Why EM Debt Can Continue to Shine

EM debt reveals its strengths as a growth asset.

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History shows that emerging markets (EM) debt can offer not just stability, but also can potentially deliver higher absolute returns than its equity counterpart. This might fly in the face of conventional thinking, which typically considers fixed income investments as safer and more stable and equity investments as the best sources of higher growth and absolute return potential. However, when it comes to EM, we believe both debt and equity can be thought of as growth assets.

EM debt's relative stability coupled with historically high income have helped it to deliver noticeably higher cumulative returns than EM equity. Therefore, while both asset classes contain many attractive opportunities for active managers, we think investors should consider EM hard

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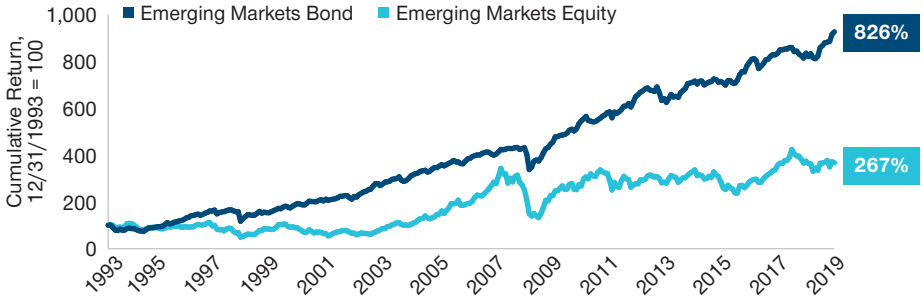
(Fig. 1) EM Debt's Sustained Outperformance

EM debt and EM equity long-term returns
As of July 31, 2019



Past performance is not a reliable indicator of future performance.
Sources: J.P. Morgan (see Additional Disclosures) and MSCI (see Additional Disclosures). Data analysis by T. Rowe Price.
EM Bond is based on J.P. Morgan EMBI Global Index. EM Equity is based on MSCI Emerging Markets Index.

currency debt as the best potential compensation for risk in the EM universe.

The reasons for EM debt's historical outperformance include the following:

- Hard currency bonds are less exposed to local currency exchange fluctuations, which have been a significant driver of EM volatility and capital loss. Higher inflation rates and persistently negative current account balances continue to pressure EM currency markets. Although many EM countries displayed fundamental economic improvements in recent years, part of this process resulted in many countries opening their economies and allowing currencies to float freely rather than maintaining capital controls or currency pegs. In many places, this has resulted in a longer-term depreciation of local currencies even as countries may have been implementing favorable reforms. Overall, EM currencies have depreciated roughly 20% against the U.S. dollar since 2003.[1]

  Furthermore, the past seven years in the wake of the global financial crisis saw an extended period of U.S. dollar strength. The relative weakness and higher volatility of EM currencies eroded equity market returns, whereas EM hard currency debt markets were not directly affected.

- EM debt also has a smaller corporate sector exposure relative to EM equity, which is entirely composed of corporate assets. While many EM companies displayed strong growth during the past 10 years, the corporate sector remains riskier and has higher volatility compared with EM sovereign bonds. By nature, EM equity does not contain any exposure to sovereign assets, so the corporate sector has a larger influence on performance.

- EM debt has generated a significant portion of its returns from coupon payments, which are a more stable component of returns than capital appreciation. The coupon rate in EM has historically been between 5% and 7%.[2] Equity markets do not have a comparable source of regular returns, with dividends at 2.9%.[3]

In our view, the key takeaway is that fixed income should be thought of as a primary source of potential long-term returns. That is not to say that investors should discount EM equity, which still offers many opportunities for investors to gain exposure to individual corporate names. At times, EM equity can also outperform EM debt and other asset classes. However, over the long term, we see reasons why EM debt can continue to deliver better risk-adjusted returns. Despite meaningful improvement and reform processes, many countries are still in the midst of structural adjustments. While there may be periods where local currencies outperform on an idiosyncratic basis, the overall weakness and volatility of local currency markets will likely continue over longer time frames.

In our view, investors searching for the best risk-adjusted returns should continue to look actively at both equity and fixed income names. Overall, though, investors should remember that EM debt is not just a more stable option, but also a driver of potential growth.

[1] Source: J.P. Morgan (see Additional Disclosures). As of August 30, 2019.
[2] Source: J.P. Morgan Emerging Market Bond Index Global (see Additional Disclosures). January 1, 2013 to September 30, 2019.
[3] Source: MSCI Emerging Markets Index (see Additional Disclosures). As of September 30, 2019.

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