Insights
Fixed Income

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Weathering the Storm in Emerging Markets

SPDR EMEA Strategy & Research

- Emerging markets have come under pressure as the crisis has unfolded, with the reasons varying by country.
- Some moves have been driven by FX and others by bond returns, making it a difficult channel to navigate and highlighting the importance of index construction.

Overview of Recent EMD Performance

Emerging market debt (EMD) has suffered during the recent global turmoil for multiple reasons. First, it has been considered a risk asset and so has seen investors exiting it for safer investments, even though many key central banks have cut rates and started their own asset purchases. Second, the grab for yield and relatively strong performance of emerging market funds meant investors were fairly 'long' EM investments ahead of the turmoil. Third, for local currency debt there has also been the double impact of the aggressive bounce in the USD. Last, many emerging markets have economies that are heavily exposed to commodities and suffered, in particular, when oil prices fell sharply.

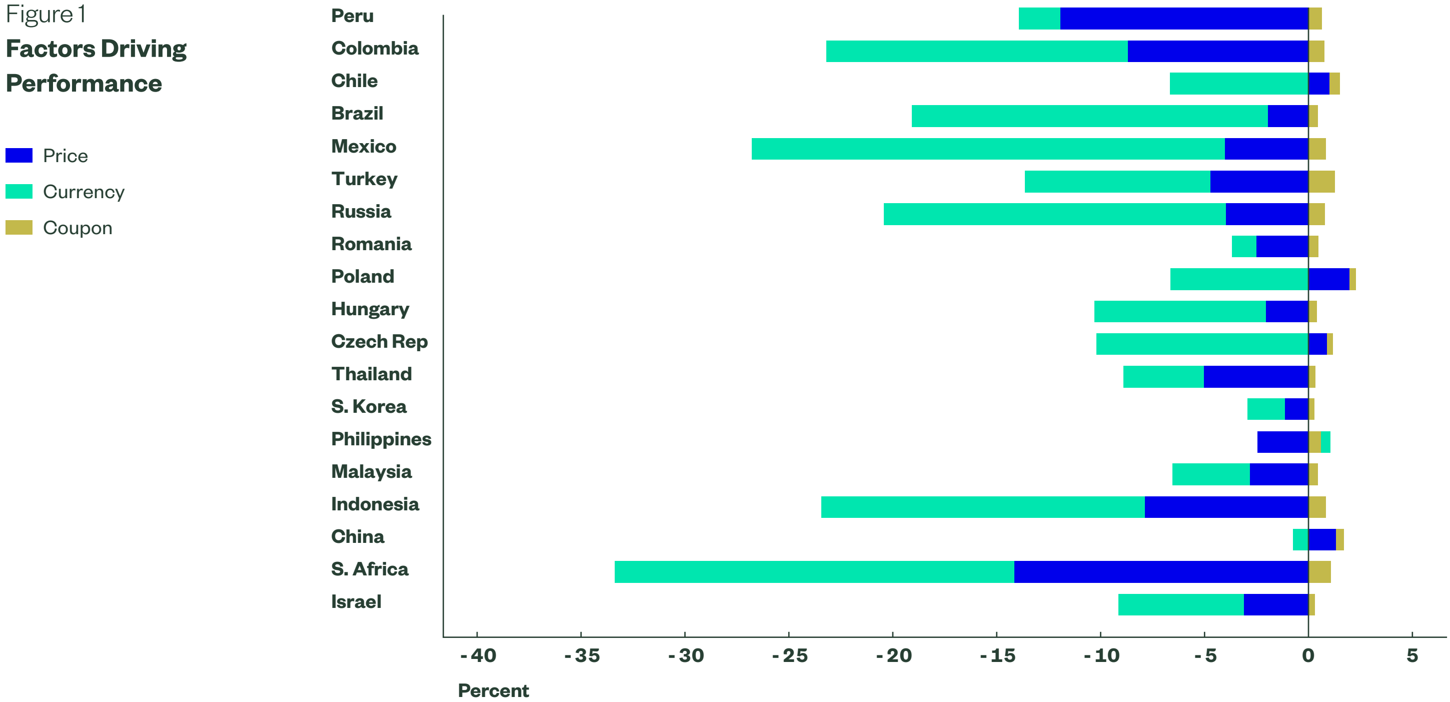
The Big Forex Move

Deconstructing the Bloomberg Barclays EM Local Currency Liquid Govt Index TR Index Unhedged USD into returns generated by moves in the bonds underlying the index and by the currency helps to explain why the moves in EM asset prices have been so extreme. Figure 1 shows this decomposition by country (including coupon returns) since 21 February 2020, which is when the market environment turned from being benign to showing signs of stress.

The chart highlights the large impact that the currency can have on a position, with 14 out of the 19 countries in the index seeing a greater move in the currency than the price return. For instance, Mexico was down by over 22% solely due to the depreciation of the peso.

Figure 1

Factors Driving Performance



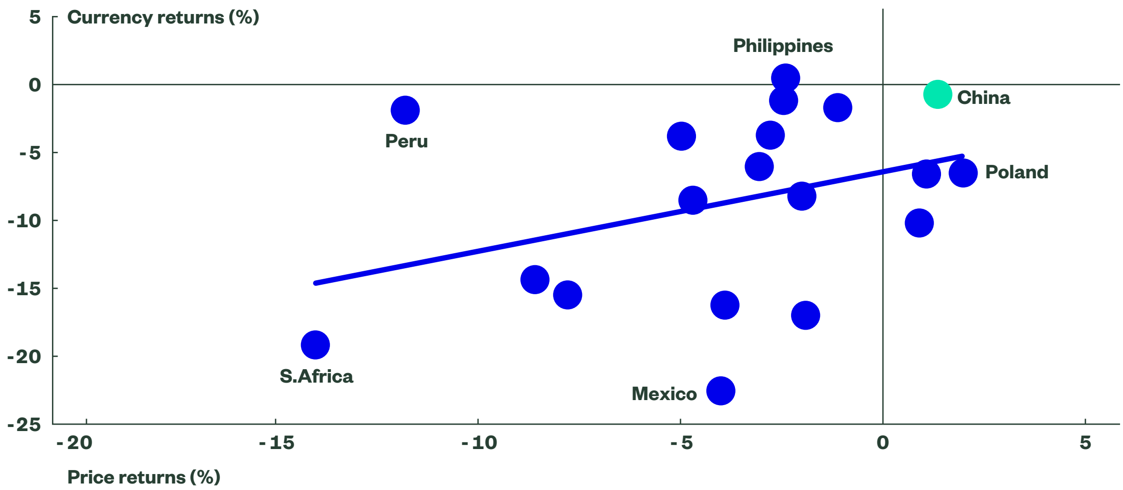
Source: Bloomberg Finance L.P., as of 3 April 2020. Past performance is not an indication of future returns.

Winners and Losers

Plotting price versus currency returns during the crisis so far shows a positive but weak relationship between the two types of return. This helps to pinpoint the countries where the index has made its main gains and losses.

Figure 2

Price and Currency Returns

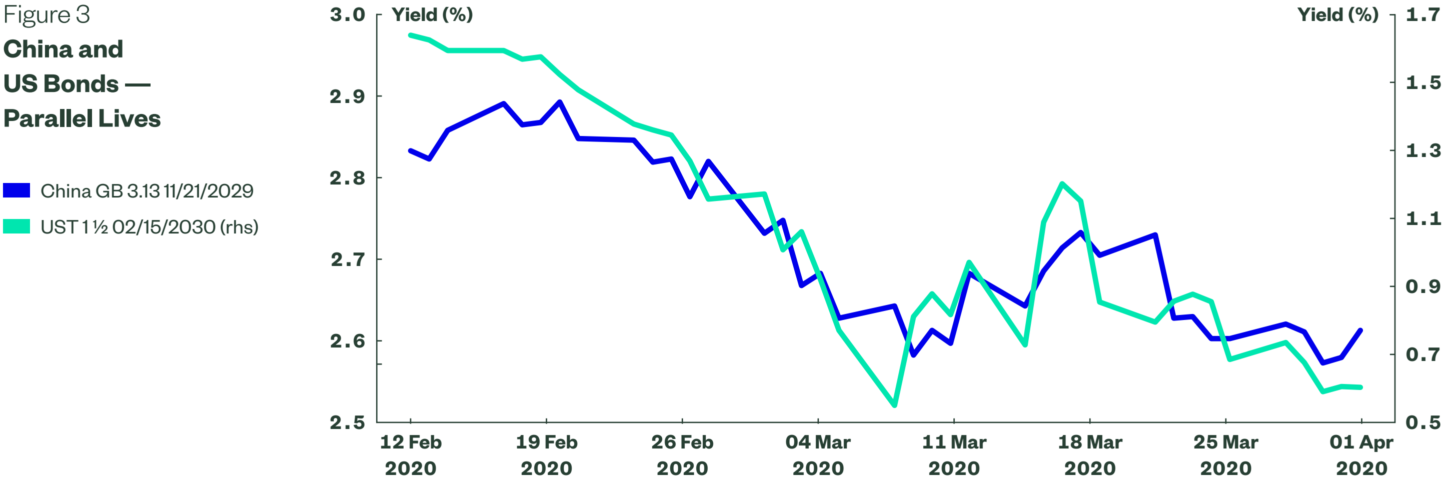


Source: Bloomberg Finance L.P., as of 3 April 2020. Past performance is not an indication of future returns.

Figure 2 highlights the strong relative performance from China, with the country almost reaching the top right-hand quadrant, the most desirable as it indicates both FX and price gains. Rate cuts from the central bank and an aggressive early lock-down to deal with COVID-19 have delivered some support for bonds but that cannot explain the degree of the outperformance. This stability appears to be more about the CNY's growing importance as a reserve currency and the fact that Chinese bonds have been adopted domestically as an alternative safe haven to US Treasuries.

Figure 3 shows that, after an initial spread widening versus US Treasures into mid-February, spreads have been broadly stable throughout the market rout.

Figure 3
China and US Bonds — Parallel Lives



Source: Bloomberg Finance L.P., as of 3 April 2020.

Few other markets have demonstrated such resilience in stressed times. There may be more scope for a rebound in the index constituents that behave more like a risk asset, but it is far from clear that the crisis is over. In this respect, we value China as an important addition to any EM portfolio as a risk diversifier.

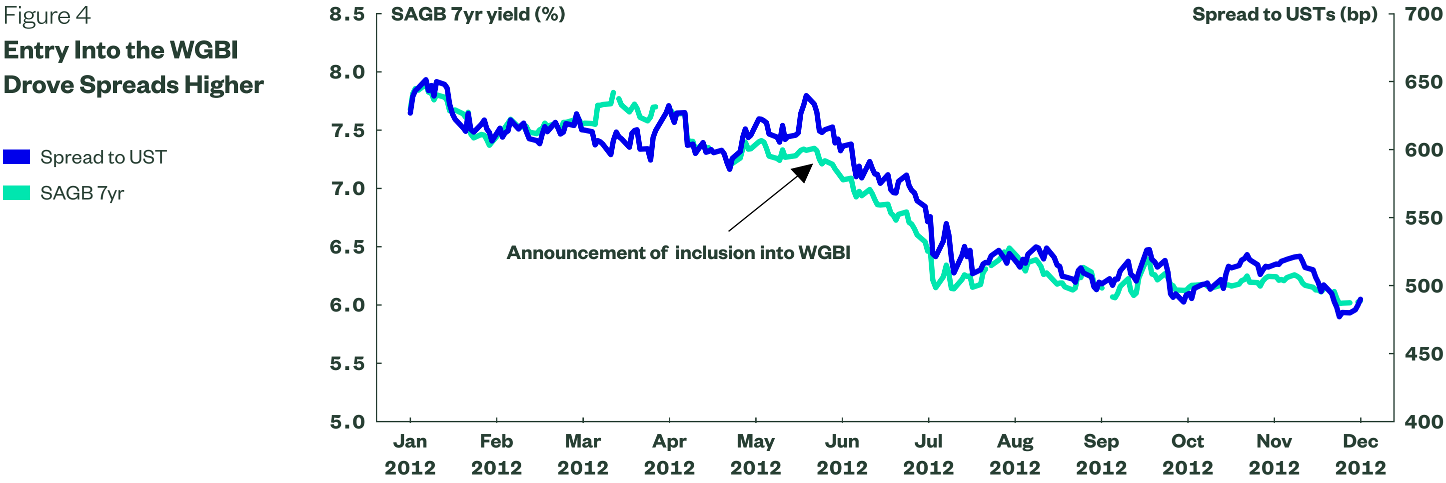
At the other end of the performance spectrum have been several countries posting declines of 25% or more. In most cases, this negative performance is largely the result of currency depreciation and, given the wild swings in the USD, it is reasonable to expect at least a part of this move to unwind when the dust settles.

Potentially more indicative of underlying economic stress is a decline in bond values. In this area, South Africa has been the greatest underperformer, with a price fall in its bonds of 14.2%. This is principally because of fears that South African bonds would end up being excluded from the FTSE/Citi's World Government Bond Index (WGBI). With the downgrade below investment grade by Moody's on Friday (27 March 2020), this now looks like a reality.

While the rebalancing of the WGBI has been postponed in response to fears over the liquidity of the underlying market, there should still be some selling by managers keen to reduce exposure before the drop. It is unclear how far this may run, but when South Africa was admitted to the WGBI it had a substantial effect.

As Figure 4 illustrates, spreads to US Treasuries tightened by around 100bp from June 2012, when it was confirmed that South African bonds would be included in the index. We could therefore expect SAGBs to continue to underperform US Treasuries, at least for the coming month while the unwinding of positions takes place.

Figure 4
Entry Into the WGBI Drove Spreads Higher



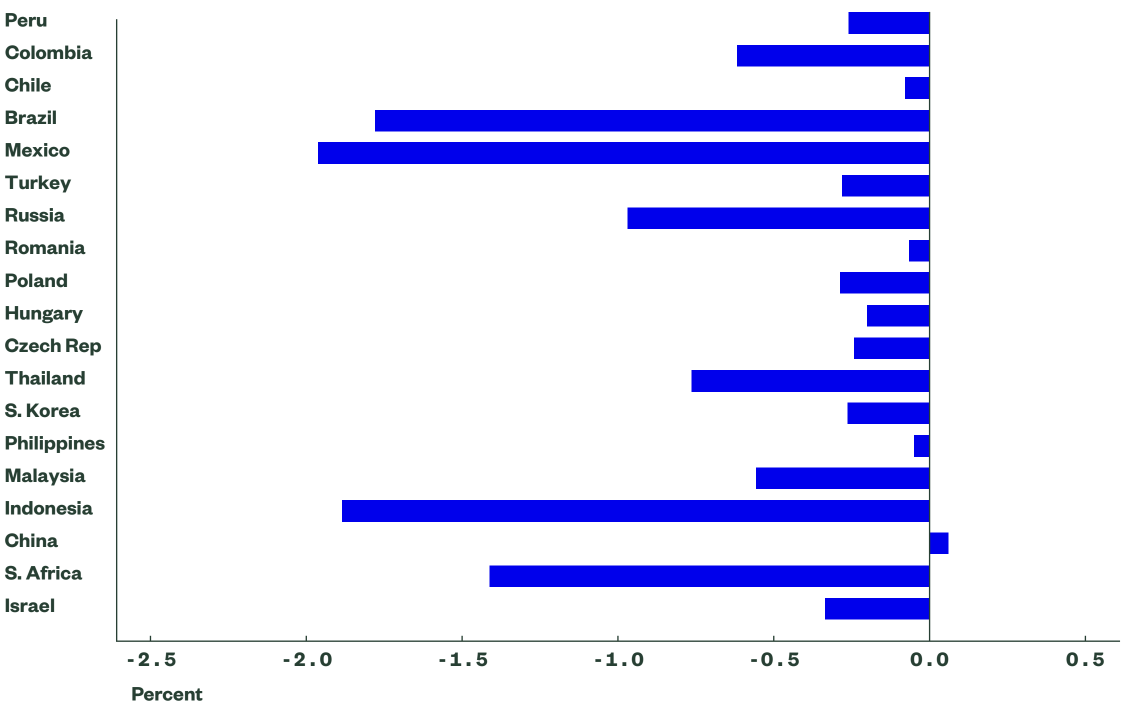
Source: Bloomberg Finance L.P., historical data as of December 2012.

It's All Relative

Having the foresight to dodge the worst performing countries is not easy, as we have already made clear in our note '**Emerging Market Debt: Indexing on the Rise.**' It also means that index composition is important.

The weighted impact of individual country performances on the Bloomberg Barclays EM Local Currency Liquid Govt Index is shown in Figure 5. The impact of certain countries, such as Columbia, is limited by its weight (just 2.8%) with the biggest drags coming from Mexico and Indonesia, but even these were limited to within -2.5%.

Figure 5
Performance by Index Weights



Source: Bloomberg Finance L.P., as of 3 April 2020. Past performance is not an indication of future results.

In this respect, the Bloomberg Barclays local currency index compares favourably with the composition of the J.P. Morgan Government Bond Index Emerging Markets Global 10% Cap 1% Floor. Performance year to date has been -13.9% against -17.5% for the J.P. Morgan EM index. On a geographical basis, some of the key drivers are listed below:

- **Africa** Exposure to Africa is slightly higher for the Bloomberg Barclays index but this is because it includes Israel, which has been one of the better performers, down by a modest 5.1% year to date. In contrast, the African exposure in the J.P. Morgan index is entirely South Africa (7.8% versus 4.6% in Bloomberg Barclays). As noted above, South Africa has been a poor performer and is likely to remain a drag on performance as it gets excluded from the World Government Bond Index.

- **Asia** The Bloomberg Barclays index is far more heavily weighted towards Asia generally and China in particular. Outside of Indonesia, negative returns have typically been more restrained in Asia, largely because FX moves have been less extreme than in other parts of the EM world. Returns for China are +2.2% year to date, which has played a big part in boosting performance. It currently has a weight of 6.6% in the Bloomberg Barclays index and is continuing to rise by 0.5% per month. By contrast, the J.P. Morgan index was late to include China bonds and is at 1%. Exposure was not increased at the March rebalancing given unstable and illiquid markets.

- **Eastern Europe** The Bloomberg Barclays index is less exposed to Eastern Europe. Performance has been mixed with Romania and Poland both with relatively contained losses year to date, while Russia has been one of the worst performers as a result of the oil price collapse.

- **The Americas** Mexico has been one of the worst performers with the J.P. Morgan index having a weight of close to 2% more than Bloomberg Barclays. Central and South America also have a higher weighting for the J.P. Morgan index and have suffered from currency collapse against the USD.

Conclusion

Emerging markets have been under pressure as the crisis has unfolded. The reasons vary by country but there have been some substantial losers. However, with some moves being driven by FX and others by the weakness of bond returns, it has been a particularly hard channel to navigate. This means index construction has been important and the well diversified Bloomberg Barclays EM local currency index has managed to weather the storm better than certain others. Of note, the index's growing exposure to China, which has been one of the top performers of the EM world during the crisis, should mean it continues to provide a degree of stability.

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