EM LOCAL CURRENCY DEBT COULD RETURN TO THE FORE LATER THIS YEAR

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Last year was not the best for bonds, and emerging market debt was not immune to the overall trend. By November 17th of last year, the Bloomberg EM US Dollar Bond index was down by 1.75%, and that was a recovery from last year's low hit on October 12th, when the index was down by 2.15% for the year.

Much of that drop was a result of falling US Treasuries, and an index of the American government bonds compiled by Bloomberg was down 3% for 2021 as of November 17th. As the numbers suggest, however, emerging market bonds outperformed the world's safest securities last year.

Part of the reason for that is because emerging market bonds offer higher yields, and are therefore less sensitive to changes in interest rates. This is an important consideration for the year ahead as analysts are split about the direction of interest rates in the US after inflation in the country hit the highest level in 30 years in the fourth quarter.

Whether the Federal Reserve caves to pressure from markets to hike rates this year will have a major impact on the performance of all emerging market assets, which tend to be quite sensitive dollar benchmark rates. Local currency debt, which fared even worse than foreign currency bonds of developing nations last year, could react even more strongly to a sudden hawkish turn at the Fed given the potential for the dollar to strengthen as a result.

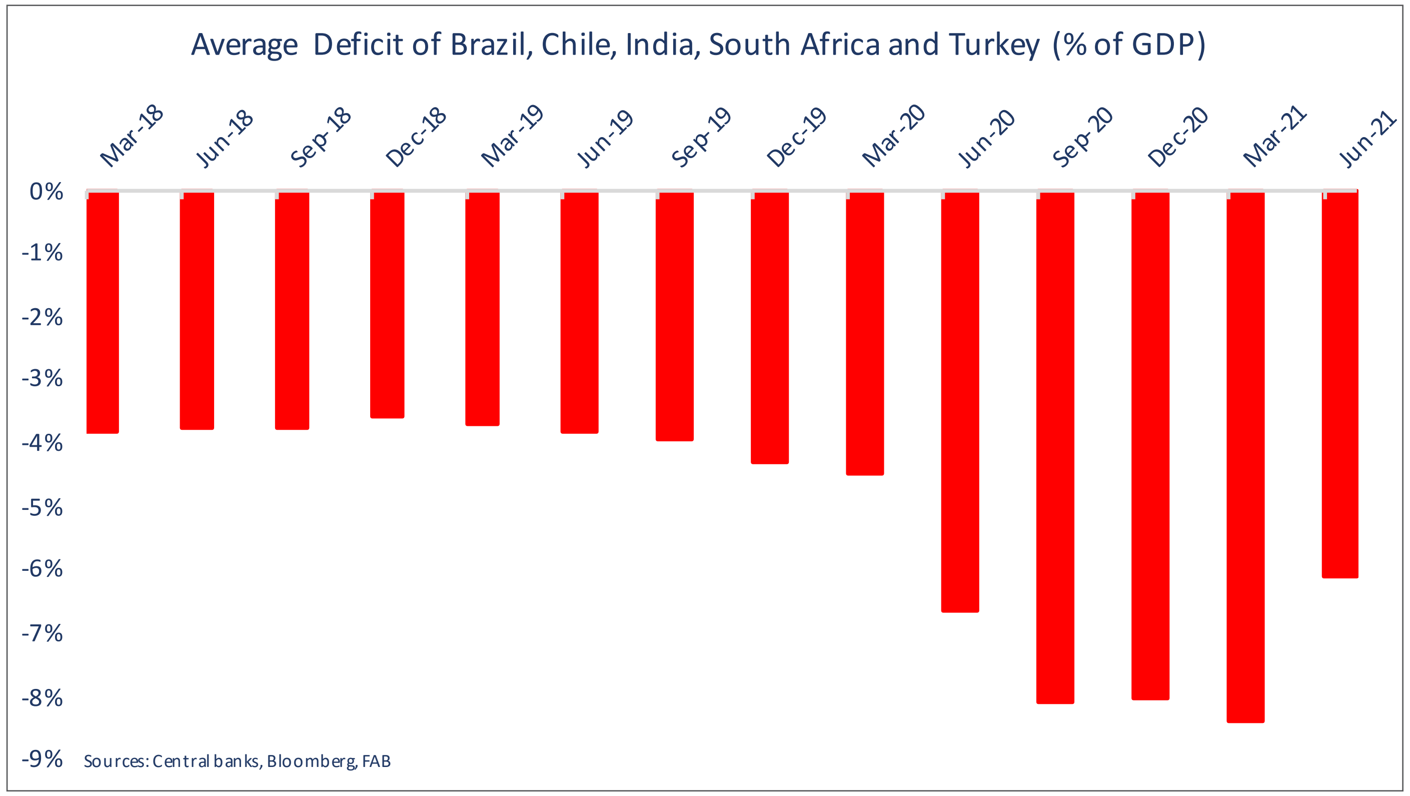
The opposite is also true. The market had priced in three interest rate hikes this year at the end of 2021, and this was reflected in asset prices, from Fed fund futures to the US dollar. If inflation tapers off as it seems it could, and the Fed can hold its fire on interest rate hikes, emerging market bonds are likely to do particularly well. In fact, certain local currency developing nation bonds, which have lagged broader markets for years, could become particularly attractive towards the second half of this year.

This is because many of the developing nations' central banks have already started to hike interest rates, and many of these governments have also started to tighten their purse strings. This means lower growth for now, which may weigh on local equity markets but also mean a progressive improvement of credit metrics. As fiscal and current account deficits become smaller or even convert to surpluses, government bonds of these countries will become more attractive, particularly local currency ones.

Emerging market currencies have suffered since the first quarter of 2018 when the trade war between the US and China began. Between April 3rd, 2018, its previous peak, and November 17th, 2021, the MSCI EM FX index gained only 0.27%, and that was mostly thanks to a 4.73% rally since the end of October 2020 when news of a potential vaccine first hit markets.

For now, the momentum remains against them, particularly as the US dollar has been on a strengthening path as more investors consider the possibility that the Fed will increase rates next year. However, the credit metrics of emerging countries have already started to recover.

Between the end of the first quarter of 2020 when the pandemic began and the same period in 2021, the average budget shortfall of Brazil, Chile, India, South Africa and Turkey nearly doubled to 8.38% of GDP from 4.44% (these countries have more timely data). By the end of the second quarter of 2021, according to the latest data available as of writing, the mean deficit had fallen to 6.12% of GDP.



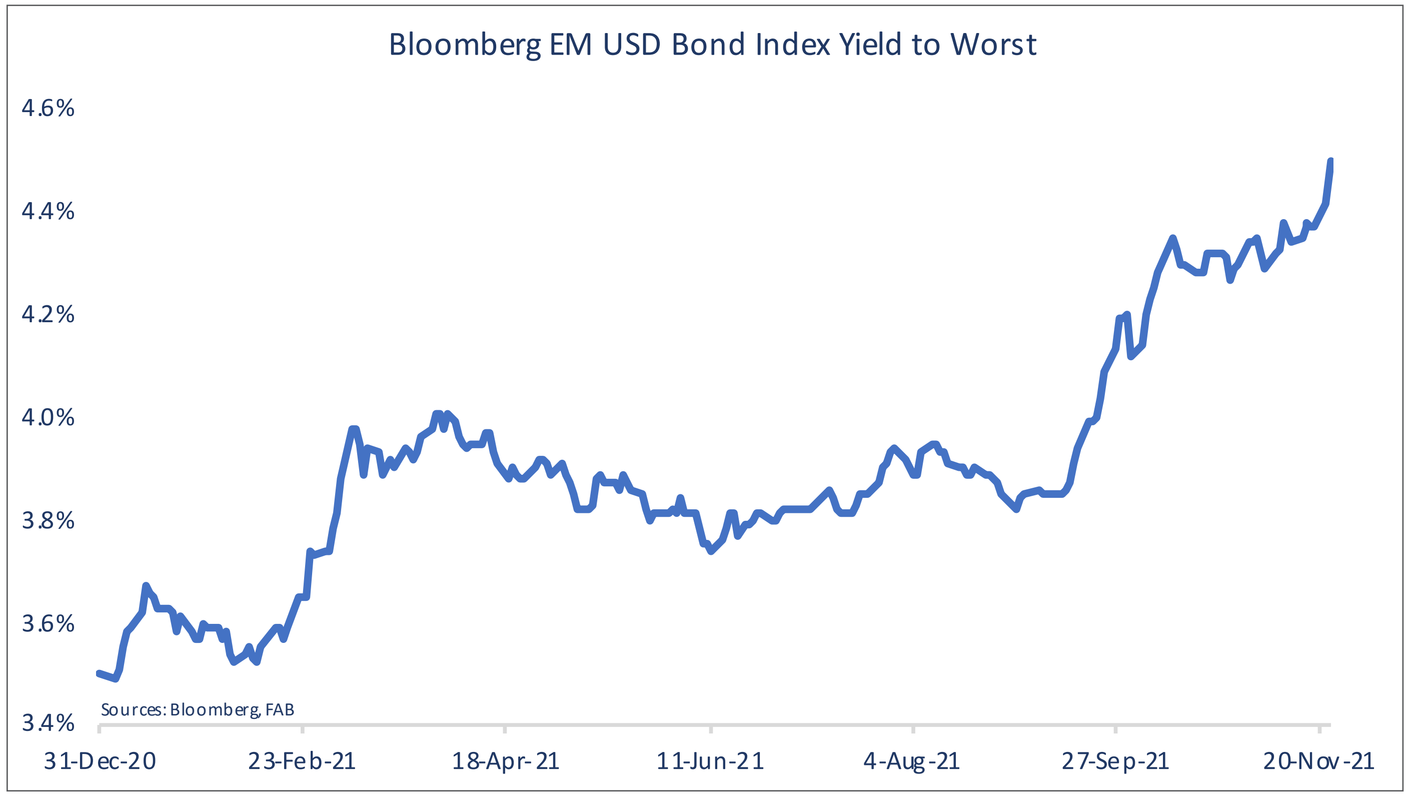
The trouble is that because deficits increased so much, they had a major impact on the debt-to-GDP ratios of these countries. To put this in perspective, South Africa's total government debt amounted to 57.4% of its GDP at the end of the first quarter of 2020 — it jumped to 70.7% one year later. It had started to retreat to 68.8% in the second quarter of 2021, but it still had a long way to go to return to pre-pandemic levels.

The jump is also partly a result of the currency depreciation some of the countries suffered. The Brazilian real, for one, fell 9.07% between March 26th, 2020, when the big COVID sell-off happened, and November 17th, 2021. This made the accounting and servicing of Brazil's foreign debt more expensive.

This higher cost, however, could also curb foreign issuance of additional foreign debt for some emerging market countries this year. That had already begun last year. Between January 1st and November 24th of 2021, Bloomberg recorded 129 sovereign dollar-denominated bond issues amounting to US$132.87 billion. This amount was a nearly 27% drop compared to the US$181.3 billion issued in the same period in 2020 according to Bloomberg data.

This dynamic could mean that the foreign currency debt of emerging markets becomes attractive earlier than local debt. Indeed, the dollar-denominated debt of emerging countries will probably become quite attractive as soon as global markets have some more clarity on the direction of US interest rates.

The yield premium on the Bloomberg Emerging Markets US Dollar index increased by about 50 basis points between February 25th, 2021, when it hit 263 basis points, the lowest since 2018, and late November 2021. In the meantime, the yield on the seven-year US Treasury, the benchmark for the EM USD index, increased by 35 basis points, suggesting the average absolute yield of emerging market dollar debt increased by about 85 basis points in the period. There could be some more to go, but foreign currency developing nation debt was looking increasingly attractive towards the end of 2021 given the prospects of lower issuance, improving credit metrics and higher yields.



To be sure, averages can be tricky, and one of the points of pressure that contributed to the overall increase in emerging market dollar-bond premiums was the situation of Chinese high-yield debt. The troubles of the world's biggest developer, China Evergrande Group, had a major impact on Asian junk bonds, pushing the average yield of the Bloomberg Asian High-Yield Bond Index to 13.57% on November 9th 2021. The index had started to recover and the average yield had dropped to 11.8% by the end of November.

It had spilled into investment-grade too, and the yield premium on the Bloomberg Asia USD Corporate Credit IG rose nearly 50 basis points between September 13th and November 9th of last year. This space, too, had started to recover towards the end of the year.

Yet, Asian bonds could still represent an opportunity despite the recent recovery and even if China is removed. From an economic standpoint, the region is likely to show the strongest growth among developing nations in 2022, given that it was the slowest to reopen and, therefore, is likely to see a boom once full economic activity resumes.

This could also mean a short-term spike in inflation, as was seen in other parts of emerging markets last year, and some monetary tightening in the likes of Indonesia, India or Malaysia. Yet overall, it points to a more positive environment for Asian credit this year. And when Asia does well, all other emerging markets tend to as well.

Again, assuming Asia manages to reopen by the second half and that, at this point, the US dollar has started to reach its apex along with the tightening cycle for many western emerging market central banks, local currency bonds could become a very attractive proposition late this year.

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