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The Potential Benefits for European Investors of a Strategic Allocation to Emerging Market Debt

Authors

Ward Brown, CFA, Ph.D.
Fixed Income Portfolio Manager

Jonathan Barry, FSA, CFA
Managing Director
Investment Solutions Group

In brief

- We believe European investors should consider a strategic allocation to EMD.
- EMD allows investors to gain access to higher-growth economies, and the asset class has matured in terms of market size, liquidity and credit quality.
- The low correlation between local and hard currency EMD suggests that a blended approach is optimal.
- EMD provides potential diversification benefits in broader portfolios, given the low correlation with other assets.

After a tumultuous year for capital markets in 2022, investors will likely face more uncertainty in 2023. However, there are several bright spots — inflation is beginning to moderate, central banks are slowing the pace of tightening and fixed income valuations are now attractive across many sectors.

Against this backdrop, emerging market debt (EMD) may warrant a closer look for European investors as it offers attractive yields relative to other fixed income asset classes with lower volatility than equity assets.

While emerging market investing is familiar to European investors, it is often underrepresented across portfolios. Much like emerging market equities, EMD allows investors to gain access to higher-growth and higher-productivity economies compared to developed market economies. Additionally, EMD has matured significantly as an asset class over the past 30 years. In the early 1990s, there were few countries in the index, and crises from the mid-1990s to the early 2000s resulted in the asset class being perceived as a high-risk proposition. Today, many EMD issuers have robust debt profiles and better credit quality than in the past. Furthermore, the depth and breadth of liquidity has increased as the size of the overall market has grown to approximately €4.7 trillion,[1] and EMD now comprises nearly 16% of the global bond universe.

Exhibit 1: Emerging market debt as a percentage of the Bloomberg Multiverse Index

Source: Bloomberg. Monthly data from 31 January 1999 through 30 December 2022. The Bloomberg Multiverse Index provides a broad-based measure of the international fixed income bond market. The index represents the union of the Global Aggregate Index and the Global High Yield Index.

Emerging market debt can be divided into two main sub–asset classes: hard currency and local currency. Hard currency EMD refers to debt issued primarily in USD but also in euro and yen. Local currency EMD refers to debt issued in the issuer's domestic currency. Hard currency EMD can be hedged back into euros or left unhedged. For local currency EMD, hedging the currencies is often impractical because it can be a complex and costly process.

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What are the key portfolio characteristics of EMD?

In considering an allocation to EMD, it is important to understand the volatility and correlation characteristics of the asset class. It is often assumed that local currency EMD is more volatile than hard currency EMD. However, the volatility profile depends on the home currency of the investor. As shown in Exhibit 2, local currency EMD has exhibited higher volatility over the past 10 years for US investors, averaging 11.4% as compared to hard currency EMD volatility of 9.0% over the same period. In euro terms, however, the volatility of local currency EMD has been much lower at 9.2%, comparable to unhedged hard currency EMD, which also averaged 9.2%. Hedging the US dollar exposure from hard currency EMD reduced the overall volatility slightly to 9.0%.

Exhibit 2: 10-year volatility and correlation for emerging market debt indices

	EMD Local Currency	EMD Hard Currency (unhedged)	EMD Hard Currency (EUR hedged)
In US dollar terms	11.4%	9.0%	9.0%
In euro terms	9.2%	9.2%	9.0%

Source: FactSet SPAR. EMD hard currency = JPMorgan EMBI Global Diversified Index, EMD local currency = JPMorgan GBI-EM Global Diversified Index. Data for the period 12/31/12 to 12/31/22.

Exhibit 3 shows the correlations between the different EMD assets, and we see a potential diversification benefit between hard and local currency with a correlation of roughly 0.7, varying slightly depending on whether the hard currency is hedged to euros or not.

Exhibit 3: Historical 10-year correlation

	Local currency EMD	Hard currency EMD (hedged to euro)	Hard currency EMD (unhedged)
Local currency EMD	1.00	0.68	0.74
Hard currency EMD (hedged to euro)	0.68	1.00	0.66
Hard currency EMD (unhedged)	0.74	0.66	1.00

Sources: FactSet SPAR, Bloomberg. EMD hard currency = JPMorgan EMBI Global Diversified Index, EMD local currency = JPMorgan GBI-EM Global Diversified Index. Data from 12/31/12 to 12/31/22. Results based on returns in EUR.

Assessing EMD in a euro investor's portfolio

To analyze the potential benefits of adding EMD in a euro denominated portfolio, we estimated the potential returns that a euro-based investor might experience over the next 10-years. We started with current yields and then made adjustments for hedging costs, default rates and currency depreciation based on current market conditions. We then estimated volatility based on historical data and calculated expected Sharpe ratios, as shown in Exhibit 4.

Exhibit 4: Forecast EMD returns, volatility and Sharpe ratios

Index	Cash	EMD local currency	EMD hard currency (hedged)
Estimated annual return	2.4%	4.6%	4.7%
Estimated volatility	0.4%	9.2%	9.0%
Estimated Sharpe ratio	N/A	0.25	0.29

Sources: Bloomberg, FactSet, S&P Global Ratings Research, S&P Global Market Intelligence. See footnote for further details on development of return assumptions.[2] Estimated volatility is based on period 12/31/12 to 12/31/22 for the respective indices. Return and volatility for cash based on MFS Long Term Capital Market Expectations (Euro edition) for January 2023. Returns shown are geometric 10-year returns. Expectations are for informational purposes only and any general commentary on market activity, industry or sector trends, or other broad- based economic or political conditions does not constitute a recommendation or investment advice. References to future expected returns and performance are not promises or estimates of actual performance that may be realized by an investor and should not be relied upon. The forecasts are for illustrative purposes only and are not to be relied up on as advice, interpreted as a recommendation, or be guarantees of performance. The forecasts are based on subjective estimates and assumptions that have yet to take place or may occur. The projections have limitations because they are not based on actual transactions but are based on models and data compiled by MFS. **The expected returns are not targeted or projected performance for any MFS portfolio or advisory service. PLEASE SEE IMPORTANT DISCLOSURES FOR IMPORTANT INFORMATION REGARDING THE ASSUMPTIONS USED IN THESE MATERIALS.**

Using these assumptions, we modeled varying combinations of local and hard currency EMD, as shown in Exhibit 5.

Exhibit 5: Blending EMD local and hard currency

Objectives	0% HC 100% LC	10% HC 90% LC	20% HC 80% LC	30% HC 70% LC	40% HC 60% LC	50% HC 50% LC	60% HC 40% LC	70% HC 30% LC	80% HC 20% LC	90% HC 10% LC	100% HC 0% LC
Expected nominal return over 10 years	4.66%	4.69%	4.72%	4.74%	4.75%	4.76%	4.77%	4.77%	4.76%	4.76%	4.74%
Expected annual volatility	9.20%	8.92%	8.68%	8.51%	8.39%	8.34%	8.35%	8.43%	8.57%	8.76%	9.01%
Sharpe ratio over 10 years	0.25	0.26	0.27	0.27	0.28	0.28	0.28	0.28	0.28	0.27	0.26

Source: See footnote for Exhibit 4 for details on assumptions used.

We see that the highest Sharpe ratios occur within a range of 40%/60% and 80%/20% hard currency/local currency EMD and the Sharpe ratio for the blended portfolios are slightly higher than either unblended portfolio. This synergy is a result of the low correlation between hard and local currency EMD that we saw in Exhibit 3. This leads us to conclude that a 50/50 blend of hard and local currency is potentially a good starting point to implement the asset class for euro investors.

While the calculations in Exhibit 5 assume that the hard currency EMD is hedged to euros, it should be noted that we obtained similar results when using an unhedged variation of the hard currency EMD. We suggest that euro-based investors hedge the hard currency strategically but allow leeway to reduce the hedge tactically as market conditions warrant.

Integration with other asset classes

Another factor to consider is the correlation of EMD with other assets commonly held in euro denominated portfolios, as shown in Exhibit 6.

Exhibit 6: Historical correlations between EMD and other asset classes

	EMD local currency (Unhedged)	EMD Hard Currency (Hedged)	Emerging market equities	Global equities	Europe ex UK equities	US investment grade bonds	Global aggregate bonds	European aggregate bonds	European high yield bonds	European investment grade bonds
EMD local currency (Unhedged)	1.00	0.68	0.71	0.53	0.47	0.53	0.42	0.42	0.53	0.53
EMD Hard Currency (Hedged)	0.68	1.00	0.65	0.55	0.60	0.83	0.64	0.60	0.79	0.76

Source: FactSet SPAR. Correlations based on data for the period 12/31/12-12/31/22 for the following indices: EM Equities = MSCI Emerging Markets Index, Global Equities = MSCI ACWI, Europe x-UK Equities = MSCI Europe ex-UK Index, US IG Bonds = Bloomberg US Corporate Investment Grade Index, Global Agg Bonds = Bloomberg Global Aggregate Index, European Agg Bonds = Bloomberg Euro Aggregate Index, European HY Bonds = Bloomberg Pan-European High Yield Index, Euro IG Bonds = Bloomberg Euro Aggregate Credit Corporate Index, EMD Local Currency = JP Morgan GBI_EM Global Diversified (Local) Index, EMD Hard Currency (Hedged) = JP Morgan EMBI Global Diversified (Hedged) Index. All results in EUR.

Those correlations, ranging from 0.42 to 0.79, indicate that EMD could potentially help diversify broader portfolio risk.

Conclusion

We believe European investors may want to consider a strategic allocation to EMD. EMD allows investors to gain access to higher-growth economies, and the asset class has matured in terms of market size, liquidity and credit quality. The low correlation between local and hard currency EMD suggest that a blended approach may be the optimal one. EMD also provides potential diversification benefits in broader portfolios, given the low correlation with other assets.

Endnotes

[1] Source: J.P. Morgan, market capitalization of JPMorgan EMBI Global Index, JPMorgan CEMBI Broad Diversified Index and JPMorgan GBI-EM Global Diversified Index, as of December 2022, converted to euros.

[2] Estimated hard currency returns are based on index yields or the JPMorgan EMBI Global Diversified and JPMorgan GBI-EM Global Diversified Indices as of 12/30/2022 adjusted as shown below to reflect estimated cost of hedging hard currency index, long term historical average of default and recovery and projected differential in inflation between Eurozone and countries represented in the local currency index. Estimated default rate based on weighted average sovereign net annual foreign currency credit rating default for AA, A and BAA rated securities from 1975 to 2021.

Index	EMD local currency	EMD hard currency (hedged)
Yield as of 12/31/2022	6.9%	8.0%
Estimated hedging cost	N/A	-2.2%
Default adjustment	-0.5%	-1.1%
Inflation adjustment	-1.8%	N/A
Estimated 10-year return	4.6%	4.7%

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