What does a stronger dollar mean for local currency bond returns?

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The previous six years in foreign exchange markets can clearly be defined as a prolonged period of trend dollar weakness. This has primarily occurred as a result of an overly large current account deficit and an excessively long period of low interest rates. However, recent economic and trade data out of the US, coupled with a more hawkish rhetoric from the Federal Reserve, suggest that this trend may be about to reverse.

One of the best performing asset classes during this period of dollar strength has been local currency emerging market bonds. Investors are becoming increasingly aware of these high returns and the benefits of investing in these markets. In 2007 local currency bonds attracted almost two thirds of all inflows into the emerging market debt asset class. This is a dynamic shift from the previous year when almost three quarters of emerging market bond inflows were invested in debt issued in dollars rather than local currency. This paper seeks to establish to what extent the weak dollar has driven dollar returns in local currency emerging market bonds and how these returns would be affected should this trend reverse.

The table below summarises the returns of some of the more popular asset classes in dollars. The table highlights that risk adjusted returns when using the dollar as the numeraire currency are extremely favourable over the six year period that local currency emerging market bond returns have been calculated. What is most interesting is that, even though the returns in this asset class are the highest, because of the diversity of the countries included in the benchmark, these returns are also achieved with an unexpected low level of volatility. For example the return on local currency emerging market bonds is more than double that of developed global bonds but only have 120bp of additional volatility.

USD Returns	EM $ Bonds	EM Local Currency Bonds	Developed Global Bonds	Developed High Yield Corporate	S&P 500	U.S. Treasury
Cum Rtn	78.1%	115.5%	46.4%	70.1%	73.7%	26.4%
Annualised Rtn	11.4%	15.5%	7.4%	10.5%	10.9%	4.5%
Annualised Vol	6.1%	8.0%	6.8%	4.9%	9.2%	4.9%

Source: JP Morgan & Rexiter Capital Management
Data covers the period 31st December 2002 – 30th April 2008

However, to what extent are these returns the result of a weak dollar and how attractive have the returns been for European investors? One way of approaching this question is to recast the same risk and return characteristics in the euro. The euro has borne the brunt of the dollar depreciation over the past six years as many of the key Asian countries continue to allow their currencies relatively little flexibility against the dollar.

EUR Returns	EM $ Bonds	EM Local Currency Bonds	Developed Global Bonds	Developed High Yield Corporate	Euro Stoxx 50	CITIGROUP European Government Bonds (EGBI)
Cum Rtn	20.2%	45.4%	-1.2%	14.7%	60.4%	21.5%
Annualised Rtn	3.5%	7.3%	-0.2%	2.6%	9.3%	3.7%
Annualised Vol	8.7%	7.9%	4.5%	8.5%	14.0%	7.8%

Source: JP Morgan, Factset & Rexiter Capital Management
Data covers the period 31st December 2002 – 30th April 2008

In nominal terms the euro has appreciated approximately 8% - 9% per annum against the dollar yet a European investor would still have enjoyed strong risk adjusted returns when restated in euro. This suggests that the attractive returns of local currency emerging market bonds have been exaggerated by a weak dollar but that the asset class retains comparatively favourable characteristics. Perhaps the returns using the euro as a numeraire are closer to those that a US investor could expect to see going forward if we are indeed in for a period of trend dollar strength.

Thus far the article has implied that a stronger dollar would result in a weaker euro but this is not necessarily the case. Therefore I have restated the results into Japanese yen below. The results again suggest that Japanese investors would also have enjoyed favourable risk adjusted returns in this asset class.

JPY Returns	EM $ Bonds	EM Local Currency Bonds	Developed Global Bonds	Developed High Yield Corporate	MSCI Japan	WGBI Japan (Government Bonds)
Cum Rtn	56.6%	89.4%	28.7%	49.5%	75.8%	3.5%
Annualised Rtn	8.8%	12.7%	4.8%	7.8%	11.2%	0.6%
Annualised Vol	9.0%	10.3%	5.2%	9.9%	15.4%	2.5%

Source: JP Morgan, Factset & Rexiter Capital Management
Data covers the period 31st December 2002 – 30th April 2008

One could argue that there are other key driving factors that have been largely responsible for the strong historic returns. However, whilst it is clear that both high real rates and commodity prices have been useful contributors to historic foreign currency returns they are not the underlying cause. Various capital control techniques have been applied but have largely failed to prevent the ongoing appreciation pressure on emerging market currencies. This is because they fail to attack the underlying cause - convergence from a developing economy into one that is transitioning to and can sustain a much higher level of GDP per capita.

We believe that there are many structural reasons that accurately explain the high returns from this asset class. The rationale for this viewpoint can be found in the case for local currency bonds on the website.

In conclusion, dollar weakness has been partially responsible for the extraordinarily strong risk return characteristics attributable to local currency emerging market bonds since JP Morgan began tracking returns. However, the tables above demonstrate emerging market foreign currency returns have been favourable whatever currency is used as the numeraire. The asset class has been and continues to remain attractive regardless of the relative strength or weakness of the majors.

Low correlations between emerging market currencies and an increased willingness by investors to differentiate between country level idiosyncratic risks will help to ensure that strong fundamental research can continue to add value in this asset class and deliver investors strong relative returns in addition to the attractive absolute levels of return on offer.