Emerging Markets: How Structural Shifts are Leading to Strong Tailwinds

Prior to the onset of COVID-19, much had been written about the appeal of emerging market debt (EMD), touting the yield advantage as well as its lower correlation to other fixed income asset classes. EMD has underperformed since then, leaving investors in Switzerland and beyond to wonder if and how EMD fits into their asset allocation. After a difficult start to the 2020s, we believe EM debt is now poised to outperform as headwinds from sharp increases in interest rates and slower growth are now reversing course. Thus, the tailwinds from lower rates, higher growth, and improving credit quality are setting the table for positive EM performance going forward.

The Maturation of EM Economies

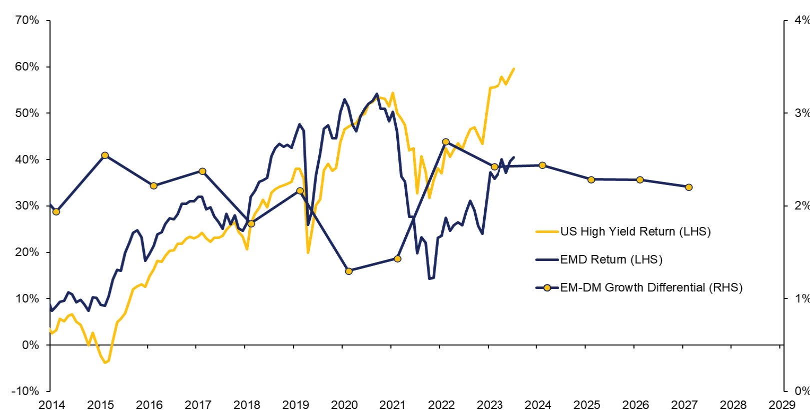
The reversal of inflationary pressures has led many EM central banks to begin rate cutting cycles. At the same time the tailwinds that have been powering EM growth for years are nearing a tipping point as many EMs move from maturing to matured. While some weaker emerging markets have suffered, most emerging market economies have remained quite resilient from a fundamental standpoint. This is a result of better policy implementation by emerging market governments and central banks, as well as exports' boost to growth and current account surpluses.

Emerging markets are not only home to the fastest growing countries, but they also control the majority of the world's GDP. In 2007, emerging markets overtook developed markets share of global GDP as China's rapid growth after 2000 drove significant gains. Since then, EM has only continued to widen that gap. Excluding China, emerging markets' share of global GDP is expected to overtake developed markets this year.

How much faster emerging markets are growing than developed markets has historically been the largest driver of returns in EM. Looking at it from a Fixed Income perspective, when EM/DM growth differentials have been above 2%, EMD has historically outperformed U.S. high yield. When that growth differential dipped below 1.5% in 2021 and 2022, EMD underperformed strongly, primarily due to the severity of successive shocks post-COVID.

That said, the consensus view is for emerging markets to regain their growth premium going forward—well above that important 2% figure and to remain above 2% for the foreseeable future (Fig. 1), making the asset class an attractive investment target for long-term investors.

Figure 1



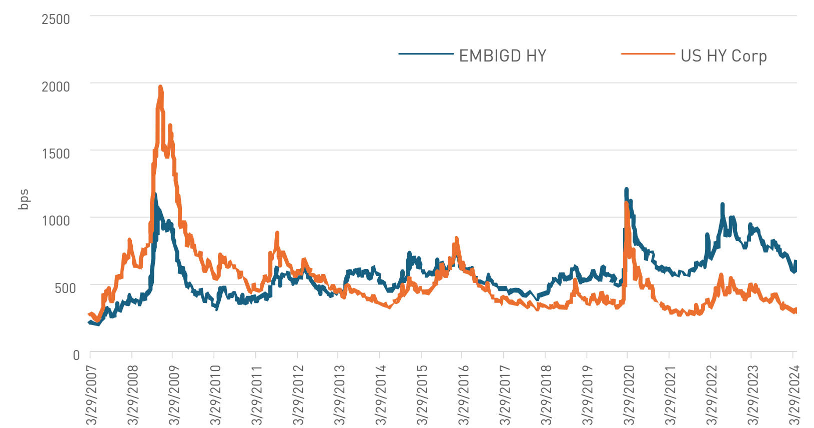
Sources: Growth data IMF as of October 2023. Returns data Bloomberg as of June 30, 2024. The forecasts begin April 2024. The forecasts presented herein are for informational purposes. There can be no assurance that these forecasts will be achieved.

From Headwinds to Tailwinds

With DM fixed income spreads generally at the tighter end of their historic range, EM debt currently appears to offer value. Looking forward, we expect returns for hard currency sovereigns to be highly positive under all but a small subset of our projected economic scenarios. Current yields (actual cashflows generated) in hard currency sovereigns are near 6.25%, which provides a significant cushion for any near-term spread volatility or potential rise in U.S. Treasury yields. Conversely, we believe just a realistic amount of spread tightening or Treasury yield compression would take EM hard currency returns into the double digits.

While the investment grade portion of the hard currency sovereign market appears fairly valued, it currently offers an attractive spread pick-up versus U.S. investment grade corporates. Given our belief that we are past the peak of financial distress, we also see meaningful value in hard currency high yield, which trades near the wides versus its historic relationship with U.S. high yield (Fig. 2). Although EM corporate spreads have tightened and are now well through their historical average, we believe the outlook is still favorable given the ~7% yield on the asset class, resilient fundamentals, and supportive macroeconomic conditions. The maturity wall of 2025 and 2026 has been extended, and we expect EM corporate high yield defaults to remain within the historical range of 3-4%, or in-line with developed markets.

Figure 2



Source: Bloomberg, Bank of America, and JPMorgan.

Within local markets, our conviction is growing that more EM central banks will be cutting rates in the second half of 2024. At current levels, the yield on the local rates benchmark is still near the top end of its year-to-date range of 6.10-6.65%. Fed rate cuts in the second half of the year could provide a further tailwind to the asset class.

In EMFX, we remain cautious and maintain long positioning in the U.S. dollar as the Fed appears set to take a relatively gradual approach. However, over the medium to longer term, we see opportunity for EM currencies to generate strong returns against the U.S. dollar as many have meaningfully repriced since 2012.

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