

Emerging Markets Debt: Outlook for the Asset Class

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May 20, 2011

- *Emerging market debt has been one of the best performing asset classes in recent years due to the sustained rebound following the 2008 sell-off. However, many investors are wondering how attractive the asset class remains in the current environment. Concerns relate to the large size of inflows over the past two years, inflation pressures and rising interest rates, and more generally the current valuation level.*
- *We take a closer look at these concerns in this note. To summarize the results, we conclude that the asset class looks attractive, especially compared to other USD-based fixed income assets, based on the following arguments:*
- *Key economic fundamentals in emerging market countries continue to be favorable. According to IMF estimates, economic growth is more than double the growth rate in advanced economies and public finances are in better shape, with substantially lower and falling debt ratio. Moreover, we believe commodity prices remain supportive of EM external positions.*
- *Inflation pressures tend to present headwinds to fixed-income investments, but key EM central banks have already raised interest rates significantly and more rate hikes are already priced into local yield curves. Moreover, many EM central banks are letting their currencies appreciate gradually to help contain inflation.*
- *The risk of rising US yields on the other hand affects all USD fixed income asset classes with duration exposure, including EMD. However, we believe EMD remains attractive, especially on a relative basis, as spreads tend to be negatively correlated with treasury yields, thus offsetting part of the effect of rising treasury yields.*
- *Despite large inflows into the asset class, we believe that many investors are still underinvested in EMD, suggesting further flows in the future. We also believe the asset class can absorb such flows as the size of the investable EMD market continues to expand.*
- *Valuations are not as cheap as they were two years ago, but current spread levels still offer room for further compression, especially considering the continued improvement in credit quality. Meanwhile, local currency yields are broadly in line with historical levels, yield differentials to US treasuries are high, and FX valuations still support further appreciation.*

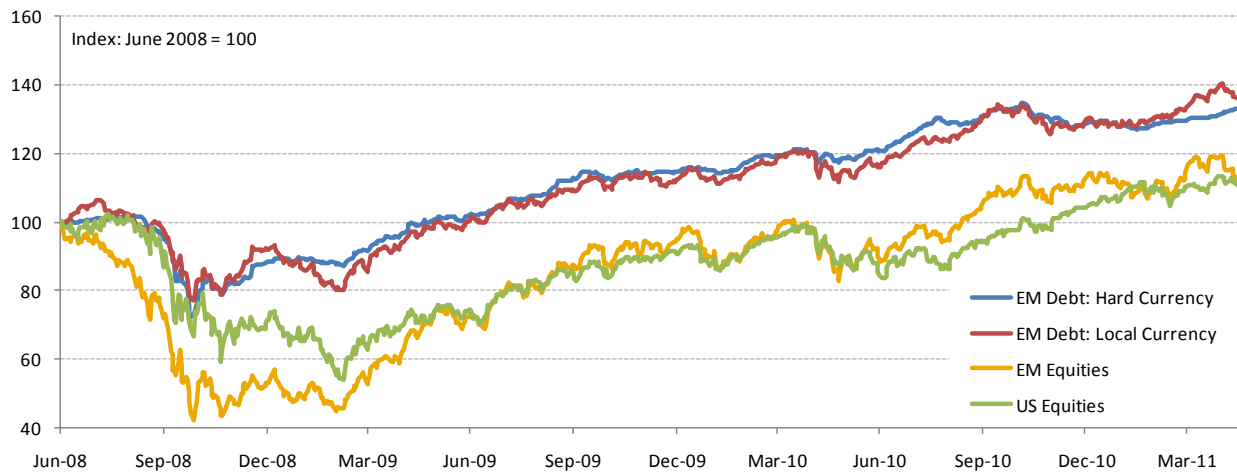
Emerging markets debt (EMD) has been one of the best performing asset classes in recent years. Average annualized returns for hard and local currency debt (measured by J.P. Morgan's EMBI Global Diversified and GBI-EM Global Diversified) were slightly above 8.5% and 10% respectively during the three years period of 2008-2010. The strong performance was the result of the sharp rebound

following the 2008 sell-off. Both the hard and local currency indices surpassed their respective pre-crisis peaks within about one year and then continued to rally, returning about 25%-30% cumulatively since then (Figure 1). In comparison, EM and US equities only very recently made up the losses incurred since their 2008 peaks. But the outlook for fixed income assets in general is now arguably not as good as it

was two years ago. Valuations are not as cheap and

we are now in a rising interest rates environment.

Figure 1: Asset Class Performance: Total Return Indices*, June 2008-May 2011



*/ EMBIG Div, GBI-EM G Div, MSCI EM Free, S&P 500
Source: Bloomberg

Major developed economy central banks are starting to plan their exit from exceptionally accommodative monetary policy and EM central banks are already in the middle of a monetary tightening cycle in response to inflation pressures and strong growth.

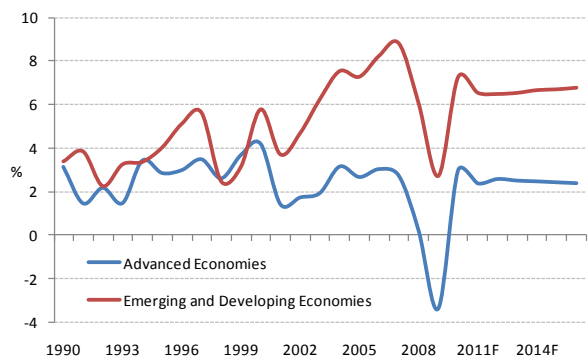
Thus, many investors are wondering if EMD is still an attractive asset class in the current environment. We believe the answer is yes, even though the return potential is lower now than it was two years ago. In our view, EMD still offers attractive risk-return characteristics compared to other assets in the global fixed income space

The fundamental case for EMD remains intact

We laid out the case for EMD in a short note at the beginning of 2010 and the key economic fundamentals supporting EM economies remain in place¹. GDP continues to grow at more than twice the

rate than in advanced economies and government finances are generally in much better shape, with lower debt burdens and lower deficits. As a result, we believe debt dynamics are much more favorable in Emerging Markets. International reserves continue to accumulate at a fast pace and external current account balances remain in surplus on average.

Figure 2: GDP Growth, 1990-2016



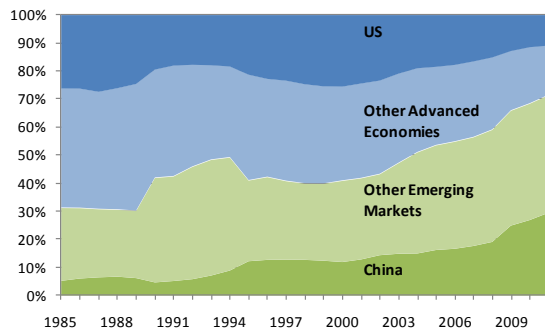
Source: Haver Analytics, IMF World Economic Outlook

A key change in the economic outlook over the past year has been the boom in global commodity prices and the related rise in EM inflation rates. Commodity

¹ *The Case for Emerging Market Debt*,
<http://www.shiplp.com/research/emd-case-studies/case-emerging-market-debt>

prices generally have a mixed impact on EMs as some countries are net commodity exporters while others are net importers. On balance, net commodity exporters dominate, especially within the subset of EM countries with accessible fixed income markets. Thus, the continued commodity boom has been generally supportive for EMD fundamentals. However, high commodity prices have also led to higher inflation rates in EMs where the weights of fuel and food items in the consumer price indices are particularly high. As a result, more EM central banks have started to tighten monetary policy. Opinions diverge among analysts and investors if EM central banks' reaction is adequate to control inflation. Our assessment is that most EM central banks are sufficiently committed to their inflation target, though this means that we'll see more monetary tightening ahead.

Figure 3: Share of World GDP Growth, 5 year rolling average, 1985-2011



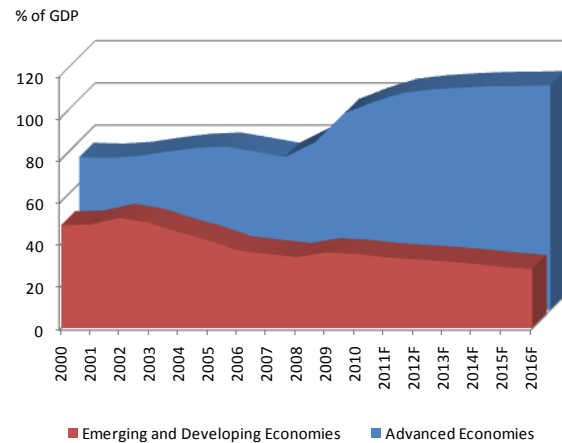
Source: Haver Analytics, IMF World Economic Outlook

EMD in a rising inflation and rates environment?

A key issue is if central banks are currently “behind the curve”. This question really summarizes two concerns: that either inflation rates will remain high for an extended period or that central banks will eventually have to slow down growth sharply to control inflation (the infamous “hard landing”). Neither scenario would be supportive for EMD. Moreover, ongoing efforts of EM policy makers to slow the

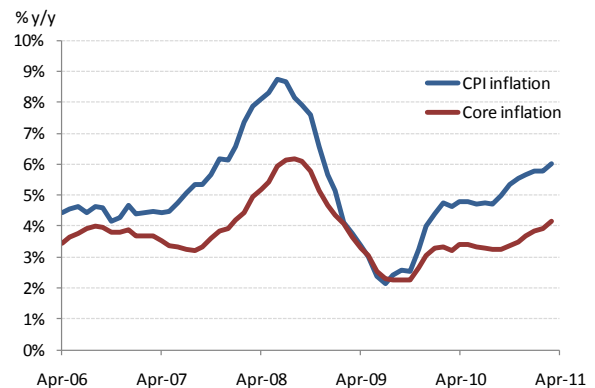
appreciation of their currencies exacerbate the risk of insufficient tightening. In this environment, many investors question whether it is the right time to invest in EMD from a cyclical perspective.

Figure 4: Gross Public Debt, 2000-2016



Source: Haver Analytics, IMF World Economic Outlook

Figure 5: EM Inflation, 2006-2011



Source: Haver Analytics, Stone Harbor estimates

We believe it is important to analyze the sources of the inflation pressure. In fact, the primary reason for higher headline inflation prints is the commodity price boom. However, when we compare the current inflation pressures with the 2007-08 inflation burst, we notice that core inflation remains more contained now which is a reflection of the fact that demand-side pressures globally (and in most EMs) still remain

lower than during 2007-08, and it is the management of demand-side pressures that ultimately determines the path of inflation.

Moreover, we believe many EM central banks are slowing the pace of currency appreciation, but they are not preventing it and in several EMs policy makers consider currency appreciation an important factor in containing inflation pressures. In our view, most EM central banks remain focused on inflation and, considering that valuations reflect significant further tightening, we believe local currency debt remains attractive in the current environment. A brief look at EM local currency debt performance during 2007 and early 2008 also confirms that it can perform well in a rising inflation environment.

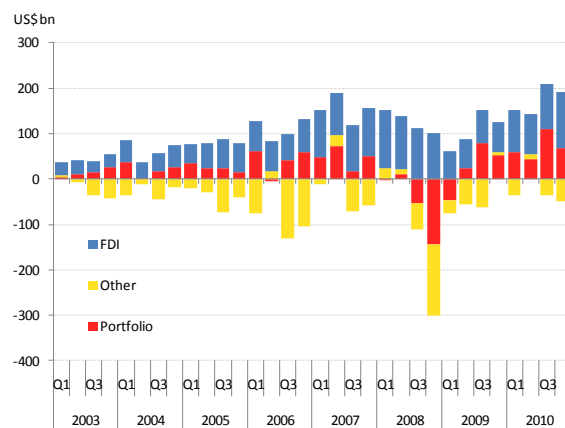
A related concern is the prospect of rising US treasury yields. Many factors point in this direction: the expected gradual normalization of US monetary policy, including the end of quantitative easing, as well as growing concerns about rising debt levels and the political obstacles in reaching an agreement on fiscal consolidation. This risk affects all USD fixed income asset classes with duration exposure. However, we believe EMD remains attractive, especially on a relative basis. Spreads tend to be negatively correlated with treasury yields. We estimate that historically about $\frac{3}{4}$ of the changes in treasury yields tend to be offset by changes in spreads at the aggregate index level, reducing the correlation between treasury yields and EMBIG yields. And among the higher yielding credits in the sovereign and corporate sector that correlation tends to be lower.

Has too much money already flowed into EMD?

Flows into EMD have been substantial over the past two years. In fact, capital flows into EMs more broadly have picked up significantly. This naturally raises the question of sustainability, investor positioning, and whether valuations have become stretched.

From a macroeconomic perspective, as we have argued in a recent research note², overall capital flows to EMs have not yet created unsustainable imbalances. Most EMs are less leveraged now than they were a few years ago (as measured by public, external, and corporate debt ratios) and most EMs are running current account surpluses or small sustainable deficits. With respect to EMD specifically, it is important to note the overall market size has been growing significantly, especially in the local currency segment which has also seen the largest inflows. This suggests that the market can absorb much larger inflows now than several years ago.

Figure 6: Capital Flows into EMs*, 2003-2010



*/ Argentina, Brazil, Chile, Mexico, Peru, Hungary, Poland, Russia, Turkey, South Africa, Ukraine, China, India, Indonesia, Malaysia, Philippines, South Korea, Thailand.

Source: Haver Analytics, Stone Harbor estimates

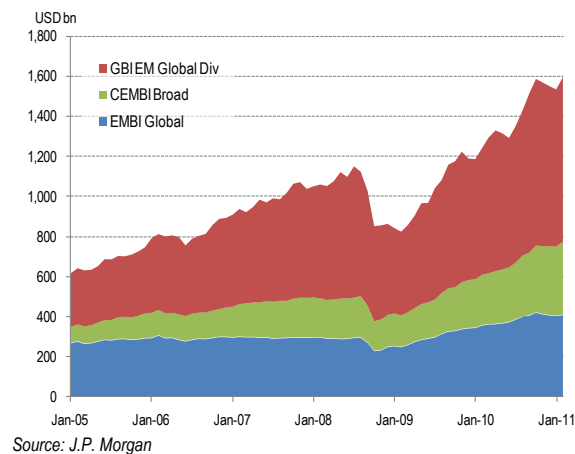
From the perspective of investor allocations we believe the most important change in recent years is the transition in the role of EMD in investors' portfolios. EMD is increasingly becoming a strategic allocation for pension funds but most US pension funds still remain underinvested in the asset class.³ In

² *Capital Flows into EMs: How Real Is the Threat of "Currency Wars"?*, <http://www.shiplp.com/research/emd-research/capital-flows-ems-real-threat-currency-wars>

³ See: "EM Moves into the Mainstream as an Asset Class", J.P. Morgan Emerging Markets Research, October 4, 2010.

our view, this bodes well for the stability of these inflows. Positioning of cross-over and retail investors is more difficult to judge but retail flows, especially out of Asia, have been large. We have argued before that growth prospects and risk appetite are the most important factors determining fixed income flows into EMs, while rate differentials are of secondary importance for aggregate flows. In any case, both EM growth prospects and rate differentials should remain supportive of inflows into EMs and monetary tightening in developed markets is unlikely to change this given the size of the interest rates differential.

Figure 7: Market Capitalization Of EM Debt Indices, 2005-2011



Valuations

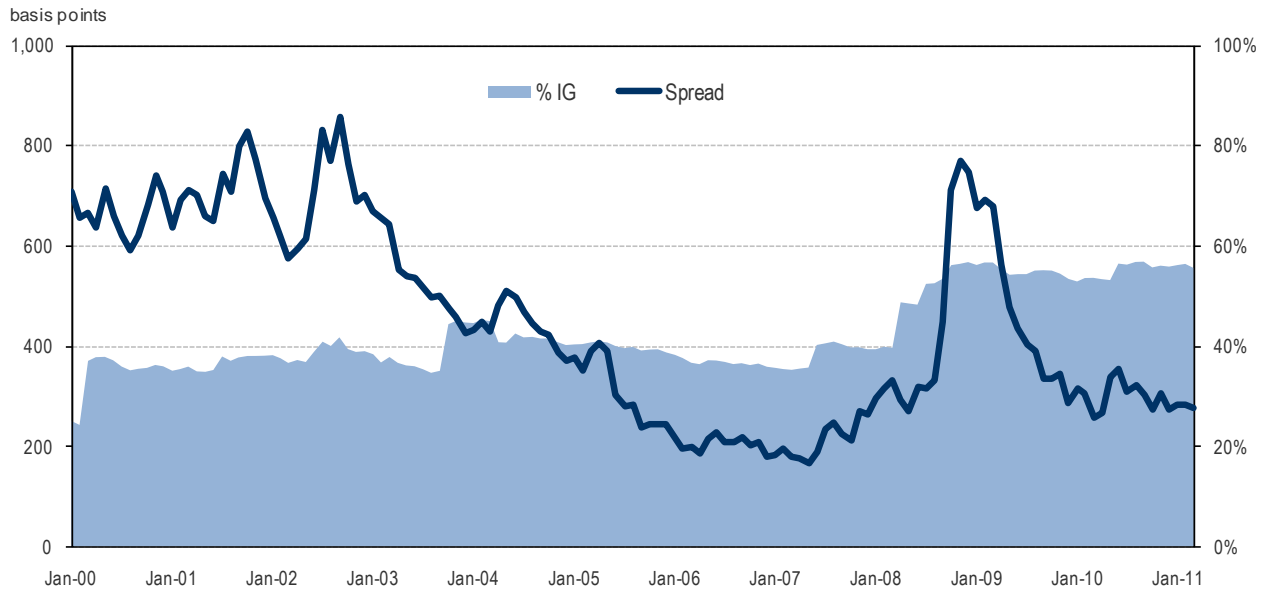
Valuations are clearly not as cheap as they were two years ago but we believe the asset class still offers value at current levels. Hard currency sovereign spreads (measured by the EMBI Global Diversified Index) have remained broadly in the 250-300bps range over the past 6 months. We believe there is some limited potential for further spread compression considering that spreads were below 200bps for some time in 2006 and 2007 while the average credit quality is actually better now with more than 50% of the index rated investment grade.

When it comes to local currency debt we believe it is important to distinguish between rates and FX. Yields

have risen substantially since the lows in October 2010 as local yield curves have been pricing in tighter monetary policy conditions in response to rising inflation pressures (Figure 9). Further rate hikes are priced into local curves and we see value at current levels. The GBI-EM Global Div currently yields about 450 bps above 5 year US treasuries (the duration of the GBI-EM Global Div is slightly less than 5 years), which is high from a historic perspective. Real yields (adjusted for inflation) of sovereign local currency bonds are also multiple times higher than those in the major developed markets. We believe there is still potential for some gradual convergence in real yields, especially in certain markets with particularly high real yields such as Brazil, though this may take several years to play out.

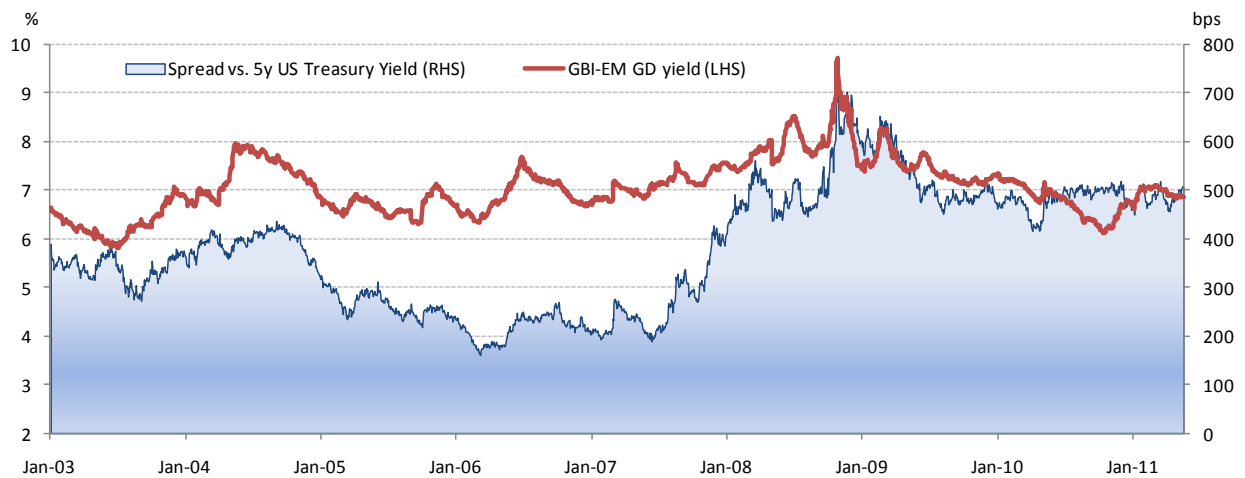
On the FX side, we believe the gradual appreciation trend of EM currencies remains in place despite efforts by some EM policy makers to slow that appreciation. Clearly, there are substantial differences across countries but we see several overarching trends. Fundamental FX valuations still support further appreciation. Absolute price levels (based on purchasing power parity calculations) are much below those in developed markets. As per capita income slowly converges, equilibrium real exchange rates in EMs tend to strengthen. But we believe the “ultimate” gauge for currency valuations are external balances, in particular the current account. Overvalued currencies tend to result in large and/or widening current account deficits. On aggregate, EMs are currently running external current account surpluses and according to IMF forecasts these surpluses are expected to rise further over the coming years. Of course there are substantial differences across individual countries but on aggregate EMs are net commodity exporters and the commodities boom is supporting stronger EM currencies. In addition, improved fundamentals more broadly, such as record levels of international reserves, lower debt ratios, and higher growth further reinforce that trend.

Figure 8: Historical Credit Quality and Stripped Spreads over Treasuries: EM Hard Currency Debt*, 2003-2011



*/ measured by J.P. Morgan's EMBIG Div Index
Source: J.P. Morgan, Bloomberg

Figure 9: EM Local Currency Debt Yields* and Spread of US Treasuries, 2003-2011



*/ measured by J.P. Morgan's GBI-EM Global Diversified Index
Source: Bloomberg

While these factors support long-term appreciation, we also see positive near term dynamics. China continues to appreciate its currency gradually which is important for many EM countries competing with China for export market share. And we believe the most important factors behind capital inflows also remain in place (such as growth and interest rate differentials with major developed economies). And despite the efforts to slow that appreciation (through intervention, macro-prudential measures, and even some capital controls), EM central banks are allowing gradual appreciation, not least with a view to dampen inflationary pressures.

The bottom line

In summary, we believe that EMD is still an attractive asset class. Economic fundamentals such as growth

and public finances remain very supportive. Despite large inflows into the asset class over the past two years, we believe that many investors are still underinvested in EMD suggesting further flows in the future. We also believe the asset class can absorb such flows as the size of the investable EMD market continues to expand with EM's rising share in the global economy. Hard currency spreads have tightened but still offer attractive return prospects, especially in some higher yielding names as well as corporates. In our view the asset class looks attractive compared to other USD-based fixed income assets. Finally, we believe local currency debt still offers significant return potential from both currency and local rates as inflationary pressures and monetary tightening are already priced into local yield curves and the yield differential remains attractive.

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