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Emerging Market Debt: Strong, Mature, and Core

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Investors who have long considered emerging market (EM) debt to be ancillary to the core portfolio may want to give the asset class another look. Between persistently low yields generated by traditional fixed income vehicles and the maturation of emerging economies, EM debt has evolved to become an essential part of the investor toolkit – adding a layer of diversification to help investors balance risk and reward in a dynamic global environment.

The short- and long-term drivers for EM debt include:

- **Resilient economies:** Emerging economies appear to have weathered the COVID-19 storm reasonably well. While certain individual EMs have struggled with COVID-19 infections, several reopened earlier or were simply less impacted by the coronavirus.
- **Growth potential:** The economic resilience of EMs allows secular growth drivers (e.g., younger populations, growing middle classes) to play out in coming years, with their position in investor portfolios likely to stay.
- **Attractive valuations:** U.S. equities and debt remain expensive, giving EM securities an enhanced role in providing attractively valued growth, yield, and diversification benefits.
- **Diversifying market:** As emerging economies grow and evolve, so too does the scope and degree of differentiation in the EM debt universe, which encompasses a wide array of risk exposures.

While EM debt continues to become more diversified as an asset class, investors should still be wary of a higher level of investment risk and intrinsic volatility within EMs, which underscores the importance of specialized expertise in the space. An active manager's ability to monitor trends and show agility in a changing landscape remains a key driver of investment success in EM debt. The expertise to change portfolio allocations dynamically across regions, maturities, and sectors to take advantage of short-term market dislocations and help mitigate market risks remains crucial to successful EM debt investing.

The outlook for emerging market debt

In early 2021 risk markets rallied, in many cases to all-time highs. In many fixed income asset classes, spreads have compressed to levels comparable to pre-pandemic (first quarter of 2020) conditions as the global economic recovery gathers strength.

We have long viewed EM debt as a core part of the investor toolkit to balance credit risk and yields. It is even more important today given higher yields relative to U.S. Treasuries and European developed market government debt. EMs regained their footing after a tumultuous period during the initial wave of COVID-19 infections and are now benefiting from the jump in demand for manufactured goods from developed economies (purchasing managers' indices are at decade highs in developed markets).

A closer look at individual emerging economies and regional groupings can provide further insight into the growth drivers for these markets:

China: The world's largest emerging economy has led the global economic rebound. While it was the first country to witness the spread of COVID-19 within its borders, China's early initiative to lock down parts of its economy also positioned it to be one of the first economies to recover. It was one of the few economies to report positive GDP growth in 2020, with expansion in nominal terms of about 4%, or 2.5% in real terms. This year, GDP growth in China is expected to come in between 8% and 9%, well above the Chinese government's stated target of above 5% growth.

India: The second-largest emerging economy is also exhibiting a strong rebound from the depths of the COVID-19 contraction. GDP growth for the 2021–22 fiscal year is expected to come in between 10% and 11%, although 2021's sharp rise in COVID-19 cases and renewed lockdowns remain risk factors.

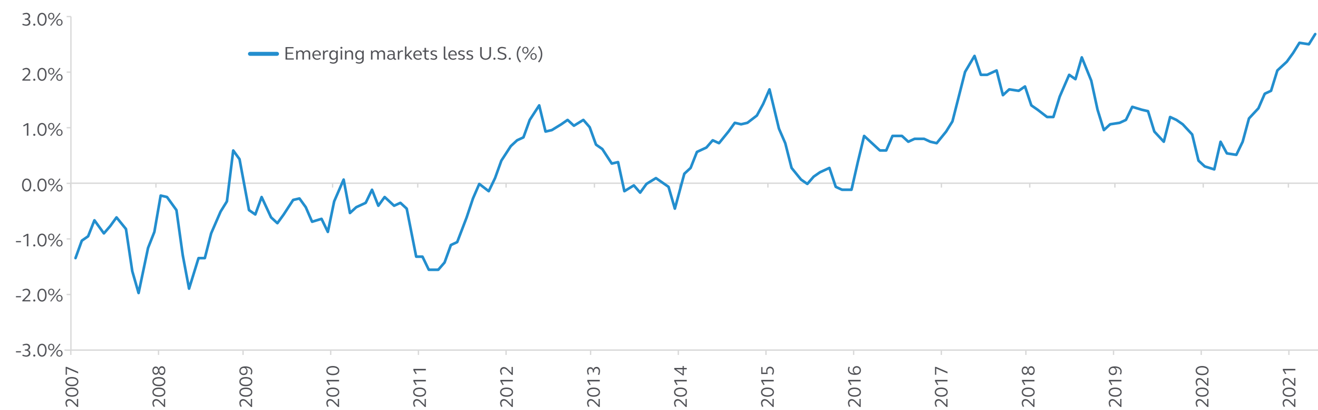
ASEAN: Governments represented in the Association of Southeast Asian Nations have generally been cautious about making any policy moves that could disrupt the economic recovery, meaning monetary and fiscal supports in these countries are expected to continue throughout 2021. This positioning should help continue to drive growth.

Collectively, EMs are on a strong footing in 2021 given the current stage of the economic cycle, especially when compared with similar stages in previous economic cycles:

- EM currencies are not expensive, multilateral trade conditions are improving, and many EMs are less dependent on foreign capital than in previous market cycles due to balance of payments surpluses.
- Low to negative real rates in developed markets are also creating demand for assets that can provide additional yield.
- The spread in real yield between EM debt and U.S. Treasuries is higher today than in comparable stages of previous market cycles.
- Finally, the trend toward EMs accounting for a larger majority of global GDP is expected to continue.

Comparing Emerging Market and U.S. Real 10-year Yields

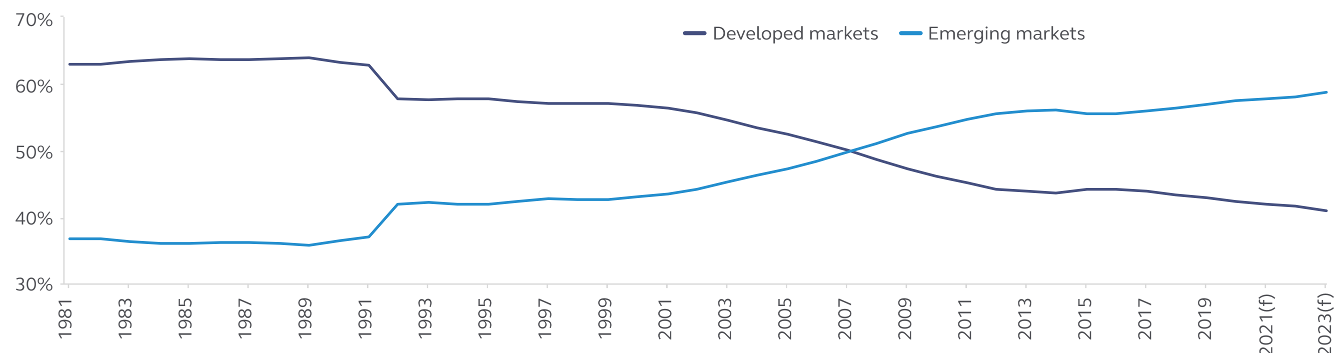
Real yield difference between EM and U.S. debt (%)



Source: Bloomberg, FactSet, Principal Global Asset Allocation. EM 10-year yields are current GDP-weighted. Data as of April 30, 2021.

Comparing Developed Market and Emerging Market Contribution to Global GDP

Purchasing power parity (PPP)-based GDP Share (%)



Source: Bloomberg, FactSet, Principal Global Asset Allocation. DM and EM GDPs are current GDP-weighted. 2021-2023 data is forecasted. Data as of April 30, 2021.

Evolution in monetary policy and interest rates

The pandemic has warranted exceptional measures from an economic policy perspective. In 2020, central banks around the world enacted massive interest rate cuts and took on approximately $8.5 trillion in fresh debt onto their balance sheets.

These challenging conditions served as a litmus test for how EM economies would respond to complex, fast-moving fiscal challenges. Broadly, the prudent approach of EMs to monetary policy was encouraging. Interest rates were cut adequately to loosen credit conditions, support growth, and prevent financial stress without stoking excessive inflation. Equally as promising, with the V-shaped turn in the global growth cycle, EMs have put rate cuts on hold, in some cases even adjusting rates higher to reduce inflation risk while still fostering growth. Prime examples of such policy actions are the People's Bank of China, which has started normalizing policy settings to neutral from accommodative, and the central banks of Brazil and Russia, both of which hiked their interest rates recently in response to higher inflation.

Room to expand: The outlook for growth and inflation

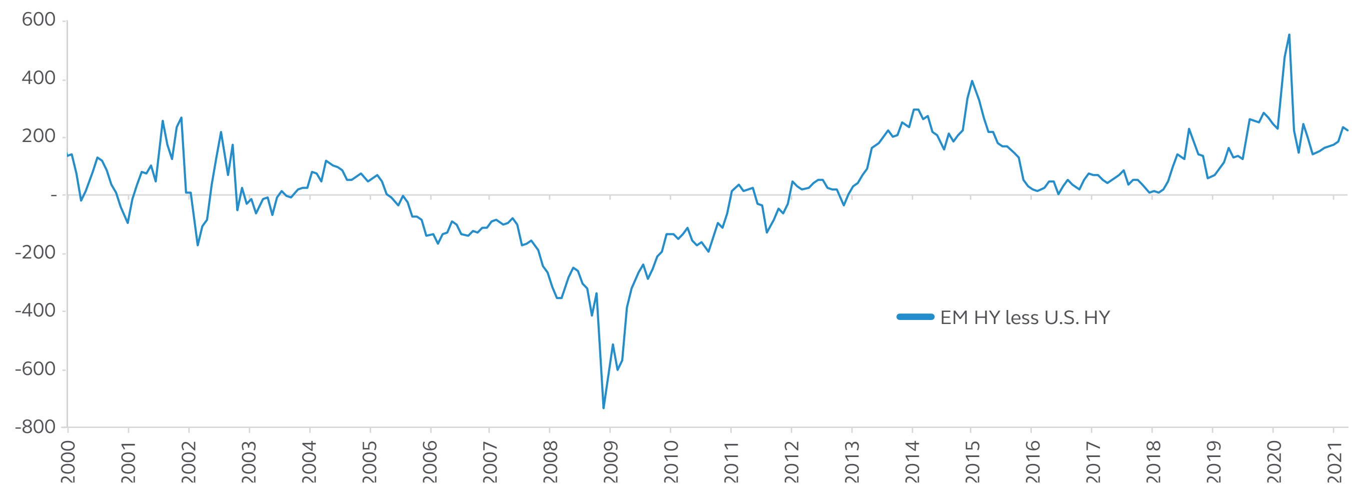
Despite the cautious approach of EM policymakers, their focus continues to be on growth. Low inflation gives EM economies policy room to exercise future fiscal and monetary stimulus, if required. This theme is particularly relevant in the larger EMs such as China, South Korea, Taiwan, and India. Principal Global Asset Allocation's proprietary EM inflation indicator, which was at 1.9% in February 2021, is likely to move toward 3% by the end of the year, a level benign by historical standards.

Supportive fundamentals mean Taper Tantrum II not likely

A combination of accommodative credit conditions worldwide and a muted inflation outlook for EMs is creating a favorable environment for investor inflows into EM debt. Such investments provide an opportunity to pick up yield and even hedge against global inflation risk, given the positive correlation between EM growth and inflation.

Comparing EM High Yield Corporate Bonds with U.S. High Yield

Yield-to-worst spread, bps



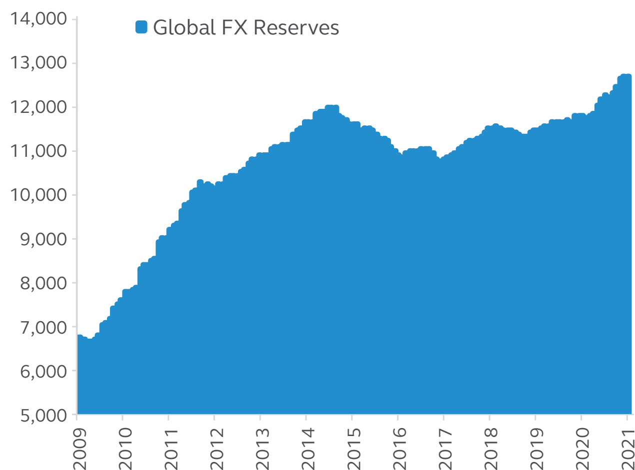
Source: Bloomberg, FactSet, Principal Global Asset Allocation. Yield to worst is from Bloomberg Barclays U.S. Corporate High Yield Index and Bloomberg Barclays EM USD Aggregate High Yield Index. Data as of April 30, 2021.

The possibility that central banks may ease off on stimulus to let economic growth proceed more organically has raised concerns over a possible repeat of the "taper tantrum" of 2013 when a signal from the U.S. Federal Reserve that it would gradually reduce quantitative easing led to a rapid selloff in global stocks and bonds. At the time, EMs experienced massive outflows and currency depreciations. We believe this situation will not repeat itself, even if monetary policies tighten further, for the following reasons:

- Local-currency-denominated EM debt remains relatively under-invested.
- The global economy is in the middle of a strong growth and rebound cycle, underpinned by increases in manufacturing goods demand.
- Major EMs are running smaller current account deficits, have larger reserves to defend their respective currencies, have stronger policy frameworks, and have currencies that are cheaper in real terms.

Global reserves are at all-time highs

Global FX reserves, USD Billion



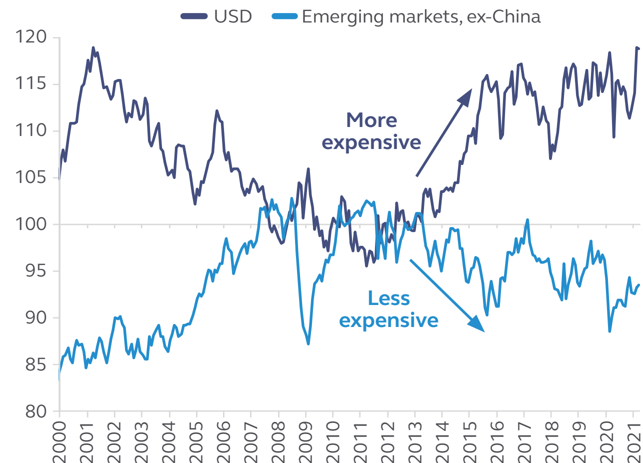
Source: Bloomberg, FactSet, Principal Global Asset Allocation. Data as of March 31, 2021.

Opportunities in EM currencies

Today, most EM currencies are undervalued and represent opportunities to gain from appreciation. In 2013, both the U.S. dollar and EM currencies were near fair value in purchasing power parity terms, which caused the former currency to rally strongly as U.S. real yields rose due to the taper tantrum. However, the situation today is different with the U.S. dollar on the expensive side and EM currencies (excluding the Chinese yuan) on the cheap side. Still, investors must remain cognizant that individual countries represent idiosyncratic risks. In particular, some countries that have taken on high debt levels in the face of the pandemic's economic challenges could see high interest payments curtail future growth.

Real effective exchange rates reveal opportunities in EM investments

Producer Price Index-based exchange rates, USD and EMs excluding China



Source: Bloomberg, Principal Global Asset Allocation. Real effective exchange rates using Producer Price Indices. EM exchange rates are current GDP weighted. Higher values indicate expensiveness. Data as of April 30, 2021.

Based on our analyses of currency risk factors, we believe investors would tactically be well suited to lower near-term exposure to the more directional, correlated (high beta) currencies like the Brazilian real and South African rand, decreasing these positions in favor of more relative value and idiosyncratic opportunities elsewhere. Over the medium term (beyond the next three months), opportunities should exist to benefit from appreciation in some EM currencies, particularly with the U.S. dollar set to weaken due to the country's large-scale fiscal stimulus and negative real interest rates.

Currency valuations have been a significant adjustment variable during the pandemic, as expected. Strategies that may include hedging for currency risk allow investors to access a wider range of yield opportunities, including those in both larger emerging markets and frontier markets. The Indian rupee is one of the more promising currency positions, more so due to its resilience rather than appreciation prospects. We also like the Israeli shekel, which continues to benefit from the strength of the U.S.

technology cycle, and the Mexican peso. In frontier markets, we have identified select opportunities in Egyptian and Ukrainian local currency issues and in Ghanaian treasury bills, markets that exhibit high real interest rates but with favorable terms of trade.

Portfolio construction: The role of core EM debt

Opportunistic yield-oriented investments, which include EM debt, U.S. high-yield credit, and preferred securities, do complement a core fixed income portfolio. Shifting focus away from traditional core investments to more opportunistic yield exposures, particularly those represented by EM debt, should be advantageous in the current environment of recovering growth and low core yields in developed markets. These types of securities tend to benefit from improving growth and credit fundamentals, enhance yield potential, and reduce sensitivity to upward moves in sovereign yields.

We remain convinced that the role of EM debt in investor portfolios is set to expand further in the coming years. While we like EM debt as an asset class, we recognize EMs represent a set of individual idiosyncratic risks and rewards. The expertise of investment managers remains as critical as ever in helping investors through the active selection of the right investments that enhance and complement core portfolios in a risk-controlled manner.

Risk factors: Understanding and mitigating key risk

There are differences with respect to how different EM economies will participate in future global recovery. Risk factors that remain include:

- Growth that will moderate from the high levels of 2021; investors should adjust their expectations accordingly.
- Developed-market growth being powered by massive fiscal and monetary support, which could fuel disproportionately high growth relative to EMs, at least in the near term.
- U.S. treasury yields rising sharply in both nominal and real terms if the U.S. Federal Reserve changes its stance abruptly, which could cause a selloff in EM assets despite their attractiveness.
- The higher servicing costs for EM debt due to higher borrowing costs, though EM debt levels are still much lower than their developed counterparts. This risk could be amplified if EM growth disappoints, pushing debt servicing costs higher relative to GDP.
- EM inflation rising faster than expected, which would mean either EM yields would have to move higher or EM currencies would need to weaken to attract investor flows.

Key takeaways: Why EM debt now?

1. A combination of macroeconomic growth drivers, current fiscal and monetary conditions, and low-yielding traditional core investments makes EM debt an increasingly attractive investment in today's environment, complementing core exposures to developed markets.
2. Emerging economies have coped with the pandemic reasonably well, which sets them on the path to a strong recovery over the next two years.
3. Undervalued EM currencies can mean additional opportunities for investors.
4. Barring some exceptions, EMs have generally exhibited mature monetary and fiscal policy approaches to the pandemic, which in concert with their secular growth drivers places EM debt in a good position.
5. The diversified opportunity set EMs offer underscores the importance of skilled active management, individual security selection, and portfolio construction expertise.

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