Demystifying Emerging Markets Debt

June 1, 2021

Emerging markets (EM) debt is a widely misunderstood asset class; as a result, we believe it is both under-researched and under-owned, and therefore may be under-valued. Yet the asset class offers diversification potential, strong historical performance, understandable risks, and a promising outlook—and when broken down to these basics, it's not much of a mystery at all.

1: Diversification Potential

The EM debt universe contains three broad sub-categories: 1) sovereign debt, which is issued directly by EM and frontier market countries; 2) quasi-sovereign debt, which is issued by companies that are fully owned by governments or have explicit government guarantees (such as Pemex in Mexico or Sinopec in China); and 3) corporate credit, which consists of more than 700 issuers, including, for example, one of the largest cement companies in the world (based in Mexico) and the largest bank in Latin America (based in Brazil).

Across these types of debt, the asset class offers access to more than 900 issuers from more than 90 countries and has a benchmark market capitalization of $4.5 trillion.

These securities can be issued in either hard currency (predominantly U.S. dollars) or local currencies, though our discussion here is limited to hard currency debt.

With numerous options for accessing hard currency debt, the diversified opportunity set allows for more efficient management of concentration risks, which in turn may limit the portfolio impact of infrequent credit events.

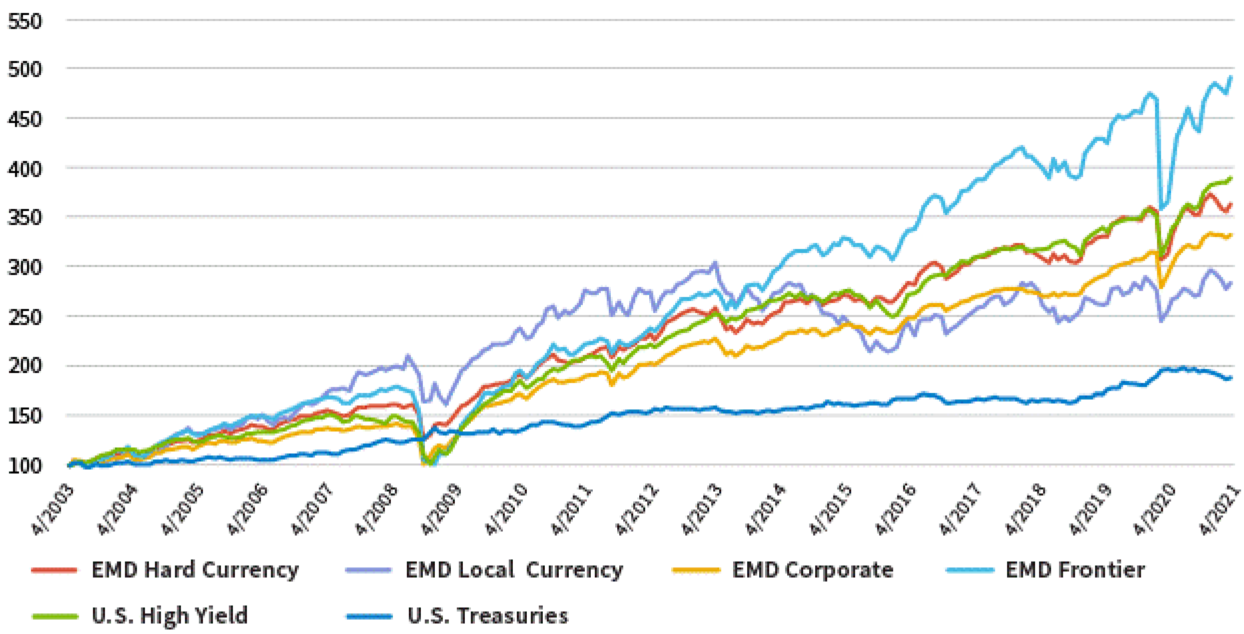
Because EM debt is an asset class that tends to display higher yields, lower default rates, and higher recovery values compared to developed markets fixed-income asset classes, we believe a diversified combination of these hard currency options optimizes returns.

2: Strong Historical Risk-Adjusted Performance

EM debt is not a mystery asset class: it comprises more than 25% of the global fixed-income market; it offers attractive credit spreads; it's diversified; it has strong fundamentals; and multilateral organizations (such as the International Monetary Fund and World Bank) provide an additional source of affordable funding to EM countries, which offers a measure of support.

This has led to strong historical performance, as the chart below shows. The three significant drawdowns since the early 2000s (which I define as greater than 10% for the EM debt hard currency asset index) saw quick recoveries. This illustrates the tendency of this asset class to mean revert as credit spreads tend to converge to long-term average levels.

Historical Market Performance

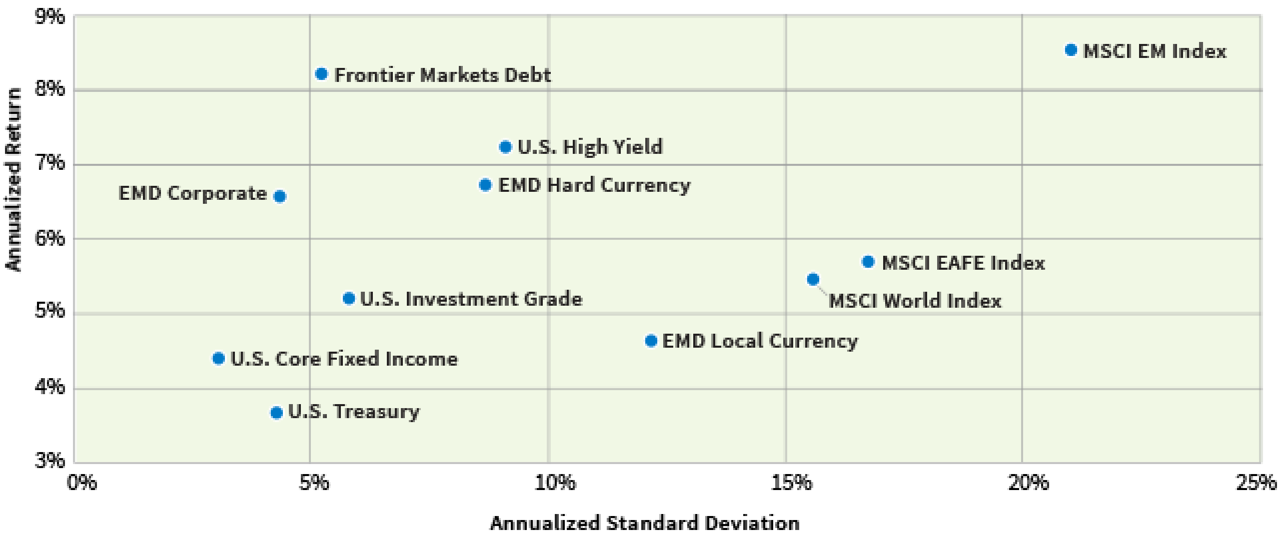


Sources: Bloomberg and JP Morgan, as of April 2021. **Past performance is not indicative of future returns**. A direct investment in an unmanaged index is not possible. Index representation is as follows: EMD hard currency, J.P. Morgan EMBI-GD; EMD local currency, J.P. Morgan GBI-EM Global Diversified Index; EMD corporate debt, J.P. Morgan CEMBI Diversified; EMD frontier, J.P. Morgan Next Generation Markets Index; U.S. high yield, Bloomberg Barclays U.S. Corporate High-Yield Total Return Index; U.S. Treasuries, Bloomberg Barclays U.S. Treasury Bill Index.

3: Misunderstood Risks Can Create Structural Value

We also believe there is a strong disconnect between perceived and actual risk in EM hard currency debt. The asset class has performed similarly to U.S. high-yield with lower volatility, and compares well with U.S. investment-grade debt (as measured by the Bloomberg-Barclays U.S. Aggregate Index), as the chart below illustrates.

Historical EM Debt Performance (15 Years Ending 3/31/21)



Sources: Bloomberg, JP Morgan, MSCI, and S&P, as of March 31, 2021. **Past performance is not indicative of future returns**. A direct investment in an unmanaged index is not possible. Index representation is as follows: EMD hard currency, J.P. Morgan EMBI Global Diversified; EMD local currency, J.P. Morgan GBI-EM Global Diversified; EMD corporate, J.P. Morgan CEMBI Diversified; frontier markets debt, J.P. Morgan Next Generation Markets Index; U.S. Treasury, Bloomberg Barclays U.S. Treasury Index; U.S. investment grade, Bloomberg Barclays U.S. Corporate Total Return Value Index; U.S. high yield, Bloomberg Barclays U.S. Corporate High-Yield Index; U.S. core fixed income, Bloomberg Barclays U.S. Aggregate Index.

The asset class has low historical default rates over a 20-year time period: 1% annualized for the J.P. Morgan Emerging Markets Bond Index Global Diversified (EMBI-GD), which represents hard currency sovereign debt, and 1.5% annualized for the J.P. Morgan Corporate EMBI Diversified Composite Index, which represents corporate credit.

Recovery values are solid as well. In fact, when defaults have occurred, investors have experienced better recoveries than investors in U.S. and European corporate high-yield credit (when using the same metrics).

The natural question is, will low default rates remain in place in the long run? After all, we've all seen the negative headlines about the pandemic-inspired slowdown in growth leading to credit deterioration in certain EMs. Growth has also slowed significantly, as it has everywhere else. That has hurt fiscal revenues and driven up deficits, and, in turn, led to higher debt levels.

But we are already seeing evidence that credit metrics are stabilizing. So, while fiscal credit metrics have deteriorated, they still appear very manageable, and we don't expect a systematic crisis in EMs. Historically, such events have been led by currency crises, debt crises, or financial sector crises, and, in our view, the elements are not in place for any of those.

However, EM high-yield sovereign spreads are still above where they were in 2019 and the beginning of 2018 by approximately 100 to 200 basis points. That's where we expect most of the spread compression going forward, because we believe that at current levels, spreads overcompensate investors for the credit risk, and also drive crossover investor capital flows into EMs.

The reason is that EM hard currency sovereigns now appear to be very cheap compared to U.S. high-yield debt, which is a competing asset class. A few years ago, U.S. high-yield spreads traded above EM high-yield debt spreads. As the chart below shows, the spread differential between EM high-yield and U.S. high-yield is now close to 300 basis points. That highlights how relatively attractive the asset class is.

EM Sovereign Debt Spread Minus U.S. High-Yield Debt Spread

Sources: J.P. Morgan, Barclays, and Bloomberg, as of April 2021. **Past performance is not indicative of future returns**. A direct investment in an unmanaged index is not possible. Index representation is as follows: EM sovereign high-yield debt, high-yield component of the JP Morgan EMBI Global Diversified; U.S. high yield, Bloomberg Barclays U.S. Corporate High-Yield Total Return Index.

4: A Promising Outlook

Lastly, the outlook is constantly changing, so staying on top of it is critical.

While the fundamental picture is improving, it is on balance neutral. Although EM credit metrics have worsened over the past year in response to the COVID-19 crisis, there are many offsetting factors to this deterioration.

First, the global economy is improving on the back of stronger economic activity in developed economies, and EMs are following suit. Second, current account balances are healthy in EM. Third, while debt levels have increased, they are still at around 60% of gross domestic product (GDP), which is significantly below levels that we see in advanced economies. Fourth, we've seen unprecedented policy stimulus; global liquidity conditions are ample; and EMs have strong multilateral and bilateral support.

Technical conditions have also improved dramatically, but on balance we also believe they are neutral.

We had favorable net debt supply conditions in April, and while May has been less supportive, it's constructive. As a result of abundant liquidity conditions, there is a significant amount of cash on the sidelines in money market funds, and the search for yield theme remains alive and well. And valuations are positive, especially in the high-yield space.

On the other hand, rising U.S. Treasury rates have added volatility, and although they have stabilized, upward is the path of least resistance. That may lead to outflows from retail investors from fixed income more broadly.

That said, we believe the implied probability of default is unrealistically priced, and there is opportunity for differentiation. The crisis has affected countries differently, and careful bottom-up analysis may help us identify opportunities on a country-by-country basis.

We are positioned for further compression in spreads between high-yield and investment-grade debt because we believe this is where the value is. And with the view that flows from crossover investors in that part of the market are likely, we are convinced that the spread should compress.

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JP Morgan Emerging Markets Bond Index (EMBI) Global Diversified tracks the total return of U.S.-dollar denominated debt instruments issued by sovereign and quasi-sovereign entities. **JP Morgan Government Bond Index Emerging Market (GBI EM) Global Diversified** is a comprehensive global local emerging market index, consisting of regularly traded, liquid fixed-rate, domestic currency government bonds. **JP Morgan Corporate Emerging Markets Bond Index (CEMBI) Diversified** is a market capitalization weighted index consisting of U.S.-dollar denominated corporate bonds issued by emerging markets entities, uniquely-weighted to result in more balanced weightings for countries included in the index. **JP Morgan Next Generation Markets Index** tracks U.S.-dollar denominated debt issued by sovereign and quasi-sovereign issuers in frontier markets. The index provides a benchmark for the smaller, less liquid population of emerging market credits. **Bloomberg Barclays US Treasury Index** measures US dollar-denominated, fixed-rate, nominal debt issued by the US Treasury. **Bloomberg Barclays U.S. Aggregate Bond Index** is a broad-based benchmark that measures the investment grade, U.S. dollar-denominated, fixed-rate taxable bond market. **Bloomberg Barclays US Corporate High Yield Index** measures the USD-denominated, high yield, fixed-rate corporate bond market. Bloomberg **Barclays US Corporate Index** measures the investment grade, fixed-rate, taxable corporate bond market. **MSCI EAFE Index** is a stock market index that is designed to measure the equity market performance of developed markets outside of the U.S. & Canada. **MSCI Emerging Markets Index** is a free float-adjusted market capitalization index that is designed to measure equity market performance in the global emerging markets. **MSCI World Index** is a market cap weighted index of stocks from companies throughout the world and is used as a common benchmark for 'world' or 'global' stock funds intended to represent a broad cross-section of global markets.

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