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Featured G

Emerging vs. Developed Market Yields: Not an Apples to Apples Comparison (Part 1)

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In this two-part series, we take a multifaceted look at emerging market real yields: on both short- and intermediate-dated bonds as well as on an absolute and relative bases. Our goal is to explain current valuations relative to developed markets, highlight some of the thematic factors that may cause spreads to eventually compress, and balance our view with some of the risks to our current outlook. In part one, we will cover 10-year yields, and then our second installment will cover short-dated yields and the global macro factors that should influence spreads.

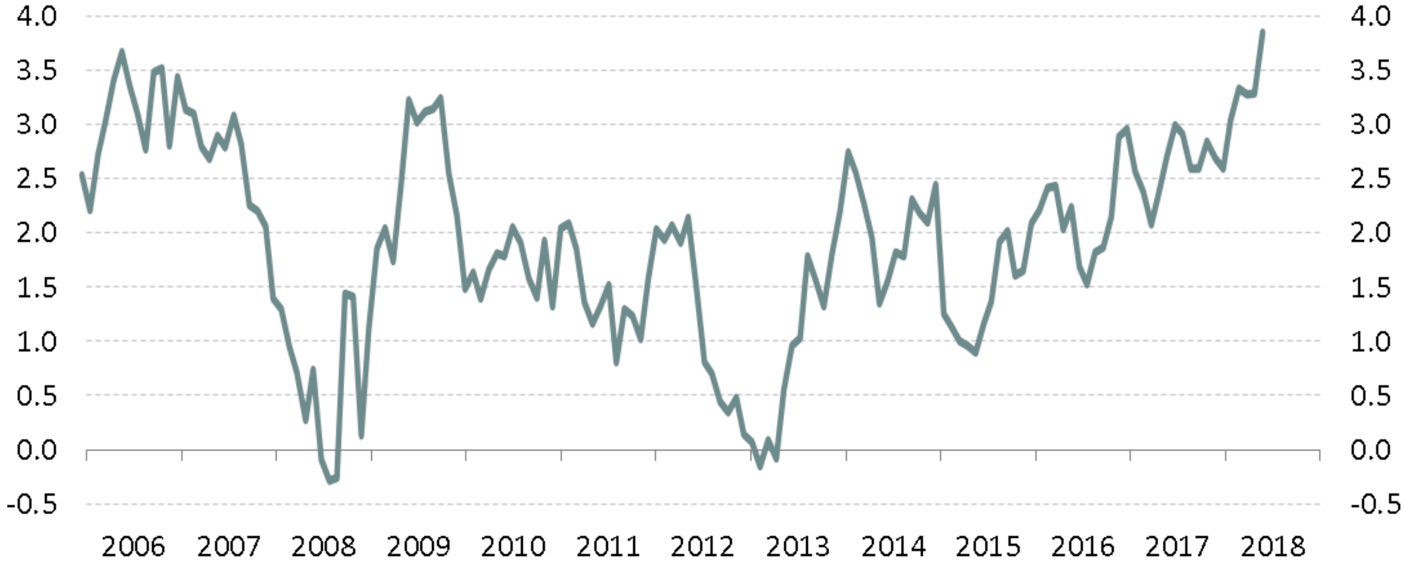
Emerging Market Real Yields

High real yields are core to our investment process at Brandywine Global. We think that in the sovereign space when comparing bond markets across countries—that in local-currency terms—the excess yield that investors get above the rate of inflation is a critical measure of value. That's not just trailing inflation but also takes into consideration where inflation will go. To us, that's one of the best measures of the value in bonds. Of course, comparing real yields between developed and emerging markets is not an apples-to-apples comparison. Emerging markets bear credit risks beyond cyclical factors alone. Still, real yields overall offer a powerful starting point in assessing opportunity across sovereign bond markets.

Absolute Value in Emerging Market 10-year Yields

Chart 1: Emerging Countries* - Real 10 Year Bond Yield

Percent, As of 5/31/2018



**Excludes China*

Source: Haver Analytics

Chart 1 above focuses exclusively on the weighted-average real yield across emerging markets. Although there are plenty of individual country-specific opportunities and risks, the message here is that emerging market bonds, overall, have rarely offered such attractive valuations over this time period on this basis. We think inflation is likely to remain subdued for cyclical and structural reasons.

Let’s start with the cyclical factors because we're in a very different situation today on inflation than we were for much of the last 10+ years. For example, in Brazil unemployment is near its highs unlike the U.S. which is near its lows. There is a tremendous amount of slack in the Brazilian economy so there isn’t any wage pressure. Brazil is a very early cycle economy. Secondly, there isn’t any credit growth of significance; the typical domestic drivers of inflation are absent. In fact, it's the opposite: conditions in Brazil are very disinflationary now. Inflation can rise for external reasons. Energy or food prices can rise for global reasons, or the Brazilian real can weaken. However, what drives the more persistent aspect of inflation is the state of domestic demand, and the fact that Brazil is only two years removed from its worst recession in 100 years tells us there's a lot of slack in the economy.

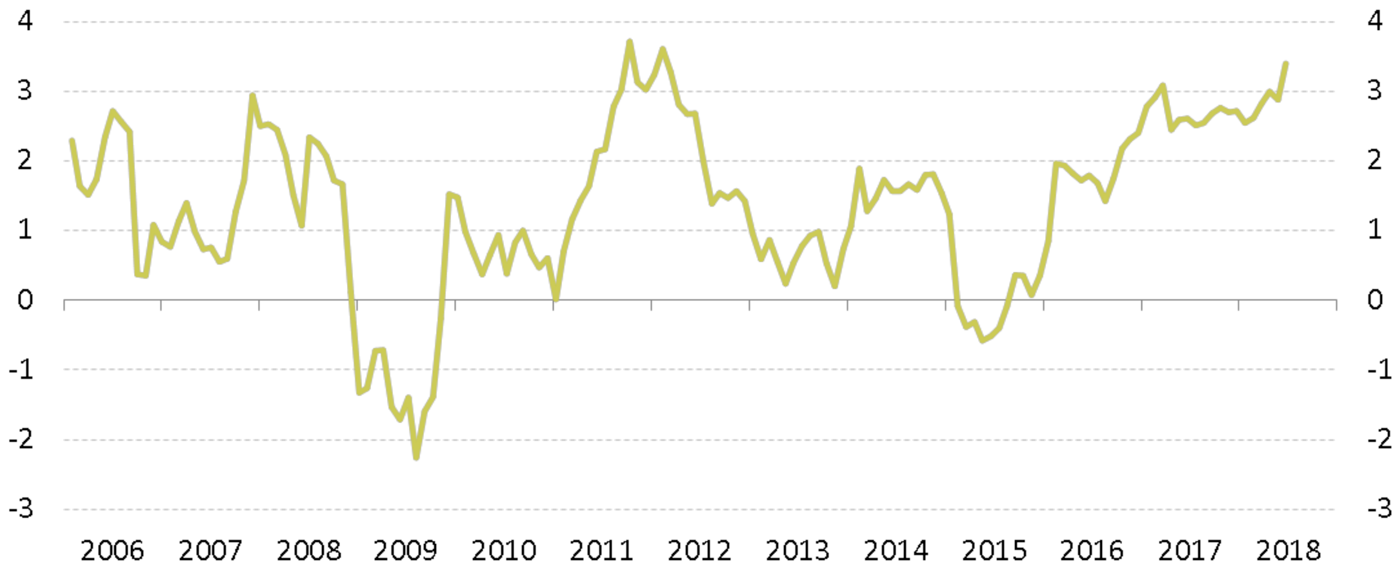
Brazil may get a bounce in inflation over the next few months because the currency has weakened recently. Inflation may move up from 2.8% to something closer to 4%. But, it's not going to last. The real would have to keep falling at that pace to keep inflation around those levels. The overall point is that inflation is down because most of these economies are earlier in their cycles and have plenty of slack in their economies. Therefore, inflation pressures are subdued. We think that inflation is going to stay at these lower levels in emerging economies.

Emerging Market 10-year Spreads

Since U.S. yields have risen over the past eighteen months, it might be the case that emerging market yields need to offer a higher premium to remain attractive in relative terms. However, emerging yield spreads are 350 basis points (bps) versus the U.S. and closer to 400bps if we include the remaining G3 bond markets:

Chart 2: Emerging Countries* - Real 10 Year Bond Yield Spread to U.S.

Percent, As of 5/31/2018



**Excludes China*
Source: Haver Analytics

Chart 3: Emerging Countries* - Real 10 Year Bond Yield Spread to G3 (U.S., Japan, Germany)

Percent, As of 5/31/2018

**Excludes China*
Source: Haver Analytics

These spreads are certainly near historical highs so there's plenty of scope for them to narrow in favor of emerging markets. It’s possible developed market yields rise further and that's how the spread narrows—that’s one possibility. Even if that was the case, investors would still earn the yield in emerging markets during that period. However, we think it's more likely that spreads compress from both sides, in which case, yields would fall, and we’d earn both the yield on emerging markets and the gain from the price appreciation. At these

current levels, we think we are well compensated for the credit risks that exist in these emerging countries.

The Impact of Foreign Financing & Capital Flows

When we're talking about local-currency emerging market yields, there are two additional factors that come into play:

1. One is their financing risk to the extent that countries have large external deficits and are reliant on foreign funding.
2. The other is the global environment to offer that financing, which then has bearing on the level of yields.

If a country might have low inflation but a large external deficit, it may need to offer a relatively high interest rate to gain that funding or financing. Keep in mind we're in an environment where the Federal Reserve (Fed) is raising interest rates, and perhaps eventually the European Central Bank (ECB), so that’s a risk for countries. Yet there has been a material improvement in emerging markets’ external balances from where they were two years ago. The actual balances are not at the levels they were in say the middle of the 2000s, like 2004-05 when balances were exceptionally high. Nonetheless, these countries are running a surplus overall. As a group, emerging markets don’t actually need foreign funding and are in better shape than they were in 2014-15.

We like to talk about the spread versus the U.S. (refer to Chart 2 above) because it’s the country where the central bank has tightened the most, and spreads are tight in most sectors of the U.S. fixed income market. U.S. yields have risen the most and yet emerging market yields are still cheap relative to the U.S. However, it’s worth evaluating emerging market spreads relative to the G3 because capital flows into emerging market bonds can come from the U.S. as well as European and Japanese investors—and other developed markets.

Part two will cover the spread in short-term rates.

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