

## PUBLIC FIXED INCOME

# EM Debt: Time to Load Up?

### INSIGHTS

A number of factors have converged to create a potentially compelling opportunity in EM debt. And with prices at attractive levels relative to history, now may be a good time to consider an allocation to the asset class.



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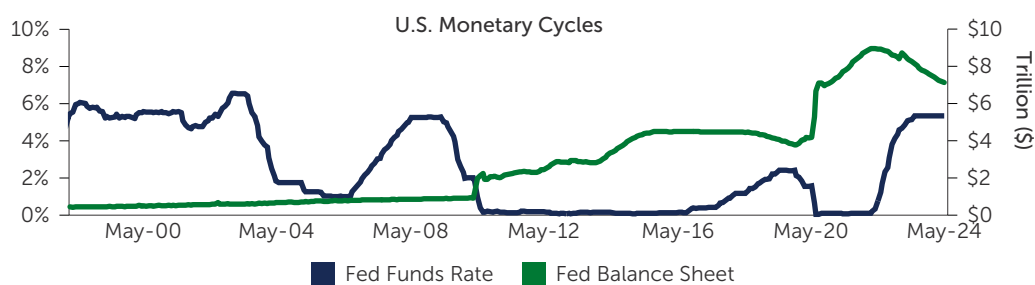
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## A Supportive Backdrop

Global financial markets have not had a traditional monetary easing cycle since before 2008. The last two rate-cutting cycles from the U.S. Federal Reserve (Fed) and other major central banks have been associated with cataclysmic events—the Great Financial Crisis (GFC) in 2008 and the Covid pandemic in 2020. During these periods, interest rate cuts were combined with large expansions of the Fed’s balance sheet (**Figure 1**). Today, the picture is somewhat different. Unless a new and unexpected crisis develops, the monetary easing cycle that recently began will likely focus solely on interest rate cutting, with the Fed continuing to shrink its balance sheet.

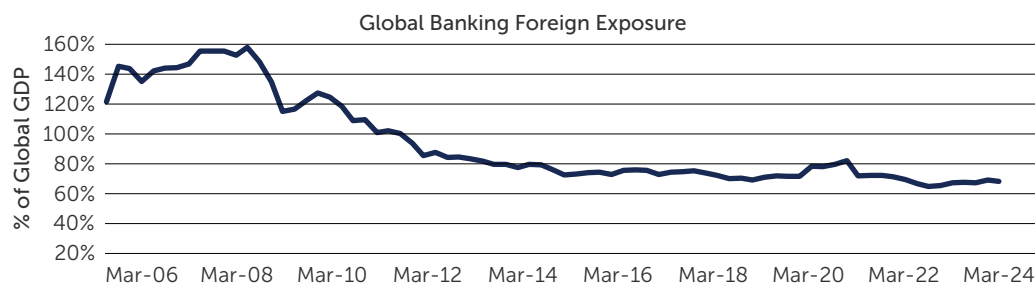
**Figure 1: Previous Easing Cycles Combined Rate Cuts with Balance Sheet Expansion**



Source: Haver Analytics; Bloomberg. As of August 30, 2024.

At the same time, after a prolonged period, global commercial banks have started to lend once again. This means, after well over a decade of bank retrenchment, the global financial system appears to be operating more in line with how it has functioned historically. As seen in **Figure 2**, the 2008 Global Financial Crisis started a protracted period of bank deleveraging, and as a result, inside money—which is money created by commercial banks rather than central banks—shrank from 160% of global GDP in March 2008 to 66% of global GDP in December 2022. Inside money is now showing signs of recovery, however, having increased to 68% of global GDP today.<sup>1</sup>

**Figure 2: Global Banks have Started to Lend Again**



Source: BIS; Federal Reserve; European Central Bank; IMF WEO. As of March 2024.

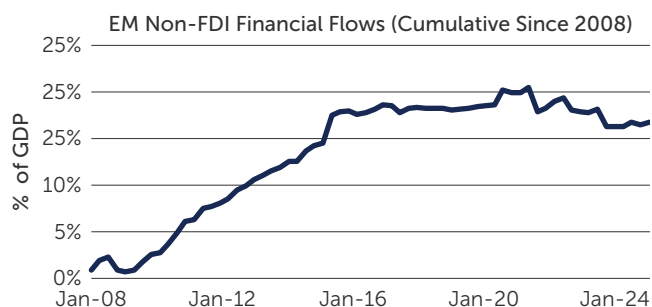
1. Source: BIS; Barings’ calculations. As of March 2024. Total foreign claims of all BIS reporting banks measured as ultimate counterparty exposure amounted to \$33.1 trillion as of March 2024 (latest available data). If we divide this by global GDP (\$48.7 trillion), we obtain a total leverage measure for the global financial system of 68.1% of GDP as of March 2024.

## Depreciation & the Potential for Upside

Lending by central banks or monetary authorities is intrinsically different than lending provided by private entities. For the former, non-economic considerations, including the nationality of the asset, play an outsized role, whereas private entities tend to be profit-motivated. It therefore comes as little surprise that non-Foreign Direct Investment (FDI) flows into emerging markets (EMs) have flattened out as a consequence of inside money shrinking, while outside money (created by central banks) has expanded (**Figure 3**).

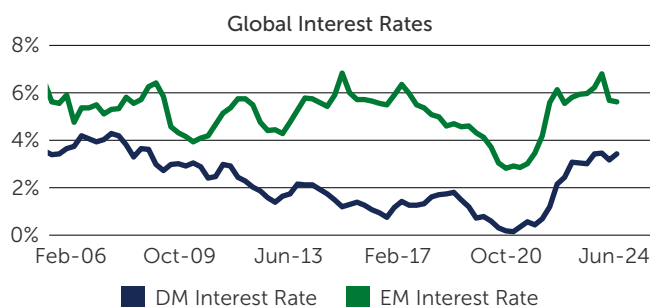
Of note, non-FDI flows into EMs did grow from 2008 to the end of 2014, as shown in **Figure 3**, even as inside money was shrinking. This growth can be explained in part by the fact that the 2008 financial crisis was concentrated primarily in developed markets rather than EMs. Additionally, with DM rates decreasing during this period and in some cases hovering at or near zero, higher-yielding EM assets looked particularly attractive to yield-starved investors (**Figure 4**).

**Figure 3: EM Non-FDI Flows Have Levelled Off**



Source: Haver Analytics; Bloomberg. As of June 30, 2024.

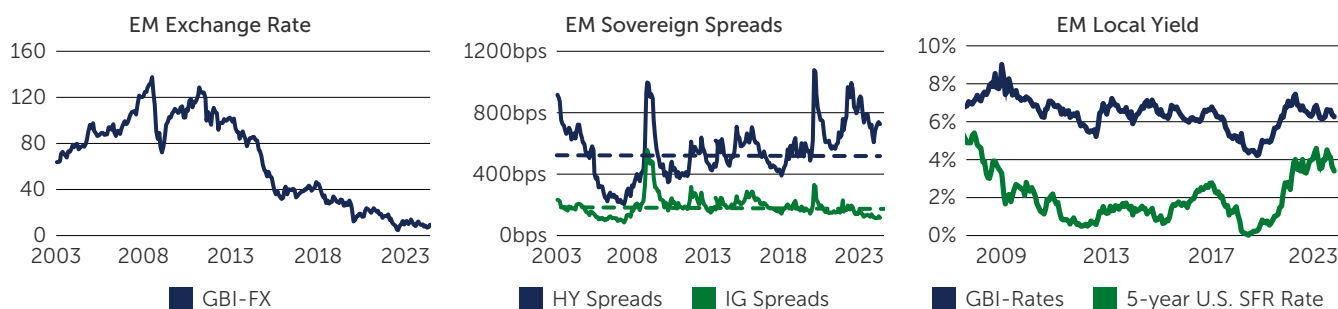
**Figure 4: EMs Offer Attractive Yields vs. DMs**



Source: Haver Analytics. As of June 30, 2024.

The flattening of non-FDI flows in terms of GDP has shaped the current EM debt landscape in a number of ways. For one, EM currencies have materially depreciated (**Figure 5**). This depreciation, combined with the pressure from multilateral organizations that favored sovereign defaults following the pandemic, has also caused EM sovereign high yield spreads to widen significantly (**Figure 5**). EM local interest rates also came under some upward pressure from the temporary spike in global inflation—though unlike their DM counterparts remain within their historical 2008–2020 range (**Figure 5**). The fact that EM central banks did not experiment with quantitative easing has resulted in a more stable interest rate environment compared to developed markets—a positive development that we believe has not yet been reflected in EM valuations.

**Figure 5: Potential for Value in EM Sovereigns, Local Debt and FX**



Source: J.P. Morgan; Bloomberg. As of August 30, 2024.

## Risks Loom Large but Appear Largely Priced in

Global geopolitical risks are rising rapidly, with wars in Ukraine and the Middle East continuing to escalate, and China becoming increasingly assertive in its claims on the South China Sea. The upcoming U.S. presidential election is arguably exacerbating these conflicts—at least indirectly—as much-needed attention from U.S. lawmakers is being diverted elsewhere. Additionally, while it remains to be seen what a new administration might bring, fiscal consolidation looks increasingly unlikely, while the de-globalization trend that started during Trump’s presidency looks set to continue.

Despite heightened risks and ongoing geopolitical devastation, prices across EM debt have been relatively stable, raising the question:

**Are EMs efficiently pricing in ongoing risks?**

*“With many EM countries outside of China now able to upgrade their production capacities and sell directly to developed markets, any contagion effect should remain minimal.”*

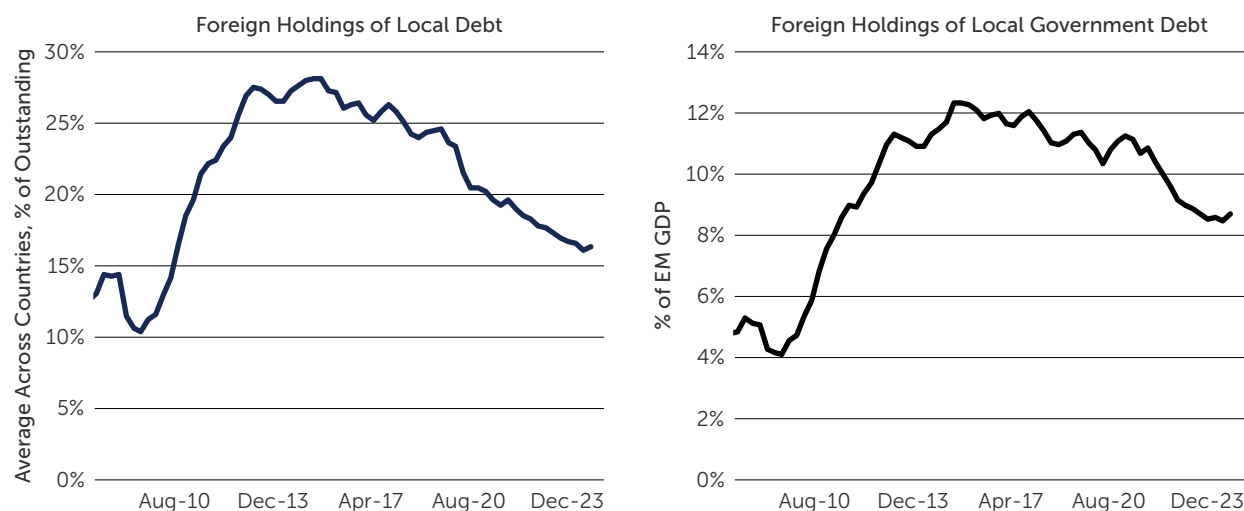
In our view, there are reasons to believe they are. For one, geopolitical risks have, for the most part, been geographically contained. It is also far from clear that the non-democratic world has the upper hand in global events. Russia has fallen short in its attempt to take over Ukraine, for instance, and China is struggling with a debt crisis that has zapped its economic strength. At the same time, the democratic world has shown the lowest level of cross-country animosity in decades—with Europe presenting as united of a front as it has in history, and Japan and Korea continuing to mend ties. Further, and perhaps most importantly, while China is tightly linked to all EMs, its economic difficulties are arguably not a major headwind for EMs overall. China was never a significant consumer of EM products, but rather an intermediary that bought commodities and repackaged them as manufactured goods. With many EM countries outside of China now able to upgrade their production capacities and sell directly to developed markets, any contagion effect should remain minimal.

## Is Now the Time for EM Debt?

Against this backdrop, there is a strong case to be made for EM sovereign debt today. While it is difficult to call a bottom, current prices across EM sovereign debt look compelling and, in some cases, have fallen to extremely attractive levels relative to history. In particular, we believe there is significant upside potential in select EM currencies including European and Latin American currencies. On the hard currency side, EM high yield sovereigns also offer value—particularly BB sovereigns with strong fundamentals such as South Africa, Colombia, Serbia, Costa Rica and Paraguay—where we believe there is room for spread tightening. EM sovereign investment grade spreads look less attractive given that they are currently tighter than their historical averages. Finally, we also see attractive entry points in EM local rates.

The compelling opportunity unfolding across the EM sovereign debt landscape also comes at a time when foreign investors’ holdings in the asset class are underweight relative to history (**Figure 6**). In fact, EM local debt holdings have dropped to levels not seen since 2011, when measured both as a fraction of outstanding EM local government debt and as a percentage of the respective countries’ GDP.

**Figure 6: Foreign Investors are Underweight EM Debt**



Source: Institute of International Finance Global Debt Monitor database. As of June 1, 2024.

For all of these reasons, we believe now may be a good time to increase allocations to EM debt, particularly local currencies, high yield sovereign hard currency debt, and local rates. Of course, as is always the case, performance could vary going forward, particularly in the event of unexpected disruptions from geopolitical or other factors. In this type of environment, selectivity and active management, along with rigorous, bottom-up credit and country selection, will remain crucial.

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