

Should Emerging Markets Debt Investors Be Afraid of the Fed Hiking Cycle?



The U.S. Federal Reserve (Fed) has begun raising rates, spurring concerns about the impact on fixed-income returns. Should emerging markets (EM) debt investors be concerned, or could this be a buying opportunity? In this paper, we examine the previous tightening cycles that occurred during the life of this asset class to gauge the potential impact of the rate hikes on EM sovereign debt returns over the next 12 months and beyond.

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In March 2022, the Fed hiked the federal funds rate for the first time since 2018, raising rates by 25 basis points (bps). This was followed by a 50-bp hike in May and another 75-bp hike in June. Together, the rate hikes drove the federal funds rate from 0.25% to 1.75%—the first time it has reached that level since 2020.

The rate hikes have weighed on EM debt returns, which were already weak in 2021 and the first quarter of 2022, thanks to investor fears about the impact of the war in Ukraine and Chinese lockdowns.

The speed and extent of further monetary tightening is uncertain, and as a result, there are concerns about the impact of rate hikes on future fixed-income returns. Should investors be concerned, or could this be a buying opportunity?

“Because past hiking cycles differ in length, speed, and the context in which the tightening took place, we investigate the key differences as well as similarities that are likely to be important drivers of performance.”

Daniel Wood, Portfolio Manager

In this paper, we review the three previous tightening cycles that occurred during the life of this asset class to gauge the potential impact of the rate hikes on EM sovereign debt returns over the next 12 months and beyond.

In each section, we examine a key fear driving concerns about the future returns of EM sovereign debt:

1. The sensitivity of EM debt to rising interest rates could hurt performance.
2. EM debt spreads could widen as interest-rate hikes hurt global growth.
3. Outflows could accelerate as fixed-income and risk assets become less attractive.
4. The U.S. dollar (USD) could strengthen as interest-rate differentials between EMs and developed markets narrow.
5. Rate hikes could squeeze liquidity and accelerate EM debt restructurings.

We take a look at each of these investor fears, assessing the legitimacy of each when compared to the three most recent Fed rate-hiking cycles: 1999 to 2000, 2004 to 2006, and 2015 to 2018. Because each of these past rate-hiking cycles differs in length, speed, and, more importantly, the context in which the tightening took place, we investigate the key differences as well as similarities that are likely to be important drivers of performance.

Will Sensitivity of EM Debt to Rising Interest Rates Hurt Performance?

The first fear driving concerns about the future returns of EM sovereign debt is that the sensitivity of EM debt to rising interest rates could hurt performance—particularly because EM debt duration is longer now than it was in previous Fed tightening cycles.

There are three main components of EM debt returns: the starting yield of the asset class; the change in EM debt spreads; and the sensitivity of yields to changes in U.S. Treasury yields.

Regarding the third component, the argument that rising interest rates—and as a result, rising Treasury yields—will hurt EM debt returns is particularly pertinent now, because the duration of EM hard currency debt has increased over the past 20 years as sovereign issuers have successfully extended the maturity of their USD issuance.

When the 1999 rate-hiking cycle began, the duration of the asset class was as short as 4.57 years. It grew to 5.77 years in 2004 and 6.65 years in 2015. When the Fed raised rates from 0.25% to 0.50% in March 2022, the J.P. Morgan Emerging Markets Bond Index Global Diversified (EMBIGD) had a duration as high as 7.37 years. This increased the sensitivity of the asset class to the move in U.S. Treasury yields.

Having established that EM debt's sensitivity to rising Treasury yields is higher now than in past Fed tightening cycles, we must ask if this should be a concern for investors—and the answer is that there is little historical evidence to suggest that Treasury yields will increase significantly once the Fed rate-hiking cycle has begun.

Using the change in the 10-year Treasury bond yield as a proxy for this risk, we can see that it is not clear that the onset of a Fed tightening cycle means that longer-dated bond yields will rise sharply. In some instances, the 10-year Treasury bond yield was actually lower a year after the initial rate hike. And after a multidecade bull market for Treasuries, the 10-year Treasury bond yield had been range-bound since the global financial crisis (GFC). We expect this theme to continue as the market balances concerns about both inflation and growth.

What does the data show us?

1999 to 2000: Yields Rise

First, 10-year U.S. Treasury bond yields rose in the year following the 1999-2000 rate-hiking cycle.

After nine consecutive years of economic growth, strong domestic demand, and generationally low unemployment, the 1999-2000 hikes were largely preemptive.

EXHIBIT 1

Longer-Dated Bond Yields Haven't Consistently Risen With Fed Tightening Cycles



Sources: Federal Reserve, U.S. Department of Treasury, as of May 2022.

Will Sensitivity of EM Debt to Rising Interest Rates Hurt Performance?

(continued)

The rate-hiking cycle lasted only six months and was limited to 125 bps of total hikes (albeit from a relatively high starting point of 5.25%).

Inflation was largely contained once the rate-hiking cycle started, peaking at 3.80% in 2000 before falling sharply as expected in 2001. At that point the rate hikes were rapidly reversed.

In this era, positive real rates were the norm rather than the exception, and the 10-year Treasury bond yield actually rose from 5.62% to 6.28% a year later. This 66-bp rise was a headwind to EM debt returns.

2004-2006: Yields Fall

In contrast, yields fell in the 12 months following the 2004-2006 rate-hiking cycle.

In this rate-hiking cycle, the Fed sought to fight rising inflation and cool off an economy that was overheating.

This cycle was much more prolonged than the 1999-2000 rate-hiking cycle, with rates starting at 1.00% and finishing exactly two years later at 5.25%.

Unlike in 1999, there was a perception that the Fed was behind the curve when it started tightening. While growth decelerated gradually, inflation remained stubbornly above 3.00% throughout the tightening cycle (although it did not spiral out of control, and actually returned to more acceptable levels soon after the last rate hike).

In this case, the yield curve was already very steep when the Fed started raising rates, with the 10-year U.S. Treasury bond yield at 4.65%. It was 3.98% a year later. This 67-bp decline was a tailwind for EM debt returns.

2015-2018: Little Changed

Then, with the 2015-2018 rate-hiking cycle, we saw something different: U.S. Treasury bond yields were little changed.

Seven years had passed since the GFC necessitated a prolonged period of accommodative monetary policy. The decision to hike rates was supported by a more positive economic outlook (although there were some

dissenting voices on the Fed, and as a result the so-called “gradualism back to normalcy” was dependent on economic data). Following a period of expansion, the Fed also communicated that it would not reduce its balance sheet for a significant time.

The rate-hiking cycle of 2015-2018 was longer than the previous two but less aggressive, with rates starting as low as 0.25% in December 2015 and ending at 2.5% three years later.

Under these circumstances, the yield curve, which began at a steep 200 bps, flattened during the rate-hiking cycle. One year after the first hike, the 10-year U.S. Treasury bond yield was at 2.45%, 17 bps higher than it was at the time of the first hike.

Our Verdict: No Yield Rise

Based on the three previous rate-hiking cycles, we believe there is little evidence that the 10-year U.S. Treasury bond yield will rise significantly in the year following the first Fed hike of the current cycle.

Similar to both the 2004-2006 and the 2015-2018 rate-hiking cycles, the curve was steep into the first hike this time around. At the time of this writing, the 10-year U.S. Treasury bond yield had already adjusted upward as the market priced in a higher Fed terminal rate. This is already a significant move and corresponds almost entirely with the rise of the 10-year U.S. Treasury bond yield in the 1999-2000 rate-hiking cycle.

We acknowledge that inflation is much higher this time around, but believe that it is largely driven by supply-side disruptions rather than an overheating economy and strong domestic demand. Therefore, we believe we may be close to peak inflation fear. A combination of both positive base effects and potential resolutions to supply-side disruptions could alleviate some current fears about where inflation and the federal funds rate might be headed.

We expect the 10-year U.S. Treasury yield to range from around 2.8% to 3.0% in one year's time, with risks to the downside as a more aggressive front-loaded tightening cycle shifts the narrative away from inflation to concerns about slowing growth.

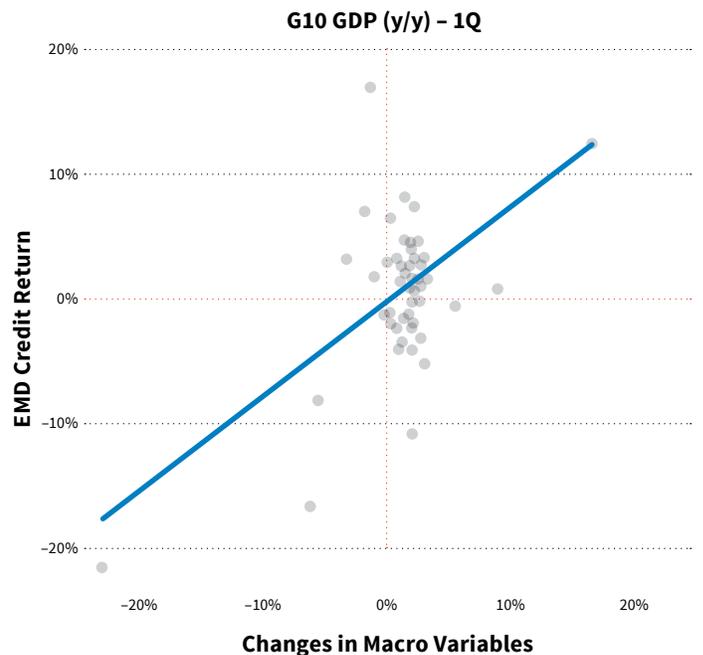
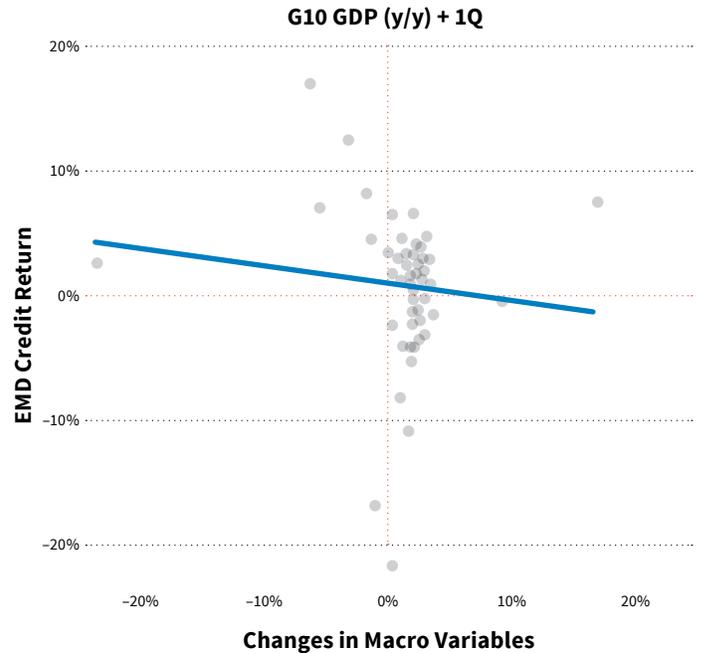
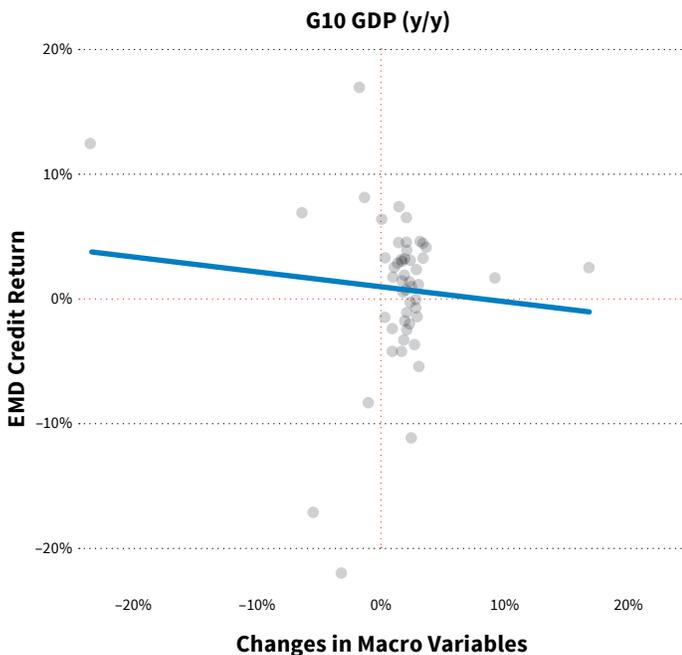
Will EM Debt Spreads Widen as Interest-Rate Hikes Hurt Global Growth?

The second fear driving concerns about the future returns of EM sovereign debt is that EM debt spreads could widen as interest-rate hikes hurt global growth (and change risk sentiment).

It is unclear if the current tightening cycle will have lasting repercussions for global growth. Rate hikes in 2004 to 2006 were followed by a recession, but this had more to do with bad loans in the financial system than it did with the level and direction of interest rates. The 2015-2018 rate-hiking cycle, meanwhile, was slower than expected and ended earlier than expected because the economy was showing signs of stress. Rate hikes that occurred during this period were quickly reversed. That cycle, then, is also a poor guide.

EXHIBIT 2

Slowing Growth Has Not Been Bad for EM Debt Spreads (Unless in a Recession)



Sources: J.P. Morgan and Bloomberg, as of September 2021. **Past performance is not indicative of future results.** Indices are unmanaged and do not incur fees or expenses. A direct investment in an unmanaged index is not possible. Index used is the credit spread component of the J.P. Morgan EMBIGD. Each panel represents the relationship between EMD credit spread return against one of three different macro variables: in panel one, year-over-year change of G10 GDP for the current quarter; in panel two, year-over-year change of G10 GDP for the next quarter; in panel three, year-over-year change of G10 GDP for the last quarter. Each dot represents one observation of a quarter, with the X axis showing year-over-year G10 GDP and the Y axis showing the EMD credit spread return for that quarter. The line represents the linear regression between the X axis and the Y axis (the dots).

Will EM Debt Spreads Widen as Interest-Rate Hikes Hurt Global Growth? (continued)

What we do know is that over the coming 12 months, global growth faces headwinds in addition to the Fed tightening monetary policy. For example, supply-chain disruptions caused by China's zero-COVID policy and the Russia-Ukraine conflict could keep food and energy prices high. Fiscal accounts are likely to come under more pressure as governments face tough choices as to how deal with this potential social crisis.

On the flip side, high commodity prices should support the finances of EM commodity exporters, improving their terms of trade. The balance-of-payments position of many sovereign credits in the J.P. Morgan EMBIGD is also strong. Lastly, growth fears may cause an early halt to the tightening cycle and may even cause policymakers to reverse course.

We believe these headwinds are significant enough to warrant caution, so we have revised our forecast for growth in both developed and emerging markets downward.

However, there is a perception that strong global growth supports EM debt returns, and this is leading to investors' fears that interest-rate hikes hurt global growth and thus widen EM debt spreads. While it is true that spreads tend to widen significantly during a global recession (such as the 2008-09 GFC and 2020 COVID-19 pandemic), our research shows that there is little correlation between EM debt returns and slowing global growth—particularly when growth comes from a reasonably strong base, as it does now.

Looking back at previous Fed rate-hiking cycles, then, there is no clear pattern or trend to draw from conclusively: It is unclear if a weaker global economy will widen spreads significantly.

1999-2000: Spreads Had Already Sold Off

In the 12 months leading up to the 1999-2000 tightening cycle, spreads had already sold off considerably. They decoupled from other risk assets, such as the S&P 500 Index, as the market digested both the Asian crisis of 1997 and the Russian crisis of 1998. Oil prices doubled during this period similar to the current energy trend and this helped spreads to recover sharply in the 12 months following the first hike.

2004-2006: Spreads Had Already Tightened

In contrast to 1999-2000, going into the 2004-2006 rate-hiking cycle spreads had already tightened marginally. This was a favorable time for EM, with China joining the World Trade Organization (WTO) and a trend toward globalization driving a commodity boom. This supported spread tightening throughout the rate-hiking cycle, with spreads finishing close to all-time lows.

2015-2018: Spreads Tightened

Similar to the lead-up to the 1999-2000 rate-hiking cycle, spreads had widened ahead of the first rate hike in 2015. This time, however, they did so aggressively, widening approximately 60 bps going into the rate-hiking cycle.

Unlike in 2004-2006, the environment was less favorable for EM. There were concerns about a hard landing in China; oversupply in the oil sector amid a U.S. shale push was creating a commodity shock; and the Brazilian corruption scandal was creating negative sentiment.

Despite of all of these EM-specific headwinds, spreads were tighter 12 months after the start of the rate-hiking cycle than when they began the cycle.

“We believe meaningful spread widening from here is unlikely unless accompanied by a global recession, an event that we think is a very low probability.”

Marco Ruijter, CFA, Portfolio Manager

Will EM Debt Spreads Widen as Interest-Rate Hikes Hurt Global Growth? (continued)

Our Verdict: Spread Widening Unlikely

Spreads have already widened significantly since June 2021, yet the global economy remains in relatively good health despite downward revision of economic forecasts.

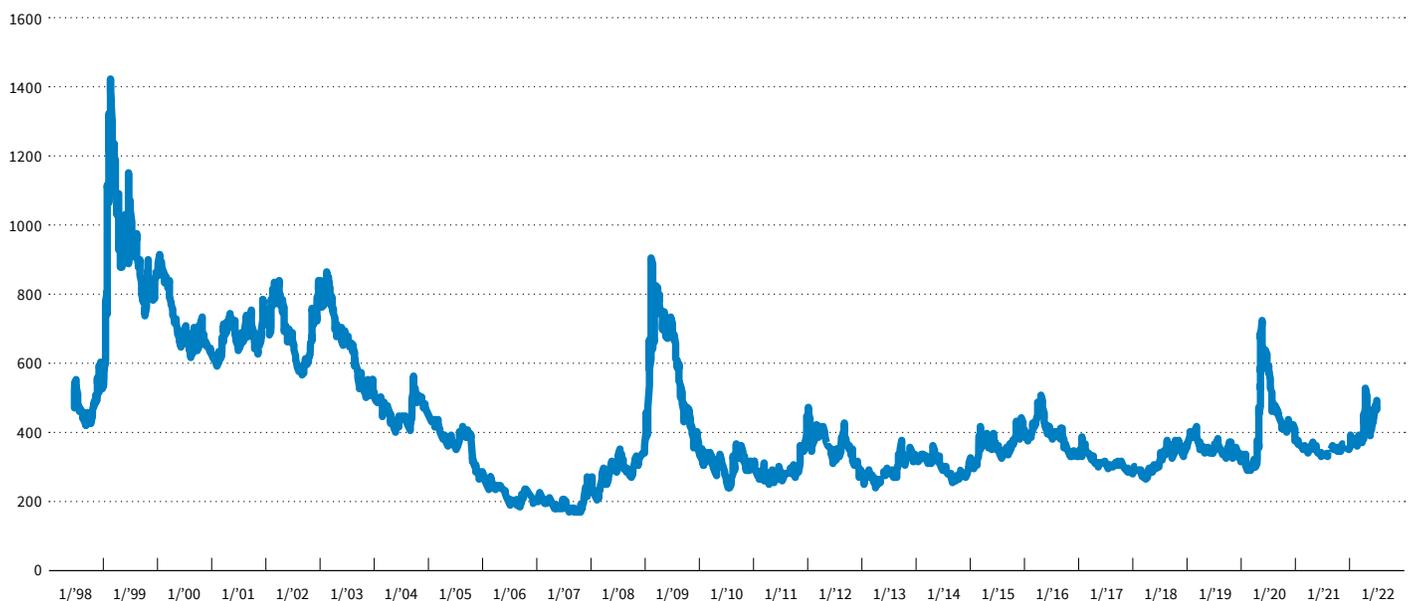
Using history as a guide, we believe meaningful spread widening from here is unlikely unless accompanied by a global recession, an event that we think is a very

low probability. Since 2000, EM debt spread widening of more than 200 bps has been uncommon, and when it has happened, spreads have tended to mean revert quickly. Exhibit 3 illustrates that this has only happened a handful of times, and each time has been followed shortly by a sharp retracement in spreads.

Our expectation, then, is that spreads will mean revert to the 380 to 420 range over the next year.

EXHIBIT 3

Spread Widening Has Been Uncommon and Has Mean Reverted Quickly



Source: Bloomberg, as of May 2022. Shows the spread component of the J.P. Morgan EMBIGD. Past performance is not indicative of future results.

Will Outflows Accelerate as Fixed-Income and Risk Assets Become Less Attractive?

The third fear driving concerns about the future returns of EM sovereign debt is that outflows could accelerate as fixed-income and risk assets become less attractive.

The perception persists that as rates rise, fixed-income investments—particularly those with longer durations—become less attractive. This, common wisdom holds, leads to a cycle of outflow and underperformance.

It is hard to draw any conclusions about the first two rate-hiking cycles, because the data is unreliable. However, during the 2015-2018 rate-hiking cycle, inflows were solid. Assets managed against the EM hard currency benchmarks actually grew by approximately 20% on strong inflows without any period of appreciable negative drawdown. Assets then then grew again by another 10% in the year following the first rate hike (2016).

Our Verdict: Flows Currently Down, but Should Improve

These findings are supported by a 2021 International Monetary Fund (IMF) paper concluding that growth optimism is not a key driver of hard currency bond flows. These flows, the paper argues, have historically been more sensitive to global risk sentiment. Moreover, one of these factors is not necessarily a determinant of the other.

In recent years, flows into dedicated EM hard currency bond funds have been positive despite negative headwinds stemming from COVID-19. This year has been the exception. In 2022 we have already seen net outflows of reasonable size as global liquidity conditions have tightened. These have been quite persistent but fell in size as we entered May.

“Our expectation is that as valuations continue to improve, flows will return to the asset class, which may act as a catalyst for higher prices.”

Daniel Wood, Portfolio Manager

The outflows we have seen thus far this year repriced EM hard currency assets well ahead of those in other credit markets, resulting in lighter positioning from both dedicated investors (who are now holding very high cash balances) and crossover investors. Average bond prices in the benchmark J.P. Morgan EMBIGD are now around \$85, which is below their COVID-19 lows registered in 2020.

Our expectation is that as valuations continue to improve, flows will return to the asset class, which may act as a catalyst for higher prices.

Will the USD Strengthen as Interest-Rate Differentials Between Emerging and Developed Markets Narrow?

The fourth fear driving concerns about the future returns of EM sovereign debt is that the USD could strengthen as interest-rate differentials between EMs and developed markets narrow.

Conventional wisdom holds that the ongoing Fed tightening cycle will magnify the strength of the USD, and with the USD trading persistently stronger, it is certainly understandable for investors to be concerned about the role of the USD in driving asset-price returns.

However, USD strength has not been a key historical driver of EM debt spreads. If anything, USD strength has a marginally positive correlation with tightening spreads.

Looking back at previous Fed tightening cycles, there is little information available about the impact of higher U.S. interest rates on USD strength and the subsequent impact on EM sovereign debt spreads.

1999-2000: USD Strong

During the 1999-2000 rate-hiking cycle, the USD did strengthen, but this was primarily due to speculation that the euro would collapse shortly after its launch.

2004-2006: USD Weak

The 2004-2006 rate-hiking cycle, meanwhile, was a weak period for the USD against the euro, given concerns about the U.S. trade deficit and investor focus shifting to monthly trade data. In this period, it was difficult to detect any positive impact on the USD from the rate-hiking cycle.

2015-2018: USD Mixed

In the initial part of the 2015-2019 rate-hiking cycle, currency volatility was quite low and the USD strong—until European Central Bank (ECB) President Mario Draghi gave his March 2017 speech in March 2017, which turned around the euro crisis and priced the euro sharply higher against the USD.

Our Verdict: Too Soon to Tell

Investors who are worried that the strong USD is bad for EM debt spreads can take some solace in the possibility that it might weaken. As we entered the 2022 rate-hiking cycle, the USD already appeared overvalued, with positioning one-sided, as exhibit 4 shows.

EXHIBIT 4

USD Already Appears Overvalued



Source: Bloomberg, as of May 2022. Data is for the J.P. Morgan U.S. CPI-Based Real Broad Effective Exchange Rate Index. Past performance is not indicative of future results.

Will Rate Hikes Squeeze Liquidity and Accelerate EM Debt Restructurings?

The fifth fear driving concerns about the future returns of EM sovereign debt is that rate hikes, and a subsequent reduction in the Fed's balance sheet, could reduce access to the market for lower-quality EM debt investors, causing a flood of defaults and restructurings. We believe this risk is already overpriced in the market, for a number of reasons.

First, multilateral and bilateral support for EMs suffering economic difficulty is extremely high, with the IMF alone currently providing about \$250 billion of support. And that is only a quarter of the IMF's \$1 trillion available lending capacity.

Second, aside from 2020, when EM sovereigns experienced a relatively high level of restructurings, historical defaults and restructurings in EM debt have been extremely low. This has been true even during previous Fed rate-hiking cycles, which have not caused a glut of defaults. Moreover, when restructuring has been necessary, recovery values have averaged 55 cents on the dollar,¹ a level far higher than that of corporate bonds.

We saw a shift away from bonds trading at a price of 100 or more at the end of 2021. The J.P. Morgan EMBIGD is also more diversified in 2022 than it was in previous Fed rate-hiking cycles, reducing the concentration risk of an isolated default.

“We believe the risk of rate hikes reducing access to the market for lower-quality EM debt investors is already overpriced in the market, for a number of reasons.”

Marco Ruijer, CFA, Portfolio Manager

¹ Source: Moody's and J.P. Morgan, from December 2000 to December 2020; refers to the J.P. Morgan Next Generation Markets Index (NEXGEM).

Conclusion

When looking at the returns of EM debt in the year following a Fed rate-hiking cycle, we do not believe that investors should be overly concerned.

Although each cycle we analyzed involved unique global economic factors, EM debt returns in the 12 months following the start of a rate-hiking cycle have been strong, as exhibit 5 shows. Double-digit returns of 14.67%, 18.44%, and 10.15% were recorded 12 months after the first rate hike in 1999-2000, 2004-2006, and 2015-2018, respectively. And in each instance spreads tightened into the hikes.

EXHIBIT 5

EM Debt Performance in Past Rate-Hiking Cycles

		1999-2000	2004-2006	2015-2018
10-Year U.S. Treasury Level	Level Right Before	5.624	4.653	2.277
	Level 12 Months After	6.276	3.985	2.449
J.P. Morgan EMBIGD Spread Level	Level Right Before	848	510	415
	Level 12 Months After	714	389	342
J.P. Morgan EMBIGD Spread Change	Change 12 Months Prior	350	-30	61
	Change 12 Months After	-133	-121	-73
J.P. Morgan EMBIGD Total Return	Returns 12 Months Prior	-6.12%	3.33%	1.18%
	Returns 12 Months After	14.67%	18.44%	10.15%
J.P. Morgan EMBIGD IG Total Return	Change 12 Months Prior	4.47%	-0.77%	-1.13%
	Change 12 Months After	5.30%	14.70%	6.98%
J.P. Morgan EMBIGD HY Total Return	Change 12 Months Prior	-7.09%	5.76%	4.34%
	Change 12 Months After	17.78%	21.19%	13.66%

Sources: Bloomberg and J.P. Morgan, as of May 2022. The J.P. Morgan EMBIGD IG refers to the investment-grade component of the J.P. Morgan EMBIGD. The J.P. Morgan EMBIGD HY refers to the high-yield component of the J.P. Morgan EMBIGD. **Past performance is not indicative of future results.** Indices are unmanaged and do not incur fees or expenses. A direct investment in an unmanaged index is not possible.

We believe the current rate-hiking cycle is unlikely to be different. Most of investors' legitimate concerns have already played out, with much of the bad news already priced into the asset class.

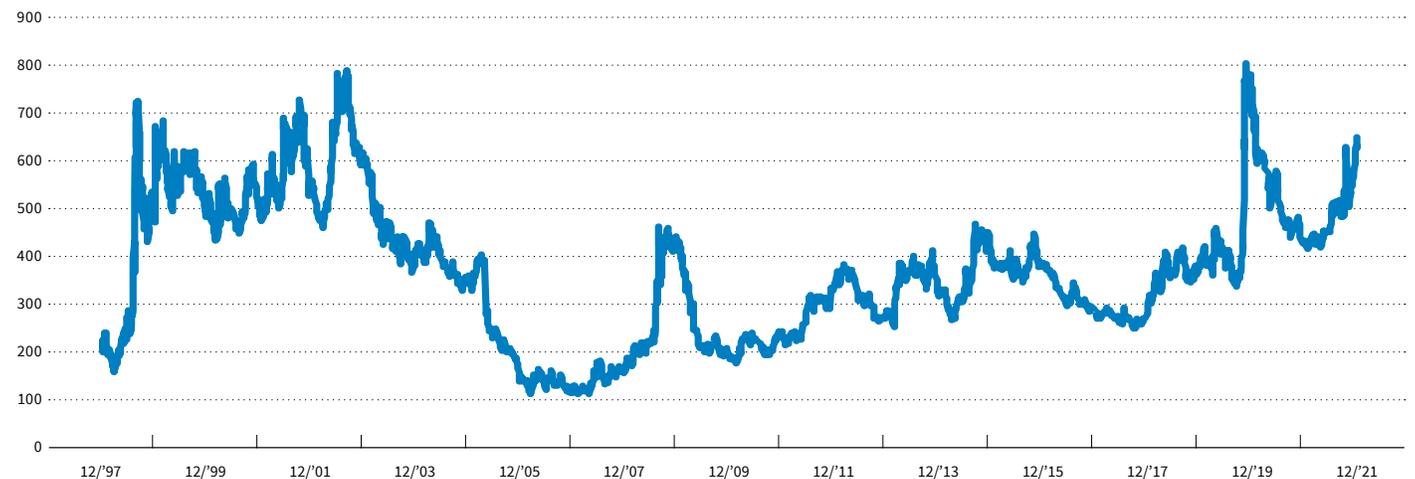
In fact, we have already begun to see a significant upward rise in U.S. Treasury yields; EM debt spreads have widened materially; and the starting yield on the J.P. Morgan EMBIGD was already beginning to look attractive as the Fed began hiking. In addition, we have already seen material net outflows from the asset class this year; the USD has strengthened to multiyear highs; and positioning is heavy.

Conclusion (continued)

In each of the past rate-hiking cycles we examined during the life of this asset class, high-yield EM debt has outperformed investment-grade EM debt in the 12 months following the first Fed rate hike. We expect the current tightening cycle to be no different. The high-yield/investment-grade spread differential is trading at historically wide levels, as exhibit 6 shows.

EXHIBIT 6

High-Yield/Investment-Grade Spread Differential Historically Wide



Source: Bloomberg, as of May 2022. Shows J.P. Morgan EMBIGD high-yield component minus the J.P. Morgan EMBIGD investment-grade component. **Past performance is not indicative of future results.**

Also, as noted in the previous section, cash prices are low across the asset class, and the number of bonds trading at distressed levels has already reached an all-time high, with prices of C-rated bonds already averaging in the mid-\$30s, which is well below historical recovery levels.

We thus believe it could be compelling to overweight the high-yield sector at the expense of investment-grade bonds that offer less probability-weighted upside, and seek to take advantage of valuations in distressed credits.

We believe only a very bearish set of circumstances is likely to generate negative returns for investors over the next year. Our analysis suggests it would likely take a combination of the 10-year U.S. Treasury yield rising and EM debt spreads widening substantially for the asset class to generate a negative return.

“We now believe that EM debt could represent a buying opportunity for investors looking to take advantage of higher yields and improved valuations.”

Daniel Wood, Portfolio Manager

This is unlikely, in our view, as spreads have tended to widen more than 200 bps on global recession fears (and they have widened nearly 150 bps since last year). If fears about a global recession do materialize, we expect to see a significant drop—rather than a rise—in the 10-year U.S. Treasury yield, which would likely act as a cushion against spread widening.

Our base case is that the U.S. 10-year U.S. Treasury yield stabilizes at around 3% and spreads tighten back to more historical levels. In this case, the asset class could generate compelling returns for EM debt investors over the coming year. And long-term, we believe low historical default rates and high recovery values bode well.

Thus, we now believe that EM debt may represent a buying opportunity for investors looking to take advantage of higher yields and improved valuations. Of course, in today’s environment, nothing is certain. We remain focused on navigating risks and changing market conditions to identify attractive investment opportunities on behalf of our clients.

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