Emerging Market Fixed Interest

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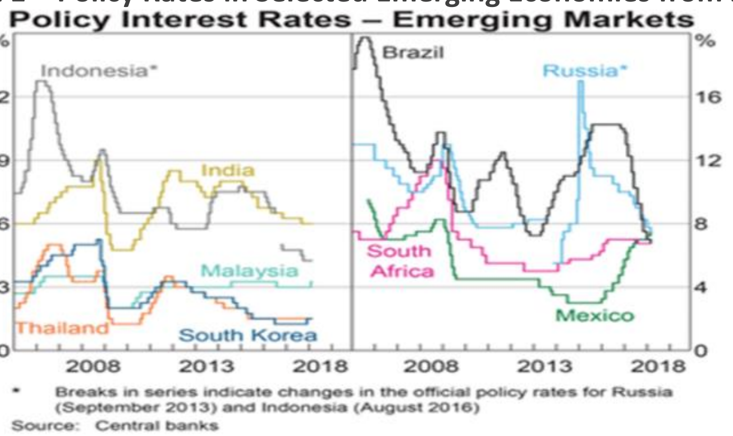
Unprecedented monetary policy stimulus over the past decade has resulted in interest rates falling significantly, to the extent interest rates are extremely or even negative. 20% of government bonds in developed countries have negative yields as at March 2017. There has been an increasing trend of investors investing in emerging markets (EM) securities in a search for higher yields.

In 2017, EM debt securities generated a return of 13% on average, substantially outperforming developed market debt securities. The higher returns were generated from a combination of generally higher interest rates, higher credit premiums and appreciation in EM currencies.

- **Nominal and Real Rates in EM**

Compared with developed markets, EM generally have higher levels of interest rates. As shown in Chart 1 below, most emerging economies have interest rates at approximately 6.0% at the end of 2017.

Chart 1 – Policy Rates in Selected Emerging Economies from 2005 to 2018

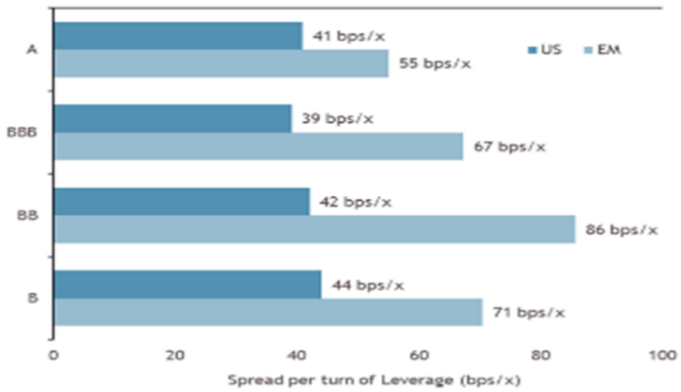


In addition to high nominal interest rates, average inflation in EM has also been at a record low in 2017. Given high nominal interest rates and low inflation, EM debt securities generally offer higher real rates than that of developed markets.

➢ Credit Ratings in EM

Compared with developed markets, most emerging market debt is not rated as "investment grade", resulting in higher credit-risk premium and higher yields. However, a positive characteristic of EM countries is they generally have lower debt-to-GDP ratios compared to developed countries. Average debt-to-GDP is above 100% in developed countries, compared with 50% in EM economies (2017). Given lower debt levels in EM, the spread per unit of leverage are materially higher on EM debt securities.

Chart 2 – Global EM Spread Based on Credit Rating

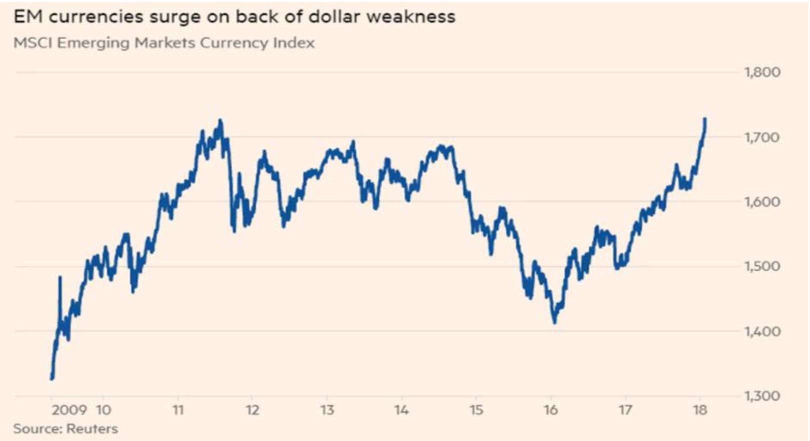


Source: BofA Merrill Lynch, EM Corporate Credit Chart

➢ EM Currencies

With improving economic fundamentals, EM currencies have been on the rise since 2016. In 2017, EM currencies appreciated by 5.8% against USD on average. With positive foreign currency effects, local-currency-denominated debt generated approximately 500 bps more than USD-denominated debt.

Chart 3 – EM Currencies against USD from 2009 to 2017



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Despite all the positive factors mentioned above which have contributed to higher yields on EM securities, higher returns do not generally come without commensurate risk. Historically, EM governments have been more likely to experience higher inflation, contributing to higher yielding securities. It is important for investors to weigh the risk of inflation, default and political upheaval and remain selective given the diverse nature of EM issuers.