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EMERGING MARKETS DEBT | GLOBAL INVESTING

# Inflation, Rising Rates, Ukraine Conflict Take Their Toll on EM Debt in 2Q

*By: Emerging Markets Debt | July 15, 2022*

**Boston** - The sell-off in emerging markets debt (EMD) continued through the second quarter along with the majority of global capital markets. Stocks and bonds generally moved in tandem, as markets continued to price in the potential for the end of the "easy money" era of the past decade.

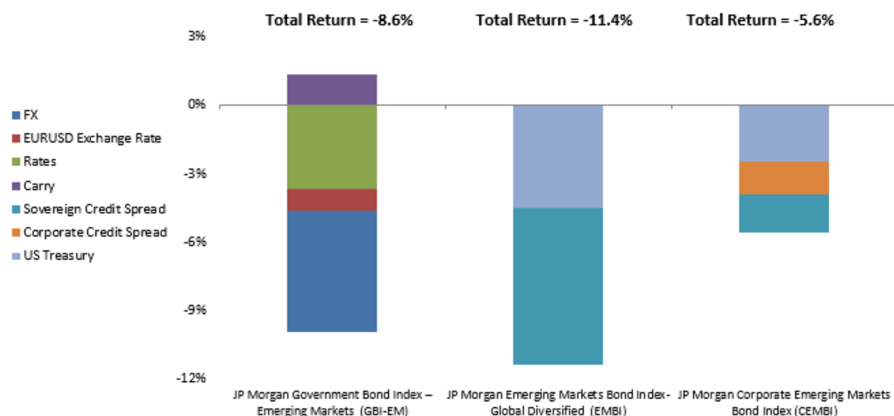
Inflation remained a key issue in just about every country, and central banks have largely been forced to react with increasingly hawkish policy stances. Higher food and energy prices, a second-order effect of the devastating war in Ukraine, continued to divert more consumption toward necessities and away from global discretionary spending and investment.

While we observed some easing of China's zero-COVID policy, it continues to create challenges for global supply chains and remains a drag on the world's second-largest economy. This combination has led investors to more seriously consider the likelihood of recession in the near term — a slowdown in which EMD markets will likely not be spared.

Outflows year to date are at all-time highs for both local- and hard-currency funds, which is reflective of the problems in the market and macro environment.

- Corporate EM debt, while losing 5.6%, was the best-performing EMD sector. Its relative outperformance reflected its country makeup — being more heavily tilted toward Latin America — as well as its higher-quality profile and the underlying relative strength of the issuers.
- EM local-currency debt lost 8.6%, weighed on by the broad rally in the U.S. dollar, while local interest rates generally also moved higher, in keeping with the global trend.
- Dollar-denominated, hard-currency debt was the worst-performing segment, with a loss of 11.4%. Spreads broadly continued to widen, and more countries saw their bond prices move toward distressed levels. Rising U.S. Treasury yields also hurt the sector, given the relatively long U.S. duration profile of most issues.

**War and rising rates continue their double whammy for EMD**




Sources: JP Morgan, Morgan Stanley Investment Management as of 6/30/22. The vertical axis reflects the amount contributed by each factor to total return-adding the bars above 0% and below 0% (negative numbers) results in the total return in the headline. FX is the gain or loss in the GBI-EM from currency changes relative to the U.S. dollar. EURUSD reflects the portion of currency movement in the GBI-EM that is explained by the change of the euro versus the U.S. dollar. Rates refers to the contribution of change in local-currency interest rates in the GBI-EM. Carry refers to the risk-free returns in each GBI-EM country that cannot be attributed to FX, EURUSD or rates. Sovereign Credit Spread refers to the spread above U.S. Treasurys in the EMBI paid by a country. Corporate Credit Spread is the spread above the sovereign spread paid by an EM corporate issuer. U.S. Treasury refers to the contribution to return in the EMBI and CEMBI (both dollar-denominated indexes) due to interest-rate changes on the U.S. Treasury.

**Looking ahead**

Through the remainder of 2022, we are optimistic on EMD, as valuations appear to be well compensating investors for the risk.

- The macroeconomic environment is challenging for all areas of capital markets, but it appears EM investors have already priced this in better than most.
- Inflationary pressures, and corresponding central bank reactions, remain the most important factor for the asset class. Commodity prices are likely to be the largest driver here and something we are watching closely.
- No end appears in sight for the devastation in Ukraine, or the impact on food and energy prices.
- China appears to be easing policy on the margin and moving slightly off its strict, zero-COVID policy. Reformers may make gains during the Party Congress in a few months, but President Xi's power remains unquestioned.
- While COVID continues to wreak havoc on lives and livelihoods, many countries have learned to live with the virus, and it appears to no longer be the most important factor in most countries.

**Bottom line:** We expect markets to continue emphasizing differences among countries and credits. That creates investment opportunities for those with research capabilities and due diligence that are up to the task. That is why we focus on country-level macroeconomic and political research, and stand-alone analysis of specific risk factors such as currency, credit spreads and interest rates — an approach we have followed for more than two decades.

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Emerging Markets Debt
Morgan Stanley Investment Management

"Second-order effects from the devastating war in Ukraine along with strict COVID policies in China contributed to inflation levels and negatively affected global growth and EMD performance. Outflows year to date are at all-time highs for both local- and hard-currency funds, which is reflective of the problems in the market and macro environment."

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