Education
Fixed Income

Q3 2024

Emerging Market Debt 101

Emerging market debt (EMD) is a versatile asset class, providing a potential yield pick-up opportunity for those fixed income investors willing to move out the risk spectrum. The asset class has shown historical diversification benefits through lower correlation to US bond markets.[1] However, there are important items to be aware of when considering allocating to EMD, like idiosyncratic risk, concentration risk, and currency risk.

What is Emerging Market Debt?

Emerging Market Debt represents bonds issued by countries and corporations that reside within developing economies. There can be different definitions of a 'developing economy' and which countries are included in the classification, but typical characteristics tend to be low/middle income per capita and higher growth rates than advanced economies.

EMD has three broad investable segments: Hard currency (HC) sovereign, hard currency corporate, and local currency (LC) sovereign. Hard currency sovereign and corporate indices are predominantly comprised of US dollar-denominated bonds issued by emerging market governments and corporates, respectively, while LC sovereign indices include local currency denominated debt issued by emerging market governments. There are also local currency corporates, but those are more difficult for US investors to access and invest in.

The key characteristics of the three EMD assets are illustrated in Figure 1. Some of the main differences across EMD assets include:

- **Mix of IG/HY with Different Levels of Quality** The three EMD segments offer varying degrees of credit quality exposure. Of the three EMD segments, local currency sovereign EMD has the lowest proportion of bonds with an investment grade rating (13%), while hard currency sovereign and corporate EMD have higher proportions (58% and 57% respectively).[2]
- **LC EMD Less Diversified** Hard currency sovereign and hard currency corporate debt are quite diversified by country and region. By way of contrast, local currency sovereign debt is relatively concentrated — the representative index contains only 19 countries, with the largest 10 making up 92%.[3]
- **Currency and Rates Risk** The hard currency sovereign and corporate EMD assets are USD based, with risks driven mainly by movements in US interest rates and credit risk in EM sovereign and corporates. The local currency sovereign EMD asset is sensitive to movements in local rates and currencies relative to the USD, along with sovereign risk.

Figure 1
Key Characteristics of EMD Assets, Global Aggregate Bonds and Global High Yield Bonds

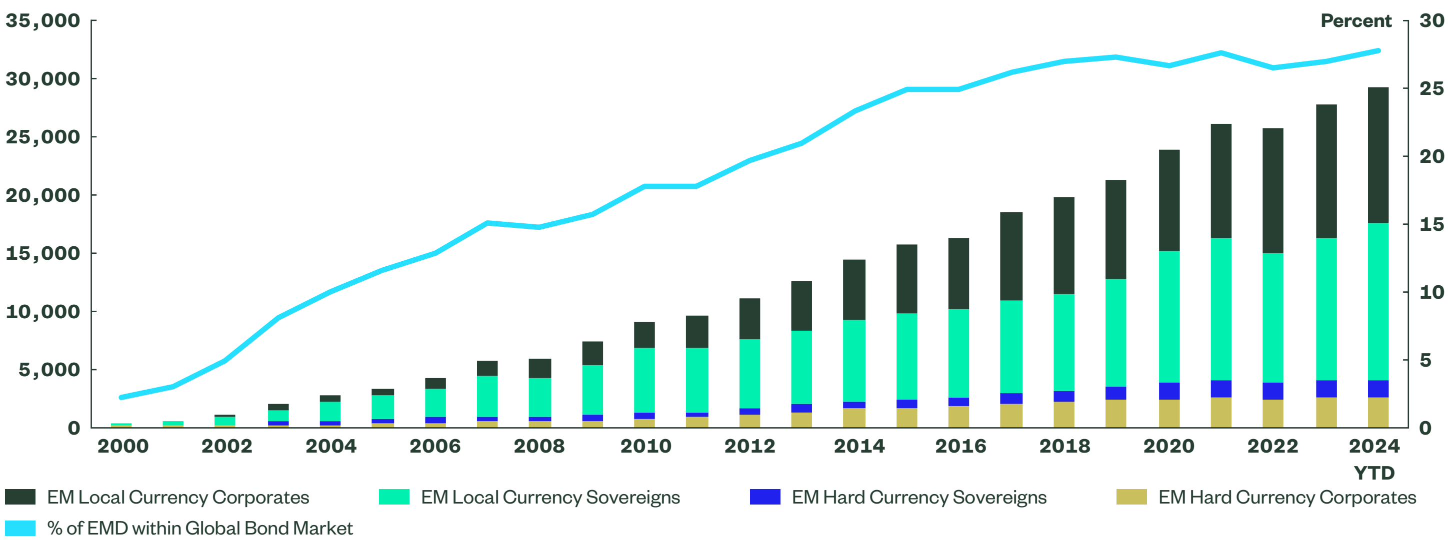
	Hard Currency Sovereign EMD	Hard Currency Corporate EMD	Local Currency Sovereign EMD
Index	Bloomberg EM Hard Currency Aggregate Sovereign	Bloomberg EM Hard Currency Aggregate Corporate	Bloomberg EM Local Currency Government
Investment Universe	76 Countries	41 Countries	19 Countries
Currency	USD	USD	19 EM Currencies
Regional Split (%)			
Asia	14	27	81
Europe	21	30	6
Latin America	33	37	9
Middle East & Africa	32	6	4
Top 10 Countries (%)	53	73	92
Index Rating	IG Credit Rating BBB-	IG Credit Rating BBB/BBB-	IG Credit Rating BBB
IG/Sub-IG Split (%)	58/42	57/43	13/87
Key Risk Drivers	US Treasuries & EM Sovereign Spreads	US Treasuries, Sovereign Risk & EM Corporate Spreads	The US Dollar, Local Rates & Sovereign Risk

Source: State Street Global Advisors, Bloomberg Finance L.P., as of September 30, 2024. Hard Currency Sovereign EMD = Bloomberg EM Hard Currency Aggregate Sovereign USD Total Return Index; Hard Currency Corporate EMD = Bloomberg EM Hard Currency Aggregate Corporate USD Total Return Index; Local Currency Sovereign EMD = Bloomberg EM Local Currency Government Total Return Index. *For the Hard Currency indexes, we use the middle rating of Moody's, S&P, and Fitch. For the Local Currency Index, we use the lowest rating of Moody's, S&P, and Fitch. Characteristics are as of the date indicated, are subject to change, and should not be relied upon as current thereafter.

Size of EMD Market

Over the past two decades, the total emerging market debt (EMD) market has grown significantly, reaching over $29 trillion in September 2024 (based on JP Morgan estimates). Its proportion of the global bond market has also increased rapidly, rising from 2% in 2000 to 28% in September 2024. Even if we exclude EM local currency corporates, EMD accounts for 17% of the global bond market (see Figure 2).

Figure 2
EMD Market Expansion Since 2000 (in USD)



Source: State Street Global Advisors, JP Morgan, Bloomberg Finance L.P., Bank of International Settlements, as of September 30, 2024.

Yield Enhancement

Emerging market debt provides an attractive yield enhancement option relative to investment grade bonds. Figure 3 displays the yield advantage EMD offers compared to US aggregate bonds, which have a higher index rating. Hard Currency EMD yields are nearly on a levels of high yield bonds, while enjoying higher average credit ratings. Hard currency corporate EMD assets have average investment grade rating about 6–7 notches below US aggregate bonds, while the duration of the index is shorter. By comparison, hard and local currency sovereign EMD have an average investment grade rating with a modified duration slightly higher than US aggregate bonds.

Figure 3
Bond Index Characteristics

	Yield to Maturity (%)	Index Rating*	Modified Duration
Hard Currency Sovereign EMD	6.31	BBB-	7.00
Hard Currency Corporate EMD	5.85	BBB/BBB-	4.65
Local Currency Sovereign EMD	3.69	BBB	7.06
US Aggregate Bond	4.23	AA	6.17
US High Yield Bond	7.31	BB-/B+	2.98

Source: State Street Global Advisors, Bloomberg Finance L.P., as of September 30, 2024. Hard Currency Sovereign EMD = Bloomberg EM Hard Currency Aggregate Sovereign USD Total Return Index; Hard Currency Corporate EMD = Bloomberg EM Hard Currency Aggregate Corporate USD Total Return Index; Local Currency Sovereign EMD = Bloomberg EM Local Currency Government Total Return Index; US Aggregate Bond = Bloomberg US Aggregate USD unhedged total return index; US High Yield Bond = ICE BofA US High Yield unhedged total return index. *For the Hard Currency, US Aggregate Bond and US High Yield Bond indexes, we use the middle rating of Moody's, S&P, and Fitch. For the Local Currency Index, we use the lowest rating of Moody's, S&P, and Fitch. Characteristics are as of the date indicated, are subject to change, and should not be relied upon as current thereafter.

Portfolio Diversifier

The long-term correlations between EMD assets and US aggregate bonds have been modest, signifying potential diversification benefits when adding EMD to a bond portfolio (see Figure 4). For US aggregate bonds, local currency sovereign EMD has provided the strongest diversification benefits with the lowest historical correlation due to its higher credit quality exposure relative to the other two EMD assets. Unlike the two hard currency EMD assets, it does not have an explicit link to US bonds and its EM currency exposure acts as a further diversifier.

Figure 4
Asset Correlations Based on USD Returns Jul 2008–Sep 2024

	Hard Currency Sovereign EMD	Hard Currency Corporate EMD	Local Currency Sovereign EMD	US Aggregate Bond	US High Yield Bond
Hard Currency Sovereign EMD	1.00	—	—	—	—
Hard Currency Corporate EMD	0.89	1.00	—	—	—
Local Currency Sovereign EMD	0.79	0.71	1.00	—	—
US Aggregate Bond	0.63	0.51	0.45	1.00	—
US High Yield Bond	0.80	0.82	0.68	0.38	1.00

Source: State Street Global Advisors, Bloomberg Finance L.P., as of September 30, 2024. Hard Currency Sovereign EMD = Bloomberg EM Hard Currency Aggregate Sovereign USD Total Return Index; Hard Currency Corporate EMD = Bloomberg EM Hard Currency Aggregate Corporate USD Total Return Index; Local Currency Sovereign EMD = Bloomberg EM Local Currency Government Total Return Index; US Aggregate Bond = Bloomberg US Aggregate USD unhedged total return index; US High Yield Bond = ICE BofA US High Yield unhedged total return index. **Past performance is not a reliable indicator of future performance.** Index returns are unmanaged and do not reflect the deduction of any fees or expenses. Index returns reflect all items of income, gain and loss and the reinvestment of dividends and other income as applicable.

Risks

The emerging market debt sector is generally more volatile than core bond segments such as investment grade corporate bonds. With this higher volatility comes a tendency to incur higher drawdowns in challenging market environments.

Idiosyncratic (or country specific) risk is a key consideration when investing in emerging markets. This is coupled with the possibility that when one country runs into difficulties, there is potential for contagion, which causes others to follow. It is important to recognize however the progress and reforms in emerging markets over the last 20 years — many countries have liberalized their capital markets (allowing for more market-oriented currency regimes), established independent central banks and built up foreign currency reserves. Thus, the hurdle today is higher for idiosyncratic risk to create contagion across the broader emerging market universe.

Emerging markets are nevertheless sensitive to swings in risk sentiment and more susceptible to external economic and geopolitical shocks. More than ever, investors need to look beyond the broad benchmark characteristics — average credit rating, average duration etc. — which tell us very little about the individual issuers in the index. Russia's ejection from benchmarks following its invasion of Ukraine was a shock, but also a timely reminder to consider country exposures and concentration risk within EM debt.

Many emerging markets are export oriented, with trade accounting for a meaningful proportion of economic growth. As global trade is largely funded in US dollars, emerging market economies are sensitive to movements in the dollar relative to their local currencies. When the dollar is weaker and global trade/growth is strong, countries and companies may seek cheaper funding (as local currency rates are generally higher than dollar rates). At the same time, foreign investors looking for higher growth and yield opportunities drive inflows into local markets.

Foreign exchange (FX) volatility and trends also play a significant role in the risk profile of local EMD. As seen in Figure 5, the value of local currency EMD generally trends in the same direction as EM currencies. In fact, movement of EM currency explains approximately an 80% of Local Sovereign EMD returns. Additionally, movement in the US dollar has the potential to impact returns of local EMD because after the debt matures, which is denominated in foreign currency, it must be converted back into US dollars, which adds currency risk. This suggests that taking a view on emerging market currencies, or a view on the US dollar, is an important consideration for USD-based investors when investing in local currency sovereign bonds.

Figure 5
Local Currency Sovereign EM Debt versus EM Currency Returns Oct 2012–Sep 2024

Source: Bloomberg Finance L.P., October 31, 2012 to September 30, 2024. Sovereign Local Currency Sovereign EMD = Bloomberg EM Local Currency Government Diversified Index. EM Currency = MSCI Emerging Markets Currency Index. **Past performance is not a reliable indicator of future performance**. Index returns are unmanaged and do not reflect the deduction of any fees or expenses. Index returns reflect all items of income, gain and loss and the reinvestment of dividends and other income as applicable.

Endnotes

1 State Street Global Advisors, Bloomberg Finance L.P., as of September 30, 2024. See Figure 4 for details.

2 State Street Global Advisors, Bloomberg Finance L.P., as of September 30, 2024. Hard Currency Sovereign EMD = Bloomberg EM Hard Currency Aggregate Sovereign USD Total Return Index; Hard Currency Corporate EMD = Bloomberg EM Hard Currency Aggregate Corporate USD Total Return Index; Local Currency Sovereign EMD = Bloomberg EM Local Currency Government Total Return Index.

3 State Street Global Advisors, Bloomberg Finance L.P., as of September 30, 2024. Local Currency Sovereign EMD = Bloomberg EM Local Currency Government Total Return Index.

ssga.com

Glossary

Credit Spread Difference in yield between a US Treasury bond and a debt security with the same maturity but of lesser quality.

R-squared A statistical measure that indicates how much variation of a dependent variable is explained by the independent variable is a regression model.

Yield Income produced by an investment, typically calculated as the interest received annually divided by the investment's price.

Yield to Worst An estimate of the lowest yield that you can expect to earn from a bond when holding to maturity, absent a default. It is a measure that is used in place of yield to maturity with callable bonds.

Important Risk Information

Investing involves risk including the risk of loss of principal.

ETFs trade like stocks, are subject to investment risk, fluctuate in market value and may trade at prices above or below the ETFs' net asset value. Brokerage commissions and ETF expenses will reduce returns.

Bonds generally present less short-term risk and volatility than stocks, but contain interest rate risk (as interest rates rise, bond prices usually fall); issuer default risk; issuer credit risk; liquidity risk; and inflation risk. These effects are usually pronounced for longer-term securities.

Any fixed income security sold or redeemed prior to maturity may be subject to a substantial gain or loss.

Investing in high yield fixed income securities, otherwise known as "junk bonds", is considered speculative and involves greater risk of loss of principal and interest than investing in investment-grade fixed income securities. These Lower-quality debt securities involve greater risk of default or price changes due to potential changes in the credit quality of the issuer.

All information is from SSGA unless otherwise noted and has been obtained from sources believed to be reliable, but its accuracy is not guaranteed. There is no representation or warranty as to the current accuracy, reliability or completeness of, nor liability for, decisions based on such information and it should not be relied on as such.

The information provided does not constitute investment advice and it should not be relied on as such. It should not be considered a solicitation to buy or an offer to sell a security. It does not take into account any investor's particular investment objectives, strategies, tax status or investment horizon. You should consult your tax and financial advisor.

The views expressed in this material are the views of SPDR Americas Research Team through the period ended September 30, 2024 and are subject to change based on market and other conditions. This document contains certain statements that may be deemed forward-looking statements. Please note that any such statements are not guarantees of any future performance and actual results or developments may differ materially from those projected.

International Government bonds and corporate bonds generally have more moderate short-term price fluctuations than stocks, but provide lower potential long-term returns.

Diversification does not ensure a profit or guarantee against loss.

Currency Risk is a form of risk that arises from the change in price of one currency against another. Whenever investors or companies have assets or business operations across national borders, they face currency risk if their positions are not hedged.

The value of the debt securities may increase or decrease as a result of the following: market fluctuations, increases in interest rates, inability of issuers to repay principal and interest or illiquidity in the debt securities markets; the risk of low rates of return due to reinvestment of securities during periods of falling interest rates or repayment by issuers with higher coupon or interest rates; and/or the risk of low income due to falling interest rates. To the extent that interest rates rise, certain underlying obligations may be paid off substantially slower than originally anticipated and the value of those securities may fall sharply. This may result in a reduction in income from debt securities income.

Investing in foreign domiciled securities may involve risk of capital loss from unfavorable fluctuation in currency values, withholding taxes, from differences in generally accepted accounting principles or from economic or political instability in other nations. Investments in emerging or developing markets may be more volatile and less liquid than investing in developed markets and may involve exposure to economic structures that are generally less diverse and mature and to political systems which have less stability than those of more developed countries.

Sovereign bonds are issued by governments and government agencies and instrumentalities, which may be unable or unwilling to repay principal or interest on debt obligations in times of economic uncertainty.

Intellectual Property

The trademarks and service marks referenced herein are the property of their respective owners. Third party data providers make no warranties or representations of any kind relating to the accuracy, completeness or timeliness of the data and have no liability for damages of any kind relating to the use of such data.

The S&P 500® Index is a product of S&P Dow Jones Indices LLC or its affiliates ("S&P DJI") and have been licensed for use by State Street Global Advisors. S&P®, SPDR®, S&P 500®, US 500 and the 500 are trademarks of Standard & Poor's Financial Services LLC ("S&P"); Dow Jones® is a registered trademark of Dow Jones Trademark Holdings LLC ("Dow Jones") and has been licensed for use by S&P Dow Jones Indices; and these trademarks have been licensed for use by S&P DJI and sublicensed for certain purposes by State Street Global Advisors. The fund is not sponsored, endorsed, sold or promoted by S&P DJI, Dow Jones, S&P, their respective affiliates, and none of such parties make any representation regarding the advisability of investing in such product(s) nor do they have any liability for any errors, omissions, or interruptions of these indices.

Distributor: State Street Global Advisors Funds Distributors, LLC, member FINRA, SIPC, an indirect wholly owned subsidiary of State Street Corporation. References to State Street may include State Street Corporation and its affiliates.

State Street Global Advisors, 1 Iron Street, Boston, MA 02210-1641. T: +1 617 786 3000.

ID2431100-5065986.3.1.AM.RTL 1024
Exp. Date: 10/31/2025