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Investment Insights

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Emerging market debt

FOR INVESTMENT PROFESSIONALS ONLY

Local and dollar bonds provide different routes to returns.

Emerging market debt has evolved as an asset class in recent years as local currency-denominated bonds and US dollar-denominated corporate debt have become much larger parts of the overall universe. The financial crisis in 2007 led to a reappraisal of sovereign and credit risk, particularly in the emerging markets.

Emerging market bonds are now a strategic holding for many investors. But the desired result from an allocation to emerging market debt cannot be achieved without first considering the attributes of US dollar- and local currency-denominated bonds – the two broad sets of investments available in the asset class – and understanding the benefits each can bring to a portfolio.

Drivers of return: emerging market dollar bonds

Emerging market US dollar bonds are essentially a credit asset, typically offering a yield pick-up over US Treasuries as compensation for taking on additional risk. Investors seek this extra yield to help cover losses that may arise from default and mitigate the risk of losing a portion of their initial investment. This yield differential includes a liquidity premium, which acts as insurance against not being able to easily convert the asset into cash. As with investment-grade corporate bonds, this yield spread is chiefly influenced by changes in the credit profile of the issuing entity and by global fluctuations in investor appetite for risk.

While the current backdrop, characterised by lower commodity prices, sluggish global growth and a strong US dollar, is a headwind for emerging market countries, many have experienced significant structural improvements in the past 15 years. Compared with the 1990s and early 2000s, when several emerging economies experienced crises, foreign exchange reserves are generally substantial, and currency pegs are less common. Likewise, in many instances government debt-to-GDP ratios are lower, and where debt loads are heavier, in some cases it's arguably a natural consequence of maturing bond markets.

That said, there is substantial variation in fundamentals among individual emerging market countries. For example, there is currently deflation in Eastern Europe, but inflation in Latin America. Meanwhile, many Asian countries have current account surpluses (in simple terms, exports and net foreign income exceed imports), while some Latin American economies confront substantial deficits. The divergence in the credit metrics of borrowers within the emerging market universe can provide valuation opportunities for active research-driven investors.

Furthermore, through US dollar-denominated bonds, investors can help mitigate or, in the case of US dollar-based investors, eliminate the risk of currency depreciation.

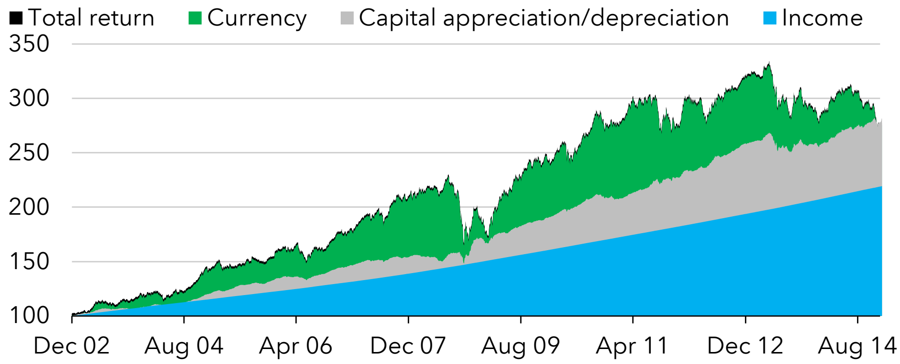
Drivers of return: local currency emerging market bonds

Currency appreciation, a gradual downward move in domestic interest rates and, increasingly, shifts in the shape of the yield curve are the key drivers of return in the local bond market. Improving creditworthiness is a less prominent contributor to returns.

Local currency bonds can carry added risk through local currency exposure. As Exhibit 1 shows, in the past two to three years the vast majority of returns has been driven by income and the capital gain associated with yield compression rather than currency gains. In other words, currency has been a major driver of volatility but not of long-term returns for the asset class. Despite the more recent US dollar bull market, there are reasons why currency appreciation can potentially continue to be a key source of return in the longer term. Emerging markets' rising productivity and growth relative to the developed world, their improved terms of trade and exposure to rising global commodities can be expected to serve as a magnet for investment inflows over the medium to long term.Currency aside, local currency bonds also allow investors to better capitalise on one of the key benign forces shaping developing economies. Domestic inflationary pressures that were once these countries' Achilles heel have generally been steadily reduced. With many nations both better equipped and more willing to bear down on inflation than at any point in their history, be it through monetary policy, deregulation or labour market reform, there is plenty of scope for both real and nominal bond yields to fall and converge with yields in developed bond markets.

Exhibit 1

Currency can remain a significant source of return in local bonds over the long term[1]



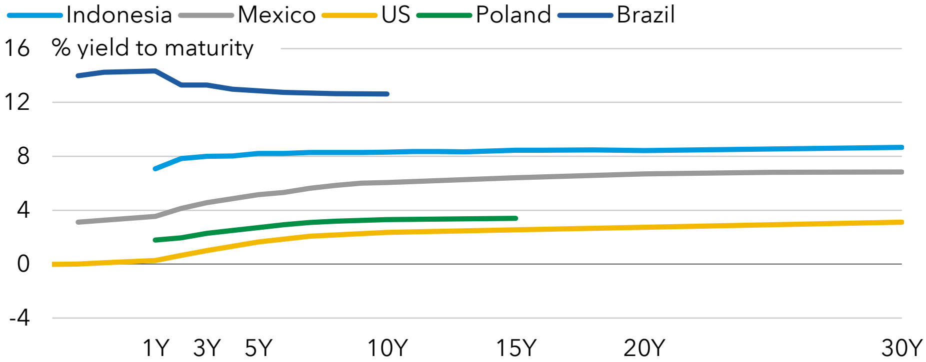
1.Data span from 31 December 2002 to 31 December 2014.
Data as at 27 August 2015. US$, rebased to 100 as at 31 December 2002. JPMorgan GBI-EM Global Diversified Total Return index, in unhedged US dollar terms.
Source: JPMorgan

In contrast to dollar bond markets, local yield curves of emerging market sovereigns also tend to be quite varied, since countries are often at different stages of monetary and fiscal cycles at any given time. This allows investors to evaluate relative value along the yield curve in individual markets as well as value across various markets. As governments seek to extend their yield curves, the range of investment opportunities will broaden.

As local currency bonds are closely tied to their countries' fiscal, monetary and macroeconomic policies, they can offer an attractive risk-reward trade-off for investors seeking currency diversification. And as sovereign borrowers build their local currency bond yield curves, duration and curve positioning will also become increasingly important sources of return.

Exhibit 2

Varied yield curves provide relative value opportunities in local markets[2]



2. As at 30 June 2015.
Source: Bloomberg

Differences in composition between dollar and local bond market

US dollar debt offers exposure to a broader range of sovereign credits but often with higher credit risk

There are substantial differences in both the number and credit quality of the sovereign borrowers who issue debt in US dollars and local currency in emerging debt markets. Compared with the local currency market, US dollar bond investors have access to a higher number of sovereign credits – 64 versus 16. With greater variety comes a higher-risk credit profile. Most of the 32 countries that raise debt exclusively in US dollars are lower-rated, export-dependent nations whose economies are at an earlier stage in their transition to developed market status. The average credit rating of emerging market dollar bonds is BBB–, compared with BBB+ for local sovereign bonds.

In terms of market weighting, Latin America makes up almost 40% of the sovereign dollar bond index but only about 29% of the local bond index, as Exhibit 3 shows.[3] Such differences in country and credit composition can have significant investment implications.

A US dollar–only emerging market bonds mandate is far more exposed to the debt of commodity-producing nations and, in more general terms, to those countries whose prospects are tied to swings in global economic conditions. As a result, the US dollar bond market can be particularly sensitive to the commodity cycle and changes in overall risk appetite. This was evident in the market rally of 2009, when dollar bonds issued by lower-rated credits such as Argentina and Ukraine saw gains of more than 100%.

3. Data in this section came from the JPMorgan CEMBI Broad Diversified, the JPMorgan EMBI and the JPMorgan GBI-EM Global Diversified Total Return indices. Data as at 31 August 2015.

Dollar bonds generally offer better access to corporate credit

Another marked difference in the opportunities available in external and local currency debt markets is in the area of corporate bonds. Local currency markets currently offer limited corporate bond exposure. Small issue size, unfavourable withholding tax treatment, poor custody arrangements, legal restrictions, and capital controls are just some of the barriers to the development of a local corporate bond market in most emerging markets.

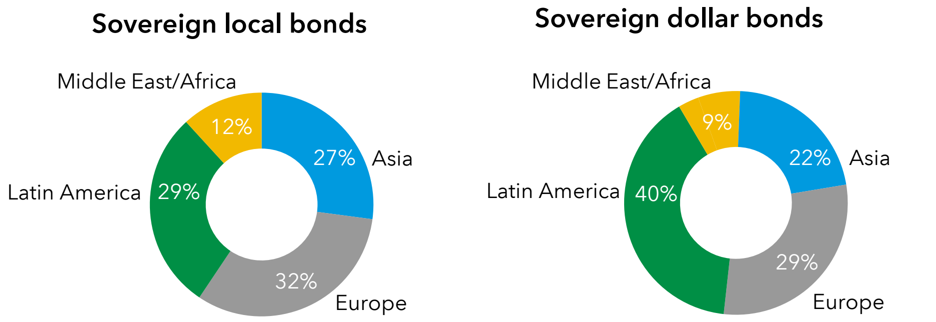
By contrast, the US dollar-denominated corporate bond market has become one of the fastest-growing areas of fixed income, and offers diverse investment opportunities – many of which are unavailable to equity investors.

As developing economies have grown over the past decade, the volume of US dollar-denominated corporate bonds outstanding has more than tripled to $809 billion since 2005. Investors can choose from issuers based in 50 countries operating across numerous industry sectors, including banking, consumer goods, industrials, mining, utilities and telecommunication services. Most of this debt is investment grade, reflecting marked improvements in the way emerging market corporations manage their balance sheets.[4]

4. Data as at 30 September 2015. Source: JPMorgan

Exhibit 3

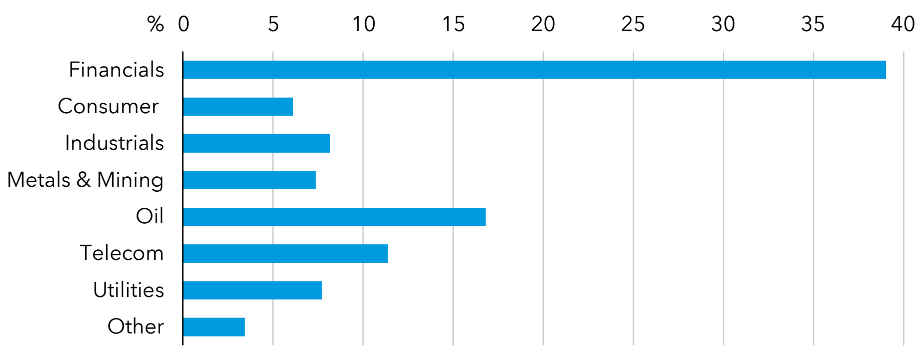
US dollar bond market dominated by Latin America[5]



5. Local bonds refers to the JPMorgan GBI-EM Global Diversified Total Return index, as at 27 August 2015. Dollar bonds refers to the JPMorgan EMBI Global index. Data as at 27 August 2015.
Source: JPMorgan

Exhibit 4

Corporate bond market offers exposure to broad range of industry sectors[6]



6. JPMorgan CEMBI Broad Diversified index as at 27 August 2015.
Source: JPMorgan

Local bond markets offer greater variety of debt instruments

While US dollar–denominated markets offer investment opportunities in a broader range of credits in both sovereign and corporate debt, the variety of fixed income instruments and alternative hedging tools available to investors is greater in local currency markets. Alongside nominal bonds, investors can choose from inflation-linked bonds and derivatives, currency-linked debt, GDP-linked warrants and money market instruments – all of which can be used to diversify a portfolio and mitigate risk.

Inflation-linked securities represent one of the fastest-growing areas of local debt. The volume of bonds outstanding has grown from about $20 billion to more than $460 billion over the last 12 years.[7] Inflation-linked bonds are attractive investments for many reasons. They can offer cost-effective insurance against bouts of inflation, which can be more pronounced in emerging markets. Inflation-linked bonds can also often help counter the effects of inflation-driven currency depreciation.

Liquidity: Local bond markets offer greater depth and growth potential

Liquidity – the ability to buy and sell assets without causing unfavourable shifts in their price – is where local bond markets possess a significant and growing advantage over their US dollar counterparts. With a market capitalisation of more than $1 trillion, the local sovereign market is almost as large as the US dollar sovereign and corporate markets combined.[8]

Not only has liquidity in local emerging markets improved at a rapid pace, but it also withstood some major tests – not least during the peak of the Global Financial Crisis in 2008, when bid-offer spreads remained relatively narrow compared with dollar bonds. There are many reasons why liquidity has improved in local currency markets, and such developments can be expected to gather momentum over the coming years.

Among the most important are:

Active debt management: Governments are steadily replacing external debt with local currency debt wherever possible to reduce foreign exchange risk and exposure to sudden shifts in foreign investor sentiment.

Increase institutional investor base: An increasing number of long-term oriented institutional investors, such as pension funds or sovereign wealth funds, have dedicated global emerging market debt allocations as part of their strategic asset allocation. This broader investment community helps deepen markets.

Deepening pools of local institutional demand: The institutionalisation of pension funds in several Latin American countries, including Mexico, Chile, Colombia, Peru and El Salvador, is creating a stable buyer base for domestic debt.

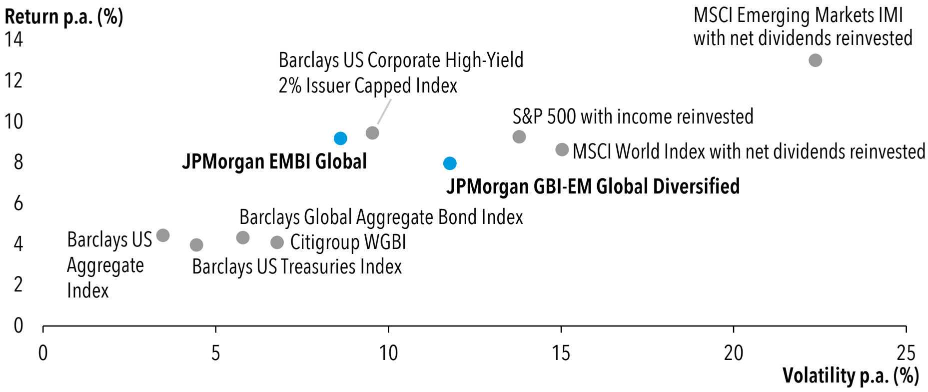
Risk, return and correlation

As a means of diversifying sources of return and risk, both local and US dollar–denominated sovereign bonds have much to offer. In terms of their risk-adjusted returns, both compare favourably with mainstream asset classes, particularly with emerging market stocks, as Exhibit 5 shows.

7. Data as at 30 September 2015. Source: JPMorgan
8. Based on the JPMorgan EMBI Global (EM US dollar sovereign bond market), the JPMorgan GBI-EM Global (EM local currency sovereign bond market) and the JPMorgan CEMBI Global (EM corporate bond market) indices. Data as at 30 September 2015. Source: JPMorgan

Exhibit 5

US dollar and local currency bonds have offered higher returns than traditional fixed income and lower volatility than equities[9]



9. Data for periods greater than one year is annualised. Volatility is calculated as standard deviation based on monthly returns. Returns in unhedged US dollar terms from 31 December 2002 to 30 June 2015.

Another way of gauging how effectively dollar and local debt can bring diversification to a portfolio is by analysing their correlation profiles. Although the credit crisis has caused many previously uncorrelated asset classes to move in lockstep, both local and US dollar emerging market bonds have maintained their historically moderate correlation with most mainstream securities, particularly developed market fixed income, as Exhibit 6 shows.

Exhibit 6

Emerging market sovereign bonds exhibit moderate to low correlation with most mainstream asset classes[10]

	US dollar EM sovereign bonds	Local-currency sovereign EM bonds
US stocks S&P 500 Index with income reinvested	0.55	0.63
US Treasuries Barclays US Treasuries Index	0.31	0.13
Developed government bonds Citigroup World Government Bond Index (hedged to US$)	0.29	0.13
Global fixed income Barclays Global Aggregate Bond Index (hedged to US$)	0.53	0.33
World stocks MSCI World Index with net dividends reinvested	0.62	0.72

10. Correlations calculated based on monthly returns in hedged US dollars from 31 December 2002 to 30 June 2015 for the JPMorgan EMBI Global (USD sovereign bonds) and the JPMorgan GBI-EM Global Diversified Total Return indices (local currency sovereign). Sources: JPMorgan, Capital Group International, Inc.

The opportunity set in emerging market debt is continuing to broaden and deepen, making it truly exciting to be able to invest in such markets.

Although hard currency emerging market sovereign index yields are relatively low in absolute terms, the current average spread over US Treasuries is meaningfully above some of the past decade's tighter levels. Moreover, there is currently a very wide range of risk premia: market pricing is reflecting differentiations in credit quality and valuations are more reflective of individual country fundamentals. Periods of greater spread dispersion have often created compelling longer-term opportunities for active, research-driven bond investors.

Different benefits from two attractive markets

In summary, US dollar bonds are a credit asset whose risk-adjusted returns compare favourably with both high-yield and developed market investment-grade debt. On the other hand, local currency bonds can be an attractive investment for investors who are seeking to diversify their currency exposure and willing to accept the investment risks associated with monetary and fiscal policymaking in the developing world. Local bond investments provide access to an increasingly diverse set of countries whose interest rate cycles are largely uncorrelated and whose markets are supported by a growing local institutional investor base.

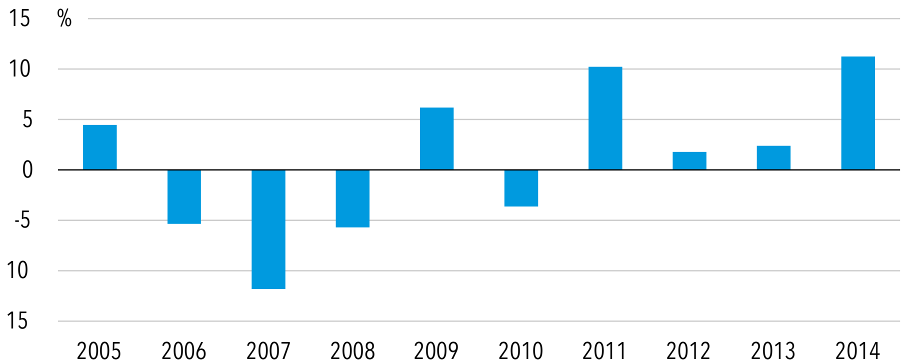
An unconstrained strategy

The term 'emerging market debt' is perhaps misleading as it implies a single asset class. The reality is that we are now able to invest in a vast universe of bonds from more than 60 countries, denominated in hard and local currencies, paying fixed and inflation-linked coupons. Different parts of the universe have different drivers of returns, different risk-return profiles and different roles to play in a portfolio.

At Capital Group, we believe that, for many investors, an optimal way to access this vast universe is to utilise all of the risk and return levers available via a single emerging market debt strategy. This would be a strategy that encompasses the broadest opportunity set available by investing in all areas of the market. Such a mandate enables portfolio managers to capture one of the last remaining informational inefficiencies in investing – the flexibility to make relative-value decisions across the different sub-asset classes in a single emerging market debt mandate. For others, who may have particular investment criteria or an alternative risk appetite, a dedicated local currency debt strategy remains a viable option. There are times in the markets, as in the midst of the credit crisis in 2008 and 2009, when dollar-denominated bonds offer the best opportunities. At other times, areas of the local debt market are more attractive. Hence, Capital Group's emerging market debt managers prefer to have the flexibility to rotate investments into the various areas of the broader market.

Exhibit 7: Dollar and local bond returns can vary materially in any one year

Excess return, US dollar vs. local currency emerging market sovereign bonds[11]



11. Returns from the JPMorgan EMBI Global and the JPMorgan GBI-EM Global Diversified Total Return indices, in unhedged US dollar terms from 31 December 2003 to 30 June 2015. Source: JPMorgan

Managers have had the freedom to invest in local currency in most emerging market debt mandates since 1999. Our unconstrained approach uses a combination of the dollar-denominated JPMorgan EMBI Global bond index and the JPMorgan GBI-EM Global Diversified Total Return (local only) index. This way, we are able to shift our asset allocation for the purposes of reducing risk or capturing credit opportunities.

Overall, the most notable aspect of investing in emerging markets is that developing economies have by and large evolved into a group of reform-minded nations that generally boast historically high rates of growth and robust public finances. It is due to such developments that emerging market bonds – comprising US dollar bonds, local currency debt and corporate bonds – are increasingly viewed as a mainstream asset class.