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Emerging Markets Debt

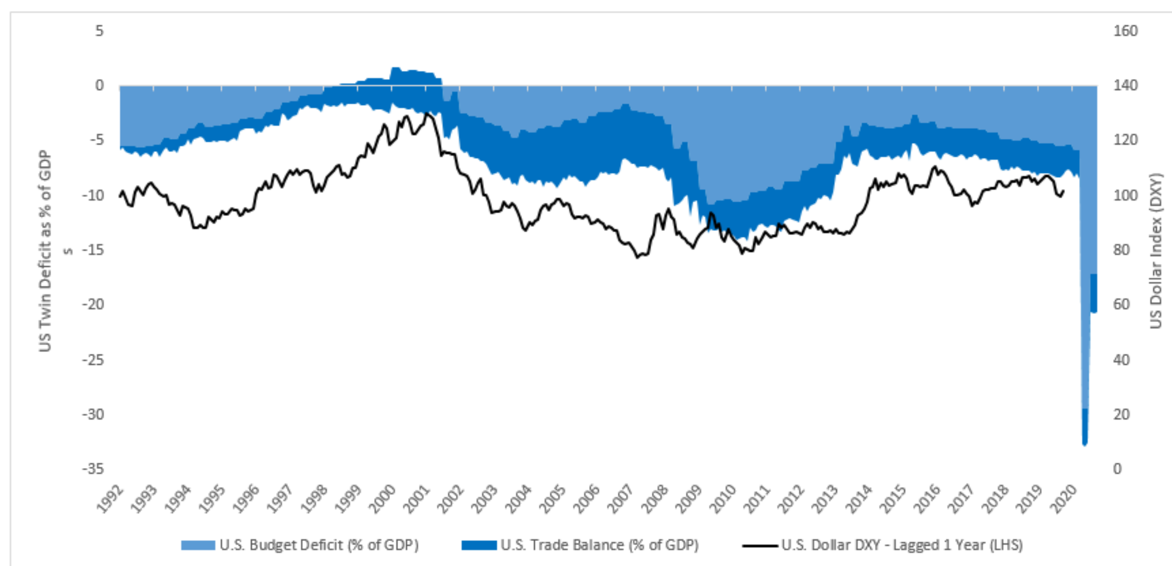
EM local currencies poised to be a major driver of EM debt returns

By: Emerging Markets Team | February 2, 2021

Boston - With the tremendous resurgence of global capital markets since March, fueled by monetary and fiscal stimulus, very few sectors can claim to have broadly attractive valuations. In our view, emerging markets local currencies (EM FX) stand as one of those attractive few. But value opportunities also need catalysts for their potential to be realized, and the case for EM FX has those as well, based on fundamentals, macro environment and technical support. Consider:

- Valuations remain cheap relative to most assets. EM FX lagged most risky assets in the post-March 2020 rebound. Last year, the FX component of the JP Morgan Government Bond Index-Emerging Markets (GBI-EM) Global Diversified was down over 7% in USD terms. Even as recently as November, many EM currencies were still trading at 2020 lows.
- Fundamentals are improving. EM economic growth is leading the global economic recovery - EM economies did not shut down to the same degree in the initial response to COVID-19, and they are not shutting down as aggressively now with additional waves, either. Global trade and EM exports have both recovered to "pre-COVID" levels. And the big rally in oil prices and commodities more broadly have improved the economic dynamics in many countries, and EM exports have already rebounded to pre-COVID levels.
- The macro environment is conducive. Developed-market monetary policies will continue to anchor core interest rates at extremely low levels, including $18 trillion of negative-yielding debt. Combined with massive fiscal stimulus in many countries, the global economy is likely to remain awash in liquidity. Further, when deficits balloon the way they have recently, historically that has led to a weaker USD. The chart below shows the correlation between the twin U.S. deficits (budget and trade) with the USD. The USD line is lagged by a year to highlight how the path of the deficits has often been a predictor for the path of the USD. If previous patterns hold, the sharp increase in the deficits could indicate further sharp erosion of USD.
- Technicals likely to remain supportive. Investors have been allocating into EM debt, including crossover buyers seeking to better the ground-hugging yields available in other sectors. Yet we believe this trend has plenty of steam left, given that cash flow into the sector didn't turn positive until the end of last year. Until that inflection point, following the start of the pandemic in March, outflows from the sector were the largest on record.

US "twin deficits" appear to be signaling a weaker US dollar



Sources: IMF, Macrobond, Eaton Vance, as of September 1, 2020 (for twin deficit data) and December 1, 2020 (for U.S. dollar index data).

From a societal perspective, positive flows into the sector can only help EM countries struggling with COVID-19, which continues to wreak havoc on lives and livelihoods. EM countries vary widely in their ability to navigate the associated economic challenges, with a growing roster of defaults and debt restructurings making selection critical. But, again, we remain broadly constructive on the space.

Bottom line: EM FX is likely to be a powerful factor driving EM debt returns this year. With proper expertise, due diligence and attention to country-specific risk, we believe EM debt deserves careful consideration from investors.

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"Emerging markets debt - and specifically emerging markets currencies (EM FX) - stand as one of few attractively valued assets in today's capital markets. But value opportunities also need catalysts for their potential to be realized, and the case for EM FX has those as well, based on fundamentals, macro environment and technical support."

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