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Schroders Emerging Markets Lens: Emerging Market Debt

Strategic Research Unit

Q4 2021

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Summary

Hard currency emerging market debt (EMD):

- Valuations vary
  1. Investment grade (IG) sovereign and corporate spreads are well below historical medians
  2. High yield (HY) spreads offer more value, especially in sovereign EMD where the dispersion between countries remains large

Local currency EMD:

- Yields increased in 2021 because of EM rate hikes and a pickup in inflation
  - Key question is how persistent the increase in core inflation will be in high inflation countries
- Offer a large real yield premium over developed market (DM) bonds, partly because soaring US inflation has depressed real yields in DM
  - Historically, this has led to strong performance of EM local currency bonds
- There are undervalued **currencies** in all three EM regions. On average, Latin American currencies are the cheapest, whereas Asian currencies have the least appealing value
- Most EM current accounts swung from deficit to surplus in the pandemic, reducing vulnerability to sharp currency depreciation

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Emerging market debt: hard currency

Summary: hard currency emerging market debt

- Valuations in hard currency EMD vary between the issuers and the types of bonds
- In sovereign EMD, the spreads of investment grade (IG) countries are well below the historical median, currently standing at post-financial crisis lows
- In the high yield (HY) part of the market, spreads are still well above pre-Covid levels, hovering near the historical median. In addition, the dispersion between countries remains large
- In corporate EMD, both IG and HY spreads are below the historical median, although there is more space in HY for spreads to fall further
- The turmoil in China's real estate sector has had very limited impact so far on the broader market, with the distress mostly contained in China HY bonds
- Credit quality has worsened in the pandemic in major sovereign and corporate EMD benchmarks
- In relative terms, EM spreads are elevated vs US corporate credit

Sensitivity of hard currency EM corporate bond market to Evergrande / China real estate

Spreads on Chinese hard currency corporate bonds[1]

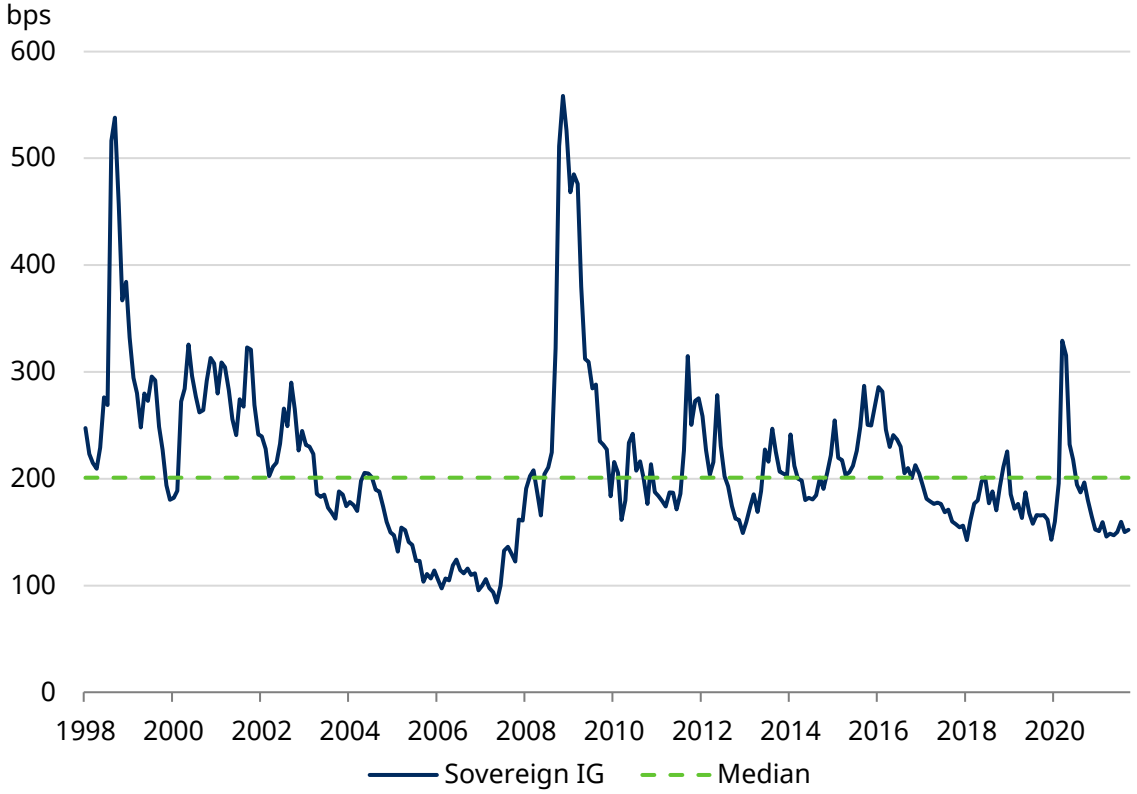
Source: J.P. Morgan. Data as at 4 October 2021. [1]The JPM CEMBI China Index spreads.

Distressed contained in China HY market, so far

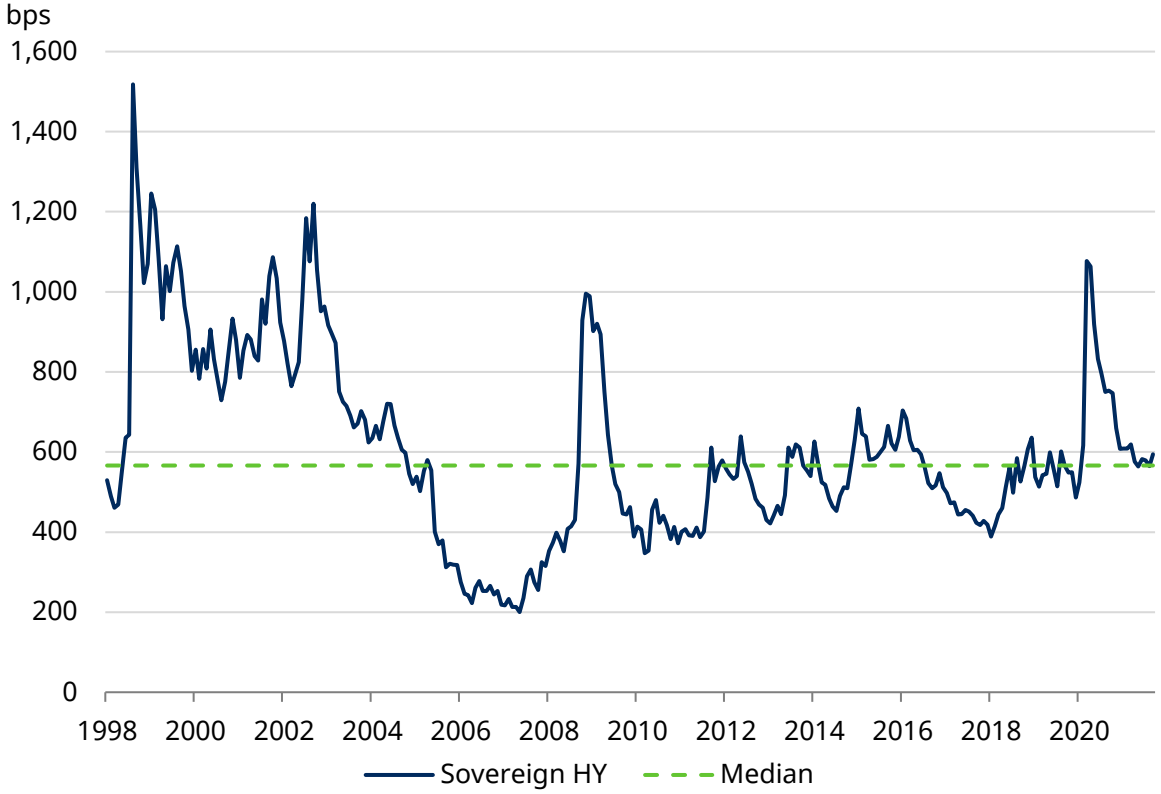
- China is around 7% of the JPM CEMBI Broad Diversified Index of corporate EMD
- The most popular Chinese hard currency corporate bond benchmark is 80% IG and 20% HY, a relatively high quality mix
- However, the real estate sector has the largest share in the index at 27%. In fact, real estate HY bonds make up 80% of all Chinese HY bonds in the index
- China HY spread at 1256bps is now higher than in the peak of the Covid-19 pandemic
- The IG spread has increased by 10bps since August, but at 168bps, it is still low compared to the March 2020 peak

Valuation of hard currency sovereign EMD

Hard currency sovereign EMD IG spread



Hard currency sovereign EMD HY spread

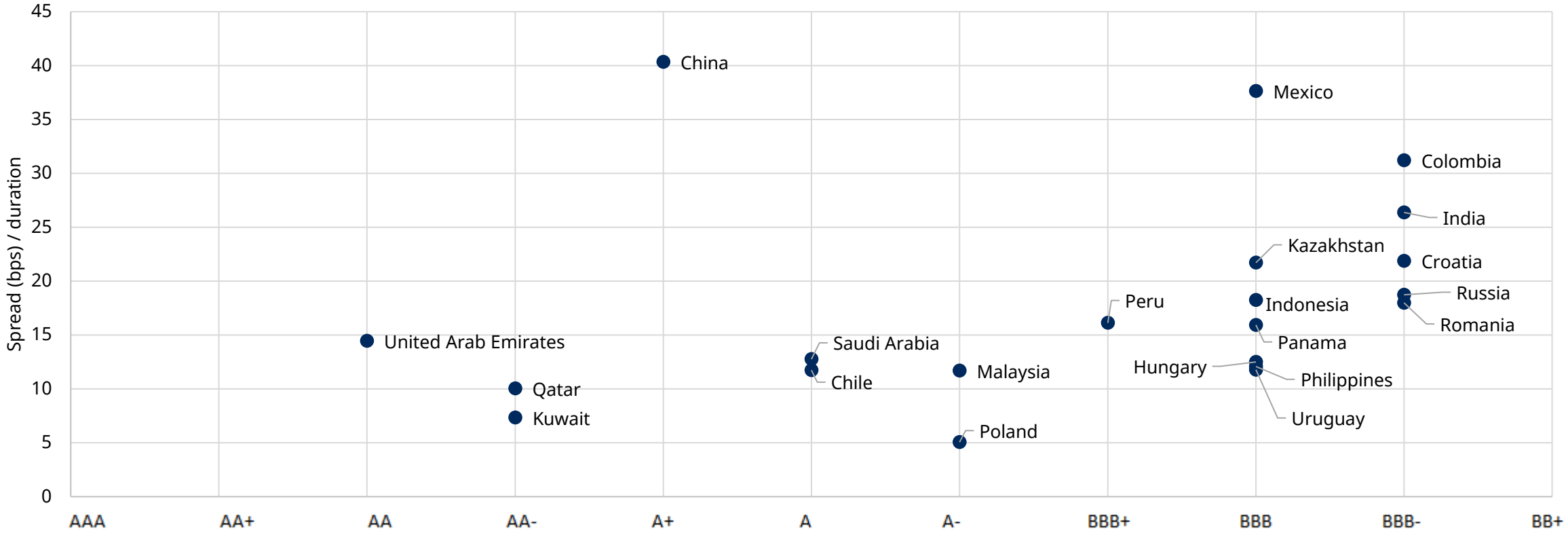


IG spread is well below the historical median; HY spread is still well above of the pre-Covid level, hovering near the historical median

Source: Refinitiv Datastream, J.P. Morgan. Data as at 30 September 2021.

Duration adjusted spreads of IG countries

Hard currency sovereign EMD IG: spread vs. duration vs. credit rating



Spreads of China and Mexico are elevated compared to similarly rated sovereigns due to issues with state owned companies in both countries

Source: Schroders, Refinitiv Datastream, J.P. Morgan. Data as at 30 September 2021.

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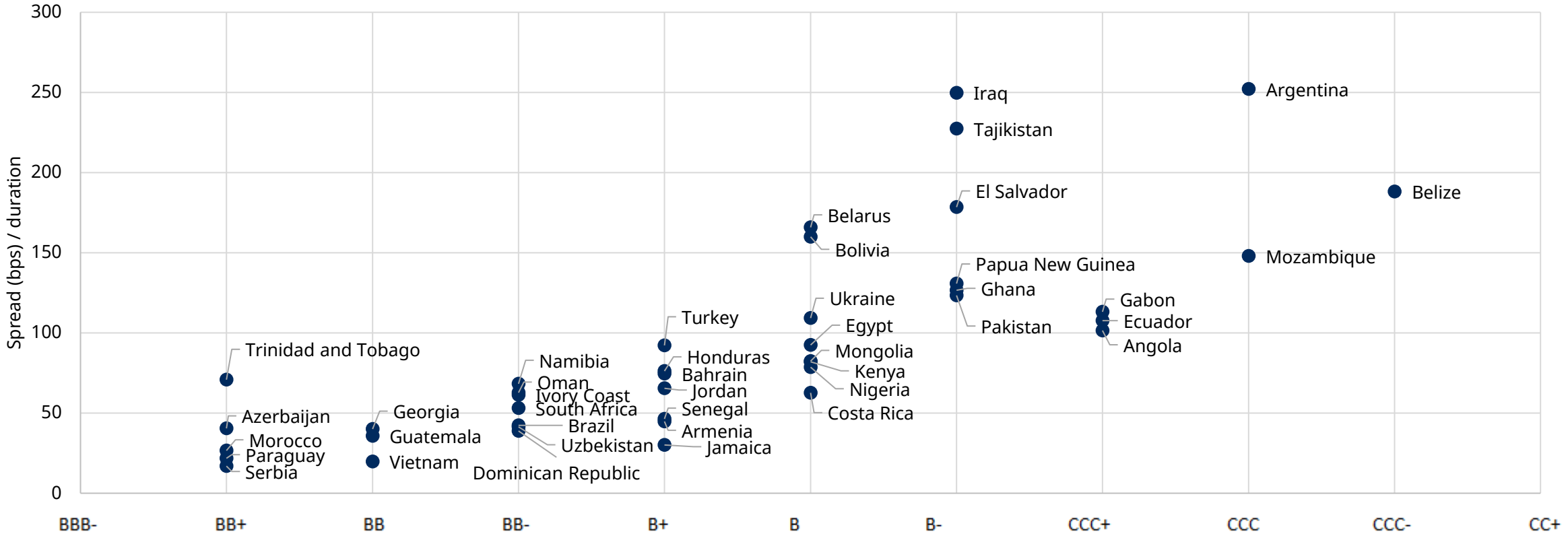
Duration adjusted spreads of HY countries

Significant variability between the countries

Hard currency sovereign EMD HY: spread vs. duration vs. credit rating



Dispersion between HY countries is wide even when adjusted for credit quality and duration

Source: Schroders, Refinitiv Datastream, J.P. Morgan. Data as at 30 September 2021.

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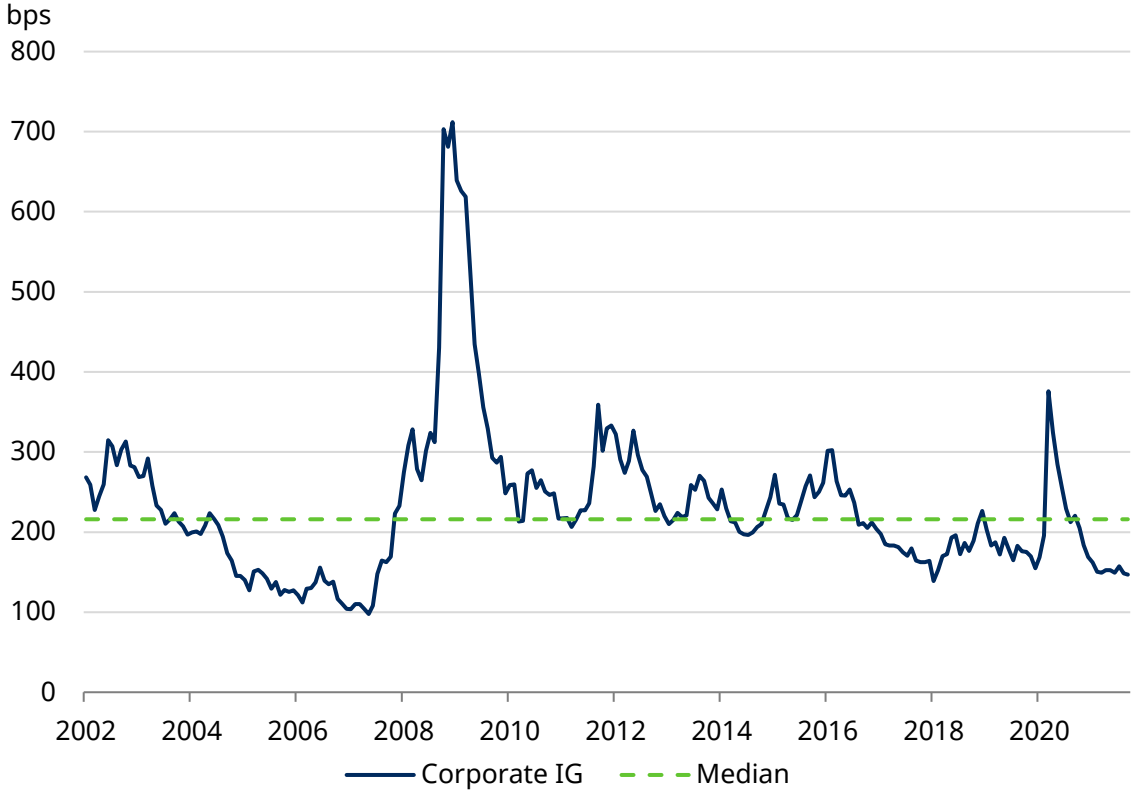
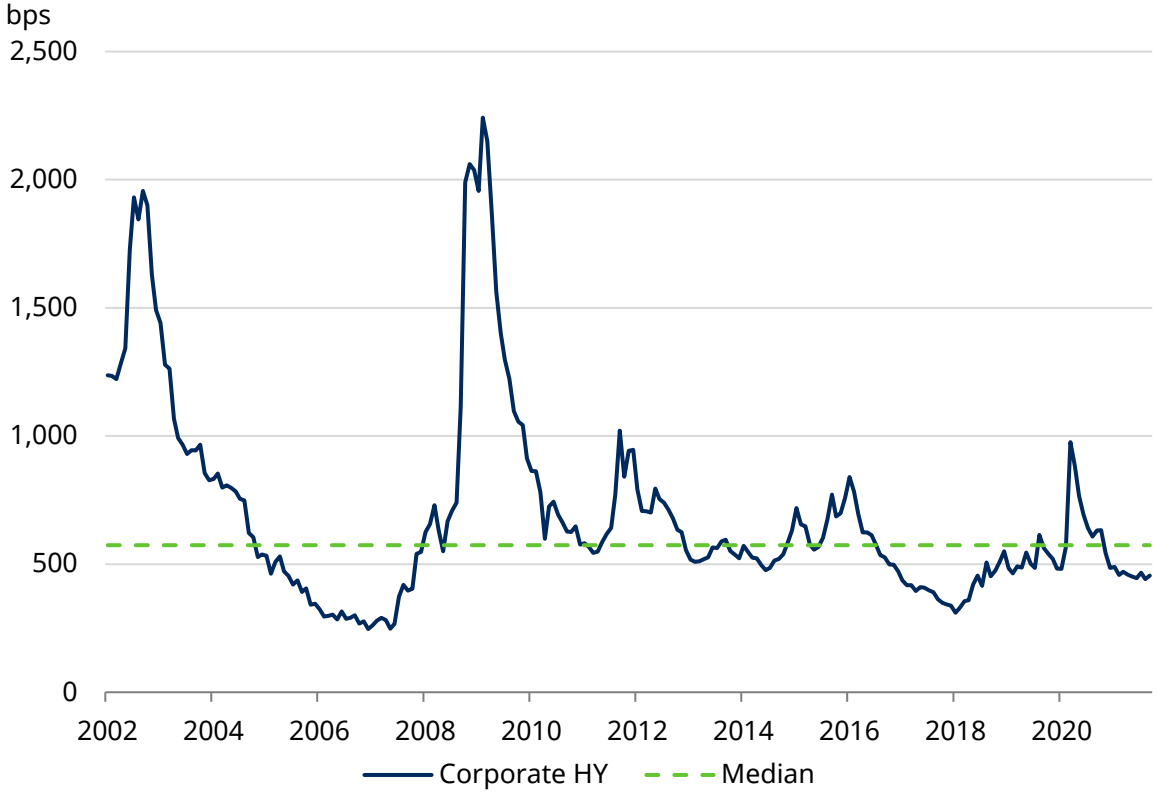
Valuation of hard currency corporate EMD

Hard currency corporate EMD IG spread



Hard currency corporate EMD HY spread



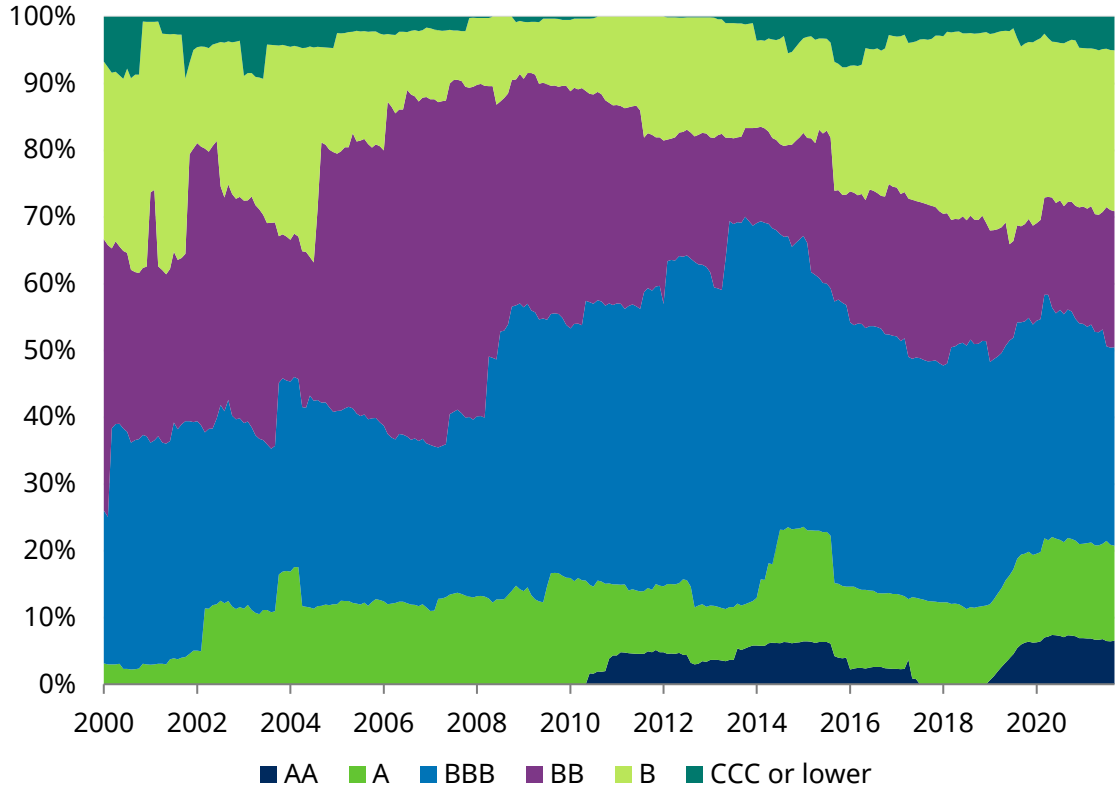
Both IG and HY spreads are below the historical median, although there is more space in HY for spreads to fall further

Source: Refinitiv Datastream, J.P. Morgan. Data as at 30 September 2021.

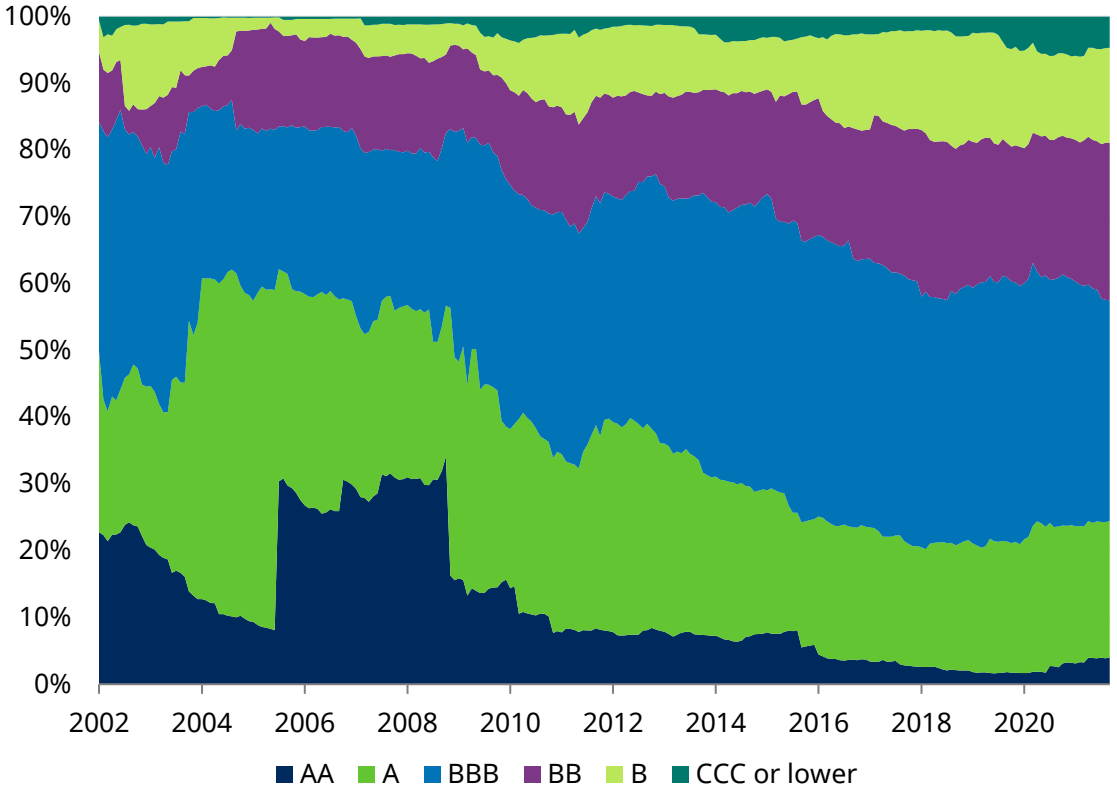
EMD historical ratings split

The share of IG bonds has been falling in both sovereign and corporate index

Sovereign EMD ratings split



Corporate EMD ratings split



Pandemic-driven ratings downgrades are yet to be reversed

Source: Schroders, J.P. Morgan. Data as at 30 September 2021.

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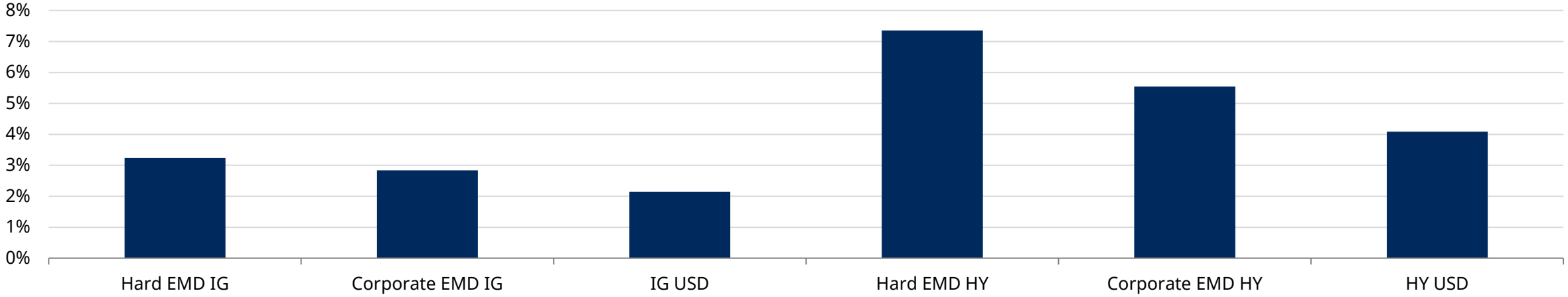
Hard currency EM debt vs. US corporate debt

	Hard EMD IG	Corporate EMD IG	IG USD	Hard EMD HY	Corporate EMD HY	HY USD
Yield	3.2%	2.8%	2.1%	7.4%	5.5%	4.1%
Spread (bps)	152	147	89	594	455	315
Duration	9.4	5.6	8.4	6.4	3.4	5.3
Rating	A3	A3	A3	B1	B1	B1
Percentage of EMD index	50.2%	54.9%	-	49.8%	45.1%	-

EM vs. DM yields



Source: Schroders, Refinitiv Datastream, ICE Data Indices, J.P. Morgan. Data as at 30 September 2021.

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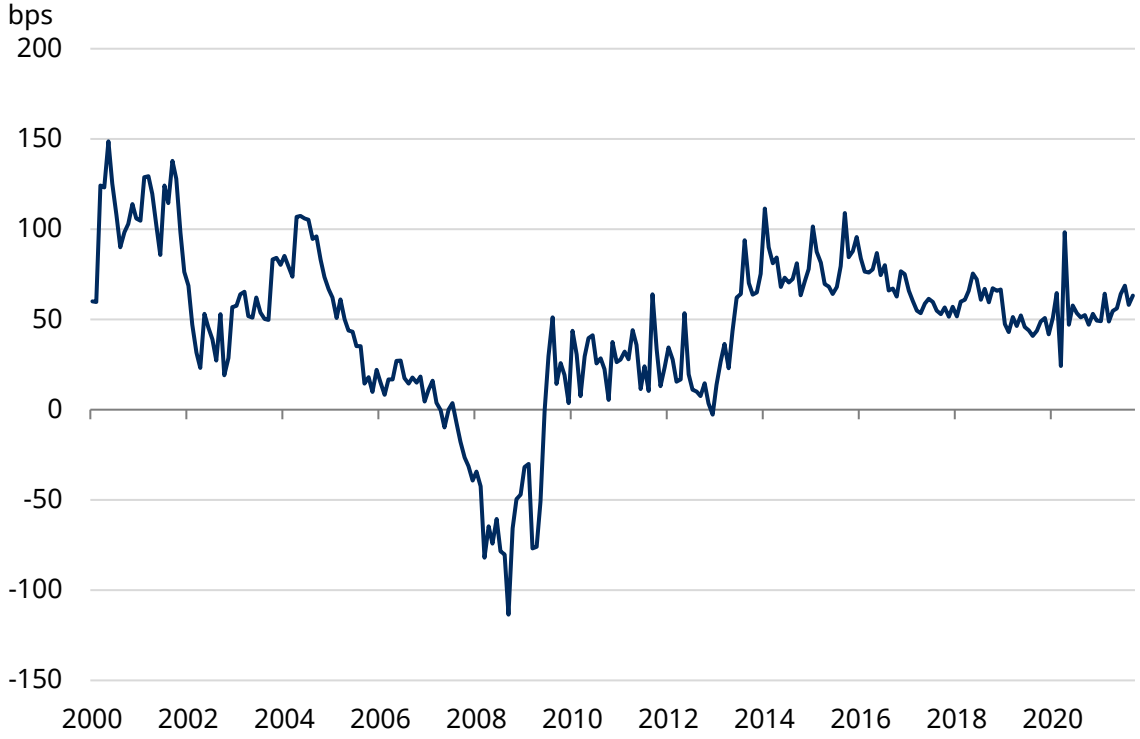
EM dollar debt: sovereign EMD vs. US corporates

Sovereign EMD IG spread minus US IG spread

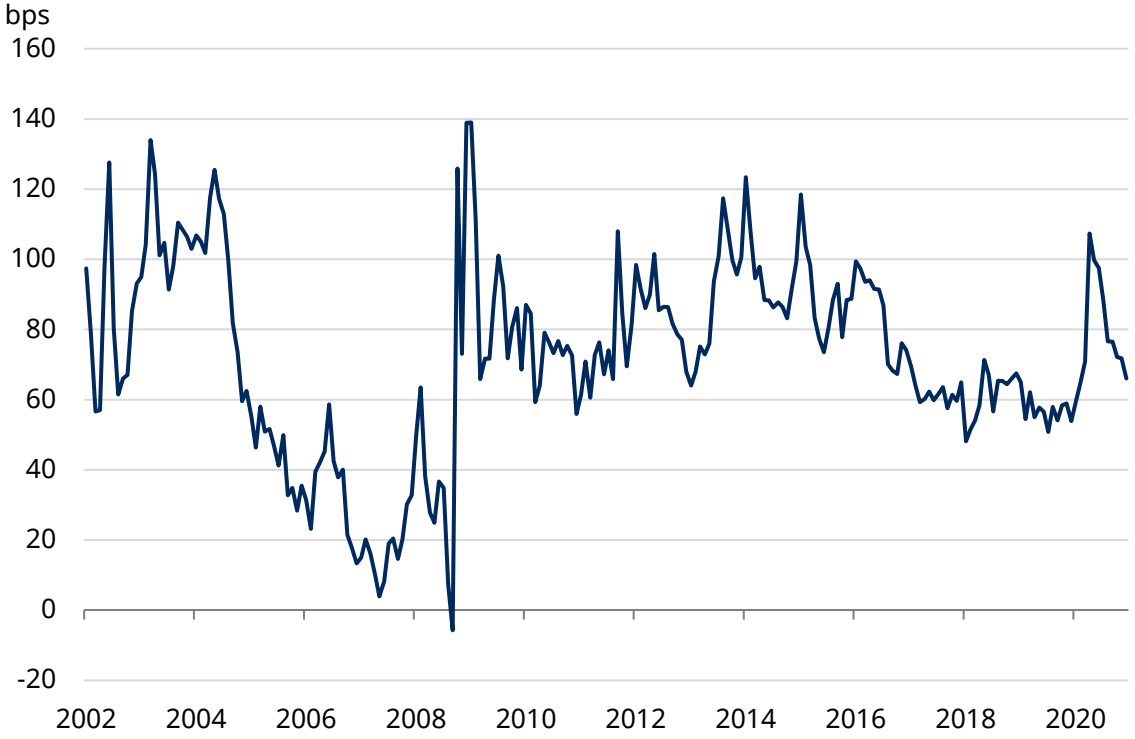


Sovereign EMD HY spread minus US HY spread

Source: Schroders, Refinitiv Datastream, ICE Data Indices, J.P. Morgan. Data as at 30 September 2021.

EM dollar debt: corporate EMD vs. US corporates

Corporate EMD IG spread minus US IG spread



Corporate EMD HY spread minus US HY spread

Source: Schroders, Refinitiv Datastream, ICE Data Indices, J.P. Morgan. Data as at 30 September 2021.

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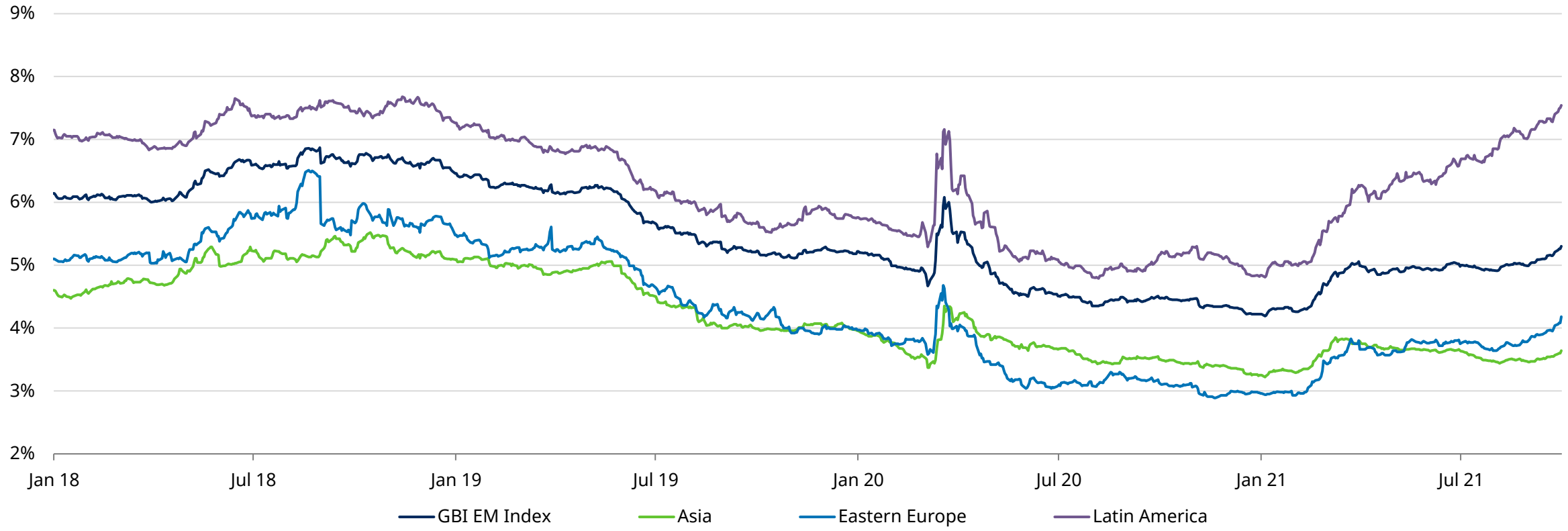
Emerging market debt: local currency

Summary: local currency emerging market debt

- Local currency EM bond yields have increased in 2021. Yields are sharply higher in Latin America on fiscal and inflation concerns. EMEA yields have started to move higher on more hawkish central banks. Yields have drifted slightly lower in Asia since early 2021
- A number of EM central banks have started to hike interest rates, although the magnitude of hikes varies considerably. Central banks in Brazil and Russia have shown the greatest determination
- EM inflation has continued to move higher in recent months even as the base effects from last year's weakness are fading. High food inflation has been a major contributor. The key question is how persistent will the increase in core inflation be in high inflation countries
- Despite the increase in inflation, EM real bond yields have started to inch to positive territory, as nominal yields have risen in most countries. Real yields in EMEA are still negative
- Because of the acceleration in US core inflation in 2021, the real yield premium of EM over DM is large. Historically, this has lead to strong performance of EM local currency bonds
- Yield curves remain steep in most EM countries despite the rates hikes, allowing decent 'roll-down' returns

EM nominal bond yields

The JPM GBI-EM Global Diversified Index yields



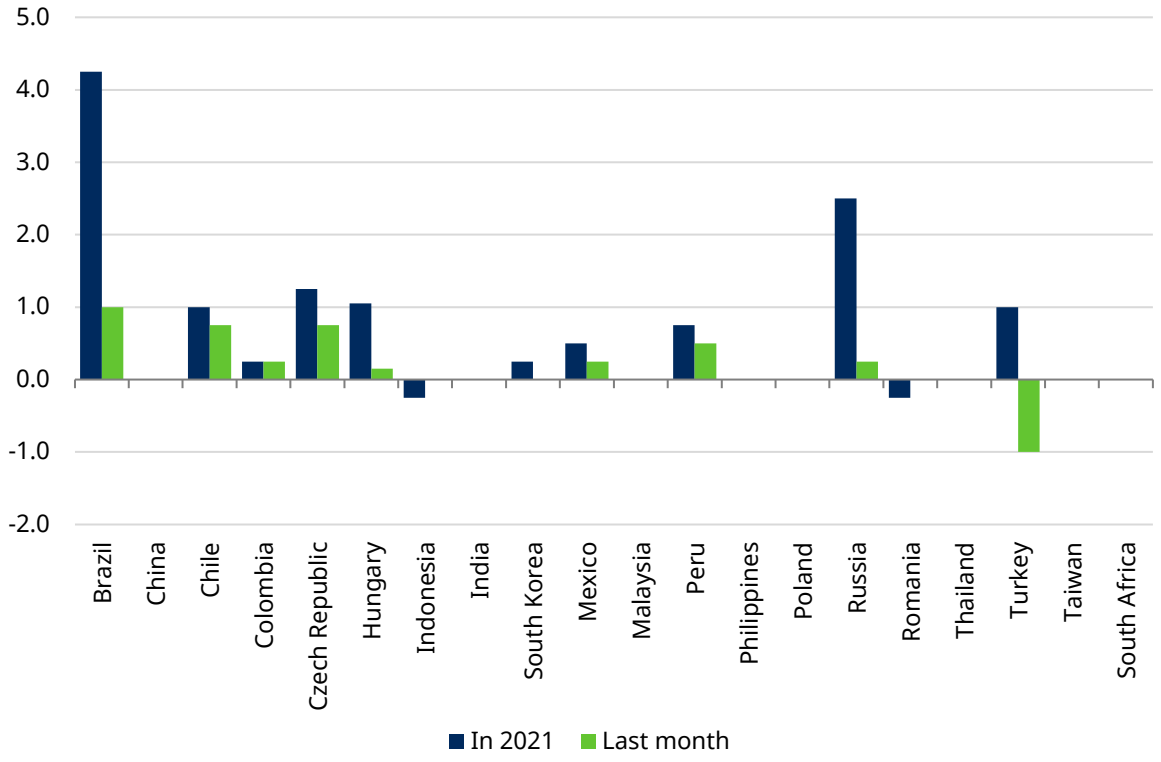
Asia yields have drifted slightly lower since early 2021; Latam yields have increased sharply because of fiscal and inflation concerns; eastern European yields have started to move higher on more hawkish central banks

Source: Schroders, Refinitiv Datastream. Data as at 30 September 2021.

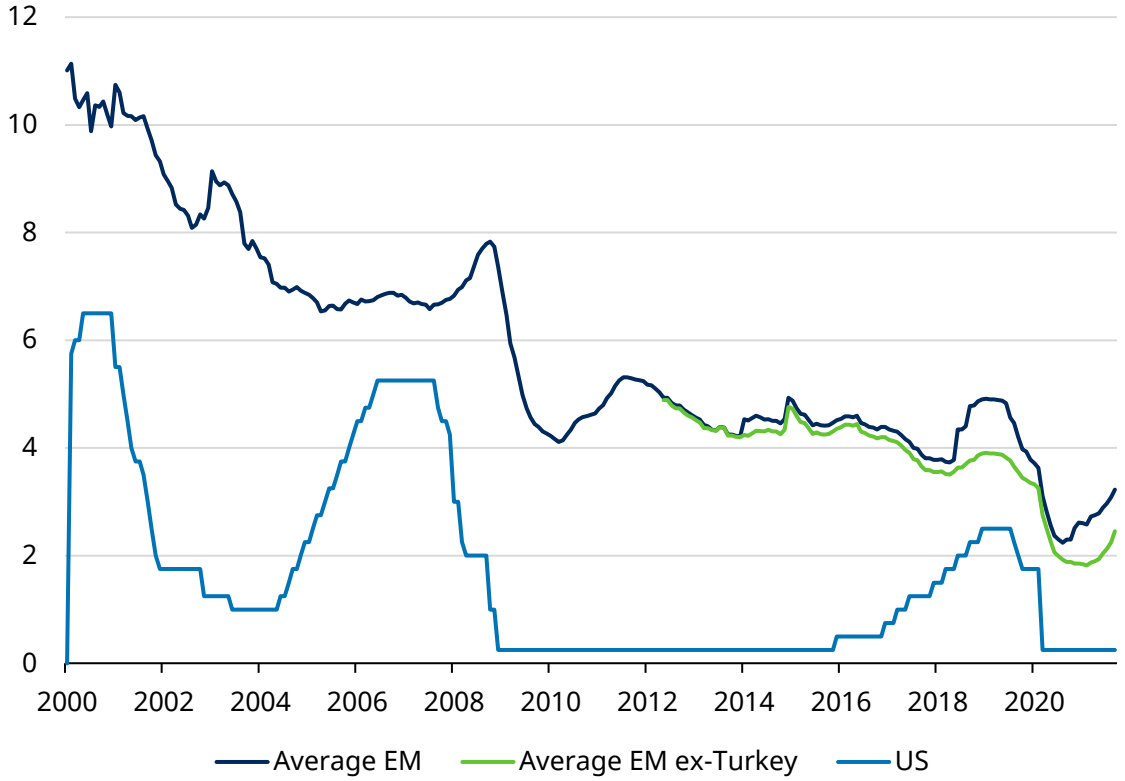
EM policy rates

A number of EM central banks have been hiking rates in 2021

Change in EM policy rates in 2021 (%)



Average EM policy rate[1] (%)



Central banks in Brazil and Russia have aggressively hiked interest rates to quell inflation; other EM central banks have taken smaller steps toward policy normalisation

Source: Schroders, Refinitiv Datastream. Data as at 30 September 2021. [1]Based on 20 major EM countries.

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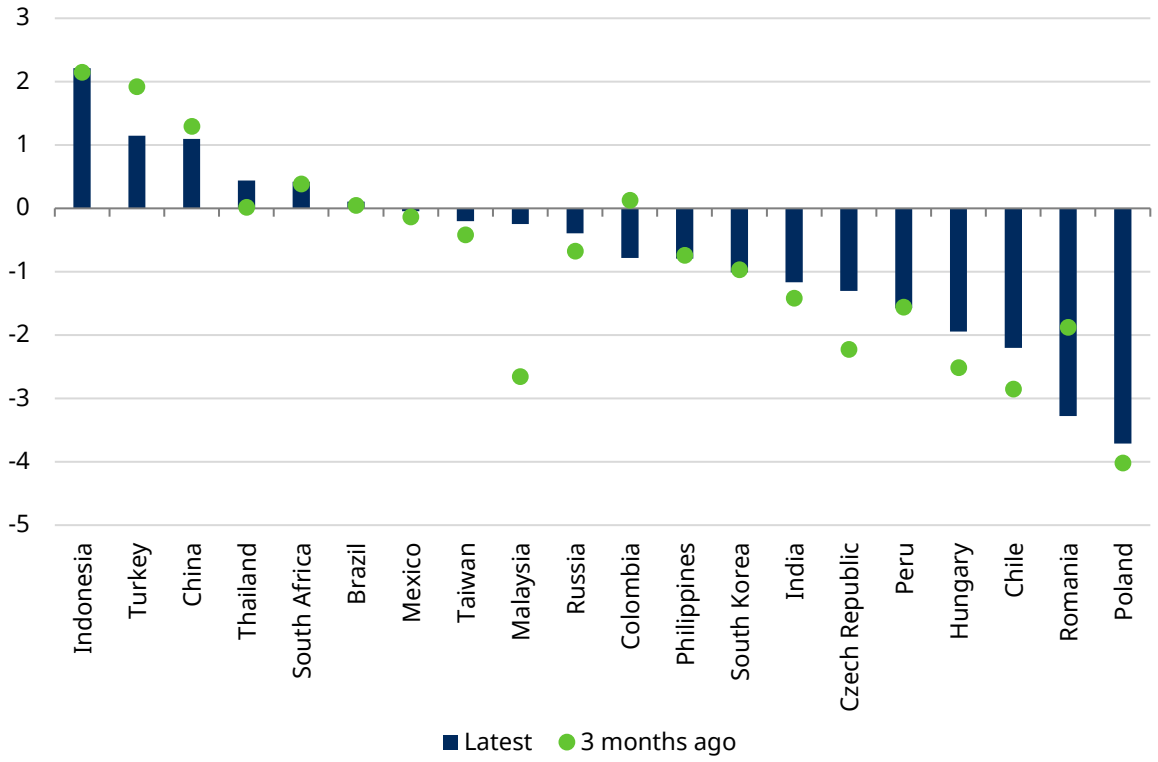
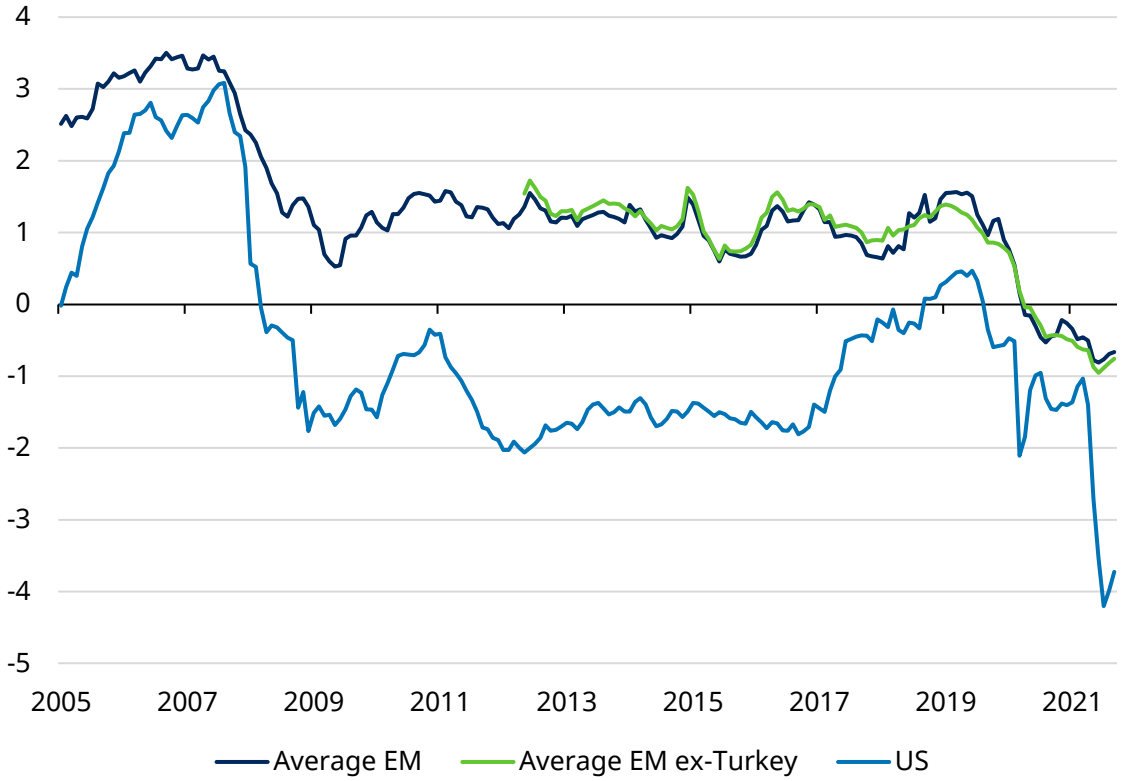
EM real policy rates

Real policy rates are still mostly negative

EM real policy rates (%)



Average EM real policy rate[1] (%)



While average EM real policy rate has fallen sharply since 2019, US real policy rate is even more depressed at -4% because of the acceleration in US core inflation

Source: Schroders, Refinitiv Datastream. Data as at 30 September 2021. Nominal policy rate minus annual core inflation. [1]Based on 20 major EM countries.

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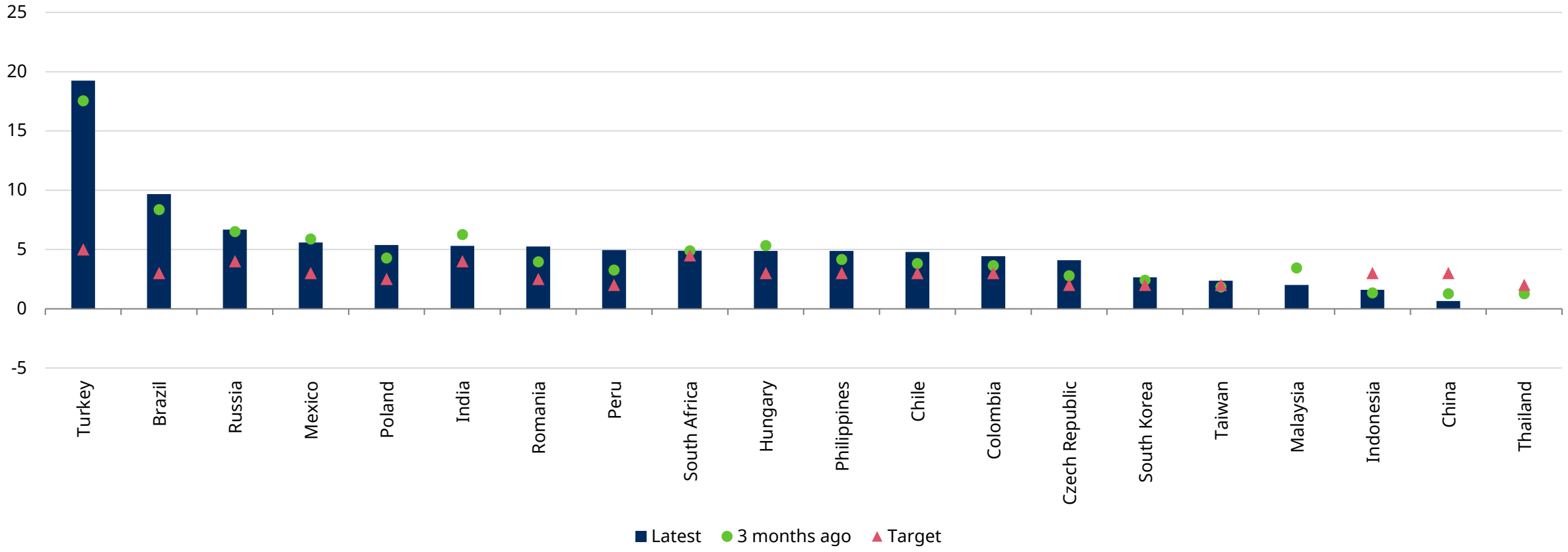
EM inflation

Headline inflation is above target in most countries

Annual change in headline inflation (%)



Source: Schroders, Refinitiv Datastream. Data as at 30 September 2021.

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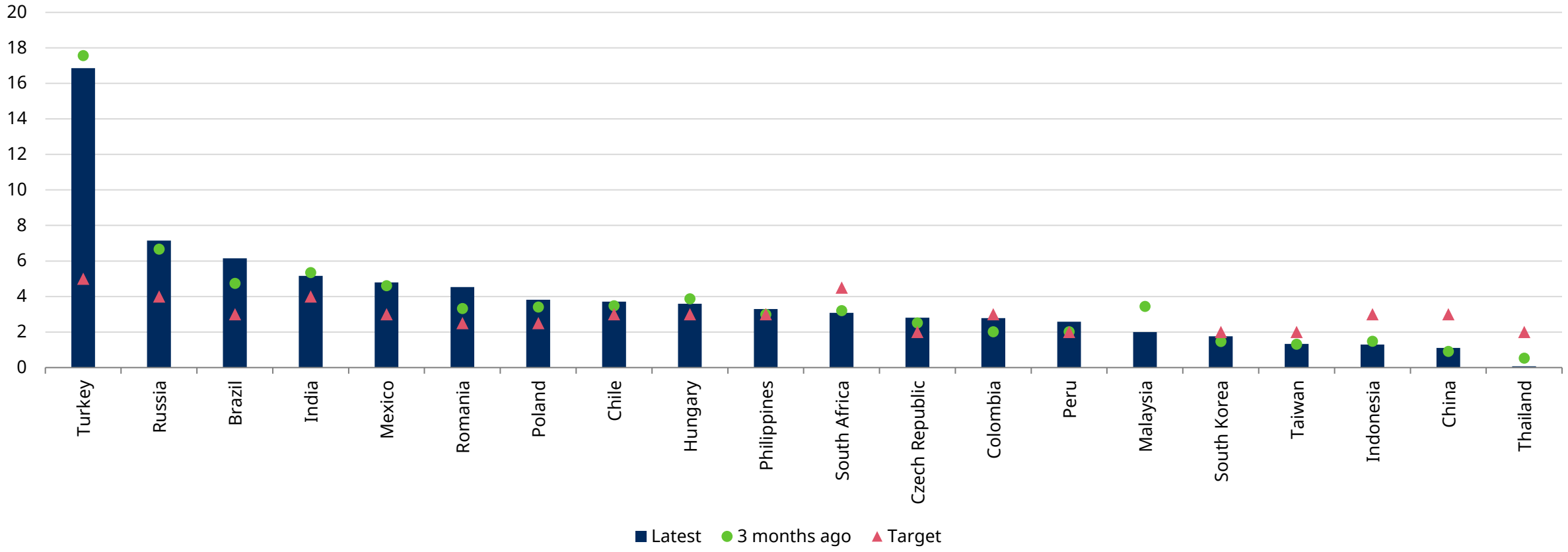
EM core inflation

Core inflation is generally closer to target

Annual change core inflation (%)



Source: Schroders, Refinitiv Datastream. Data as at 30 September 2021.

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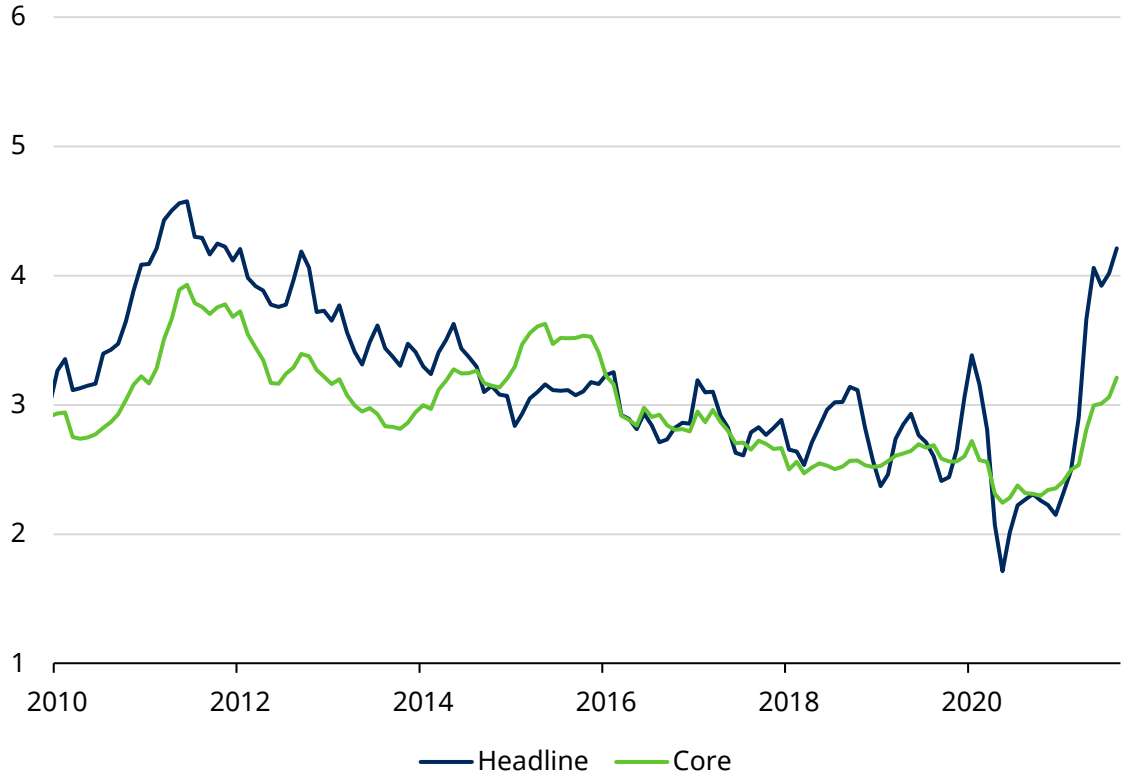
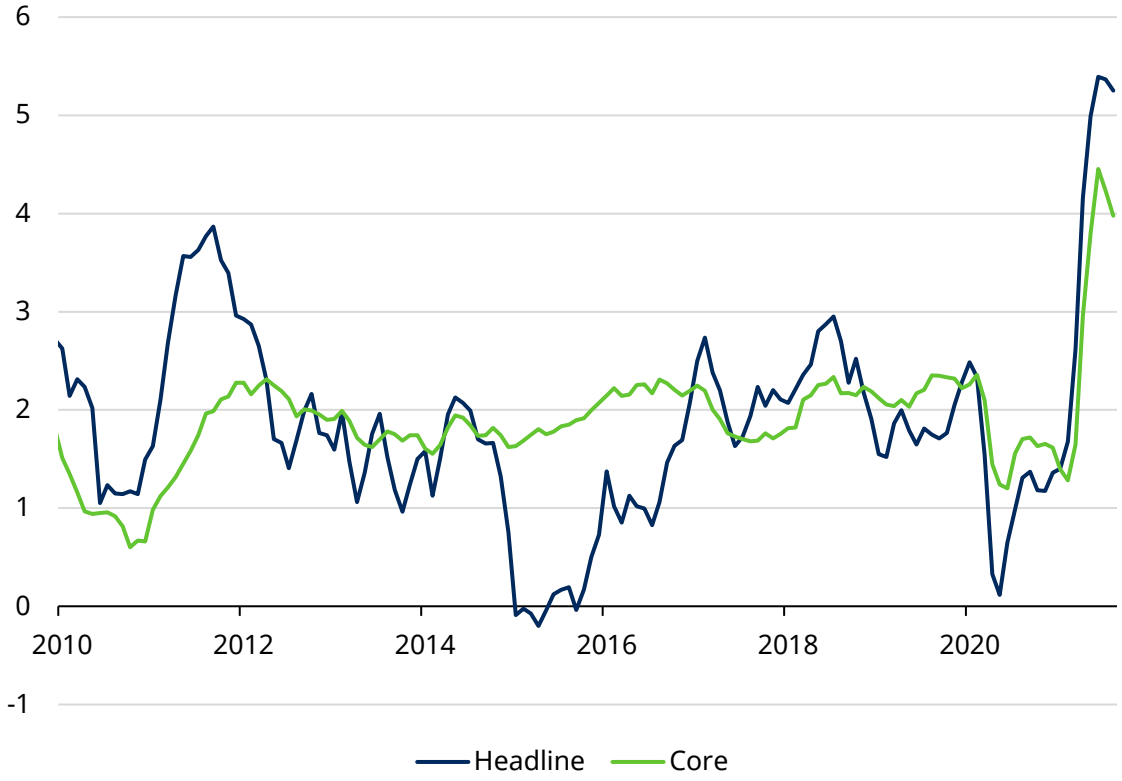
EM inflation ticking higher even as the base effects are fading

Core inflation has yet to peak in most countries

Average EM inflation ex-Turkey[1] (%)



US inflation (%)



The crucial question is how persistent is the increase in inflation in both EM and the US

Source: Schroders, Refinitiv Datastream, ICE Data Indices, J.P. Morgan. Data as at 30 September 2021. [1]Based on 20 major EM countries.

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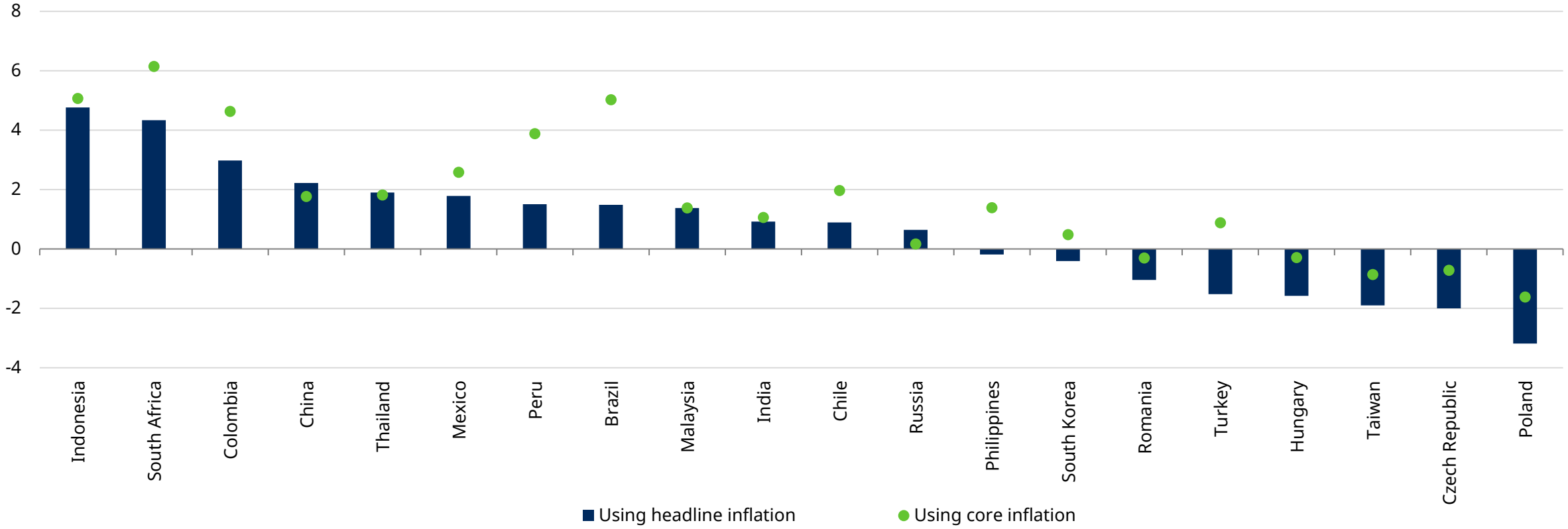
Wide dispersion in EM real bond yields

Real 10 year government bond yield (%)



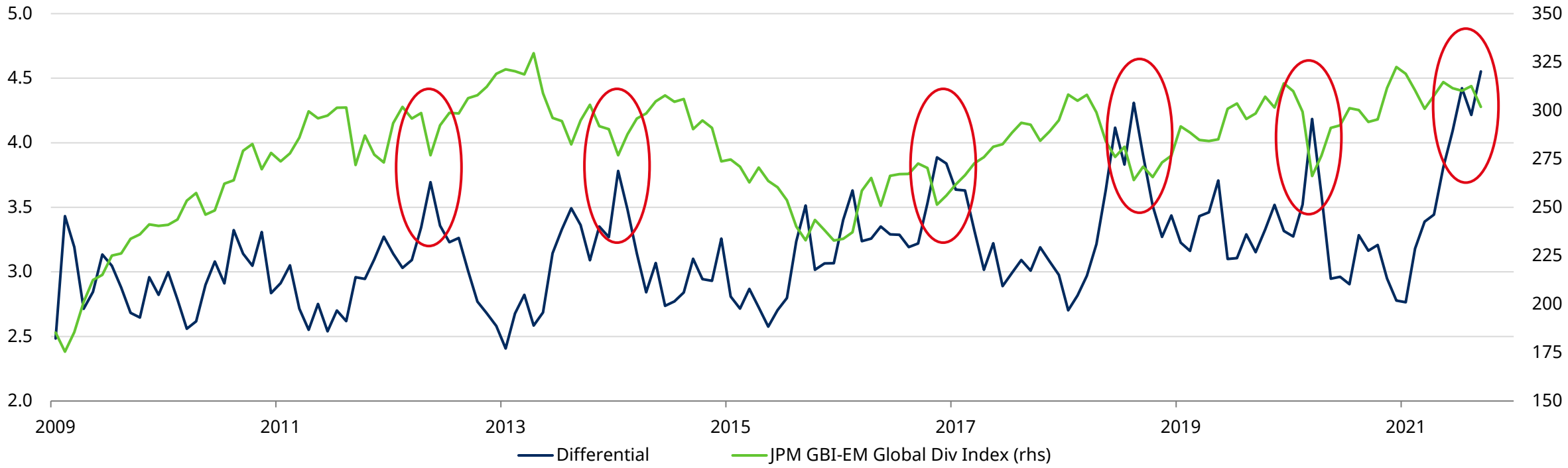
Real yields are negative in EMEA because of either very low nominal yields or high inflation

Source: Schroders, Refinitiv Datastream. Data as at 30 September 2021. Nominal 10 year yield minus annual headline or core inflation.

EM/DM real yield differential

EM local currency bond valuation

EM/DM real yield differential (%)



Real yield differential implies significant premium for local currency EM bonds. Historically, this has been supportive for local currency EM bond returns

Past performance is not a guide to future performance and may not be repeated.

Source: Schroders, Refinitiv Datastream, ICE Data Indices, J.P. Morgan. Data as at 30 September 2021. EM real yield is weighted average of individual JPM GBI-EM index nominal yields deflated by core inflation. DM real yield is 5Y government bond yields of US, UK, Euro zone, Japan deflated by core inflation, weighted by the size of individual government bond market.

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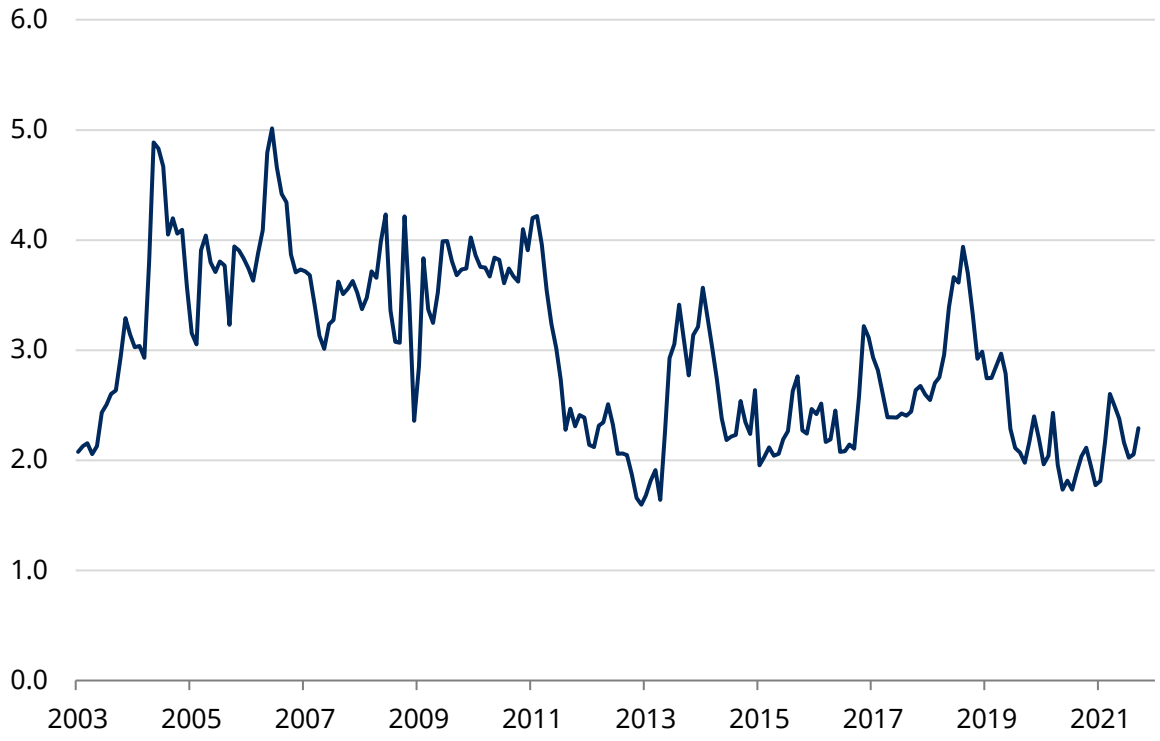
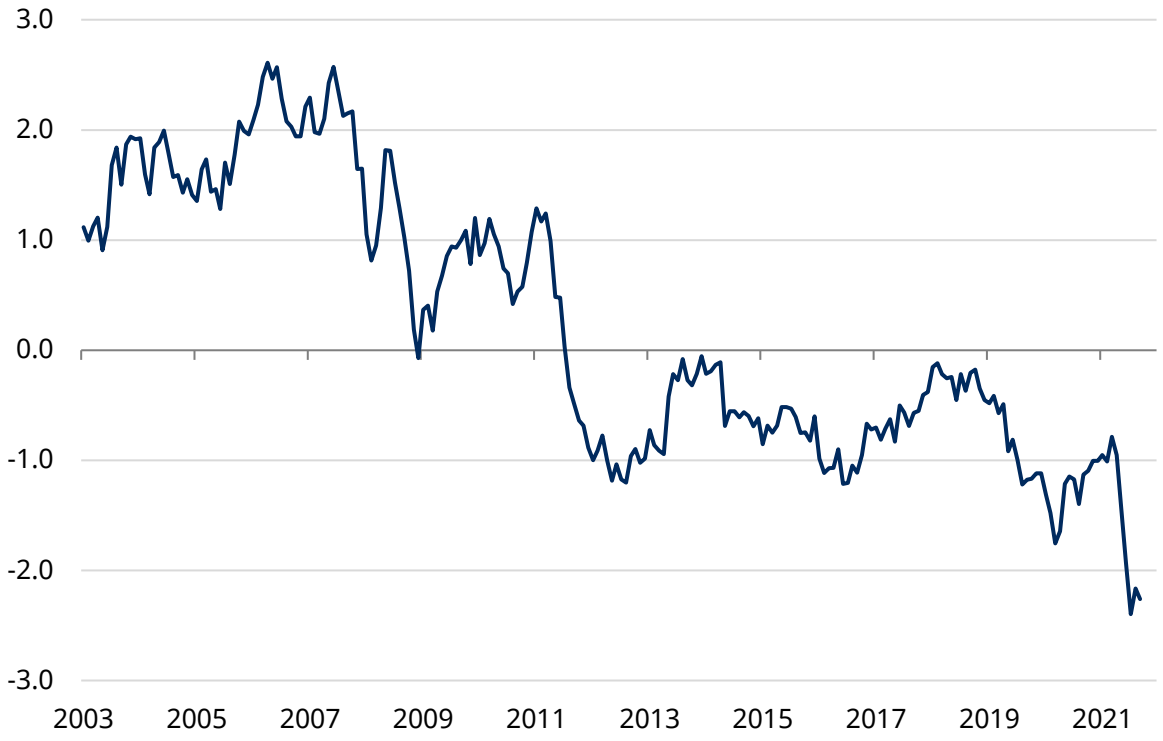
EM and DM real yields

Individual drivers of the real yield differential

EM real yield (%)



DM real yield (%)

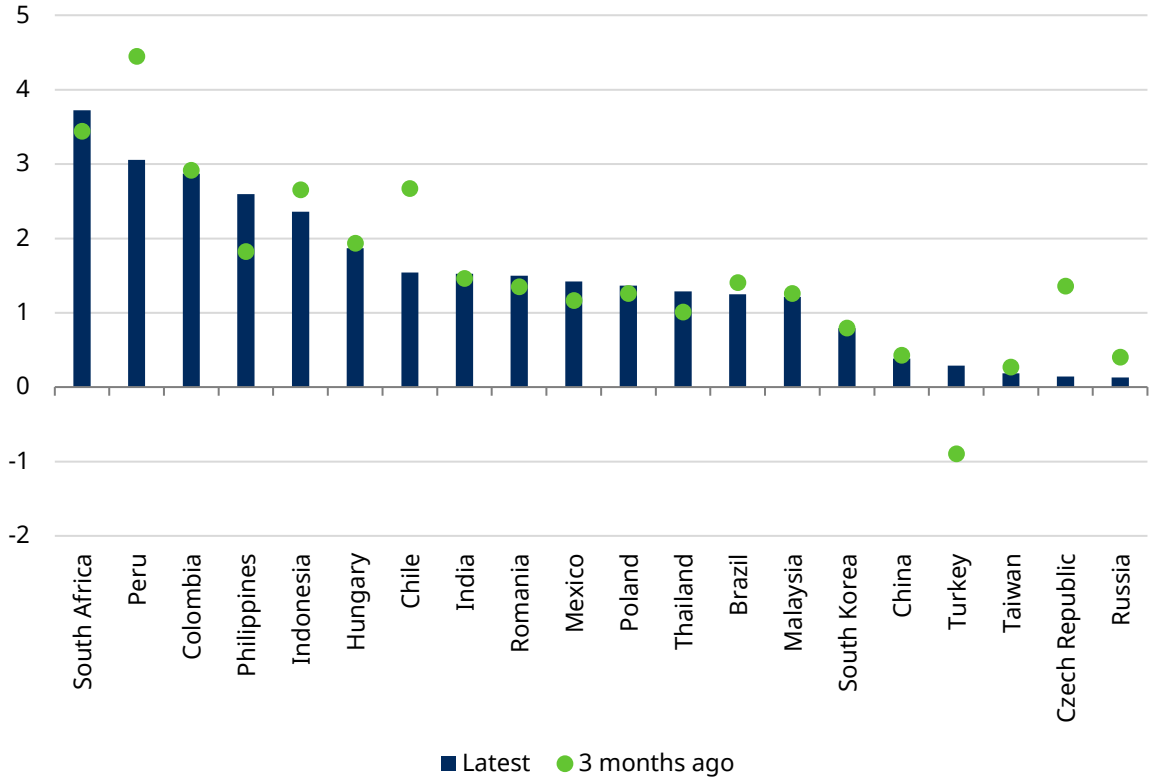


DM real yield has fallen sharply as US core inflation has accelerated

Source: Schroders, Refinitiv Datastream, ICE Data Indices, J.P. Morgan. Data as at 30 September 2021. EM real yield is weighted average of individual JPM GBI-EM index nominal yields deflated by core inflation. DM real yield is 5Y government bond yields of US, UK, Euro zone, Japan deflated by core inflation, weighted by the GDP PPP of each country.

EM yield curve shape

Yield curve steepness (10y yield – 2y yield)



Average EM yield curve steepness (10y yield – 2y yield)[1]

Despite the recent rate hikes, yield curves remain steep in most countries

Source: Schroders, Refinitiv Datastream. Data as at 30 September 2021. [1]Based on 20 major EM countries,

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Emerging market currencies

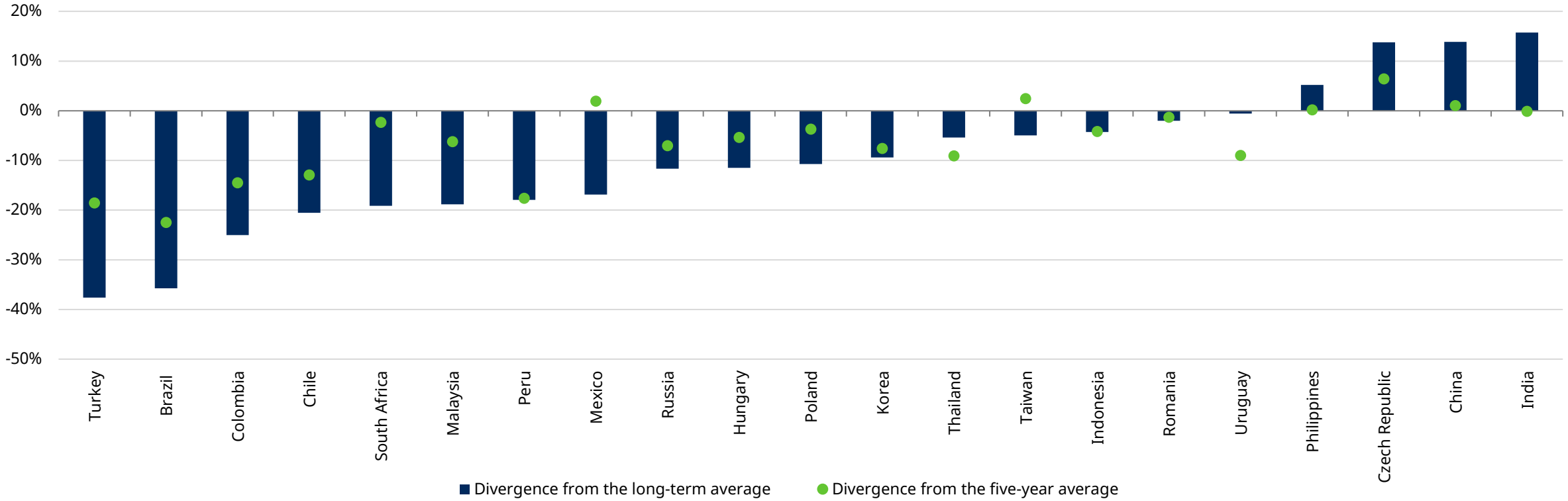
Summary: emerging market currencies

- The value in EM currencies varies significantly. There are undervalued currencies in all three EM regions, although Asian currencies have on average the least appealing value
- In countries where the currencies appear expensive, the current accounts are in surplus. This reduces vulnerability and the need for currency depreciation if EM currencies become under pressure
- EM FX carry, the strategy of buying higher-yielding EM currencies against lower-yielding currencies to earn the interest rate differential, is making a comeback because of EM rate hikes. The average EM carry is the highest since 2016, although it varies across countries

EM currency value

Some currencies are significantly undervalued

Real exchange rate: deviation from average

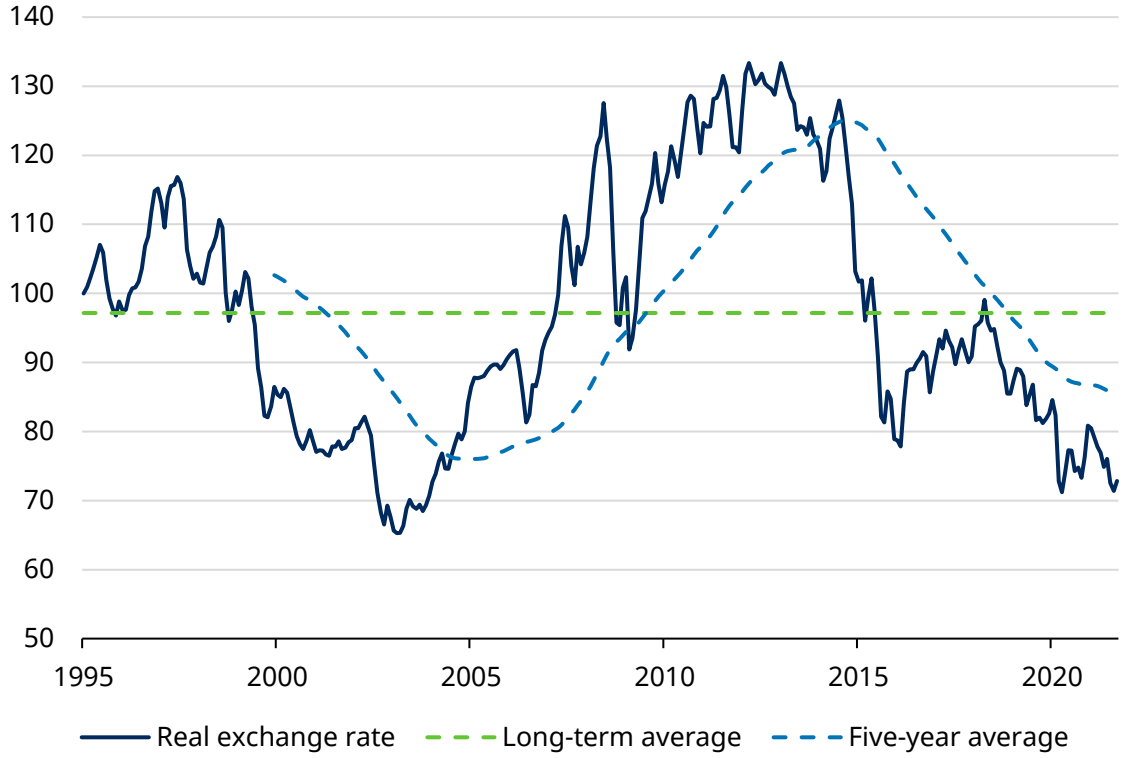


Turkey, Brazil and Colombia have the cheapest currencies; Philippines, Egypt, Czech Republic and China have the real exchange rates above the long-term and the five-year average

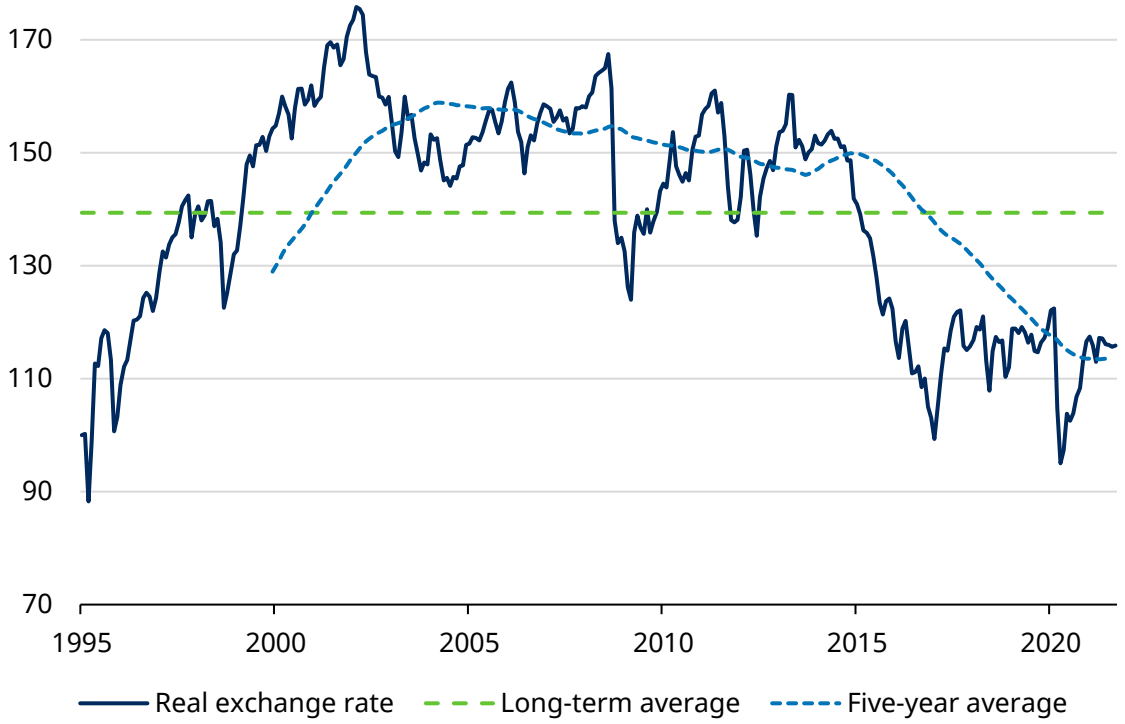
Source: Schroders, Refinitiv Datastream. Data as at 30 September 2021. Real exchange rate is the nominal dollar exchange rate deflated by the CPI of each EM country vs. US. Long-term average is since January 1995.

EM currency value: Colombia vs. Mexico

Colombia real exchange rate (1995 = 100)



Mexico real exchange rate (1995 = 100)



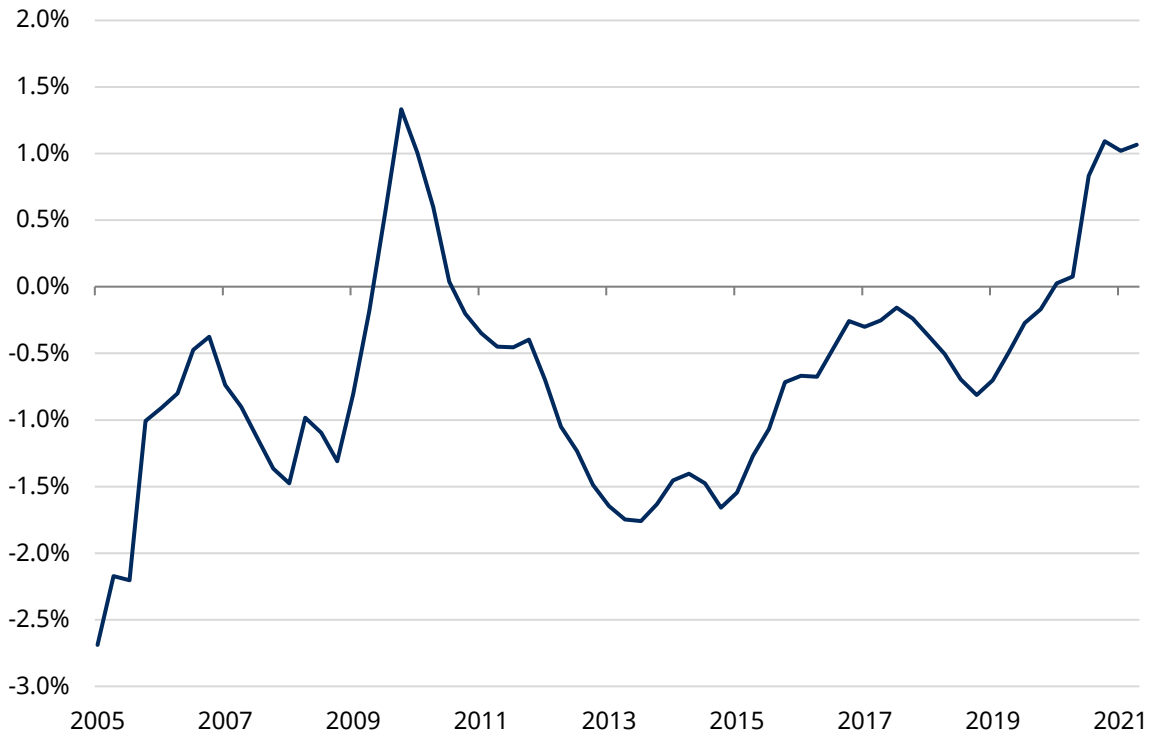
While the real exchange rates of Colombia and Mexico are both below the long-term average, the former is also below the five-year average

Source: Schroders, Refinitiv Datastream. Data as at 30 September 2021. Real exchange rate is the nominal dollar exchange rate deflated by the CPI of each EM country vs. US. Long-term average is since January 1995.

EM current account balance vs. currency valuation

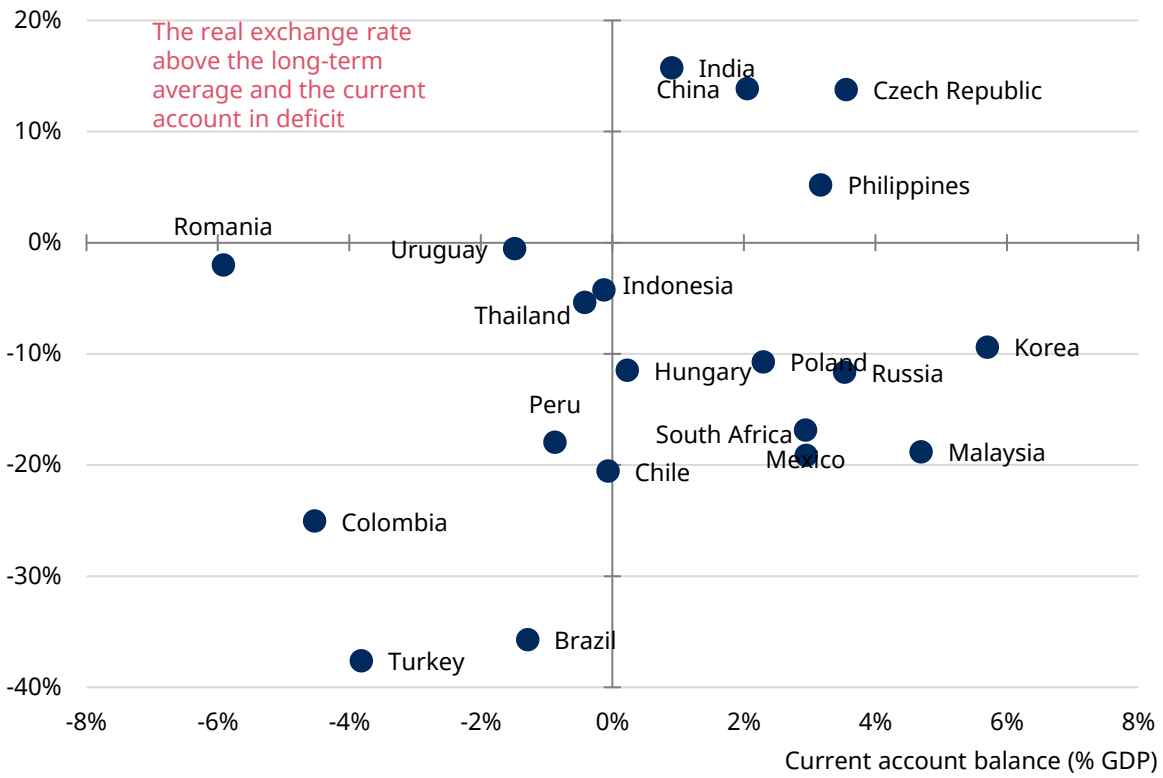
No country has expensive currency and current account in deficit

Average EM current account balance[1]



EM currency value[2] vs. current account balance

Real exchange rate deviation from long-term average



Most EM current accounts swung to positive in the pandemic, reducing vulnerability to sharp currency depreciation

Source: Schroders, Refinitiv Datastream. Current account data as at Q2 2021, currency value data as at 30 September 2021. [1]Based on the historical country weights of the JPM GBI-EM Global Diversified Index. [2]Currency value is the deviation of the real exchange rate from the long-term average since 1995.

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EM FX carry is making a comeback on the back of EM rate hikes...

Average EM carry[1]

Even when excluding Turkey, EM carry is the highest since 2016

Source: Schroders, Refinitiv Datastream. Data as at 30 September 2021. [1]The return of holding 1-year FX forward vs US dollar to maturity. Based on 20 major EM countries.

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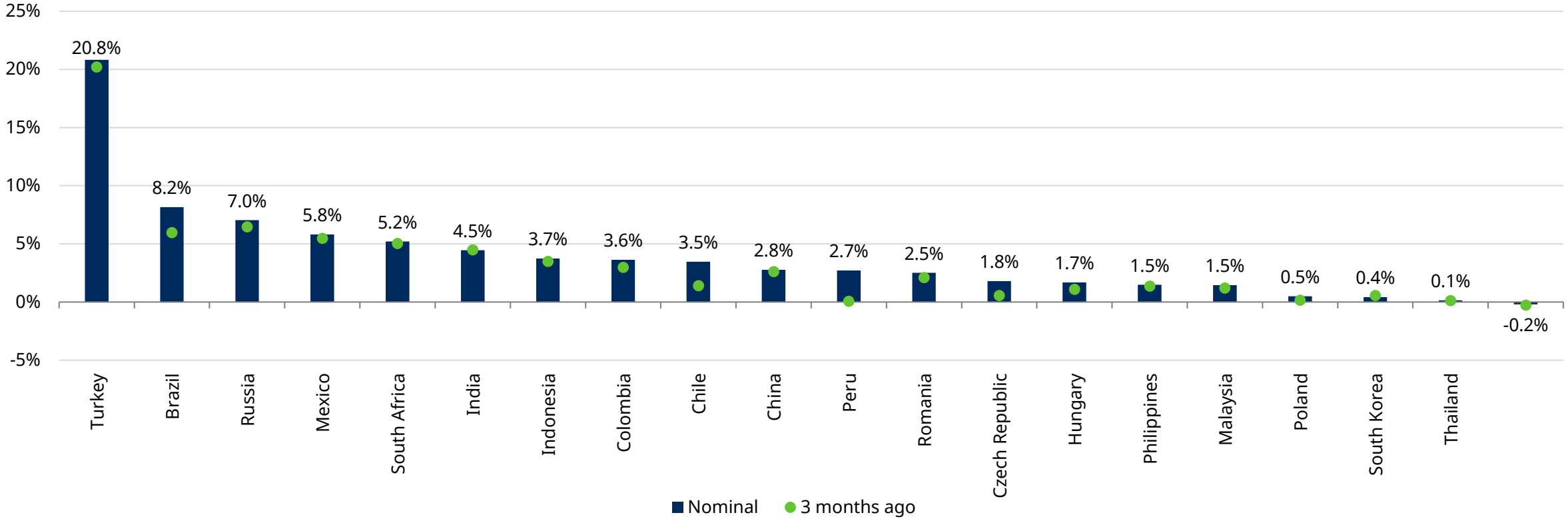
...although it varies significantly between the countries

EM FX carry[1]



Source: Schroders, Refinitiv Datastream. Data as at 30 September 2021. [1]The return of holding 1-year FX forward vs. US dollar to maturity.

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Important information (1 of 3)

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