

Emerging market local currency debt – taking advantage of strong fundamentals



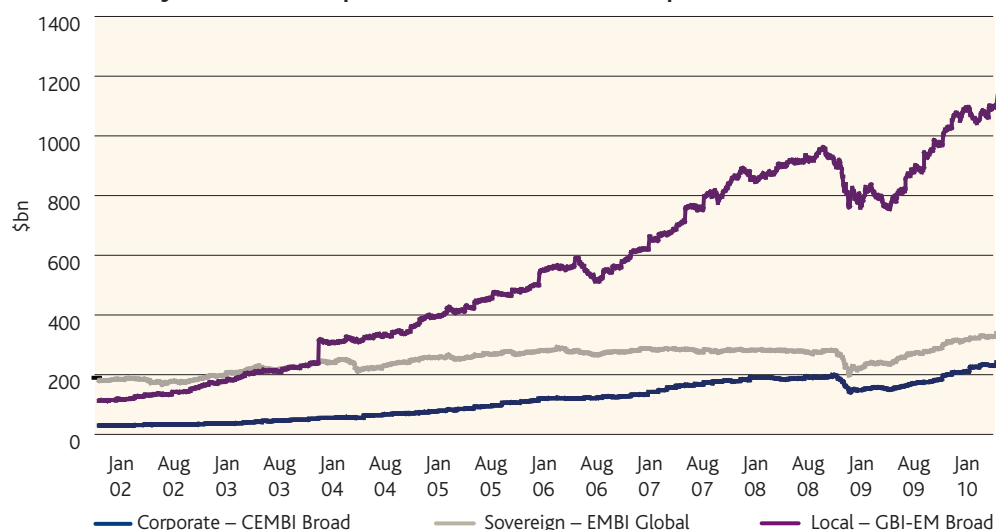
Many investors, while diversifying their equity portfolios into emerging markets, have yet to go down the same route with their fixed income portfolios. Unfortunately, many remain over exposed to underperforming G7 government bonds. But, burdened by large levels of debt, it is unlikely that developed economies, particularly the US and UK, will return to the heady pre-crisis days when they enjoyed attractive bond returns.

The attractions of investing in emerging markets have been well documented over the past few years. Unsustainable debt-fuelled growth, deteriorating fiscal deficits, weak currencies and political instability were once the characteristics of emerging market countries, but now more accurately describe the so called developed nations. After a decade of crises in the 1990s, emerging market countries embraced sustainable fiscal and monetary policies during the noughties, and are now largely characterised by strong fundamentals – namely sound financial systems, growing domestic demand, attractive demographics and stable currencies.

The improvement in fundamentals over the past ten years has resulted in strong performance of emerging market debt. Hard currency sovereign bonds now represent a lower risk asset class that, while still attractive, is unlikely to deliver the same double digit returns that it did before the credit crisis. On the other hand, local currency debt offers higher yields, with the added benefit of currency appreciation.

The emerging market local currency debt market has grown significantly in recent years, and is now roughly triple the size of the hard currency debt market. Having drawn on lessons from past funding crisis periods, emerging market countries have over the past decade focused on developing their local yield curves to meet financing requirements. This development has had two significant impacts: it has reduced the dependence on external financing, and has resulted in deeper, and more liquid local government bond markets. We would expect this trend to continue in the coming years, which in turn will reduce sovereign default risk.

EM local currency debt market capitalisation now more than triple the size of EM external debt



Source: JP Morgan, March 2010

The benefit of currency appreciation also supports the investment in local currency debt. More favourable fiscal debt levels and the higher growth potential of emerging markets should, over time, result in stronger currencies compared to the developed world. Indeed, recent events such as speculation that China may gradually remove its peg to the US dollar, and Singapore's recent revaluation of their currency, add fuel to the argument that emerging market currencies are set to rise.

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Enhanced returns should be available on the back of this trend over the next few years.

The low correlation to other asset classes is another benefit of emerging market local currency debt. If you look at the asset class versus other major asset classes, particularly global bonds and US treasuries, diversification into local currency debt is appealing.

Low correlations with other fixed income asset classes

Asset class	JPM GBI-EM GD (local currency)	JPM EMBI GD (hard currency)
Emerging market equities	0.80	0.71
Global equities	0.79	0.72
Global bonds	0.48	0.36
US equities	0.73	0.68
US bonds	0.18	0.22

Benchmarks used: JPM EMBIGD , JPM GBI-EMGD, MSCI EM, MSCI WORLD, CG WGBI, S&P 500, Citigroup USBIG Treasury Agency. Source: Aberdeen Asset Management, Bloomberg, JP Morgan, Russell Mellon Analytics, USD, 5 years to 31/03/2010.

Note: 1 = perfect correlation. 0 means no correlation. -1 means inverse correlation, i.e. if market goes up, this will go down by an equal measure.

Emerging market local currency bonds not only have higher yields than hard currency bonds, but are also a higher rated asset class, with over 80% of the local currency bond index now investment grade compared with around 53% of the hard currency index^A. These are also trends that we expect to continue over the coming years, with the local index expected to be essentially 100% investment grade, with the upgrade of Indonesia and Turkey, in the next few years.

Many investors remain under-invested in the asset class, but there are compelling arguments for investors to increase allocation to emerging market debt. Given the current woes in the developed world, it would seem clear that investors should look to diversify their fixed income portfolio into the higher growth part of the world - one that also offers more attractive returns. In our view, emerging market local currency debt would seem an obvious choice through which to do this.

^A Source: JP Morgan, March 2010

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