

A case for:

Emerging markets local currency debt

Introduction

In recent years, emerging market local currency debt has become an increasingly attractive asset class, characterised by strong risk-adjusted returns. This has led to growing demand from institutional investors in developed markets, keen to take advantage of the enhanced return potential and significant diversification benefits that this relatively new asset class offers.

Development of the emerging market bonds asset class

Emerging market sovereign issuers have a long history of involvement in international capital markets through the issuance of US dollar or other hard currency denominated bonds. Over the past decade, improvements in macroeconomic fundamentals, institutional structures and governance have enabled central banks in emerging markets to significantly increase the issuance of local currency bonds. Demand has been particularly strong from domestic buyers such as local banks, as well as from pension plans experiencing rapid expansion. For emerging market governments and institutions, this has reduced exposure to external risks, as well as addressed financing imbalances that have been at the root of past emerging market crises.

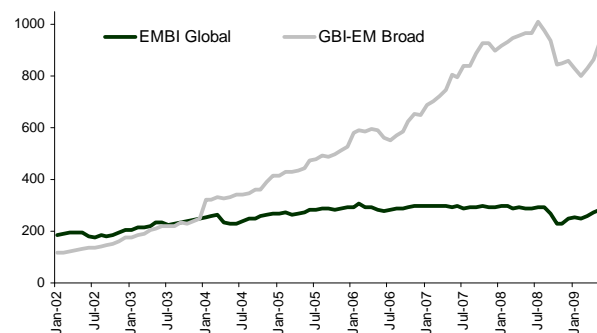
The growth of the asset class has been rapid. Since 2002, emerging market local currency debt has risen from less than 40% of the total market value of bonds outstanding to more than 75% in June 2009¹. In addition to increased local issuance, this change has been enabled by countries actively pursuing a policy of lowering their external debt burden through buybacks and reduced hard-currency refinancing. Several emerging countries have even achieved the status of net external creditor. As a result, issuers have become less dependent on foreign capital flows, thus improving both creditworthiness and policy flexibility.

The extension and deepening of local currency yield curves has been an equally important development in the last decade. For domestic investors, this is essential for asset / liability matching and efficient portfolio management. In Latin America, pension funds already own approximately half of the total sovereign debt outstanding and are growing rapidly.

Similar trends can be found in Asia and Eastern Europe. Perhaps more importantly going forward, the development of local currency capital markets establishes a foundation for pricing for corporate bond issues.

More recently, the global financial crisis has shown that emerging markets haven't wholly shed their need to attract foreign capital in order to finance infrastructure development and economic growth. As risk aversion rose, capital flowed into the perceived safety of US treasuries. The extra yield of emerging market bonds over these treasuries – the yield spread - widened to reflect increased refinancing risks. However, as the crisis intensified with the collapse of Lehman Brothers in September 2008, the finances of these countries remained relatively robust and emerging markets did not experience the levels of default and contagion that investors expected. Consequently, investors concluded that the price of emerging markets sovereign debt was not reflective of their relatively strong fundamental background, and spreads compressed sharply. Sovereign issuers were able to take advantage of returning risk appetite early this year and refinance at reasonably low historical rates.

Figure 1: Emerging market debt composition (USD bn)²



Improved fundamentals and lower risks

Investor interest in local currency emerging market debt has been led by the rapid improvement in the macroeconomic fundamentals of emerging countries. Among the major export driven economies, foreign exchange reserves have increased tremendously through central bank sterilisation of trade flows. These reserves provide the means to stabilise the exchange rate and avoid the cycles of hyper inflation and

¹ JP Morgan indices used as proxies for total emerging market debt asset class. EMBI Global for hard currency bonds and GBI EM Broad for local currency bonds.
² Source: JP Morgan.



currency devaluation that had kept risk adverse investors out of the asset class. In countries like China and Brazil, central banks have also funded counter-cyclical fiscal policy which has helped to maintain positive growth as developed markets contract.

Such stimulus spending is particularly important and useful in emerging markets. These countries have huge infrastructure and development needs which means the government can spend on productive projects that will fuel future growth and investment. Project costs have also fallen with declining commodity prices and with spare capacity at high levels, the spending is unlikely to be inflationary.

Emerging market governments have also made significant headway in a number of areas such as strengthening property rights, controlling fiscal spending and de-pegging currencies. Many emerging market countries have also come to realise the importance of an independent central bank with a transparent and clear inflation-targeting monetary policy. These improvements have already had visible benefits such as dampening inflation expectations, improving sovereign debt ratings and thus boosting the growth of local currency investing. While exceptions exist, primarily among the EU ascension countries in Eastern Europe and the socialist Bolivarian countries in Latin America, the broad trend has been positive. This reduces the incidence of significant economic imbalances arising and reduces the severity of cyclical downturns.

Another significant positive development has been the expansion of domestic economies and the growth of the middle classes. These new markets provide an important source of diversification that continues to support emerging market growth in spite of weak demand externally. Diversification away from solely producing primary commodities or manufacturing for export has reduced contagion risks and lowered exposure to developed market contraction.

High risk-adjusted returns with low correlations to other asset classes

Above all, the real attractions of the asset class for developed market institutional investors are the high historical risk-adjusted returns and low correlations to other asset classes. As shown below, emerging market local currency bonds and cash compare very favourably with alternatives such as US high yield bonds on a Sharpe ratio basis. Currency movements and high yields have comprised the bulk of positive returns but with inflation expectations falling with global GDP growth, there is a greater opportunity to capture capital gains on bonds.

Figure 2: Risk and return characteristics³

	EM Local Currency Bonds	EM Currency	EM US\$ Bonds	EM Equities	High Yield Corporate Bonds	High Grade Corporate Bonds	US Equities
Annualized Return	12.94%	9.77%	9.60%	17.25%	8.30%	4.89%	1.75%
Annualized Vol	12.00%	7.46%	9.97%	25.46%	11.93%	4.14%	14.60%
Sharpe Ratio	0.82	0.89	0.65	0.56	0.44	0.43	-0.09

Incorporated into a diversified portfolio, emerging markets debt can also add value by reducing systematic risk. As illustrated below, the returns are least correlated to developed markets assets, investment grade bonds in particular.

Figure 3: Correlation of monthly returns in USD³

	EM Local Currency Bonds	EM Currency	EM US\$ Bonds	EM Equities	High Yield Corporate Bonds	High Grade Corporate Bonds	US Equities
EM Local Currency Bonds	1.00						
EM Currency	0.93	1.00					
EM US\$ Bonds	0.79	0.70	1.00				
EM Equities	0.76	0.78	0.66	1.00			
High Yield Corporate Bonds	0.65	0.60	0.75	0.68	1.00		
High Grade Corporate Bonds	0.43	0.33	0.65	0.11	0.17	1.00	
US Equities	0.69	0.70	0.61	0.82	0.72	0.08	1.00

Despite strong flows into the asset class over the past five years, investor allocations to emerging market bonds are still only a fraction of those invested in developed market high yield bonds and emerging market equity. On a global GDP weighted basis, these bonds should form a larger component of diversified institutional portfolios so there is a lot of scope for demand growth and liquidity premium compression. The asset class is also under-researched, enabling active managers to exploit inefficiencies and add alpha.

Conclusion

As risk appetite rises and confidence returns to the financial markets, investing in emerging market debt has become increasingly appealing. More robust fundamentals, effective governance and a relatively strong economic outlook should help these countries to outpace the economic growth of the developed world and provide attractive opportunities for investors. At a time when Western governments are flooding the market with new bond issuance, investors rightly concerned about over-supply are seeking alternatives to protect against rising dollar yields.

With emerging market debt offering historically high risk-adjusted returns and low correlation with other asset classes, rising demand from institutional investors looks set to continue.

³ Source: JP Morgan, Citigroup, MSCI Barra, S&P (31 Dec 2002 to 31 July 2009).



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