Why emerging markets local currency debt?

March 2010 - Author: Daniel Wood, Fund Manager

The phrase "every cloud has a silver lining" can be traced way back to 1634 to John Milton's masque "Comus". Over 350 years later, as the global economy struggles to emerge from the deepest recession since World War II, silver linings are in short supply for investors. Investment portfolio values have been severely impaired by a decade of stagnant equity prices and pension shortfalls are now the rule rather than exception. Therefore, many investors now need to invest in assets that generate a higher return than their benchmark. With paltry global interest rates and inflationary fears fuelling growing concerns over the future direction of bond prices, asset allocation has never been more difficult.

Through the gloom however, one asset class is slowly catching institutional investors' attention as an attractive alternative to the more traditional fixed income opportunities. Emerging market local currency debt has been stress tested to the extreme during the previous two years of the global financial crisis and has passed the exam with flying colours. This asset class is currently just a small fraction of global pension fund allocations but this is changing rapidly. Although those not currently invested have missed out on some very strong risk adjusted returns over the past seven years, the silver lining is that we are still only at the beginning of what we believe is a very exciting structural shift in the growth of this asset class.

Below are ten reasons why we believe that an allocation to local currency emerging market debt makes good sense for European institutional investors.

1. Attractive yield*

The current yield to maturity on JP Morgan's Government Bond Index – Emerging Markets Global Diversified (GBI-EMGD) is currently 7.13%. This benchmark is currently comprised of the local currency bonds of fourteen emerging market governments with each country capped at a maximum 10% weighting. Yields across the index vary widely from country to country with Brazilian bonds currently paying in excess of 11.5% and Thai bonds as low as 3.74%. The overall yield on offer compares favourably with other asset classes.

There was a time when interest rates tended to rise when global pressures increased as monetary policy would need to be defensive rather than counter-cyclical. However, the past two years have demonstrated that this is no longer the case and rates are now dictated predominantly by domestic inflationary expectations and local monetary policy actions. This can be evidenced by the fact that overnight borrowing rates and bond yields in countries as diverse as Brazil, Turkey, South Africa and Indonesia have fallen considerably throughout the global crisis. Additionally, we believe that yields still have the potential to fall further as the structural borrowing costs of emerging market governments decline reflecting the successful shift towards inflation targeting policy.

	Emerging Market Debt [1]	Euro Denominated Government Bonds [2]	Euro Denominated Investment Grade Corporate Bonds [3]	Euro Denominated High Yield Corporate Bonds [4]	European Equity [5]
Yield to Maturity	7.13%	2.88%	3.20%	7.01%	3.36%
Modified Duration	4.27	5.33	4.05	3.94	N/A

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Sources: Bloomberg, FactSet.

*Data as of 5th March

[1] JP Morgan Government Bond Index – Emerging Markets Global Diversified
[2] Citigroup EuroBIG
[3] Citigroup EuroBIG Corporate
[4] Barclays Capital Pan-European High Yield
[5] S&P Europe 350

2. Lower duration

Recent conversations with investors have very quickly turned to the potential inflationary impact of global monetary easing. Interest rates are universally low, fiscal deficits widening and the level of quantitative easing in the developed world is unprecedented. Huge question marks still linger over the medium and longer term benefits and costs of this policy and investors remain divided on its effect on asset prices going forward. We have no clearer insight than the average investor on this issue but believe the vast amounts of money both borrowed and printed by developed market authorities will eventually result in a sharp increase in borrowing costs for their governments, and subsequent capital losses for investors. Central banks have the capacity to dictate the overnight borrowing rate but ultimately the market sets longer tenor interest rates. As questions about the sustainability of developed market sovereign debt looms large, these borrowing costs will rise.

Conversely, emerging markets generally entered the financial crisis in a position of relative financial strength owing to low use of leverage and conservative fiscal policy. As illustrated by the table below, the level of policy response by emerging market authorities to the crisis has not been as elevated as their developed market counterparties. This considerably reduces the potential for supply side shocks in the price of emerging market debt and with capacity utilisation levels historically low, inflationary pressures in emerging markets remain weak in the near term. The table above highlights that the overall duration level of the GBI-EMGD is lower than that of its European counterparts, helping to reduce the risks for investors who fear we are now entering an inflationary period.

Regional Fiscal Deficits

	2008	2009E	2010F
Developed Markets	-3.40%	-8.10%	-7.60%
Emerging Markets	-0.90%	-4.00%	-3.10%
LATAM	-0.80%	-3.00%	-2.50%
CEEMEA	-0.10%	-6.20%	-5.00%
Emerging Asia	-1.30%	-3.80%	-2.80%

Source: J.P. Morgan Emerging Markets and Strategy Outlook for 2010 (November 25th 2009)

3. Strong risk - return characteristics

One of the key decisions for any investor will ultimately be the anticipated level of risk adjusted returns. Historically emerging market local currency debt compares favourably with other more traditional asset classes and we expect this trend to continue as the asset class evolves. Although we do not anticipate the 18%+ returns in euros achieved in 2009 to be repeatable in 2010 and beyond, we do expect strong risk adjusted returns going forward. We believe the high yields on offer, potential for lower borrowing costs and appreciation pressure on emerging market currencies should ensure potential returns of approximately 10% per annum over the course of the next five years.

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	EM Local Currency Govt Bonds[1]	EM Local Currency Cash[2]	Euro Area Govt Bonds[3]	Euro Area Inv Grade Corp Bonds[4]	Euro Area HY Corp Bonds[5]
Annualized Return	9.11%	5.53%	4.66%	5.07%	10.36%
Annualized Vol	8.84%	6.52%	3.12%	3.26%	12.96%
Sharpe Ratio	0.71	0.41	0.58	0.68	0.58

Sources: Bloomberg, FactSet.
Index returns are unhedged in EUR. Statistics calculated over the period from 31 Dec 2002 to 28 Feb 2010.

[1] JP Morgan Government Bond Index – Emerging Markets Global Diversified
[2] JP Morgan Emerging Local Markets Indes Plus (ELMI+)
[3] Citigroup EuroBIG
[4] Citigroup EuroBIG Corporate
[5] Barclays Capital Pan-European High Yield

Arguments have been made that the strong returns in this asset class over the past seven years have coincided with a period of strong capital flows into emerging market economies and that these returns are not sustainable gong forward. The GBI-EMGD index has only been recorded back to December 2002 and it is therefore difficult to prove the longer term case for emerging market bonds statistically. However, we anticipate approximately one third to one half of the expected returns earned by developed market investors to derive from currency appreciation of emerging market FX.

Conveniently, JP Morgan has constructed a benchmark comprised of emerging market currencies that dates back as far as 1993. Interestingly, of the ten years of data available, investors in euros have only experienced two years of losses. This is significant as this is a period that includes at least five emerging market crises. What's more, each subsequent emerging market crisis has contained less contagion that the one before meaning lower volatility and shorter payback periods for developed market investors.

4. Low correlations with more traditional asset classes

The table below illustrates the correlations between emerging market local currency debt and more traditional investment opportunities. These low correlations demonstrate that an allocation towards this asset class could potentially decrease the overall risk of a typical institutional portfolio.

	EM Local Currency Govt Bonds[1]	EM Local Currency Cash[2]	Euro Area Govt Bonds[3]	Euro Area Inv Grade Corp Bonds[4]	Euro Area HY Corp Bonds[5]
EM Local Currency Govt Bonds	1				
EM Local Currency Cash	0.78	1			
Euro Area Govt Bonds	0.15	-0.11	1		
Euro Area Inv Grade Corp Bonds	0.32	-0.02	0.76	1	
Euro Area HY Corp Bonds	0.39	0.12	-0.09	0.48	1

Sources: Bloomberg, FactSet.
Unhedged in EUR covering the period from 31 Dec 2002 to 28 Feb 2010.

[1] JP Morgan Government Bond Index – Emerging Markets Global Diversified
[2] JP Morgan Emerging Local Markets Indes Plus (ELMI+)
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5. Low correlations between benchmark countries

Not only does emerging market debt have low correlations with more traditional developed market asset classes, there is also low correlation between the asset prices of countries contained within the GBI-EMGD itself. This is the key driver of the relatively low volatility of the asset class. Of the 338 currency pairs within JP Morgan's Emerging Local Markets Index Plus (ELMI+), only 8 have correlation co-efficient of greater than 0.8 calculated over the last 250 business days. Local currency bond prices are also highly sensitive to the idiosyncratic risks posed in each markets domestic economy rather than global inflationary trends.

6. Trend currency appreciation

As stated above, we anticipate that one third to one half of the returns generated from this asset class earned by developed market investors will derive from currency appreciation of emerging market FX over the next five years. Annualised returns for euro investors in the ELMI+ index since 1999 are close to 5% and it is notable that euro investors would actually have made money investing in emerging market currencies even through the financial crisis of 2008 when "carry trade" currencies were under threat from large scale capital withdrawals from the western world.

Emerging market authorities are now back to wrestling with the problem of how to best mitigate the appreciation pressure on their currencies which is a natural consequence of convergence of emerging economies with the western world. We believe that the theme over the next five years will continue to be one of strong net inflows into emerging markets as the secular improvements to these economies continue to present investors with great investment opportunities.

For euro and Swiss franc investors, the case is even more compelling. A 2009 (13th July) report in The Economist concluded that these two currencies were significantly overvalued relative to the dollar on a real effective exchange rate basis, whilst the majority of emerging market currencies are still undervalued. These mispricings have reversed a little since the report was concluded in July yet there is still significant room for correction before they can be construed as fair value.

7. Strong balance sheets

Emerging markets entered the crisis by and large with much stronger balance sheets that those of their developed counterparts. This ensures that a much more flexible fiscal and monetary response to the economic crisis can be taken without the huge structural risks to medium term economic stability posed to the developed world. OECD country government deficits average close to 8% and public debt excluding contingent liabilities is now over 100% GDP. These levels are much higher than in the emerging world. The table below illustrates the risks posed in perceived "strong balance sheet" countries such as Germany and France relative to "high risk" emerging markets such as Turkey, Poland and Hungary. Not only are developed market rollover requirements as high as some of the most indebted EMEA countries, none of the Eurozone countries are able to unilaterally increase demand for their debt by pumping liquidity into the money markets. We believe event risk is now much higher in the group of countries that have already adopted the euro rather than those that have the advantage of freely floating exchange rates.

The scale of quantitative easing and vast expansion of central bank balance sheets in the US, Europe, the UK and Japan is unprecedented and their ultimate effects unknown. However, we believe it highly likely that the trend level of growth in many of these countries will be lower for the next decade.

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2010 Estimates	General Government Debt as % GDP	General Government Balance as a % GDP
Germany	77.40%	-5.40%
France	86.40%	-9.10%
Italy	122.50%	-6.40%
Greece	122.40%	-11.60%
Poland	53.50%	-5.50%
Hungary	79.80%	-4.20%
Turkey	51.40%	-3.70%

Source: J.P. Morgan and European Commission

The market however, has yet to reflect this shift in economic importance from developed to developing markets. For example, Japan has public debt over 200% GDP yet can borrow at a little over 1.4% for 10 years, whereas Brazil has a public debt level just over 40% and is now a net external creditor, yet its 10 year borrowing rate is still 13%. In spite of the high savings rate that has allowed Japanese governments to finance their deficit internally, this status quo is largely due to historical factors and is not sustainable over the medium term. This example is mirrored elsewhere and rating agencies are beginning to appreciate the structural improvements in emerging economies with upgrades rather than downgrades forecast for 2010. Other than Turkey, Indonesia and Colombia, all other borrowers in the GBI-EMGD are now investment grade. However, many borrowers in the developed world are now sweating about losing the AAA rating they have complacently felt was unassailable. Although we see little potential for actual default or restructure in the developed world, there is a growing pessimism that proxy sovereign defaults either in the form of rampant inflation or currency depreciation are likely.

A repeat of 2008 where large scale capital withdrawals placed downward pressure on emerging market currencies is also unlikely. Throughout the crises, emerging market FX reserves actually increased and are now double the level of developed market reserves. These vast reserves give countries the ability to manage volatility of their currencies and reduce vulnerability to external shocks. Many emerging market countries are in fact net external creditors. Many of the crises that investors in emerging markets were exposed to historically were caused by over-valued currencies with pegged exchange rates and an over-reliance on external borrowing. These risks to emerging market investors are now minimal.

8. Favourable demographics

Emerging markets account for 85% of the global population, 75% of the land and mass and 70% of global FX reserves. The number of people joining the working population is a crucial driver of long term growth potential and this figure is six times higher in emerging markets in comparison to developed economies. Emerging markets are largely perceived to be largely export based and vulnerable to a slowdown in the western world, but domestic consumption is increasing quickly and these consumers becoming more demanding. Many emerging economies now have a large, aspiring and recently-arrived middle class who have no intention to return to poverty. They prize education highly and in this globalised world we now live in, the west should fear a glut of underpaid, highly schooled engineers, financiers and doctors flooding the job market in the next decade.

China has overtaken the US as the largest auto market in the world, but this is not just a China story. Excluding China, emerging market countries purchased as many motor vehicles in January 2010 as the US, Japan and developed Europe combined. They are also very keen on technology and are prepared to pay up to increase the quality of their lives. Headline GDP growth is strong, but it is also profitable growth rather than growth dependant on leverage and skewed unfavourably by unprecedented government intervention. They are also under-represented in the institutions of global economic governance today. But that is quickly changing as we can see. It would be very easy to imagine the G7 disbanding permanently and the G20 taking central prominence on the world stage.

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9. Strong liquidity

Emerging market authorities now appreciate the benefits of developing a full yield curve and understand more fully the risks of excessive external borrowing. As a result they are committed to developing local capital markets. Last year set another new record for total issuance with $217bn placed in the primary market. Even in emerging market dollar debt the average rating is just below investment grade with 60% now investment grade. This makes these issues more palatable to conservative pension funds and demand is expected to grow.

As much as we expect to see a growing number of emerging market governments borrow in their local currency and the breadth and depth of local currency bonds continue to increase, net sovereign issuance is still small compared to anticipated inflows into asset class. This will place upward pressure on bond prices and stabilise the market further. Bid-ask spreads were stress tested throughout the crises but remained generally narrow. The Emerging Market Trading Association calculate approximately $15bn of emerging market debt is traded daily. Over half of this is now local currency rather than emerging market dollar debt.

The trend continued to be one of rapid inflows into the asset class from a wide range of both local and domestic investors. Over $50 billion is now managed against the GBI-EM series - an increase of $15bn in 2009 alone and emerging market fixed income market capitalisation is now more than $1tn. However, on a GDP weighted basis, European institutional investor allocations to emerging markets remain insufficient and will be a multiple of current levels in the next five years.

10. Conservative allocation increases risk adjusted return

Theoretically the case for emerging market debt looks compelling, but how does the inclusion of emerging market local currency debt change the risk adjusted returns of an investment portfolio? We have constructed two theoretical portfolios to try to gauge this impact. The first portfolio would be a typically conservative basket of euro denominated government, high grade and high yield corporate bonds and a basket of the currency majors. The second portfolio adds what we believe to be a conservative allocation of 20% to emerging market local currency debt (actual portfolios illustrated below).

PORTFOLIO 1 – NO EM EXPOSURE

SECTOR	WEIGHT
Euro Area Govt Bonds[1]	40%
Euro Area Inv Grade Corp Bonds[2]	20%
Euro Area HY Corp Bonds (EUR)[3]	20%
Equally weighted GBP/USD/JPY 3M LIBOR[4]	20%
EM Local Currency Govt Bonds[5]	0%
TOTAL	**100%**

PORTFOLIO 2 – 20% EM EXPOSURE

SECTOR	WEIGHT
Euro Area Govt Bonds	30%
Euro Area Inv Grade Corp Bonds	15%
Euro Area HY Corp Bonds (EUR)	15%
Equally weighted GBP/USD/JPY 3M LIBOR	20%
EM Local Currency Govt Bonds	20%
TOTAL	**100%**

[1] Citigroup EuroBIG
[2] Citigroup EuroBIG Corporate
[3] Barclays Capital Pan-European High Yield
[4] Bloomberg
[5] JP Morgan Government Bond Index – Emerging Markets Global Diversified

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The table below highlights that a 20% exposure to emerging market local currency debt increased the annualized return of the portfolio by 80bp per annum. Moreover, although annualised volatility is higher with the inclusion of emerging market debt, the risk adjusted return rises 13bp.

RISK/RETURN CHARACTERISTICS

	Portfolio 1	Portfolio 2
Annualized Return	5.17%	5.97%
Annualized Volatility	3.34%	3.81%
Sharpe Ratio	0.69	0.82

Sources: Bloomberg, FactSet, Rexiter.
Returns are unhedged in EUR. Statistics calculated over the period from 31 Dec 2002 to 28 Feb 2010.

What can an active manager add?

In 2009 the market was largely driven upwards by developed-world supplied liquidity and yield-chasing activity. We expect idiosyncratic factors to be more influential in 2010 as global markets stabilise. Although we are very bullish on the case for emerging market debt overall, our confidence does not extend to every country within the benchmark. Strong fundamental research combined with an effective risk control framework can help active managers to enhance returns by avoiding markets that we feel are overpriced and overweighting countries where we feel values do not reflect the underlying fundamentals.

As active managers, we can reduce or add duration at the country level based upon our expectations of future yield curve moves and include inflation linked bonds where relevant to hedge against potential capital losses. We can also extend or hedge currency exposure using forward and non-deliverable forwards where appropriate. We do not believe that this asset class currently lends itself well to passive investing. The benchmark is rapidly evolving making rebalancing expensive and due to the very specific risks contained within each country, effective replication of one country for another is impossible.

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