EMERGING MARKETS

EM debt rebounded strongly in the second quarter

By: Emerging Markets Debt Team | July 14, 2020

Boston - The second quarter represented a dramatic rebound for financial markets, including emerging markets, after the severe sell-off in March. COVID-19 continues to pose a generational challenge to the lives and livelihoods of some of the world's most vulnerable people.

But at the same time, investor sentiment was buoyed by the massive policy responses around the world and the perception that a lot of the bad news was already reflected in lower asset prices, resulting in broadly compelling valuations. The positive tone was reinforced by high investor cash levels and the easing of lockdown measures, which convinced many investors that peak uncertainty is likely past and that forthcoming economic surprises are likely to be to the upside.

The three main EMD indexes experienced significant gains during the quarter, with FX, local rates, sovereign credit spreads and corporate credit spreads all rallying (see chart).

Every EM debt risk factor turned sharply positive in 2Q

Sources: JP Morgan, Eaton Vance as of 6/30/20. 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 US dollar. **EURUSD** reflects the portion of currency movement in the GBI-EM that is explained by the change of the euro versus the US 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 US Treasurys in the EMBI paid by a country. **Corporate credit spread** is the spread above the sovereign spread paid by an EM corporate issuer. **US Treasury** refers to the contribution to return in the EMBI and CEMBI (both dollar-denominated indexes) due to interest-rate changes on the US Treasury.

- Local-currency sovereign debt, as measured by the JP Morgan Government Bond Index - Emerging Markets (GBI-EM), gained 9.8%, largely as a result of strong FX and interest-rate performance.
- External sovereign (dollar-denominated) debt, as measured by the JP Morgan Emerging Markets Bond Index - Global Diversified (EMBI), advanced 12.3%, thanks to significant compression of sovereign spreads over US Treasurys.
- EM corporate debt index gained 11.15%, as measured by the JP Morgan Corporate Emerging Market Bond Index (CEMBI), on the strength of big gains from both corporate and sovereign spread compression.

Looking ahead

From a macro perspective, easy monetary and fiscal policies from the world's major central banks will likely provide support for the asset class as will the low yields available in core sovereign bond markets (USTs, bunds, etc.).

As the financial shocks from COVID-19 and oil settle in, focus has turned to individual country fundamentals. While the rally in Q2 was broad, differentiation among countries was evident, based on varying policy responses and resulting economic outcomes, and the reverberations will continue over the rest of the year throughout the world.

Many EM countries cannot afford to remain on lockdown and we are seeing continued reopenings, for better or worse. The trouble spots that we have identified in the past, like Lebanon, Argentina, Zambia, Ecuador and Sri Lanka, remain under significant pressure and we expect additional countries to be added to the list.

Bottom line: We entered the quarter cautious, turned bullish midquarter, and are now more neutral overall. Pockets of opportunity still remain in the EM sector, but professional due diligence and selectivity remain more important than ever for taking advantage of them.

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***J.P. Morgan Emerging Markets Bond Index (EMBI)** Global Diversified is an unmanaged index of USD-denominated bonds with maturities of more than one year issued by emerging markets governments.*

***J.P. Morgan Government Bond Index-Emerging Markets (GBI-EM) Global Diversified** is an unmanaged index of local-currency bonds with maturities of more than one year issued by emerging markets governments.*

***J.P. Morgan Corporate Emerging Markets Bond Index (CEMBI) Broad Diversified** is an unmanaged index of USD-denominated emerging markets corporate bonds.*

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