INSIGHT

Size, diversification and fundamentals

Three reasons to be optimistic about emerging-market debt

By Joshua Butt and Barney Goodchild

December 2021

AVIVA INVESTORS

"It's time to address the common misconceptions investors have over EMD."

It's time to put the tired old cliches aside: EMD offers investors the opportunities to achieve attractive, sustainable returns from some of the world's most dynamic economies.

Despite consistently delivering strong risk-adjusted returns, emerging-market debt (EMD) is still viewed as a relatively risky or niche part of the fixed-income universe. Many investors remain structurally underinvested in the asset class, either ignoring it altogether or only allocating to it on a tactical basis.

Such thinking is outdated; it is time to address the common misconceptions investors have over EMD to understand why. Strategic allocations to the asset class can offer investors:

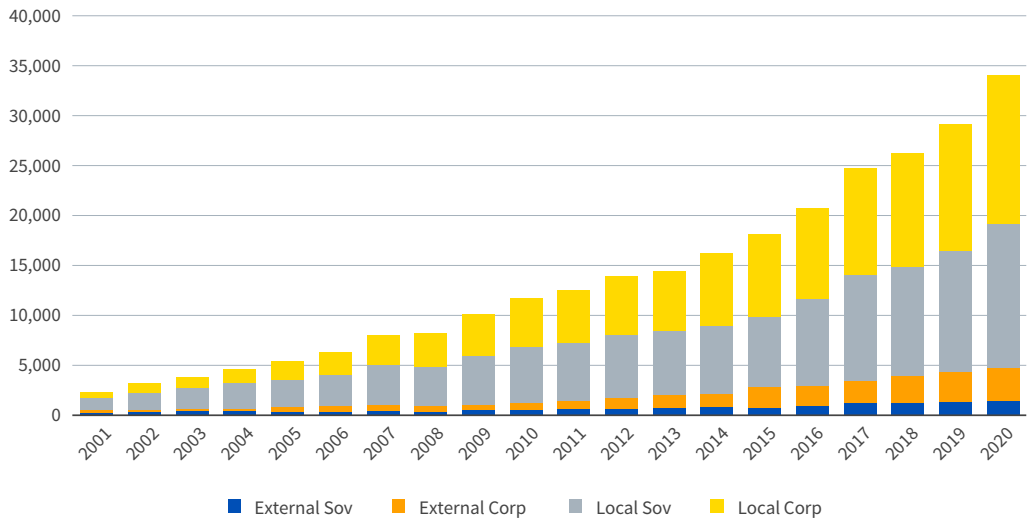
- Diversification across geographies and economic cycles;
- Strong and improving fundamentals relative to developed-market (DM) peers;
- The opportunity for attractive risk-adjusted returns.

Too big to ignore

Emerging markets represent over 40 per cent of global GDP, yet EMD makes up less than 23 per cent of global fixed-income assets – highlighting it is a structural overweight for many investors.[1] Indeed, a recent survey of European pension schemes showed less than 30 per cent have exposure to EMD.[2]

Growth of the asset class

Figure 1. **The EM debt stock by asset class (US$ trillions)**



Source: Bank of America Merrill Lynch, data as of December 31, 2020

EM investible assets have grown, broadened and matured considerably in the past twenty years. From what started in the early 1990s as a predominantly hard-currency bond market, EM debt is mostly now in local-currency form.

The tradeable EMD stock has seen a massive increase over this period, from around $2 trillion in 2000 to around $34 trillion in 2020. This reflects the growing maturity of government and corporate borrowing patterns, with local currency bonds by far the largest component at $29.4 trillion. The hard-currency segment is around $4.6 trillion for sovereigns and corporates combined. By way of context, the combined size of the DM government and corporate bond markets is $148 trillion.

As fixed income assets in developed markets offer low prospective returns, global demand for EMD has been strong – though DM exposure remains concentrated in hard-currency bonds.

"Tradeable EMD stock has increased from around $2 trillion in 2000 to around $34 trillion in 2020"

A diverse set of assets and return drivers

EMD can offer value through diversification. For example, local-currency EMD has a low correlation with US Treasuries and a relatively low correlation with developed market corporate bonds and high-yield debt.

By contrast, hard-currency and corporate EMD have a slightly higher (but still low) correlation with US Treasuries but a lower correlation with equity markets. Furthermore, there is great variety in correlations of the sub-components of EMD. For example, A-rated and corporate hard-currency EMD are less exposed to credit risk and more sensitive to movements in US Treasuries. These differences make EMD a flexible set of assets, whose exposures can be adjusted depending on the prevailing market environment.

EMD is often viewed as a single asset class. In reality, it is a combination of three separate asset classes, each with their own investor base and return drivers.

Hard-currency debt is similar to DM corporate debt, with returns directly influenced by movements in US interest rates alongside investors' assessment of the creditworthiness of issuers.

Local-currency bond yields are a function of domestic rather than US interest rates, with local inflation and the exchange rate being the key influences. The addition of currency risk makes local EMD more volatile than hard currency.

Definitions

Hard-currency sovereign: Sovereign and quasi-sovereign (state-owned or partially state-owned companies) debt issued in external (hard) currencies, predominantly US dollars but also euros. Debt issued is subject to US or European law.

Hard-currency corporate: Debt by companies domiciled in emerging markets issued in external currencies, predominantly US dollars but also euros. This is viewed as the most defensive part of the EM market, given the higher credit quality and shorter duration of the debt.

Local-currency debt: Debt issued in the local or domestic currency. Debt is subject to local legal rules and interpretation. This is the most growth-

Figure 2. **An overview of the EMD universe**

Benchmark	Hard-currency EMD JPM EMBI Global Diversified	Local-currency EMD JPM GBI-EM Global Diverisifed	Corporate EMD CEMBI Broad Diverisifed
Asset class size ($ trillion)	1.3	10.8	2.4
Index AUM	1.3	1.4	0.64
Number of issuers	170	32	806
Number of countries	73	20	59
IG/HY split %	62%/38%	80%/20%	57%/43%
Average credit rating	BBB-	BBB+	BBB-
Duration (years)	8.13	5.24	4.91
Relationship with commodity prices	Positive	Negative	Negative
Relationship with trade-weighted US$	Negative	Negative	Negative
Drivers of return	Treasury yield and spread	Local currency bond yield and currency moves	Treasury yield and spread

Source: Aviva Investors, BRS Aladdin, as of June 30, 2021

Favourable default rates

"Defaults for EM HY corporates are significantly lower"

One of the common misconceptions about EMD is that default rates are significantly higher than their DM equivalents. In fact, defaults for the high-yield component of sovereign EMD has been broadly similar to US high yield, while defaults for EM HY corporates are significantly lower, as the table below shows. For local-currency and DM sovereigns, defaults are less of a concern as issuers can always print more currency if needed.

Figure 3. **Historic default rates (per cent)**

	CEMBI HY	EMBIG HY	US HY
Average default rate 2000-2020	2.65	3.60	3.68

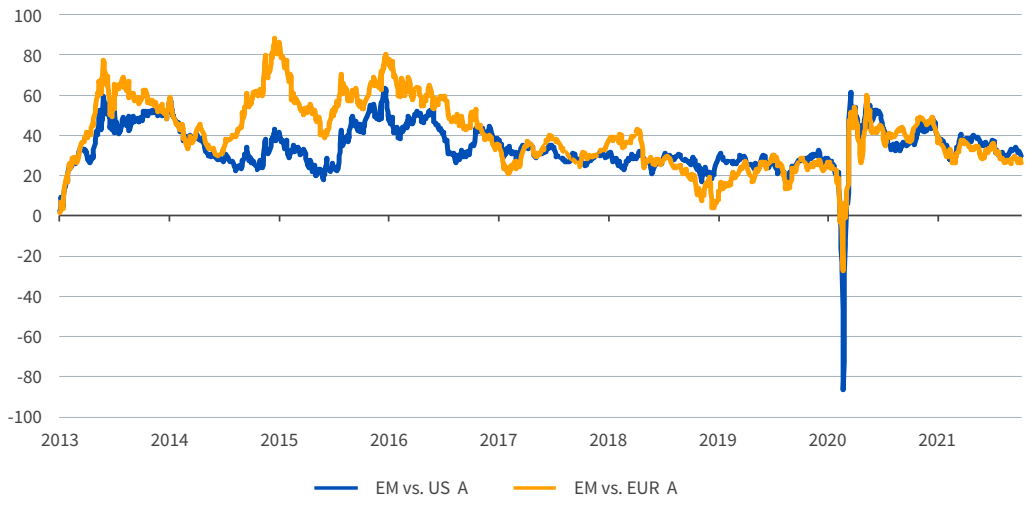
Source: Aviva Investors, JP Morgan, data as of December 31, 2020

Yield and spread advantage

Despite the similar default experiences to DM credit, EM has tended to trade at a higher spread or yield to comparable DM issuers. In part, this premium can be understood by the difficulty investors face in assessing not only the ability, but also the willingness, of issuers to repay their debt. The consistent cheapness of EM versus DM credit spreads can be viewed as an overestimation of this risk relative to realised defaults.

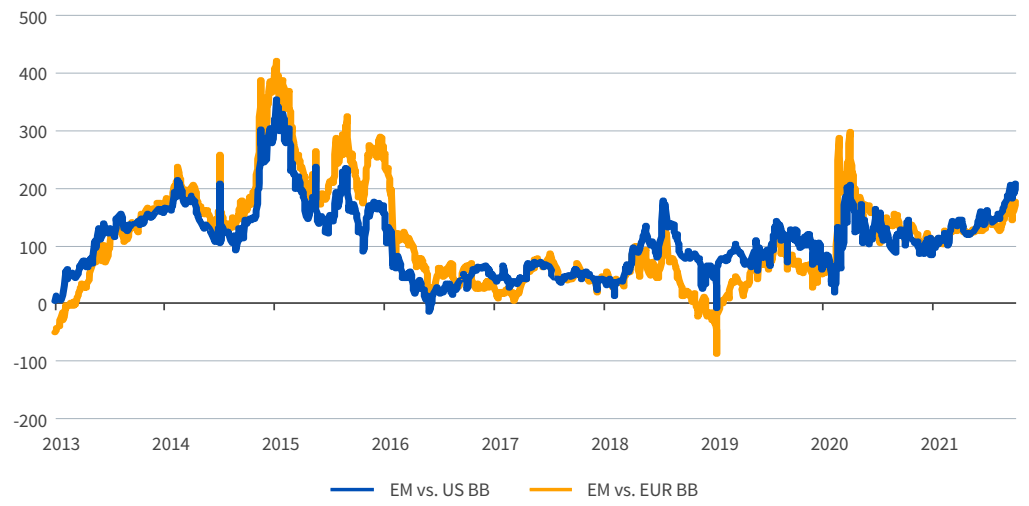
> *"EM has tended to trade at a higher spread or yield to comparable DM issuers."*

Figure 4. **EM spread premium versus DM markets (investment grade)**



Note: Does not depict any Aviva product or strategy
Source: Aviva Investors, Barclays, as of October 31, 2021

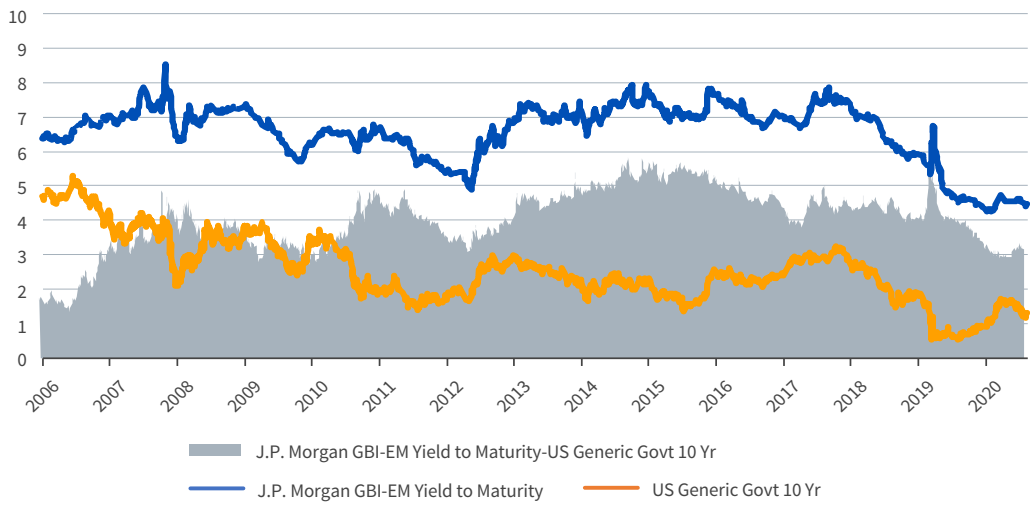
Figure 5. **EM spread premium versus DM markets (high yield)**



Note: Does not depict any Aviva product or strategy
Source: Aviva Investors, Barclays, as of October 31, 2021

Both local interest rates and views of local inflation tend to be higher in emerging economies, meaning local EMD has offered a persistent yield pick-up over DM government bonds.

Figure 6. **Local currency risk premium versus US Treasuries (yield in per cent)**

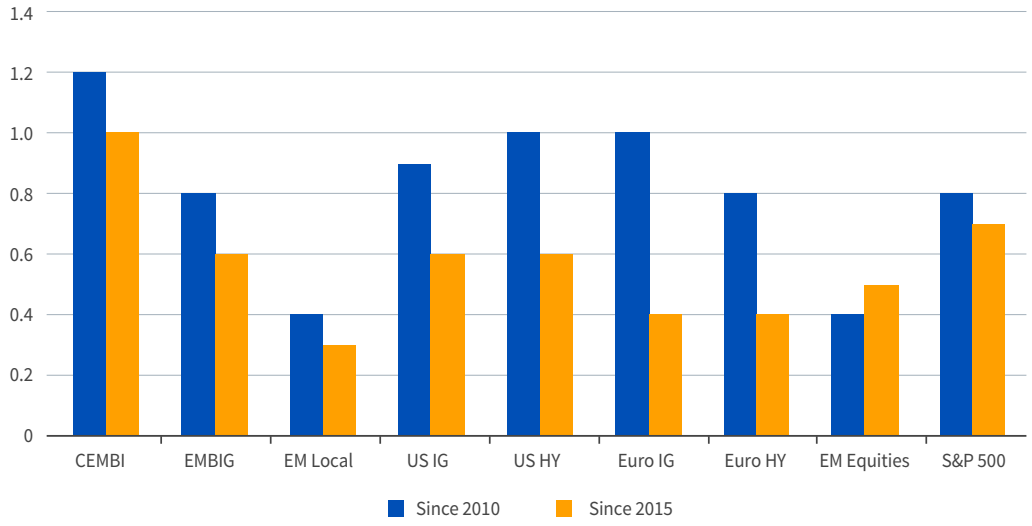


Source: Bloomberg, data as of June 30, 2021

Attractive returns?

Historic risk-adjusted returns for EM compare favourably to DM fixed income and equities, as the chart below highlights.

Figure 7. **Major indices - Sharpe ratio**



Source: Bloomberg, data as of June 30, 2021[3]

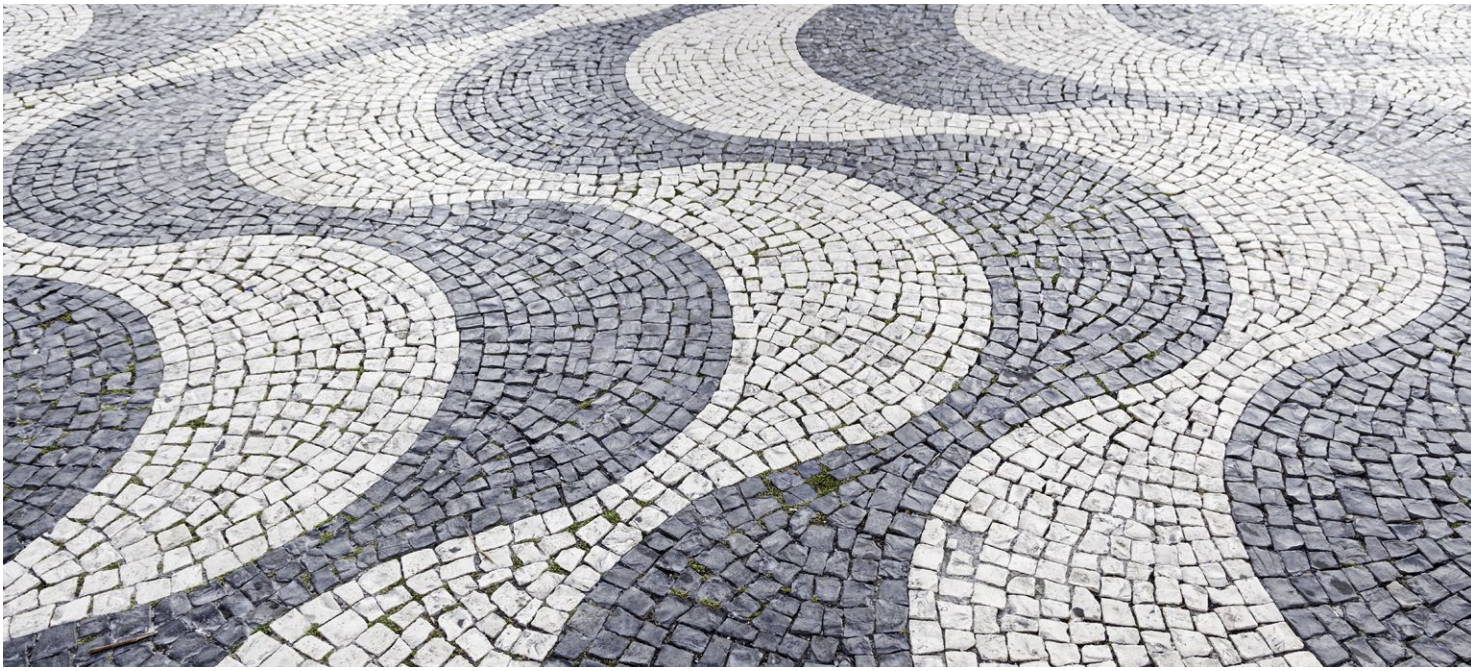
Looking at total returns, EM hard-currency sovereigns have outperformed US high yield over the past decade, while EM corporates have outperformed US investment-grade credit.

EM sovereigns have enjoyed a period of relatively low default rates that, alongside falling risk-free rates and unconventional monetary policies such as quantitative easing, have helped keep global yields low and supported returns for the asset class.

Why EMD, why now?

- Once investors move past outdated misconceptions that have prevented them from allocating capital to this asset class, EMD can be a useful addition to portfolios as DM yields continue to trade at or near historical lows.
- EMD can offer important diversification within a broader global bond portfolio, as the asset class has traditionally had low correlation to US Treasuries. The investible universe within EMD has grown significantly in the past twenty years, offering a wide array of opportunities in local and hard currencies.
- While EMD is typically more volatile than DM IG or sovereign debt, investors have been well compensated for this on an absolute and risk-adjusted basis.
- Investors seeking a truly diversified portfolio and the prospect of higher long-term returns should consider adding exposure to emerging markets, which are too big and dynamic to overlook. The improving fundamentals occurring within many EM countries also support the investment case.

"EMD can offer important diversification within a broader global bond portfolio."



References

1. Bloomberg Barclays Multiverse Index
2. Mercer European asset allocation insights 2020
3. CEMBI refers to J.P. Morgan CEMBI Broad Diversified Core Index for hard currency Corporates. EMBIG: J.P. Morgan EMBIG Global index for hard currency sovereigns. EM Local refers to JP Morgan GBI-EM Global Diversified for local currency sovereigns

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258439 - 31/12/2022