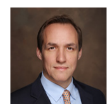
Five Reasons Why Investors Should Consider EM Local Bonds

Attractive yields and cheap currencies make the sector stand out.

November 2020



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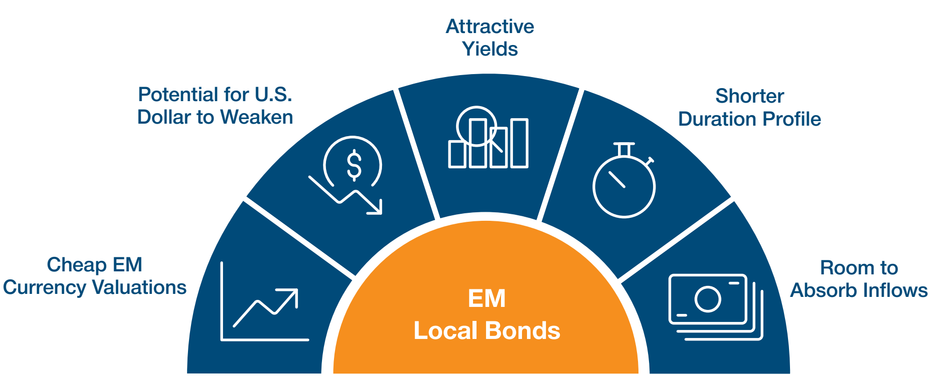
KEY INSIGHTS

- Emerging market (EM) currencies are bolstered by compelling valuations and the possibility of a turn in the U.S. dollar cycle.
- EM local bonds offer real income potential in a world of very low- and negative-yielding bonds across developed markets.
- Shorter duration profile and potential inflows are also supportive for EM local bonds.

With investors struggling to find much-needed yield for their portfolios, we believe a strong opportunity remains within emerging market (EM) local bonds. The yields on offer from a number of EM local bond markets are among the highest currently available in fixed income, while EM currencies are attractively valued and look set to benefit from the U.S. dollar cycle potentially turning. Below, we identify five factors that we believe support the case for this sometimes underappreciated asset class.

Why EM Local Bonds Could Shine



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Compelling Valuations in EM Currencies

EM currencies look attractive, in our view. The multiyear U.S. dollar bull run has driven developing currency values down significantly—indeed, according to our internal research model, EM currencies as an asset class were potentially as much as 18% undervalued (see chart) at the end of September. This is significant and suggests that there is ample room for EM currencies to appreciate against the dollar over the medium term. For this to happen, however, there will need to be a catalyst for U.S. dollar weakening—and we believe that catalyst is here.

U.S. Dollar Weakness a Potential Game Changer for EM Local Bonds

The U.S. dollar appears to be at a key inflection point. Several indicators, including an ultra-easy Federal Reserve, large internal and external imbalances, and the likelihood of a slow and volatile U.S. economic recovery, point to dollar weakness ahead. Such a scenario could see EM currencies finally turn the tide and start to appreciate against the dollar—and, as our research shows, there is some way to go before EM currencies even reach our estimates of fair value.

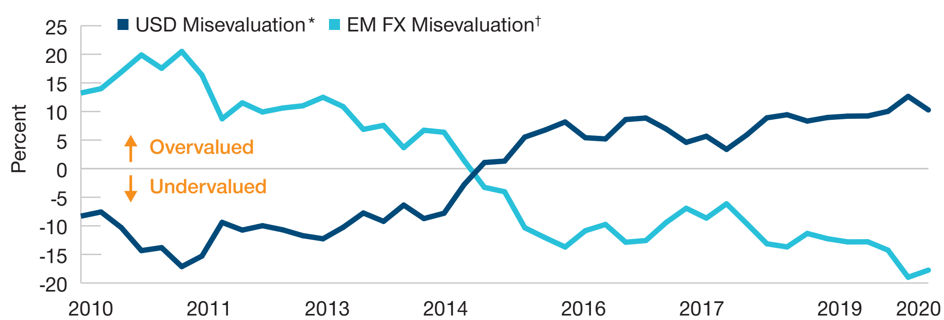
For EM local bonds, currency appreciation is also beneficial. Why? The return of EM local bonds is composed of three parts: an interest return component, a price return component, and an FX return component. When EM currencies strengthen against the U.S. dollar, that last factor will contribute positively to performance and typically will drive gains and flows into the asset class.

A Rare Find When It Comes to Yield

For investors, EM local debt offers an increasingly rare source of positive income in the fixed income space. Currently, there is more than USD 16 trillion[1] of negatively yielding

Attractive Valuations in EM FX

EM currencies appear to be undervalued against the U.S. dollar



As of September 30, 2020.
The T. Rowe Price Dynamic Equilibrium Exchange Rate model estimates the equilibrium value of a currency using relative terms of trade and productivity differentials as independent variables.
*USD Misevaluation: Average potential misevaluation of the U.S. dollar using our effective exchange rate model.
† EM FX Misevaluation: Average potential misevaluation of EM currencies using our effective exchange rate model based on their market weight in the J.P. Morgan GBI-EM Global Diversified Index (excluding Argentina), see Additional Disclosures.
For outputs below zero, the model is signaling that EM currencies are undervalued. Above zero, the model is signaling that EM currencies are overvalued.
This material is not intended to forecast or predict future events. Actual future outcomes may differ materially. Changing assumptions may yield different results.
Sources: BIS/Haver Analytics, analysis by T. Rowe Price.

[1] Source: Bloomberg Barclays Global Agg. Negative Yielding Debt Market Value in USD, as of October 31, 2020. See Additional Disclosures.

developed market debt. At the end of October, the average nominal and real[2] (inflation-adjusted) yields on developed market sovereigns[3] were just 0.9% and -1.4% respectively; by comparison, the average nominal and real yields on EM bonds[4] were 4.5% and 0.6%.

With major central banks expected to keep accommodative policies in place for some time, that picture is unlikely to materially change anytime soon. Against this backdrop, securing yield is likely to become increasingly important.

Attractive Duration Profile

It is not just a yield story. The lower-duration characteristics of EM local are also more favorable than developed markets, where the maturity of outstanding debt is longer. Why is this an attractive feature? Because the longer the duration, the greater the level of potential volatility and sensitivity to changes in interest rate rises. At the end of October, the average duration in EM local bonds[5] was 5.3 years compared with an average of 7.1 years for U.S. Treasuries[6] and 8.6 years for German bunds.[7]

Room to Absorb Investor Inflows

EM local bonds are still in recovery mode from the March sell-off. Investor outflows have not yet been fully recouped, in contrast to EM hard currency corporates and EM hard currency sovereigns, which have recovered more substantively. This means that there is still ample room to absorb investor inflows—and given that the asset class has been relatively underinvested for several years, there is some way to go before concerns emerge about excess inflows or a potential price bubble forms.

Taking these five factors into account, we believe the case for EM local bonds is very compelling. We believe it is much more than just an attractive yield story—the sector's duration profile and the potential to gain from EM currencies appreciating are also supportive. But it is important to take a long-term view because, like most risk assets, EM local bonds are vulnerable during periods of risk aversion. For now, though, the path ahead for risk assets looks a bit smoother with the U.S. election risk out of the way and progress being made on a vaccine for the coronavirus.

[2] Average real yields as measured by 5-year forwards less 1-year inflation expectations.
[3] Average U.S., Japan, and Eurozone yield. Source: Bloomberg (see Additional Disclosures).
[4] J.P. Morgan GBI-EM Global Diversified Index (see Additional Disclosures).
[5] Average modified duration in the J.P. Morgan GBI-EM Global Diversified Composite Index.
[6] Average modified duration in the Bloomberg Barclays US Aggregate Treasury Index.
[7] Average modified duration in the Bloomberg Barclays Global: Germany Unhedged USD Index.

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