Emerging Markets Debt: Where are the Opportunities?

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U.S. Dollar and local currency Emerging Markets Debt (EMD) declined significantly in February and March due to the impact of the pandemic. Similar to other credit sectors, EMD rebounded quickly starting in late March due to a massive injection of liquidity from Global Central Banks, new monetary stimulus from the U.S. and other governments, and a quicker than expected economic recovery in most countries around the globe. But, the recovery in Emerging market bond prices has been very uneven with higher quality EMD greatly outperforming high yield EMD. For this discussion, I am focusing on U.S. Dollar Sovereign and quasi-sovereign bonds, and using the JP Morgan EMBI Global Diversified Index. Below are the returns for the year as of 9/30/2020 for the overall index and the investment grade and high yield portions of the index.

	Weight %	YTD Return
JP Morgan EMBI Global Diversified Index	100	-0.5%
Investment Grade	54	5.8%
High Yield	46	-7.8%

Source: JP Morgan
As of September 30, 2020

As you can see, the high yield portion of EMD underperformed higher quality by almost -14% for the year. Higher quality EMD held up much better in February and the first three weeks of March in the downturn. Although high yield EMD performed very well in the 2nd quarter, the underperformance relative to higher quality continued in the 3rd quarter. This has led to a much wider spread to Treasuries and higher yields for lower quality EMD. Below is a table that shows how yields and spreads have changed this year for the overall index, investment grade EMD, and high yield EMD.

12/31/2019	Yield	Spread	Duration	Avg. Rating
JP Morgan EMBI Global Diversified Index	4.9%	291	7.6	Ba1/BB+
High Yield EMD (46%)	6.8%	487	6.3	B1/B+
Investment Grade EMD (54%)	3.5%	143	8.7	Baa1/BBB+
Difference (HY-IG)	3.3%	344	-2.4	
9/30/2020	**Yield**	**Spread**	**Duration**	**Avg. Rating**
JP Morgan EMBI Global Diversified Index	5.2%	432	8.1	BA1/BB+
High Yield EMD (44%)	8.2%	753	6.4	B2/B+
Investment Grade EMD (56%)	2.9%	196	9.4	A3/BBB+
Difference (HY-IG)	5.3%	557	-3.0	

Source: JP Morgan

The spread for high yield EMD started the year at +487 which was +344 bps wider than investment grade EMD. As of the end of September, high yield EMD was +753 bps over Treasuries which was +557 bps over higher quality EMD. From a yield perspective, the yield for lower quality EMD increased by 200 bps as compared to investment grade and started the 4th quarter at 8.2%. This is a substantial yield given the current environment where developed government yields are frequently negative, and investors are searching for yield to enhance returns. In addition, the duration of high yield EMD is three years shorter than higher quality. This could help if interest rates rise over the long-term.

We are strong believers that high yield EMD presents an attractive relative return opportunity over the next few years as compared to most other fixed income asset classes. The timing of the rally is very hard to determine due to the uncertainty in both the economic recovery and the timing of changes in investor sentiment. In addition, there have been several restructurings in EMD over the last year (Argentina, Ecuador, Lebanon) and there is always the possibility that additional countries could experience difficulties. Country selection will be very important to avoid any potential problems and to overweight the “winners” over the next few years in this period of uncertainty. At DuPont Capital Management, we have over 20 years of experience in investing in EMD and have always focused on the lower quality, higher yielding countries in our investment process.

Mark Foust, Senior Portfolio Specialist, is responsible for serving as primary point of contact for the Fixed Income investment team to provide our clients with ongoing communication and in-depth portfolio insight regarding our fixed income strategies. Mr. Foust is responsible for understanding and communicating portfolio positioning and buy/sell rationale, attribution analysis, and serving as a representative for senior investment professionals such that they are primarily engaged in investment-related activities. Mr. Foust joined DuPont Capital in 2009 and has been in the financial services industry since 1985. Mr. Foust holds a B.S. in Administration and Management Science from Carnegie-Mellon University and he earned an M.B.A. in Finance from the Pennsylvania State University.