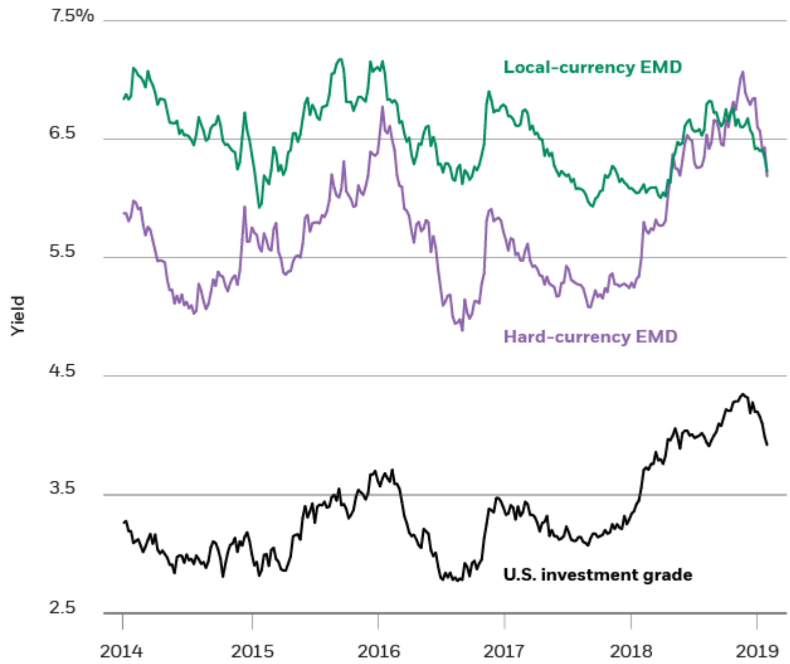
Emerging Market Debt: Opportunity or simply too risky!?

When viewed within the context of other fixed income assets, Emerging Market Debt (EMD) has a great deal going for it: it's a mature, diverse and liquid market offering cheap valuations, relatively low default rates and attractive yields. Moreover, despite perceptions to the contrary, economic fundamentals for many EM countries are meaningfully superior to the world's major developed nations. Yet, in spite of these attributes, EMD remains very much unloved, under-owned and in many cases excluded from many developed market investors' portfolios.

Following a tough 2018, EMD has rallied strongly since the start of this year – so is now a good time to add exposure?

The extent of this rally, measured in yield terms can be seen in the chart below – in price terms, this equates to a 7.01% increase in the JP Morgan (hard currency) EM Bond Index in USD. While yield spreads between EMD and U.S. investment grade bonds have tightened as a result, EM bonds remain attractive on an absolute and relative basis over the longer term, in our view.

EMD and U.S. Investment Grade Yields, 2014-2019



Source: BlackRock Investment Institute, with data from Thomson Reuters, February 2019

Of the major drivers of this year's EMD rally, all of which look likely to continue into the second part of the year, the most significant has been the policy backdrop which has turned more supportive. The FED's swift pivot from a tightening narrative during 2018 to a policy pause has assisted the demand for EMD, as has the subsequent fading of USD strength. As we know, a pause in the FED's hiking cycle eases the burden on emerging markets with high external debt loads, while a softer or more stable USD continues to support EM currencies. All of which is supportive for positive EMD returns in the near term.

The risks to this view are an escalating U.S.-China trade conflict, a return of recessionary fears or an inflation resurgence sparking earlier-than-expected Fed tightening. U.S.-China trade negotiations look to be progressing, though frictions related to competition for global technology leadership are likely to continue – all of which, we will continue to keep a close eye on.

When considering how to gain exposure to EMD, our view is that the most suitable approach is to utilise a fund with the broadest possible remit. That means a manager who approaches the task from both the top-down and bottom-up, who is looking at and taking into account interest rates, currency and credit views along with being afforded a mandate which allows full flexibility (go-anywhere – active management) to invest across the range of investable instruments i.e. local and hard currency, sovereign and corporate debt. In an ideal world that manager should operate without any specific benchmark constraints whilst looking to capture the potential of the ***best ideas*** within the entire EMD space.

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