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THE (RE-)EMERGING INVESTMENT CASE FOR EMERGING MARKET DEBT

Emerging market debt (EMD) has continued to grow over the past decade as a proportion of the global bond market. At the same time, emerging market (EM) economies' share of global GDP has grown at an even faster pace. As a result, EM debt levels remain lower than in most developed markets (DMs) where the effects of the post GFC high debt burdens are still leading to painful outcomes. The structural argument for integrating EMD into an institutional asset allocation framework remains as strong as ever.

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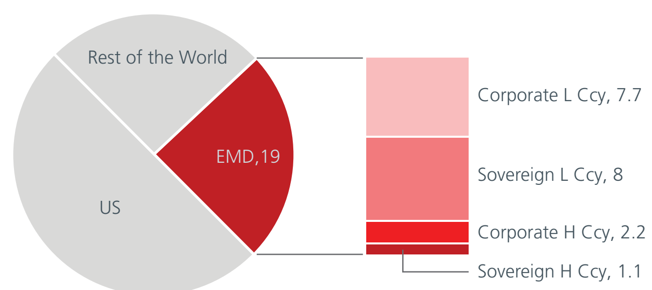
Sovereign EM local currency debt, which represents the largest subset of EMD with a market capitalisation of some USD8 trillion, has grown from 8% to 11% of global fixed income since 2008 while EM economies grew from 31% to 40% of the global economy. Sovereign EM hard currency debt amounts to over USD1 trillion in market capitalisation, not far from the size of the US High Yield market. In total, EMD currently represents a near USD20 trillion universe, or about half of the non-US debt market – clearly too large an asset class to ignore (see Fig.1).

A DIVERSE, EXPANDING UNIVERSE

The asset class expansion followed the deepening of financial markets in developing economies. Just as with other fixed income markets, EMD now has a wealth of instruments and issuers, in high and

Fig.1: Size of EMD in the global fixed income market (USD tn)[1]



L Ccy = Local Currency H Ccy = Hard Currency

low-yield space. Beyond sovereign or quasi sovereign issuance, a buoyant fixed income market for EM corporate issuance has developed, allowing internationally competitive enterprises based in emerging markets to fund themselves globally. With many EMs seeing their domestic markets expand, the relative size of local markets has grown significantly. Governments fund themselves in their local currencies and are able to avoid the build-up of external vulnerabilities that come with excessive foreign borrowing.

Notably, parts of the EM fixed income universe now more closely resemble traditional fixed income markets than the highly volatile EM bonds of the past. With political risks on the rise in developed markets, as exemplified by Brexit and populist governments in Europe, the lines between EM and DM fixed income are increasingly blurred. It would be imprudent to retain a fixed income allocation that is excessively invested in DMs.

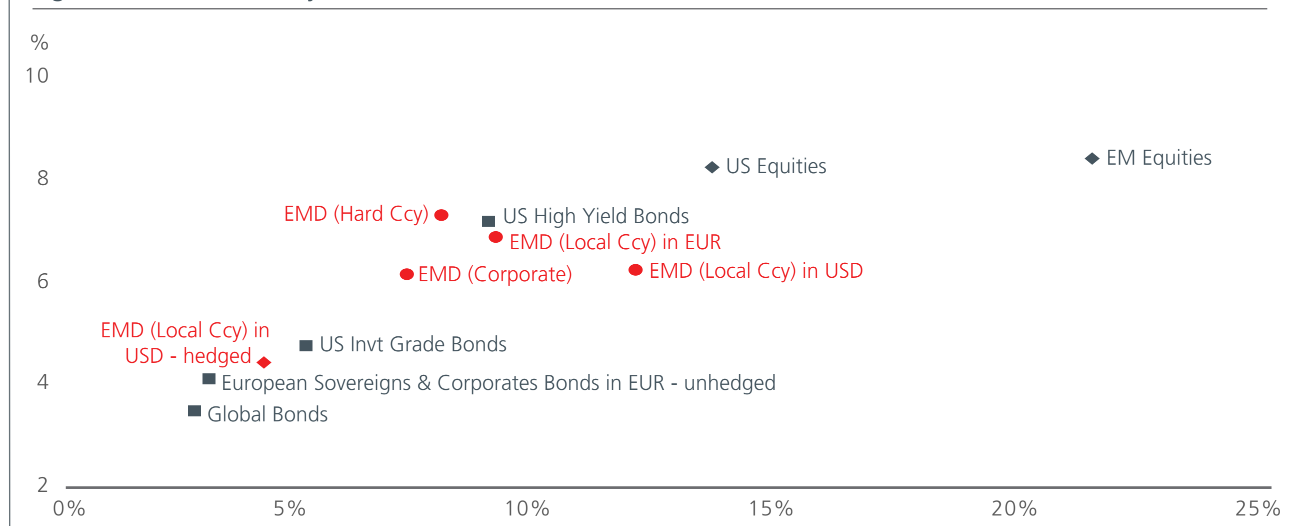
In terms of the opportunity set, EM sovereign and quasi sovereign USD-denominated issues from 67 different countries are reunited in the most traditional EMD index, the JP Morgan EMBI Global Diversified. Exposure to this part of the EMD universe rewards investors with an additional pick up in yields over US Treasuries, according to how markets price the additional credit risk of EMs at any given point in time. Adding EM corporate issues to the mix expands the opportunity set significantly.

Additionally, those EMs which have developed domestic bond markets and therefore present eligible local currency instruments are reunited in JP Morgan's GBI-EM index of local government bonds. At present, the index counts 19 countries in its most widely followed version (the GBI-EM Global Diversified). China and India are two potential additions in the future, as they open up their local markets for foreign investors. Those able to access local markets not only gain exposure to a wider pool of liquidity but also more diverse return drivers deriving from the currency and rate markets of all the emerging countries in the index.

ATTRACTIVE RISK-ADJUSTED RETURNS

EMD is often regarded as a volatile asset class. This perception overshadows the fact that EMD's risk-adjusted returns have proven to be compelling. Furthermore, EMD can enhance returns and Sharpe ratios in a global fixed income portfolio due to its higher-yielding, albeit higher volatility feature. It also compares favourably to equity allocations from a risk-return perspective (see Fig 2).

Fig.2: Annualised risk-adjusted returns across asset classes since 2004[2]



With institutional investors committing structurally to the asset class for longer holding periods, the volatility of annualised returns in EMD diminishes. A decade ago, most allocations to EMD were tactical and timing was essential. But considering 5- or 10-year investment horizons, the question of the entry point matters less for the attainable annualised returns.

Taking local currency debt as an example, the volatility of returns for any 1-year holding period has historically been 12.3%. However, for a rolling 10-year window, the volatility of annualised returns has been below 3% (see Fig.3). Obviously, getting in at the right moment still helps in building confidence to hold the asset class structurally over the long-term, which is why we highlight 2019 as a tactically favourable moment to engage in this asset class.

AN OPPORTUNE TIME TO ENGAGE

The last 5 years have been challenging for EMD investors. This has led to a slowdown in institutional flows into the asset class, putting a pause to the re-allocation away from developed market debt initiated after the European debt crisis in 2011. But years of austerity have not succeeded in stabilising debt levels in core European economies, instead leading to a rebellion by the electorate that can re-ignite a crisis at any moment.

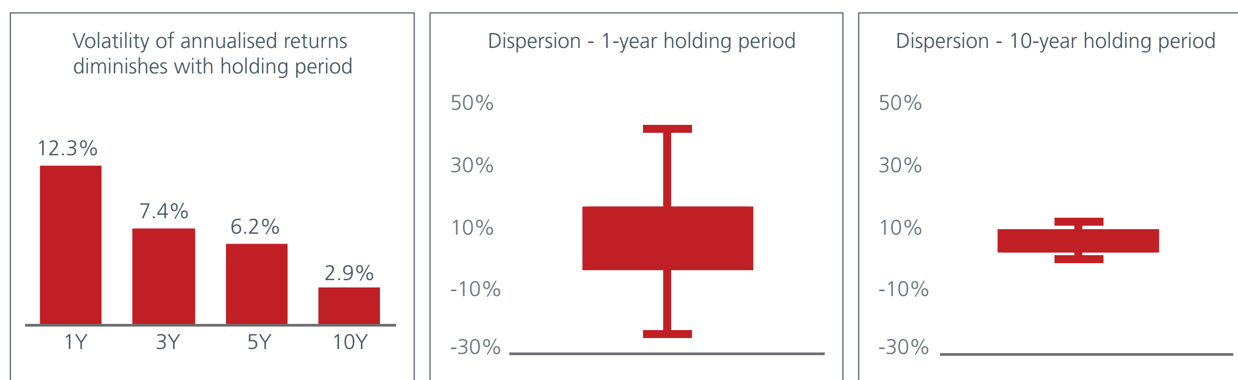
Moreover, with the US debt-to-GDP level above 100% and fiscal policy having already been run in expansionary mode throughout the Trump administration, the sustainability of the US deficits will be called into question. It could well be that, when faced with the next recession, we will be looking at the US the way we looked at some European economies in 2011 and Italy as recently as in 2018.

With most or all of the tightening by the US Federal Reserve behind us, the current late cycle stage of the US expansion is an opportune moment for institutional investors to further increase their allocation to the attractively valued EMD.

Yields are on average a touch below 6.5%, coincidentally at the same level for both the EMBI and the GBI-EM indexes. The level of yields in both indexes has remained relatively close over the past year, a consequence of the rise in US Treasury rates impacting directly on the EMBI yields. Even if not directly comparable, given the different nature of local currency and USD-denominated debt and the different universe of countries, these yields represent an attractive level of carry in both segments, with returns expected to be boosted further by the structural convergence story in EMs.

Over the long run, as these economies mature and become more competitive, their policies become more predictable, and their inflation rates

Fig.3: Volatility and dispersion across time periods[3]



become lower and more stable, all the drivers of returns (credit spreads, local interest rates and currencies) should contribute positively and boost the returns further.

SEIZE ALPHA VIA ACTIVE MANAGEMENT

All said, it is never too much to caution that EMs are a vast and extremely varied universe. With the economies at very different stages of economic development, and sometimes finding themselves at very different points of their economic cycles, trends in spreads or local rates can be completely opposed in two different EMs.

It is important to actively adjust portfolio compositions to adapt to the various trends. In-depth, bottom-up research of EM sovereigns and corporate entities can uncover significant additional value. At times, it is essential to shun certain exposures to protect the portfolio, while on other occasions there are significant opportunities to chase with much increased allocations.

It is also necessary to acknowledge that EM benchmarks are imperfect by nature: they do not include all the EM universe and they are market-cap weighted, meaning that they tend to allocate more to the most indebted nations or entities. For all these reasons, we remain committed to actively manage our EMD portfolios and dedicate our efforts to generate consistent alpha for our investors.

Source: [1]JP Morgan, IMF, IIF, Dec 2018. [2]Bloomberg, US Equities – S&P 500 Index, EM Equities – MSCI EM Index, EM (Hard Ccy) – JPGCCOMP Index, EMD (Local Ccy) in EUR – JGENVUEG Index, EMD (Local Ccy) in USD – JGENVUUG Index, EMD (Corporate) – JBCDCOMP Index, EMD (Local Ccy) in USD hedged – JGENVHUG Index, US High Yield Bonds – ICE BofAML US High Yield Index, US Invt Grade Bonds - ICE BofAML US Corporate Index , Global Bonds – JPMGGLTR Index, European Sovereigns & Corporates – Bloomberg Barclays Euro Aggregate Total Return Index unhedged in EUR. [3]Volatility: Annualised standard deviation of one-, three-, five- and ten-year returns for the J.P. Morgan GBI-EM Global Diversified Index. Return distributions: Annualised one-and ten-year returns for the J.P. Morgan GBI-EM Global Diversified Index. Source: JP Morgan, Bloomberg, Eastspring Investments

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