Time for a Fresh Look at Emerging-Market Bonds

In a world marked by low, or even negative, rates on government debt, investors continue to search for yield. Here's one approach for them to consider.

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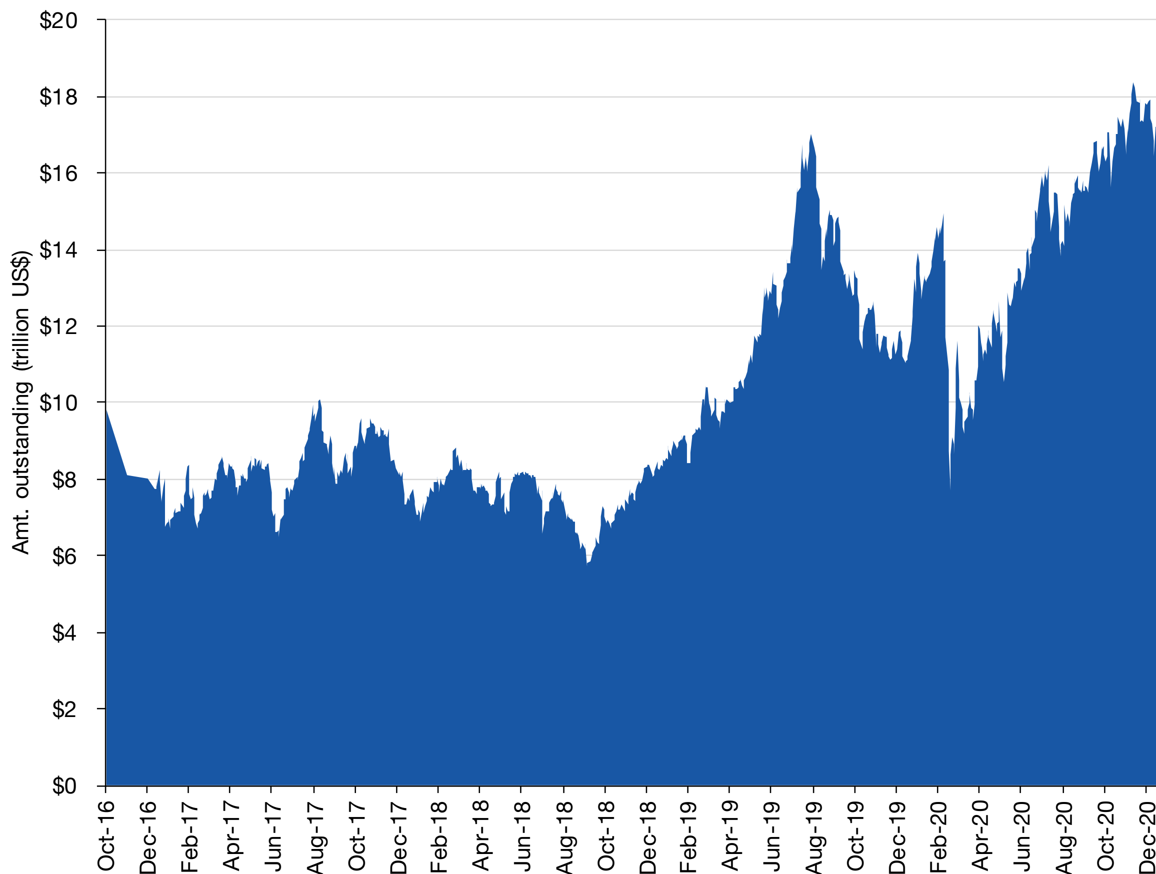
Figure 1. Globally, Negative-Yielding Debt Has Risen Significantly

Total global amount of negative-yielding debt outstanding, February 29, 2016–January 27, 2021



Source: Bloomberg. Data as of January 27, 2021. For illustrative purposes only and does not represent any specific portfolio managed by Lord Abbett or any particular investment. Based on the Bloomberg Barclays Global Negative-Yielding Debt Index, which represents negative-yielding, global, investment-grade debt and includes treasury, government-related, securitized, and corporate bonds from emerging- and developed-markets issuers.

We believe several factors are poised to contribute to a positive environment for emerging markets in 2021, chiefly, the extraordinary liquidity measures provided by both the U.S. Federal Reserve (Fed) and central banks across developed and emerging markets. Amid the ongoing COVID-19 pandemic, these institutions have committed to providing continued, stimulative monetary policy in order to support the global economy through the crisis—and perhaps beyond 2021.

Of course, the massive global liquidity measures designed to keep economies afloat and maintain low interest rates and low volatility have also contributed to the record levels of negative-yielding debt at the end of 2020 (see Figure 1, first page). Although the increase does signal demand for low-risk assets, we believe it will also intensify investors' search for yield within the EM debt markets.

Attractive EM Debt Fundamentals

The exceptional policy response by the International Monetary Fund (IMF) and central banks enabled certain EM companies to withstand the blows of the pandemic. Many people may find it surprising that default rates following the March 2020 market tumult have been much lower than expected among EM corporate debt (see Figure 2). Overall default rates (as measured by the J.P. Morgan Corporate Emerging Markets Bond Index) are also forecast to remain below 3% in 2021. We view low current and expected EM corporate debt default levels as favorable.

Figure 2. Global Default Rates in Late 2020 Were Below Expectations

	2013	2014	2015	2016	2017	2018	2019	2020*	2021F
Asia	1.2%	1.5%	3.1%	1.0%	1.0%	2.5%	1.6%	2.7%	2.6%
EM Europe	2.3%	4.0%	2.5%	3.6%	3.6%	0.0%	0.0%	3.3%	1.1%
Latin America	10.6%	6.5%	5.7%	9.2%	2.0%	2.1%	2.3%	4.4%	3.6%
Middle East & Africa	0.0%	4.6%	4.0%	5.7%	3.2%	0.0%	1.6%	2.2%	3.4%
EM Corp HY (ex. 100% quasis)	**4.3%**	**3.8%**	**3.8%**	**5.1%**	**2.2%**	**1.6%**	**1.5%**	**3.5%**	**2.8%**
Index Level Default Rates									
CEMBI HY	2.8%	3.7%	2.5%	4.0%	1.4%	1.2%	0.8%	3.2%	2.8%
Developed Market Default Rates									
U.S. High Yield	0,7%	3.0%	2.6%	4.3%	1.5%	1.9%	2.9%	6.7%	3.5%
European High Yield	1.7%	0.9%	1.2%	2.5%	1.1%	1.4%	1.8%	2.9%	2.0%

*Through November 24.

Source: J.P. Morgan. Data as of November 24, 2020 (latest available). F=Forecast. J.P. Morgan Corporate Emerging Markets Bond Index (CEMBI) is a market-capitalization-weighted index that tracks total returns of U.S. dollar-denominated debt instruments issued by corporate entities in emerging-market countries. CEMBI High Yield (HY) is the below-investment-grade subset of the CEMBI. "Quasis" is a term for quasi-sovereign bonds, which are corporate bonds in which the government owns a partial stake in the issuing company. Asia = CEMBI Asia. EM Europe = CEMBI Europe. Latin America = CEMBI Latin America. Middle East & Africa = CEMBI Middle East & Africa. For illustrative purposes only and does not represent any specific portfolio managed by Lord Abbett or any particular investment. Forecast default rates are not guaranteed, and 2021 defaults may be higher depending on general market conditions and other factors that may affect particular countries, industries, or companies.

Sovereign EM debt fundamentals have been improving over a long period of time. Local currency markets have evolved, allowing for natural market forces to determine prices instead of pegged currency exchange rates. Stable currency exchange rates have significantly improved inflationary pressures in emerging economies, while promoting stability and growth. Central banks have also learned from previous financial crises and have adapted the use of their complete monetary policy tool kits, which further support EM sovereigns and provide access to capital previously limited during times of stress.

China on the Rebound

One of the most important factors influencing our outlook for EM debt in 2021 is the recovery in China. China has become the second largest economy in the world and is now more important to emerging-market growth than developed markets. China's capacity to adapt economic activity during the pandemic has had a very positive impact on emerging-market economies that are dependent upon commodity exports to China. North Asian countries, such as China, South Korea, and Taiwan, have led the world in measures taken to reduce the spread of the virus and have also shown exceptional economic resilience. We believe the improved recovery profile in this region will provide a boost to fundamentals.

Summing Up

Our overall positive view toward EM debt is focused on external forces and EM debt-specific factors that we believe provide support to the asset class in 2021. These positive implications, however, are not uniformly anticipated across countries or regions. Challenges to vaccine penetration, significant debt burdens, and changing political landscapes are only a few reasons why we believe country, region, and security selection remain key to investing in the EM debt markets.

A Note about Risk: The value of investments in equity securities will fluctuate in response to general economic conditions and to changes in the prospects of particular companies and/or sectors in the economy. The value of investments in fixed-income securities will change as interest rates fluctuate and in response to market movements. Generally, when interest rates rise, the prices of debt securities fall, and when interest rates fall, prices generally rise. High-yield securities, sometimes called junk bonds, carry increased risks of price volatility, illiquidity, and the possibility of default in the timely payment of interest and principal. Bonds may also be subject to other types of risk, such as call, credit, liquidity, interest-rate, and general market risks. Bonds issued or guaranteed by non-U.S. governments and governmental entities (commonly referred to as "sovereign debt") present risks not associated with investments in other types of bonds. The sovereign government or governmental entity issuing or guaranteeing the debt may be unable or unwilling to make interest payments and/or repay the principal owed. Non-U.S. investments generally pose greater risks than U.S. investments. The securities markets of emerging-market countries tend to be less liquid, to be especially subject to greater price volatility, to have a smaller market capitalization, and to have less government regulation. Investing in non-U.S. denominated and/or domiciled securities may involve heightened risk due to currency fluctuations, and economic and political risks, which may be increased in emerging markets.

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Statements concerning financial market trends are based on current market conditions, which will fluctuate. There is no guarantee that markets will perform in a similar manner under similar conditions in the future.

Glossary

Foreign Exchange (forex or FX): The trading of one currency for another. For example, one can swap the U.S. dollar for the euro. Foreign exchange transactions can take place on the foreign exchange market.

International Monetary Fund (IMF) is an international organization created for the purpose of promoting global monetary and exchange stability, facilitating the expansion and balanced growth of international trade, and assisting in the establishment of a multilateral system of payments for current transactions.

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