The Investment Case for Emerging Markets Sovereign Debt

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Emerging markets sovereign debt can be divided into two distinct asset classes: local currency debt and hard currency debt. Local currency bonds that meet the liquidity requirements for inclusion in major emerging market benchmarks reflect a certain level of financial maturity. These bonds are mainly issued by the more developed emerging markets, such as Poland, Malaysia, and Mexico, and are largely targeted at domestic investors, including pension funds and local banks. On the other hand, hard currency bonds, often issued in U.S. dollars, span a broader spectrum of countries. This category includes not only more financially advanced emerging markets but also frontier markets, such as Angola, Ecuador, and Mongolia, where issuing external debt is often easier due to less developed domestic capital markets. This article will examine both asset classes and discuss how each can benefit from the current shift in the U.S. economic cycle.

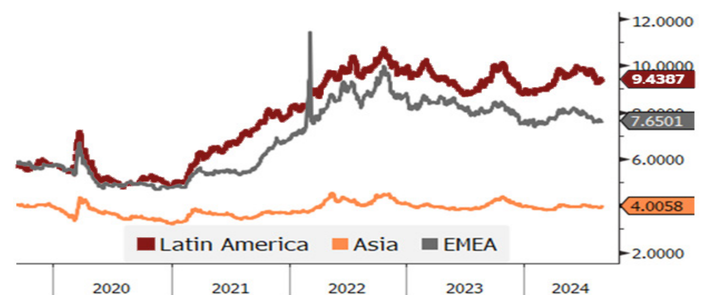
LOCAL CURRENCY EMERGING DEBT: A COMPELLING OPPORTUNITY AS THE FED EASES POLICY

With recent data pointing to a cooling labor market in the U.S. and inflation appearing to be increasingly under control, the Federal Reserve is expected to move toward a more accommodative monetary policy in the near future. In this context, local currency emerging debt is currently well-positioned, benefiting from historically elevated yields and favorable currency valuations.

ATTRACTIVE VALUATION

Following the COVID-19 pandemic and the surge in global inflation rates, yields on local currency emerging debt have risen significantly, particularly in Latin America and the EMEA (Europe, the Middle East, and Africa) regions. While inflation rates have already decreased substantially, yields in this asset class remain elevated. On average, sovereign debt in Latin America yields 9.44%, while in EMEA, it offers 7.65%.

Local Currency Debt Yields (in %)



Sources: Bloomberg, Syncicap AM, end of August 2024

With exposure to 20 emerging countries, the asset class also provides the potential for gains from local currency appreciation, particularly in light of the rise in overall commodity prices since the pandemic. Historically, a rise in commodity prices has often been accompanied by an uptick in emerging market currencies. This correlation stems from the fact that many emerging economies are commodity exporters. When commodity prices increase, it bolsters their balance of payments, contributing to the appreciation of their currencies.

Emerging Currencies & Commodity Prices

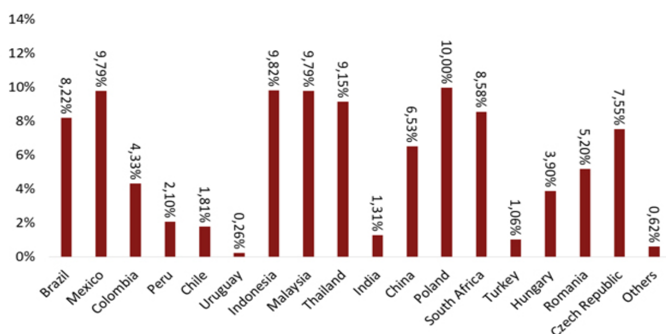
Sources: Bloomberg, Syncicap AM, end of August 2024

Surprisingly, emerging currencies have not experienced the anticipated boost following the increase in commodity prices post-Covid. This deviation can likely be attributed to the substantial increase in the Federal Reserve's funds rate and the remarkable performance of US equities, which have diverted attention and investments away from emerging markets. However, with the Fed anticipated to cut rates as early as September 2024 and US stock valuations appearing elevated, emerging markets could finally start to get the attention that they deserve.

DIVERSIFICATION AND LIQUIDITY

The asset class also provides exposure to multiple economic conditions and interest rate cycles, thereby offering diversification benefits. For instance, in August 2023, Brazil initiated its rate-cutting cycle, reducing interest rates from 13.75% to the current 10.50%. By contrast, the Federal Reserve increased its target funds rate by 0.25% that same month, bringing it to a range of 5.25% to 5.50%. Additionally, many of these countries are rated as investment-grade, and boast well-developed domestic financial systems, enabling them to issue debt in their local currencies. This capability not only reduces currency risk but also enhances the overall liquidity of the asset class. As of Today, we estimate the investment universe for local currency emerging debt to be around $9 trillion. It is therefore large and liquid enough to make meaningful investments possible, even for large investors.

Country Allocation of the Asset Class

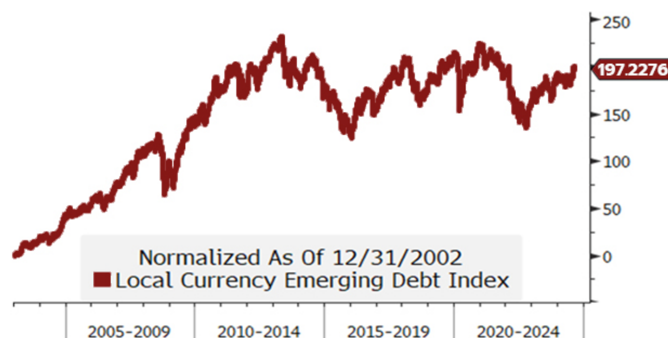


Sources: Bloomberg, Syncicap AM, J.P. Morgan, August 2024

HISTORICAL PERFORMANCE & OUTLOOK

Between 2003 and 2013, local currency emerging debt significantly outperformed most asset classes, including the S&P 500, with an average annual return of 10.17%. This strong performance was driven by a 10-year cyclical downturn in the US dollar following the burst of the dot-com bubble, China's rapid ascent, and a substantial increase in commodity prices. Unfortunately, the next decade proved to be more challenging, with the asset class underperforming due to poor governance, a strong US dollar, and declining commodity prices resulting from overcapacity and the US shale revolution.

Historical Performance (in % vs USD)



Sources: Bloomberg, Syncicap AM, J.P. Morgan, August 2024

Since 2023, however, conditions have started to improve: many countries have reduced their budget and current account deficits, and there have been significant advances in governance. For instance, In South Africa, Cyril Ramaphosa's re-election for a second term in June 2024 was secured through a coalition of the African National Congress (ANC), the Democratic Alliance (DA), and other smaller parties. This coalition was well-received by the markets, particularly because far-left parties like the EFF and MKT were completely excluded. Furthermore, the pro-market stance of the Democratic Alliance could facilitate crucial economic reforms, potentially lifting the country out of its current low-growth period and attracting new foreign investments. Since the elections, South African debt has risen by over 19% against the dollar.

Turkey provides another example of a country shifting its economic approach. Once known for its economic mismanagement, Turkey has recently adopted more orthodox policies. After Recep Tayyip Erdoğan was re-elected in May 2023, the Turkish central bank took the notable step of significantly raising interest rates to combat inflation – a step that would have seemed unlikely just a few years ago. Additionally, the country recently repaid a $5 billion deposit to Saudi Arabia, signaling economic confidence and progress in rebuilding its foreign currency reserves.

Looking ahead, the asset class should benefit from several favorable trends. Beyond the Federal Reserve's easing cycle, commodity prices – and by extension emerging markets – are

set to gain from the surge in renewable energy development and the increasing demand for raw materials like copper and nickel essential for these technologies. Moreover, in recent years, there has been a growing intent among Western nations to diversify their supply chains away from China. This shift has led to a substantial rise in foreign direct investments in several emerging countries. A notable strategy in this context is the "China +1" approach, where companies retain operations in China while also expanding production capabilities in other Southeast Asian countries such as Malaysia, Thailand, and Indonesia. The trend of "nearshoring" is also gaining traction. Latin America, for example, is emerging as a preferred destination for companies targeting the North American market, with countries like Mexico and Brazil experiencing a boom in manufacturing and assembly activities.

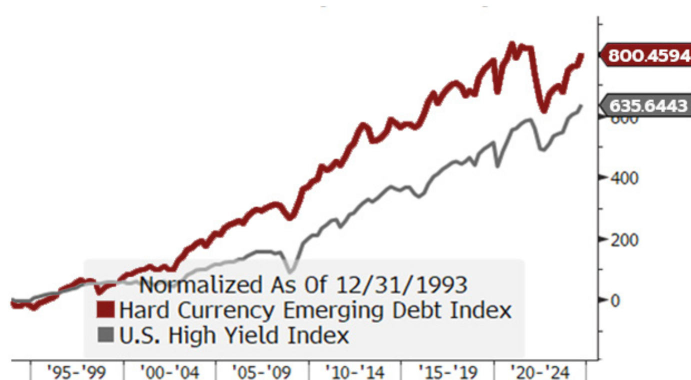
HARD CURRENCY EMERGING DEBT: A STRONG ALTERNATIVE TO U.S. CORPORATE CREDIT

Although the asset class invests in bonds issued by emerging countries, it is closely linked to the US treasury market and the broader U.S. economy. For investors looking for an alternative to U.S. Corporates, this asset class is very compelling. It provides better risk-adjusted returns and has demonstrated relatively consistent performance over the long term.

SUPERIOR RISK-ADJUSTED RETURNS

Over the past 30 years, Hard Currency Emerging Debt has delivered an average annual return of 7.42%. Performance has been closely tied to the U.S. credit cycle, and the asset class has outperformed U.S. High Yield despite having a similar credit risk profile.

Historical Performance (in % vs USD)

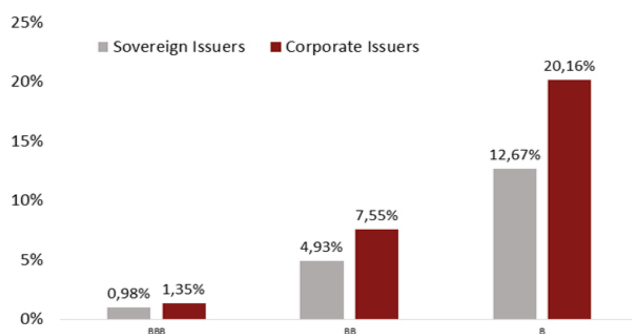


Sources: Bloomberg, Syncicap AM, J.P. Morgan, August 2024

This outperformance can be attributed to the fact that, after adjusting for ratings, emerging market sovereign bonds generally trade at a higher spread than U.S. corporate bonds. This occurs despite sovereigns typically having lower default rates and higher recovery values compared to corporate bonds. The reason for this phenomenon is unclear, but it may be partly due to the unfamiliarity of emerging markets. Investors are often more comfortable investing in companies whose products they buy rather than in distant countries they have never visited.

Between 1983 and 2021, the default probability for sovereigns below investment grade over a one-year horizon was 2.727%, compared to 4.167% for U.S. High Yield. Furthermore, during the same period, the recovery value was on average 53% for sovereigns, and only 37% for U.S. High Yield.

Probability of default after 5 years between 1983 and 2021

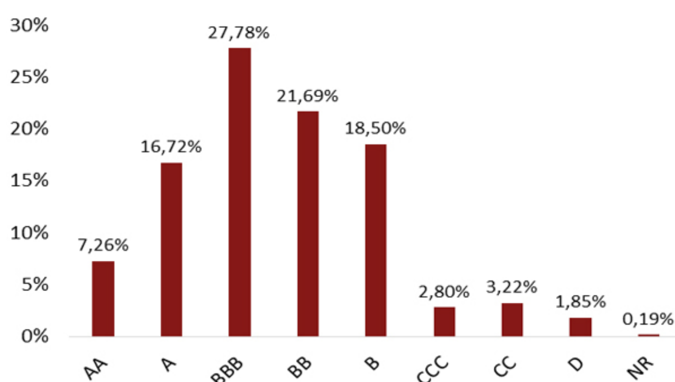


Sources: Bloomberg, Syncicap AM, J.P. Morgan, August 2024

ACTIVE MANAGEMENT & LIQUIDITY

It is worth noting that, similar to U.S. Corporates, the alpha in the asset class primarily lies in trading the credit cycle rather than positioning for structural tightening. During downturns, carry is often insufficient to offset the spread widening of high yield issuers, but investment grade issuers tend to show greater resilience. This dynamic makes the asset class particularly appealing when paired with active management strategies to effectively time credit cycles. Additionally, the asset class invests across nearly all rating categories, from AA to CC names, allowing for relatively easy adjustments in risk exposure.

Rating Allocation of the Asset Class



Sources: Bloomberg, Syncicap AM, J.P. Morgan, August 2024

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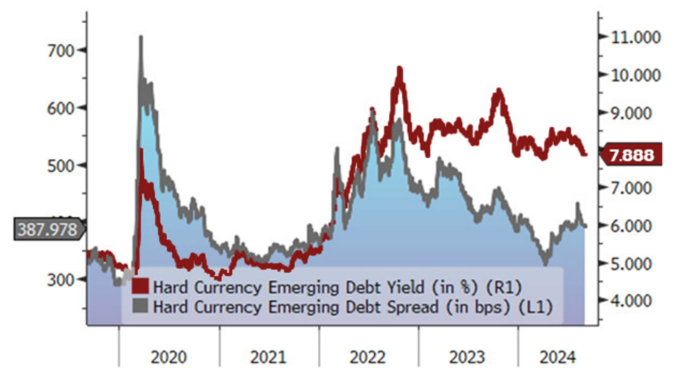
Trading Hard Currency Emerging Debt also involves in-depth bottom-up analysis in order to make informed, country-specific investment choices. This process typically involves evaluating a country's external financial position, government finances, and debt levels. Often, bonds appear mispriced in relation to their credit fundamentals, presenting unique opportunities within this asset class. With an investment universe of approximately $2 trillion, the asset class is substantial enough to accommodate large investors, yet not so liquid that all potential alpha has been arbitraged away. Furthermore, a significant portion of the investment universe is Euroclearable, meaning these bonds can be processed through a clearing house for settlement. This feature enhances market accessibility and simplifies the investment process.

Hard Currency Emerging Debt Yield & Spread



Sources: Bloomberg, Syncicap AM, J.P. Morgan, August 2024

CURRENT VALUATION

The asset class is currently at a crossroads. On one hand, yields are elevated, averaging 7.89%. On the other hand, spreads could widen as macroeconomic indicators suggest a potential turning point in the U.S. economic cycle.

However, the asset class stands to benefit directly from a decline in U.S. Treasury yields. In our view, at current valuations and with effective credit risk management, investors have the potential to gain from capital appreciation in addition to the coupon income offered by emerging market bonds.

In summary, both asset classes present compelling investment opportunities. Economic fundamentals in many emerging markets are showing signs of improvement, and valuations are attractive. Additionally, structural trends such as the global transition to green energy and the rise of nearshoring are expected to further support these markets. As the Federal Reserve moves toward a more accommodative monetary policy, investor interest in emerging markets sovereign debt may soon increase.

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The figures cited deal with past years. Past performances are not a reliable indicator of future performances.
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