EMERGING MARKET DEBT – THE OPPORTUNITY

Emerging market debt returns have outpaced most developed market assets over the past decade[1]. Today the EM debt market has grown into a mainstream asset class, boasting far higher credit quality and greater depth and liquidity relative to a decade ago. There are a number of different categories that constitute emerging market debt. These include hard currency bonds, local currency bonds, Eurobonds, traded loans and local market debt instruments issued by sovereign, quasi-sovereign and corporate entities of emerging economies.

EMERGING MARKET DEBT – THE ASSET CLASS

The three fixed income categories that are most frequently traded by investors are **local debt** (sovereign bonds issued in a country's local currency), **external debt** (sovereign bonds issued in hard currency, typically in U.S. dollars), and **EM corporate debt**, also issued in hard currency (typically in U.S. dollars).

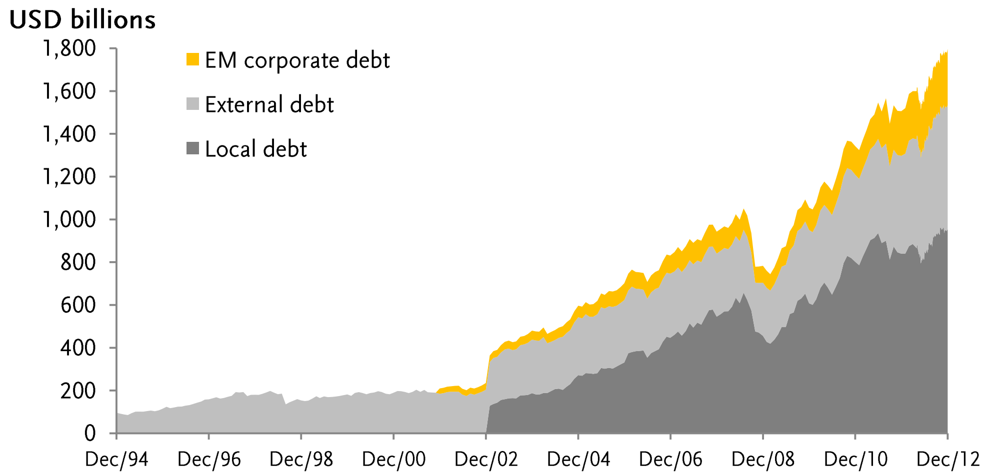
Prior to the early 2000s, most emerging markets did not have the ability to issue bonds in their local bond markets and had to pursue external financing with the support of the IMF to raise debt in U.S. dollars or the euro. The external debt market was typically the primary funding method for most sovereigns. However, the mismatch in currency between their liabilities and hard-currency-denominated funding increased their vulnerability to external shocks and currency devaluations, which were common occurrences in the 1980s and 1990s.

During the past decade, however, emerging economies have proactively implemented prudent macroeconomic policies and enacted important reforms. This has facilitated a reduction and, in some cases, the elimination of external financing needs. Instead, issuing local currency bonds has become a reliable form of financing. This has led to more stable economic performance and increased resiliency to external shocks, as exemplified by the economic recovery in EM from the 2008 global financial crisis. Consequently, the outstanding issuance of external sovereign debt has been on a net decline, whereas local currency debt, by far the largest part of the emerging market debt asset class, is growing at the fastest pace (**Figure 1**).

The last of the three main emerging market fixed income categories is the EM corporate bond market, denominated in hard currency. This is another rapidly growing part of the EM debt universe. The local currency bond market and EM corporate bond market both offer greater opportunity sets as they still represent a relatively small portion of the investable universe.

[1] Source: J.P. Morgan EM Fixed Income Rerates as an Asset Class, September 2012.

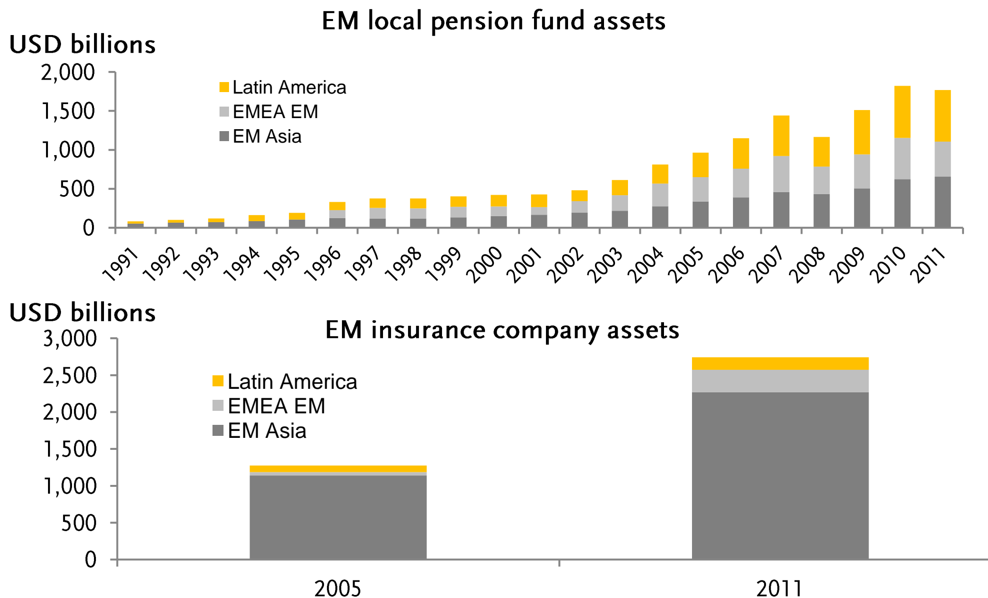
Figure 1: Growing emerging market debt universe



Source: J.P. Morgan. Data to December 31, 2012.

Foreign investor flows into EM local bond markets have increased considerably over the last number of years due to higher yields, improving economic stability, increased inflation targeting, less reliance on external financing and better growth prospects relative to the developed world. Even more importantly is the increased presence from local institutional investors in EM markets, which has led to increased issuance, stability, breadth and liquidity in local bond markets (**Figure 2**). This differs dramatically from the market during the 1990s, when low local investment led to more volatile markets, particularly during periods when foreign investors divested from the asset class.

Figure 2: Rising institutional assets



Source: J.P. Morgan, September 2012.

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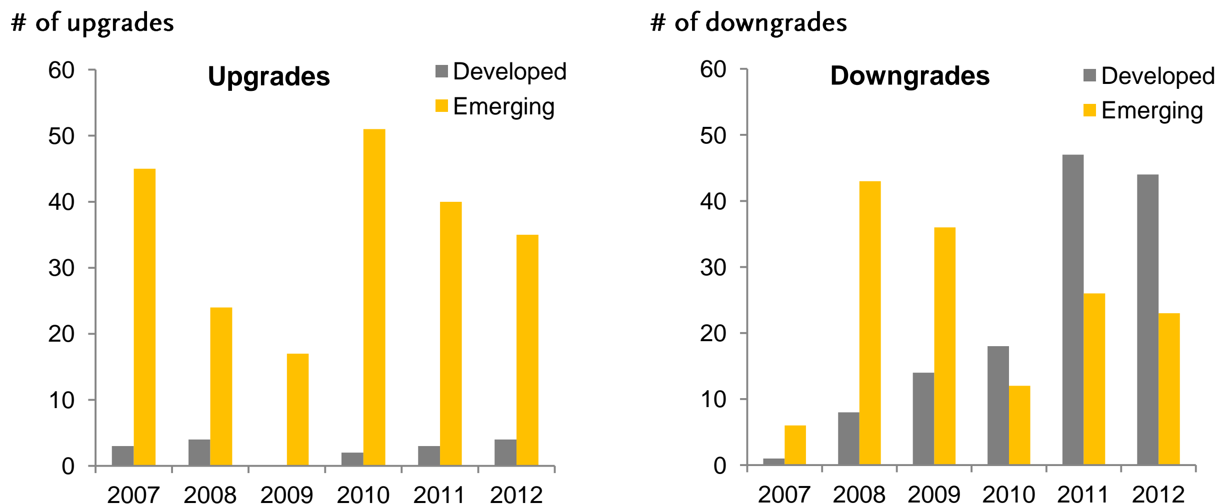
HIGHER QUALITY OFFERINGS

To reflect continued economic and political improvements in emerging economies, the credit ratings of both sovereign and corporate bonds have been trending higher. Investors often assume emerging market bonds are high yield bonds but this is a misnomer. Comparatively, to the surprise of many investors, 62% of external sovereign bonds are now rated investment grade, compared to only 16.5% in 1998[2]. EM corporate bonds have also exhibited dramatic improvements in credit quality with 72% now rated investment grade[3].

These credit rating increases have been due to the overall improved fiscal health of the emerging markets as a result of prudent macroeconomic policies and reform measures that have been implemented. This has also come about as EM countries have increased their foreign currency reserves and adopted more flexible foreign exchange regimes. Since the onset of the global financial crisis, the gap between developed and emerging market sovereign ratings has continued to narrow. EM sovereigns have experienced more upgrades versus developed market sovereigns (**Figure 3**).

Figure 3: Upgrades and downgrades of developed and emerging market sovereigns



INCREASING MARKET SIZE AND LIQUIDITY

Emerging market economies accounted for almost half of global GDP in 2012, based on a Purchasing Power Parity (PPP) basis, and is forecasted to surpass developed markets in 2013, according to the International Monetary Fund. However, emerging market bonds only account for approximately 11%[4] of the global fixed income market. This indicates that there is

[2] Source: "EM Moves into the Mainstream as an Asset Class" J.P. Morgan, October 4, 2010 (data as of June 2010).
[3] J.P. Morgan Corporate Emerging Markets bond Index Broad Diversified. Data as of February 13, 2013.
[4] Source: "Emerging Market Debt" From "Niche" to "Core". GSAM, April 2010 (data as of 2007)

room for substantial growth as local markets continue to attract local and foreign investor flows. This should also help to deepen, diversify and improve overall liquidity in these markets.

HIGHER YIELDS

Emerging market government bond yields are typically higher than those offered by other sovereign bonds, due to the added risk of investing in the emerging markets. Some of these risks include shorter records of sound economic policies, less-established institutional and government frameworks and political and inflation risks.

With bond yields at multi-decade lows, there is the potential for negative returns on developed market government bonds over the next few years. With little upside potential from government bonds, this poses serious implications from a total return and capital preservation perspective. For investors who may not have the risk appetite to invest in high-yield bonds, emerging market bonds may be an ideal alternative.

CONCLUSION

While emerging market bonds offer considerable opportunities, risks do remain. However, with improved resilience from external shocks, higher growth rates than in developed economies, improved external debt positions and greater policy flexibility, the emerging market debt asset class continues to mature.

Allocating a portion of client's assets to emerging market debt may provide significant growth potential and compelling diversification benefits. Emerging market debt can be an excellent complement in a well-diversified portfolio, due to its typically low correlation with other asset classes.

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