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Adding emerging market debt exposure? Look to local bonds.

From the Field
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Judging by my conversations with clients around the world in the first quarter of 2024, many investors have realized that they are underallocated to emerging markets in their global fixed income portfolio. This is, in part, a response to the eye-catching returns of emerging market debt in 2023, when it easily outperformed both global developed market bonds and U.S. investment-grade debt.[1]

While some investors may be wary of exposure to faltering growth in China, the fundamental strength of emerging market bond sectors—external "hard currency" sovereign debt denominated in U.S. dollars or euros, corporate bonds, and sovereign bonds denominated in local currencies—and their attractive portfolio diversification characteristics are enough to make the case for a structural allocation to emerging markets.

Here are five factors that I think make a strong case for emerging markets in global fixed income:

1. Improved credit quality, deeper capital markets

As various developing countries exited crisis periods in the 1990s and adopted needed reforms to make long-term growth and debt more sustainable, emerging market bonds have seen significant improvements in credit quality. In the mid-1990s, there were no investment-grade external sovereign issuers. Today, more than half of the emerging market opportunity set has investment-grade credit ratings.

Paralleling this improvement in credit quality, capital markets have deepened for emerging markets. The countries now primarily fund themselves in local currencies versus hard currencies, and emerging market corporate debt has seen steady growth over the last 10 years to become a larger opportunity set than emerging market external sovereigns. We expect the corporate market to continue to rise in prominence over the next 10 years and maintain its status as a less volatile way to access the strong economic growth of emerging markets.

[1] In 2023, the J.P. Morgan Emerging Market Bond Index Global Diversified returned 10.45%, the Bloomberg Global Aggregate Ex-USD Bond Index returned 5.72%, and the Bloomberg U.S. Aggregate Bond Index returned 5.53%. **Past performance is not a reliable indicator of future performance.**

2. Recent debt distress is catalyzing reforms

Those long-term improvements don't hide the fact that some emerging market countries entail more risk than their developed market peers. This is particularly evident on the external sovereign side, which is only recently recovering from one of its most acute periods of debt distress since the 1990s. Today, nearly 50% of the credit spread[2] in emerging market sovereign bonds[3] originates from a handful of distressed markets. We've seen several CCC rated issuers default and restructure since the COVID crisis crippled many parts of the global economy and the Federal Reserve embarked on its most aggressive hiking cycle since the 1970s.

The upside is that the market should come out stronger than before as countries continue to press for domestic reforms, such as Oman's sharp deleveraging and Angola's shift toward more democratic governance with an anticorruption stance. And a number of countries—including Sri Lanka and Zambia—will soon exit debt restructurings with more sustainable debt loads and policymaking.

3. Opportunities for portfolio diversification

Emerging markets can offer exposure to economic cycles that differ markedly from developed markets. For instance, central banks in some emerging markets, such as Brazil and Chile, have already started cutting rates, while investors are still waiting for most major developed market central banks to begin easing.

Also, the diverse economic makeup of different emerging markets can mean that some can benefit from macroeconomic trends that weigh on most developed markets. An energy price spike, for example, would boost the creditworthiness of commodities exporters such as Colombia, while Chile has benefited from recent increases in copper prices as the world's largest producer of the metal.

There are also opportunities for diversification within the broad emerging market debt asset class: The external sovereign sector provides exposure to a wide range of credit quality across more than 80 sovereign issuers, corporate bonds to a variety of high-quality businesses, and local sovereigns to interest rates. Investors can also include foreign exchange exposure as a component of local debt and another potential source of differentiated returns.

4. Corporates offer exposure to emerging and developed markets

Emerging market corporate bonds in particular can offer a high-quality way to add exposure to companies that are global leaders in their industries. Moreover, companies ranging from producers of consumer baked goods to steel and cement manufacturers can hold a meaningful presence not just in their domestic market, but in developed markets as well.

In some cases, emerging market corporate issuers have credit ratings that are subject to an effective ceiling of the corresponding sovereign. This results in corporate bonds that have a lower rating—and often a higher yield—than their actual fundamental credit quality would entail.

5. Local debt has surprisingly defensive characteristics

The local debt segment can have surprisingly defensive characteristics in terms of low correlation[4] with developed market interest rates, particularly when currency risk is hedged to eliminate volatility associated with swings in exchange rates. Treating the local rate and currency components as separate investment decisions allows investors to not only express a direct view on local central bank policy or exchange rates, but also to manage overall volatility to a level that better aligns with their underlying risk appetite.

Even as some emerging markets have already begun easing monetary policy, the local sovereign market continues to offer meaningful opportunities via its exposure to local interest rates. In fact, emerging market local bonds currently represent the best way to access the fundamental strength and diversification advantages of the asset class, in my opinion. As for concerns about exposure to China within emerging market debt, we will set out our views on China in a forthcoming Ahead of the Curve post.

[2] Credit spread measures the additional yield that investors demand for holding a bond with credit risk over a similar-maturity, high-quality government security.
[3] Represented by the J.P. Morgan Emerging Market Bond Index Global Diversified.
[4] Correlation measures how one asset class, style or individual group may be related to another. A perfect positive correlation means that the correlation coefficient is exactly 1. This implies that as one security moves, either up or down, the other security moves in lockstep, in the same direction. A perfect negative correlation means that two assets move in opposite directions, while a zero correlation implies no relationship at all.

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