Macro factors remain strong for EM debt after 1Q21 sell-off

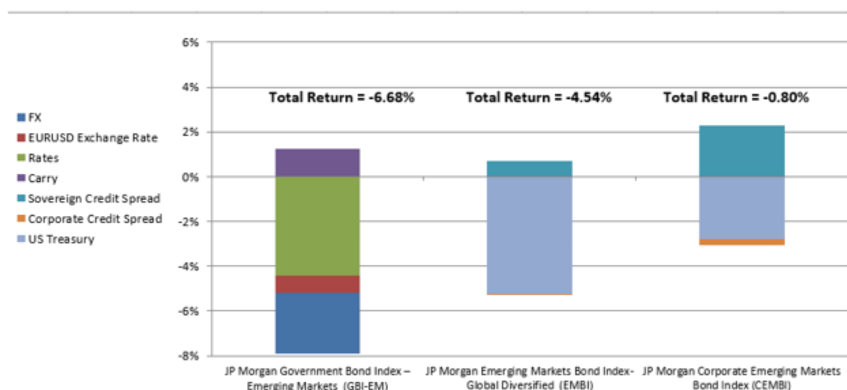
By: Emerging Markets Team | April 14, 2021

Boston - Emerging markets debt (EM debt) stumbled out of the gates in 2021, producing negative returns across the asset class during the first quarter. We came into the new year expecting that the macro backdrop would be broadly supportive of the asset class, but the backup in real rates in the U.S. undermined this view, for the time being.

The rate backup led to an extremely volatile and, at times, somewhat disorderly environment, which proved too much for EM debt, particularly local rates and currencies. Fundamentals continued to improve broadly along with prospects for the global economy and generally higher commodity prices. But these net positives were easily eclipsed by the negative macro environment —thedominant factor for most EM debt investors. (See table below.)

- EM local-currency debt was hit by a double whammy. In many countries, real rates rose even further than in the U.S., depressing prices. EM currencies were also hit notably by the broad, strong U.S. dollar environment, and the sector lost 6.7%.
- Dollar-denominated, hard-currency debt had sovereign spreads tighten to U.S. Treasurys, but the rise in U.S. rates overwhelmed that, resulting in a negative 4.5% return.
- Corporate EM debt held its own, as tightening sovereign spreads gave it a sizable boost. But it was offset by rising rates, and the sector had a small loss for the quarter.

The backup in US rates drove losses in EM debt in 1Q21



Sources: JP Morgan, Eaton Vance as of 3/31/21. 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. **US 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.

Despite the sell-off, inflows into EM debt remained robust, with approximately $29 billion during the quarter, continuing to provide strong technical support for the asset class amid the global search for yield. The new-issuance market remained wide open, maintaining broad market access for countries across the credit quality spectrum.

Looking ahead

- We don't believe the absolute level of U.S. Treasury yields is problematic for EM debt. The biggest issue in the first quarter for EM debt was the rapid, sharp increase in rates. Yields across developed markets remain low and, combined with ballooning deficits in the U.S., the U.S dollar is likely to resume weakening.
- While COVID-19 remains the dominant macro factor for markets and individuals, many EM countries have learned to live with it. The vaccine is a positive development, even though the timing of distribution to many EM countries is still a question.
- Oil and commodities, more broadly, continued their rally from the end of 2020 and have improved the economic dynamics in many countries.
- The potential for crossover buyers into EMD, along with broad interest in the higher yields available in the asset class, will continue to provide support.
- While the EM debt outlook remains rosy, we will see more defaults and a reminder of the differentiation that exists across the universe.

Bottom line: The first quarter sell-off increased the yield advantage offered by EM debt compared with developed markets, while the macro picture remains broadly positive for the sector. With proper due diligence and attention to country-specific risk, we believe EM debt deserves careful consideration from investors.

Data provided is for informational use only and should not be considered investment advice. Information has been obtained from sources believed to be reliable, but JP Morgan does not warrant its completeness or accuracy. The Indexes are used with permission. The indexes may not be copied, used, or distributed without JP Morgan's prior written approval. Copyright 2019, JP Morgan Chase & Co. All rights reserved.

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.*

Emerging Markets Team
Eaton Vance Management

"We don't believe the absolute level of U.S. Treasury yields is problematic for EM debt. The biggest issue in the first quarter for EM debt was the rapid, sharp increase in rates. Yields across developed markets remain low and, combined with ballooning deficits in the U.S., the U.S dollar is likely to resume weakening."

The views expressed in these posts are those of the authors and are current only through the date stated. These views are subject to change at any time based upon market or other conditions, and Eaton Vance disclaims any responsibility to update such views. These views may not be relied upon as investment advice and, because investment decisions for Eaton Vance are based on many factors, may not be relied upon as an indication of trading intent on behalf of any Eaton Vance strategy. The discussion herein is general in nature and is provided for informational purposes only. There is no guarantee as to its accuracy or completeness.

Eaton Vance is part of Morgan Stanley Investment Management, the asset management division of Morgan Stanley

The information on this Web site is for U.S. residents only. The information on this Web site does not constitute an offer to sell, or a solicitation of an offer to purchase, securities in any jurisdiction to any person to whom it is not lawful to make such an offer.

There are no guarantees regarding the achievement of investment objectives, target returns, portfolio construction, allocations or measurements such as alpha, tracking error, stock weightings and other information ratios. The views and strategies described may not be suitable for all investors. Not all of Eaton Vance's recommendations have been or will be profitable. Eaton Vance does not provide tax or legal advice. Investing entails risks and there can be no assurance that Eaton Vance (and its affiliates) will achieve profits or avoid incurring losses. Prospective investors should consult with a tax or legal advisor before making any investment decision.

NOT FDIC INSURED | OFFER NO BANK GUARANTEE | MAY LOSE VALUE | NOT INSURED BY ANY FEDERAL GOVERNMENT AGENCY | NOT A DEPOSIT

© Eaton Vance Management. All rights reserved. Two International Place, Boston, MA 02110.