Emerging Markets Debt: Where do we go from here?

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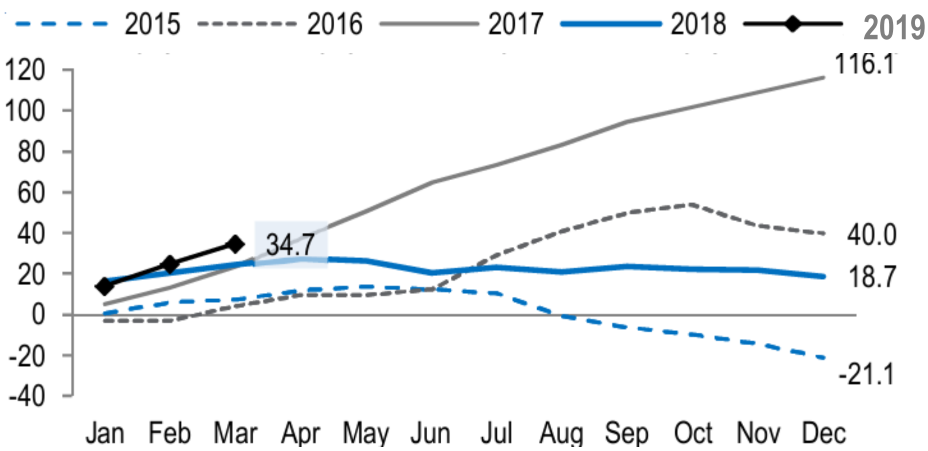
Following a sharp sell-off in 2018, this year has seen a welcome reversal for the Emerging Markets Debt (EMD) asset class with positive returns and strong inflows. A more dovish US Federal Reserve, ongoing US-China trade negotiations and a rebound in oil prices have all helped fuel investor risk appetite.

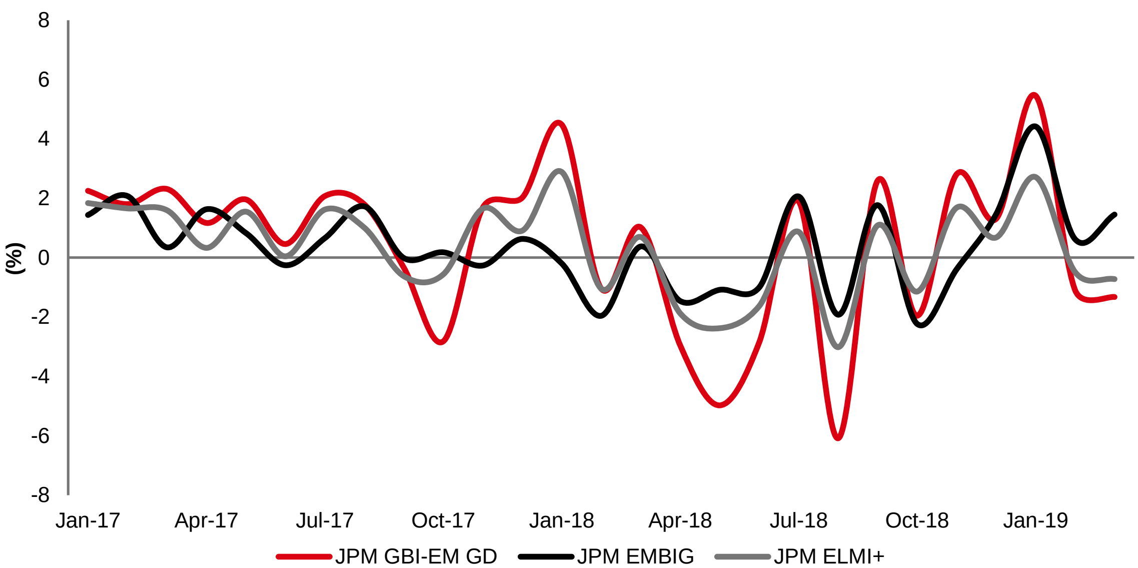
Through March 2019, over $34.7 billion flowed into EMD markets (see Figure 1). This, combined with a manageable EM supply calendar has contributed significantly to the robust returns. The EMD hard currency index (JPM EMBIG) returned 6.59% in Q1 2019 and the EM local debt index (JPM GBI-EM GD) returned 2.92%. (See Figure 2.) Overall, we believe returns in both the EM hard currency and local debt space should continue to outpace those of developed markets in 2019.

Figure 1: Flows into EMD 2015 – Q1 2019



A number of factors have supported the performance rebound in EMD this year, including cheaper valuations, largely sound fundamentals, appropriate macro-economic policies and resilient-though-moderate growth. However, the key element for this turnaround has been the pivot from the Fed to a much more dovish stance in January. This shift supports our view that EMD hard currency and local debt assets can continue achieving positive performance through to the end of 2019.

Figure 2. Returns for EM hard currency and local debt: 2017 – Q1 2019



Source: JPMorgan, HSBC Global Asset Management, as of March 31, 2019.

Expected returns—remainder of 2019

EM local debt

The Fed's pause in rate hikes has reduced the risk of sharp yield increases—an important positive for EM local debt assets. With this supportive backdrop, we think that there is potential for further yield compression for EM local debt (as captured by the JPM GBI-EM GD index), particularly as inflation pressures in EM appear benign (with a few exceptions) and real rates remain elevated.

We think that EM local currencies remain appealing because of their cheaper valuations following the 2018 sell-off where they fell 11% on average driven by the stronger US dollar. Absent a major extraneous shock, we do not anticipate the already-overvalued USD to appreciate further and, as such, EM currencies could see modest appreciation in addition to the 4.5% carry on the currency index (as represented by the JPM ELMI+ index) for the remainder of 2019.

In summary, a blended EM local rates and currency benchmark (50% JPM GBI-EM GD / 50% JPM ELMI+) could experience a return between 5.5 % to 6.5% % for the remainder of 2019.

EMD hard currency

For EM hard currency debt, a supportive macro environment and more dovish central bank policies in developed markets should help suppress volatility. The technical picture—with muted new issuance levels and strong inflows—should also reinforce this positive backdrop. Over the course of 2019, we expect spreads on EM hard currency debt assets to experience further compression (in the 25-30 basis point range) from their current level at close to 370 bps. Also, with the Fed's "patience," we anticipate US 10-year Treasury yields will remain range-bound between about 2.5%-2.75%. In terms of negative pressures on the asset class, with the sharp decline in Treasury yields that occurred in March, there may be some negative impact on duration with a retracement from the March month-end level of 2.40%. In addition, we recognize that inflows and the subsequent spread compression have been fairly outsized so far this year and we would not be surprised by a slowdown in inflows for the balance of the year, or by a pickup in issuance.

In summary, we expect EM hard currency debt will capture the yield (4.65%) for the rest of 2019, plus some appreciation from spread compression, resulting in a potential return of 5%-6%. On top of Q1 2019's return of 6.5%, the EM hard currency debt asset class could end the year with a total return in the low double digits.

Expected returns longer-term—next 3 years

The long-term investment case for EMD also remains decidedly positive. In our scenario analysis for long-term return expectations, we assume a moderate rise in developed markets (DM) rates of +25 basis points over the next three years—given the central banks easing across the globe. This is our baseline view on DM rates; impacts for higher and lower rate hikes are also shown.

In this base case, the EMD hard currency universe (ex-Venezuela)[1] could generate an annualized return of 5.83% in each of the next three years—mainly from its attractive yield. We assume that spreads will fluctuate over the next three years, but expect that they will remain close to current levels and should have little impact on longer-term return projections.

Figure 3: Annualized 3-yr returns for EM hard currency debt (ex-Venezuela)
Gradually rising DM rates and no EM spread change

Hard Currency- Ex Vene - Annualized 3 Year Returns

	Germany	Japan	US	EM Ext
-100	4.00	3.53	5.77	8.58
-50	2.37	1.90	4.33	7.48
-25	1.55	1.08	3.61	6.93
0	0.74	0.26	2.88	6.38
+25	-0.08	-0.55	2.16	5.83
+50	**-0.90**	**-1.37**	**1.44**	**5.28**
+100	**-2.53**	**-3.00**	**-0.01**	**4.18**
+150	**-4.17**	**-4.64**	**-1.45**	**3.08**
+200	-5.80	-6.27	-2.90	1.98

The EM local debt universe[2] could generate an annualized return of 7.32% over the next three years in this scenario, generated from its attractive yield as well as from some compression (see Figure 4). We assume that the yield differential between EM local debt and DM could compress by approximately 50bps in the three year period due to the wide yield variance seen today. Further, this analysis does not include the potential for EM currency spot changes which could serve as an additional lever for increasing local debt returns as we believe the US dollar is currently overvalued.

Figure 4: Annualized 3-yr returns and 50bps spread change
Gradually rising DM rates and EM yield differential -50bps

Local Debt – Annualized 3 Year Returns

bps	Germany	Japan	US	EM Local
-100	4.00	3.53	5.77	9.45
-50	2.37	1.90	4.33	8.60
-25	1.55	1.08	3.61	8.17
0	0.74	0.26	2.88	7.75
+25	-0.08	-0.55	2.16	7.32
+50	**-0.90**	**-1.37**	**1.44**	**6.90**
+100	**-2.53**	**-3.00**	**-0.01**	**6.05**
+150	**-4.17**	**-4.64**	**-1.45**	**5.19**
+200	-5.80	-6.27	-2.90	4.34

1. Note that we use the JPM EMBIG index but exclude Venezuela due to its idiosyncratic risks and subsequent potential impacts on the index yield.
2. We use the JPM GBI-EM GD index as a proxy for the EM local debt universe.

Source: HSBC Global Asset Management, Bloomberg. Germany, Japan and US performance based on 10y bond, EM Ext performance based on JPM EMBIG Ex Vene index, EM Local performance based on JPM GBI-EM Gb Div index. Scenarios shown are hypothetical and do not represent actual investment accounts. Results are provided for illustrative purposes only and are no guarantee of future performance. Hypothetical examples have many inherent limitations and are generally prepared with the benefit of hindsight. In addition, there can be sharp differences between hypothetical results and actual results. Past performance is no guarantee of future results.

Both EMD asset classes offer attractive return profiles for the next three years, given their high relative yields and the supportive macro backdrop. To put this into context, fixed income assets in Germany and Japan are likely to deliver negative annualized returns in the same scenario environment, while the U.S. would provide significantly lower returns than either EM hard or local debt. It is important to note, however, that these are return expectations based on a steady state. Although we do not foresee a recession in 2019-2020, we should remain keenly aware that the possibility exists and would clearly be negative for risk assets, including EMD.

Conclusion

We believe the current macro environment is supportive for EMD assets in 2019 and beyond.

The asset class should provide investors with an attractive risk premium over its DM counterparts. 2018's "re-pricing" of EMD, which led to cheaper valuations, continues to provide an attractive entry point for investors and the yield differential between EM and DM fixed income remains compelling. Even amid moderating global growth, we believe the stabilization in oil prices, some remediation in trade tensions along with certain stimulus measures in China and the Fed's pause in rate hikes should support risk assets including EMD.

- EM hard currency debt. Following the sell-off in 2018, hard currency spreads widened significantly and entered 2019 at their widest levels since the commodity collapse of 2014/2015. While Q1 2019 brought some recovery, we remain positive on the asset class and continue to find attractive segments—particularly in the high yield sector.
- EM local currencies. EM local currencies have also become more attractive following 2018's underperformance. As EM central banks have been raising rates in line with, or ahead of, the Fed, the carry trade has improved, and currently offers a compelling risk-adjusted return.
- EM local rates. We see opportunities in EM local debt given the attractive real yield compensation currently available. However, one must exercise caution in EM local debt. While inflation appears under control, the rate hike agendas adopted across many EM countries have produced rising yields to compensate investors. We are highly selective, targeting countries with high real yield compensation and steeper yield curves.

Volatility will continue to present challenges to this generally favorable environment. Idiosyncratic factors will certainly play their role in lifting volatility with an extensive upcoming EM election calendar (e.g., in Argentina, South Africa, India and Indonesia) and with the continuation of geopolitical tensions in the Middle East.

We continue to see significant divergence among EMD constituents so that careful discrimination between specific countries and regions remains key to driving alpha. Consequently, we will be dynamically positioned to take advantage of any bouts of idiosyncratic volatility while mitigating portfolio risk for the challenges that may well emerge.

Source: HSBC Global Asset Management, as of March 31, 2019. The views expressed were held at the time of preparation and are subject to change without notice.

Key Risks

There is no assurance that a portfolio will achieve its investment objective or will work under all market conditions. The value of investments may go down as well as up and you may not get back the amount originally invested. Portfolios may be subject to certain additional risks, which should be considered carefully along with their investment objectives and fees.

- Exchange Rate Risk Changes in currency exchange rates could reduce or increase investment gains or investment losses, in some cases significantly.
- Counterparty Risk The possibility that the counterparty to a transaction may be unwilling or unable to meet its obligations.
- Liquidity Risk is the risk that a Fund may encounter difficulties meeting its obligations in respect of financial liabilities that are settled by delivering cash or other financial assets, thereby compromising existing or remaining investors.
- Operational Risk may subject the Fund to errors affecting transactions, valuation, accounting, and financial reporting, among other things.
- Derivatives Risk Derivatives can behave unexpectedly. The pricing and volatility of many derivatives may diverge from strictly reflecting the pricing or volatility of their underlying reference(s), instrument or asset.
- Emerging Markets Risk Emerging markets are less established, and often more volatile, than developed markets and involve higher risks, particularly market, liquidity and currency risks.
- Interest Rate Risk When interest rates rise, bond values generally fall. This risk is generally greater the longer the maturity of a bond investment and the higher its credit quality.
- Default Risk The issuers of certain bonds could become unwilling or unable to make payments on their bonds.
- Credit Risk A bond or money market security could lose value if the issuer's financial health deteriorates.
- CoCo Bond Risk Contingent convertible securities (CoCo bonds) are comparatively untested, their income payments may be cancelled or suspended, and they are more vulnerable to losses than equities and can be highly volatile.

Important Information

The **JP Morgan EMBI-Global (EMBIG) Index** includes USD-denominated Brady bonds, Eurobonds, and traded loans issued by sovereign and quasi-sovereign entities, and is a traditional market-capitalization weighted index. The **JP Morgan GBI-EM Diversified Index** provides a measure of local currency denominated, fixed rate, government debt issued in emerging markets. Weightings among the countries are more evenly distributed within the diversified index compared to it's three main composite indices consisting of the GBI-EM, GBI EM Global, and GBI EM Broad indices. The **JP Morgan ELMI+** Index is an emerging markets currency (FX) benchmark; the index contains more countries and also brings in the currency aspect of the market, which is an important component of our strategy.