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OUTLOOK FOR EMERGING MARKET DEBT

OCTOBER 2013

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BACKGROUND

Investing in emerging market debt (EMD) refers to investing in the sovereign and corporate bonds issued by emerging market (EM) countries and companies. This can be done either by investing in hard-currency bonds (often issued in US dollars, which can be readily hedged by non-USD investors) or local-currency bonds (issued in local currency, which is relatively expensive to hedge and hence requires embracing currency risk). Returns will be driven by absolute yield levels, possible yield compression, and currency movements (for local currency bonds). We have most recently favored investments in local currency debt for a number of reasons but principally on the grounds of higher yield, improved issuer credit quality, and the potential for EM currencies to appreciate over time. Accordingly, the focus of this paper is to revisit our views on the outlook for local currency EMD.

We acknowledge that hard currency EMD is also a valid way to gain exposure to EMD, though we note that the hard currency universe comprises a different mix of issuer countries, typically with a lower average credit quality and a longer duration than the local currency universe. There will be times when the relative valuations between these two EM categories will ebb and flow, and we are aware that a number of investment managers offer "blended" strategies that invest in both sectors of the market. An allocation to this type of strategy may also include some exposure to EM corporate debt, an asset class of increasing interest given exponential growth in issuance. We are cognizant of the fact that some investors may want to invest in these types of products as they offer a greater degree of diversity in terms of country exposure, as well as reduced volatility due to lower currency risk. In the Appendix, we have included a table depicting the various characteristics of the different indices. We now recap the strategic investment case for investing in local currency EMD.

THE INVESTMENT RATIONALE

- **Attractive return potential:** current yield around 6.5%, with potential currency appreciation over time.[1]
- **Yield premium over sovereign debt:** currently in region of 4.5% versus US Treasuries.[2]
- **Portfolio diversification:** reduced correlation with developed market equities and developed market bonds, hence acting as a good portfolio diversifier.
- **Relatively short duration (around 4.6 years):** this may help in a rising yield environment.

THE RISKS

- **Idiosyncratic risks**: each EM country poses its own political, social, and economic risks that drive the risk of capital impairment, via default or currency depreciation.
- **Macroeconomic risks**: many EM countries are dependent on commodity demand or other export demand, making them particularly vulnerable to conditions in China, as well as the US and Western Europe.
- **Higher volatility**: despite improving fundamentals, emerging economies are vulnerable to changes in global risk appetite, which exaggerates volatility compared to developed market bonds and currencies.

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[1] Based on JPMorgan GBI-EM Global Diversified index, as at September 30, 2013.

[2] Based on JPMorgan GBI-EM Global Diversified index and US Treasury seven-year yield as at September 30, 2013.

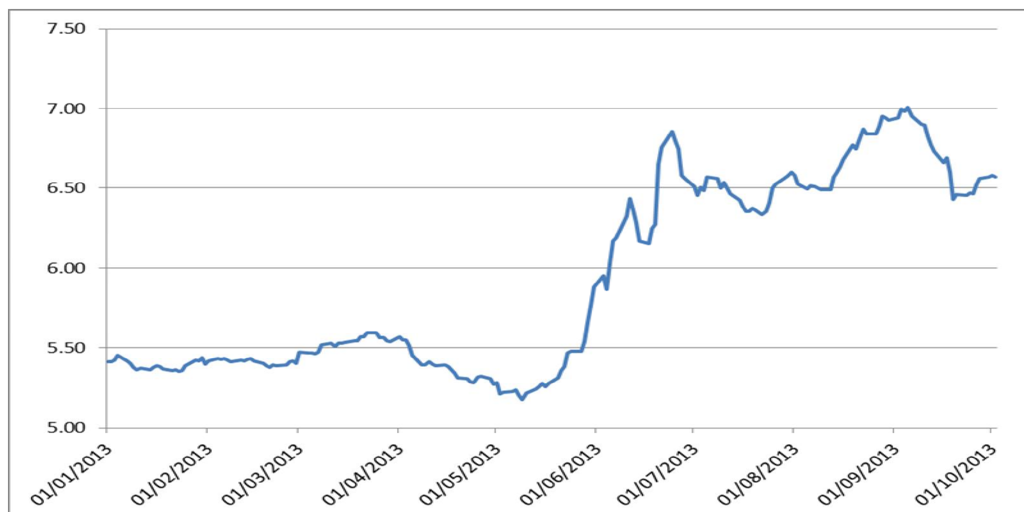
RECENT MARKET BEHAVIOR

After a reasonably steady start to the year, the second quarter of 2013 saw significant volatility in global bond markets, including EMD. Local currency EMD yields were at about 5.5% at the start of the year. In April, yields moved sharply lower, driven by the announcement of unprecedented levels of quantitative easing (QE) in Japan. Local currency EMD yields hit historic lows, reaching 5.16% on May 8. Ten-year yields in developed bond markets hit their lows around the same time with yields in the US and UK falling to around 1.6%.

However, the second half of May saw a strong reversal in risk appetite as investors were unnerved by Federal Reserve Chairman Ben Bernanke's statement on possible QE “tapering” in the US and the impact this might have on global asset flows. This sparked a sell-off in developed market bonds (particularly US treasuries and UK gilts where 10-year yields hit 3% by early September), which in turn led to a sell-off in EMD. The sell-off in EMD was also influenced by disappointing economic data in some EM countries, most notably poor growth numbers (relative to expectations) in China and Brazil. In contrast, much of the recent data flow for the US (and indeed Europe) has been reasonably positive. Political worries also weighed on the EMD market, with specific political issues in certain EM countries as well as more broad-based concerns over the situation in the Middle East.

The sharp sell-off continued into June, with the local currency EM index yield hitting 6.7% in late June — a rise of 150 bps in six weeks. Markets calmed down briefly during August, but volatility increased again toward the end of August and yields moved higher again, touching 7% by early September. Although the rise of around 180 bps from May to early September in local currency EMD yields appears large, it should be noted that 10-year yields in developed markets rose around 140 bps over the same period. However, in mid-September the US Fed unexpectedly announced that it would not be commencing the tapering of its QE policy. This boosted markets, including EMD, bringing the local currency index yield down to 6.5%. Chart 1 below shows the index yield movements since the start of 2013.

Chart 1. Local Currency EMD Index Yield in 2013



Source: JPMorgan

The other major development during this period was that many EM currencies weakened sharply. The reversal in portfolio flows, as investors “repatriated” assets away from EM markets to home countries, meant that there was significant selling of EM currencies. Since local currency EM investments are often made on an unhedged basis (due to the cost of hedging EM currencies), these currency moves severely affected returns for investors.

The focus on currency markets continued into the third quarter, with particular steps taken in countries such as Brazil and India to intervene in their currency markets to try and stem the declines. This led to a heightened sense of volatility, as markets reacted to macro and asset flow data on one hand, and potential policy reactions on the other. Indeed, in some cases the two-way nature of the policy situation was very marked. In Brazil, for example, an intervention plan was announced by the Central Bank in early August, yet in mid-August the finance minister commented that currency weakness was helpful to the economy. This saw the Brazilian real weaken in August from 2.20 to 2.40 versus the US dollar (a 17% decline from the 2.00 level seen back in April). However, decisive intervention actions by the central bank in late August brought the currency back towards 2.30, and subsequently the currency strengthened to 2.20 following the Fed’s tapering announcement in mid-September. Chart 2 below shows the moves in the Brazilian real versus the US dollar this year, while Table 1 sets out various EM currency moves in recent months.

Chart 2. USD Versus Brazilian Real Since April 2013

(Source: Bloomberg)

Table 1. Selected EM Currency Movements in 2013

Main EMD currencies versus US Dollar	Q2 change	Q3 change
Brazil	-9.4%	0.5%
Poland	-2.0%	6.6%
Mexico	-4.9%	-1.1%
Malaysia	-2.8%	-2.4%
South Africa	-6.5%	-1.5%
Thailand	-5.6%	-0.8%

Main EMD currencies versus Euro	Q2 change	Q3 change
Brazil	-10.7%	-3.2%
Poland	-3.4%	2.4%
Mexico	-6.2%	-4.9%
Malaysia	-4.2%	-6.2%
South Africa	-7.9%	-5.3%
Thailand	-7.1%	-4.4%

Main EMD currencies versus Sterling	Q2 change	Q3 change
Brazil	-9.5%	-5.4%
Poland	-2.1%	0.1%
Mexico	-4.9%	-7.1%
Malaysia	-2.2%	-8.9%
South Africa	-6.6%	-7.4%
Thailand	-5.9%	-6.6%

(Source: Bloomberg)

ASSET FLOWS AND CURRENT ACCOUNTS

Portfolio flows into EM bonds have been very strong for the last two to three years. But the weakness in EM markets in recent months has seen a sharp reversal in tracked portfolio flows. Chart 3 below clearly shows this phenomenon. However, portfolio flows have since stabilized, and we also note anecdotal evidence that the most recent data in September on fund flows have just returned to a small positive again for EMD funds. According to JPMorgan, in-flows returned for the first time after 17 consecutive weeks of out-flows as the Fed's non-taper acted as a catalyst for renewed risk appetite. As per JPMorgan’s survey, EM bond funds posted $743 million of retail subscriptions for the week ending September 25, while their EM client survey recorded an additional $9 billion in strategic in-flows, largely in the third quarter, confirming sustained institutional in-flows since May. JPMorgan estimates that in-flows into dedicated EM fixed income stand at around $19.7 billion for the year to date.

Chart 3. EMD Strategic and Retail Fund Flows

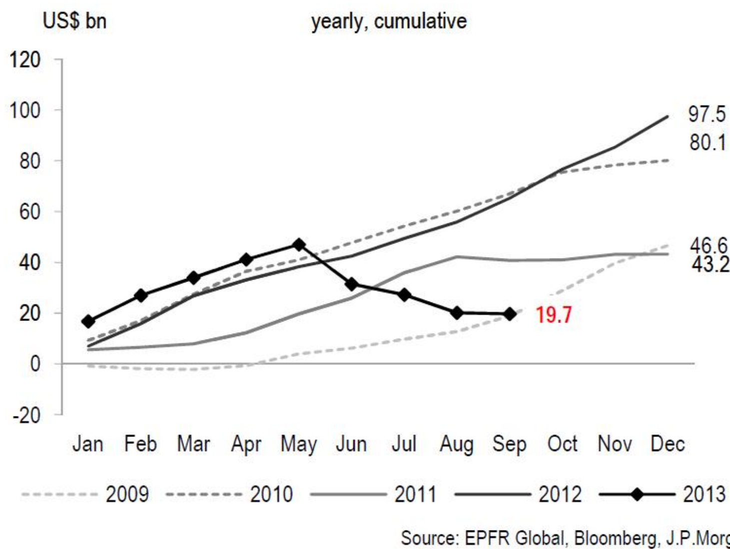
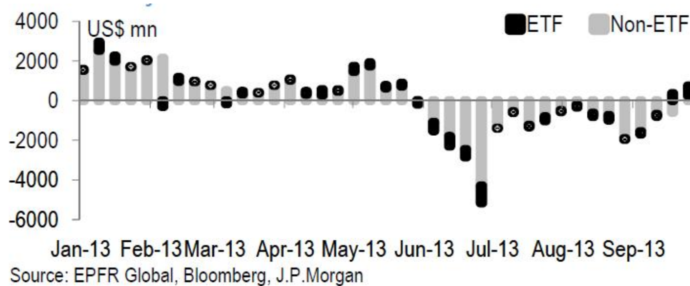


Chart 4. EMD Mutual Fund Flows

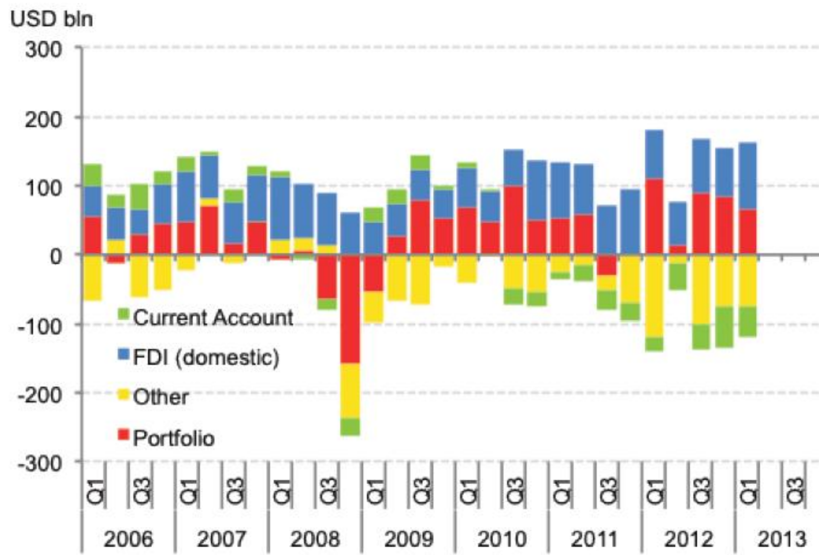


However, it is important to note that such fund flows do not represent the total EMD market. Industry estimates suggest these fund flows represent about 20% of the market,[3] and that much of this is retail-oriented money that can be relatively short-term in focus. Anecdotally, it would seem that a significant proportion of asset flows into EMD in recent years has been institutional mandates, and such mandates tend to be longer-term investors and most will not show up in the data. Broadly speaking, Mercer's own analysis backs this up, with our annual Asset Allocation Survey showing that 13% of European pension funds had an allocation to EMD in 2013, versus 2% in our 2010 survey.

An associated question for EM countries relates to their current accounts. One of the positive factors for EM economies in recent years has been that current accounts generally were in a positive balance. This in turn generated sizeable currency reserves. However, in recent years these current account balances have become meaningfully negative. The reduction in current account surpluses causes some concern, since it raises questions regarding who will finance such deficits if they become more entrenched. The answer to this lies partly in portfolio flows, but it is also reliant on Foreign Direct Investment (FDI). In this regard, the data shows that FDI flows have been consistently positive for the past few years, and they have always been larger than the current account balance (surplus or deficit).

[3] Tharian S. "Delving Deeper into EM Bond Flows," Standard Chartered, July 2013.

Chart 5. Capital Flows to EM Countries (ex China)



Sources: Haver Analytics, Stone Harbor Investment Partners LP

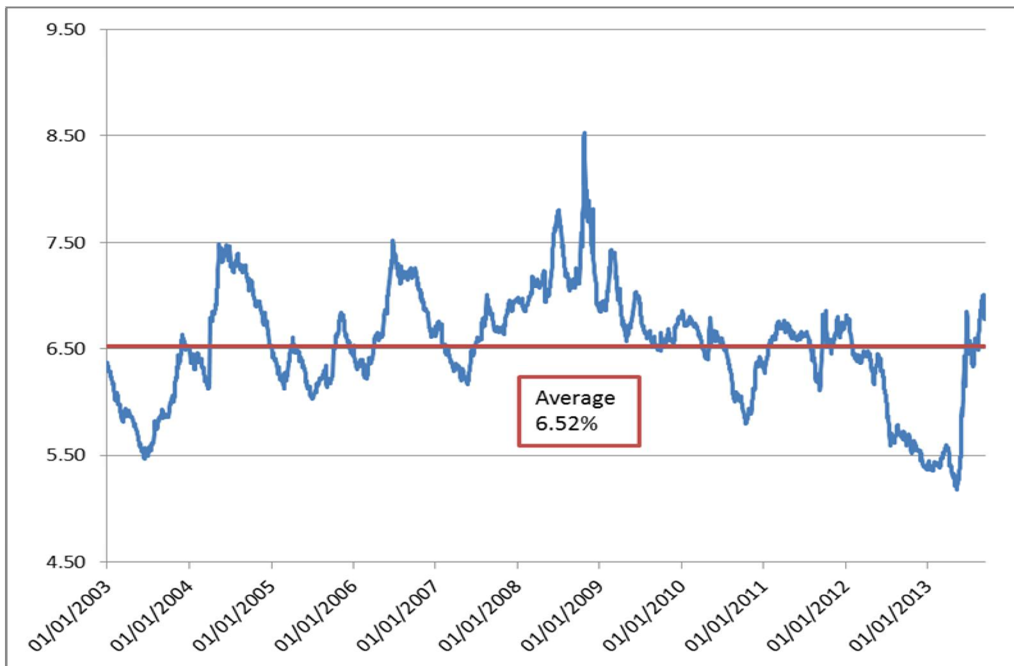
If the broad story of EM economic growth remains intact, it seems likely that FDI flows would continue to be positive, since the reasons for such growth include factors such as productivity gains and favorable demographics, which attract global capital investment. Allied to an increasingly institutional portfolio asset flow (and bolstered by reserves built up from previous surpluses), these factors suggest that EM countries should be able to adequately finance current account deficits.

VALUATION

In a longer-term context, the recent back-up in yields brings the market to levels last seen in early 2011, and it could be regarded positively for investors considering making new or increased allocations to EMD. Interestingly, the current index yield level is now trading modestly above the 10-year average. However, over this period, the creditworthiness of the issuers in the index has improved markedly. The index now has an average issuer credit rating of A-,[4] with just over 70% of the market being rated investment grade, compared with 50% in 2003. This would suggest that there is a lot more value in today's yield than at the similar yield levels ten years ago.

[4] Source: JPMorgan and Stone Harbor Investment Partners, Index — JPMorgan EMBI Global Index..

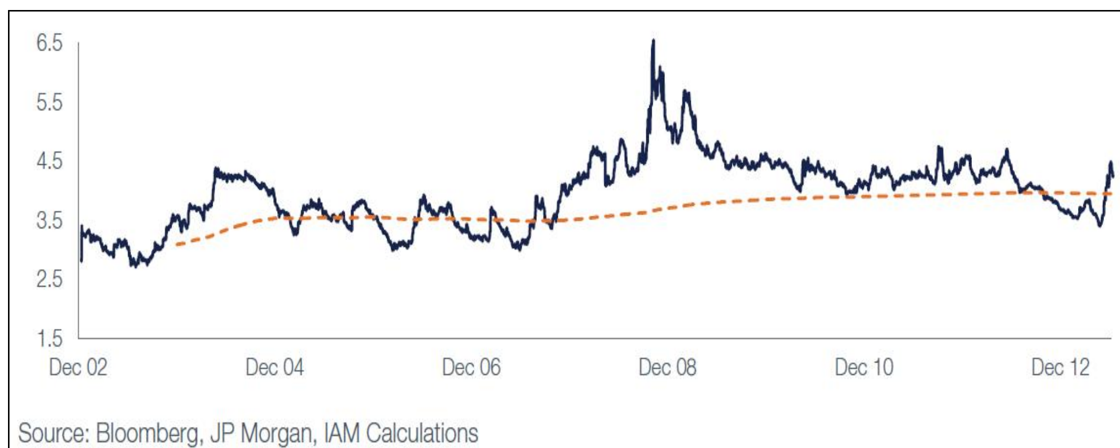
Chart 6. Local Currency EMD Index Yield Since 2003



Source: JPMorgan

The relative valuation of EM bonds versus developed market sovereign bonds also looks attractive. This partly reflects the improved creditworthiness of EM countries over time, as mentioned earlier. It also reflects some deterioration in the quality of developed market issuers, most obviously in the eurozone periphery (although it should be noted that this is only a small portion of the overall market). Chart 7 below shows the spread between the two categories. Looking back historically, we can see that the spread generally does not often move much higher than the current level of around 450 bps. The relative attractiveness of EM yields is further enhanced by the low (albeit rising) absolute level of global sovereign yields.

Chart 7. Spread Between Local Currency EMD and Global Sovereign Yields



Source: Bloomberg, JP Morgan, IAM Calculations

A significant positive factor for EMD is the relatively low debt/GDP ratios of the EM issuer countries, with most ratios being a good deal lower than the developed economies of the world. This can be seen in Table 2 below:

Table 2. Debt/GDP Ratios — Developed and Emerging Market Economies

Statistical Table 4. Advanced Economies: General Government Gross Debt and Net Debt
(Percent of GDP)

	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Average	76.9	74.2	81.3	94.9	101.5	105.5	110.2	109.3	109.5	108.7	107.6	106.5	105.4
Euro area	68.6	66.5	70.3	80.0	85.6	88.1	92.9	95.0	95.3	94.6	93.2	91.8	90.0
G-7	85.3	83.2	91.5	106.6	114.9	120.1	124.8	123.9	124.2	123.3	122.0	120.9	119.9
G-20 advanced	81.6	79.4	87.4	102.0	109.0	113.5	117.8	116.6	116.7	115.8	114.5	113.3	112.0

Statistical Table 8. Emerging Market Economies: General Government Gross Debt and Net Debt
(Percent of GDP)

	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Average	36.9	35.4	33.5	36.0	40.3	36.7	35.2	34.3	33.6	32.5	31.3	29.9	28.3
Asia	34.4	34.8	31.4	31.4	40.8	34.4	32.2	31.0	30.0	28.6	27.0	25.2	23.1
Europe	26.4	23.5	23.6	29.5	29.1	27.8	26.1	25.9	26.4	26.3	26.2	26.0	25.5
Latin America	50.8	49.7	50.5	53.5	51.9	51.7	52.4	50.9	50.3	49.4	48.3	47.3	46.6
Middle East and North Africa	78.4	71.1	62.3	64.9	66.8	70.1	74.9	78.8	77.1	74.8	71.7	68.1	63.9
G-20 emerging	36.5	35.4	33.0	34.6	39.9	35.5	33.7	32.4	31.6	30.5	29.2	27.7	26.0

Source: IMF World Outlook April 2013

Looking forward, low debt/GDP levels are a healthy starting point, but ongoing and future economic growth is required to help maintain the ratios at such levels. Generally speaking, most commentators' forecasts for EM countries continue to be positive, and below we set out the IMF growth projections for a relevant selection of EM countries (that is, those that are significant issuers of local currency bonds) out to 2014. These forecasts show higher projected growth rates for these EM countries than for the developed world economies.

However, it may be worth noting that the highest growth projections are for the Asia region (around 7% growth rates), particularly China and India (neither of which is a constituent member of the most common local currency EMD index). Presumably, a corollary that can be deduced is that the positive growth projections for the wider group of EM countries are to some extent dependent on China and India successfully delivering their own growth projections. We note that the projections below are from the *IMF World Outlook* of July 2013, and so they were published after the tough market conditions experienced in the second quarter of 2013.

Table 3. Real GDP Projections (Year-on-year percentage) — *IMF World Outlook*, July 2013

Country	2011	2012	Projection 2013	Projection 2014
Brazil	2.7	0.9	2.5	3.2
Mexico	3.9	3.9	2.9	3.2
ASEAN 5	4.5	6.1	5.6	5.7
Central and Eastern Europe	5.4	1.4	2.2	2.8
Advanced economies	1.7	1.2	1.2	2.1

Source: *IMF World Outlook*, July 2013. ASEAN 5 refers to Indonesia, Malaysia, Thailand, Philippines, and Vietnam. The first three are issuers of local currency debt.

The relatively benign behavior of inflation in EM economies (given the historic problems that many of these countries have had with high inflation and, indeed, hyperinflation) was a factor

that helped drive the bull market in EMD in recent years. The recent weakness of some key EM currencies is unhelpful in this regard, since a sharply falling currency will typically push up inflation, at least in terms of a one-off effect. That such currency weakness caused Brazil recently to undertake a significant intervention program to support its currency, and increase interest rates to 9%, is testimony to the gravity of such currency moves and a desire for EM countries to avoid inflation. Table 4 below summarizes recent inflation history across the main EM issuer countries; we can generally see that the inflation performance has been good. On balance, we feel that the ability demonstrated by EM countries in recent years to bring down inflation successfully marks a significant improvement in the credibility of their bond markets and, indeed, their central banks.

Table 4. Inflation Levels, Policy, and Base Rates

Country	Inflation target	Latest reading	Base rate	Last change
Brazil	4.5% +/- 2%	6.3% (July 2013)	9.0%	+0.5% (Aug 2013)
Malaysia	None specified	2.0% (July 2013)	3.0%	+0.25% (Jun 2011)
Mexico	3.0%	3.5% (August 2013)	3.75%	-0.25% (Sep 2013)
Poland	2.5% +/- 1%	1.1% (July 2013)	2.5%	-0.25% (Jul 2013)
Thailand	0.5% - 3.0% (core)	1.6% (August 2013)	2.5%	-0.25% (Jul 2013)
South Africa	3%–6%	6.3% (July 2013)	5.0%	-0.5% (Jul 2012)
Russia	5%–6%	6.5% (August 2013)	8.25%	+0.25 (Sep 2012)

Source: Individual country central bank websites

To help see EMD in a broader global context, Table 5 below shows a summary that sets out key bond and economic metrics for the main local currency EM issuers, along with a number of developed market countries. Although the data is summary in nature, it does show some interesting contrasts between the various bond markets, perhaps most strikingly in relation to the growth outlook and indebtedness.

Table 5. Bond Market and Economic Data by Sample Countries

Country	10-year bond yield	Credit rating	Debt/GDP ratio	2014 GDP growth forecast	Inflation rate (most recent data)
USA	2.8%	Aaa	106.5%	2.7%	2.0%
UK	2.9%	Aa1	90.3%	1.5%	2.8%
Germany	2.0%	Aaa	82.0%	1.3%	1.5%, euro 1.3%,
Italy	4.5%	Baa2	127.0%	0.7%	1.2%, euro 1.3%,
France	2.5%	Aa1	90.3%	0.8%	0.9%, euro 1.3%,
Brazil	11.8%	Baa2	68.5%	3.2%	6.3%
Poland	4.5%	A2	55.2%	2.2%	1.1%
Malaysia	3.9%	Aa1	55.5%	5.2%	2.0%
Mexico	6.2%	Baa1	43.5%	3.2%	3.5%
Thailand	4.3%	Baa1	44.3%	4.2%	1.6%
Sth. Africa	7.8%	Baa1	42.3%	2.9%	6.3%
Russia	7.3%	Baa1	10.9%	3.3%	6.5%

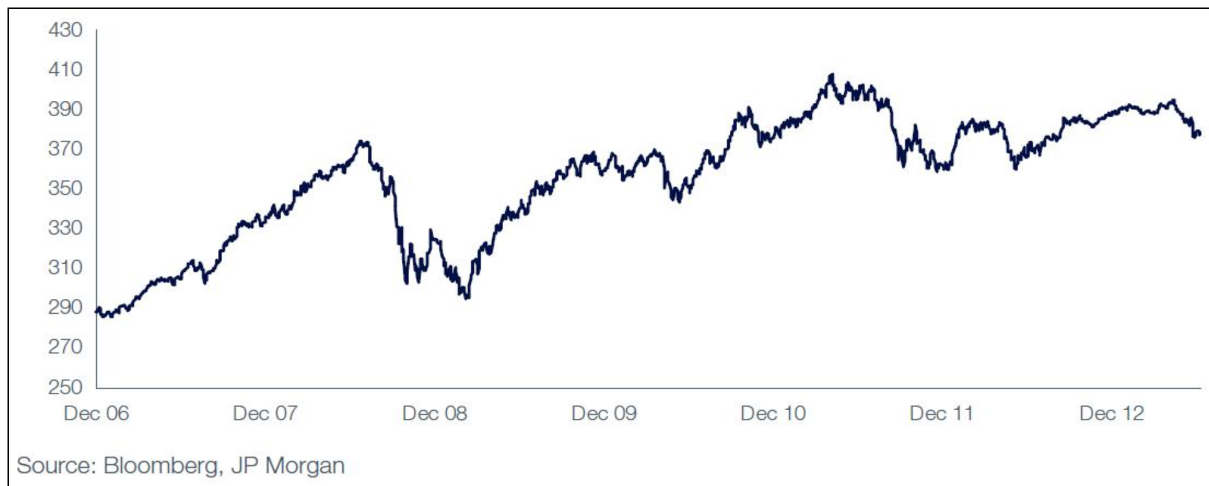
Source: Bloomberg and individual county central bank websites. Bond yields as at 12 September 2013. EM bond yields in local currency. Credit ratings from Moody's. Debt/GDP ratios and growth forecasts from IMF.

CURRENCY OUTLOOK

We believe there are a number of factors that should support EM currencies over time, leading us to expect a modest appreciation of such currencies against developed country currencies over the medium term. These factors are higher economic growth rates, strong levels of FDI, and higher yield levels (both nominal and real). The main challenges to such an assessment come from policy/political will, and from a change in the dynamics of EM current account balances as countries develop and begin to generate larger consumer-led import balances.

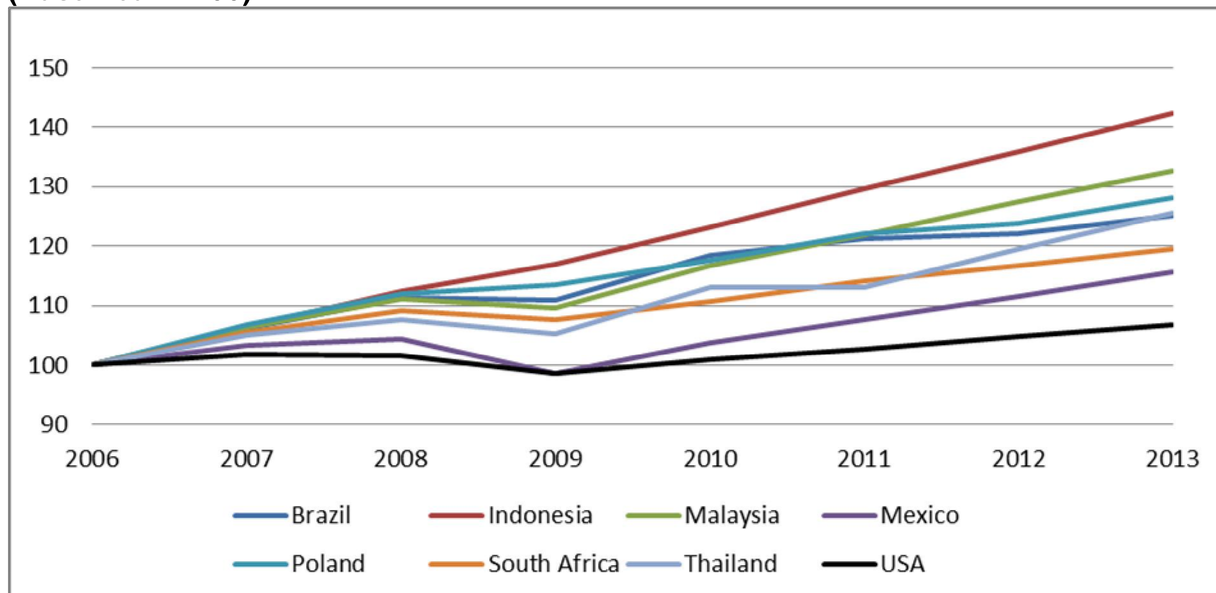
Chart 8 below shows the performance of EM currencies in aggregate versus the US dollar since 2005, and appreciation of the EM currencies over that time period. Chart 9 illustrates the relative GDP performance of various EM countries and the US over the same period. It can be seen that over this period, the EM countries have indeed achieved higher levels of growth than the US. Also over this period, EM countries showed a positive pattern of FDI flows, as shown in Chart 5 of FDI flows (see Asset Flows and Current Accounts section).

Chart 8. EM Currencies Versus the US Dollar



Source: Bloomberg, JP Morgan

Chart 9. EM GDP Growth Rates Versus the US Since 2006 (Base Year = 100)



Sources: 2006–2012 World Bank; 2013 IMF

Looking forward, the main factors underpinning our view (that is, growth levels, FDI flows, and yield differentials) remain supportive of EM currencies. However, as EM countries develop further, it is fair to say that there will be some convergence of these factors. With the US and European economies now on some form of recovery trajectory after the global financial crisis and the eurozone sovereign crisis, and with China aiming for lower sustainable growth, the "growth advantage" for EM currencies is less than it has been previously. Nevertheless, it remains a positive advantage. As mentioned, the weakening of current account surpluses is another factor that can weigh on EM currencies. To some extent, such a pattern is to be expected, since the development of a country will tend to mean a social rebalance from low-income to middle-income levels that in turn leads to increased demand for consumer goods, which in large part is satisfied by imports.

Table 6 below does indeed show that current account balances in many countries are moving to negative readings. Nevertheless, assuming the broad story of EM growth remains intact, it seems likely that wider capital in-flows can continue to be a positive for EM countries, since the reasons for such growth include factors (such as productivity gains and favorable demographics) that attract global capital investment. As with the earlier point on growth rates, the move to modest current account deficits does represent a weakening of this factor in favor of EM currencies, but nevertheless it is likely to remain a positive for a number of years.

Table 6. Inflation and Current Account Balances — Emerging Market Economies

Region			2011	2012	2013	2014	2015	2016	2017	2018
ASEAN-5	Inflation CPI	%	5.9	3.9	4.5	4.5	4.5	4.3	4.0	3.7
ASEAN-5	Current A/C	% GDP	2.6	0.8	0.6	0.4	0.0	-0.2	-0.6	-0.8
Lat Am/Caribb.	Inflation CPI	%	6.6	6.0	6.1	5.7	5.4	5.2	5.1	5.1
Lat Am/Caribb.	Current A/C	% GDP	-1.3	-1.7	-1.7	-2.0	-2.1	-2.2	-2.3	-2.4

Source: *IMF World Outlook*, April 2013

Of course, in many asset classes, currency exposures are routinely hedged. We have therefore asked ourselves if it would be worth strategically hedging EM currency exposures. In short, the answer is no, since hedging costs for EM currencies tend to be prohibitively high. At an overall index level, hedging costs could eat up to 3% per annum; that is, nearly half of the prevailing yield. One could consider a selective hedging approach (for example, hedge only those currencies for which the analysis does not indicate a positive currency appreciation over time). Although this would reduce the overall hedging cost, it would not do so by very much, since the “selected” currencies generally happen to be those with the relatively higher hedging costs. However, this does indicate scope for potentially significant added value by selecting an active manager that has the skillset to manage EM currency exposures and opportunistically hedge at times when it is appropriate to do so.

LOOKING FORWARD

In the short term, it is possible that the US economy will generate further positive news flow while the large emerging markets continue to struggle with the diverse set of challenges facing their economies. This raises the prospect of further liquidity withdrawals from emerging markets as investors revisit concerns around the possible timing of QE tapering and contemplate the implications of a strengthening dollar, rising treasury yields, tighter credit conditions in China and the urgent need for economic reforms in India Tensions in the Middle East add to concerns, and it is also worth noting that elections are looming in some countries like Brazil, India, and Indonesia. In Merrill Lynch’s Global Fund Manager Survey posted in July it showed sentiment towards emerging markets was as negative as it has been for over a decade and some have argued that the recent liquidity reversal could be self-reinforcing, with market moves both responding to and exacerbating any economic weakness. However, a counter-argument could be that extreme readings in sentiment indicators can turn out to be good contrarian signals. In this regard, we also note that the most recent data on fund flows have just turned positive for EMD funds.

From our viewpoint, we believe that the long-term strategic case for emerging market investment remains strong: growth in emerging economies is expected to outpace developed world growth over the next 5-10 years; emerging market government balance sheets are much less encumbered by debt than most developed economies; and demographic trends (with some

exceptions) are more favorable than for developed economies. Although these positive economic conditions will not necessarily feed directly through to market performance, it seems reasonable to expect faster growing, more vibrant economies, with a growing labor force and greater flexibility in their fiscal and monetary policies, to create a positive environment for investors. This does contrast with lower than normal growth rates in the more indebted developed market economies.

CONCLUSIONS

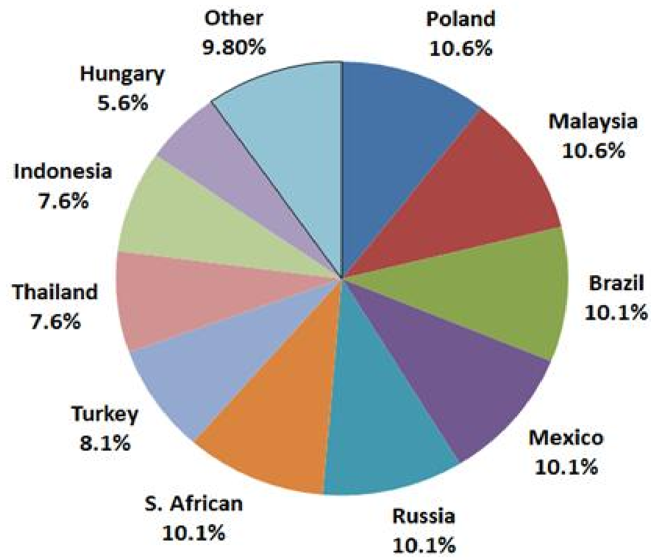
Overall, our judgment is that the sharp market moves seen in recent months are more reflective of market behavior and positioning, rather than a substantial change in the fundamentals of EMD issuers from a bond-creditworthiness viewpoint. We view the recent back-up in yields and currency weakness as an opportunity to invest in this asset class. We continue to favor local currency debt over hard currencies as the core of a portfolio on the grounds of higher issuer quality, higher yield, and the potential for currency appreciation over time. We recognize, however, that hard currency may provide an attractive opportunity in the near term, particularly as talks of a Fed taper, and its impact on the dollar, intensifies. As a result, blended products (with both hard and local currency) may play an increasingly significant role to play.

The recent volatility does serve to highlight the risks of investing in EMD. As with all growth assets, there are a number of risks and uncertainties that can affect the asset class. Growth prospects for EM economies are heavily influenced by the wider global economy, while the narrowing of current account surpluses into deficits is a “growing pain” that can put stress on EM currencies and, through this mechanism, on monetary policy. Given the policy uncertainties that exist at a global level, such as the eurozone crisis and more recent changes in US monetary policy, volatility in EMD may persist for some time, and investors need to be aware of these factors. This being the case, it may be appropriate for some investors to consider making any new allocations to EMD on a phased basis, in order to mitigate timing risk. And we reiterate our strong preference for active management in this asset class. As this paper outlines, there are a number of risks and challenges facing EM economies in the current environment and active management is essential in order that portfolios can be appropriately constructed to reflect the manner in which various issuer countries address these challenges.

APPENDIX

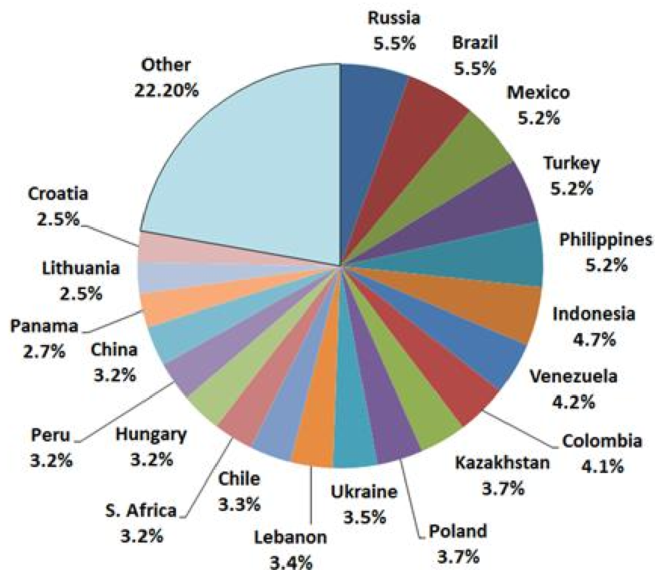
EMD Local Currency Market

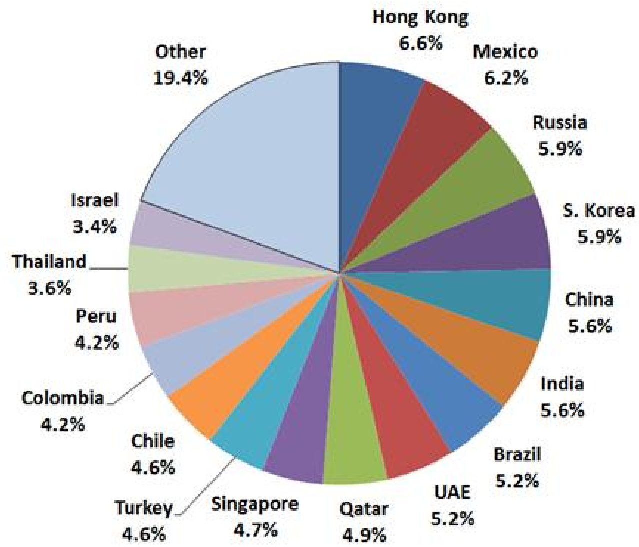
JPM GBI-EM Global Diversified	
Mod Duration (years)	4.65
Maturity (years)	6.82
Yield	6.82%



EMD Hard Currency Market

JPM EMBI Global Diversified	
Mod Duration (years)	6.49
Avg Life (years)	10.31
Yield	5.91%





Source: Blackrock Investment Management

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