What are emerging markets? What types of debt are there? What is emerging market local currency sovereign debt?

This document offers a broad, introductory overview of emerging markets and the risks and benefits of investing in the local currency sovereign debt universe.

What is an emerging market?

The term ‘emerging market’ (EM) broadly describes an economy experiencing rapid growth and industrialisation in a country which is carrying out political reform and transitioning from closed to open market economic policies. Many countries have been characterised by export-led growth and development, but increasingly domestic drivers of growth are coming to the fore.

In addition to growth rates, an investor should also evaluate other country-specific factors that have a bearing on local asset prices. These factors include the prevalence of liquidity in local debt markets, the development of both a regional and international banking system, a move towards an orthodox, independent, inflation-targeting central bank and the degree to which a country has carried out structural reforms to engender competitiveness within the economy. Clearly these markets will not have progressed as far down this path as today’s developed markets (DM), and as such, these economies will be subject to a higher level of risk premia than their developed counterparts and thus reward investors with a higher yield.

Fig. 1 Emerging markets – not all countries are at the same stage of development

Evolution of EM to DM

<table>
<thead>
<tr>
<th>Number of DM Characteristics</th>
<th>Stage of Development</th>
</tr>
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<tbody>
<tr>
<td>Tanzania</td>
<td>Frontier</td>
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<tr>
<td>Developing EM</td>
<td>Developing EM</td>
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<tr>
<td>Mature EM</td>
<td>EM/ Nearly DM</td>
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<td>South Korea</td>
<td>DM</td>
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DM characteristics

- Well-established, liquid local debt markets
- Established local insurance/pension fund industry
- Structural reforms to engender competitiveness within the economy
- Established regional and international banking system
- Free-floating currency/liberalised exchange rate regime
- Open economy (lack of strict barriers to entry/tariffs etc.)
- Clearly-defined and enforced institutional framework (i.e. laws/regulations etc.)
- Orthodox, independent, inflation-targeting central bank
- Market exchange + regulatory framework

At a glance: EM local currency sovereign debt

- EM debt can be broadly split into three sub-asset classes: hard currency debt, local currency debt and corporate debt
- EM local currency sovereign debt on average carries higher yields than DM equivalents
- Investing in EM debt provides access to the inherent growth story present in industrialising nations
- Huge steps have been made within EM to strengthen the domestic macroeconomic environment
- Within EM local currency sovereign debt, investors have access to opportunities within both FX and rates
- JP Morgan Government Bond Index-Emerging Market Broad Diversified (GBI-EM) local currency sovereign index comprises 18 countries, 261 issues, average credit rating of A-
- Investors can attain diversification benefits through EM debt’s historically low correlation with DM debt

Data source: BlueBay Asset Management
**The different types of emerging market debt**

Investors into EM fixed income have access to a broad range of sub-asset classes from which to choose. Broadly they are split into sovereign debt and corporate debt, which in turn can be further divided into hard and local currency assets. The range of sub-asset classes greatly increases the diversification benefits investors can achieve by allocating into EM debt.

The majority of foreign-based investors who invest in local currency sovereign debt markets, actively or passively manage their portfolios to the JP Morgan GBI-EM range of indices. Fig.2 highlights the composition of the JP Morgan GBI-EM Broad Diversified.

**Fig. 2 JP Morgan GBI–EM Broad Diversified Characteristics**

| Market cap | US$1,630bn |
| No. of issuers | 18 |
| No. of issues | 266 |
| Countries | 18 |
| Weighted yield to worst (%) | 6.49 |
| Weighted IR duration (yrs) | 4.87 |

Data source: JP Morgan Emerging Markets Bond Index Monitor, as at 30 June 2014

**What is emerging market local currency sovereign debt?**

EM local currency sovereign debt is a government bond denominated in the domestic currency of an EM issuer e.g. the Mexican government issuing a 10-year bond denominated in the Mexican peso. From the perspective of a foreign investor, an EM local currency sovereign bond can be split into two components: FX and rates. The FX component comprises the local currency return relative to the US dollar while the rates component is made up of the yield carry combined with the effect of interest rate movements.

Local currency sovereign indices generally have a better level of credit quality than their hard currency counterparts as the more stable and developed EM countries have looked increasingly to their domestic markets for financing, thus issuing in their domestic currencies. The average credit rating of the JP Morgan GBI-EM Broad Diversified is around BBB+ while for hard currency it is circa BBB-. Investing in local currency sovereign assets inherently comes with more volatility, although this is balanced by superior credit quality.

For an EM to market their local currency sovereign bonds to international investors, firstly they must have a reasonably developed banking sector that is both domestically and internationally oriented, with a significant amount of local demand. Therefore the 18 countries that constitute the JP Morgan GBI-EM Broad Diversified are comparatively more developed than the majority of countries in the hard currency index.

Fig.3 overleaf depicts the breakdown of total returns for the JP Morgan GBI-EM Broad Diversified, split into FX and rates components.

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*From the perspective of a foreign investor, an emerging market local currency sovereign bond can be split into two components: FX and rates*
What are the risks?

Those investing in EM local currency sovereign debt are exposed to the usual risks associated with bond investing, such as interest, currency, inflation and credit risk. However, these risks are accentuated by the EM country risk exposure of the instruments; notably social and political idiosyncratic risk, a lower degree of market efficiency and a regulatory framework still in development. However, investors are compensated for this additional risk in the form of more attractive yields relative to sovereign bonds issued in developed markets with comparable credit quality. A key characteristic of EM local currency sovereign debt is the FX premium relative to the US dollar and these FX fluctuations can increase volatility in the asset class.

In addition, there is the risk for increased mark-to-market volatility. From the time of issuance to maturity, the fluctuation in price may be greater with an EM sovereign bond relative to its DM counterpart.

What are the benefits?

Despite the continuously improving fundamental backdrop, this debt on average carries higher yields than DM debt, despite being of comparable credit quality. This results in an attractive risk-reward profile, complementing the diversification benefits that can be attained through EM debt’s historically low correlation with developed market debt.

The case for investing in EM has strengthened considerably in recent times. Huge steps have been taken within EM countries to improve infrastructure and to develop stronger property rights. We have also seen fewer incidences of political or social unrest and the introduction of more orthodox monetary and fiscal policies, which has helped to smooth volatility along the economic cycle.

Consequently we believe the investment opportunity within EM continues to strengthen, providing investors with access to the underlying fundamental growth story and the diversification benefits and higher yields inherent within the asset class.