LPL RESEARCH

BOND MARKET PERSPECTIVES

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EMERGING MARKET DEBT: RISKS REMAIN

John Lynch *Chief Investment Strategist, LPL Financial*
Shawn Doty *Senior Analyst, LPL Financial*

KEY TAKEAWAYS

Signs of emerging market debt (EMD) weakness have been evident since late April.

EMD spreads are more attractive than they have been in some time, potentially offering an opportunity for patient investors; however, headwinds remain, leaving us neutral on the asset class in the near term.

Not all EMD countries are created equal, which may set up opportunities for active management in the space.

Emerging market debt (EMD) recently had a rough month, with the Bloomberg Barclays Emerging Markets Sovereign Index losing 3.3% from April 18–May 18, 2018. The index currently yields almost 6.2%, its highest level since early 2016, and the spread to comparable Treasuries has also increased back to mid-2016 levels near 3.1%, as shown in Figure 1. However, before we can determine if EMD represents an opportunity at current levels, it is important to look at the major causes of recent weakness, which include rising yields, a stronger dollar, and the continued potential for trade disruptions.

RISING YIELDS AND DOLLAR STRENGTH ARE HEADWINDS

Rising expectations for Federal Reserve (Fed) rate hikes, higher growth and inflation expectations, and additional supply in the U.S. Treasury market have all conspired to push Treasury yields higher in recent months. These changes, as

1 EMD YIELD AND SPREAD ARE HIGHER THAN THEY HAVE BEEN SINCE 2016

Source: LPL Research, Bloomberg 05/21/18

EMD - Emerging Market Debt

OAS - Option-adjusted spreads represent the difference between the index yield and the yield of a comparable maturity Treasury. The OAS can be used to measure the risk levels markets are placing on high-yield bonds.

Yield to worst is defined as the lowest potential yield that can be received on a bond without the issuer actually defaulting and reflects the possibility of the bond being called at an unfavorable time for the holder.

Indexes*

* Indexes are unmanaged and cannot be invested into directly. Unmanaged index returns do not reflect fees, expenses, or sales charges. Index performance is not indicative of the performance of any investment. Past performance is no guarantee of future results.

Index referenced is Bloomberg Barclays EM Sovereign Index.

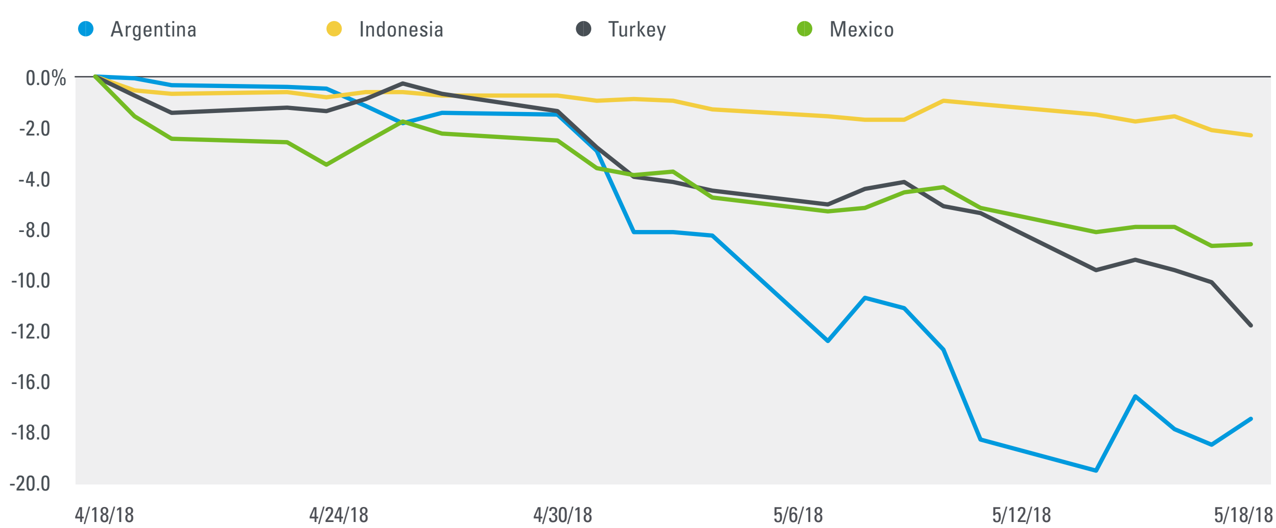
well as economic data missing expectations in other parts of the world, have also pushed the dollar higher (as discussed in this week's [Weekly Economic Commentary]).

Accommodative policy from major global central banks led to a search for yield in recent years, which helped push U.S. and other developed market investors toward the relatively higher rates of EMD. EMD also benefited from stronger economic growth and lower debt levels than many developed nations. However, EMD also presents a different risk profile than developed bonds. The export-driven nature of many small EM nations, and the fact that a significant portion of debt is issued in dollars, means that EMD can be sensitive to factors that those nations don't have control over, such as the global economy and central bank policies of major developed nations.

The recent rise in Treasury yields can make U.S. debt look more attractive, on a risk-adjusted basis, and may cause investors to pull money from EMD to invest domestically. For debt issued in a country's local currency, as investors pull money out, they convert the local currency to dollars, which can lead to weakness in a country's currency. However, many EM countries issue at least a portion of their debt in dollars. This removes currency risk from the equation for U.S.-based investors, but adds currency risk for the issuing country, given that they have to convert their local currency to dollars in order to pay interest and principal to investors. Debt levels are generally lower for EM countries, which may limit the potential for default, but this could still be a concern for heavily indebted countries or in situations where currencies experience significant weakness versus the dollar.

Currency depreciation over the past month versus the U.S. dollar for the four countries with the largest weighting in the Bloomberg Barclays EM Sovereign Index is depicted in Figure 2.

2 **U.S. DOLLAR STRENGTH HAS BEEN A FACTOR IN EMD WEAKNESS, BUT NOT ALL EM CURRENCIES HAVE FOLLOWED THE SAME PATH**



Source: LPL Research, FactSet, Bloomberg 05/18/18

EMD - Emerging Market Debt

Illustration is historical, and no guarantee of future results.

The Argentine peso and Turkish lira experienced the worst depreciation, though all countries saw a decline in the value of their currencies relative to the dollar. It is also interesting to note that while China is the largest country in the MSCI Emerging Markets Equity Index (see this week's *Weekly Market Commentary* for more on EM equities), it makes up just 0.2% of the EMD index, given that the country issues relatively little dollar-denominated debt.

EM COUNTRIES ARE NOT CREATED EQUAL

While rising U.S. yields and a stronger dollar are factors in EMD weakness, it is also essential to keep in mind that each EM country is its own entity, and political, economic, and fiscal situations can vary widely between countries. The way countries react to their situations can vary as well. For this reason, we believe that active management may be beneficial in this asset class.

While Argentina may be South America's second largest economy, the country is not immune to volatility (as seen in **Figure 2**) and saw a large decline (17%) in the value of its currency relative to the dollar recently. The Central Bank of Argentina responded by raising its reference rate from 30% to 40% in recent weeks, and the government is also speaking to the International Monetary Fund (IMF) about an emergency line of credit. Both of these actions are in-line with widely accepted economic principles; so at the very least, investors can see that Argentina is handling the situation in a mostly responsible manner, even if there may be continued pain in the near term.

Turkey, another large part of the index, is handling things in a different way. During a recent Bloomberg interview, President Erdoğan indicated that he may take a more hands-on approach to monetary policy following an upcoming election, which many investors may perceive as political interference in monetary policy, a move that may damage investor perception of Turkish debt.

CONCLUSION

Recent weakness in EMD has made yield spreads to comparable Treasuries more attractive than they have been in over a year, though the potential for additional moderate dollar strength, rising rates, and trade disruptions remain headwinds for the asset class. For appropriate investors who can potentially ride out some additional volatility and want to take advantage of recent weakness, consider evaluating an active manager given the wide disparity between the economic situations of individual countries under the EMD umbrella. ■

IMPORTANT DISCLOSURES

The opinions voiced in this material are for general information only and are not intended to provide specific advice or recommendations for any individual. To determine which investment(s) may be appropriate for you, consult your financial advisor prior to investing. All performance reference is historical and is no guarantee of future results. All indexes are unmanaged and cannot be invested into directly.

The economic forecasts set forth in the presentation may not develop as predicted and there can be no guarantee that strategies promoted will be successful.

Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values and yields will decline as interest rates rise, and bonds are subject to availability and change in price.

Government bonds and Treasury bills are guaranteed by the U.S. government as to the timely payment of principal and interest and, if held to maturity, offer a fixed rate of return and fixed principal value. However, the value of fund shares is not guaranteed and will fluctuate.

International debt securities involve special additional risks. These risks include, but are not limited to, currency risk, geopolitical and regulatory risk, and risk associated with varying settlement standards. These risks are often heightened for investments in emerging markets.

Currency risk is a form of risk that arises from the change in price of one currency against another. Whenever investors or companies have assets or business operations across national borders, they face currency risk if their positions are not hedged.

Active management involves risk as it attempts to outperform a benchmark index by predicting market activity, and assumes considerable risk should managers incorrectly anticipate changing conditions.

INDEX DESCRIPTIONS

The Bloomberg Barclays Capital Emerging Markets Sovereign Index (USD) measures the investment return of U.S. dollar-denominated bonds issued by governments of emerging market countries.

The MSCI Emerging Markets Index captures large and mid-cap representation across 23 emerging markets (EM) countries. With 822 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country.

The Bloomberg Barclays U.S. Treasury Index is an unmanaged index of public debt obligations of the U.S. Treasury with a remaining maturity of one year or more. The index does not include T-bills (due to the maturity constraint), zero coupon bonds (strips), or Treasury Inflation-Protected Securities (TIPS).

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