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EM Local Debt: Is the EM-U.S. Disconnect an Overlooked Opportunity?

INSIGHTS

Emerging markets have become increasingly out of sync with the U.S. in terms of inflation and economic growth. Markets are ignoring the disconnect, which could spell an opportunity for investors.

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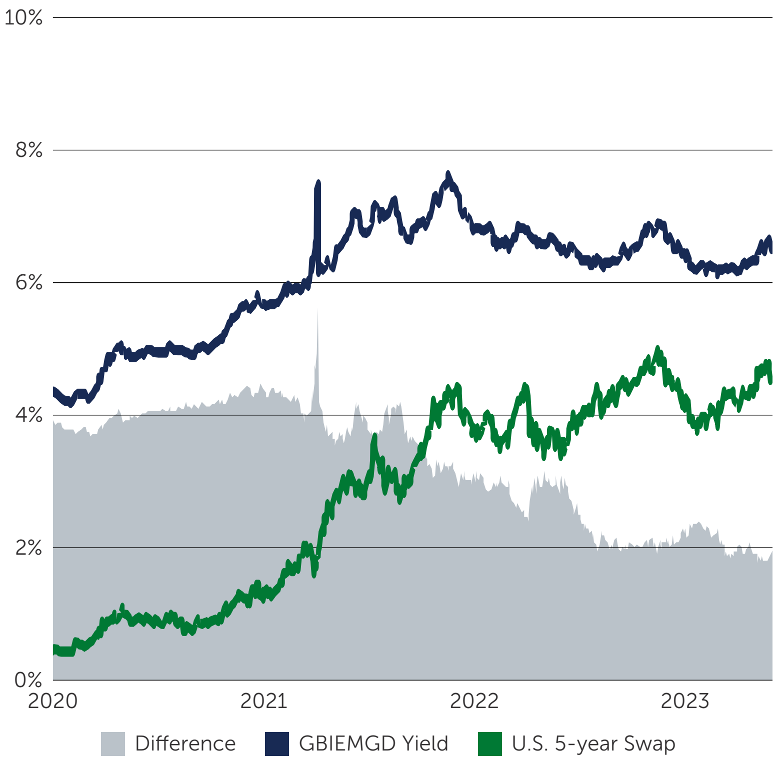
As U.S. inflation and economic growth have remained surprisingly strong so far this year, emerging markets (EM) local interest rates have also moved higher **(Figure 1)**. But the inflation dynamics in EM, unlike their local rates, are not in sync with the U.S.—particularly given that EM inflation has continued to decelerate and is now very near or at central bank targets. We believe this disconnect is presenting a potentially attractive opportunity for investors.

Figure 1: EM and U.S. Rate Differential



Sources: Bloomberg; JP Morgan. As of May 1, 2024.

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EMs are Ahead of the U.S. on Inflation

Part of the reason for the EM-U.S. decoupling can be attributed to the notably faster reaction of most EM central banks to the acceleration of inflation in 2022. Many EM central banks raised interests rates faster and sooner than the U.S. Federal Reserve. For instance, the average EM inflation rate (ex-Turkey) was 9.3% when inflation peaked in the U.S. in June 2022 **(Figure 2)**. At that time, the EM average policy rate was 4.7%, resulting in a real rate of interest of -4.6%, based on past inflation. The U.S. policy rate at that time was 1.2%, for a real rate of -7.8%, based on past inflation.

Figure 2: EMs and U.S. Inflation and Interest Rates: A Comparison

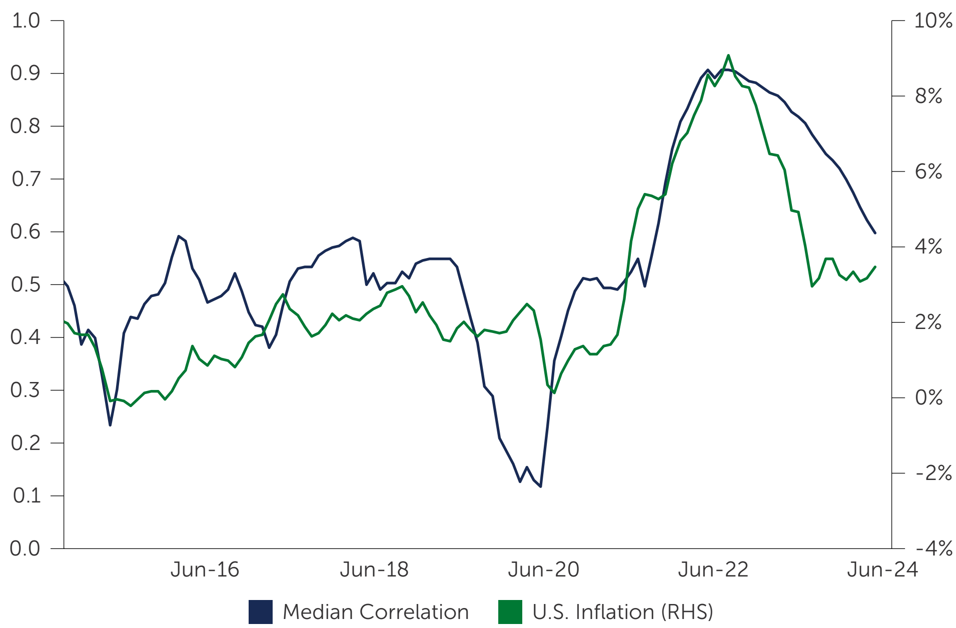
	12-month Inflation		Policy Interest Rate		Real Rates (Past Inflation)	
	Mar-24	Jun-22	Mar-24	Jun-22	Mar-24	Jun-22
Brazil	3.9%	11.7%	11.0%	12.9%	7.1%	1.1%
Chile	3.2%	12.5%	7.2%	8.8%	4.0%	-3.8%
Colombia	7.4%	9.7%	12.5%	6.0%	5.1%	-3.7%
Czechia	1.8%	17.0%	6.1%	6.1%	4.3%	-10.9%
Hungary	3.9%	12.0%	8.9%	6.2%	5.1%	-5.8%
India	4.9%	6.9%	6.5%	4.8%	1.6%	-2.1%
Indonesia	3.1%	4.4%	6.9%	3.7%	3.9%	-0.7%
Israel	2.7%	4.4%	4.5%	0.8%	1.8%	-3.6%
Korea	3.1%	6.0%	3.5%	1.8%	0.3%	-4.3%
Malaysia	1.8%	3.3%	3.0%	2.0%	1.2%	-1.3%
Mexico	4.3%	8.0%	11.4%	7.4%	7.1%	-0.5%
Peru	3.1%	8.8%	6.2%	5.3%	3.2%	-3.5%
Philippines	3.6%	5.9%	6.5%	2.3%	2.9%	-3.6%
Poland	2.1%	15.4%	5.8%	5.8%	3.7%	-9.6%
Romania	6.6%	15.0%	6.3%	4.7%	-0.3%	-10.3%
Serbia	5.0%	11.9%	5.3%	1.5%	0.2%	-10.3%
South Africa	5.3%	7.4%	8.4%	4.9%	3.1%	-2.5%
Thailand	-0.5%	7.6%	2.5%	0.5%	3.0%	-7.1%
Turkey	68.0%	79.0%	44.6%	12.5%	-23.4%	-66.5%
U.S.	3.5%	9.1%	5.3%	1.2%	1.9%	-7.8%
EM Average (ex-Turkey)	**3.6%**	**9.3%**	**6.8%**	**4.7%**	**3.2%**	**-4.6%**

Source: Bloomberg. As of March 31, 2024.

Fast-forwarding to March 2024, EM inflation had eased to 3.6%, while nominal policy rates stood at 6.8%—still higher than they were in June 2022—which has resulted in real rates at 3.2%. That compares with a U.S. real rate of 1.9%.

The same point is illustrated in **Figure 3**, which shows the two-year correlation between EM inflation and U.S. inflation. As EM inflation continues to decline, the rate of U.S. inflation has flattened out in the past nine months, reducing the tight correlation between EM and U.S. inflation seen in 2022 to lower, long-term averages.

Figure 3: Correlation Between EM and U.S. Inflation



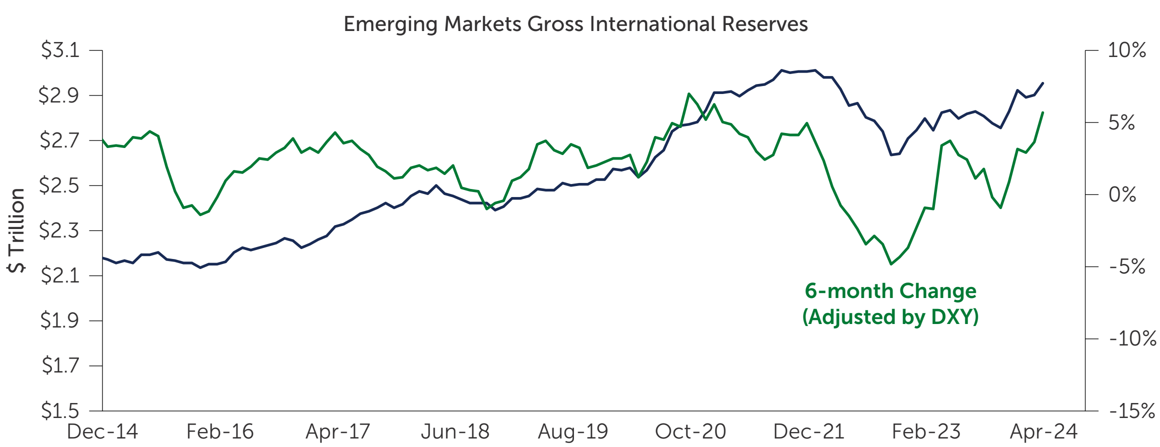
Sources: Bloomberg; JP Morgan. As of May 1, 2024.

EM International Reserves Rise

Supporting the case for a possible investment opportunity is the behavior of international reserves among EMs, the stock of which has risen fairly consistently over the past 18 months. **Figure 4** shows the rising stock of international reserves held by the 18 countries in the sample (ex-Turkey), together with our estimate of the annual rate of accumulation adjusting for valuation. More specifically, as the U.S. dollar has become more expensive in recent years, and as central banks' reserve holdings are diversified to include non-U.S. dollar currencies, we estimated the flow effect of reserve accumulation adjusting for valuation effects, i.e. adjusting for the falling value of non-U.S. dollar reserves held by central banks in the past few years.

An alternative way of expressing the same idea is that the stock of international reserves in EM has increased even when adjusting for valuation effects given their composition. What this ultimately means for investors is that EM economies are seeing inflows that could precede potentially positive returns going forward. In particular, rising foreign exchange rate reserves are a reflection of overall net positive flows into EMs—they don't necessarily only come from portfolio investments but from direct investments as well. To take it a step further, these inflows, coupled with the still-wide interest rate differential between EM and developed market economies, make EM currencies increasingly attractive. In particular, we believe select currencies such as the Brazilian real, Indonesia rupiah, and South African rand offer the potential for attractive valuations and high carry.

Figure 4: EM International Reserves Rise



Sources: Haver Analytics; Bloomberg; Barings. As of March 2024.

Key Takeaway

Given the riskier environment facing markets—from political uncertainty in the year ahead to rising geopolitical risks—EM local debt has largely sold off since December 2023. However, with inflation dynamics between EM countries and the U.S. diverging, and EM international reserves moving higher, this selloff has arguably translated into an attractive buying opportunity in EM local debt.

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**As of March 31, 2024*

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