Should EMD investors worry about higher for longer?

Zachary Knope

With US Federal Reserve rate hikes appearing to have ended, the market now expects rate cuts in 2024. However, with inflation pressures persisting and robust US economic growth, labour market and productivity, the probability that US rates will settle well above post-Global Financial Crisis (GFC) and pre-COVID levels has increased.

Emerging market debt (EMD) presents an attractive opportunity for the long-term fixed income investor with a high tolerance for risk—given strong fundamentals, yield opportunity and duration exposure—but an active approach with careful considerations to country and issuer selection will be critical in an environment in which rates remain above the lows of the past decade.

Coming off a period in which central banks hiked interest rates to multi-decade highs, the trajectory of inflation has reversed course and global labour markets have remained resilient, widening the path towards an elusive 'soft-landing.' This has raised the probability that US interest rates will settle at a higher level than we saw for much of the post-GFC period, but leaves us with the question, how might persistently higher interest rates affect emerging market debt?

Given the relatively short history of EMD investing past analogs are rare. One comparable soft-landing episode occurred in the mid- to late-1990s. During this time, rates remained in the 4.75% to 6.50% range before the next significant rate cutting cycle began in 2001, following the bursting of the tech bubble.

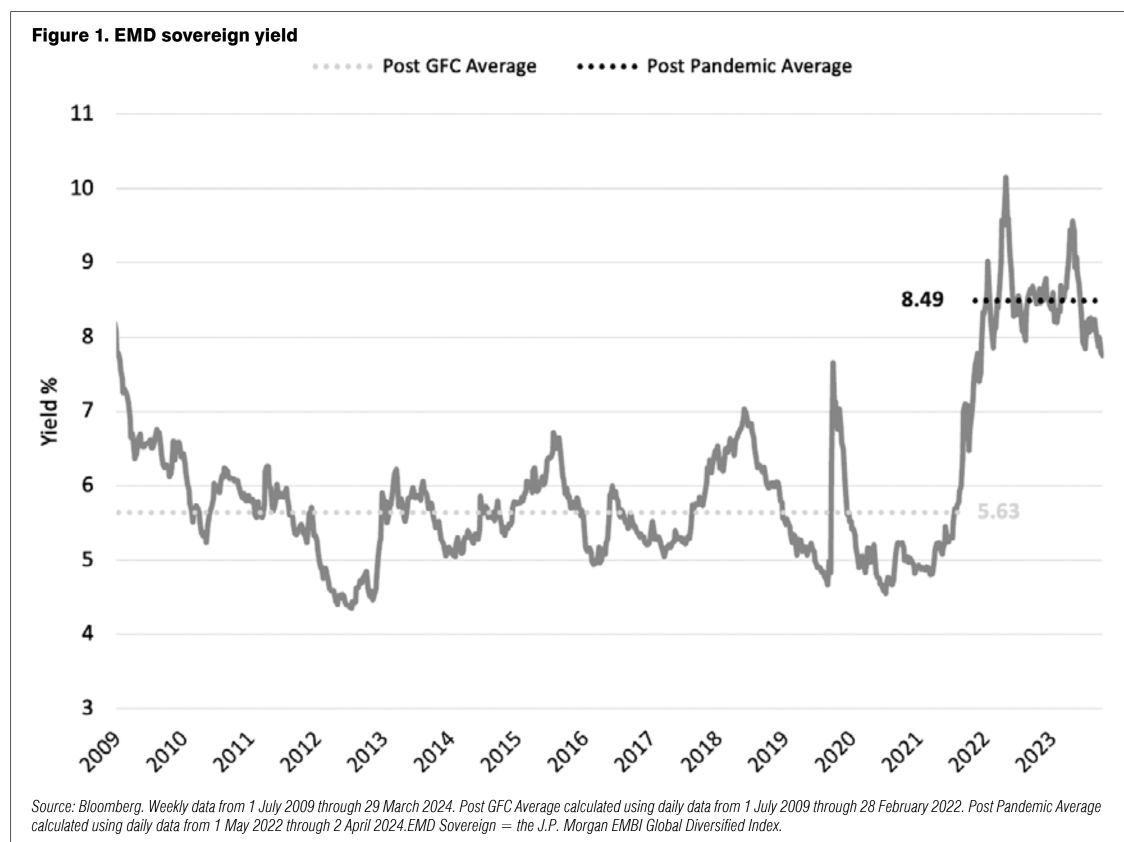
The 1990s were a challenging period for EMD. There were widespread defaults, currency crises and significant volatility. Moreover, emerging market macro conditions were much different. Many emerging markets had fixed exchange rates, which turned out to be an important vulnerability in a world where capital could move freely among countries. Today, very few emerging market countries have fixed exchange rates, and the emerging market landscape is considerably more mature, reflecting the progress made on policy, institutional and fiscal reforms many countries have undertaken to shore up access to capital and to enable growth.

For the EMD investor, today's higher rate environment will have implications that demand an active approach with careful considerations to country and issuer selection. To implement such, this paper will examine some of the important factors EMD investors should consider in this evolving environment.

Focus first on the fundamentals

The foremost implication of higher interest rates on emerging market issuers is higher debt servicing costs, which make it more difficult to borrow money and service debt obligations. This can limit the ability of emerging market economies to put capital to productive use, weigh on economic growth and increase economic uncertainty. As Figure 1 on the next page demonstrates, the average EMD yield has jumped from a pre-pandemic average of 5.6% to a post-pandemic average of 8.5%.

Figure 1. EMD sovereign yield



Source: Bloomberg. Weekly data from 1 July 2009 through 29 March 2024. Post GFC Average calculated using daily data from 1 July 2009 through 28 February 2022. Post Pandemic Average calculated using daily data from 1 May 2022 through 2 April 2024.EMD Sovereign = the J.P. Morgan EMBI Global Diversified Index.

However, despite the rapid rise in yields, higher interest costs are unlikely to tip the fiscal position of many emerging market economies into troubled territory thanks to the composition, improvement and strength of several fiscal metrics, including the amortisation profile of the asset class's maturity wall, external debt, reserves and fiscal balances.

The amortisation profile of the asset class's upcoming bond maturities provides one window into the effects of higher rates and helps paint the picture that the impact of higher rates will not be felt immediately. Rather, it will take time for lower coupon bonds to roll off the books, to be replaced by higher coupon bonds priced at today's yields, increasing the overall cost of capital gradually. Figure 2 on the next page helps demonstrate much of the current outstanding debt has been financed at last decade's favourable yields, helping to forgo the impact of today's higher rates.

The composition of EMD external debt balances is also supportive of higher borrowing costs remaining manageable for the asset class. As the name implies, external debt measures the amount outstanding owed to non-residents of an economy, and there are two important trends to consider. First, growth in EM external debt has largely been in the private sector while government external debt balances have remained at sustainable levels. Second, external debt to GDP ratios have improved post-COVID. Inflation, in the form of higher export prices, has supported nominal GDP growth in relation to existing debt stock, particularly for energy exporters, and has driven recent improvement in the external debt to GDP metric.

Currency reserves are another important factor, suggesting many emerging market countries are able to withstand higher debt servicing costs. Reserves act as a buffer and can be used to assess a country's flexibility in reacting to unexpected adverse events, which have limited capital flows to EM in the past. This is particularly important for hard-currency debt investors, as local-currency debt is not constrained by the stock of foreign currency reserves to meet near-term debt obligations.

Determining the adequate currency reserve level for any country is a challenging task that must balance factors such as short-term debt levels, capital flight risk, import sustainability and broad money supply, as well as weighing the opportunity costs of holding cash versus investing the funds productively elsewhere.

One measure of reserve adequacy is to look at a country's foreign exchange reserves, minus total short-term foreign currency denominated debt (public and private), less the current account deficit. As Figure 3 on the next page exhibits, currency reserves across many EM countries are healthy. However, there are exceptions, and active management with a robust country selection process is of paramount importance in this space.

Fiscal balances are of paramount importance as the cost of capital climbs and help measure how much government spending is reliant on debt funding. Fiscal balances

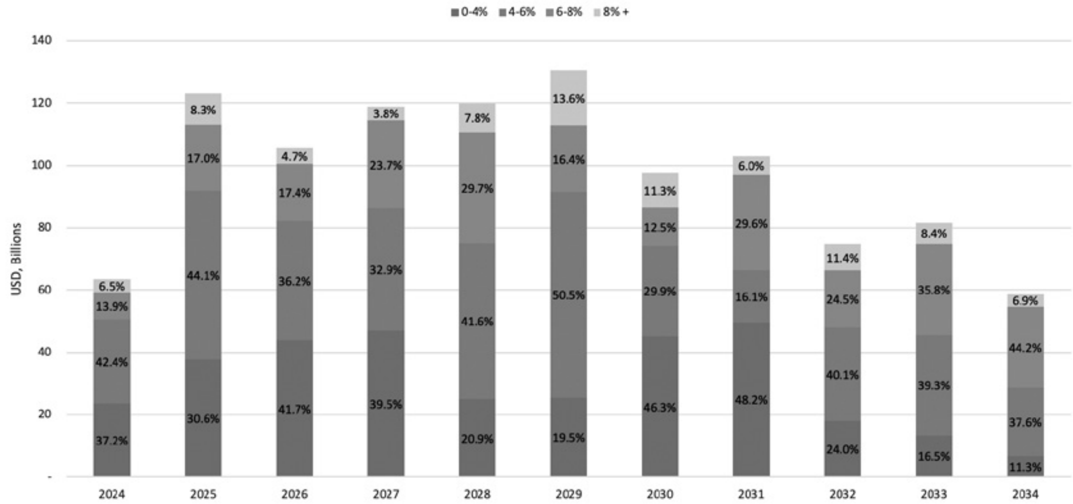
Zachary Knope, MFS Investment Management

Zachary, CFA, is a lead analyst in the investment solutions group at MFS Investment Management®. With a focus on fixed income, he is responsible for working with investment teams globally to bring the best thinking from across the firm to our distribution teams and clients via thought leadership content and client consulting projects. Zachary graduated magna cum laude with a Bachelor of Science degree in corporate finance and accounting from Bentley University. He served as director for the CFA Society of Orlando from 2015 to 2020.

The quote

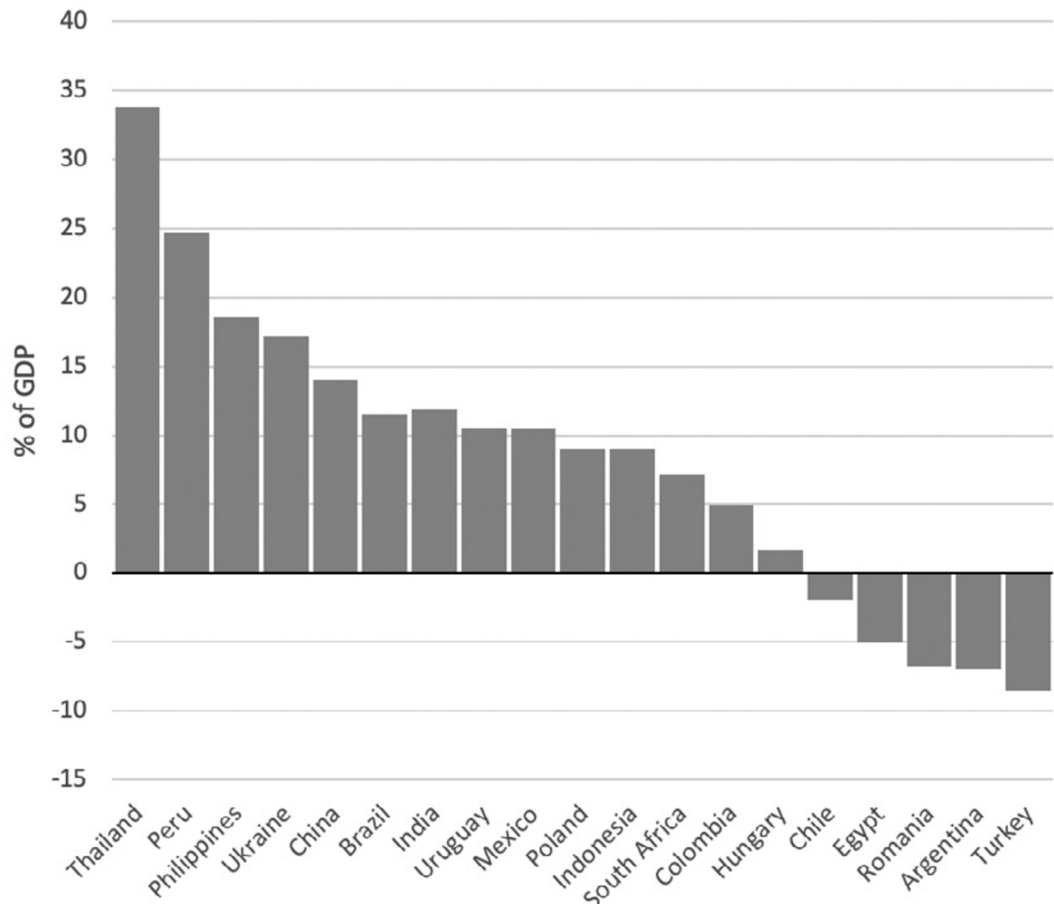
Growth in EM external debt has largely been in the private sector while government external debt balances have remained at sustainable levels.

Figure 2. Sovereign EMD maturity wall by coupon rate



Source: Bloomberg. Data as of 2 April 2024. Maturity profile generated for all emerging market debt government bonds classified as sovereigns, government agencies, government regional, supranationals, and government local denominated in USD. Includes fixed and floating rate coupons. % displayed represents the % of each coupon rate bucket relative to the total maturity.

Figure 3. Reserve adequacy levels



Source: Dallas Federal Reserve & IMF. Data as of 31 December 2022. Reserve adequacy measured by the Guidotti-Greenspan Rule and equals central bank foreign exchange reserves minus short-term foreign currency denominated debt plus the four quarter moving average of the current account, all as a percentage of GDP. From paper entitled 'Emerging-market Countries Insulate Themselves from Fed Rate Hikes' by Davis and Sagnanert, dated August 8, 2023.

deteriorated sharply during the pandemic as shown by Figure 4, leading to countries across the globe unleashing unprecedented support for their economies so that those balances have stabilised and since recovered.

Many factors impact a country's fiscal balance. Revenues are impacted by taxation policies and grants, as well as the trailing impact of past fiscal expenditures. In a higher rate environment, expenditure management is key to ensuring debts are successfully serviced and repaid, while ensuring that debt levels do not get out of hand.

For EMD investors, the good news is that, in aggregate, EM fiscal balances are comparable to their advanced economy counterparts, suggesting the yield premium of EMD over developed market debt may offer real value, but are current fiscal balances sustainable in a world of higher rates?

One way to evaluate this question is through demand for credit default swaps, which act as insurance against sovereign defaults. Presently, EMD credit default swaps spreads are well below the prior decade's average as can be seen from Figure 5, indicating the market is not worried about widespread defaults across EMD.

With fundamentals sound: What might higher rates mean for future returns?

EM valuations, characterised by spreads and yields, warrant careful consideration in a higher rate environment.

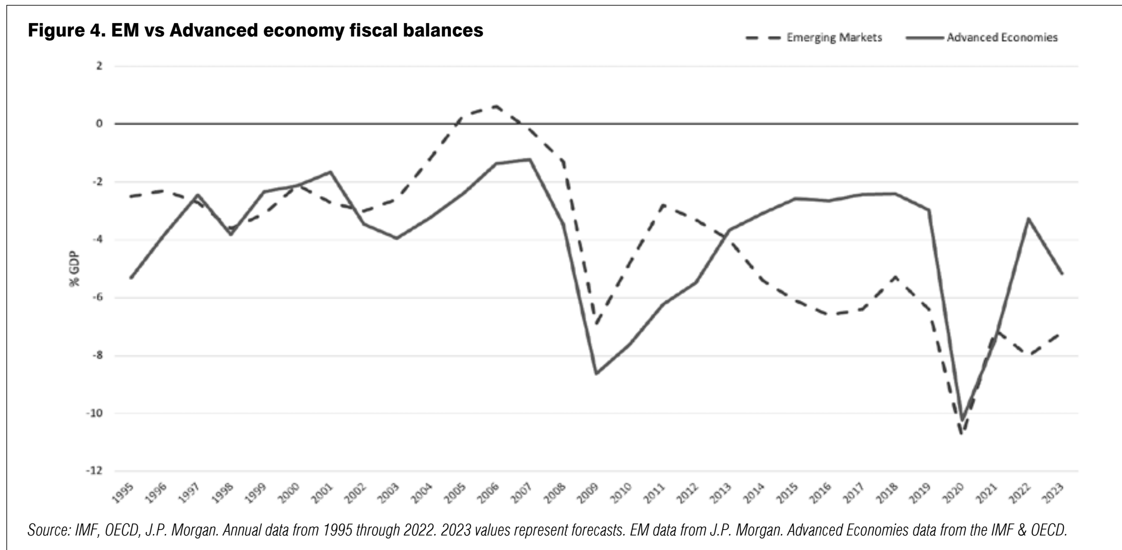
In hard landing environments, higher rates are often followed by a recession in which spreads typically widen, reflecting increased credit risk. However, this dynamic often provides an attractive entry point for investors who can afford to wait for spreads to narrow.

In the current environment, in which sentiment favours

The quote

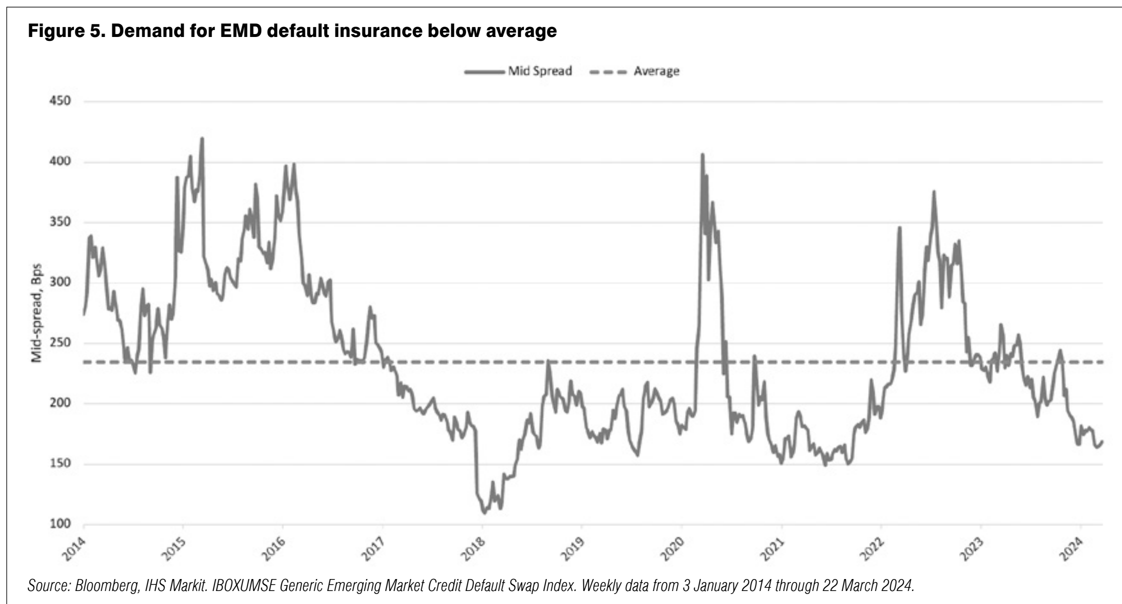
In aggregate, EM fiscal balances are comparable to their advanced economy counterparts, suggesting the yield premium of EMD over developed market debt may offer real value.

Figure 4. EM vs Advanced economy fiscal balances



Source: IMF, OECD, J.P. Morgan. Annual data from 1995 through 2022. 2023 values represent forecasts. EM data from J.P. Morgan. Advanced Economies data from the IMF & OECD.

Figure 5. Demand for EMD default insurance below average

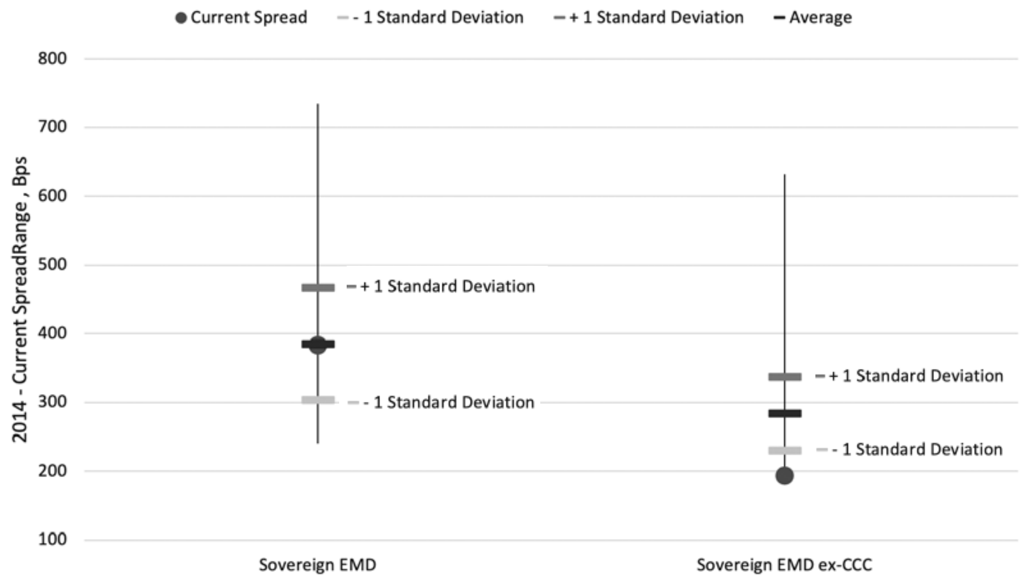


Source: Bloomberg, IHS Markit. IBOXUMSE Generic Emerging Market Credit Default Swap Index. Weekly data from 3 January 2014 through 22 March 2024.

The quote

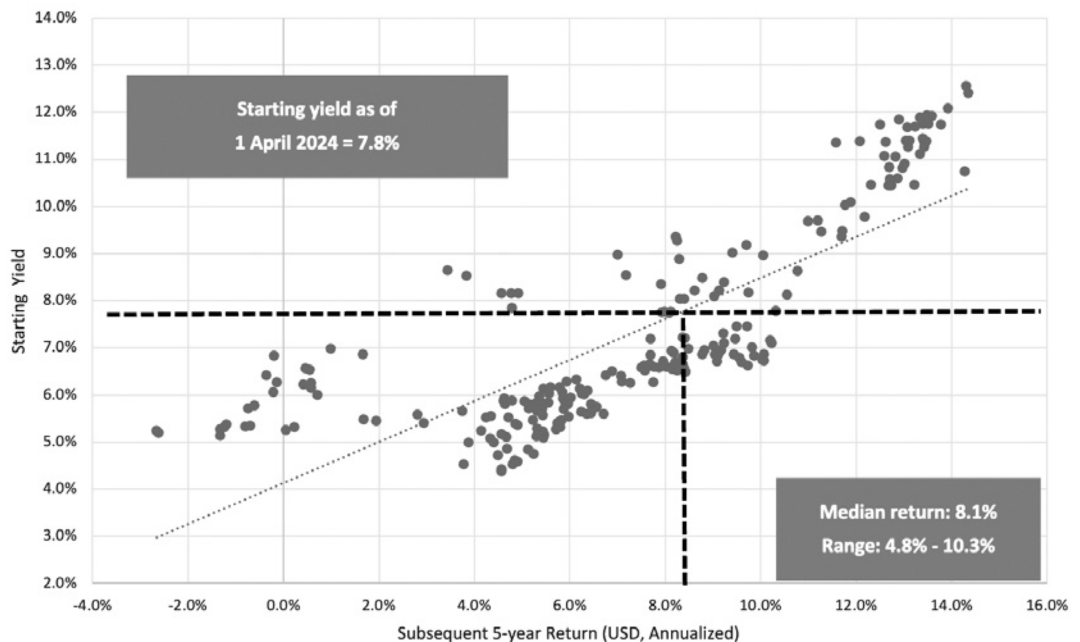
Emerging market debt (EMD) presents an attractive opportunity for the long-term fixed income investor with a high tolerance for risk …but an active approach with careful considerations to country and issuer selection will be critical.

Figure 6. Selectivity is key with sovereign EMD spreads tight



Source: J.P. Morgan. Spread ranges, average, +/- standard deviations calculated based on daily data from 2 January 2014 through 1 April 2024. Sovereign EMD = J.P. Morgan EMBI Global Diversified Index. Current = 1 April 2024. Spreads are z-spread to worst.

Figure 7. Sovereign EMD starting yields and subsequent 5-year total returns



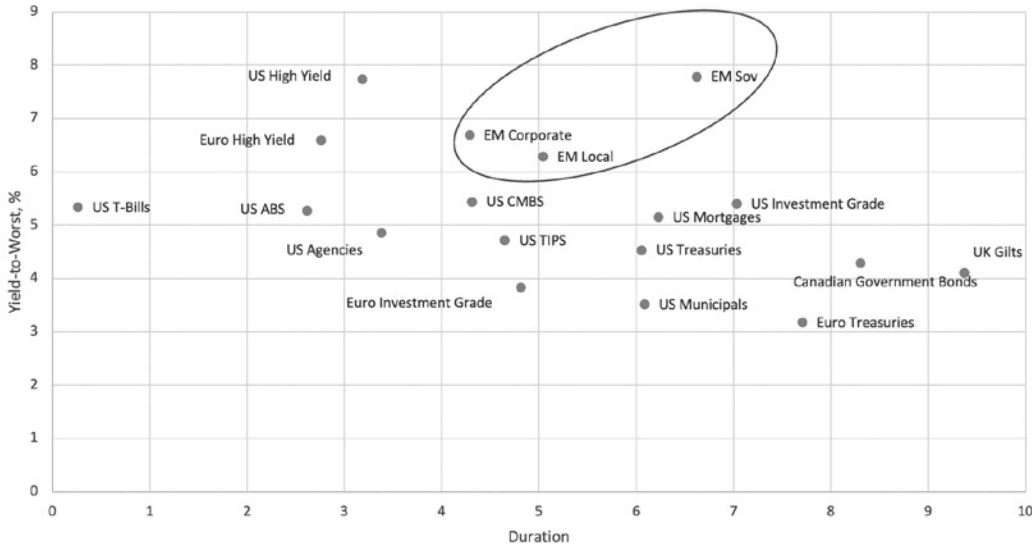
Source: Bloomberg. Sovereign EMD = J.P. Morgan EMBI Global Diversified Index. Monthly data from 31 January 2000 through 31 March 2024. Subsequent 5-year returns are in USD and annualized. Past performance is no guarantee of future results. It is not possible to invest directly in an index.

a soft landing, Figure 6 shows that EM sovereign spreads trade fair relative to recent history on the surface, but a closer examination reveals that spreads in the higher credit quality segments of the index are rich. This does not mean there is not value in these tranches to be found. It places a premium on managers with the skill and expertise to identify and selectively capitalise on opportunities that arise.

While spreads demand selectivity, yields in the EM space are attractive and offer investors an opportunity to lock in high coupon rates that historically have been a driver of long-term returns.

Figure 7 helps demonstrate the strong relationship between starting yields and historical annualised returns. For starting yields that range 30 basis points above and

Figure 8. Yield-to-worst versus duration across fixed income



Source: Bloomberg. Data as of 1 April 2024. Duration measured by option-adjusted duration to Treasuries. US T-Bills = Bloomberg US T-Bills 2-5 mths Index. US ABS = Bloomberg US Agg ABS Index. US High Yield = Bloomberg US Corporate High Yield Index. US CMBS = Bloomberg US Agg CMBS Index. US Agencies = Bloomberg US Agencies Index. US Treasuries = Bloomberg US Treasury Index. US Municipals = Bloomberg Municipal Bond Index. US Mortgages = Bloomberg US MBS Index. US TIPS = Bloomberg US Treasury Inflation-Linked Bond Index. US Investment Grade = Bloomberg US Corporate Index. Euro Investment Grade = Bloomberg Pan European Aggregate Index. Euro High Yield = Bloomberg Pan European High Yield Index. Euro Treasuries = Bloomberg Pan European Agg Treasury Index. UK Gilts = Bloomberg Sterling Gilts Index.EM Credit = J.P. Morgan CEMBI Broad Diversified Index. EM Local = J.P. Morgan GBI-EM Global Diversified Composite Index. Canadian Government Bonds = Bloomberg Canada Aggregate Government-Related Index.

below the starting yield of 7.8% as of April 1, 2024, the historical median 5-year annualised return is 8.1%, and returns have ranged from 4.8% to 10.3%.

While emerging market debt is associated with higher risk, the asset class offers some of the highest yields across global fixed income as shown by Figure 8. All three emerging market debt asset classes—EM Sovereign, EM Credit and EM Local—also offer attractive duration exposure in relation to yield and would stand to benefit if global central banks begin cutting interest rates as inflation continues to normalise.

Conclusion

A post-pandemic, higher-rate world poses debt servicing challenges to borrowers across the globe. Emerging market countries have seen significant progress in fiscal metrics, institutions and policies that place the asset class in a strong fundamental position and better prepared to overcome the challenges of higher rates, making it an attractive investment opportunity given the high level of yields and duration exposure.

However, the idiosyncratic nature of the asset class and its wide investable universe demand an active approach, backed by robust research and risk management processes with a focus on country and issuer selection to both help manage downside risk and capitalise on opportunities presented by temporary dislocations in the market. **FS**

The quote

EM Sovereign, EM Credit and EM Local offer attractive duration exposure in relation to yield and would stand to benefit if global central banks begin cutting interest rates as inflation continues to normalise.