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WHITE PAPER

The Case for Emerging Market Local Bonds

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Executive summary

For many emerging market debt (EMD) investors, an allocation to EMD is typically achieved through investing in emerging market sovereign bonds, which are denominated in a hard currency, most commonly U.S. dollars. This fixed income category, which represents a country's external borrowings, is most commonly referred to as external debt. U.S. dollar-denominated external debt is benchmarked off of U.S. Treasuries (trades at a spread over similar maturity U.S. Treasury bonds) but typically has higher yields to reflect factors such as inferior liquidity and lower credit quality.

A common misconception is the belief that an allocation to external debt will expose an investor to the long-term cyclical and structural benefits that the emerging markets can offer. These include:

- superior economic growth,
- stronger fiscal positions relative to developed economies,
- exposure to the spending power of the expanding middle class and
- favourable demographic trends.

However, external debt is not always the optimal way to capture the full potential of these benefits.

A better way to participate in the full benefits of emerging markets is through an allocation to EM local currency debt (local debt), which are sovereign bonds issued in local EM currencies. The risk and return profile of local debt is driven mainly by currency and duration and thus, reflects the monetary and fiscal policies as well as the domestic inflation dynamics within EM economies.

Another main fixed income category within the EMD universe is EM corporate debt, which is debt issued by corporations that are domiciled in the emerging markets. EM corporate debt is similar to external debt in that it is benchmarked off of U.S. Treasury yields but also has a spread component related to the default risk of the borrowing entity.

All three EMD categories possess their own unique characteristics that result in a different return profile. It is important to note that even though local debt and EM corporate debt have only really developed over the last decade, both fixed income categories now exceed the market capitalization of external debt.

In this paper, we provide a brief history of the EMD. We highlight the increased yield and capital appreciation potential of EMD relative to developed market fixed income and review historical performance for the category. And finally, we provide an overview of the growth and strength of the EM local debt market and the current opportunities and risks within this category.

The evolution of the EM debt market

During the 1980s and 1990s, emerging market countries were typically unable to issue local currency bonds to fund internal growth initiatives such as large infrastructure projects or to refinance maturing debt. In order to access funding, countries would often source external financing, typically in U.S. dollars, as local funding was too costly and often prohibitive. The challenge with external financing is the resulting currency mismatch between revenues (a government's tax receipts in the local currency) and debt repayment (denominated in a foreign currency, typically U.S. dollars). This sort of financing, even in large amounts, is manageable when local and global economic growth is relatively strong but can be crippling to an economy's finances if the local, regional or even global economy is under duress. In the past, this has resulted in the depreciation of the local currency, which exerts strain on a country's finances, making debt repayment extremely difficult or sometimes impossible. During the 1980s and 1990s, this was often the case, resulting in EM countries defaulting on or restructuring their debt.

Today, however, emerging market economies have exhibited increased resilience against external economic shocks. In fact, many EM economies proved surprisingly resilient during the 2008-2009 global financial crisis when compared to the pain endured in past crises. By adopting lessons from the past and implementing tough fiscal and reform measures in addition to prudent counter-cyclical policies, emerging markets have helped shield their economies from market and economic stress. Other recent positive measures include increasing foreign exchange reserves, focusing on greater policy autonomy and implementing more flexible foreign exchange regimes. Emerging economies have also garnered increased inflation-fighting credibility over the past decade. These measures have contributed to the expansion and diversification of emerging market bond and stock markets and have led to increased foreign direct investment, stronger sovereign balance sheets, positive ratings upgrade momentum and EM currency appreciation. EM countries have in turn reduced their external financing needs and have fostered a more stable and supportive environment that has aided in the proliferation of localized bond markets.

Development of a local debt market

By increasing bond issuance in local currencies and reducing the amount of external debt, emerging market economies have been able to reduce the mismatch between revenues and liabilities, which has contributed to increased fiscal sustainability. In fact, there has been a dramatic structural change in the source of funding in the past decade. The EM local bond market has grown rapidly when compared to the external debt market, which has lagged significantly in comparison. Where external financing used to be the predominant source of financing for many EM countries over a decade ago, it now constitutes only 20% of all financing needs today. In terms of trading activity, 70% of all trading volume is now in local debt (J.P. Morgan, April 30, 2013).

Currently there are 16 countries within the GBI-EM Global Diversified benchmark with Romania being the most recent addition in March 2013.[1] This compares to the external debt benchmark, which has 58 countries.[2]

FRONTIER MARKETS: THE NEXT WAVE

Countries such as Namibia and Zambia, known as frontier emerging markets, are still in the early stages of EMD funding and continue to access external financing in U.S. dollars as global integration and cross border trades require foreign exchange reserves. Moving forward, frontier markets will need to engage in proactive measures for improved governance, establish primary dealers and foster a culture that supports credit, in order to join the transition from external funding to local currency financing.

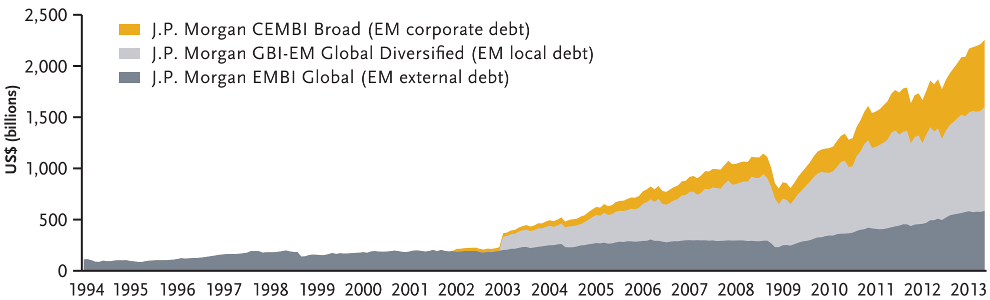
Of the 58 countries that make up the J.P. Morgan EMBI Global Index, the external debt benchmark , 27 constitute frontier markets, which make up approximately 47% of the Index by number of countries but only 7.8% in terms of market capitalization. This differential is due to the fact that larger markets in the index such as Mexico, Russia and Venezuela are approximately 10 times bigger than the largest frontier market. Yet, frontier emerging markets have garnered increased attention recently for their attractive investment opportunities, offering higher yields and greater capital appreciation potential despite their increased risk.

[1] Source: J.P. Morgan. J.P. Morgan Global Bond Index – Emerging Markets Global Diversified as of May 31, 2013.
[2] Source: J.P. Morgan. J.P. Morgan Emerging Markets Bond Index Global as of May 31, 2013.

EM local bond markets have flourished in the last five years. Cross-border inflows into EM local bond markets have been strong and hit record inflows in 2010 and then again in 2012.[3] Beyond stronger fundamentals, the growing interest in local debt markets is likely a factor of low global interest rates and the overabundance of extremely accommodative easing measures in developed economies. It could also be a result of the shortage of safe-haven assets as many developed markets have been downgraded in the aftermath of the credit crisis.

While outstanding total debt in the emerging markets is estimated at US$11 trillion,[4] the investable universe is significantly smaller at approximately US$2.7 trillion.[5] Figure 1 shows the growth of the specified J.P. Morgan benchmarks since 1994, but because of capital controls and other inclusion rules by the benchmark provider, the total capitalization amounts of the specified benchmarks amount to just over US$2.2 trillion. Note that the majority (approximately 45%) is local debt, followed by EM corporate debt (approximately 29%) and external debt (approximately 26%).[6] As the EMD asset class continues to develop in terms of ongoing economic growth and constructive reform measures, additional countries will continue to tap the market for funding, which should lead to additional investment opportunities for investors.

Figure 1: J.P. Benchmark growth



Source: J.P. Morgan, April 25, 2013.

To the surprise of some investors, the local debt benchmark boasts an impressive investment grade rating with approximately 86% of the constituent holdings in the benchmark claiming investment grade status.[7] In comparison, 60% of the external debt index and 69% of the EM corporate debt index have an investment grade rating.[8] The countries that have higher ratings, such as Mexico, Brazil and Malaysia, tend to have more mature bond markets and more established economies. It is for this reason that the countries that have established local bond markets generally have a higher credit rating and have experienced lower historical defaults in the past decade.

Local institutional investors have provided strong support to these markets over the last decade, which has improved their overall size and liquidity. As a result, some of these bond markets are able to issue long-dated bonds, some with maturities of up to 30 years or longer. For institutional investors, such as pension plans and insurance companies, long-dated bond maturities provide a closer match for their long-dated liabilities. Foreign investors have also been attracted to the EMD asset class in these countries as a result of higher yields and increased capital appreciation potential. Mexico and Brazil, considered among the largest EM bond markets, had foreign participation of 15% and 7%, respectively, prior to the financial crisis of 2008-09. Today, foreigners own 37% of Mexican local debt and 14% of Brazil's local debt.[9] Beyond the attractive yields and higher potential returns, EM debt also offers attractive diversification benefits because of its typically lower correlation with other asset classes, as shown in Figure 2.

[3] Source: EPFR.

[4] Source: Bank of International Settlements. Based on Securities Statistics Tables (International and Domestic Debt Securities). Includes countries under the Developing Countries category only.

[5] Source: J.P. Morgan Global Emerging Markets Research, February 15, 2013.

[6] Source: J.P. Morgan, April 30, 2013.

[7] Source for index is the J.P. Morgan Global Bond Index – Emerging Markets Global Diversified as of April 30, 2013. Ratings: Bloomberg composite for each country in the benchmark as of April 30, 2013.

[8] Source: J.P. Morgan indices: JPM CEMBI Broad Diversified, JPM EMBI Global as of April 30, 2013.

[9] Source: J.P. Morgan EMEA EM Local Market Bond and FX Technicals Report, April 26, 2013.

Figure 2: Strong historical risk-adjusted returns for EMD over global bonds and equities

	EM corporate debt	External debt	Local debt	Global investment grade	U.S. high yield	World government	Canadian bonds	U.S. equities	Canadian equities	EM equities	World equities
EM corporate debt	1										
External debt	0.92	1									
Local debt	0.66	0.71	1								
Global investment grade	-0.23	-0.25	-0.05	1							
U.S. high yield	0.75	0.76	0.44	-0.45	1						
World government	-0.25	-0.25	-0.04	0.99	-0.48	1					
Canadian bonds	0.42	0.44	0.42	0.46	0.08	0.47	1				
U.S. equities	0.56	0.57	0.35	-0.49	0.72	-0.50	-0.06	1			
Canadian equities	0.56	0.55	0.25	-0.50	0.65	-0.52	-0.05	0.8	1		
EM equities	0.60	0.62	0.40	-0.53	0.69	-0.54	0.03	0.77	0.82	1	
World equities	0.56	0.57	0.34	-0.54	0.74	-0.56	-0.08	0.97	0.84	0.83	1

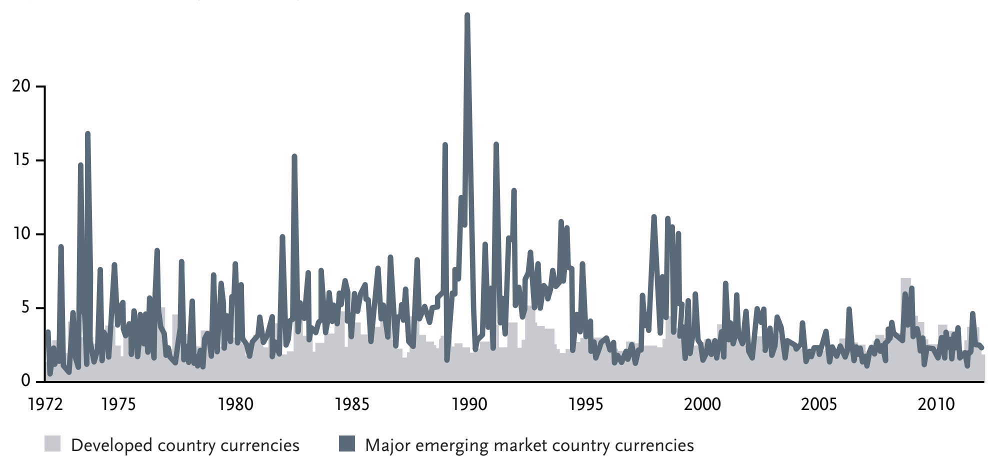
Source: J.P. Morgan and Encorr, 10-year period from January 1, 2003 to January 1, 2013. In U.S. dollars.

Currency component of EM local bonds

Currency is often the least understood component of EM local debt investing and at the same time it often represents the largest component of a portfolio's return profile. In the past, EM currency volatility often caused severe economic pain, particularly during the various crises that weighed on EM, including the 1973 oil crisis, the Latin American debt crisis in the early 1980s and the Asian and Russian financial crises that occurred in the late 1990s.

Over the last decade, however, emerging market economies implemented countercyclical fiscal and monetary policies to partially offset downturns in their economies, which have resulted in foreign reserve management programs, low public sector debt levels, improved external positions and stringent inflation-fighting policies, all leading to increased stability and central bank credibility. These policies have also led to more stable exchange rate movements so that EM currencies now behave more like developed market currencies.

Figure 3: Currency volatility over time, 1972-2011



Source: Elroy Dimson, Paul Marsh and Mike Staunton, Credit Suisse, February 2012

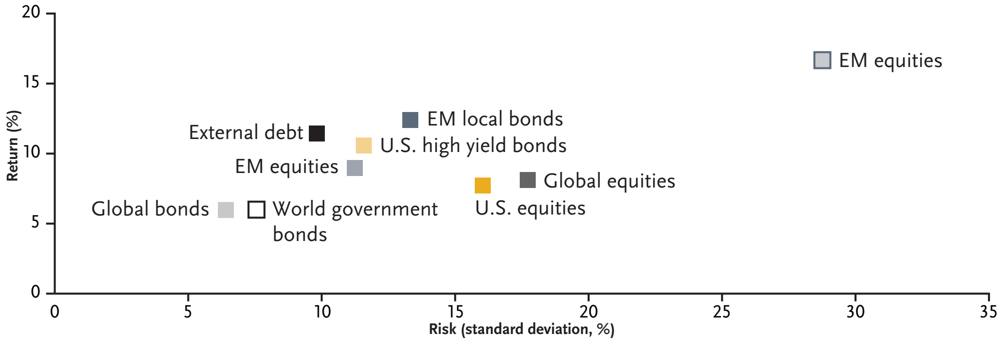
EM countries have also built up an impressive war chest of currency reserves over the past decade. Currency reserves play an important role in shielding economies from external shocks but also play a part in support of cross-border flows, which has increased significantly over the years, not only with developed markets but also intra-trade with other emerging market economies. The accumulation has been so strong that EM economies now hold two-thirds of the world's US$10.9 trillion[10] in currency reserves, or US$7.25 trillion. This compares to 1995 when their share was one-third, or US$457 billion.

However, EM local bond investing does come with currency risk that needs to be properly and actively managed. A local currency bond and the associated currency risk are two separate investments that do not necessarily move together and are driven by different fundamental factors. Typical fixed-income managers rarely buy the bonds and hedge the associated currency risk. Rather, a process that separates these two decisions can give investors the best combination of overall return from both return sources.[11]

Historical performance of the EMD asset class

As a country's economy strengthens, a natural consequence is for yields to trend lower as the risk premium declines over time. This has led to strong historical performance for the EMD asset class over the past decade. Since the onset of the financial crisis of 2008-2009, EM local debt has produced superior risk-adjusted[12] returns compared to most other asset classes.

Figure 4: 10-year risk/return favourable for EMD

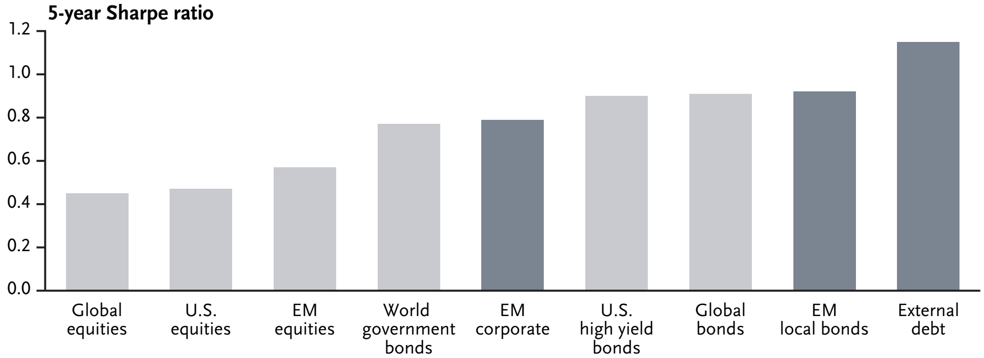


Source: J.P. Morgan and Encorr, 10-year period from January 1, 2003 to January 1, 2013. In U.S. dollars.

Strong risk-adjusted returns experienced by the EMD asset class over the past decade has resulted in a high Sharpe ratio, particularly for external debt, which has benefited from declining U.S. Treasury yields and tighter spreads. While the Sharpe ratio for external debt is currently greater than for local debt, we argue that with U.S. Treasury yields hovering around multi-decade lows, and barring any future economic or financial crisis, the prospect for strong future returns for external debt is somewhat limited. External debt has already experienced significant underperformance year to date relative to local debt (J.P. Morgan EMBI Monitor, April 30, 2013). This could lead to a declining Sharpe ratio over time.

[10] Source: IMF, Currency Composition of Official Foreign Exchange Reserves, preliminary as of December 31, 2012.
[11] *Institutional Investor*, February 13, 2013.
[12] Risk is measured by monthly standard deviation of returns

Strong historical risk-adjusted returns for EMD over global bonds and equities



Source: J.P. Morgan, data as of April 30, 2013.

Conclusion

We anticipate that the significant growth differential that exists between emerging and developed markets coupled with other supportive fundamental factors will continue to support EM local debt valuations going forward. We also expect that the long-term secular appreciation trend for emerging market currencies will remain intact albeit at a slower pace than what we have experienced in recent years and that volatility, which has recently been low, will gradually increase.

As funding needs continue to increase, EM local debt markets will continue to grow commensurate with expanding economic growth, fuelled by accelerated consumption and investment spending. We believe the current fiscal health of EM economies will remain superior relative to developed economies and we anticipate they will continue on an upward credit rating cycle.

With higher yield and capital appreciation potential, strong historical risk-adjusted returns coupled with improved stability and resilience, the EM local debt universe is a growing asset class that cannot be ignored.

INSTITUTIONAL SUPPORT FOR EM LOCAL DEBT

Pension funds and insurance companies in the emerging markets are natural buyers of local debt and make up a substantial portion of local currency EMD. These two large institutional buyers within EM represented close to US$5 trillion at the end of 2011.* Also, with estimated assets under management of US$16 trillion in OECD pension fund assets, an allocation close to zero is currently allocated to EM fixed income. With both of these large institutional players, a marginal increase in allocation to EMD could result in significant flows into the asset class, providing further support for EMD. Of course, these flows could turn in the opposite direction, but over the last decade, we have witnessed increased positive flows not negative. We expect this positive trend to continue in the years to come.

* Source: J.P. Morgan Global Emerging Markets Research, February 15, 2013.

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