Multi Asset | Mixed Investments

The building blocks of the Mixed Investment Funds

Emerging Market Debt

In a low-yield world, emerging market debt has become a popular asset class for income-hungry investors. But which dynamics drive this unique asset class?

Developed market government bonds have long been a cornerstone of multi-asset portfolios, offering a low-risk option with which to diversify equity portfolios whilst providing regular cash flows.

Yield hunting within the fixed income universe has traditionally led investors away from government bonds and towards corporate bonds. Over the past few decades, a newer offering has presented itself to investors: emerging market debt. Spanning the emerging market debt universe is an array of securities; some of the debt is denominated in hard currency, whilst some is denominated in local currency (more on this later), some of the debt is issued by governments whilst some is issued by corporations, there is even debt which derives its value from the level of inflation in the economy.

HOW BIG IS THE MARKET?

Predominantly, emerging market debt is considered in two broad buckets: hard currency debt (debt issued by an emerging market country in a global reserve or widely-used, 'hard' currency such as US dollars or euros) and local currency debt (debt issued by an emerging market in their home or local currency like the Brazilian real or Turkish lira).

Hard Currency

US Dollars
Pounds sterling, Euro

or

'Soft'

Local Currency
e.g. Ruble, Brazil real

Example ~ 10 Year Bonds			
	Developed Market Bond	**Hard Currency Bond**	**Local Currency Bond**
Issuer	US Government	Brazilian government	Brazilian government
Currency	US dollars	US dollars	Brazilian real
Yield	2.6%	4.7%	8.2%

Correct at 14 March 2019, based on mid YTM

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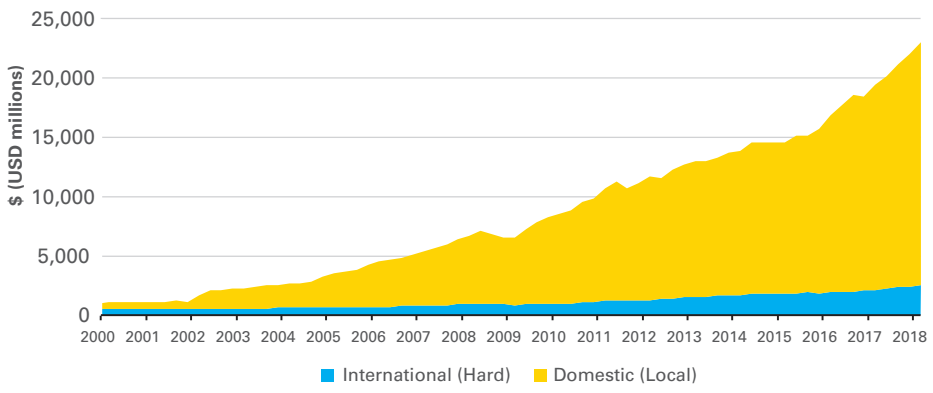
INVESTMENT MANAGEMENT

Local currency debt is a slightly newer phenomenon than its companion, primarily because traditionally investors were reluctant to invest in less well-developed local debt markets. But in recent years local debt markets have seen an explosion in size as the market matures. Hard currency markets have grown five-fold since the turn of the century, rising to $2.5tn at the end of the first quarter of 2018. This is overshadowed by the fifty-fold growth experienced in the local currency market, which now stands at just over $20tn.[1]

While many countries issue local currency debt, domestic Chinese debt amounts to over half of the total across all emerging economies, standing at over $12 trillion. The hard currency debt market is significantly less concentrated, with the 10 largest issuers accounting for 60% of the total outstanding debt; the same proportion of local currency debt that China has issued.

Figures 2 & 3 show the breakdown of countries that the Mixed Investment Funds gain exposure to, through LGIM funds which track J.P. Morgan indices. These indices exclude China due to restrictions around foreign investors holding Chinese debt.

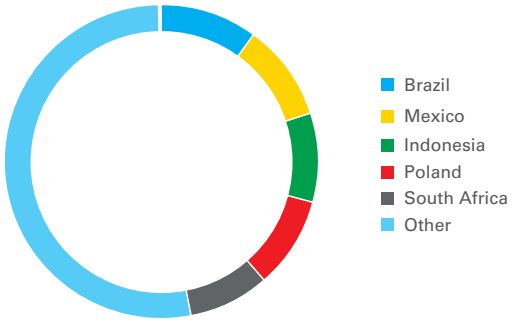
Figure 1: Total stock of debt



Source: BIS as at 31 March 2018

Figure 2: Local Currency Debt

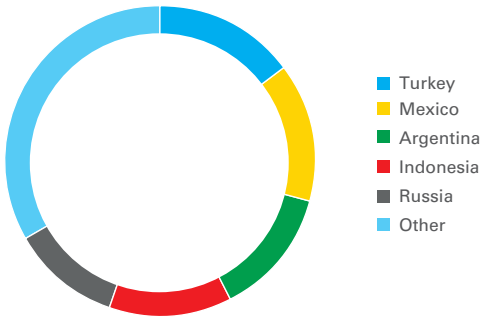
J.P. Morgan GBI-EM Global Diversified Index



Source: J.P. Morgan as at 31 December 2018

Figure 3: Hard Currency Debt

J.P. Morgan EMBI + Index



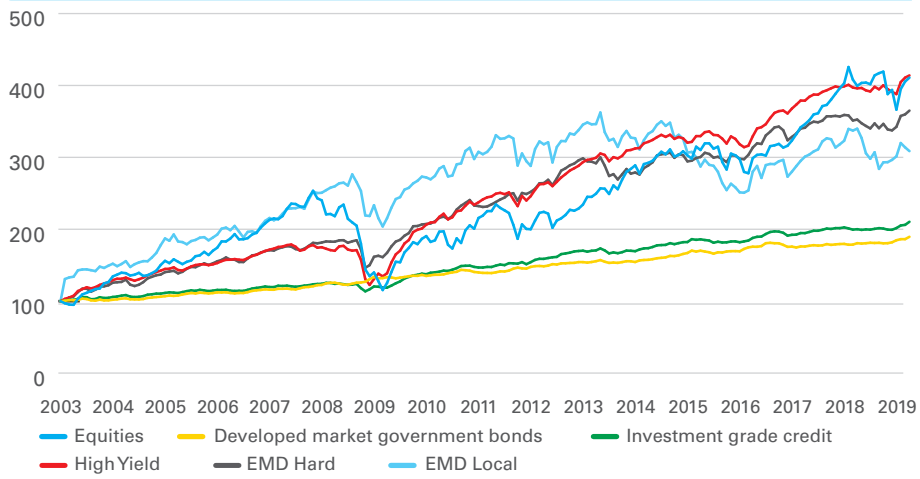
Source: J.P. Morgan as at 31 December 2018

1 Source: BIS as at 31 March 2018

RETURNS & CHARACTERISTICS

To the right is a comparison between emerging market debt and several broad asset classes, which form a significant proportion of the Mixed Investment Funds, in terms of returns, volatility and correlations. Emerging market debt returns and volatility numbers since the end of 2002 have demonstrated that both types of debt fall into the mid-high risk category. To put this in a cross-asset context, emerging market debt is risker than developed market bonds, but less risky than equities, much like high yield bonds. As can be seen in the table in Figure 4, correlations to other key asset classes are not excessive, making them a good diversifier within portfolios, although hard currency debt does exhibit a reasonably high correlation with credit and high yield markets.[2]

Figure 4: Cumulative Returns



Past performance is not a guide to the future performance

Correlations

	Equities	Developed market government bonds	Investment grade credit	High Yield	EMD Hard	EMD Local
Equities		-0.21	0.38	0.77	0.62	0.55
Developed market government bonds	-0.21		0.63	-0.08	0.32	0.11
Investment grade credit	0.38	0.63		0.61	0.78	0.42
High Yield	0.77	-0.08	0.61		0.81	0.57
EMD Hard	0.62	0.32	0.78	0.81		0.65
EMD Local	0.55	0.11	0.42	0.57	0.65	

	Equities	Developed market government bonds	Investment grade credit	High Yield	EMD Hard	EMD Local
Returns per annum	9.1%	4.0%	4.7%	9.1%	8.3%	7.2%
Volatility per annum	14.8%	2.8%	3.8%	8.7%	8.1%	14.6%

Source:Bloomberg, date range: 31 December 2002 to 31 March 2019

KEY CONSIDERATIONS WHEN INVESTING IN EMERGING MARKET DEBT

As is usual with debt, default risk is one of the key drivers of its value. Emerging market debt is no exception; risky countries offer higher yielding bonds to compensate investors for the elevated chance they will not be paid back. One of the other key characteristics of emerging market debt is exposure to currency risk, albeit in different ways.

Issuers of hard currency debt carry the risk of foreign currency liability mismatches – i.e. that they need to pay interest on the debt issued in US dollars, but they may not have any US dollars to make the payments. The best way for an emerging market government to acquire US dollars is through trade, but there are other mechanisms too. The country may sell its own currency and purchase dollars on the open market to finance the mismatch. However, this is not ideal due to the volatility of currency markets, as most of us know from booking foreign holidays, when we find the pound has weakened drastically the trip ends up costing much more than anticipated. Another option commonly employed is to save foreign currency in reserves, using these reserves when the dollar is expensive and replenishing them when it's cheap. If a country can't get their hands on dollars through any of these mechanisms, it will default on the debt. To understand this better, consider Mexico issuing hard currency debt. They need to pay the interest on this debt in dollars. There are three options for the sources of these dollars. Revenues earned on the sale of goods and services could be used, as could dollars purchased on the open market using pesos, or alternatively they could dip into their dollar reserves. If they had issued their debt in pesos instead, they could simply have gone to the mint and printed pesos to repay their debt, and this is where local currency debt really differs.

2 Indices used here are as follows:
Equities: FTSE All-World Total Return Index, in USD
Developed market government bonds: Barclays Bloomberg Global Aggregate Treasuries Total Return Index, USD hedged
Credit: Barclays Bloomberg Global Corporate Aggregate Total Return Index, USD hedged
High yield: Barclays Bloomberg Global High Yield Total Return Index, USD hedged
EMD hard: J.P. Morgan EMBI Total Return Index
EMD local: J.P. Morgan GBI-EM Total Return Index, in USD. Date range 31 December 2002 – 31 March 2019

Government issuers of local currency debt have the benefit that they have control over monetary policy, making the debt much safer in local currency terms. However, foreign investors in local currency emerging market debt are purchasing an asset denominated in an alternative currency, so currency fluctuations will affect returns for investors. Exceptional monetary policy decisions will impact a currency, so whilst printing money ensures the safety of the debt, it also could lead to a deterioration in the value of the currency. This currency risk is therefore an additional risk to investing in local currency bonds, borne by the investor.

The returns difference generated by the currency component is not a moot point, as can be seen through the reasonably weak relationship between the returns of hard and local currency emerging market debt, as well as the difference in yield.

Hard currency debt has a greater level of correlation to other fixed income asset classes, in particular to credit and high yield. Investors often assess hard currency debt in a similar manner; considering the 'credit spread' above US Treasuries. When deciding whether to invest in hard currency debt, an investor should ask how much risk there is that the issuer will be unable to repay their debt. The less likely, the greater the risk; therefore, the more compensation an investor will demand, increasing the bond's yield. This is the same question an investor asks when considering a corporate bond.

In recent years, we have grown accustomed to high correlations between similar assets across developed economies, indicating the increased synchronisation of economic cycles. This synchronisation does not occur on a global scale. Including emerging market debt in our portfolios, especially in local currency, brings exposure to a greater variety of economies at differing stages in the economic cycle and with different underlying economic profiles, providing greater diversification.

HOW DO WE INVEST?

Exposure to emerging market government bonds is achieved via investments in index tracker funds managed in-house by the index team at LGIM. The funds in question track the J.P. Morgan Emerging Markets Bond Index Plus (EMBI+) for hard currency debt and the J.P. Morgan Government Bond Index Emerging Markets (GBI-EM) Global Diversified for local currency debt. Making the most of LGIM's world class index capabilities in this way allows us to achieve high transparency whilst, keeping our ongoing charges figure (OCF) as small as possible.

We believe that strong risk-adjusted returns coupled with diversification benefits provided by emerging market debt justifies the inclusion of the asset class within the Mixed Investment Funds. Aided by strong in-house capabilities and the increased maturity of the market, emerging market debt has become a key diversifying component of our funds.

DID YOU KNOW?

In 2012, hedge fund Elliot Capital Management seized the ARA Libertad, a ship owned by the Argentine navy, as part of a ruling made by the Ghanaian government after Argentina defaulted on a bond in 2001.

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