Tailwinds for Emerging Markets

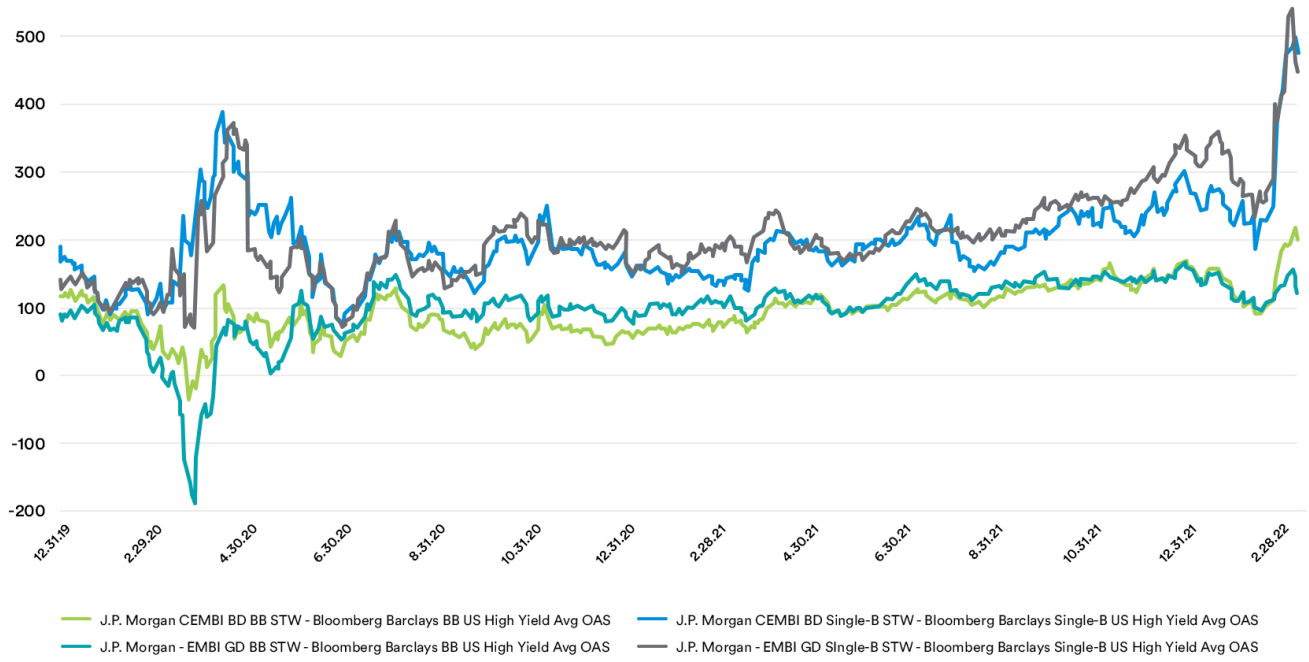
Attractive valuations, diversification benefits and increased yields could make EM debt a standout in fixed income.

Between new coronavirus variants, rising inflation, supply chain issues, China's zero-COVID policy and now a war raging between Russia and Ukraine, it has been a rough couple of years for global economies. Emerging markets, in particular, have borne the brunt of the uncertainty. As the pandemic constricted global activity, central banks in developed markets stepped in with liquidity and fiscal policymakers stimulated aggressively. On the other hand, policymakers in emerging economies were limited in their ability to provide liquidity, and fiscal balance sheets were also more constrained by lack of credit. As a result, emerging markets debt hasn't attracted the capital flows or experienced the performance of developed markets fixed income.

Now that's changing.

"Prior to the crisis unfolding in Ukraine, the developed world was having the hangover effect of all the stimulus, and the cost of it is inflation everywhere," says Todd Howard, portfolio manager for emerging market debt and multisector at MetLife Investment Management (MIM). Given recent global events, some of these factors are likely going to worsen.

Emerging Markets High Yield vs. U.S. High Yield Spreads



Source: Bloomberg L.P., J.P. Morgan

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Emerging markets do not have the same anchored inflation expectations as developed markets because investors have much more recent examples wherein inflation became problematic. With less of a price stability anchor, policymakers in Central and Eastern Europe and Latin America have already increased policy rates by hundreds of basis points—and they will continue to as necessary. This means that as the Federal Reserve or European Central Bank starts to raise rates, there's less risk that capital will flow out of emerging market debt.

"Our assumption, prior to the Russia/Ukraine war, was that inflation would likely peak this year, and as it moderates, we believe this could represent a tailwind for emerging market assets, especially the markets that have tightened the most,"
Howard says.

Valuations at the beginning of the year and since the crisis in Europe has begun are another potential tailwind. Over the last year, the yield spread on emerging market sovereign debt with a BB credit rating widened to 100 basis points over U.S. BB-rated debt. For B-rated EM debt, the yield spread is even wider at 150 basis points relative to U.S. B-rated debt. Currency devaluation over the past year is adding to that value, as central banks in emerging markets moved to tighten monetary policy and use some of their reserves to maintain currency stability.

For many of the markets MIM looks at, there is a lot priced in—and as we move through this year and obtain more visibility on some of the key macro drivers and specific EM-related concerns like Russia and Ukraine and Latin American politics, valuations could eventually be a catalyst for an emerging market rally.

Idiosyncratic opportunities

While there are attractive drivers for emerging markets debt, there's also a great deal of dispersion. In other words, not all emerging market opportunities are created equal.

"The market today is more divided than ever," says Scott Moses, a portfolio manager for emerging market debt at MetLife Investment Management, citing the default rates in emerging market sovereign high yield. "It's no longer 'a rising tide lifts all boats.' There are definitely some boats that are getting left behind."

"The idiosyncratic nature of the asset class has always existed, but now it's more dynamic than it's ever been." — Scott Moses, Portfolio Manager, Emerging Market Debt, MetLife Investment Management

Higher levels of uncertainty mean there is plenty in emerging markets debt that is priced cheaply until there is more clarity.

"There's some pockets of value we created within our asset class that have not been created in others," Moses says, noting there are pricing dislocations even on good assets. Investors have been concerned about macro factors such as ongoing tension between the U.S. and China or, more recently, Russia's invasion of Ukraine.

Despite the turmoil, "there are still some really good countries and companies that are going to need capital," Moses says, "but end up paying more for it because of market conditions. One example is the Dominican Republic, which could see a strong revival in tourism as COVID-19 disruptions fade."

A bright spot in emerging market debt is corporate bonds. As sovereign balance sheets continue recovering, corporate bonds have outperformed in the asset class as revenue, EBITDA and free cash flow returned to pre-pandemic levels. "Companies have proven themselves to be more resilient," Moses says, citing their ability to handle costs amid the pandemic.

As a result, corporate emerging market debt has done well. By contrast, sovereign debt has not responded as uniformly. "The idiosyncratic nature of the asset class has always existed, but now it's more dynamic than it's ever been," he says.

Another idiosyncratic opportunity MIM sees currently is with oil producers such as Angola, Oman

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and Ecuador, which are supported by high oil prices and positive underlying fundamentals. Angola, a top oil producer in Africa, delayed almost $3 billion in debt payments last year under the Group of Twenty's Debt Service Suspension Initiative. While there are concerns about this program coming to an end, there could be potential for credit-rating upgrades this year, and MIM sees opportunities in high-yield debt in the country.

In Oman, high oil prices, coupled with the country's economic reforms—which include cutting subsidies and introducing some taxes—have improved its outlook. In Latin America, Ecuador has been on the radar since Guillermo Lasso, a market-friendly banker, won the country's presidency.

A changing role in portfolios

Even though emerging markets debt has many tailwinds and pockets of opportunity, Howard emphasizes the asset class should not be considered a hedge against a down market like traditional high-quality fixed income.

That said, it can be a good diversifier for portfolios seeking income if they can stomach a bumpier road. Because emerging market debt has underperformed the last two years, some investors don't see it as an attractive asset class. "But if you want the diversification benefits and attractive valuations, I think it's an asset class that stands to benefit the most in fixed income, assuming a transitory inflation environment and no escalation of the Russia and Ukraine conflict," he says.

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Appendix

This appendix contains details for the preceding charts and provides additional information for greater accessibility.

Emerging Markets High Yield vs. U.S. High Yield Spreads

Note:

- All values are approximate
- Throughout the time period of the graph, all the lines have many short-term, small variations in addition to the variations over longer periods.
- The "J.P. Morgan CEMBI BD BB STW - Bloomberg Barclays BB US High Yield Avg OAS" line has the following characteristics:
    - End of December 2019 to End of August 2020: Moderate decline to about -34 just before end of March 2020, then moderate rise followed by sharp rise to about 131 at about mid-April 2020, then sharp decline to 65, then relatively level but with a few large variations of about 100 over relatively long periods to end of August 2020.
    - End of August 2020 to End of December 2021: Slight decline to about 40 at end of September, then gradual rise to 168 at end of December 2021.
    - End of December 2021 to just before end of March 2022: Moderate decline to about 91 at mid-February, 2022, then moderate rise followed by sharp rise to 216 and immediate decline to 200 just before end of March 2022.
- The "J.P. Morgan-EMBI GD BB STW - Bloomberg Barclays BB US High Yield Avg OAS" line has the following characteristics:
    - End of December 2019 to End of August 2020: Gradual to moderate decline to end of February, then moderate decline followed by sharp decline to about -185 at end of March 2020, then sharp rise to about 77 at about mid-April 2020, then gradual to moderate rise with a few large variations of about 120 to end of August, 2020.
    - End of August 2020 to End of mid-March 2022: Relatively level to end of May 2021, then gradual rise to about 162 at end of December 2021, then gradual to moderate decline to about 97 in mid-February 2022, then moderate rise to about 153 and immediate decline to 122 just before end of March 2022.
- The "J.P. Morgan CEMBI BD Single-B STW - Bloomberg Barclays Single-B US High Yield Avg OAS" line has the following characteristics:
    - End of December 2019 to Early-July 2020: Moderate decline to end of January 2020, then relatively level with variations of about 40 to mid-March 2020, then moderate to sharp rise with large, sharp variations of about 100, peaking at about 386 in mid-April 2020, then moderate to sharp decline with large, sharp variations of about 70, bottoming out at about 74 in early-July 2020.
    - Early-July 2020 to Mid-November 2020: Moderate rise to the 210 region at end of July 2020, then gradual to moderate decline to about 122 near end of September 2020, then moderate rise to about 250 just before mid-November 2020, with variation of about 80, then sharp decline to 185.
    - Mid-November 2020 to Mid-March 2022: Gradual decline to about 128 in late-March 2021, then gradual rise to 300 just before end of December 2021, with variation of about 80, then moderate decline to 188 in mid-February 2022, with variation of about 57, then sharp rise to about 497 and immediate decline to 477 just before end of March 2022.

- The "J.P. Morgan - EMBI GD Single-B STW - Bloomberg Barclays Single-B US High Yield Avg OAS" line has the following characteristics:
    - End of December 2019 to Early-July 2020: Gradual decline to about 94 in early March 2020, then a moderate to sharp rise to about 372 in late-April 2020, with a few large, sharp variations of about a maximum of 182, then a short decline followed by a very short, sharp decline from 335 at the end of April 2020 to 185 shortly after that, then a gradual to moderate decline to about 74 in early July 2020, with variations of about 90.
    - Early-July 2020 to End of October 2020: Moderate rise to about 227 at end of July 2020, then sharp decline to about 145 in mid-August 2020, then relatively level to end of September 2020, with variations of about 40, then sharp rise followed by moderate rise to about 240 in late-October 2020, then small, sharp decline to 205 at end of October 2020.
    - End of October 2020 to Late-August 2021: Gradual decline to about 150 in early January 2021, then gradual to moderate rise to about 244 in early-April 2021, then moderate decline to about 170 at end of May 2021, then moderate rise to about 247 in early-July 2021, then moderate decline to about 196 in late-August 2021.
    - Late-August 2021 to Mid-March 2022: Gradual to moderate rise to late-November 2021, then moderate rise to 352 at end of December 2021, then a short decline to about 307 in early January 2022 followed by a rise to about 361 in late-January 2021, then a moderate to sharp decline to about 233 in mid-February 2021, then a short, moderate rise followed by a sharp rise to about 540 in early-March and an immediate decline to about 449 in mid-March 2021.
- Source: Bloomberg L.P., J.P. Morgan

Month.Day.Year	J.P. Morgan CEMBI BD BB STW - Bloomberg Barclays BB US High Yield Avg OAS	J.P. Morgan-EMBI GD BB STW - Bloomberg Barclays BB US High Yield Avg OAS	J.P. Morgan CEMBI BD Single-B STW - Bloomberg Barclays Single-B US High Yield Avg OAS	J.P. Morgan - EMBI GD Single-B STW - Bloomberg Barclays Single-B US High Yield Avg OAS
12.31.19	116	88	190	142
2.29.20	48	26	94	108
4.30.20	71	71	293	335
6.30.20	31	60	82	82
8.31.20	91	119	188	159
10.31.20	51	88	168	205
12.31.20	65	99	173	210
2.28.21	68	108	134	182
4.30.21	108	116	193	190
6.30.21	108	119	196	210
8.31.21	111	128	168	213
10.31.21	136	142	239	261
12.31.21	168	162	295	352
2.28.22	153	125	349	389