Vanguard

Expert Perspective

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Why we're bullish on emerging markets debt

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Introduction

Inflation worries continue. Recession fears are gripping the market. Equities have dropped. Federal Reserve rate hikes are aggressive. Credit spreads have widened. And interday volatility remains at crisis levels.

These are all reasons your clients are reaching out to you for answers and ways to capture more alpha in their portfolios. We believe emerging markets may be an unexpected opportunity for your clients as you consider rebalancing their portfolios. Our team sees current valuations as likely setting the stage for emerging markets debt to generate high income and strong total returns over the next 12 to 18 months, with adequate compensation for risk.

Consider Vanguard Emerging Markets Bond Fund

Here's a look at the relative performance of Vanguard Emerging Markets Bond Fund, which was launched in 2019, as of July 31, 2022:

Period	Fund	Index	Difference
July, 2022	3.80%	2.89%	0.91%
Year to Date (July 2022)	-15.49%	-18.01%	2.52%
Since Inception (Cum. 3rd December 2019 - July 2022)	0.02%	-13.26%	13.28%
Since Inception (Ann. 3rd December 2019 - July 2022)	0.01%	-5.21%	5.22%

Note: Past performance is no guarantee of future results. The performance of an index is not an exact representation of any particular investment, as you cannot invest directly in an index.

Why emerging markets bonds?

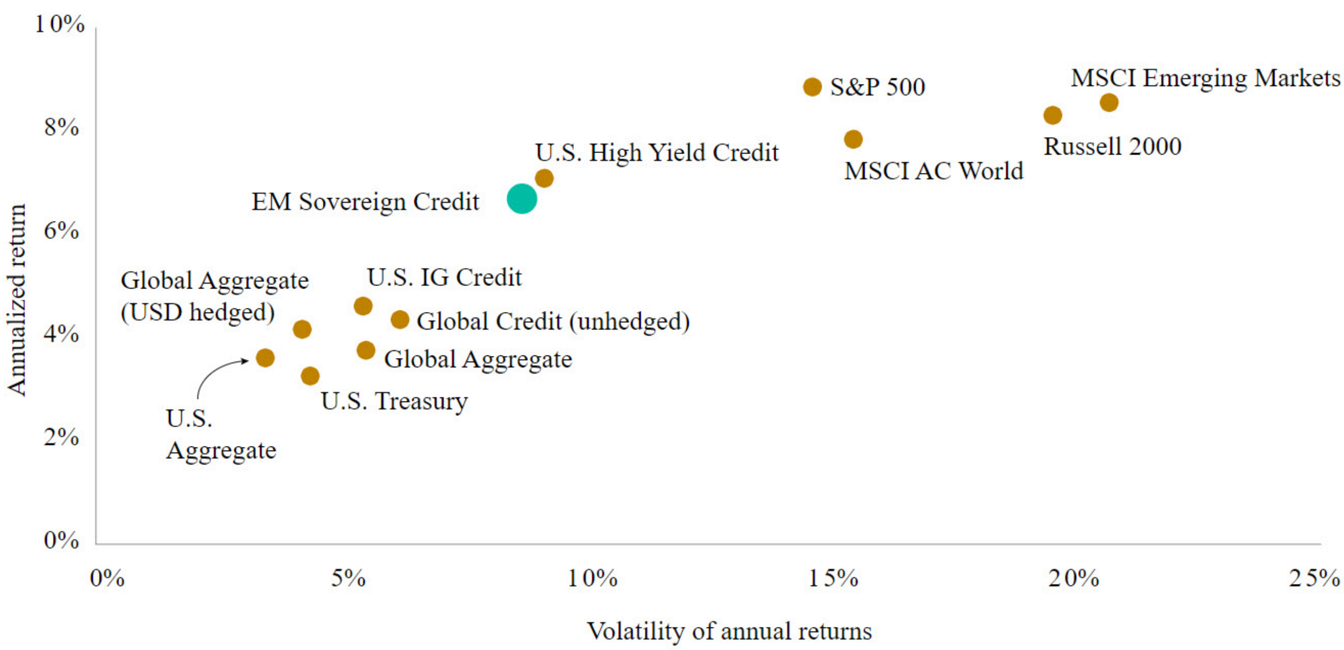
Emerging markets debt stands out from other parts of the credit market for three reasons.

Performance history

Emerging markets external debt (dollar-denominated bonds of emerging markets sovereign issuers) has a long history of strong risk-adjusted returns as this chart shows:

An asset class with an intriguing risk-return profile

20-year horizon, from March 31, 2002–March 31, 2022



Sources: Vanguard calculations, using data from Bloomberg, J.P. Morgan, S&P Dow Jones Indices, MSCI, and Russell.
Past performance is no guarantee of future results. The performance of an index is not an exact representation of any particular investment, as you cannot invest directly in an index.
Note: Volatility calculated as annualized standard deviation of monthly returns.

Greater global diversification

Emerging markets debt is significantly more diversified than it has ever been, with numerous new issuers from both sides of the credit spectrum. The category includes low-income countries from sub-Saharan Africa and wealthy oil exporters from the Persian Gulf. A more diversified issuer base translates into less idiosyncratic risk and more active management opportunities.

Sovereign resilience

Another strength of this asset class is the resilience of sovereign issuers. Emerging markets countries have access to pools of financing from multilateral and bilateral lenders not available to private issuers. They also can fund domestically and raise additional revenues through taxes.

This certainly does not make emerging markets investments risk-free, and defaults do happen, but the incentive to pay the debt is very high. In fact, recovery rates after default are often higher than for corporate issuers because countries do not simply disappear as a company may. Once a recovery is in place, returns from emerging markets debt can be very significant as longer bond maturities can sustain price appreciation and countries strive to improve their credit fundamentals.

Why emerging markets now?

The specific case for emerging markets debt comes down to valuations and improving technical factors, while fundamentals are mixed. Many emerging markets issuers will continue to benefit from higher commodity prices, but some are exposed to higher import costs for food and fuel. Government revenues have been strong, but higher imported inflation is increasing costs for domestic borrowing as costs for external borrowing have risen.

Financial markets have already factored current fundamental risks into prices. As of June 30, the J.P. Morgan Emerging Markets Global Bond Index Diversified yield stood at 8.57%. For comparison, this yield just touched 8% during the peak of the COVID liquidity crisis in March of 2020, and the last time we saw these levels was in the aftermath of the global financial crisis. The more than 22% drawdown since the middle of September 20211 already exceeds the worst drop in 2020 and is within 5% of the peak drawdown in 2008.

Emerging markets debt is further along in its adjustment. Triggered by early signs of global monetary tightening, the emerging markets sell-off began in the fourth quarter of 2021, much earlier than in the sell-off in the broader credit market. That's one reason we believe emerging markets debt is closer to its bottom and better positioned for recovery than other asset classes. The rapid selloff in spreads and global interest rates has resulted in historically low dollar prices for emerging markets bonds. While this mostly supports distressed issuers that may be forced to restructure (minimizing any loss given default), it should also result in tighter spreads for healthy credits, given the lower dollar amount investors have to put at risk for each bond purchased.

Technical factors are improving. Weaker emerging markets issuers (over 20% of the market) are currently locked out of market access and will need to fund through alternative means. Another 20% of the market consists of wealthy oil exporters with very low funding needs due to high oil revenues. As a result, we expect to see negative net issuance this year, offsetting the impact of fund outflows. While emerging markets funds (along with other fixed income products) continue to see outflows, those outflows are relatively contained as a percentage of assets under management. Given high cash levels in emerging markets funds, any stabilization or reversal in flows could lead to a rapid repricing higher.

Bottom line, emerging markets fixed income is attractive

While it's always hard to pick the exact bottom, we feel comfortable about the outlook for emerging markets debt returns for 12 to 18 months. We're now positioned constructively in our emerging markets portfolios and encourage you to consider increasing allocations to emerging markets debt in your clients' portfolios.

Note

- Past performance is no guarantee of future results. All investing is subject to risk, including possible loss of principal. Diversification does not ensure a profit or protect against a loss.
- Bond funds are subject to the risk that an issuer will fail to make payments on time, and that bond prices will decline because of rising interest rates or negative perceptions of an issuer's ability to make payments.
- Bonds issued by companies based in emerging markets are subject to national and regional political and economic risks and to the risk of currency fluctuations. These risks are especially high in emerging markets.

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