

A New Chapter in Emerging Markets Debt

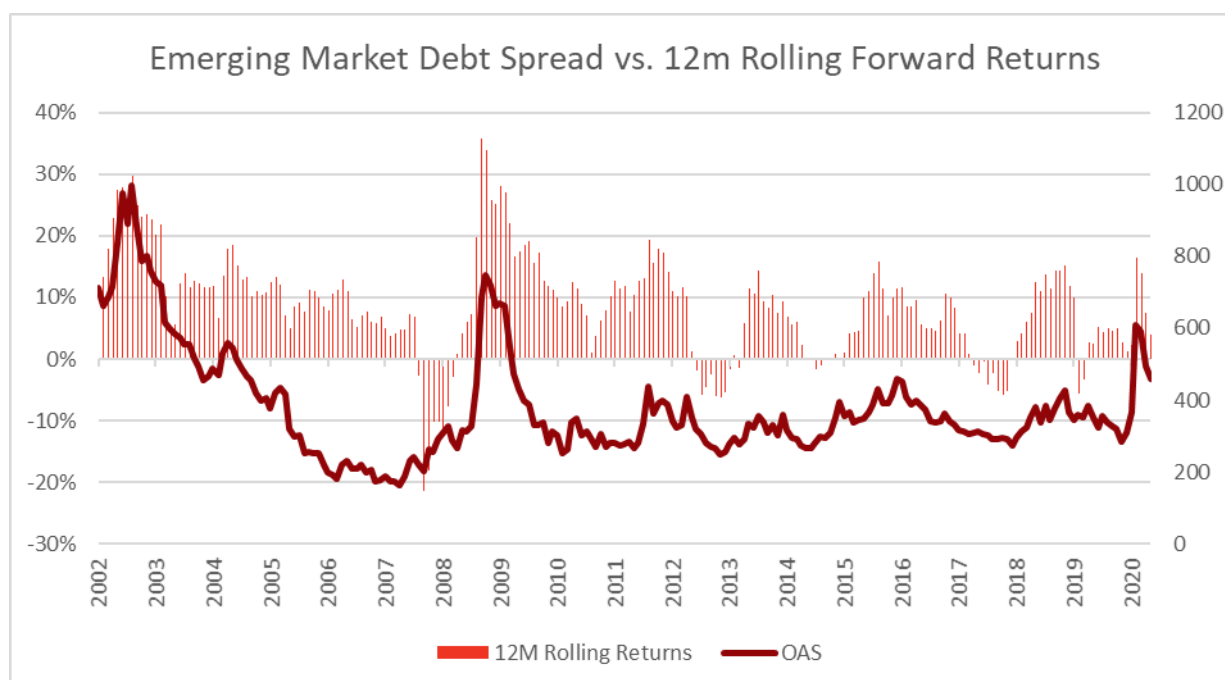
August 2020



MAPPING THE EMERGING MARKET DEBT LANDSCAPE POST-COVID

The unprecedented addition of US\$6 trillion to G20 central bank balance sheets in just over four months has reversed investor sentiment, resulting in the recovery of Emerging Market (EM) debt markets and spreads tightening.

Since the beginning of the COVID-19 crisis, EM sovereign spreads first widened by over 400 basis points (bps), from around 285 to 685 bps, followed by a tightening of around 200 bps, to the current below 450 bps level (see chart below).



Source: JP Morgan, QIC. EM Index is the JP Morgan Emerging Market Bond Index Core, which is a hard currency EM Sovereign index. Data as of 31st July 2020. OAS = Option Adjusted Spread. Emerging Market Debt Spread is defined as the spread over the interpolated spread over the reference curve in each hard currency.

DEFINING EM DEBT PARAMETERS

EM debt comes in two forms: hard currency or local currency bonds.

This market is primarily dominated by sovereign issuers in hard currency, predominantly US\$. However over time the asset class has become more diverse, with investors able to access EM debt via sovereigns and corporates in hard and local currency.

Exposure to long-term secular growth is the central theme of the emerging markets investment story – with the EM sovereign hard currency market segment the main character favoured by investors. While the local currency component of the market can offer higher returns, this can come with greater volatility.

A good example of a local currency corporate bond market developing significantly in the last 10 years has been the on-shore China corporate bond market. The local currency (CNY) corporate bond market has evolved into a sizable, diverse, high-quality investible universe, buoyed by solid fundamentals.

Increased allocations into EM debt may prove to be beneficial given the positive dynamics of EM Debt, which today outweigh the investment case for developed market bonds. As EM Debt rebounds out of the pandemic over the next decade, we expect its growth and development to outpace developed markets. As an example, China in the last 15 years has grown from the world's fifth largest economy (as measured by GDP) to the second largest.

WHY BUY EM DEBT?

The below drivers support the attractiveness of EM Debt to investors:



1. Favourable Fiscal and Monetary support

- Huge liquidity provisions from central banks should continue to support EM hard-currency bonds
- Low risk-free rates and high benchmark spreads suggest attractive returns could be found in EM spreads



2. Volatility will remain suppressed

- Lower asset class volatility combined with the prospect of suppressed yields over a longer period, will ensure investors' search for higher yielding assets is set to continue.

The VIX index (the 30-day market-implied volatility of the S&P 500) has fallen to 24.5 as of end-July, after peaking at 83 in mid-March at the height COVID-19's market dislocation. If we also considered the MOVE index (US Treasury yield volatility implied by one-month OTC options on US Treasuries) – which compressed from its peak of 164 in March, to 42 – this has not only surpassed the lows just prior to the pandemic but are now at an all-time historical low. In addition, 10-year US Treasuries have been largely confined to a very narrow range over the past month – 55bp to 70bp.

- Despite seeing a strong recovery since March, EM Debt volatility regime and momentum offers investors a significant opportunity to outperform in risk, especially during a crisis.



3. Valuations are relatively attractive

- On a relative basis as the crisis has evolved, EM Debt significantly outperformed US and European corporate bonds despite initially lagging in the rebound.
- The forward-looking return profile of EM debt has become increasingly attractive (see chart above) offering investors attractive yields and long-term entry levels.



4. Flows turning positive

- EM bond funds have started to see small inflows but have a long road to replenish the year-to-date net bond portfolio outflows of US\$37 bn (as of July 31st, 2020). Non-ETF funds leading the outflows at US\$31 bn while ETF funds redemptions year-to-date are at US\$4 bn.

OUR VIEW ON PLAYING THE LONG-GAME

The course ahead: There are still unknowns and risks as the COVID pandemic continues to unfold, undermining a clear path towards recovery.

Current state of play: We are currently witnessing two key factors making EM Debt an emerging and promising asset class for active investors:

- Multiple mis-pricings in the market; and
- EM Debt is still cheap, trailing other bond markets

Price of admission: One such attractive long-term entry point would be starting yields (and coupons) which are currently high.



THE AUTHOR

Paul Nicholson
Director, Global Absolute Return & Income Funds
p.nicholson@qic.com

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