Santander
Private Banking

Emerging Markets Debt: an alternative to diversify portfolios

23.7%

Weight of emerging markets debt within global fixed-income markets[1]

~8%

Average Yield to Worst on the asset over the last 18 months[2]

2.7%

Emerging markets vs. developed markets growth differential at a 10-year high[3]

1 Source: SIFMA. End 2022.
2 Source: Bloomberg, J.P. Morgan EMBI Global Core Yield to Worst. Data as of 18/09/2023.
3 Source: International Monetary Fund. World Economic Outlook July 2023.

Controlled inflation, high real interest rates, and improving economic fundamentals

Why emerging markets debt and why now?

Emerging markets debt and, more specifically, that issued in local currency has outperformed global and developed fixed income markets over the last 18 months due to: (i) emerging market central banks' early reaction to the pick-up in inflation, and (ii) improved fundamentals due to structural reforms aimed at bringing the fiscal situation back on track, contrasting with the weak situation in the US.

1. Early action by central banks

Based on their historical experience, emerging countries' central banks understood very quickly that the inflation surge was not "transitory". As a result, major countries in this bloc **began an early hiking cycle**, with Brazil and Russia leading the way in the first quarter of 2021, followed by Mexico, Chile, Poland and South Africa, **several quarters ahead of their developed country counterparts**.

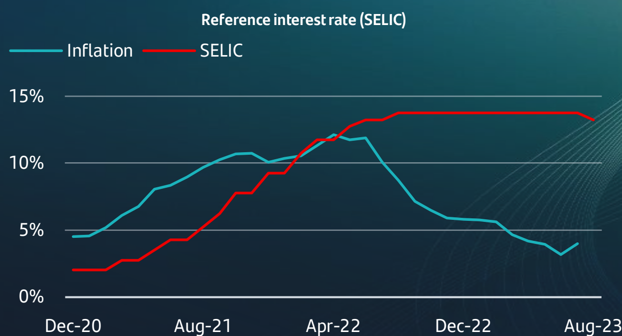
This early action had the effect of controlling inflation more quickly. We compare how inflation and rates performed in **Brazil** and the United States. On the left, by the end of 2021, Brazil had raised rates by 725 basis points (bps) and paused in August 2022 at 13.75%, **having increased rates by a total of 1175bps**.

Inflation was brought down to 5.8% by the end of that year and to 4.0% in August 2023. With inflation under control again, **Brazil is ahead in the monetary cycle: rate cuts started in August 2023, and rates are expected to have been reduced by a total of 150bp[1] by the end of the year**.

On the right, the United States. **The Federal Reserve initially considered inflation to be transitory and, consequently, was slow to start raising rates, only beginning in March 2022; as a result, it had to move very quickly and aggressively to try to rein in inflation**, which reached 3.2% in August 2023.Unlike Brazil, in July 2023 the Fed raised rates by 25bp in what would appear to be the last hike of this cycle. **It will foreseeably not start reducing them until mid-2024[2]**.

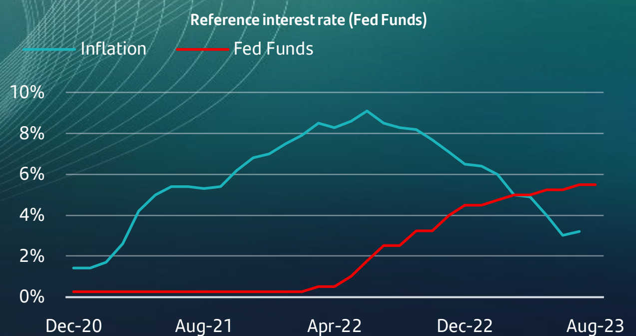
Brazil

Source: Bloomberg. Data as of August 2023



United States

Source: Bloomberg. Data as of August 2023



1 Estimates for December 2023 from the Central Bank of Brazil's Weekly Survey of Economists as of 8 August 2023.
2 Bloomberg WIRP estimates for interest rates as of 8 August 2023.

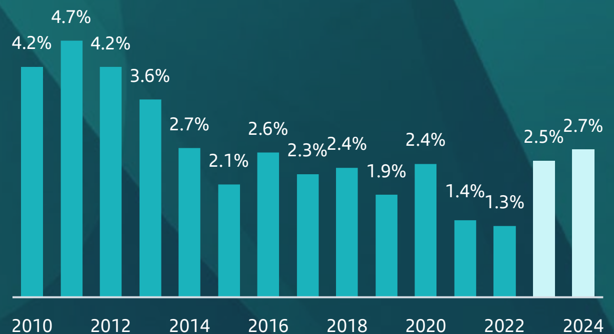
2. Better fundamentals in EM vs. DM favour emerging currencies vs. the US dollar

Higher 10-year growth differential

According to data from the International Monetary Fund (IMF) in its July 2023 World Economic Outlook, growth in developed economies (DM) is expected to slow from 2.2% in 2022 to 1.5% in 2023 and 1.4% in 2024. Emerging economies (EM), meanwhile, are expected to grow by 4.0% in 2023 and 4.1% in 2024, up from 4.0% in 2022. **The growth differential is at its highest in a decade. The shift towards a more accommodative monetary policy that has already begun in some emerging economies (Brazil, Chile, China) favours growth.**

EM - DM growth differential

Source: IMF World Economic Outlook Update (WEO) July 2023

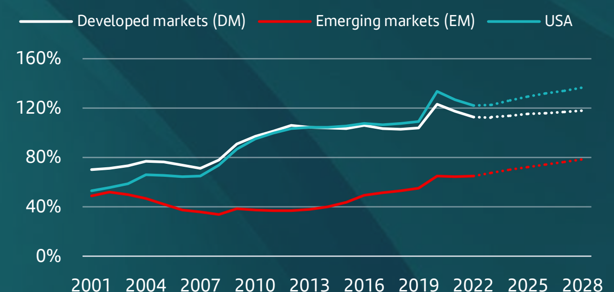


Lower debt, better fiscal position

Government debt in developed economies increased significantly due to the sizeable stimulus measures adopted to counteract the pandemic's negative effects on growth. **Rising interest rates also increase the burden of debt interest payments and make the fiscal situation of these countries, especially the United States, more complex than in emerging countries**, where government debt is 65% of GDP (compared with 120% in the US).

Government debt as a % of GDP

Source: FMI. World Economic Outlook (WEO) April 2023

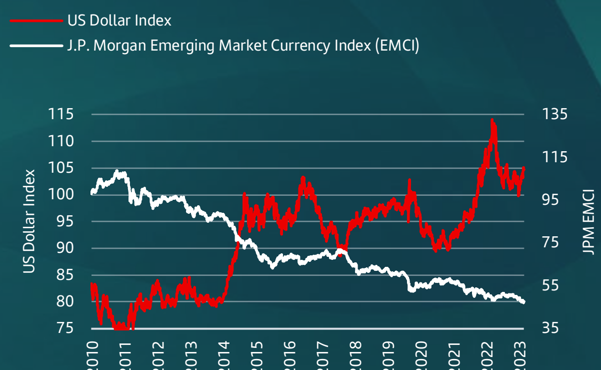


Better prospects for emerging currencies compared with the US dollar

As shown in the right-hand chart, the Dollar Index, which measures the value of the US dollar relative to a basket of foreign currencies, peaked in the second half of 2022 and has been depreciating ever since. In contrast, emerging currencies are currently quite undervalued (EMCI Index in the chart). **Given better growth expectations and a fairly healthy fiscal position compared to the United States, they are expected to appreciate against the USD in the short term.**

USD performance vs. emerging currencies

Source: Bloomberg. Data as of 13/09/2023



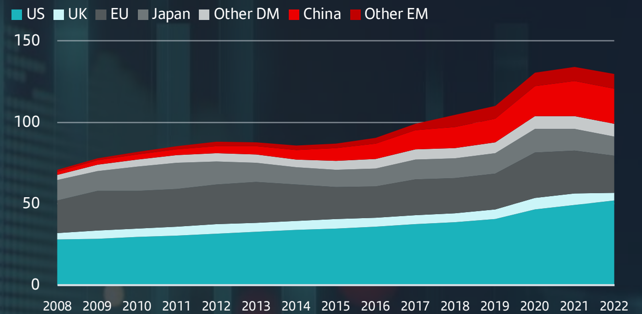
3. An important and growing asset class

The fixed-income market has grown strongly over the last 15 years, having almost doubled in size (1.8x). Much of this growth is due to **emerging market debt**, led by China, which has **increased 9-fold**.

As a result, emerging debt grew from **4.8% of the global fixed-income market in 2008 to 23.7% at the end of 2022.** This suggests that this asset class **should account for a meaningful strategic share of a diversified portfolio**.

Size of the global fixed-income market

Source: SIFMA. End 2022. USD billion



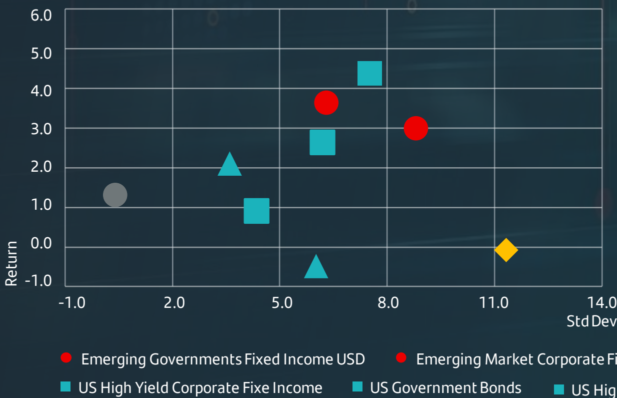
4. Risk-Reward

The emerging fixed-income market can be divided into **three asset classes:** (i) **hard currency** (HC) **government debt, i.e. in USD or EUR**, (ii) **local currency government debt**, and (iii) **corporate debt** (generally issued in HC). Local currency debt is the largest segment and it is also the one with the greatest volatility due to currency fluctuations. This historical headwind seems unlikely to have a major influence in the coming quarters, which makes this asset class more attractive.

It is important to note that the three asset classes are mutually complementary as each offers exposure to a different type of issuer with different risk features. Which one is more advisable depends on the situation in the cycle. Looking back at performance in comparison with other markets (10-year chart, bottom left), **there is a risk premium due to the higher** perceived risk. Focusing on the short term (as the quality composition of the indices has changed over the years), we can see that emerging markets offer a more attractive risk-reward trade-off (1-year chart, bottom right).

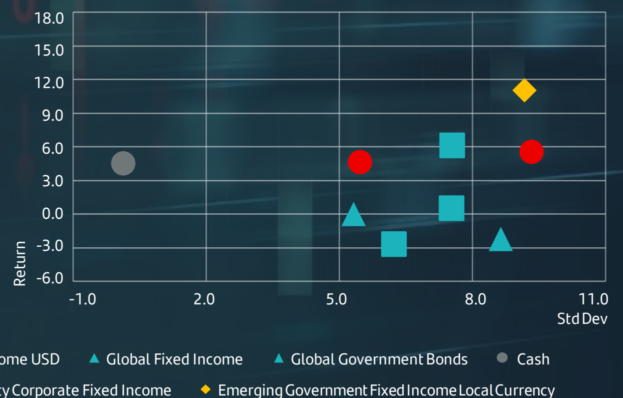
10 years Risk-Reward

Source: Morningstar Direct and Santander. Period: 01/09/2013 to 31/08/2023



1 year Risk-Reward

Source: Morningstar Direct and Santander. Period: 01/09/2013 to 31/08/2023



- Emerging Governments Fixed Income USD
- Emerging Market Corporate Fixed Income USD
- Global Fixed Income
- Global Government Bonds
- Cash
- US High Yield Corporate Fixe Income
- US Government Bonds
- US High Quality Corporate Fixed Income
- Emerging Government Fixed Income Local Currency

How to invest in emerging markets debt?

Given the growing importance of this asset class, we consider it is interesting to **start building a strategic position** in our portfolios.

To build the position, it is advisable to opt for an **actively managed vehicle that is capable of positioning itself across the whole emerging debt spectrum**. As a complementary **tactical option**, we can choose a solution based on **local currency** debt.

To summaries, the **sort of product to look for would be**

01 Actively managed through a mutual fund

02 Build a strategic position with a fund covering all asset classes (local, hard and corporate)

03 Complement tactically with a fund oriented towards debt denominated in local currency

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