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# EM Local Debt: Time to Shift the Perspective?

EM local debt has historically offered higher yields than the comparable U.S. risk-free rate, and recently has begun to exhibit more stability as well—which presents a compelling case for investors.

INSIGHTS


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U.S. Treasury rates are often referred to as "risk-free," with Treasury yields serving as a benchmark against which other "risk" asset yields are measured. Recently, however, U.S. Treasury yields have become more volatile relative to both history and EM local debt yields, which begs the question: do investors need to shift their perspective regarding the "risk-free" rate?

While the answer to that question is perhaps broader than what we can cover in this piece, it does point to what has arguably become a very attractive environment for emerging markets (EM) local debt.

## Comparing Yields Over Time

J.P. Morgan launched its EM local debt index in 2003, and it remains the most accurate representation of what an investor can obtain in the more liquid domestic EM local debt markets. Historically, EM local bond yields have been significantly higher than U.S. 5-year Treasuries,[1] a reflection of the greater perceived risks in the asset class—in other words, investors have demanded a higher yield for the higher risk they are accepting in their EM debt investments **(Figure 1)**.

**Figure 1: EM Debt Yields Have Historically Been Higher Than U.S. Treasury Yields**


Source: Bloomberg, JP Morgan. As of November 7, 2024.

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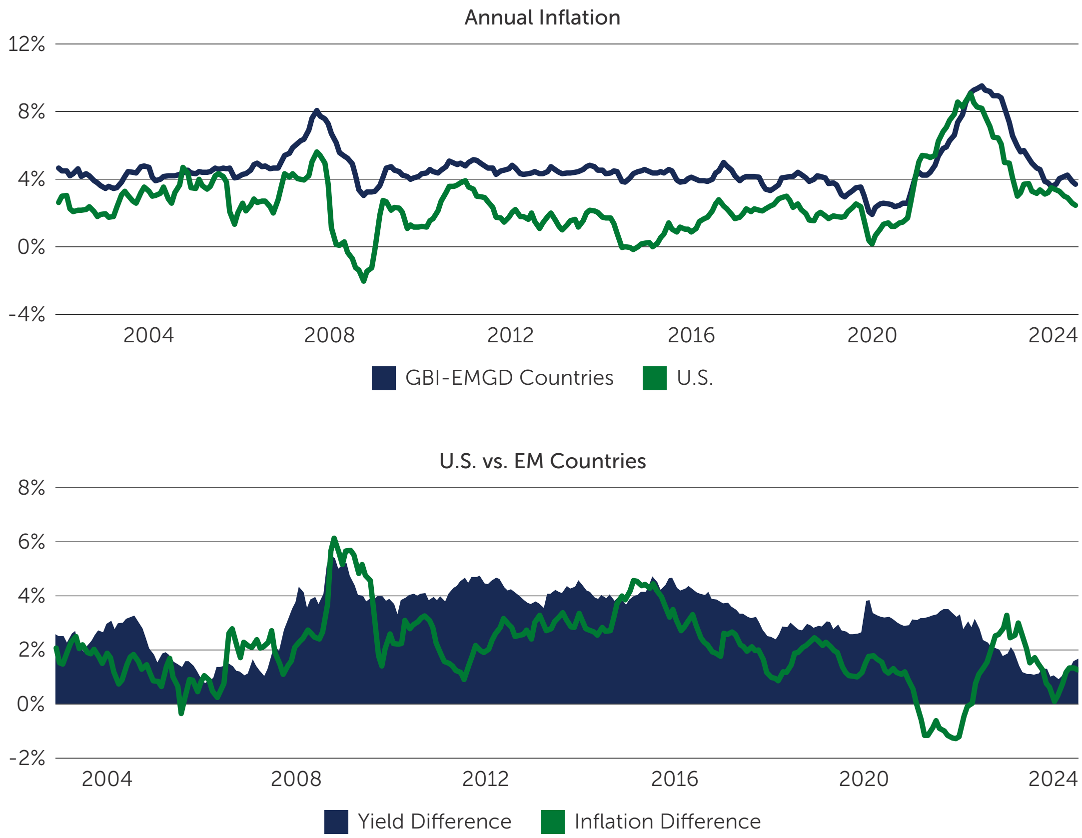
1. We use the 5-year Treasury for comparison purposes given that the duration of the EM index has been approximately five years since inception.

Since 2003, the yield spread between the EM index and the 5-year U.S. Treasury note has fluctuated between 2% and 6%. During that period, the difference between the index-weighted inflation rate of the countries in the EM index and the U.S. inflation rate has ranged between -1% and 4%. And, as **Figure 2** highlights, the inflation differential has been highly correlated with the yield differential over the years.

**Figure 2: Inflation and Yield Differentials Have Been Highly Correlated Over the Years**




Source: Haver Analytics, JP Morgan. As of September 30, 2024.

Of course, a U.S. investor investing in EM local bonds likely cares more about the USD value of their investments than the inflation differential between the U.S. and EM countries. And indeed, the relentless appreciation of the U.S. dollar against EM currencies that began in mid-2011 has been a strong headwind for EM local bond returns. In particular, the currency value of the index against the USD has fallen by more than half since 2011, from 140 to just above 60 **(Figure 3)**. This has undoubtedly been a powerful deterrent for new investors, especially those that have been looking for USD returns.

During that time, the total return of the index, in USD terms, has fluctuated from -20% to +38% on a 12-month rolling basis—with yearly returns ranging from a high of 23% in 2004 and a low of -15% in 2015, despite the headwind from a strengthening U.S. dollar.[2]

2. Source: JP Morgan, Bloomberg. As of November 12, 2024.

## The Pace of EM Currency Depreciation is Slowing

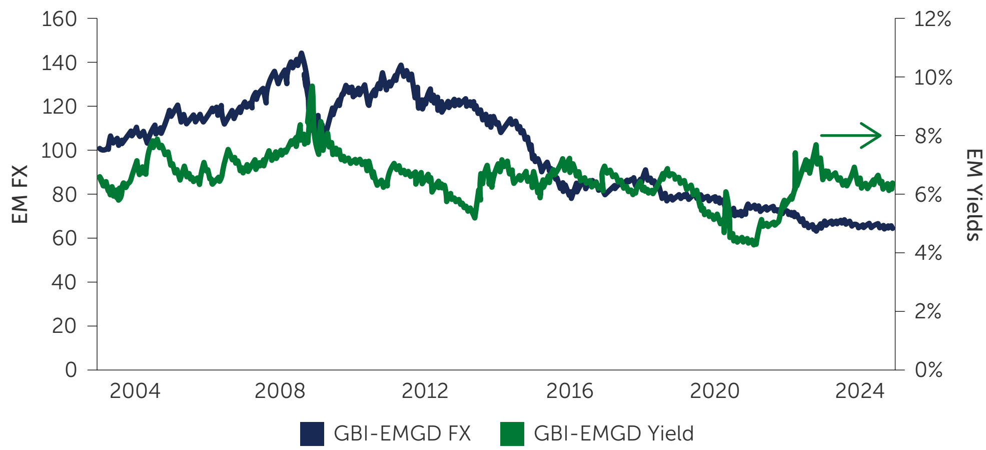
A closer look at the data also reveals that the pace of decline in the EM local exchange rate has slowed materially since 2016 **(Figure 3)**. Specifically, since then, the exchange rate of the EM index vis-à-vis the USD has fallen from 77.5 to 63.3 today.[3] This is an annualized depreciation rate of 2.2%. And in fact, as **Figure 3** also highlights, the pace of currency depreciation has been on a steady decline for over a decade. The yield of the index, on the other hand, has recovered to levels similar to those that the index has averaged since inception.

What does this mean? For investors in EM local debt, a steady index yield at around 6%, combined with a 2% currency depreciation against the U.S. dollar, would result in a USD return of around 4%.[4] While this rate of return may appear underwhelming at first, considering the inherent perceived risk of EM bonds, the story is more nuanced—particularly considering that safe or risk-free interest rates have become more volatile than "risky" ones.

## Attractive Risk-Adjusted Return Potential

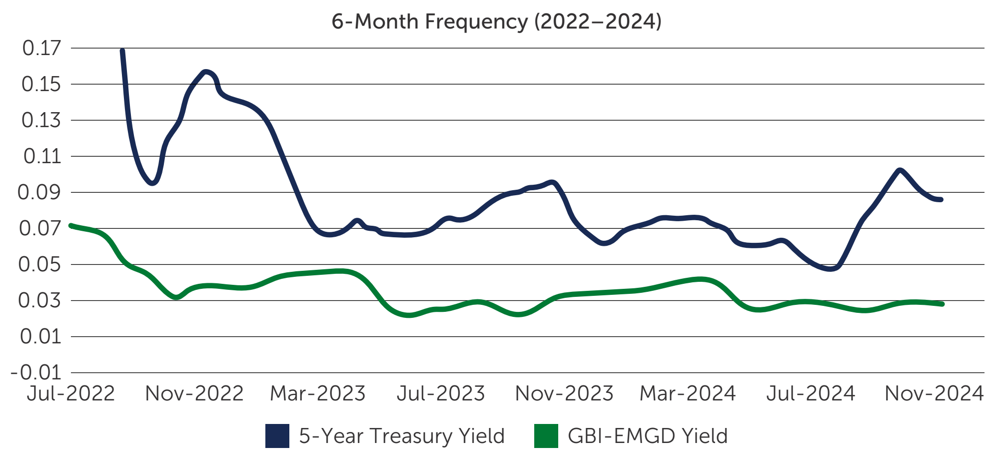
Indeed, U.S. interest rate volatility has risen to twice that of EMs **(Figure 4, top)**. This represents a stark difference from the last time global interest rates were materially above zero, which was during 2003–2007 **(Figure 4, bottom)**.

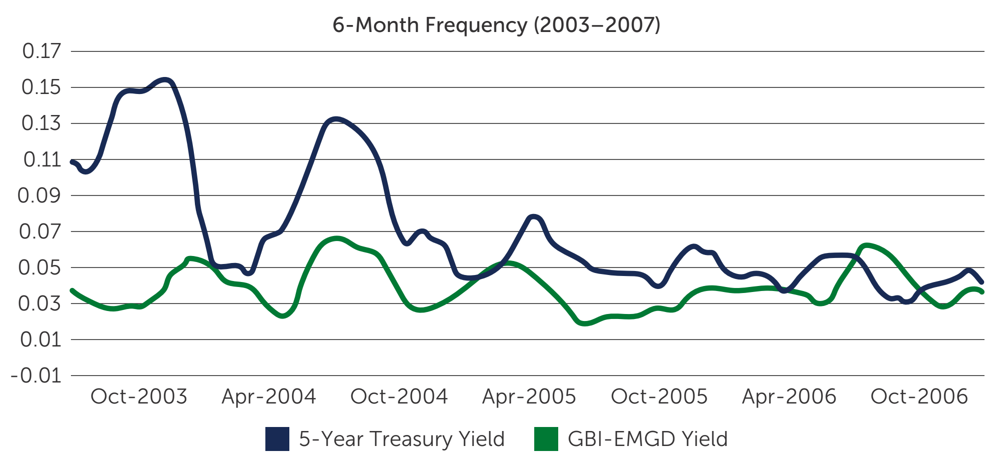
**Figure 3: Steady Currency Depreciation, But Index Yields Recover**




Source: Bloomberg, JP Morgan. As of November 12, 2024.

**Figure 4: U.S. Interest Rate Volatility is Twice That of EMs**




Source: Bloomberg, JP Morgan. Data for top chart as of November 15, 2024. Data for bottom chart as of January 2, 2007.

3. Source: JP Morgan, Bloomberg. As of November 12, 2024. Data calculated from January 20, 2016.
4. Source: Barings' calculations. As of November 15, 2024.

A relatively more stable EM index yield compared to that of U.S. Treasuries has translated into a more attractive risk-adjusted return profile for EM debt **(Figure 5)**. Specifically, during the past decade, EM index hedged to USD has returned 3.7% annually with a realized volatility of 5.1%, resulting in a modified sharp ratio of 0.73. In comparison, the average annual return of investing in U.S. Treasuries has been 3.2% with an annual volatility of 5.1%, resulting in a modified Sharpe ratio of 0.62. For non-USD investors, returns have been higher—Euro-based investors, for instance, have achieved a 9.9% annual return with a return volatility of 5.8%, resulting in a modified Sharpe ratio of 0.58.

**Figure 5: Risk-Adjusted Returns in EM Debt**

| | GBI-EMGD USD Unhedged | GBI-EMGD USD Hedged | GBI_EMGD Euro Unhedged | Bloomberg 5–7 Year UST |
|---|---|---|---|---|
| Volatility | 12.8% | 5.1% | 9.9% | 5.1% |
| Average return | 5.4% | 3.7% | 5.8% | 3.2% |
| Ret/Volatility | 0.42 | 0.73 | 0.58 | 0.62 |

Sources: JP Morgan, Bloomberg. As of November 15, 2024.

## Will a Change in Administration Derail the Story?

When considering the potential implications of a second Trump administration, two key considerations come to mind:

1. Incoming President Donald Trump's first term began in 2017. During the four years of his first term, which included COVID, the USD unhedged EM index's annualized rate of return was 5.5%, with EM currencies depreciating against the USD by 2.2% annually (the latter being included in the index total return).
2. The 10% tariff proposed by President Trump, if enacted, would likely result in an additional appreciation of the USD against all other currencies. While the scale of depreciation will depend on the elasticity of exports and imports, it will likely be in the range of 0% to 10%. If we consider the mid-point estimate of around 5%, and assume that EM currencies will continue to depreciate structurally at a rate of 2% per year, we can calculate that a 7% depreciation of the EM currency index could be in store.

As of November 14, 2024, the EM currency index was 3.3% below its 12-month average—suggesting that it is already halfway to fully pricing in Trump's return to office.[5] Over the next 12 months, if historical patterns reoccur, approximately half of the index's yield could be eroded by currency depreciation. However, there are reasons also to believe that this may be more of a worst-case scenario than the most likely one. Namely, Trump has recently made numerous public comments suggesting he would like to see a weaker U.S. dollar. While this sentiment is at odds with other statements he has made about the dollar's ongoing role as the world's reserve currency, it suggests a less negative scenario for EM overall.

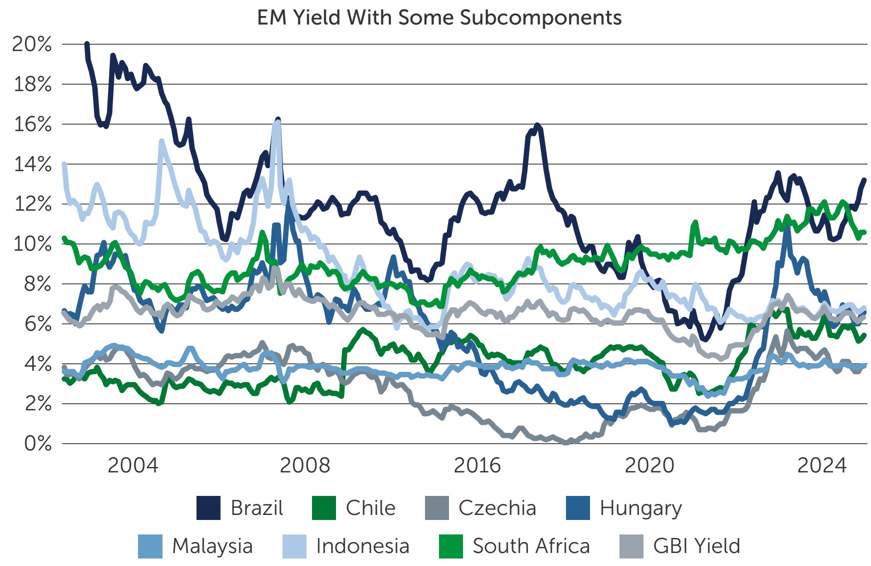
5. Source: JP Morgan. As of November 14, 2024.

## Key Takeaway

EM local debt markets in aggregate have historically offered a higher yield potential than the comparable U.S. risk-free rate, and recently have begun to exhibit more stability as well—which presents a compelling case for investors seeking USD returns. While a second Trump presidency certainly introduces some unknowns, for the reasons above we think it will likely have a more limited impact on the attractiveness of EM local debt than some may be anticipating. These considerations, when combined with declining EM exchange rate levels, suggest the optimal entry point may not be too far ahead.

One important caveat to this scenario is that the EM index yield is substantially more stable than some of the individual country components **(Figure 6)**. This makes sense given the vastness and diversity offered by the asset class. It also suggests that while select attractive opportunities are available for an experienced local rates manager to capitalize on, a cautious approach, together with rigorous country and credit analysis, is paramount to navigating this market.

**Figure 6: Not All EM Yields Are Stable**




Source: Bloomberg, JP Morgan. As of July 30, 2024.

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