February 28 2017

EMERGING MARKETS DEBT: A DELICATE BALANCE

Matthew E. Peterson *Chief Wealth Strategist, LPL Financial*
Shawn Doty *Senior Analyst, LPL Financial*

KEY TAKEAWAYS

EMD has now recovered to pre-election levels, making it among the best performing bond sectors year-to-date.

Attractive yields and debt levels that are generally lower than many developed market counterparts have driven investors toward EMD over the past year.

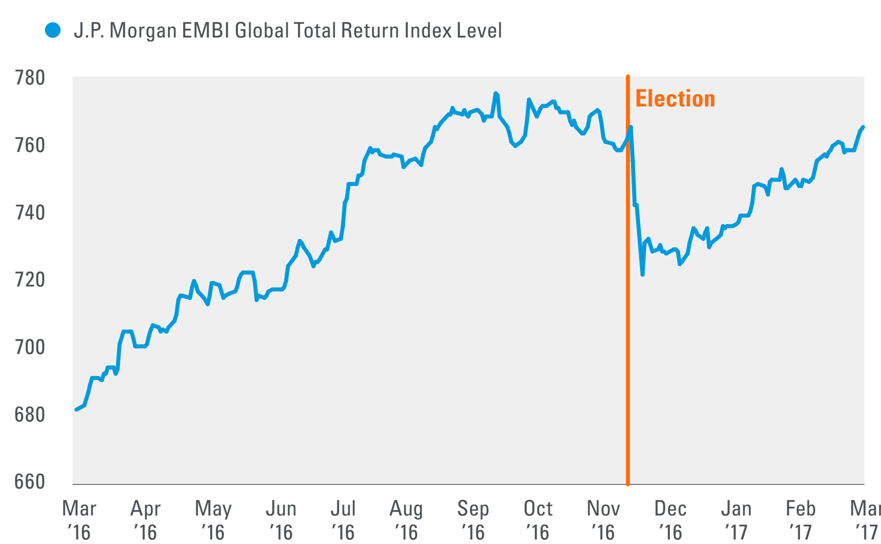
Though prices have recovered, protectionist trade policy and aggressive Federal Reserve policy remain risks for the asset class.

Emerging markets debt (EMD), as measured by the J.P. Morgan EMBI Global Total Return Index, fell 6% in the immediate aftermath of the U.S. presidential election in November 2016. However, as of Friday, February 24, 2017 prices have recovered completely and now stand just slightly above the level seen on November 8, 2016 [Figure 1], leaving EMD with a year-to-date total return of 3.9%, the second strongest performance of any bond sector (exceeded only by preferreds' 4.3% return, as measured by the Merrill Lynch Preferred Stock Hybrid Securities Index).

ARE OIL WORRIES A THING OF THE PAST?

One of the key factors driving EMD returns over the past couple of years has been oil prices. The majority of EM debt issuance is sovereign, not corporate. Many EM countries are reliant on commodity exports, and the 76% drop in oil prices starting in mid-2014 until the February 2016 lows caused EMD investors to demand higher yields (lower prices) for the risks of increased defaults. The impact of oil

1 EMD HAS RECOVERED TO PRE-ELECTION LEVELS



Source: LPL Research, Factset, Bloomberg 02/24/17

Past performance is not indicative of future results. Indexes are unmanaged and cannot be invested into directly.

on EMD performance becomes obvious when we view a chart of the spread of EMD to comparable Treasuries versus movement in the price of oil [Figure 2].

The oil-EMD trend saw its first significant disconnect in June of 2016, as oil prices fell to near $40/barrel, but EMD spreads continued to contract as markets turned their focus toward the U.S. presidential election. More recently oil has stabilized, but EMD spreads have continued to tighten, and have now reached levels last seen in September of 2014, just after the oil pullback began. All of this taken together seems to suggest that markets are not as concerned about the impact of commodity prices on emerging markets economies moving forward, which makes sense given that oil prices have started to stabilize. Even though markets are looking past the risk for now, it is important for EMD investors to be aware that if oil prices do fall meaningfully again (not our base case view, which is that oil prices average near $50/barrel in 2017), EMD prices would likely react negatively.

FED AND TRADE RISKS REMAIN

Commodity-related risks aren't the only factor that markets have been looking past in recent months. Two additional risks we are watching related to EMD in the near term are the impact of Federal Reserve (Fed) rate hikes and the impact of potential protectionist trade policy from the Trump administration.

It may not make sense at first glance that Fed policy can have an impact on EMD. The Fed is focused on the U.S. economy, so how could moves here impact overseas economies? As the Fed increases short-term rates, yields on U.S. debt rise, making them more attractive to overseas investors (and thus EMD less attractive, all else equal). Treasuries and other dollar-denominated debt must be purchased with U.S. dollars, so foreign buyers have to sell their local currencies and purchase dollars, pushing the value of the dollar higher, and making it harder for some EM countries to pay back their dollar-denominated obligations.

2 **OIL WAS A DRIVER OF EMD PERFORMANCE, BUT THE TWO HAVE DISCONNECTED RECENTLY**

Source: LPL Research, FactSet 02/24/17

One additional risk on the horizon for many EM countries is the potential impact of changes to trade policy. One of the keystones of the Trump campaign was to renegotiate trade agreements to make them more favorable for the U.S. Large emerging market trading partners like China and Mexico could be negatively impacted if trade policy were to be changed, or if tariffs were to be introduced (See our recent *Weekly Economic Commentary* "Facts on NAFTA" for more detail on U.S. trade policy and the impact of any potential changes).

THE DRAW OF YIELD

We have discussed several risks that could impact EMD in the near future, but the fact remains that the asset class has overcome them all and moved higher as of late. What has caused investors to overlook the above mentioned risks and drive EMD prices higher over the past few months? It may be that investors believe those risks to be overstated, but there's another more simple answer: EMD yields are attractive in a low-yield world.

Many developed nations, especially those in Europe and Japan have seen yields fall to zero or below as central banks have provided unprecedented liquidity in order to improve economic growth. Figure 3 shows debt to gross domestic product (GDP) ratios for several of the most debt-burdened developed and emerging markets countries. Debt levels in developed nations are often much higher than those in emerging markets, and the risk of default as measured by credit default swap spreads (CDS), a financial instrument that helps protect buyers in the event of default, are on par, or even higher in some cases, than they are for the most indebted EM nations. However, developed market debt yields far less than EMD, given the impact of central bank policy. Investors are therefore able to get a higher rate of interest, with less CDS market-implied default risk in some cases, making EMD a logical choice for some investors seeking yield.

3 EMD YIELDS ARE OFTEN HIGHER THAN THOSE OF DEVELOPED NATIONS

	Country	Debt/GDP (%)	5-Year CDS (%)	10-Year Government Bond Yield
Emerging Markets	Hungary	75%	1.14%	3.4%
	Brazil	75%	2.23%	9.9%
	Malaysia	55%	1.09%	4.0%
Developed Markets	Japan	234%	0.24%	0.1%
	Greece	181%	10.50%	7.1%
	Italy	132%	1.95%	2.2%

Source: LPL Research, Bloomberg, FactSet 02/24/17

CONCLUSION

Emerging markets are often looked at as a single asset class, but in reality there are a number of countries with many different circumstances. Overall though, EMD has performed well over the past few months as investors have judged yields attractive enough to compensate for near-term risks. Yields are enticing, but the fact that spread levels to comparable Treasuries are at their lowest level since before the oil pullback gives us pause on valuations. We also believe that markets may be overlooking risks related to Fed rate hikes and potential changes to trade policy from the new administration, potentially making the asset class more risky. As with any bond sector, investors should pay particular attention to the geographic concentration within their EMD portfolio. Differing from EM equities, where exposure breakdowns tend to be in larger more economically developed countries, EMD tends to be concentrated in less developed countries where credit risk is a factor.

Though prices are high and risks exist in our eyes, the fact remains that EMD does offer an attractive yield in a low-yield world. It is possible that the risks we mentioned may not materialize, and even if they do it’s possible that markets could continue to overlook them in the name of yield for some time. Given all these factors, we remain neutral on the asset class overall. ■

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.

Investing in stock includes numerous specific risks including: the fluctuation of dividend, loss of principal and potential illiquidity of the investment in a falling market.

Investing in foreign and emerging markets securities involves special additional risks. These risks include, but are not limited to, currency risk, geopolitical risk, and risk associated with varying accounting standards. Investing in emerging markets may accentuate these risks.

All indexes are unmanaged and cannot be invested into directly.

Because of their narrow focus, specialty sector investing, such as healthcare, financials, or energy, will be subject to greater volatility than investing more broadly across many sectors and companies.

Commodity-linked investments may be more volatile and less liquid than the underlying instruments or measures, and their value may be affected by the performance of the overall commodities baskets as well as weather, geopolitical events, and regulatory developments.

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.

Yield spread is the difference between yields on differing debt instruments, calculated by deducting the yield of one instrument from another. The higher the yield spread, the greater the difference between the yields offered by each instrument. The spread can be measured between debt instruments of differing maturities, credit ratings, and risk.

INDEX DEFINITIONS

JPMorgan Emerging Market Bond Index (EMBI) are a set of three bond indices to track bonds in emerging markets operated by J P Morgan. The indices are the Emerging Markets Bond Index Plus, the Emerging Markets Bond Index Global and the Emerging Markets Bond Global Diversified Index.

The Merrill Lynch Preferred Stock Hybrid Securities Index is an unmanaged index consisting of a set of investment-grade, exchange-traded preferred stocks with outstanding market values of at least $50 million that are covered by Merrill Lynch Fixed Income Research.

Gross Domestic Product (GDP) is the monetary value of all the finished goods and services produced within a country’s borders in a specific time period, though GDP is usually calculated on an annual basis. It includes all of private and public consumption, government outlays, investments and exports less imports that occur within a defined territory.

RES 5806 0217 | Tracking #1-586033 (Exp. 02/18)