Investment Insights

Invesco Fixed Income

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Invesco

Hemant Baijal
Head of Multi-Sector
Portfolio Management – Global Debt

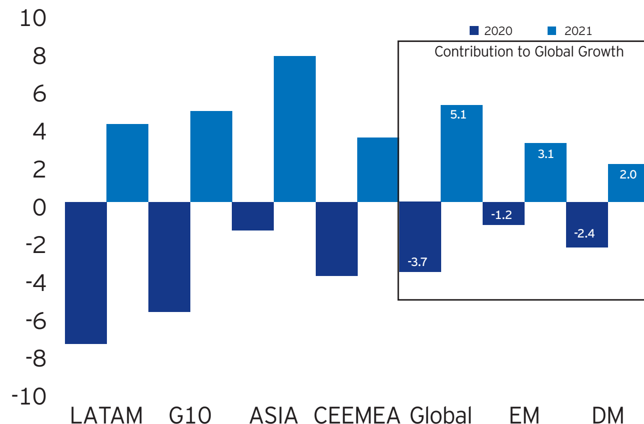
The case for emerging markets fixed income amid improving global growth

We believe global macro conditions and a shift in central bank frameworks have set the stage for a sustained outperformance of emerging market (EM) assets over the next two to three years. Global growth is expected to accelerate in the next few years, aided by the massive fiscal policy response in developed economies and some EMs. The changing policy framework at the US Federal Reserve (Fed), in particular, should ensure that US financial conditions remain favorable for a sustained, positive EM cycle. And while we consider the most influential policy change to be in the Fed's framework, we expect policies of all major developed market central banks to support the EM asset class for the foreseeable future.

Global growth and its implications for EM

We expect global growth to improve significantly in 2021, as recovery gains momentum after the virus-induced economic collapse in Q2 2020. While second and third waves of COVID-19 have reduced our near-term growth forecasts, as some countries will likely post contractions in Q4, our forecasts for next year and beyond have not changed significantly. Our forecasts assume the availability of at least a partially successful vaccine by Q1 2021, and they could be revised upward if the efficacy and uptake of the vaccine is very high.

Figure 1: Global GDP forecasts (%)



Source: Invesco calculations, as of Oct. 30, 2020.
The box shows the contributions of EM and DM to global GDP growth. CEMEEA is Russia, Turkey, Poland, South Africa, Hungary. EM is Brazil, Mexico, Argentina, Colombia, Chile, Peru, China, Hong Kong, India, Indonesia, Korea, Malaysia, Philippines, Thailand, Taiwan, Singapore. DM is US, European Union, Japan, UK, Canada, Australia, Sweden, Norway, New Zealand.

The major factor underlying our expectations is the Fed's new policy framework that should prevent US financial conditions from tightening as growth expectations improve. Going forward, growth differentials between the US and other countries will likely matter less for aggregate EM performance than they have in the past, as the market will likely not reprice the Fed's path as growth picks up. We believe this is the most significant differentiator for the upcoming cycle when compared to the 2013 taper tantrum and the 2018 tax and budget deal. In the current environment, we expect improving global growth, whether driven by the US, other developed markets or EM, to be net-positive for EM assets and investment flows.

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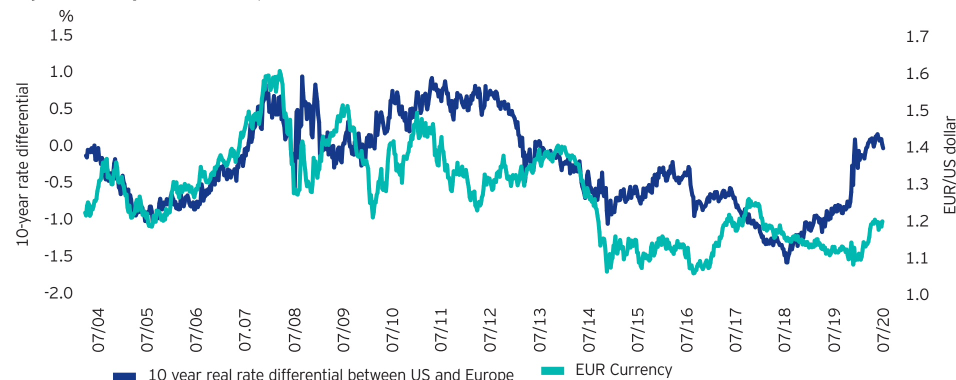
Real interest rate differentials could trigger US dollar weakness

In an environment in which short and medium-term nominal US interest rates cannot rise to reprice the Fed's path and only long-term rates can rise, the likely outcome is for the US dollar to weaken. Without the ability to reprice nominal rates, real rates will likely fall to accommodate increased inflation expectations. This should add to the already negative impact on the US dollar from increasing twin US deficits. In such an environment, growth differentials between the US, Europe, China and other EMs should matter less for aggregate EM performance, but should still matter for relative EM performance and alpha generation.

In recent months, real interest rates in the US have dropped significantly vis-à-vis other developed market peers, removing one of the underpinnings of US dollar strength. Given the Fed's greater credibility compared to other major central banks regarding its ability to create inflation, we believe real rates in the US will fall further into negative territory as growth improves. Figure 2 shows the real interest rate differential between the US and Europe and its correlation to the euro. The real interest rate differential is currently hovering around zero. With growth, we would expect US real rates to fall below European real rates, creating the conditions for broad-based US dollar weakness. A similar dynamic exists vis-à-vis Japan. Amid broad-based US dollar weakness, we would expect EM currencies to first stabilize and then appreciate.

Figure 2: 10-year US/Europe real interest rate differential vs. the euro



Source: Bloomberg, data from July 23, 2004 to Oct. 23, 2020.

US dollar weakness could trigger a virtuous cycle in EMs

The weakening of the US dollar could have two beneficial impacts on EM assets. First, it becomes easier for EMs to finance fiscal and external deficits and second, it improves balance sheets for countries with negative net international investment positions. EM countries, in aggregate, have improved the management of their external liabilities, leading to smaller current account deficits and less need for capital inflows to be unhedged. In our view, a stable-to-weaker US dollar could create a positive feedback loop in which embedded currency premia would not need to rise as economic activity picks up. These global conditions, combined with attractive valuations in most EM countries, could create the conditions for cyclical outperformance.

Attractive yield curves will likely support total return opportunities

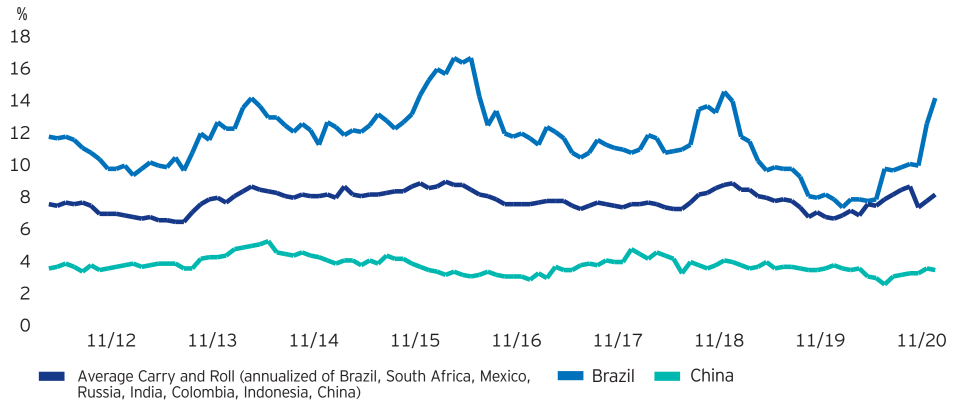
Yield curves in most EM countries have steepened with interest rate cuts across most EM countries, as EM central banks took advantage of monetary policy room that opened when the Fed cut rates to zero. Figure 3 shows the term premia in selected EM countries.

Figure 3: EM yield curves (10-year bonds vs. overnight rates) in selected high yielding countries

Source: Bloomberg, data from Dec. 1, 2014 to Nov. 1, 2020.

Consequently, the expected static return (comprising carry and roll) has stayed near, or above, pre-COVID-19 levels in several EM countries – both higher and lower yielding. Figure 4 shows the average expected (static) annualized return in several EM countries and shows consistent returns for the country with the highest expected return (Brazil) and the country with the lowest expected return (China). Despite lower yields, the expected return for this group has not fallen. Even in China, the expected rate of return is stable and above the return currently available in other developed markets.

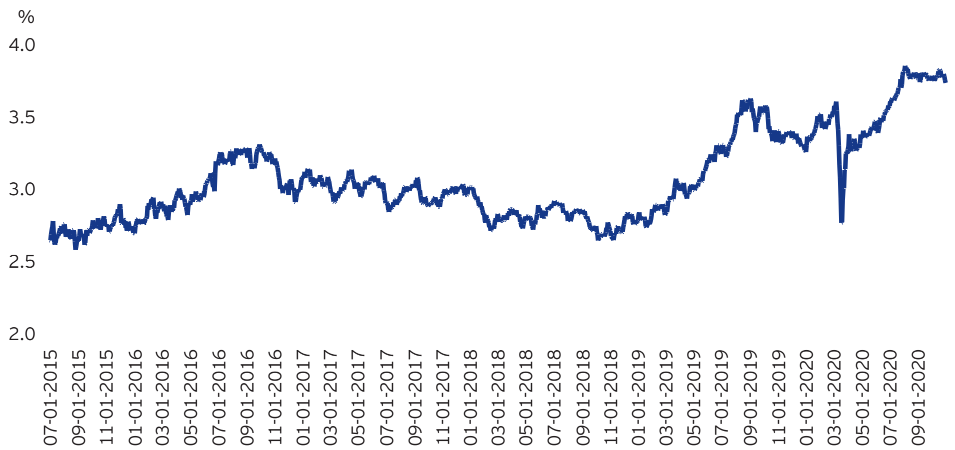
Figure 4: Annualized expected static return (carry and roll for 5-year government bonds) in selected EM countries



Source: Bloomberg L.P., data from Feb. 1, 2012 to Nov.1, 2020.

Another method of identifying relative valuation in EM is to look at the real yield differential between EM and developed market interest rates. Figure 5 shows that this differential is currently at its widest level in the past five years, providing the potential for EM assets to outperform cyclically without significant policy action.

Figure 5: 10-year real yield differential between selected EM and developed market countries



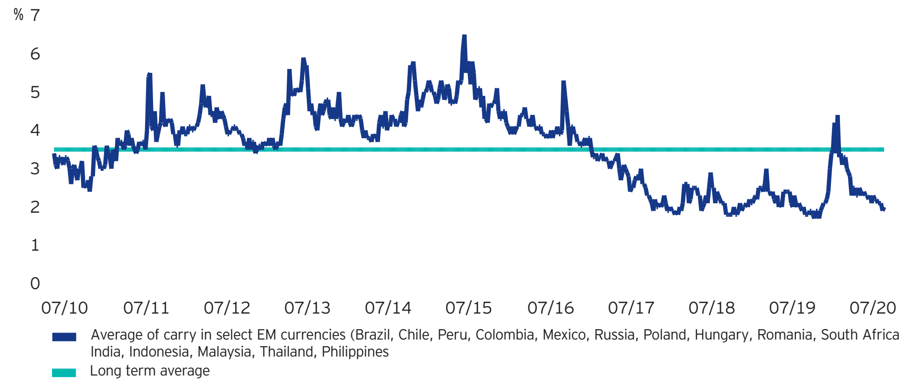
Source: Bloomberg, data from July 1, 2015 to Oct. 30, 2020. EM countries are Brazil, Mexico Colombia, South Africa, India and Indonesia. Developed market countries are US, Europe, UK, Japan and Australia.

Currency-hedged duration is potentially attractive

Given the well-behaved external accounts of most EM countries, currency premia embedded in EM currencies have declined in recent years and the need for unhedged capital flows has declined, even in some historically "savings-deficit" countries. The flip side to lower currency premia is a lower cost of hedging EM bonds for investors who do not want to take currency risk due to high capital requirements or volatility. Rarely have the term premia on EM assets exceeded the cost of currency hedging, making EM an attractive asset class, in our view, based on its interest rate characteristics.

Figure 6 shows that the average EM currency premium is at a decade low. However, in a global environment in which developed market interest rates are at the zero bound and likely to remain so, this lower currency premium is still quite substantial at 2% annualized (Figure 6). Given the high static expected rate of return in many countries, for investors who prefer little or no currency risk, the hedged return is likely to be an attractive alternative to developed market rates.

Figure 6: Currency carry in selected EM currencies



Source: Bloomberg L.P., data from July 23, 2010 to Oct. 30, 2020.

Conclusion

Given attractive carry and roll and positive currency premia, expected returns on EM local fixed income could remain attractive for the next two to three years. Improving global growth conditions and the right conditions for a weaker US dollar are supportive of the asset class, in our view, relative to developed markets faced with a decade of near-zero nominal returns. While most EM countries should benefit from these conditions, significant dispersion in returns is possible, making sequencing investments within this opportunity set critical. Given this dynamic, the alpha component should exhibit greater value relative to the beta component, although our expectations for the beta component remain solid.

Investment risks

The value of investments and any income will fluctuate (this may partly be the result of exchange rate fluctuations) and investors may not get back the full amount invested. Past performance is not a guide to future returns.

Fixed-income investments are subject to credit risk of the issuer and the effects of changing interest rates. Interest rate risk refers to the risk that bond prices generally fall as interest rates rise and vice versa. An issuer may be unable to meet interest and/or principal payments, thereby causing its instruments to decrease in value and lowering the issuer's credit rating. The values of junk bonds fluctuate more than those of high quality bonds and can decline significantly over short time periods.

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All data as of October 31, 2020, unless otherwise stated. All data is USD, unless otherwise stated.

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