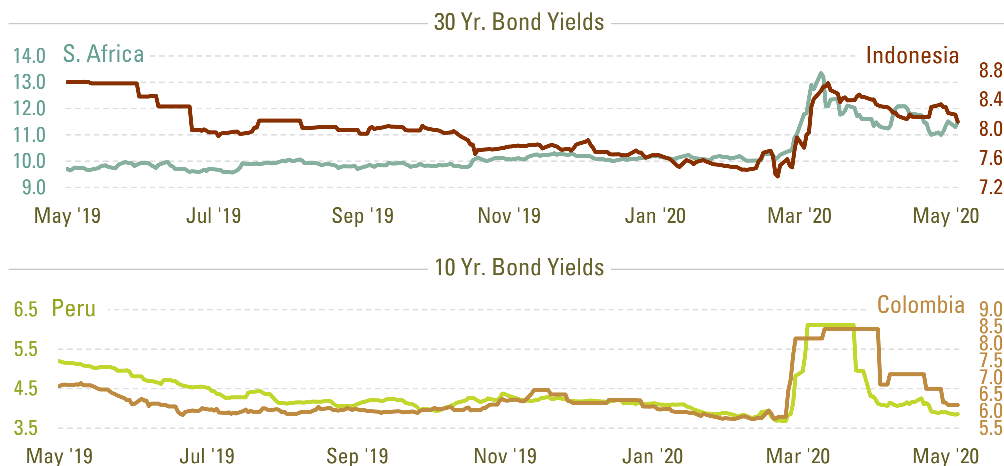
COVID-19 Research Update

Global Fixed Income Themes & Market Conditions

The 10-year U.S. Treasury has yielded somewhere between 50-70 basis points over the last two months—with German Bunds and Japanese Government Bonds producing even lower yields. In yield-starved developed markets, U.S. investment grade credit has provided more attractive returns relative to G3 sovereign bonds. However, the sovereign world is not completely yield starved. For example, emerging market bonds have also participated in the recent sovereign debt rally. **Figure 1** shows how bond yields for four emerging market countries have come off their March 2020 peaks.

Figure 1 Bond Yields
As of 5/14/2019



Source: Bloomberg (© 2020, Bloomberg Finance LP)

These emerging market bonds have rallied in spite of the uncertain environment. This rally is not idiosyncratic, and instead reflects the underlying constructive factors supporting bond markets in an otherwise economically challenged period. Among these factors is the emerging market inflation backdrop, which has been relatively benign since the Great Financial Crisis—or in some cases—over the last two decades. See **Figure 2** (on **Page 2**) for Consumer Price Index (CPI) inflation rates from 2000-present.

We have taken note of the credibility that many emerging market central bankers have established over the last 20 years, namely by taking steps to gradually drive down inflation rates. The economies in which inflation rates fall within their central bank targets generally have attractive real sovereign bond yield opportunities.

Although policy rate cuts usually do not spark a sovereign bond rally, the benign inflation backdrop in many emerging market economies continues to provide investors with a comfortable real yield cushion. **Figure 3** (on **Page 2**) shows the policy rates for South Africa, Peru, Colombia, and Indonesia.

With prolonged economic weakness expected as a result of the coronavirus, the emerging market inflation backdrop should remain weak due to the widening output gaps. The slack in these emerging market economies should provide their respective central banks with enough cover to continue easing and aid in the subsequent recoveries.

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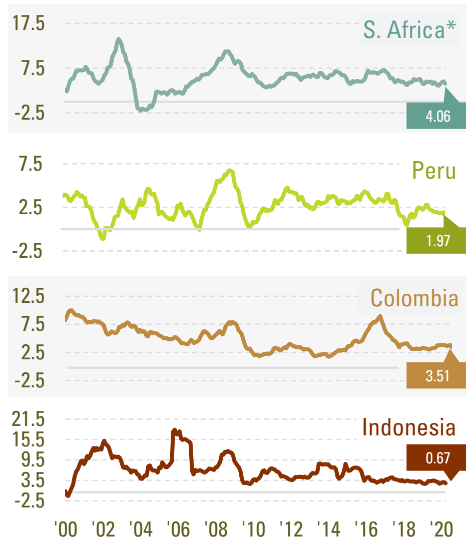
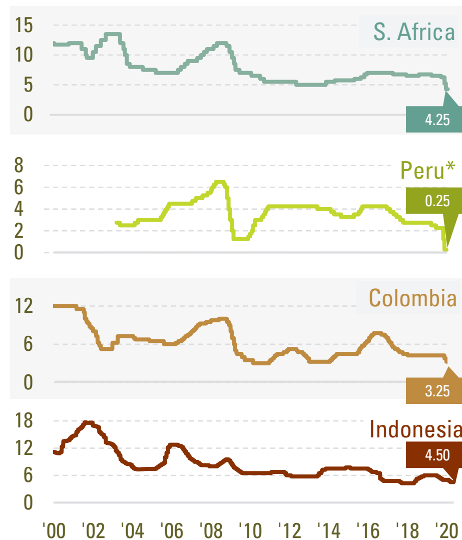
Figure 2 CPI Inflation
%, As of 4/30/2020



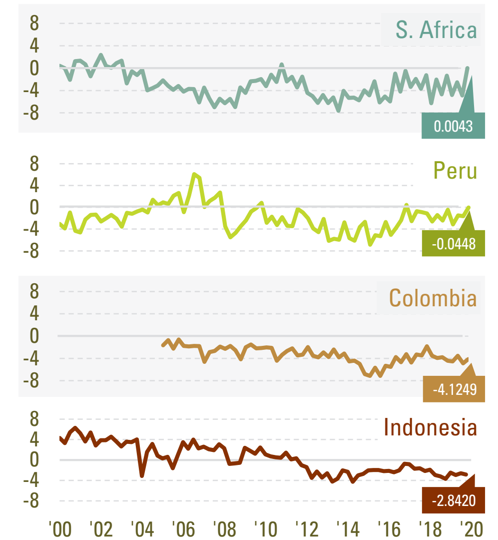
*South Africa as of 3/31/2020
Source: Brandywine Global, Macrobond, StatSA, INEI, DANE, EPS

Figure 3 Policy Rates
%, As of 5/19/2020



*Peru as of 5/18/2020
Source: Brandywine Global, Macrobond, SARB, BCRP, Central Bank of Columbia, BI

Figure 4 Current Account Balance
As % of GDP, As of 12/31/2019



Source: Brandywine Global, Macrobond, SARB, BCRP, Central Bank of Columbia, BI

Therefore, central bank independence will remain an important factor in the emerging world. As an example, Bank Indonesia and the South African Reserve Bank have fostered investor confidence over the years by implementing monetary policy independent from political agendas. Central bank independence has been paramount in controlling inflation for these countries. Furthermore, the role of a central bank is a significant pillar in how effective a country's governance is—one of the triumvirate factors in ESG analysis and an eventual determinant of sovereign borrowing costs. Depending on how sharp and prolonged a country's economic downturn will be, various government agencies may come under pressure to produce a recovery—including central banks. We will continue to monitor emerging market monetary policy to assess overall governance, and more specifically,whether decisions are driven by fundamental conditions or influenced by political pressure.

Financing will become a prominent issue that countries need to address as their current account balances reflect an increase in underfunded external liabilities. The current account balances of South Africa, Peru, Colombia, and Indonesia are featured in **Figure 4**. What may bode well for these countries is that their current accounts are net neutral or the deficits leveled off at a certain level. So they were in relatively better positions prior to the COVID-19 crisis. However, these counties are all heavy exporters of commodities and natural resources; their trade balances should take a hit as the slowdown in global trade increases their external liabilities. The Fed's emergency repo facility, and pending International Monetary Fund assistance, should help countries address any significant foreign currency funding liabilities. Any temptation these governments have to increase spending to offset the economic consequences of the coronavirus would also contribute to the deterioration of their current accounts. Therefore, in order for these sovereign bonds to continue participating in the rally, attract foreign investors, increase portfolio inflows, these countries must retain control over fundamentals such as inflation and interest rates.

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