MFS® Fixed
Income Insights

August 2023

Finding a Sweet Spot for Local Emerging Market Debt

Authors

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

Robert M. Almeida, Jr.
Portfolio Manager and
Global Investment Strategist

What are the structural differences between dollar-denominated debt and local emerging market debt?

Local debt is in local currency. If you're lending in local currency to the Brazilian government, you're lending in Brazilian reais as opposed to US dollars. There are different drivers of local debt. The biggest driver is inflation. Local currency debt behaves like US treasuries. When the US Federal Reserve hikes rates, treasury rates go up and treasury bond prices fall. That's true of the local currency debt in all emerging markets. In Brazil, as the central bank hiked interest rates over the past year, the prices of the local bonds fell. That's the main difference: inflation and the local business cycle doesn't affect US dollar debt because it's in US dollars. Local inflation doesn't matter. What affects the dollar debt is mainly the risk of the sovereign defaulting, which, of course, can affect the local debt as well. Local is like dollar debt plus a business cycle inflation component.

You mentioned inflation and business cycle. What other key performance indicators are important to you?

You want a sound macroeconomic framework. The fiscal deficit is on a sustainable path. Debt is stable or declining. When that's the case, inflation credibility is usually high. Inflation's well anchored, and the country's inflation target is believable. That's the ideal. While not many emerging markets are ideal, we look for countries headed in that direction.

Has that fiscal framework improved for the asset class?

Big time. In the late 1990s and early 2000s, there were several emerging market crises. The macro framework was very different. It was based on fixed exchange rates that were unsustainable. Countries got rid of the pegged exchange rates, introduced inflation targets and became more credible in their fiscal policies. As a result, the inflation targets also became credible. In the 10 years prior to the pandemic, actual inflation rates in emerging markets declined steadily, partly attributable to sounder macro frameworks. That overall improvement in the macro framework and inflation explains why the asset class has done so well for a long period of time.

Can you walk us through the four cycles of emerging markets local debt?

In any business cycle, if inflation's too high, the central bank raises interest rates. If the economy goes into recession, the central bank then cuts interest rates. The business cycle in emerging markets is linked to US business. If the Fed raises rates and an emerging market doesn't, its currency will probably depreciate. If the currency depreciates, sometimes inflation in that country will go up, which forces their central bank to hike.

Usually at the beginning of stage one, US interest rates are low, the US economy is recovering, and the Fed begins to hike rates. In the second stage, the Fed keeps hiking, rates become more restrictive and emerging markets start to feel the impact. Their currencies depreciate and those central banks hike interest rates as well. Stage three is when the Fed pauses and there are two possible outcomes — a soft landing or hard landing — leading to stage four. Stage four is when the Fed cuts rates. In a soft landing, inflation declines, but you don't go into recession. Because inflation declines, the Fed starts cutting rates. The second outcome of stage four is a hard landing. The US economy goes into a recession, and the Fed cuts rates more aggressively. In both cases, EM central banks will also cut rates.

An attractive entry for local currency debt is when central banks start cutting rates. Once the Fed has done enough to stabilize risk appetite, we start to see capital flowing into emerging markets and you get some dollar weakness. Emerging market currency start to appreciate, which helps support disinflation which allows central banks to cut more. Growth starts and capital starts flowing. In effect, the fourth stage creates a positive feedback loop.

Risk assets and the real economy (the shape of sovereign bond yield curves) are flashing conflicting signals. What's your view on the global economy? What does it mean for the Fed and central banks?

The priority of central banks is to bring inflation down even if it means a recession, and I think there’s a high probability of a recession. Central banks are looking at lagging indicators, such as core inflation, to gauge their policy adjustments, which means they're unlikely to cut before unemployment starts rising. Rising unemployment is really the beginning of a recession, and historically once it starts rising, it usually rises a lot. I think the macro setup is a high probability of recession.

On the investing side, the question becomes what assets compensate for that risk of recession? We often debate with our colleagues how a soft landing could come about. While the outlook for a soft landing is less clear, it could happen. If it did, risk assets would do quite well. Looking at emerging market debt, only a part of the asset class is pricing in a hard landing, but it is also not completely pricing in a soft landing. So, there is room for this asset class and others, I think, to rally somewhat in a soft-landing environment. But risk assets don’t compensate for a hard landing. We think that it pays to be cautious in a lot of assets, especially in risk allocation, because not many assets compensate for the hard landing probability, which I think is fairly high.

Thinking about emerging market debt and the opportunity set, why should investors be thinking about it now?

We talked about the standard cycle: stage one, the Fed hikes, stage two, EM central banks hike. However, this cycle has been a bit different. Stages one and two got reversed this time. EM central banks were way ahead of the Fed. It's quite remarkable. Usually when the Fed hikes, EM currencies experience significant weakness. We didn't see that last year. Yes, the dollar was very strong, but it was strong against the euro and other developed countries. EM hung in with those countries and outperformed the euro last year. That’s because EM central banks started hiking before the Fed and the European Central Bank (ECB) did. That puts them in a very different position. If we go into a hard landing, the scope for cuts by EM central banks is large. In Brazil, we're talking about a 13.5% policy rate with inflation under 4% right now. They tightened earlier and to a greater extent. That’s a huge cushion.

In the beginning of the fourth stage, risk aversion typically means investors want to go back to the dollar. That can be problematic for central banks in emerging markets. But today, EM central banks have hiked so much that they've built a big risk cushion for a recession and a spike in risk aversion, which should help stabilize these currencies. In the past, EM central banks were behind the Fed, risk assets would sell off and EM central banks would have to hike even more. That's the usual playbook, but I don't think it will work this time because EM central banks started before the Fed. They're in a strong position with room to cut. When the Fed pivots to a dovish stance, they'll get the green light and it will provide a lot of space for EM central banks to cut rates. It will start to usher in some dollar weakness. That's when EM local currency returns can be quite strong.

Conclusion

As we've discussed, local currency debt goes through typical business cycles. It's gone through four of them over the last 20 years, and right now we're approaching one of the stages of the cycles where returns can be quite favorable in emerging market local currency debt. Investors may want to keep their eyes open for these opportunities.

We've been talking about countries with different funding needs, revenue sources and business cycles all tied to the Fed. How important is fundamental homework and security selection?

I've generalized some of what we've talked about. It's not true of every country in EM. Country selection is a key component to investing in emerging market debt. It's extremely important to be aware of countries with fragile sovereign risk profiles. Those countries could cut rates too. But if they have a sovereign debt problem, that rate cutting will be put on hold and may go the other way. We've seen that many times. You have to be wary of countries that are vulnerable. At the same time, you also need to use good country selection to find the spots in the asset class that have the most upside.

We're not overweight duration everywhere in the asset class. There are spots of great opportunity which we think will dominate the index. But there are also areas, like much of Asia, that lack opportunities for rate cutting cycles, and we're very cautious there.

The views expressed are those of the author(s) and are subject to change at any time. These views are for informational purposes only and should not be relied upon as a recommendation to purchase any security or as a solicitation or investment advice. No forecasts can be guaranteed.

Unless otherwise indicated, logos and product and service names are trademarks of MFS® and its affiliates and may be registered in certain countries.

Distributed by: **U.S. -** MFS Investment Management; **Latin America -** MFS International Ltd.; **Canada -** MFS Investment Management Canada Limited. No securities commission or similar regulatory authority in Canada has reviewed this communication.

Please note that in Europe and Asia Pacific, this document is intended for distribution to investment professionals and institutional clients only.

Note to UK and Switzerland readers: Issued in the UK and Switzerland by MFS International (U.K.) Limited ("MIL UK"), a private limited company registered in England and Wales with the company number 03062718, and authorised and regulated in the conduct of investment business by the UK Financial Conduct Authority. MIL UK, an indirect subsidiary of MFS®, has its registered office at One Carter Lane, London, EC4V 5ER. **Note to Europe (ex UK and Switzerland) readers:** Issued in Europe by MFS Investment Management (Lux) S.à r.l. (MFS Lux) – authorized under Luxembourg law as a management company for Funds domiciled in Luxembourg and which both provide products and investment services to institutional investors and is registered office is at S.a r.l. 4 Rue Albert Borschette, Luxembourg L-1246. Tel: 352 2826 12800. This material shall not be circulated or distributed to any person other than to professional investors (as permitted by local regulations) and should not be relied upon or distributed to persons where such reliance or distribution would be contrary to local regulation; **Singapore -** MFS International Singapore Pte. Ltd. (CRN 201228809M); **Australia/New Zealand -** MFS International Australia Pty Ltd (" MFS Australia") holds an Australian financial services licence number 485343. MFS Australia is regulated by the Australian Securities and Investments Commission.; **Hong Kong -** MFS International (Hong Kong) Limited ("MIL HK"), a private limited company licensed and regulated by the Hong Kong Securities and Futures Commission (the "SFC"). MIL HK is approved to engage in dealing in securities and asset management regulated activities and may provide certain investment services to "professional investors" as defined in the Securities and Futures Ordinance ("SFO").; **For Professional Investors in China –** MFS Financial Management Consulting (Shanghai) Co., Ltd. 2801-12, 28th Floor, 100 Century Avenue, Shanghai World Financial Center, Shanghai Pilot Free Trade Zone, 200120, China, a Chinese limited liability company registered to provide financial management consulting services.; **Japan -** MFS Investment Management K.K., is registered as a Financial Instruments Business Operator, Kanto Local Finance Bureau (FIBO) No.312, a member of the Investment Trust Association, Japan and the Japan Investment Advisers Association. As fees to be borne by investors vary depending upon circumstances such as products, services, investment period and market conditions, the total amount nor the calculation methods cannot be disclosed in advance. All investments involve risks, including market fluctuation and investors may lose the principal amount invested. Investors should obtain and read the prospectus and/or document set forth in Article 37-3 of Financial Instruments and Exchange Act carefully before making the investments.

MFSE_FLY_2109581_8_23
55582.1