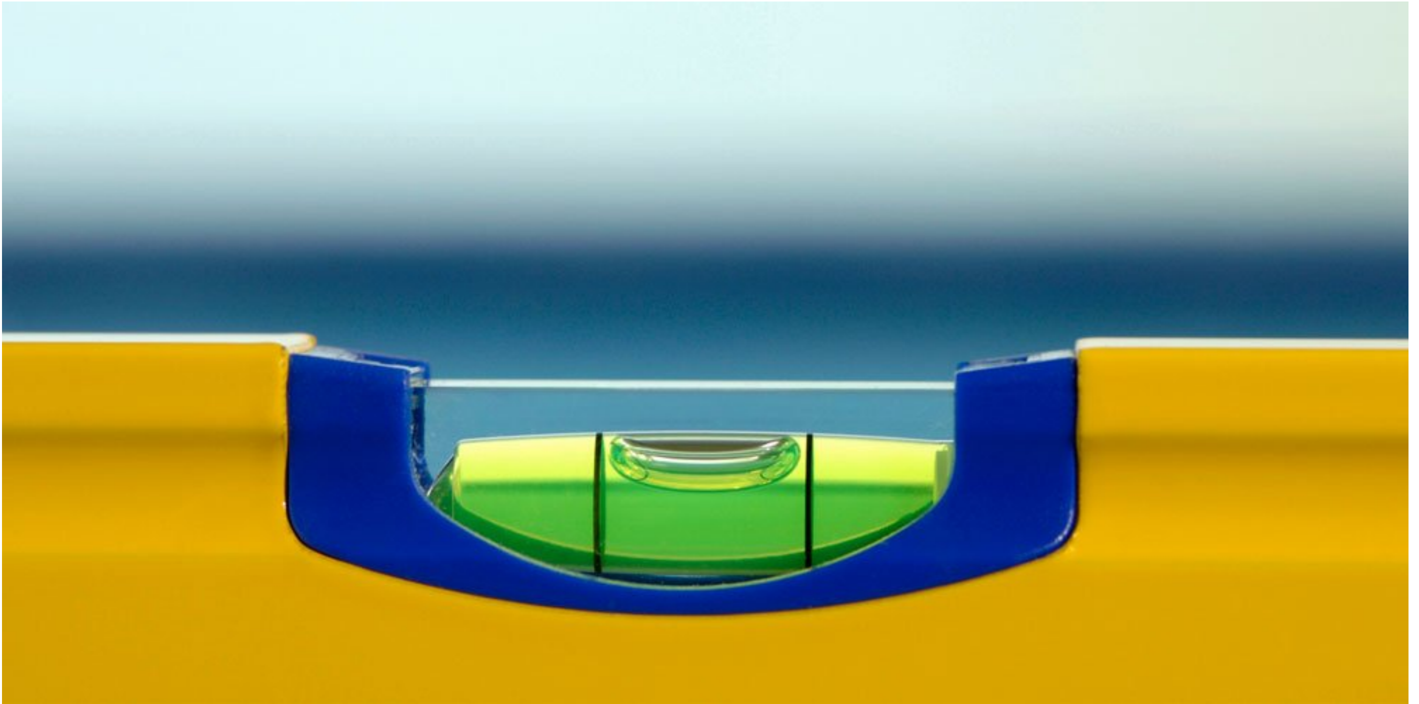


Stabilizing U.S. Treasury Yields Help EMD Returns

April 21, 2021

Emerging markets debt (EMD) performance was significantly impacted by the sharp increase in U.S. Treasury yields during the first quarter of the year. Looking ahead, we anticipate a smaller impact on performance as we expect yields to stabilize in the near term. At the same time, improving EMD fundamentals, supportive technical conditions, and attractive valuations should continue underpinning the case for tighter EMD credit spreads.

Improving Growth + Monetary Accommodation

Optimism about vaccine rollouts and the approval of a $1.9 trillion fiscal package in the United States shored up expectations for a sharp global economic recovery.

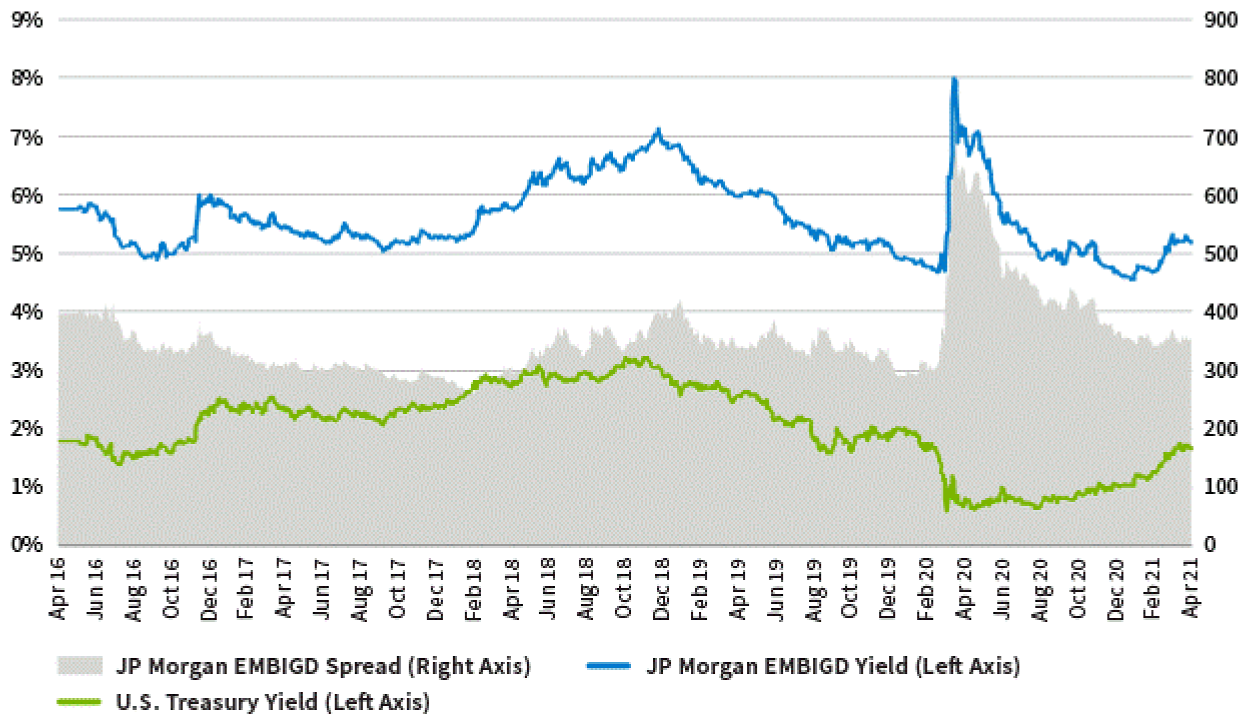
Despite the improving growth outlook, major central banks continued to strike a note of caution, signaling the continuation of extraordinary monetary policy accommodation.

The positive combination of improving global growth prospects and favorable liquidity conditions sustained investor sentiment, leading to higher equity and commodity prices and tighter credit spreads.

Unlike in previous quarters, however, the sharp improvement in growth expectations resulted in higher government bond yields globally, particularly in the United States, where Treasury yields rose significantly. Rising interest-rate differentials between the United States and other major economies also contributed to the strong performance of the U.S. dollar during the period.

While EMD hard currency credit spreads were stable at about 350 basis points (bps) during the first quarter, the J.P. Morgan Emerging Markets Bond Index Global Diversified (EMBIGD) lost 4.54% in U.S. dollar terms during the quarter. This was almost entirely driven by the rise in U.S. Treasury yields, as the chart below illustrates.

Despite the sharp increase in U.S. Treasury yields and a busy primary market (with close to $50 billion issued), EMD hard currency showed impressive resilience in our view during the period.



Sources: J.P. Morgan, Bloomberg, William Blair, as of April 2021. Spread is in basis points.

Outlook: Tighter Credit Spreads Offset Higher U.S. Treasury Yields

While U.S. Treasury yields could remain a significant headwind for EMD returns, we anticipate a smaller impact on performance as we expect yields to stabilize in the near term.

We believe temporarily higher inflation and a strong economic rebound in the United States should continue to exert upward pressure on interest rates. However, the Federal Reserve is committed to the gradual normalization of monetary policy, and this should anchor long-term rates. Overall, we anticipate the continuation of very favorable financing conditions for issuers in emerging markets.

Meanwhile, we believe credit fundamentals in emerging markets should continue to recover amid improving economic growth, rising global trade, and higher commodity prices. In addition, prospects for a $650 billion increase in the International Monetary Fund's (IMF's) Special Drawing Rights (SDR) allocation to emerging markets underscore strong support from multilateral organizations.

In our opinion, technical conditions should also remain supported by positive investor flows and contained new net debt issuance. EMD hard currency dedicated portfolios received approximately $12 billion inflows during the first quarter, according to J.P. Morgan, and we expect inflows to continue. We also expect strong inflows from nondedicated, crossover investors attracted by favorable valuations of EMD relative to developed-market credit.

Meanwhile, we estimate that net refinancing needs to be at a very manageable $25 billion during the second quarter of the year.

In our view, EMD hard currency valuations remain attractive, especially in the high-yield space, where credit spreads remain above long-term averages. Valuations appear to be particularly attractive relative to U.S. high-yield corporate credit. We believe the risk premia in EMD hard currency sovereign credit overcompensate investors for default and loss-given-default risks.

In this overall context, we see scope for EMD risk premia compression, and we expect tighter credit spreads to partly offset marginally higher U.S. Treasury yields in the coming months.

But improving credit fundamentals, ample liquidity conditions, positive investor flows, strong support from multilateral organizations, and attractive valuations should likely all underpin the performance of the asset class during the second quarter of the year.

Investment Implications

Overall, we have a strong preference for less interest-rate-sensitive credits because we are cautious about the direction of U.S. Treasury yields.

We seek to segment our investable universe into three buckets based on different risk profiles: low-beta, medium-beta, and high-beta countries.

We are currently overweight the high-beta and middle-beta countries, because we expect returns to be driven by further compression in high-yield spreads, where the risk premia continue to overstate credit risks. We are underweight low-beta countries, where valuations in our opinion are broadly unappealing and sensitivity to rising U.S. Treasury yields is higher.

Largest Active Positions

	Overweight	Underweight
High-Beta	Ukraine Ghana Egypt	Nigeria Kenya Mozambique
Medium-Beta	Brazil Dominican Republic Belarus	Kazakhstan Jamaica Azerbaijan
Low-Beta	Romania United Arab Emirates Serbia	Uruguay Peru Malaysia

Source: William Blair, as of April 2021.

High-Beta Bucket

In the high-beta bucket, our largest overweight positions are in Ukraine, Ghana, and Egypt, and our largest underweight positions are in Nigeria, Kenya, and Mozambique.

Ukraine's relationship with the IMF has recently become more complicated, but we do not believe this is sufficient to derail IMF support.

Ghana's government continues to assert fiscal prudence through a combination of revenue and expenditure measures.

We believe Egyptian valuations remain attractive relative to historical spreads. We are also constructive on the prospect of further compression in Egyptian credit spreads, driven by fundamental improvement. In our view, the U.S.-dollar-denominated sovereign curve is one of the steepest in the investable universe given front-end support from local Eurobond buyers.

Moving on to underweights, Nigerian fundamentals are weak despite a recovery in oil prices. The poor performance in revenue mobilization and slow pace of reform, particularly in the foreign exchange market, are key constraints to Nigeria's creditworthiness.

Our underweight to Kenya is largely driven by valuations. While the fundamental outlook is supported by the prospect of fiscal reforms and support from the IMF, this was largely already priced into the spreads. The focus is now likely to shift to implementation risks under the program. Furthermore, the possibility of substantial Eurobond issuance in the near future may provide more attractive opportunities to reengage.

Lastly, Mozambique's fundamental outlook appears to be clouded by substantial political uncertainty. The escalation of violence in the region, where substantial hydrocarbon developments are ongoing, is likely to weigh

on foreign direct investment and delay the potential export and fiscal revenues from these projects.

Medium-Beta Bucket

In the medium-beta bucket, our largest overweight positions are in Brazil, the Dominican Republic, and Belarus, and our largest underweight positions in Kazakhstan, Jamaica, and Azerbaijan.

While Brazilian sovereign bonds have mediocre valuations, we are particularly constructive on fundamental risks in corporate credit, where we have positions in the oil and gas, consumer, industrial, and financial sectors.

In the Dominican Republic, vulnerability to external risks remains high despite strong economic growth, but valuations are attractive, especially in the long end of a very steep sovereign curve.

In Belarus, we are concerned about the fallout from last year's presidential election, but valuations are attractive and there is reason for optimism about the potential for constitutional amendments.

Moving on to underweights, Kazakhstan has unattractive valuations and deteriorating fundamentals as large twin deficits, rising unemployment, and higher inflation pose significant challenges. In Azerbaijan, valuations are stretched, the fiscal deficit is likely to stay elevated on reconstruction spending, and rising levels of COVID-19 cases are hurting economic recovery. And in Jamaica, COVID-19 has hurt the tourism-dependent economy.

Low-Beta Bucket

Across the low-beta universe, our largest overweight positions are in Romania, Serbia, and the UAE, and our largest underweight positions are in Uruguay, Peru, and Malaysia.

In Romania and Serbia, we find valuations attractive in U.S.-dollar-hedged, euro-denominated instruments relative to U.S.-dollar-denominated benchmark bonds. Issuance of euro-denominated bonds in Eastern European remains in short supply.

In the UAE, we find value in the higher spread credit of Sharjah, which has recently issued debt again in the primary market. We believe there is sufficient support from Abu Dhabi to justify lower yields in the current market. This support has been further emphasized by the potential issuance of a state bond.

We are underweight in Uruguay because of unappealing valuations. The country has shown one of the best COVID-19 crisis management programs in the region and, unlike its neighbors, has limited the impact of the pandemic on its economy. The better macroeconomic background in Uruguay has led to a significant outperformance of its debt, in turn resulting in rich valuations relative to peers.

On the other side of the spectrum, Peru has been one of the South American countries worst hit by COVID-19. Before the pandemic, Peru had one of the strongest sovereign balance sheets in the region because of a history of strong growth and fiscal discipline. But fiscal deficits are likely to jump to double digits as a percentage of GDP this year. We currently dislike valuations, especially given fundamental and political risks.

Lastly, we are underweight Malaysia because of unappealing valuations in long-duration sovereign and quasi-sovereign bonds. The rebound of global growth and strong performance of commodity markets should bode well

for an economic recovery, but we believe that the upside has already been fully priced in.

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