Investment Management
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UNDERSTANDING EMD

Demystifying Emerging Markets Debt

Understanding emerging markets (EM) debt involves recognizing the risks, myths, and opportunities that differentiate it from other asset classes. Critically analyzing these aspects is essential for gaining insight into this often-misunderstood asset class.

Key Topics:

- The four universes of EM debt
- The investment risks and opportunities in EM debt
- The diversification characteristics of EM debt
- The performance drivers of EM debt
- The myths of EM debt

What is Emerging Markets Debt?

The EM debt investable universe is composed of fixed-income securities issued by EM governments and companies.

Securities can be issued in hard currencies or local currencies, and there are four universes within EM debt: hard currency sovereign debt, hard currency frontier markets debt, hard currency corporate debt, and local currency sovereign debt.

Hard currency debt is denominated in developed-market currencies (such as the U.S. dollar), issued in international markets, and subject to the issuing country's laws.

Local currency debt is denominated in EM currencies (such as the Brazilian real or the Mexican peso) and predominantly issued in local markets under the issuing country's laws.

Overall, EM debt consists of 900 issuers from more than 90 countries, with a combined market capitalization of $4.5 trillion.

Marcelo Assalin, CFA, Partner
Head of Emerging Markets Debt Team

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This is an excerpt from our continuing education series *Demystifying Emerging Markets Debt*.

Eligible CE credit: One hour CIMA, CPWA, RMA, CFA, CFP

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Rationale for Investing in EM Debt—Diversification

	EMD HC	EMD LC	EMD Corp.	Global Equities	EM Equities	U.S. IG	U.S. HY	U.S. Treasurys
EMD Hard Currency	1.00	0.83	0.92	0.68	0.75	0.81	0.79	0.28
EMD Local Currency		1.00	0.77	0.71	0.85	0.63	0.68	0.17
EMD Corporate			1.00	0.64	0.75	0.77	0.77	0.21
Global Equities				1.00	0.83	0.50	0.78	-0.08
EM Equities					1.00	0.54	0.77	-0.04
U.S. Inv. Grade						1.00	0.65	0.60
U.S. High Yield							1.00	-0.07
U.S. Treasurys								1.00

Lowest to highest correlation

Source: ICE BofA Merrill Lynch, J.P. Morgan, and MSCI, for the 15 years ending September 30, 2023. **Past performance is not indicative of future returns.** Index representation is as follows: EMD hard currency, J.P. Morgan EMBI Global Diversified; EMD local currency, J.P. Morgan GBI-EM Global Diversified; EMD corporate, J.P. Morgan CEMBI Diversified; global equities, MSCI World Index; EM equities, MSCI Emerging Markets Index; U.S. investment grade, J.P. Morgan U.S. IG Corporate Index; U.S. high yield, J.P. Morgan U.S. High Yield Index; U.S. Treasuries, Bloomberg U.S. Treasury Bills Index. A direct investment in an unmanaged index is not possible. Please see back page for additional information.

Why Invest in Emerging Markets Debt?

EM debt is a sizable asset class that has substantially grown over the years. It now represents close to a quarter of the global fixed-income universe, and is diversified across countries, currencies, and corporate credit issuers.

Multilateral and bilateral institutions provide strong support for EM countries, with accessible and affordable financing. This helps contribute to lower default rates.

In addition, EM debt tends to have a lower correlation to other global asset classes, which offers investors the potential for diversification. EMD debt is also under-owned and under-researched, which provides alpha opportunities for skilled investors.

Performance Drivers of Emerging Markets Debt

The performance of EM debt is primarily driven by two forces: global economic growth and global liquidity conditions.

Improving economic conditions tend to lead to fundamental improvement in EM countries, which can result in lower risk premiums. And when global interest rates are low and global liquidity is abundant, EM debt appears to perform well.

In market environments with declining inflation or falling interest rates, EM debt also performs well, as it tends to display a higher sensitivity to rates. In volatile market environments, EM debt will typically display higher volatility than other fixed-income asset classes in the developed market space due to rising risk aversion and investor outflows. But this asset class has historically performed well after periods of high market volatility.

In addition, the U.S. dollar plays an important role in EM debt, and securities are likely to benefit when the U.S. dollar depreciates.

12 Myths of Emerging Markets Debt

Investing in EM debt is often viewed through a lens of caution, underscored by a common narrative that emphasizes heightened risk. Common myths include:

1. EM debt is a very volatile asset class.
2. EM debt default risk is high.
3. There is a lack of transparency in assessing EM debt.
4. Exchange-traded funds (ETFs) are a safer option for EM debt investors.
5. EM debt is a niche asset class.
6. EM corporate debt is riskier than EM sovereign debt.
7. EM debt is a narrow universe with limited opportunities.
8. EM debt is illiquid.
9. Higher U.S rates could result in economic problems for emerging economies and EM debt.
10. EM debt carries too much currency risk.
11. A strong dollar will hurt EM debt.
12. EM debt isn't right for my portfolio.

These myths tend to overshadow the nuanced realities of EM debt, but dissecting them reveals an asset class that, when navigated with insight and expertise, presents compelling opportunities for discerning investors.

"The excess risk premium provided by EM debt tends to compensate investors for the relative higher volatility of the asset class."

Marcelo Assalin, CFA, Partner

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Past performance is not indicative of future results. Investing involves risks, including the possible loss of principal. Investing in foreign denominated and/or domiciled securities may involve heightened risk due to currency fluctuations, and economic and political risks. These risks may be enhanced in emerging markets. Investing in the bond market is subject to certain risks including market, interest rate, issuer, credit, and inflation risk. Rising interest rates generally cause bond prices to fall. High-yield, lower-rated securities involve greater risk than higher rated securities. Sovereign debt securities are subject to the risk that an entity may delay or refuse to pay interest or principal on its debt because of cash flow problems, insufficient foreign reserves, or political or other considerations. Diversification does not ensure against loss.

J.P. Morgan U.S. High Yield Index measures the performance of U.S.-dollar-denominated below-investment-grade corporate debt publicly issued in the U.S. market. **J.P. Morgan U.S. Investment Grade Corporate Index** measures the performance of U.S. investment-grade corporate debt. **J.P. Morgan CEMBI Broad Diversified Core Index** tracks the performance of U.S-dollar-denominated bonds issued by emerging market corporate entities. **J.P. Morgan GBI-EM Global Diversified Index** tracks local currency bonds issued by emerging market governments. **J.P. Morgan EMBI Global Diversified Index** tracks liquid, U.S. dollar emerging market fixed- and floating-rate debt instruments issued by sovereign and quasi-sovereign entities. (Index information has been obtained from sources believed to be reliable, but J.P. Morgan does not warrant its completeness or accuracy. The indices are used with permission. The indices may not be copied, used, or distributed without J.P. Morgan's prior written approval. Copyright J.P. Morgan Chase & Co. All rights reserved.) **MSCI Emerging Markets Index** is a free-float-adjusted market capitalization index that is designed to measure equity market performance in global emerging markets. **MSCI World Index** is a market-capitalization-weighted index of stocks from companies throughout the world and is used as a common benchmark for "world" or "global" stock funds intended to represent a broad cross-section of global markets. **Bloomberg U.S. Treasury Bills Index** measures U.S.-dollar-denominated, fixed, rate, nominal debt issued by the U.S. Treasury. Index performance is provided for illustrative purposes only. A direct investment in an unmanaged index is not possible.

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