

Emerging bonds. End of the Q1 tur- moil?

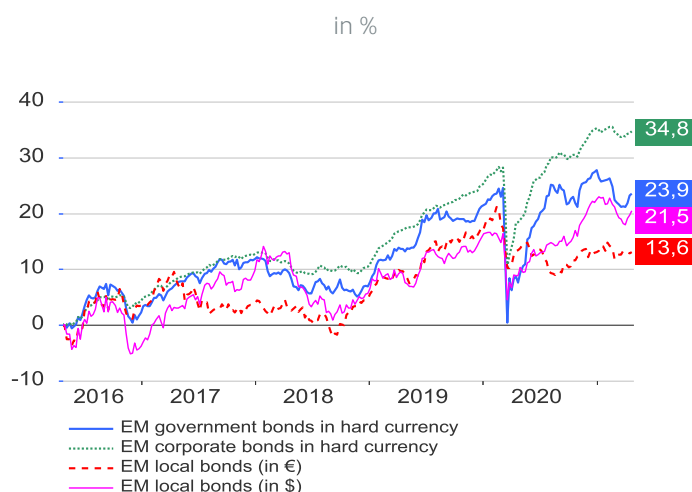
Summary

- Emerging Market bonds suffered at the beginning of the year.
- Changes in US long-term real interest rates and dollar fluctuations are two of the main components of the performance of Emerging Market bonds.
- The stabilisation of US real interest rates as well as the dollar weakness we expect should allow Emerging Market bonds to pick up.
- Thanks to their high yields, Emerging Market bonds offer some protection in the event of falling prices.
- Investing in Emerging Markets is also a way to diversify a portfolio.
- We remain positive on EM hard currency and local currency bonds.

Performance

The first quarter of the year was challenging for Emerging Market bonds. Valuations fell, especially between mid-February and early March, as US real interest rates rose sharply. Since 1 January, EM hard currency (USD) government and corporate bonds have returned -2.0%, while local currency bonds have delivered -1.7% in USD and 0.0% in EUR.

EM RETURNS OVER 5 YEARS



Source: Refinitiv Datastream, 23/04/2021

Source : BNP Paribas Wealth Management

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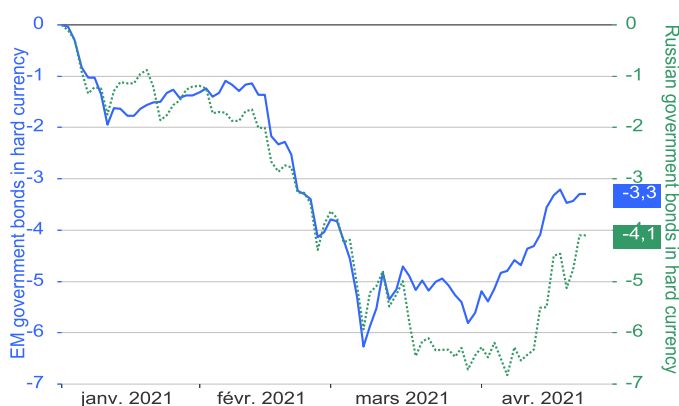
The outlook for Emerging Markets darkened at the beginning of the year. Covid-19 infection cases soared in several countries, particularly in Brazil and India. Inflationary pressure forced the central banks of a few countries (Brazil, Russia, Turkey) to raise their key interest rates while growth was still sluggish.

On the positive side, the International Monetary Fund is expected to distribute USD 650 billion of new Special Drawing Rights (SDRs) by the summer to emerging countries. This is a welcome liquidity provision to combat the economic effects of the pandemic.

US-Russia political tensions

On 15 April, the US government decided to impose sanctions on Russia. Among these was the ban on US banks buying ruble-denominated government bonds in the primary market (the purchase of hard currency government bonds in the primary market was banned in 2019). The impact on the Russian bond market could prove relatively small as the government has no pressing need to issue new bonds given the high level of cash balances. Ultimately, the risk is that its central bank will have to tighten its policy rate faster than expected to reflect the risk premium and limit volatility in the financial markets. The market already appears to have adjusted to this new risk, as the most recent performance suggests.

RUSSIAN GOVERNMENT BONDS RETURNS (%)

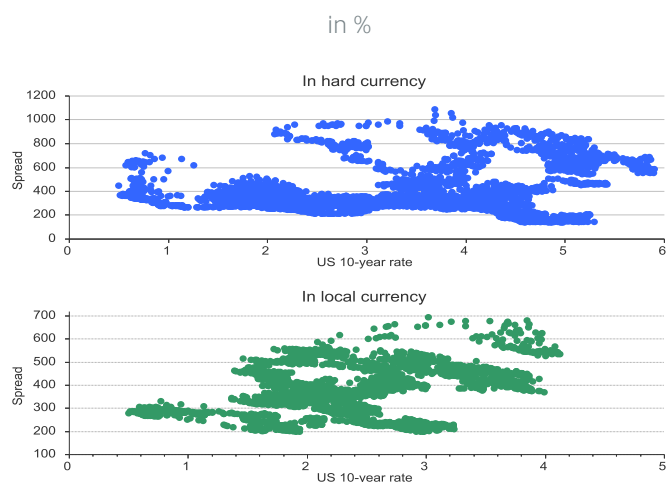


Source : BNP Paribas Wealth Management

US interest rate

Emerging Market bonds have little sensitivity to long-term US nominal interest rates. This may appear intuitive as low interest rates mean a low cost of debt, but history shows that US interest rates have fallen for more than 40 years and this has not stopped Emerging Market bonds from defaulting. There is no statistical relationship between the US 10-year interest rate and the EM bond spread.

HISTORICAL RELATIONSHIP BETWEEN THE US 10 YEAR NOMINAL RATE AND THE AVERAGE SPREAD OF EMERGING BONDS



Source : BNP Paribas Wealth Management

In contrast, the evolution - and the speed of such evolution - of long-term US real interest rates is a chief factor in the performance of Emerging Market bonds. A sharp rise in US real interest rates does not bode well for Emerging Market bonds, in hard currency and local currency.

Moreover, for EM hard currency bonds, the statistical regression suggests that, if US real interest rates increase sharply (by more than 0.40% per month in the example), then spreads widen significantly (as EM yields become less attractive relative to US yields) and they widen also when rates fall sharply (as in the case of a crisis).

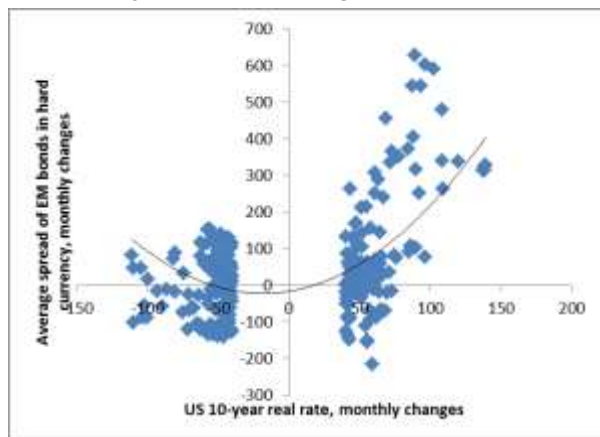


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RELATIONSHIP BETWEEN THE MONTHLY CHANGE IN THE US REAL RATE AND THAT OF THE AVERAGE SPREAD OF EMERGING BONDS IN HARD CURRENCY OVER THE PAST 10 YEARS

Monthly interest rate changes < 0.40% excluded

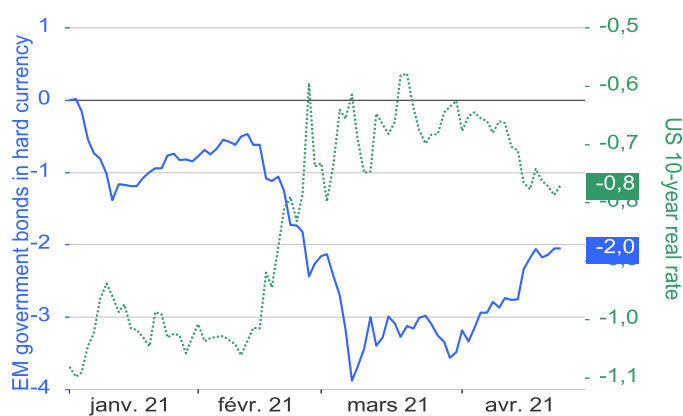


Source : BNP Paribas Wealth Management

So if US real interest rates stabilise, or continue to fall a little further as technical analysis suggests, Emerging Market bonds will benefit. We believe that long-term US interest rates will start to rise again after the summer, when the US Federal Reserve puts tapering on the agenda of its monetary policy committee meetings. The upside potential for real rates, however, seems quite low.

EM HARD CURRENCY BOND RETURNS AND US 10-YEAR REAL RATE

in %



Source : Refinitiv Datastream, 23/04/2021

Source : BNP Paribas Wealth Management

The dollar

Another important factor is the dollar, as countries issuing hard currency debt see their borrowing costs rise when the dollar appreciates. We expect the dollar to weaken over the course of the year when the health situation is more under control. For the moment, the dispersion and volatility of emerging currencies remains strong and shows that there is still a Covid risk premium for emerging currencies. Risk appetite remains weak in general, although it has improved very recently, particularly in Latin America.

EM CURRENCY INDEX

in %



Source : Refinitiv Datastream, 23/04/2021

Source : BNP Paribas Wealth Management

Inflation

Local currency bonds are sensitive to interest rates and local inflation. Inflation is likely to surprise to the upside in the near term due to supply pressure, but it is likely to remain at relatively low levels in the medium term.

Positive yield to maturity

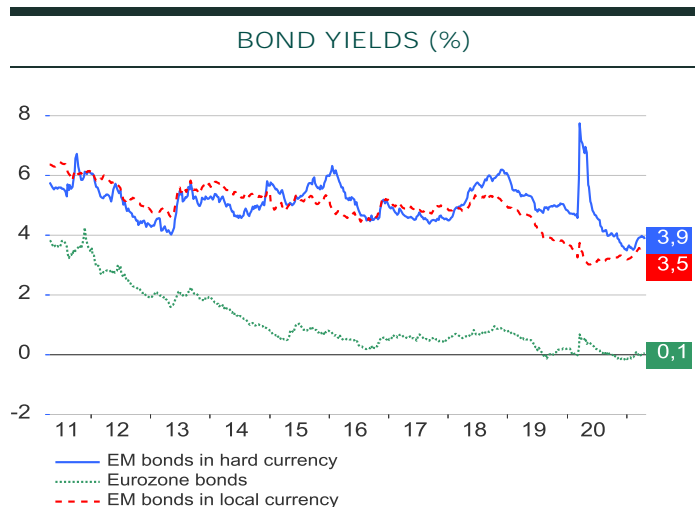
Emerging Market bonds offer yields with positive maturities and significantly higher than those of developed countries (21% of bonds worldwide have yields with ma-



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turities below zero); this is a safety net in the event of a fall in prices.

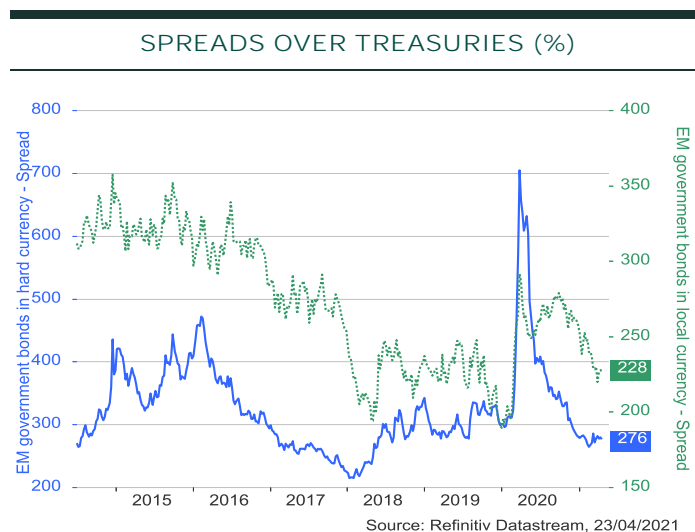


Source : BNP Paribas Wealth Management

Valuation

The performance of Emerging Market bonds has been lagging since the beginning of the year compared with other asset classes, penalised by the rise in US real interest rates and the stronger dollar.

EM hard currency bond valuations are not cheap in absolute terms, but are relatively attractive relative to US High Yield bonds. As for local currency Emerging Market bonds, the currency component, which is the main one of performance, is undervalued in our view.



Source : BNP Paribas Wealth Management

Conclusion

We remain positive on hard currency Emerging Market bonds, assuming that most of the rise in US real yields has already taken place. We also maintain a positive view on local currency bonds. Emerging market currencies are likely to appreciate in the medium term. Inflation fears seem exaggerated and the recovery in global growth as well as accommodative financial conditions are beneficial to emerging countries.



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