



# Local currency emerging market debt: deserving of a closer look

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## Key takeaways

- Local currency debt has become one of the largest fixed-income universes over the past eight years, yet remains under-appreciated
- We can see a number of triggers for a pick-up in demand
- We believe growth is the main forward indicator for currencies
- The asset class offers multiple opportunities, collating a heterogeneous group of bond issuers including countries in different stages of the economic and monetary policy cycle

## Full commentary

At a time when many bond investors vacillate between concerns over rising interest rates and the belief that the multi-decade bull market in fixed income is not over yet, local currency emerging market debt deserves to be given more attention than it often gets these days. Or so argue Bryan Carter and JC Sambor, Head and Deputy Head of Emerging Market Fixed Income, respectively.

## Under-appreciated, so under-owned?

In part, the cold shoulder for local currency debt reflects an underappreciation of the size of the asset class and the opportunities it offers. It has become one of the largest fixed-income universes over the past eight years, with local currency debt issued by emerging market governments rising to USD 8 trillion by January 2018 and corporate debt in local currencies exceeding USD 7.6 trillion.

The asset class has become deeper, with market liquidity improving, and broader, with more countries now issuing debt as well as more EM corporates. This has expanded the range of investment opportunities, also in high-quality, investment-grade debt.

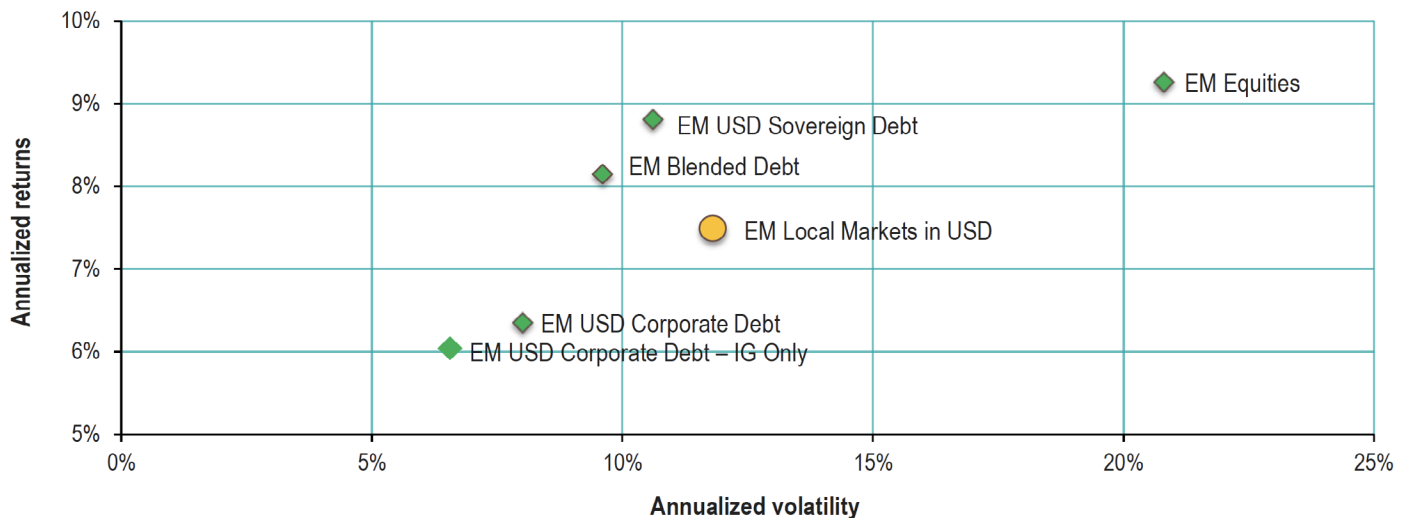
The bad rap can also be attributed to the perception among certain investors that local currency bonds tend to be very volatile. This is indeed a perception. The reality is that historically, the volatility has been well below that of emerging market equities. Over the last 15 years, the volatility of local currency debt has averaged around 12%, which is well short of the level of over 20% for emerging market equities.



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Figure 1: Local debt volatility has been overestimated



Source: BNP Paribas AM, JPMorgan, MSCI, 31 December 2017.  
 Past performance is not indicative of current or future performance. EM: emerging markets. IG: investment-grade

This realisation should contribute to an improving debt profile. Equally, the understanding that default risk is typically overestimated, especially in local currency debt, and that the risk/reward trade-off is clearly positive should lift the prospects of greater ownership of local currency debt.

### Index inclusion is one source of demand...

Apart from a reassessment of these attractions of emerging local currency debt, there is also room for giving these bonds a bigger place in portfolios. Looking back over the past 10 years, allocations to emerging debt in global portfolios, and local currency debt in particular, are below average.

We can see a number of triggers for a pick-up in demand. Chinese bonds are due to become part of most major global emerging market debt indices and inclusion of the world's third-largest fixed income market should automatically create demand as index-focused investors adjust their portfolios. Foreign ownership of the Chinese onshore bond market is currently at only roughly 4%. India can be expected to follow suit in the next three to five years.

### ...as is investment from foreign investors lagging that of domestic buyers

Another factor for upside potential is the still reasonable foreign participation in this market. The 2017 rally in local emerging debt was driven mostly by local buyers. The share of foreign ownership has not risen materially in most markets or has even fallen in large markets such as Malaysia. There is room for catch-up there.

It is worth noting that these local investors inject a note of stability into these markets and have become more diversified over time, ranging from pension funds and insurance companies to banks and even asset managers. They are adding these bonds to their portfolios in the knowledge and with the full understanding of the local, often idiosyncratic, drivers of this market. This growing domestic investor base has proven an efficient cushion during recent bouts of volatility.

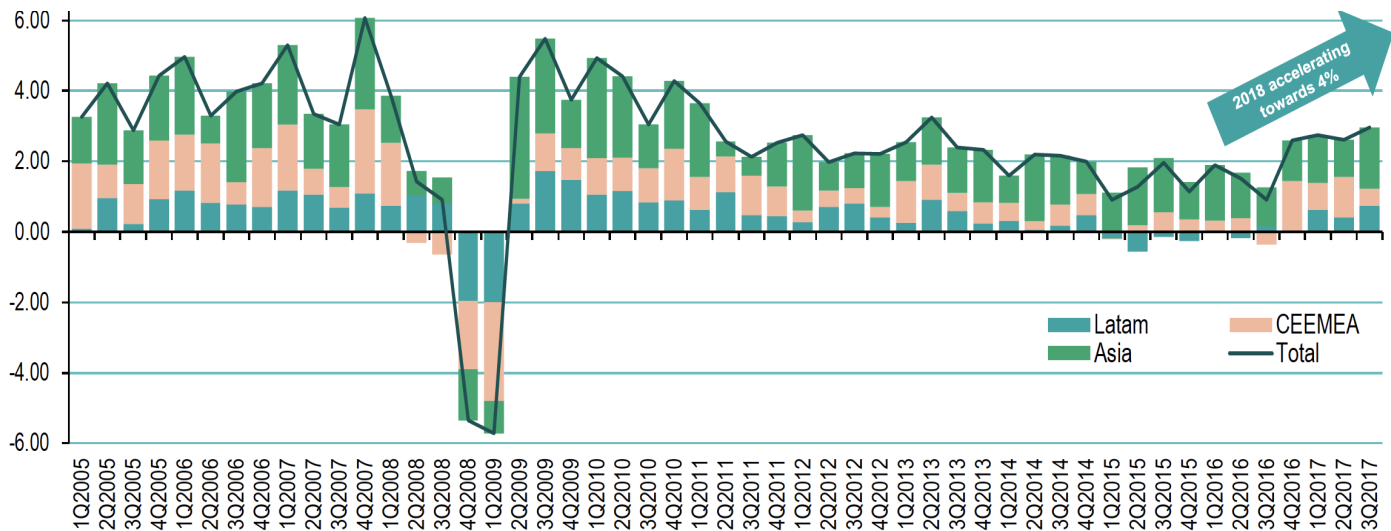
Regarding foreign involvement, the fact that “real money” – from long-term investors such as insurance companies and pension funds – is increasingly involved rather than short-term speculative money should also mean that these investments are not a fad or part of a bubble, but genuine and return-driven, which should help curb market volatility.

## What of the currency component of these bonds?

Historically, US dollar trends and US monetary policy have been sizeable factors for emerging market exchange rates. We believe the regime for emerging currencies is currently favourable. Global growth looks strong, and with it global trade, which bodes well for emerging market exporters generally and for commodity exporters especially. Under these conditions, emerging currencies have room to appreciate, which adds an attraction to local emerging debt. We currently see emerging market currencies as the cheapest segment of the overall emerging market asset class.

For us, growth is the main forward indicator for currencies. The current growth trend for emerging markets is the best since 2010, with GDP growth in emerging economies excluding China expected to accelerate towards 4% in 2018. That is also ahead of the rate in developed economies. All three major regions – Asia, Europe and Latin America – are now contributing to this trend, underscoring the momentum in emerging markets.

Figure 2. Emerging market growth trend: best since 2010



QoQ%, SAAR, 2010 GDP-weighted; source: Haver Analytics, own calculations, through 3Q 2017. Emerging market universe: Brazil, Mexico, Colombia, Chile, Peru, Uruguay, India, South Korea, Indonesia, Thailand, Malaysia, Singapore, Hong Kong, Russia, Turkey, Poland, South Africa, Israel, Czech Republic, Romania, Hungary

Looking deeper, we believe strongly in the long-term edge in terms of productivity that emerging economies have over the developed economies. This should allow emerging currencies to strengthen over the US dollar and other developed currencies over the long run. In that respect, in our view, emerging currencies are one of the most obvious, if not the only, value trade left when it comes to emerging market assets. That should underpin demand for local currency debt. As long as growth remains strong, we believe volatility will be contained. Improving growth prospects combined with a still benign inflation outlook bode well for local currency debt.

## And what about the other components of local currency debt returns?

As said, the market technicals – for example, ownership of the asset class and coupled with that, the demand prospects – and the fundamentals, such as the outlook for economic growth, all look favourable to us. We believe in upside potential on the currency side. Combining the various factors, we are forecasting a total return for the emerging local debt benchmark of more than 10% in 2018, which is more than double that for hard currency debt. Of course, the latter stands to lose ground as US monetary policy is tightened and US interest rates rise, even if this occurs only gradually.

## One asset class, multiple opportunities

While the prospects for local emerging debt as an asset class look encouraging, it remains indispensable to keep in mind that it collates a heterogeneous group of bond issuers including countries in different stages of the economic and monetary policy cycle.

Despite the monetary policy tightening cycle in the US, interest rates are likely to be cut in many emerging markets. Thus, it is important to consider factors such as inflation, inflation expectations, the fiscal outlook and technical factors. Interest rates in countries such as Brazil, Russia and Colombia have room to be cut further and countries such as Malaysia and Indonesia are likely to maintain the currently accommodative monetary conditions for a while. Domestic investors in some emerging countries are more active in these markets than in others.

Doing a deep dive on both the structure of the domestic and foreign investor base undeniably helps investors understand the price action of these local bond markets. Gaining an in-depth understanding of the domestic investor base is definitely one of the key elements needed to be able to outperform in these markets since most of the time, many investors regard them as a black box.

We believe this is also a market that requires a broad perspective and an open mind when it comes to investing. Accordingly, we look beyond the traditional benchmarks and also invest in high-quality opportunities that combine a corporate growth story and a sizable yield premium relative to local government bonds. Our interest also extends to up-and-coming frontier countries offering high-carry opportunities, relatively low market volatility and with a low share of foreign ownership.

## Biographies



### L. Bryan Carter

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Bryan is responsible for setting strategy, generating alpha ideas and risk budgeting for the firm's emerging markets fixed income business. Bryan joined our firm in 2016 and is based in London. Prior to joining us, Bryan was a portfolio manager at Acadian Asset Management, where he was lead manager for the Emerging Market Debt and Global Absolute Return Bond strategies. Prior to that, he was an economist at T. Rowe Price Associates Inc., where he developed economic models to analyse global economic data, estimate risks to growth and inflation, and forecast interest rates. He began his career as an international economist at the United States Treasury Department, where he recommended US vote on hundreds of International Monetary Fund, World Bank and Inter-American Development Bank loans. Bryan has 15 years of investment experience. He holds a bachelor's degree in Economics and Spanish from Georgetown University as well as a Master of International Development from Harvard University. Bryan is a CFA charterholder.



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Jean-Charles is responsible for supporting the management of all Emerging Market Fixed Income (EMFI) portfolios and developing a unified EMFI investment process. He joined our firm in 2016 and is based in London. Prior to joining us, Jean-Charles was at the Institute of International Finance (IIF) where he served as Asia-Pacific Regional Director and CEO of IIF APAC Ltd in Singapore. Prior to that, he was a senior portfolio manager and head of Emerging Markets Fixed Income for Everest Capital, where he was responsible for the launch and management of an absolute return emerging market debt fund as well as a long only frontier markets fixed income fund. Prior to that, he worked as a senior vice president in the EMFI Team at Trust Company of the West (TCW) in Los Angeles. Jean-Charles has 14 years of investment experience. He is an alumnus of Ecole Normale. He holds a BA in Economics and Philosophy and a master's degree in Epistemology and Philosophy of Economics from Sorbonne University. He also holds a master's degree in International Economics from UPMF in Grenoble, France.



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