# Emerging Market Debt

## Addressee

This paper is addressed to the Investment Subcommittee of Leicestershire County Council Pension Fund ("the Fund"); it provides an updated version of Appendix 6 of our Asset Structure paper addressed to the Pension Fund Management Board of the Fund.

## Highlights

- Emerging Market Debt is issued as external debt (typically denominated in US$ or Euro, and referred to as hard currency debt) or local currency debt;
- The markets are substantial in size;
- The yield available on Emerging Market Debt has risen in recent months and may now provide an attractive entry point to these markets.

## Background

Emerging Market Debt yield spreads over developed market bonds have widened in recent months. Whilst a number of the Emerging Debt markets warrant these higher yields (because of their higher risk), current yield levels present a potentially attractive entry point to these markets at a time when developed markets still offer little value.

**Chart 1: Yield premium**

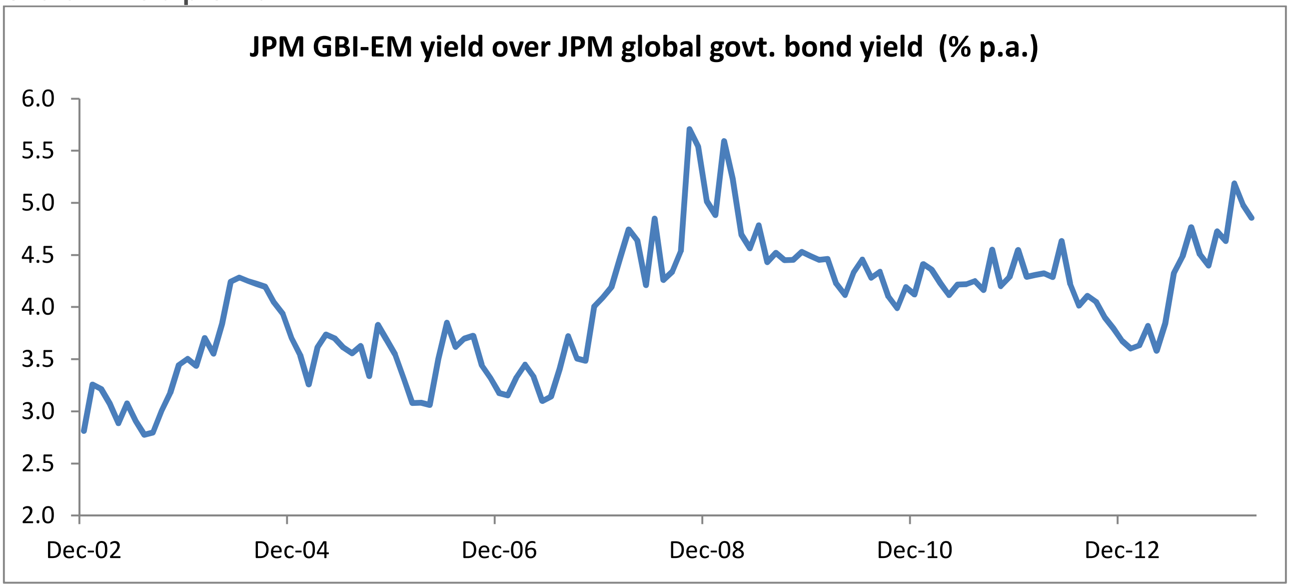



Chart 1 above shows that the yield on the **local** Emerging Market Debt index (JPM GBI-EM Diversified), which equates to an absolute yield of 6.8%, currently offers a 4.8% premium over the Global Government Bond index (JPM Global Govt. Bond).

In the context of the Fund's return requirement of at least 4% per annum real, this would appear to be a sufficiently attractive return; with expected volatility around 10% per annum, the risk adjusted returns are also attractive.

EMD can be considered as part of a broader allocation to higher yielding bonds, or as a stand-alone return generator. The Fund currently has some exposure to EMD within the JPMorgan mandate, although in practice, this has only ever been a small percentage of that mandate.

## Development of EMD Markets

There have been four major phases in the development of the EMD market in the last 30 years;

- Prior to the late 1980's the majority of debt capital to Emerging Market (EM) countries was provided in loan format by commercial banks.
- The late 1980's through to the mid 1990's saw the transfer of this loan finance into the wider capital markets through tradable 'Brady bonds'. These bonds helped to form the basis of a more efficient, liquid market as it stands today.
- The mid 1990's onwards saw the growth of US dollar (hard currency) denominated EMD which was heavily skewed towards Latin America. The market went through a number of crises (e.g. the Asian financial crisis in 1997 and the 1998 Russian default). However, the improvement in fiscal and monetary policies in many EM countries has produced a steady increase in the credit quality.
- 2000 onwards has seen the rise of local rather than hard currency EMD. This now represents the majority of the market in terms of outstanding debt issuance.

Today's diverse EMD asset class is the result of fundamental changes in many EM countries. These countries now run disciplined fiscal and monetary policies which allay investors' concerns about the potential for inflation, currency devaluation or bond defaults.

In brief, the universe has evolved into both hard and local currency sovereign representation (including inflation-linked) and corporate bonds, a continual improvement in credit quality, and broader index representation from 5 continents and nearly 50 countries.

**Evolution of the Emerging Markets Debt Universe.**


**Source: Russell Research**

We comment below of the three categories of the current EMD universe:

- Hard currency - Sovereign and quasi-sovereign bonds denominated in major international currencies;
- Local currency - Sovereign and quasi-sovereign government bonds issued in each country's own currency;
- Corporate bonds - Debt instruments issued by public and private sector corporate issuers.

### Hard Currency

Emerging Markets hard currency debt, also referred to as external debt, consists of dollar and euro denominated sovereign bonds. The asset class originally emerged out of the Brady Plan to restructure and standardise the market for EMD instruments in the 1980's and were named 'Brady bonds'

Hard currency debt is a USD1.4 trillion investment universe, which includes 54 countries and more than 325 securities. However, the investable universe (represented by the market's preferred index JPM EMBI Global Diversified) has a market capitalisation of approximately USD 330 bn.

The primary risk faced by investors in hard currency EMD is credit risk (the risk that the principal or coupon is not repaid, including changes in capital value due to the markets assessment of this risk).

### Local Currency

Local currency bond markets are now the largest component of the EMD universe. This change has happened as EM government finances have improved, enabling longer debt maturity and allowing them to borrow in local currency at reduced cost.

The growth in the asset class has coincided with the establishment of pension funds across Emerging Markets over the past decade. Pension funds and other domestic financial institutions such as insurance companies and mutual funds have been buyers of this longer- dated debt. It is now an USD 6 trillion universe, but as is the case for hard currency debt, the investable universe (represented by the market's preferred index, the JPM GBI-EM Global Diversified) has as a market capitalisation of approximately USD 926bn.

Local currency debt gives an investor exposure to both rates and currencies across Asia, Latin America, Eastern Europe, and increasingly to frontier markets, such as Vietnam, Pakistan and Nigeria. These markets are influenced by the same domestic and international factors that influence developed sovereign bond markets.

The main risk and return factors faced by local currency EMD investors are interest rates and the appreciation or depreciation of the local currency.

The majority of EM local currency sovereign bonds are owned by domestic (local EM) investors; however the overseas institutional investor base has been growing. One of the important drivers of return from local currency EMD is the appreciation/depreciation of the currency. This has been an important driver of local currency EMD returns historically. EM currencies have become increasingly volatile since the 2008 financial crisis (e.g. in September 2011, May 2012) and are likely to remain an important driver of returns and volatility going forward.

### Corporate Bonds

Global financial markets are today channelling more capital into the private sector in Emerging Markets than into the public sector. Since 2003 EM corporate debt issuance has been approximately twice that of sovereign debt issuance and EM corporate debt has rapidly developed into a significant asset class.

Many EM corporates are global-sized players who are among the world's lowest cost producers with leverage in both investment grade and high yield EM corporate debt materially lower than leverage in comparable developed market corporates. Approximately 70% of EM corporate debt stock is investment grade and includes issuers from around 70 countries.

The primary issuance is in **hard currency**. Corporate bonds now constitute the majority of outstanding EM hard currency debt. The investable universe is approximately $280bn.

Default rates have declined dramatically compared to a decade ago, as companies have reduced gearing and strengthened their balance sheets. However, 2009 was the year of high default rates, with a default rate for high yield EM corporate bonds of 6.1% (of which approximately 75% came from the Kazakhstan banking sector). This compares with, for example, 11.2% for US high yield corporate bonds.

Liquidity can be an issue with the smallest 300 (of 520 issuers) in the index accounting for less than 20% of the outstanding market value.

### The Leading Benchmark Indices

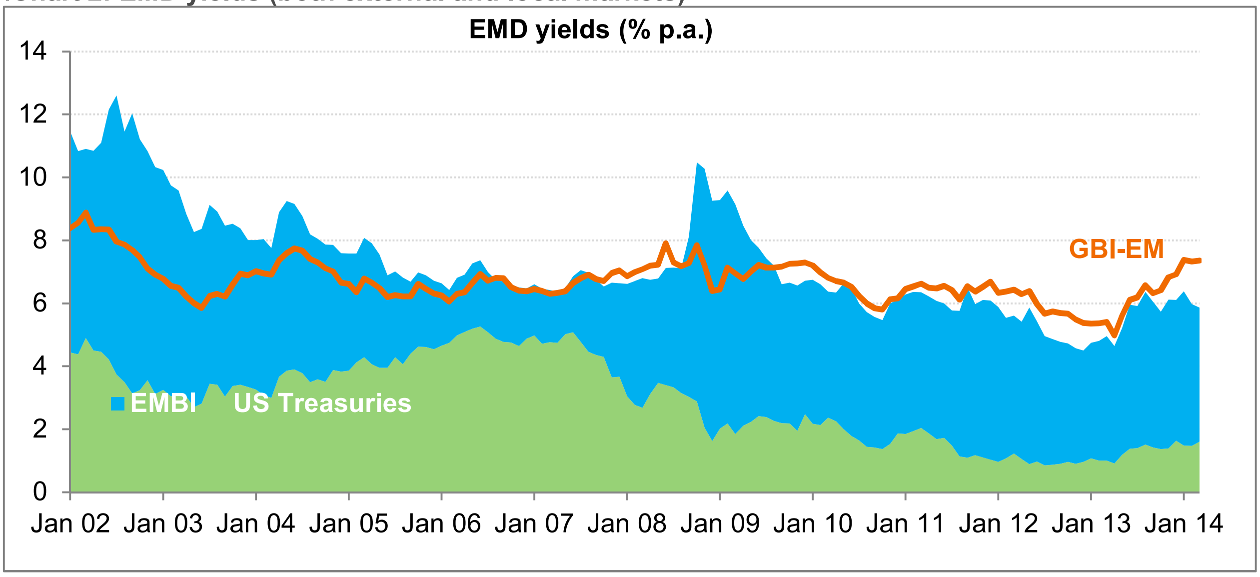
The J.P. Morgan range of indices is generally accepted as the market leader for both hard and local currency debt and for Emerging Market corporate bonds:

- **JPM EMBI Global Index**: External denominated Emerging Market sovereign debt, with USD denominated debt making up the largest component of the market (index).
- **JPM GBI-EM Diversified Index**: Local Emerging Market Government Bonds, the index excludes those countries with foreign investment constraints, including India and China and also limits any one country representing more than 10% of the overall index.
- **JPM CEMBI Diversified Index**: External denominated debt issued by corporate entities. Skewed towards Asia and Latin America (66% of the overall index).

### Expected Returns and Market Outlook

Returns from EMD have consistently outperformed other fixed income asset classes over the last ten years. The fundamentals of the issuers have significantly improved as emerging market countries economies have improved and they have grown at a faster pace than developed markets. The following chart summarises the long-term return and risk characteristics of EMD.

**.Chart 2: EMD yields (both external and local markets)**




Returns from hard currency EMD (JPM EMBI index) have been driven by coupon payments, spread compression and a fall in US treasury yields.

Returns in local currency EMD (GBI-EM Diversified index) have been driven by currency and interest rate movements. Price has been a relatively stable contributor to local currency returns. Yields have not necessarily improved markedly over the past five year period. Currencies have become increasingly volatile since 2008, and are likely to remain an important driver of returns and likely to be the key driver of volatility going forward.

For a given issuer, local currency debt is usually expected to have a higher yield than bonds denominated in hard currency. This arguably reflects the risk of holding emerging market currency (see Table 1 below).

**Table 1: Risk/return profile over the last 10 years**

| Asset Class | Annualised Returns (%) | Annualised Volatility (%) | Yield (%) |
|---|---|---|---|
| EM Local Currency Debt | 9.2 | 12.4 | 7.0 |
| EM Hard Currency Debt | 8.4 | 9.0 | 6.0 |
| EM Corporate Debt | 7.5 | 10.2 | 5.5 |
| Global Bonds | 4.8 | 5.8 | 2.3 |
| Investment Grade Bonds (US) | 4.8 | 3.6 | 2.7 |
| High Yield Bonds (US) | 8.6 | 10.4 | 6.0 |

Source: Bloomberg, returns and volatility from 29 February 2004 – 28 February 2014 in USD. Yield as at 28/02/14.

A few years ago, the major appeal of EMD as an asset class was its low correlation to other assets. More recently this diversification benefit has reduced, as the correlation of EMD with other asset classes has increased.

**Table 2: Monthly correlations from January 2003 to February 2014 (excluding June 2008 – June 2009)**

| | JPM EMBI Global | JPM GBI-EM GD | S&P 500 | US Treasury | US High Yield |
|---|---|---|---|---|---|
| JPM EMBI-Global | 1 | 0.80 | 0.53 | 0.15 | 0.55 |
| JPM GBI-EM GD | 0.80 | 1 | 0.66 | 0.13 | 0.65 |

Source: JP Morgan, S&P, Bloomberg. Data as at 28 February 2014

### Market Access

As the universe of issuers has become more diverse there is an argument that the broad long-term EMD premium has reduced and that the appeal of the asset class is therefore as much tactical as strategic. This view might suggest EMD exposure should be part of a broader return-seeking bond portfolio where allocation to different bond categories is actively managed. Within a broader bond portfolio, EMD can offer diversification benefits: sovereign rather that corporate risk, currency risk.

Our historic research suggests that passive management of EMD can be just as rewarding as active management, primarily due to the high fees of active management outweighing the excess returns. However, the a wide range of markets now included in the indices with economies at very different positions in their cycles currently argues for an active approach rather than passive. Therefore, we currently favour access within a higher yielding multi credit portfolio or via a specialist active manager.

The drivers of local currency and hard currency EMD returns can be quite different; local currency are dependent on a combination of currency moves and local interest rates, and hard currency on the ‘spread’ above US government bond yields. We tend to favour a combination of both local and hard currency EMD bonds, offering diversification across a range of countries and different instruments.

Allowing a skilled manager the freedom to allocate between the EMD asset classes in a ‘blended’ portfolio allows the potential for optimal returns from the EMD asset class.

**Notes and Risk Warnings**

The report should not be released or otherwise disclosed to any third party except as required by law or regulatory obligation or without our prior written consent. We accept no liability where the note is used by, or released or otherwise disclosed to, a third party unless we have expressly accepted such liability in writing. Where this is permitted, the note may only be released or otherwise disclosed in a complete form which fully discloses our advice and the basis on which it is given.

Please note the value of investments, and income from them, may fall as well as rise. This includes equities, government or corporate bonds, and property, whether held directly or in a pooled or collective investment vehicle. Further, investments in developing or emerging markets may be more volatile and less marketable than in mature markets. Exchange rates may also affect the value of an overseas investment. As a result, an investor may not get back the amount originally invested. Past performance is not necessarily a guide to future performance.