GLOBAL X
by Mirae Asset

GLOBAL X ETFs RESEARCH

Q3 2020 Commentary: Emerging Market Bond ETF (EMBD)

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Topic: Income, International

Related ETFs

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EMBD – Global X Emerging Market Bond ETF

During Q3, the actively managed Global X Emerging Markets Bond ETF (EMBD) outperformed its benchmark, the JPMorgan EMBI Global Core Index, by 72 basis points, primarily due to security selection of corporate issuers. EMBD took advantage of price dislocations caused by forced selling in the market and invested in fallen angels and downgraded corporate issuers. These investments positively contributed to EMBD's performance as credit spreads recovered while markets absorbed rating impacts.

EMBD's overweight positions and security selection in corporate issuers within Brazil's pulp paper sector positively contributed to relative performance, while local currency depreciation helped improve issuers' earnings profiles. An overweight in Moroccan phosphate producers also positively contributed, as phosphate prices rose. Overweight positions and security selection within Colombia and India also contributed to outperformance, with macroeconomic conditions in both countries improving with the easing of lockdown measures. The fund's underweight positions in Argentina and sub-Saharan African issuers also had a positive contribution.

The main detractor from performance was the underweighting to Sri Lanka, which posted a 7.8% gain after the nation's parliamentary election in August solidified President Rajapaksa's position and ultimately reduced political uncertainty. As the macro backdrop for risk assets improved on the back of the continued global economic recovery, EMBD increased its credit spread duration exposure during the sell-off in September.

Outlook

Despite growing concerns of a second wave of COVID-19, which could slow or reverse the momentum of the ongoing economic recovery, we are cautiously optimistic over the medium term. We expect that global growth will continue to recover into 2021 with supportive monetary and fiscal policy measures. We expect that key growth drivers will come from Europe, as the continent starts implementing EU recovery funds in Q4, while China continues its strong recovery. The increased possibility of a Democratic Party sweep in the upcoming US elections may result in a second major Coronavirus fiscal stimulus package, which could further boost growth heading into 2021. But, the uncertainty around the US elections should not be overlooked, nor should the potential for a divided or gridlocked Congress, which may impede fiscal stimulus efforts. Overall, we anticipate that supportive monetary policy measures helping companies rebuild liquidity buffers may guard against adverse macro developments.

As for EM, we maintain our cautious outlook and anticipate a continued divergence between regions, countries, and issuers going into 2021. Our preference for high-quality assets over high-risk assets remains in-place as fundamentals for weaker quality issuers are still under pressure. A leading risk for EM issuers is the potential for multinational organizations such as the G20 or IMF to pressure for burden-sharing within the private sector. Conservative corporate management behaviors focused on strengthening balance sheets before the pandemic provided resilience, while the burden of dealing with health care expenses and recovery efforts still falls largely on public sector balance sheets, further deteriorating the public sector's credit profile. Given these considerations, we continue to prefer EM corporates over EM high-yield sovereign issuers.

Despite such headwinds, global central banks' ample liquidity coupled with the fragile economic recovery may bring capital flows back into emerging debt markets. Given a historically low-yield environment for developed markets, we believe the active strategy to differentiate among EM countries facing varying degrees of fiscal, external, and political pressures will be critical in navigating volatile markets.