EMD: A Survivor—Past, Present, Future

February 27, 2018

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Following a strong 2017, emerging-market debt (EMD) held its own in January despite a sharp rise in US interest rates. That's no accident. Economic fundamentals have improved dramatically, leaving EMD well positioned to withstand future turbulence.

US Treasury yields surged in January as investors belatedly began pricing in higher inflation and the possibility of as many as four interest-rate hikes this year from the Federal Reserve. Even so, many EMD indices for US dollar– and local currency¬–denominated bonds produced positive returns. Local-currency debt did especially well, even outpacing global high-yield corporates.

Active EMD managers produced even more impressive results; more than 75% of active hard-currency managers outperformed their benchmarks in January.

Neither the current volatility nor EMD's recent performance should come as a surprise. We warned late last year that a reassessment of inflation and US interest-rate risk was overdue and that volatility would increase. We also urged investors to stay active and be selective about their EMD exposure. But we did not suggest pulling back on EMD, which we said was in a strong position to withstand increased volatility.

What explains the sector's staying power? To answer that, let's quickly review where EMD has been, where it is now and where we think it's headed.

The Past. Over the past few years, many emerging economies have reduced their current account deficits, tamed inflation and started to shore up their public finances by instituting spending caps and simpler tax systems and ending energy and other subsidies.

It wasn't always so. In the early part of the decade, many EM countries ran larger current account deficits and depended on portfolio inflows—money invested in domestic stock and bond markets—to finance them. When the Federal Reserve first hinted in 2013 at plans to tighten its easy monetary policy, global investors took that as their cue to cut risk, causing EM currency values to plunge and interest rates to rise.

The vast improvement in EM economic fundamentals has reduced the vulnerability of these countries to these types of sudden portfolio outflows. Today, foreign direct investment, a more stable source of funding than portfolio flows because it tends to be longer term, is strong enough to finance today's smaller deficits.

The Present. Country, company and sector selection within EMD still matter, of course. That's partly because political risk can't be ignored. Several countries are facing important elections in 2018. The good news is that political risk varies greatly by country. The risks in Brazil or Russia are different from those in Mexico or Venezuela.

This is why it's so important to embrace an active approach. The latest bout of market volatility indicates how valuable such an approach can be. According to Morningstar data, 80% of actively managed EMD strategies beat their benchmarks.* We've seen similar results over the longer haul. Between 2004 and 2017, 69% of active EMD managers beat the J.P. Morgan EMBI Global over three-year rolling periods.

The Future. Developed-market interest rates, led by those in the US, are likely to keep rising as the post-financial crisis era of easy money comes to an end. The Fed has signaled plans for several more rate hikes this year, and our economists expect the European Central Bank to end asset purchases in 2018 and start raising rates in 2019.

That should push up long-term Treasury and other bond yields. But as long as tighter policy and higher bond yields come with strong global growth, this shouldn't be a problem for EM assets. Strong growth in the US and other advanced countries tends to boost economic activity elsewhere. And emerging markets' strong economic fundamentals will add another layer of support for EMD.

What's more, EMD has shown in recent years that it can withstand gradual rises in rates. Since 1993, there have been nine periods in which the 10-year US Treasury yield rose by at least 100 basis points. Hard-currency EMD produced positive cumulative returns in seven of them. Local-currency EMD has a shorter history, but has also held its own through most of the recent periods of rising yields.

EMD’s strong performance during this very volatile period suggests it should be a core holding in any fixed-income allocation. We think investors who take an active approach to EMD and are selective about their exposures give themselves a better chance of increasing their portfolio returns.

*Includes all constituent funds within the EAA Fund Global Emerging Markets Bond Morningstar Category vs. the J.P. Morgan EMBI Global Diversified

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