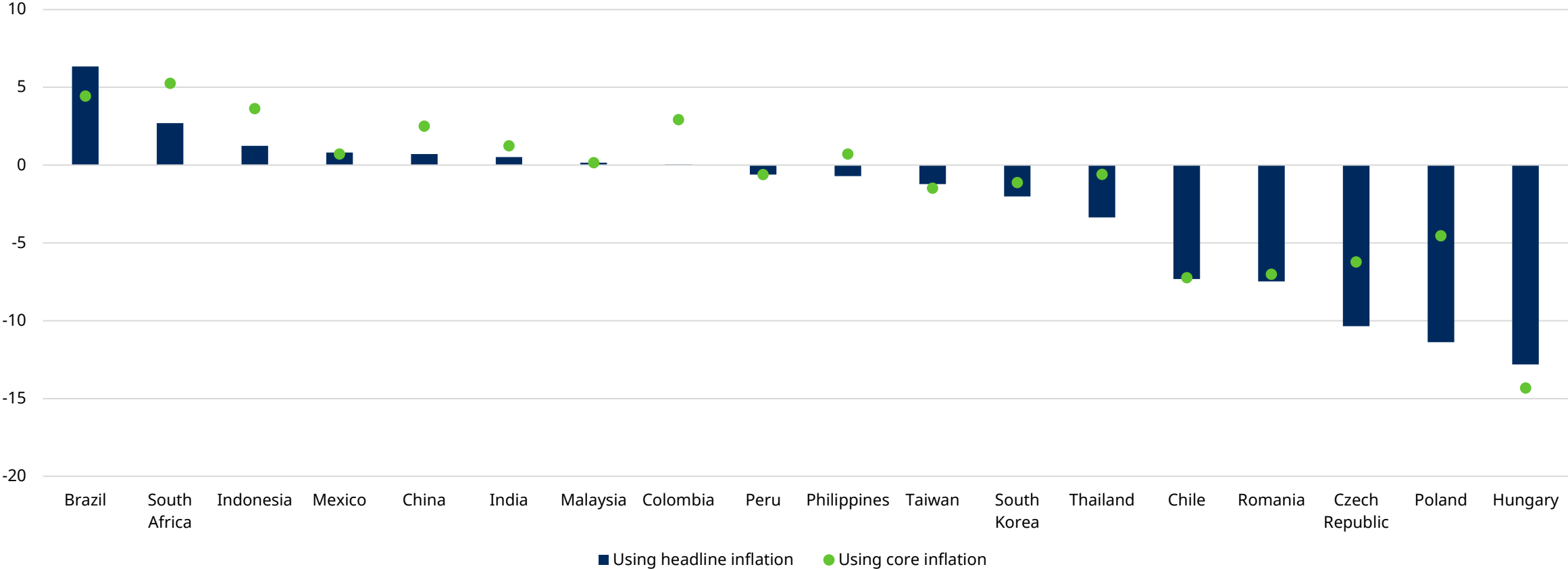


¹Based on 19 major EM countries. Turkey excluded because of significantly higher inflation in the country compared to the rest of the EM. Source: Schroders, Refinitiv Datastream. Data as at 30 November 2022.

Real bond yields are deeply negative in certain EM

Half of countries have a positive real bond yield relative to core inflation

Real 10 year yield

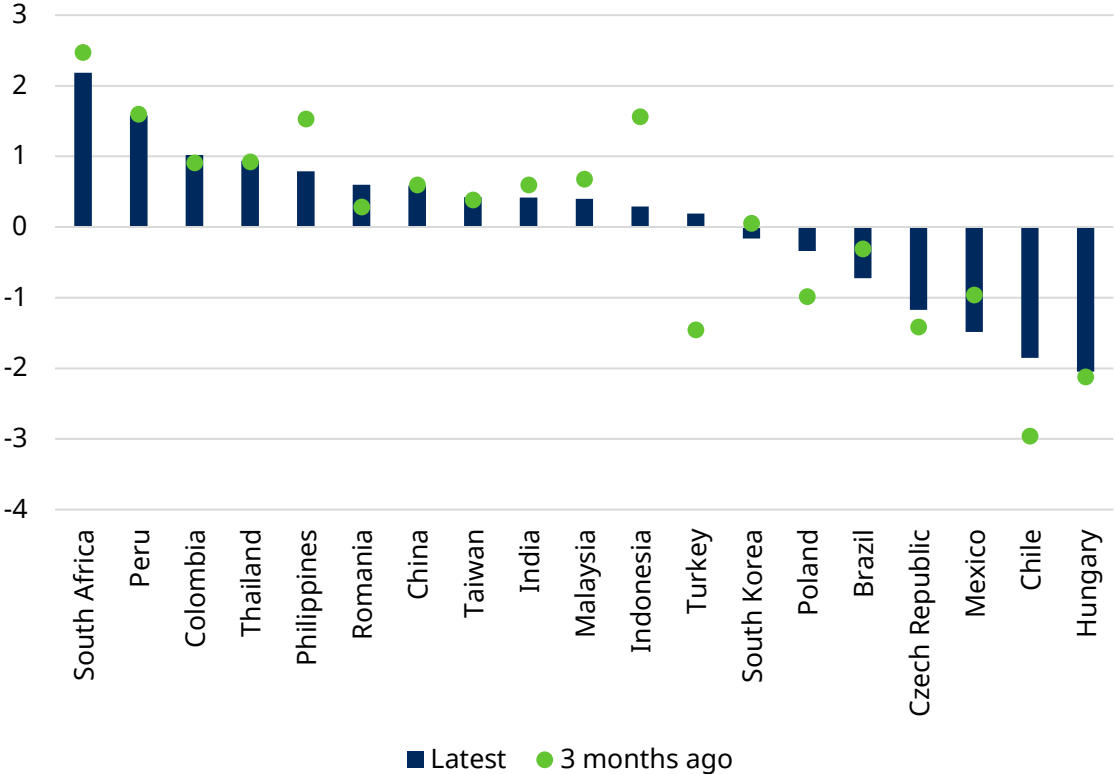


EM Europe real yields stand out

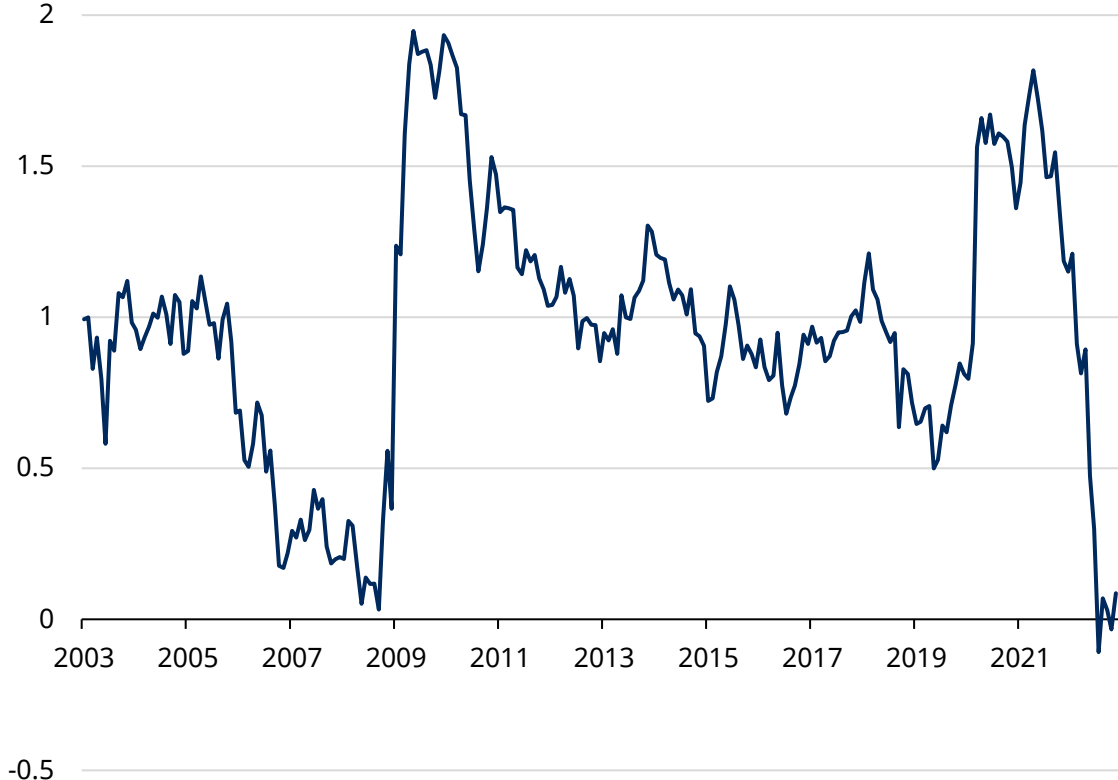
Nominal 10 year yield minus annual headline or core inflation
Source: Schroders, Refinitiv Datastream. Data as at 30 November 2022.

EM yield curve shape

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



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



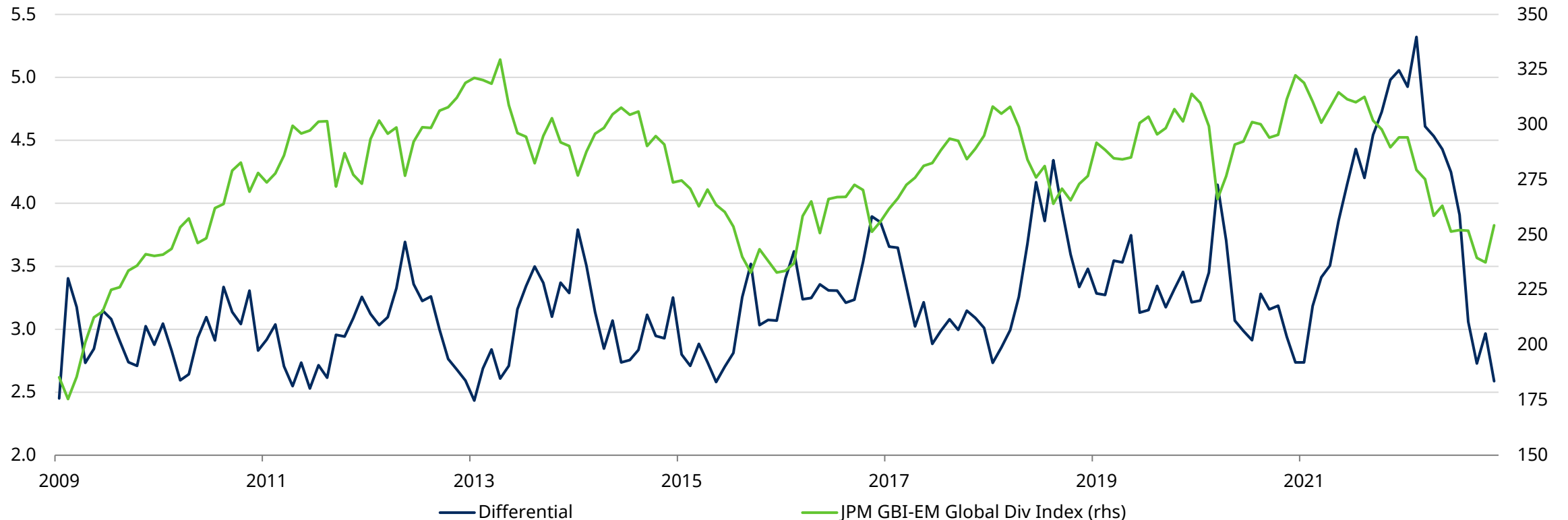
Most EM yield curves are flattening as central banks are hiking short-term interest rates; a number of curves have already inverted

¹Based on 19 major EM countries.
Source: Schroders, Refinitiv Datastream. Data as at 30 November 2022.

EM/DM real yield differential

EM local currency bond valuation

EM/DM real yield differential (%)



Real yield differential has fallen to the lower end of its post-GFC range

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

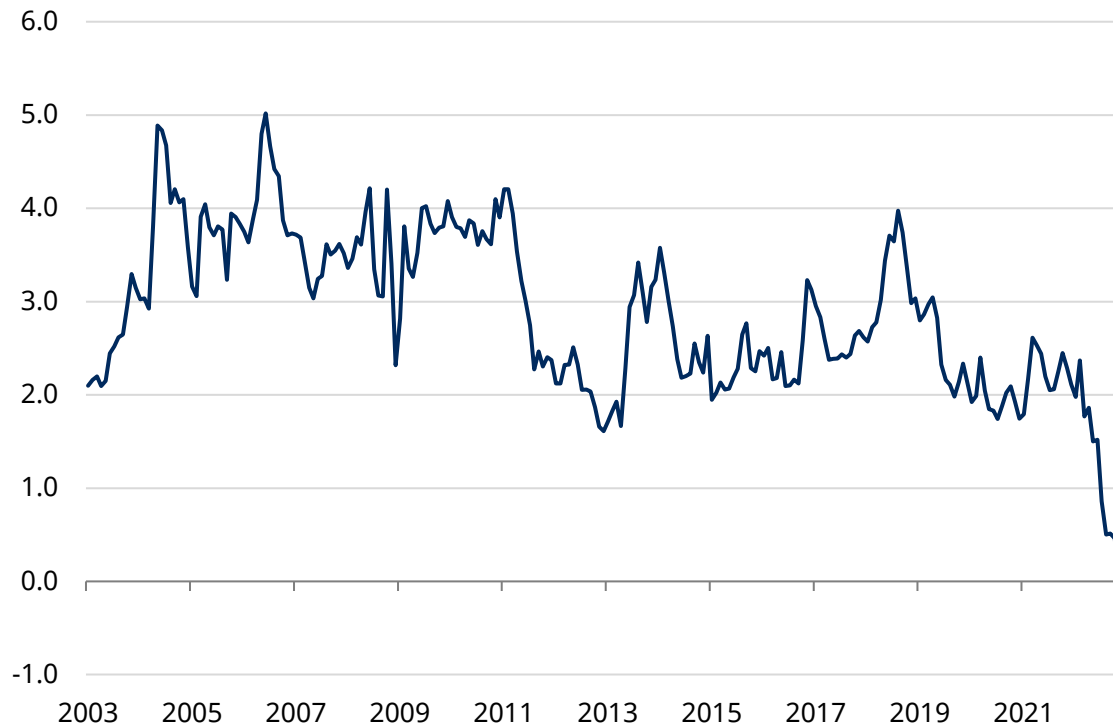
EM real yield is weighted average of individual JPM GBI-EM index nominal yields deflated by core inflation. DM real yield is 5Y government bond yields of US, UK, Euro zone, Japan deflated by core inflation, weighted by the size of individual government bond market.

Source: Schroders, Refinitiv Datastream, ICE Data Indices, J.P. Morgan. Data as at 30 November 2022.

EM and DM real yields

Individual drivers of the real yield differential

EM real yield (%)

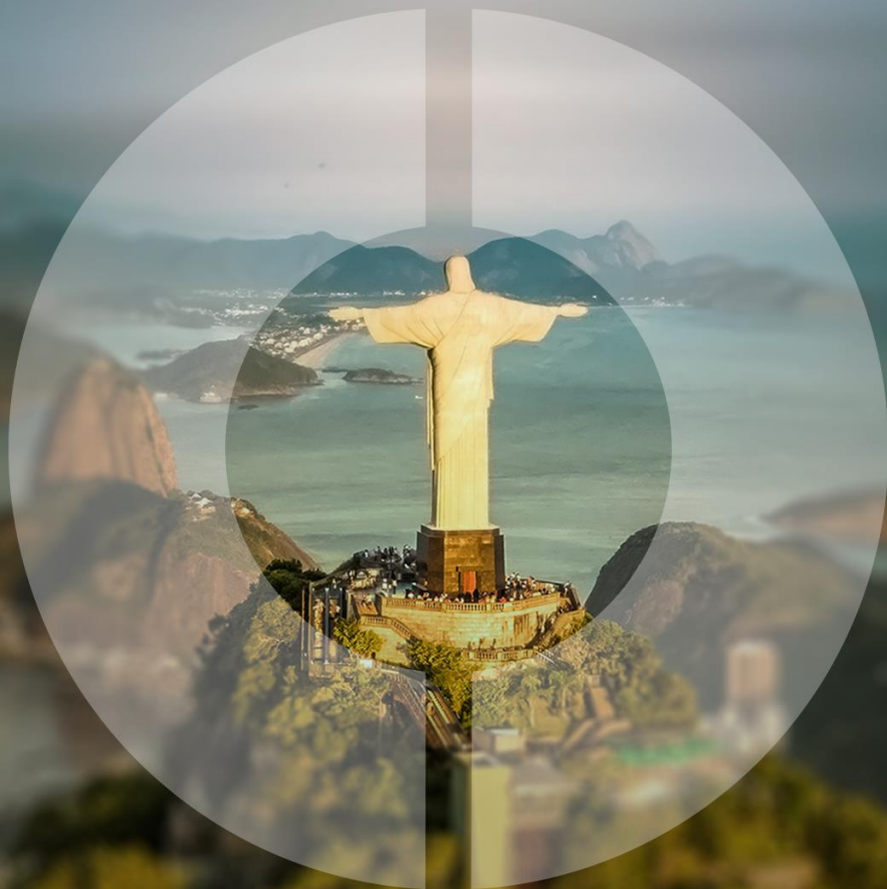


DM real yield (%)



EM real yield has continued to fall; DM real yield remains negative, despite recent move up

Source: Schroders, Refinitiv Datastream, ICE Data Indices, J.P. Morgan. Data as at 30 November 2022. 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.



Emerging market currencies

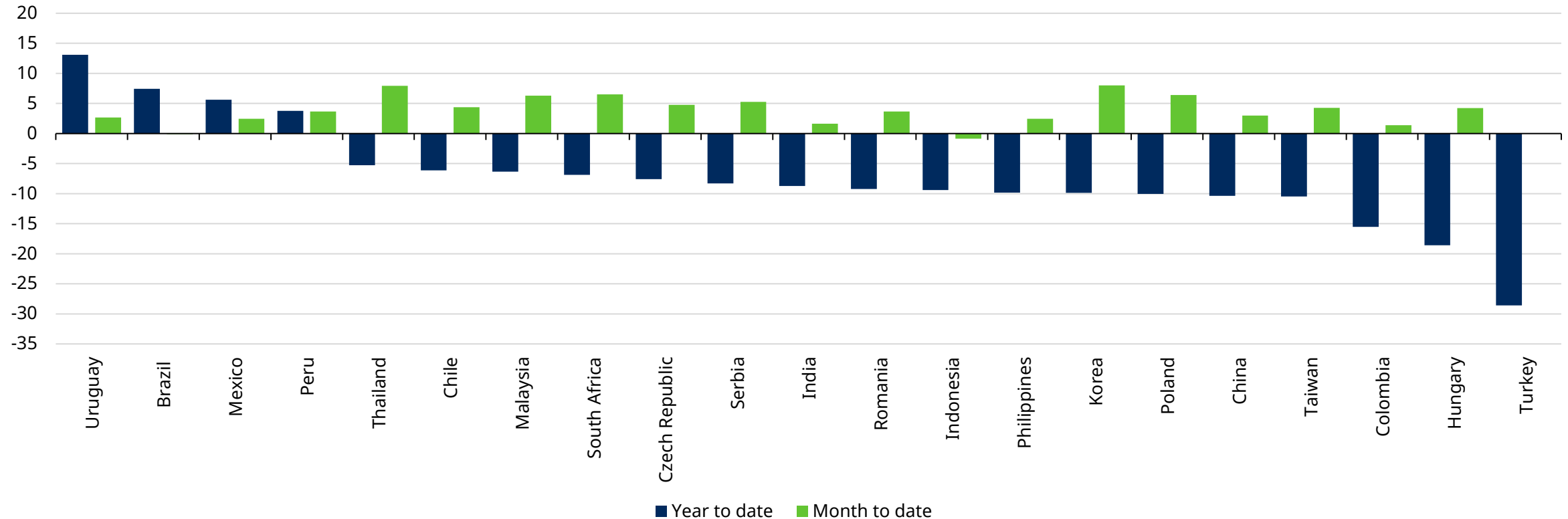
Summary: emerging market currencies

- A rising US dollar has weighed on most EM currencies YTD. However, the past month has seen a reversal in this trend.
- India and Czech currencies are the only EM currencies above their long term averages. After recent weakness, China's currency is slightly below its long term average on a trade-weighted basis.
- The currencies of Eastern European countries have fallen YTD because of Russia's invasion of Ukraine and accelerating inflation. In the case of Turkey, lira weakness relates to ongoing unorthodox policy.
- The degree of value in EM currencies varies significantly. There are undervalued currencies in all three EM regions.
- 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 is now fading.

EM currency performance vs US dollar

EM currencies were broadly stronger against the dollar in November

EM currency returns (%)



...but most have depreciated YTD

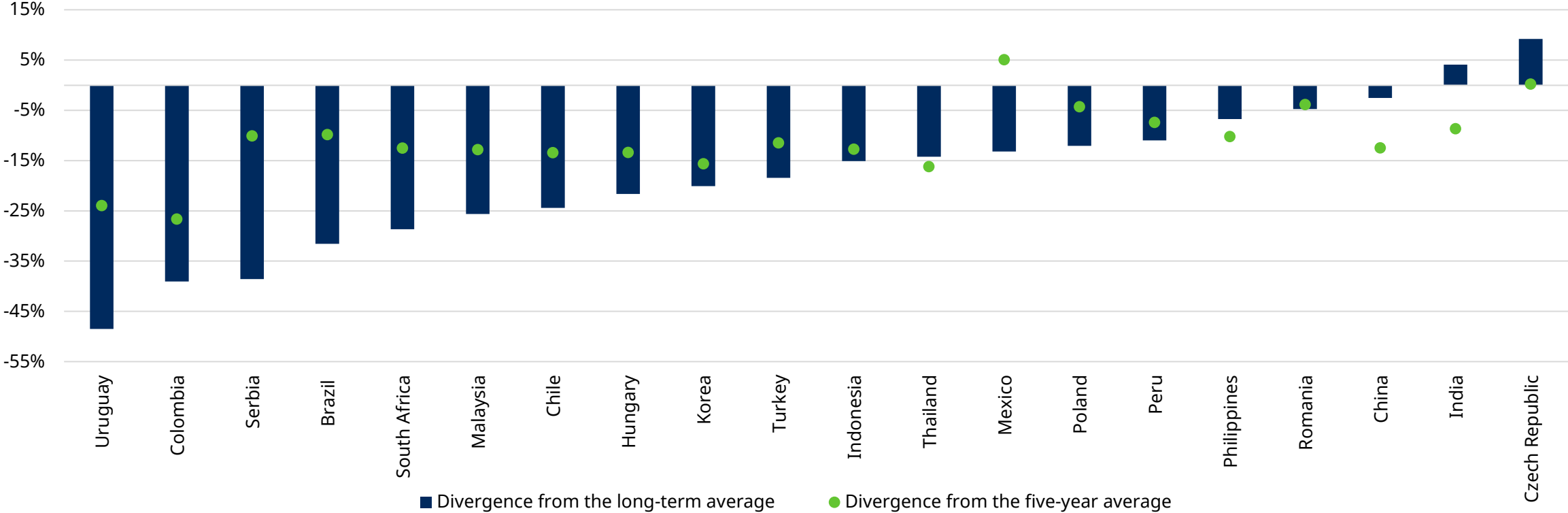
Past performance is not a guide to future performance and may not be repeated.

Source: Schroders, Refinitiv Datastream. Data as at 30 November 2022.

EM currency value

Some currencies are significantly undervalued

Real exchange rate: deviation from average



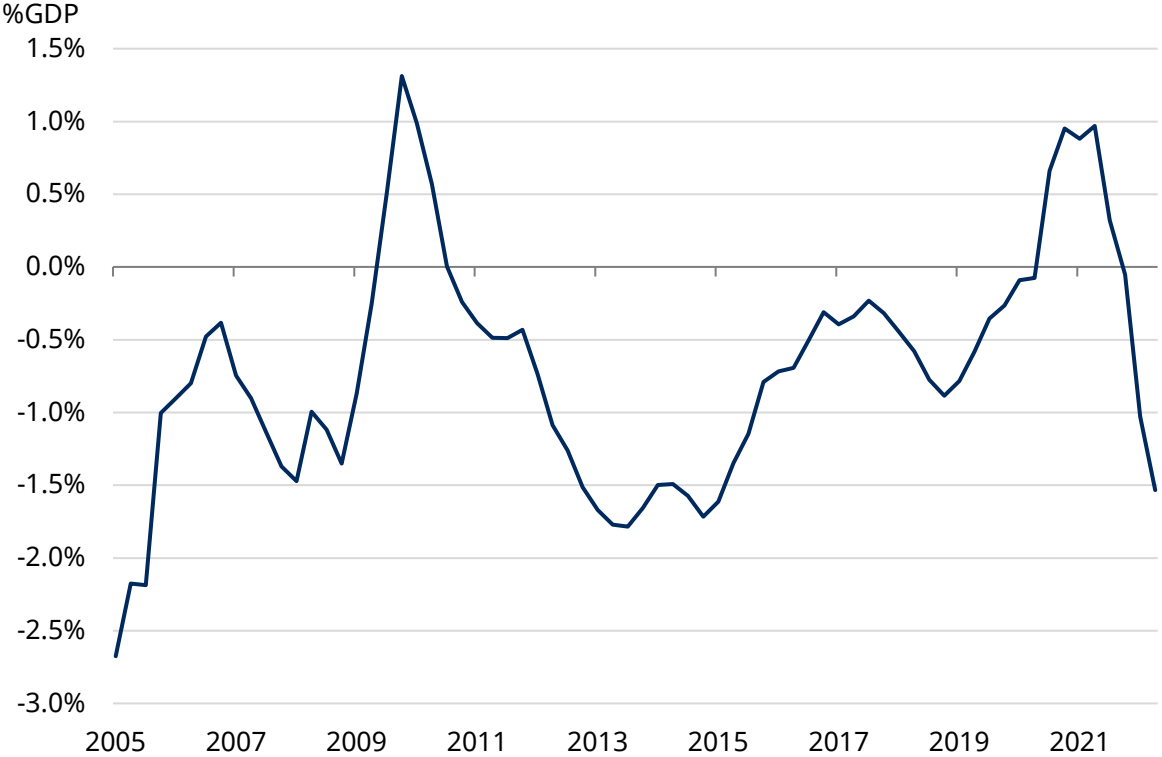
Uruguay, Colombia and Serbia have the cheapest currencies

Source: Schroders, Refinitiv Datastream. Data as at 30 November 2021. 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.

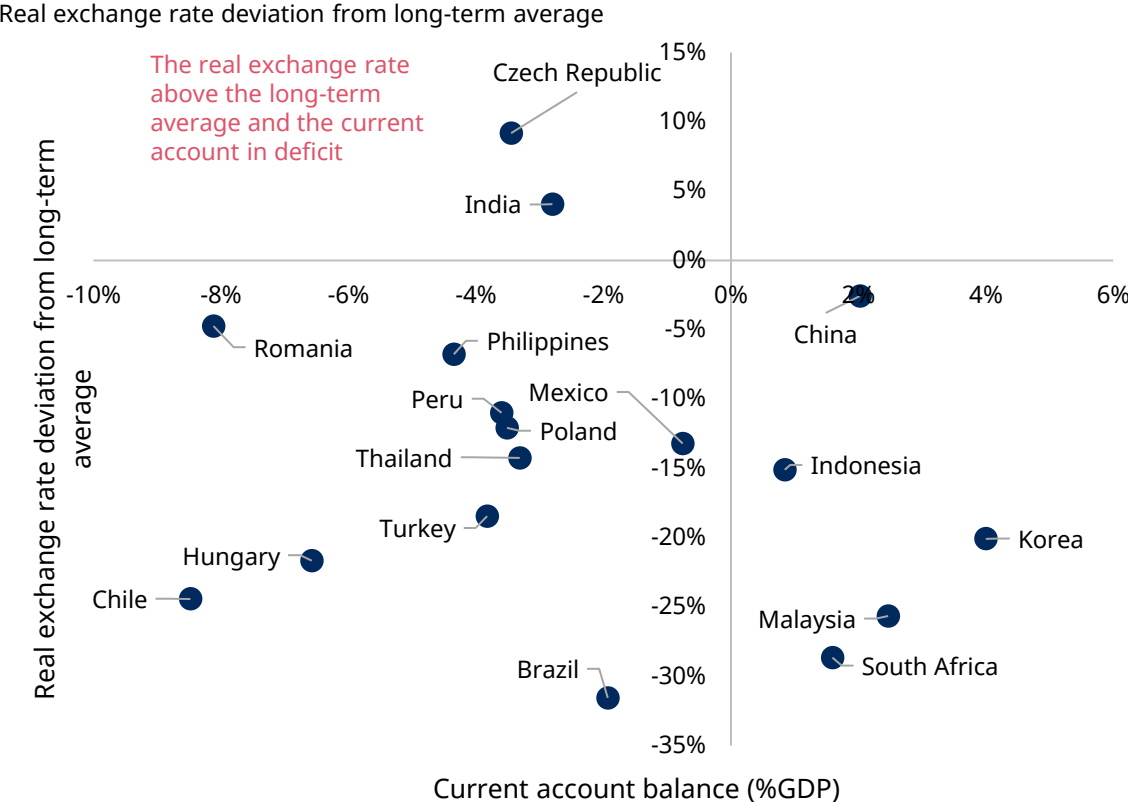
EM fundamentals: current account vs. currency valuation

Current accounts of commodity importers have deteriorated

Average EM current account balance¹



EM currency value² vs. current account balance

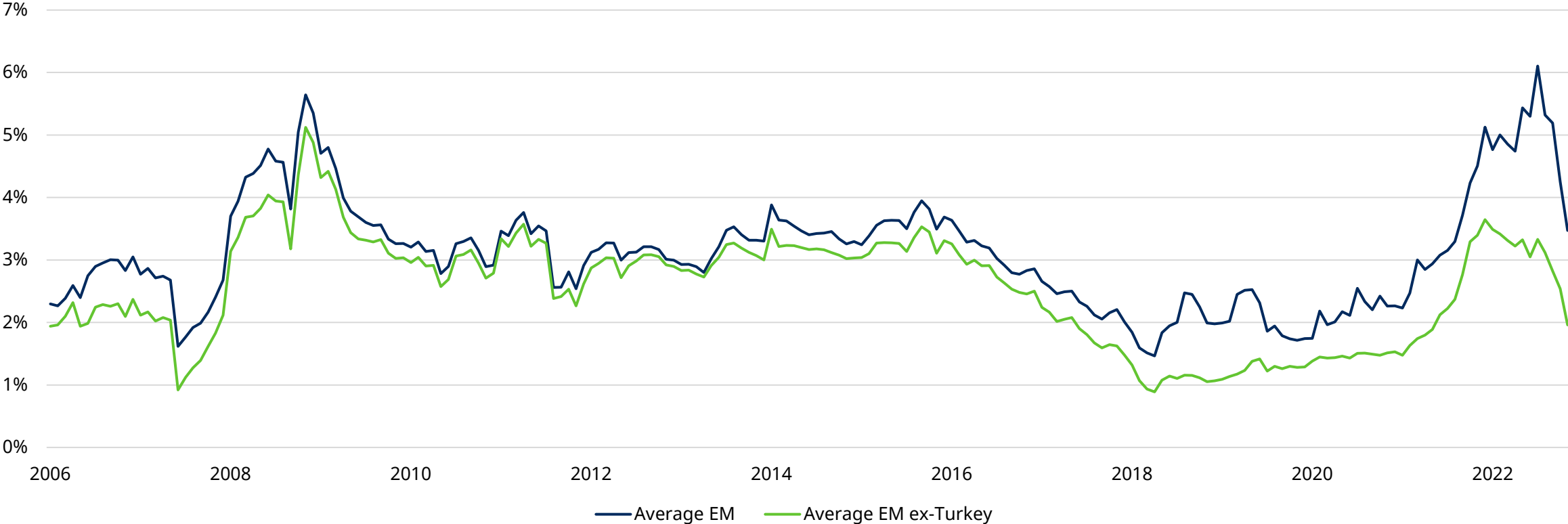


Czech Republic and India are most vulnerable to currency weakness

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 Q2 2022, currency value data as at 30 November 2022.

EM FX carry made a comeback on the back of EM rate hikes but is now fading...

Average EM carry¹

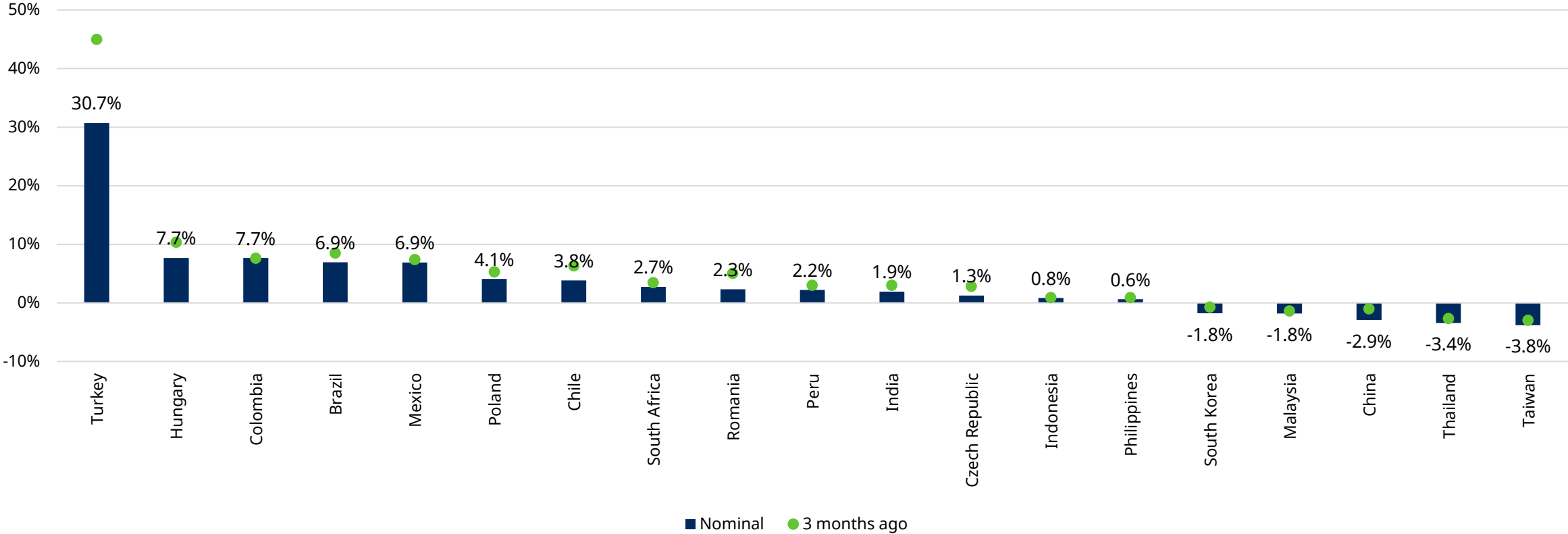


The recent down trend in EM carry persists

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 30 November 2022.

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 30 November 2022.

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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