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Why Emerging Markets Local Currency Sovereign Bonds Now?

*The answer to this question consists of 5 parts
– each of them is a separate investment decision:*

1 Why Emerging Markets?

Emerging market economies (i.e., economies of the countries which are not yet rich) grow faster than the developed world. These positive growth differentials first appeared about a decade ago (following the cleansing experience of the Asian crisis and the Russian default), have persisted throughout the recent global financial crisis and are set to continue in the future due to the combination of improved macro-economic fundamentals, favorable demographic trends, a very competitive cost structure, and a lower starting base of non-rich countries.

2 Why Local Currency?

The US\$-denominated emerging markets debt has become a victim of its own success. US\$-denominated bonds are driven by spreads over US Treasuries, which by now have already tightened significantly to reflect the improved credit quality of emerging market sovereigns. As such, US\$-denominated emerging market bonds have graduated to a lower risk/lower return asset class which, in contrast to its historical experience, can no longer deliver double-digit returns. Yet, there is much more upside left in the local currency exposure.

In our opinion, the local currency exposure provides an attractive way to capitalize on the positive growth differentials between emerging markets and the developed world. These growth differentials serve as a magnet for capital flows into emerging market countries that exert the appreciation

pressure on local currencies. According to a recent report by the Institute for International Finance (IIF), the current conditions for capital flows into emerging market economies are more propitious than ever. The improvement in the outlook for emerging market countries is only one reason behind this categorical conclusion. Another reason is the gloomy prospects for the developed world. Note that currency valuations are based on the relative, not absolute, economic and financial conditions.

3 Why Sovereign?

Sovereign bonds offer superior liquidity (a typical sovereign bond issue is in excess of US\$ 1 billion) and are supported by the structural bid from local financial institutions, such as the rapidly growing pension plans. According to JPMorgan, less than 20% of local sovereign bonds are owned by foreign investors, the rest is still in the hands of locals who continue to bid these bonds at primary auctions and on the secondary market. In contrast, even though emerging market corporate bonds typically offer a yield pick-up, they are less liquid and their market technicals are far less supportive.

In addition, improvements in emerging market countries over the past decade have been primarily at the sovereign level (e.g., higher foreign exchange reserves, more sustainable public debt burdens, lower inflation, etc.). In contrast, it is much more difficult to find similar evidence of structural improvements at the level of individual corporations in emerging markets, especially in areas such as managerial incentives, protection of minority shareholder rights, adequacy and timeliness of accounting disclosures.

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4 Why Bonds?

Based on the available historical data, local bonds have produced much better risk-adjusted returns than emerging market equities. In particular, local bonds have provided approximately three-quarters of the return of emerging market equities with less than half the volatility.

Local bonds can also be seen as a geographical diversifier relative to emerging market equities. This is because the countries represented in the emerging market equity indices are not the same as the countries comprising the local bond universe. In fact, the extent of overlap is less than half.

Another important question to consider is why invest in bonds and not just currency forwards (i.e., local cash instruments). In this regard, it is important to point out that currency-hedged returns of local bonds have historically been positive, indicating that local bonds have outperformed currency forwards. Above all, this outperformance reflects the positive term premium of local yield curves. For bond managers, however, the use of currency forwards enables them to invest in countries where the currency is attractive but not prospective duration returns. Also, at least in several countries, an option exists to invest in inflation-linked bonds.

5 Why Now?

While spreads on various fixed income asset classes have already come down to their pre-Lehman levels, emerging market currencies are still trading noticeably weaker than in

August 2008. Thus, we believe, there is still the potential to “catch up” as the global recovery is taking hold. This potential is attributable to the actions of emerging market central banks which have slowed the process of appreciation by intervening against their own currencies. However, in most cases, central banks are just “smoothing volatility” – slowing the process of adjustment, rather than preventing their local currency from appreciating beyond a certain level.

Summary

We believe that emerging markets local currency sovereign bonds are an attractive asset class with the potential to generate low double-digit returns on an annual basis (local yield of 7% + moderate currency appreciation). Among other liquid asset classes, there are only two that carry the same “promise”: equities and high-yield corporate bonds. Although local bonds contain risks of their own, they neither take on the direct equity risk nor carry a high amount of credit risk. Indeed, the weighted average credit quality of local currency bond benchmarks is solidly investment grade (to be included in the benchmark an emerging market country has to have a fairly well developed local fixed income market – a hard condition to satisfy if the country is still struggling with creditworthiness concerns). As such, institutional investors worldwide are increasingly realizing the important role of at least a limited allocation to the asset class in a well-diversified portfolio.



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