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Fixed Income

DO VALUATIONS OFFER AN ENTRY POINT TO EMERGING MARKETS DEBT?

KEY POINTS

- The recent sell-off in emerging markets (EM) debt has potentially resulted in an attractive entry point as it currently offers investors one of the highest-yielding opportunities within fixed income.
- Valuations in key EM are currently cheap to both developed market asset classes as well as to EM fundamentals.
- A disciplined, active approach remains essential to uncover the best potential opportunities across sovereign, corporate, and local currency debt.
- Although risks remain, many of the catalysts for first-half weakness have subsided, leaving a potentially better environment ahead for EM debt markets.

ARE VALUATIONS A REASON TO RETURN TO EMERGING MARKETS DEBT?

Emerging markets (EM) debt have suffered a difficult first half of 2018 amid destabilizing geopolitical headlines alongside tightening monetary conditions in developed markets. However, widespread selling pressures have resulted in improved valuations, and, speaking broadly, many sectors of EM fixed income now sit at cheap-to-fair value levels relative to their history. So, are cheaper valuations a compelling enough reason to return to the asset class?

Certainly, valuations are more supportive, but the recent underperformance has also opened up a wider-than-usual value gap over developed markets investment-grade and high yield assets. Local currency assets are particularly cheap relative to other areas of fixed income. Average yields across local currency bonds are currently in excess of 6.50%, which is very attractive by most standards. Hard currency sovereign and corporate bonds also offer many compelling opportunities, with average spreads at their widest point in recent years.

Furthermore, the last time yields and spreads in EM were this attractive, fundamentals across the asset class were far less favorable. Today, however, the picture is much brighter. Even with a mild easing in EM economic growth and increased pressures on EM currencies, most EM countries are in a far better state to weather the headwinds of global volatility. Many economies benefit from well-contained levels of inflation, still solid growth, and central banks boasting healthy reserve levels.

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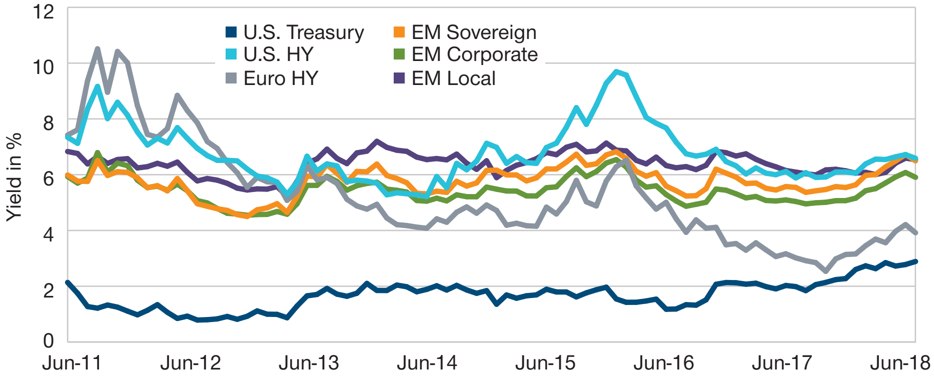
The diversity of EM debt is one of its primary benefits, and this is becoming even more important considering the recent divergence in global economic growth and monetary policy.

FIGURE 1: **Emerging Markets Yields vs. Core Markets**

As of July 31, 2018



U.S. Treasury: J.P. Morgan par 6yr Treasury rate data; EM Sovereign: J.P. Morgan Emerging Markets Bond Index Global (EMBIG); EM Corporate: J.P. Morgan Corporate Emerging Markets Bond Index Broad Diversified (CEMBI BD); EM Local: J.P. Morgan Government Bond Index–Emerging Markets Global Diversified; U.S. HY: J.P. Morgan Domestic HY Index; Euro HY: J.P. Morgan Euro HY Index.
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It is also important to remember that much of the volatility that sparked recent EM debt underperformance has come from external sources rather than internal ones. Monetary tightening in developed markets, political uncertainty, and concerns over global trade protectionism have weighed heavily on these markets even though underlying fundamentals remain supportive in most cases. However, we are more optimistic because markets are becoming more comfortable with these pressures and are now refocusing on the fundamentals of these markets. Therefore, rather than focusing on the recent underperformance, investors should instead search for opportunities to add to potentially oversold and now undervalued areas of EM. Encouragingly, we are finding many of these opportunities through our rigorous research.

For example, leading Latin American economies, Brazil and Mexico, suffered from political uncertainty as well as wider currency pressures earlier this year. However, the election of Andrés Manuel López Obrador in Mexico in early July has not been the market-negative event that many had feared, and the regional market has potential to stabilize, going forward, following a rocky first half. Brazil will also hold a general election later this year, and while the markets may see blips of volatility in the runup, we believe that improved valuations alongside better economic fundamentals make this market an attractive opportunity.

Meanwhile, on the credit side, well-managed companies across many EM geographies are continuing to enjoy increased earnings, improved balance sheets, and reduced external vulnerabilities. Additionally, default rates remain at cyclical lows. With this in mind, investors can now locate some of the best risk-adjusted value globally in high yield emerging markets corporate bonds while also benefiting from lower average duration. Getting more specific, we view the Asian credit markets as particularly compelling following the recent concerns over slowing growth in China. Now that the People's Bank of China is easing policy to ensure growth remains intact, this could offer an excellent buying opportunity in some of the sectors we favor, like Asian real estate and technology.

SELECTIVITY STILL ESSENTIAL

The diversity of EM debt is one of its primary benefits, and this is becoming even more important considering the recent divergence in global economic growth and monetary policy. However, structural difficulties within specific EM countries could result in some sectors and geographies continuing to underperform. For example, in Turkey, while both lira- and U.S. dollar-denominated corporate and sovereign bonds stand out as historically cheap, the longer-term policy direction of the government is likely to result in further weakness.

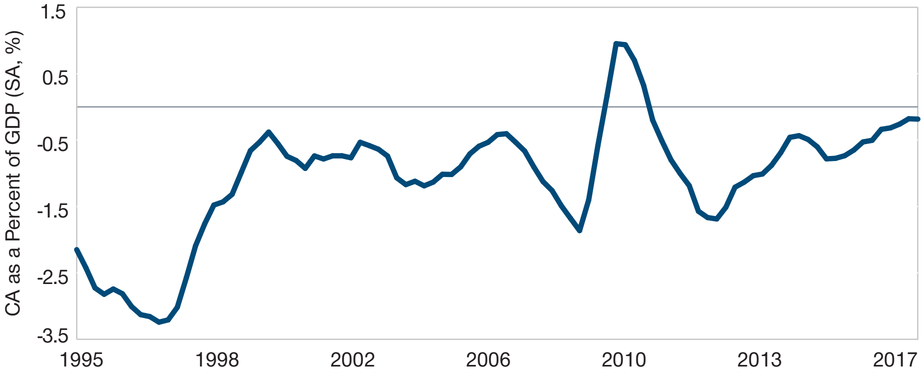
For this reason, it is essential to go beyond the numbers and identify areas of EM that exhibit both improved valuations as well as a commitment to implementing structural reforms and realizing long-term potential. South Africa stands out, in this regard, with the recent election of Cyril Ramaphosa as president. He is helping to drive structural reform, and we view both the rand and the country's sovereign debt as attractive as long as the country continues on its constructive path. Another example where improved valuations combine with favorable reforms is in Serbia. The country has strengthened its fiscal situation and there are strong signs that policy action is reducing their current account deficit meaningfully.

In Asia, constructive reforms in Indonesia and India underpin the case that the recent improvement in valuations forms an opportunity to buy local currency assets as well as dollar-denominated credit from these countries' markets.

EM debt is currently offering investors some of the most attractive opportunities in both its recent history as well as across the current global fixed income universe.

FIGURE 2: **EM Current Account Balance**

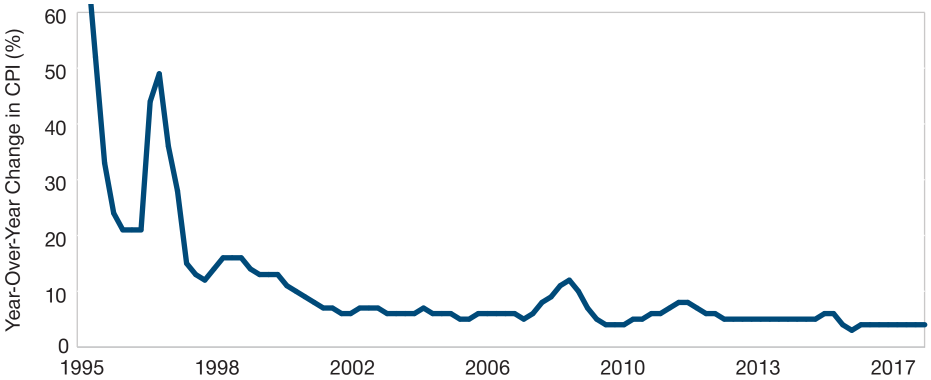
Four-quarter rolling average as of March 31, 2018



Current account (CA) balances include all available country constituents of the J.P. Morgan EMBIG and J.P. Morgan CEMBI BD.
Source: International Monetary Fund/Haver Analytics; data analysis by T. Rowe Price.

FIGURE 3: **EM Inflation History**

As of June 30, 2018



Source: International Monetary Fund/Haver Analytics; data analysis by T. Rowe Price.

RISKS ARE DIMINISHING

We recognize that risks remain in the coming months and that cheaper valuations alone may not be enough to provide shelter should a sustained period of risk aversion feature in the near term. The ongoing concerns regarding further escalations in global trade protectionism remain an issue that could have a negative impact.

However, even if 2017's global economic growth peak is gone, we believe that the wider macro backdrop within EM is more robust than the market tone currently reflects, trade wars notwithstanding. Election uncertainties that hung over markets earlier in the year are now largely past, and oil prices have stabilized.

While the headwind from U.S. monetary tightening and a stronger dollar will likely persist, much of the downside has now been priced into the market. Growth in the U.S. may ease in the second half following an above potential pace in recent months that would reduce the risk of the Federal Reserve tightening faster than expected. For us, investors should be focusing less on the developed market monetary tightening and a gradual slowdown in economic growth to focus more on the divergence between regions and countries to identify areas where still strong fundamentals stand alongside much-improved valuations. EM debt is currently offering investors some of the most attractive opportunities in both its recent history as well as across the current global fixed income universe. Rather than seeing the first-half weakness as a reason to turn away from EM, we see it as a window to employ a disciplined and global approach to find undervalued assets.

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