Emerging Markets
Global Debt Outlook 2021

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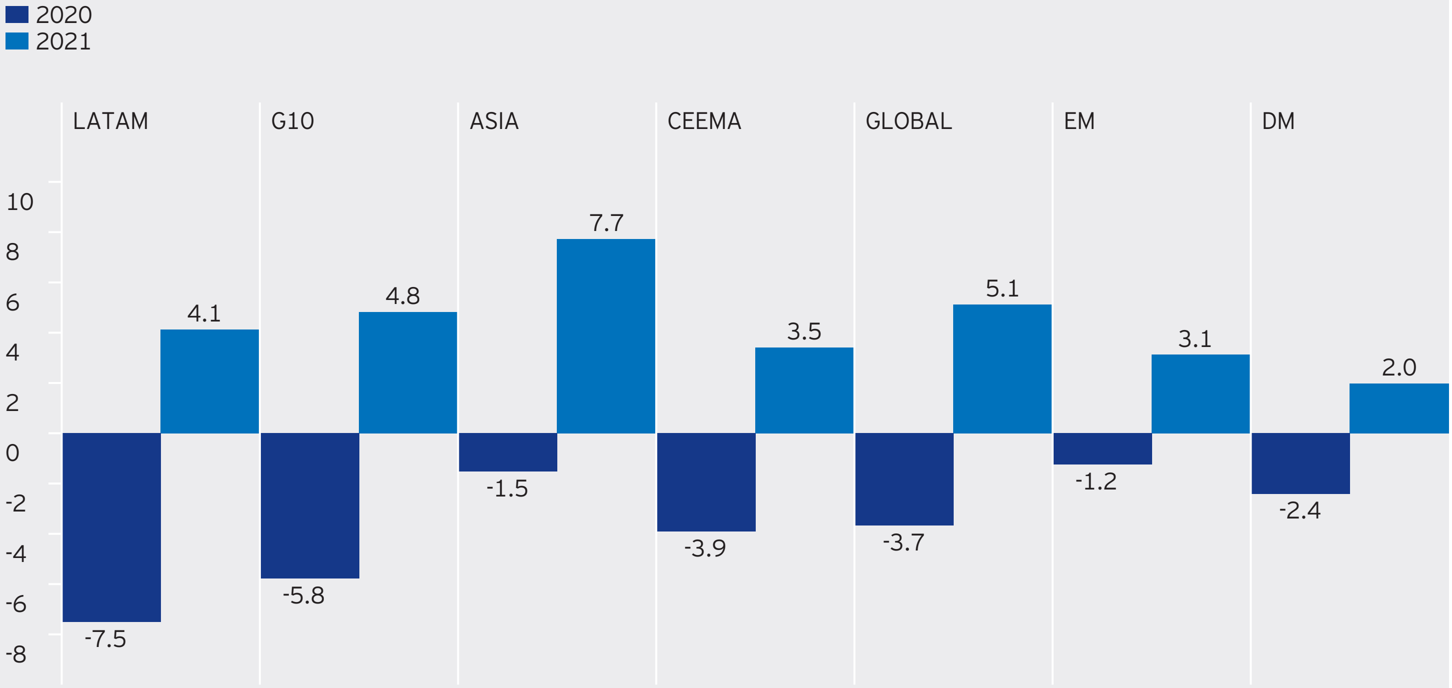
The case for emerging markets fixed income amid improving global growth

We believe global macro conditions and a shift in central bank frameworks have set the stage for a possible sustained outperformance of emerging markets (EM) assets over the next two to three years. We expect global growth to accelerate in the next few years, aided by the fiscal policy response in developed economies and some EM. The changing policy framework at the US Federal Reserve (Fed) should also ensure that US financial conditions remain favourable for a sustained positive EM cycle. And while we consider the most influential policy change to be in the Fed's framework, we expect policies of all major developed market central banks to support the EM asset class for the foreseeable future.

Global growth and its implications for EM

We expect global growth to improve significantly in 2021, as recovery gains momentum after the virus-induced economic collapse in Q2 2020. While second and third waves of Covid-19 have reduced our near-term growth forecasts, with some countries likely to post contractions in Q4 2020 growth, our forecasts for next year and beyond have not changed significantly. Our forecasts for next year and beyond assume the availability of at least a partially successful vaccine by Q1 2021 and could be revised upwards if the efficacy and uptake of the vaccine is very high.

Figure 1
Global GDP forecasts



Source: Invesco internal calculations, as at 30 October 2020.

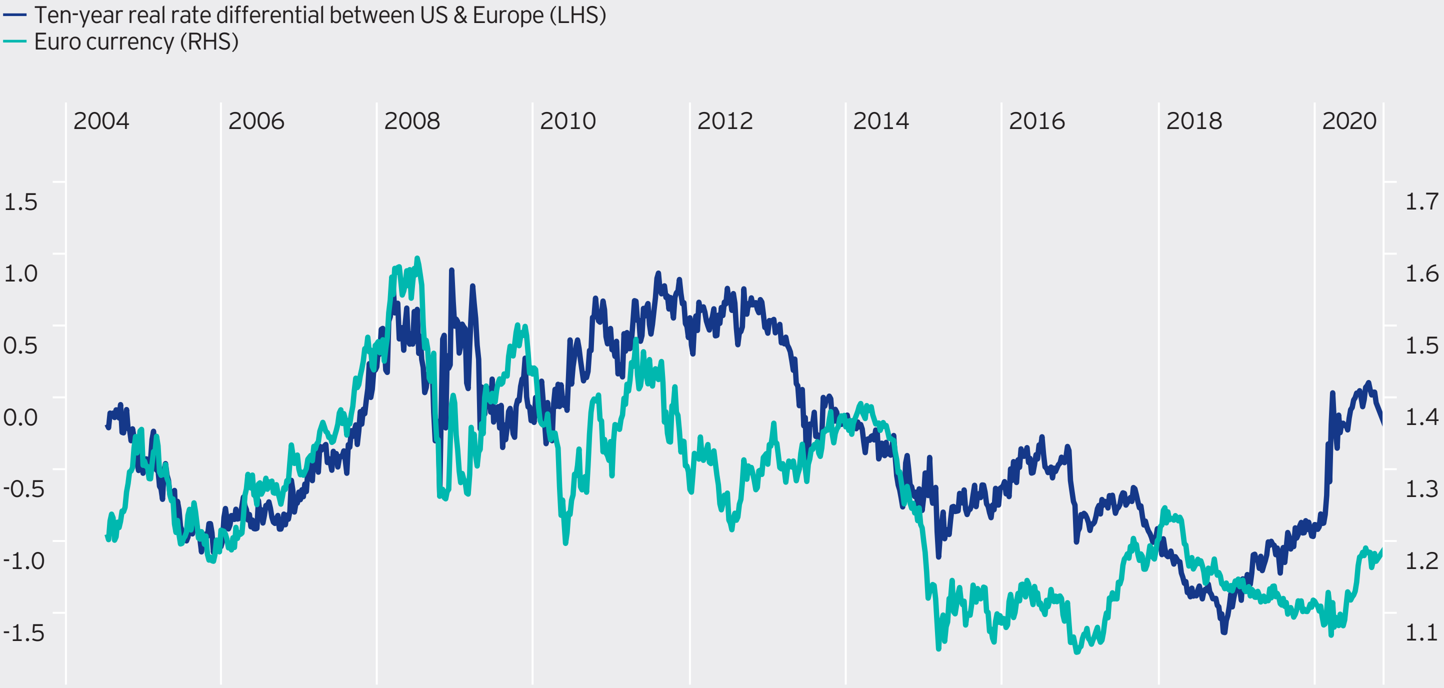
The major factor underlying our expectations is the Fed's new policy framework that should prevent US financial conditions from tightening as growth expectations improve. Going forward, growth differentials between the US and other countries will likely matter less for aggregate EM performance than they have in the past, as the market will likely not reprice the Fed's path as growth picks up. We believe this is the most significant differentiator for the upcoming cycle when compared to the 2013 taper tantrum and the 2018 tax and budget deal. In the current environment, we expect improving global growth, whether driven by the US, other developed or EM, to be a net positive for EM assets and investment flows.

Real interest rate differentials could trigger US dollar weakness

In an environment in which short- and medium-term nominal US interest rates cannot rise to reprice the Fed's path and only long-term rates can rise, the likely outcome is for the US dollar to weaken. Without the ability to reprice nominal rates, real rates will likely fall to accommodate increased inflation expectations. This should add to the already negative impact on the US dollar from increasing twin deficits. In such an environment, growth differentials between US, Europe, China and other EMs should matter less for aggregate EM performance, but should still matter for relative EM performance and alpha generation.

In recent months, real interest rates in the US have dropped significantly vis-à-vis other developed market peers, removing one of the underpinnings of US dollar strength. Given the Fed's greater credibility compared to other major central banks regarding its ability to create inflation, we believe real rates in the US will fall further into negative territory, as growth improves. Figure 2 shows the real interest rate differential between the US and Europe and its correlation to the euro. The real interest rate differential is currently hovering around zero. With growth, we would expect US real rates to fall below European real rates, creating the conditions for broad based US dollar weakness. A similar dynamic exists vis-à-vis Japan. Amid broad-based US dollar weakness, we would expect EM currencies to first stabilise and then appreciate.

Figure 2
Ten-year real interest rate differential between the US and Europe and the level of the euro



Source: Bloomberg as at 23 October 2020.

US dollar weakness could trigger a virtuous circle in EMs

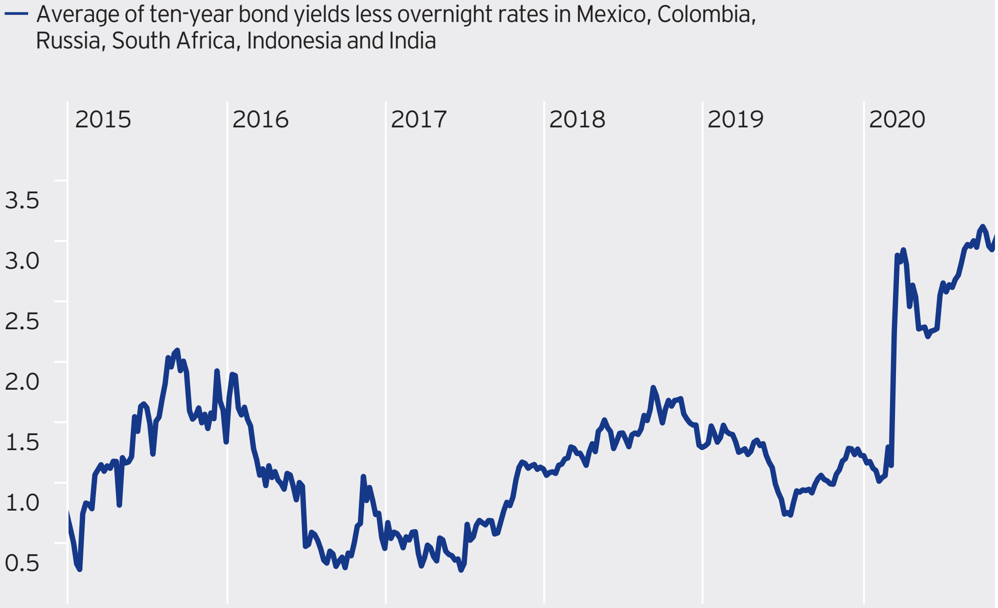
The weakening of the US dollar could have two beneficial impacts on EM assets. It becomes easier for EMs to finance fiscal and external deficits and it improves balance sheets for countries with negative net international investment positions. Emerging countries have improved the management of their external liabilities, leading to smaller current account deficits and, less need for capital inflows to be unhedged. In our view, a stable-to-weaker US dollar could create a positive feedback loop in which embedded currency premia would not need to rise as economic activity picks up.

These global conditions, combined with attractive valuations in most emerging countries, could create the conditions for cyclical outperformance.

Attractive yield curves will likely support total return opportunities
Yield curves in most EM have steepened with interest rate cuts across most emerging countries, as EM central banks took advantage of monetary policy room that opened when the Fed cut rates to zero. Figure 3 shows the term premia in selected emerging countries.

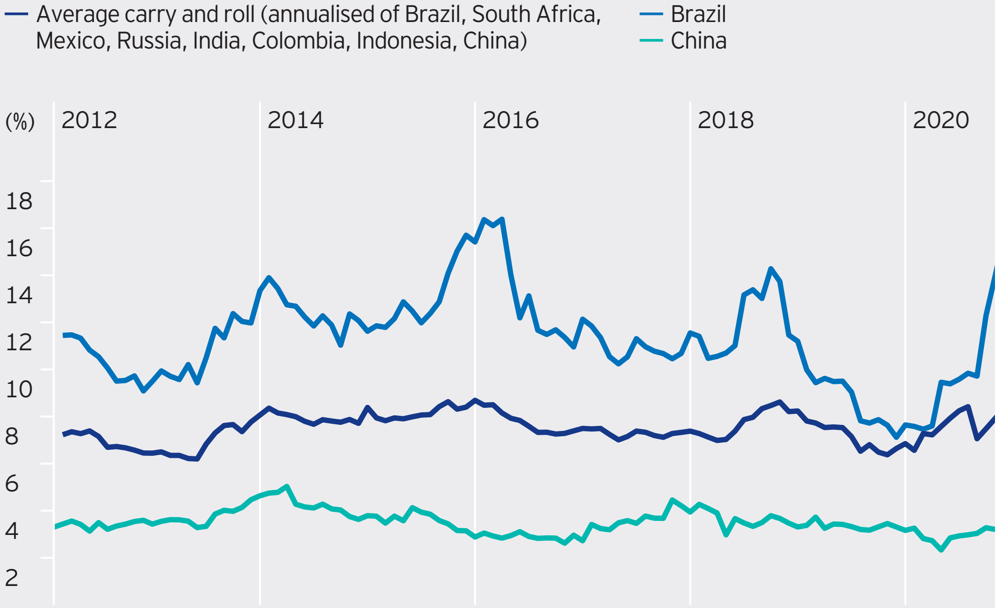
Consequently, the expected static return (comprising carry and roll) has stayed near, or above, pre-Covid-19 levels in several emerging countries – both higher and lower yielding. Figure 4 shows the average expected (static) annualised return in several emerging countries and shows consistent returns for the country with the highest expected return (Brazil) and the country with the lowest expected return (China). Despite lower yields, the expected return for this group has not fallen. Even for China, the expected rate of return is stable and above the return currently available in other developed markets.

Figure 3
EM yield curves (ten-year bonds versus overnight rates)



Source: Bloomberg as at 1 November 2020.

Figure 4
Annualised expected static return (carry and roll) for five-year government bonds



Source: Bloomberg as at 1 November 2020.

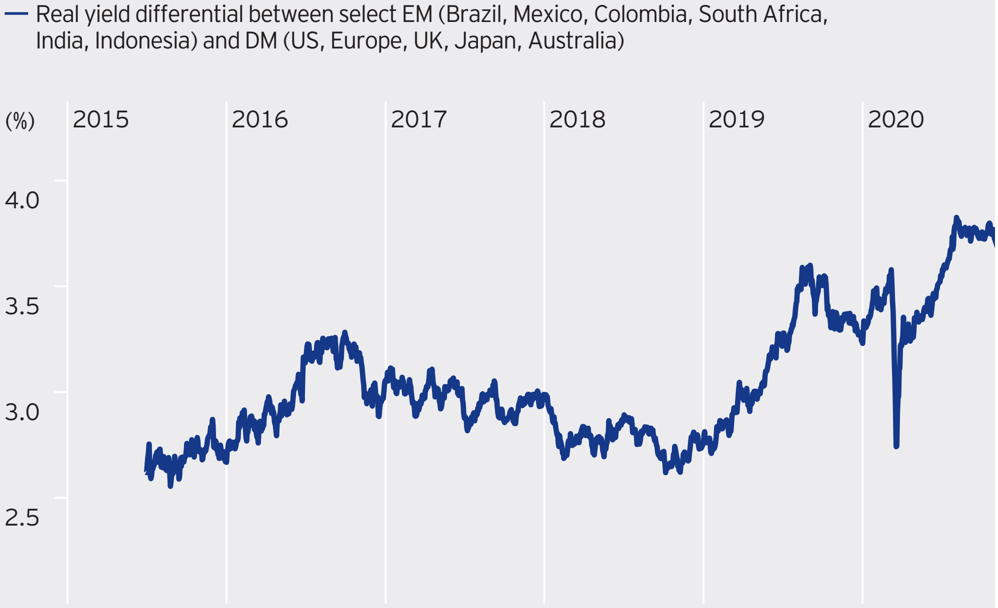
Another method of identifying relative valuation in EM is to look at the real yield differential between EM and developed market interest rates. Figure 5 shows that this differential is at its widest level in the past five years, providing the potential for EM assets to outperform cyclically without significant policy action.

Currency-hedged duration is potentially attractive

Given the well-behaved external accounts of most emerging countries, currency premia embedded in EM currencies have declined in recent years and the need for unhedged capital flows has declined, even in some historically "savings-deficit" countries. The flip side to lower currency premia is lower cost of hedging EM bonds for investors who do not want to take the currency risk due to high capital requirements or volatility. For the first time, the term premia on EM assets more than compensates for the cost of currency hedging, making it an attractive asset class, in our view, based on its interest rate characteristics.

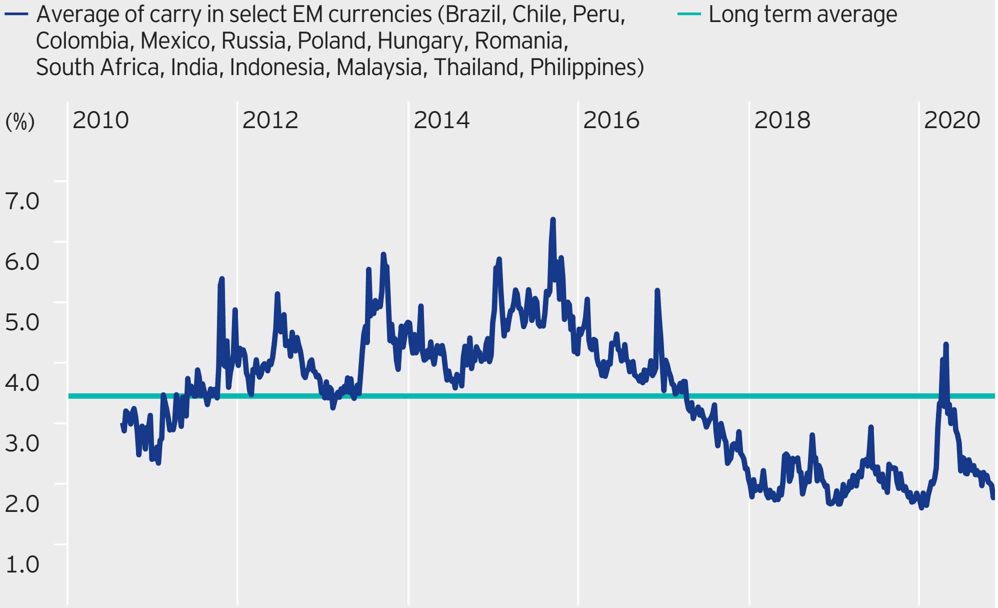
Figure 6 shows that the average EM currency premium is at a decade low. However, in a global environment in which developed market interest rates are at the zero bound and likely to remain so, this lower currency premium is still quite substantial at 2% annualised. Given the high static expected rate of return in many countries, for investors who prefer little or no currency risk, the hedged return is likely to be an attractive alternative to developed market rates.

Figure 5
Ten-year real yield differential between selected emerging and developed countries



Source: Bloomberg as at 30 October 2020.

Figure 6
Currency carry



Source: Bloomberg as at 30 October 2020.

Conclusion

Given attractive carry and roll and positive currency premia, we expect returns on EM local fixed income to remain attractive for the next two to three years. When combined with improving global growth conditions and the right conditions for a weaker US dollar, we believe the asset class will be attractive relative to developed markets that face a decade of near-zero nominal returns. While most EM boats will likely be lifted, we expect a significant dispersion in returns and believe that sequencing investments within this opportunity set will be key; in our view, the alpha component will provide greater opportunity than the beta component, but we maintain solid expectations for the beta component.

Investment Risks

The value of investments and any income will fluctuate (this may partly be the result of exchange-rate fluctuations) and investors may not get back the full amount invested.

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