

# Emerging Markets Debt: Only Compelling on a Relative Basis

## Most emerging markets debt assets are not priced to achieve investors' objectives

- Over the last decade EM currencies have appreciated significantly against the US dollar in real terms and seem unlikely to generate attractive returns going forward given limited carry.
- Local currency EM sovereign bonds have attractive nominal yields, but real yields, which drive returns, are lower. We are neutral on the asset class, recognizing that some issuer-specific opportunities are attractive.
- US\$-denominated EM bonds offer broader geographic exposure and a “purer” way to invest in improving sovereign fundamentals; low yields and a potential backup in underlying US Treasury yields make the asset class unattractive.

EM debt—currencies and local currency sovereign bonds—has rallied year-to-date, in many instances recouping losses following last May’s “tapering scare” and the associated concern over the vulnerability of some countries to investor outflows. Despite this performance, lackluster trailing returns (Figure 1) and relatively high yields have caused some investors to ask whether this area presents one of the last remaining attractive *betas* in credit. EM debt does compare favorably relative to other parts of the credit market, like US high-yield bonds, which feature extremely stretched valuations. However, EM debt on its own does not look as attractive; its return potential seems limited relative to certain other diversifying assets and categories of growth assets that include EM equities. Some skilled managers do continue to generate *alpha* via both asset selection and rotation across EM debt market segments, and though we are lukewarm about EM debt assets, we find these strategies worth a look.

This research note reviews the fundamentals and technicals for the major sectors of EM debt and provides our current view on valuations across sectors.

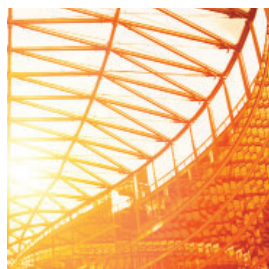
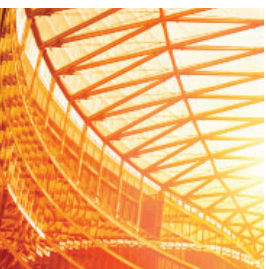
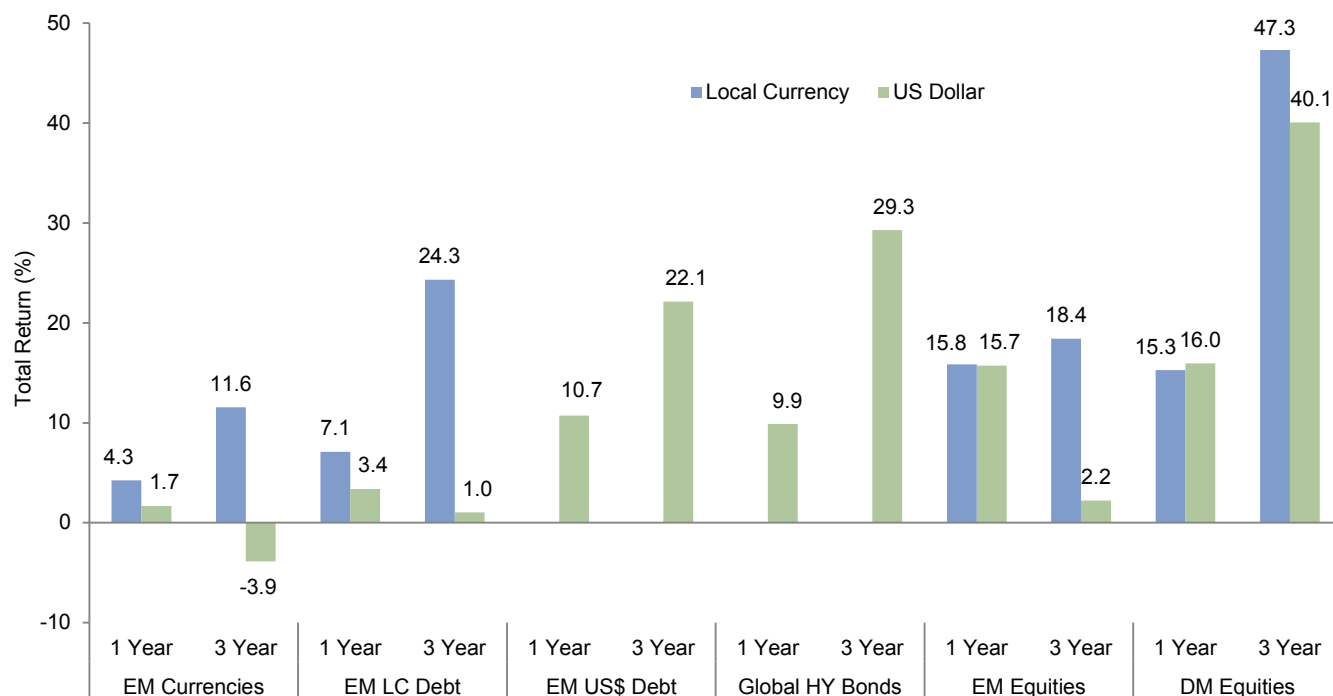


Figure 1. Fixed Income and Equity Trailing Returns  
As of July 31, 2014



## Fundamentals

On an absolute basis credit fundamentals for EM sovereigns have softened but remain attractive; on a relative basis they have not weakened to the extent seen in developed markets like Europe and Japan. GDP growth has fallen due to a variety of forces that include Chinese rebalancing and reduced developed markets demand for exports, but remains above that seen in developed markets. Looking forward, growth is expected to accelerate in most regions as developed markets growth recovers and as exporters receive a boost from the currency depreciation of the past three years (Figure 2).

Although budget deficits have risen as governments try to provide a buffer against slower growth and rising commodity prices, debt levels remain well below those seen in developed nations. Sovereign debt/GDP ratios have trended downward and remain below 50% (Figure 3) for large local currency borrowers like Indonesia, Mexico, South Africa, and Turkey, whereas developed country levels have soared and are nearly twice as high in many instances (e.g., the United States and the United Kingdom). Many EM countries are also reducing their borrowing in non-local currency, providing a buffer against currency volatility and easing repayment concerns.

Figure 2. Change in Exchange Rates Over the Past Three Years  
July 31, 2011 – July 31, 2014

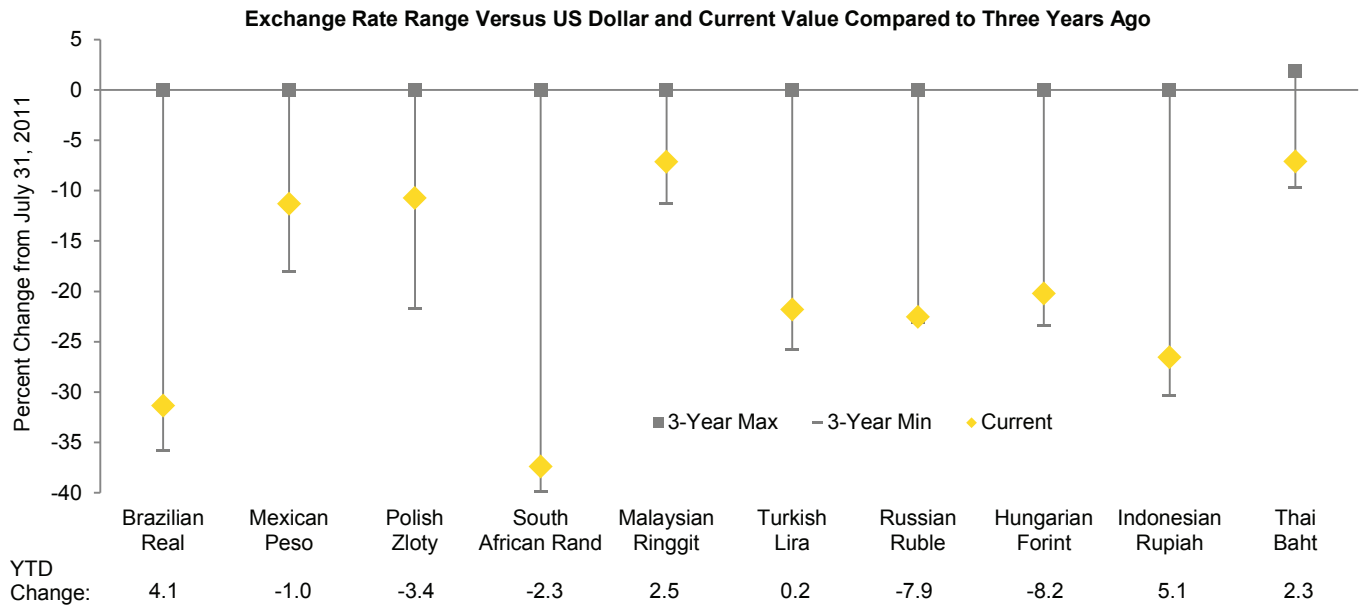
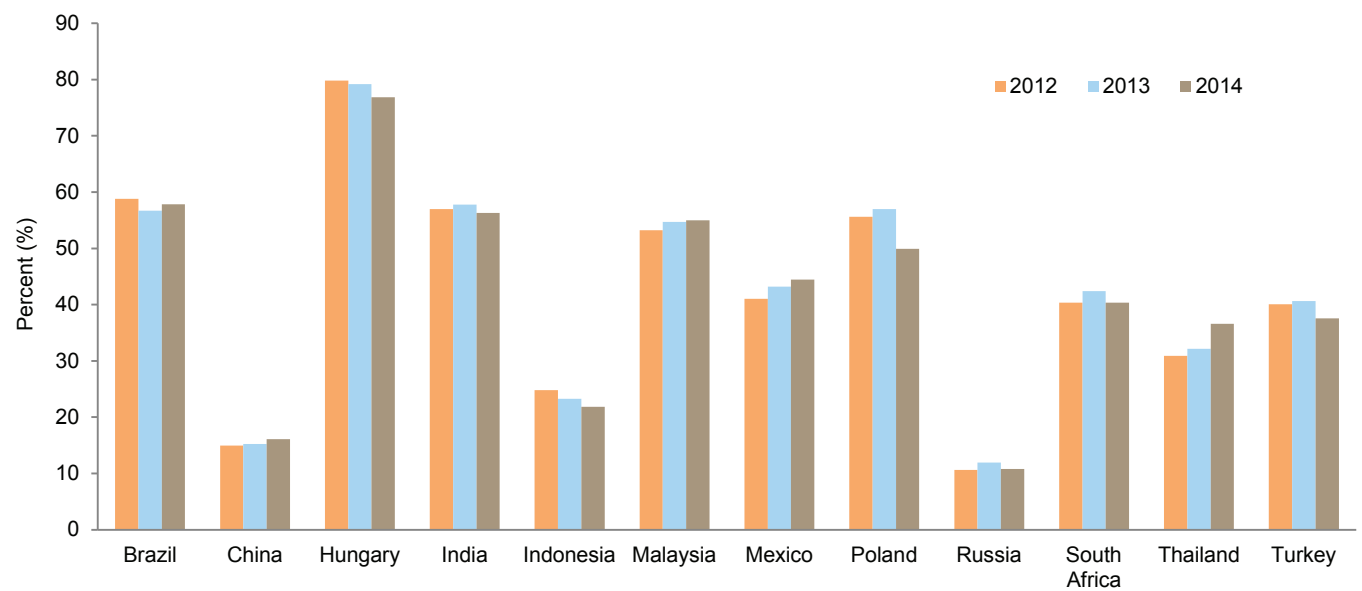


Figure 3. Gross Government Debt (as a Percentage of GDP)  
2012–14

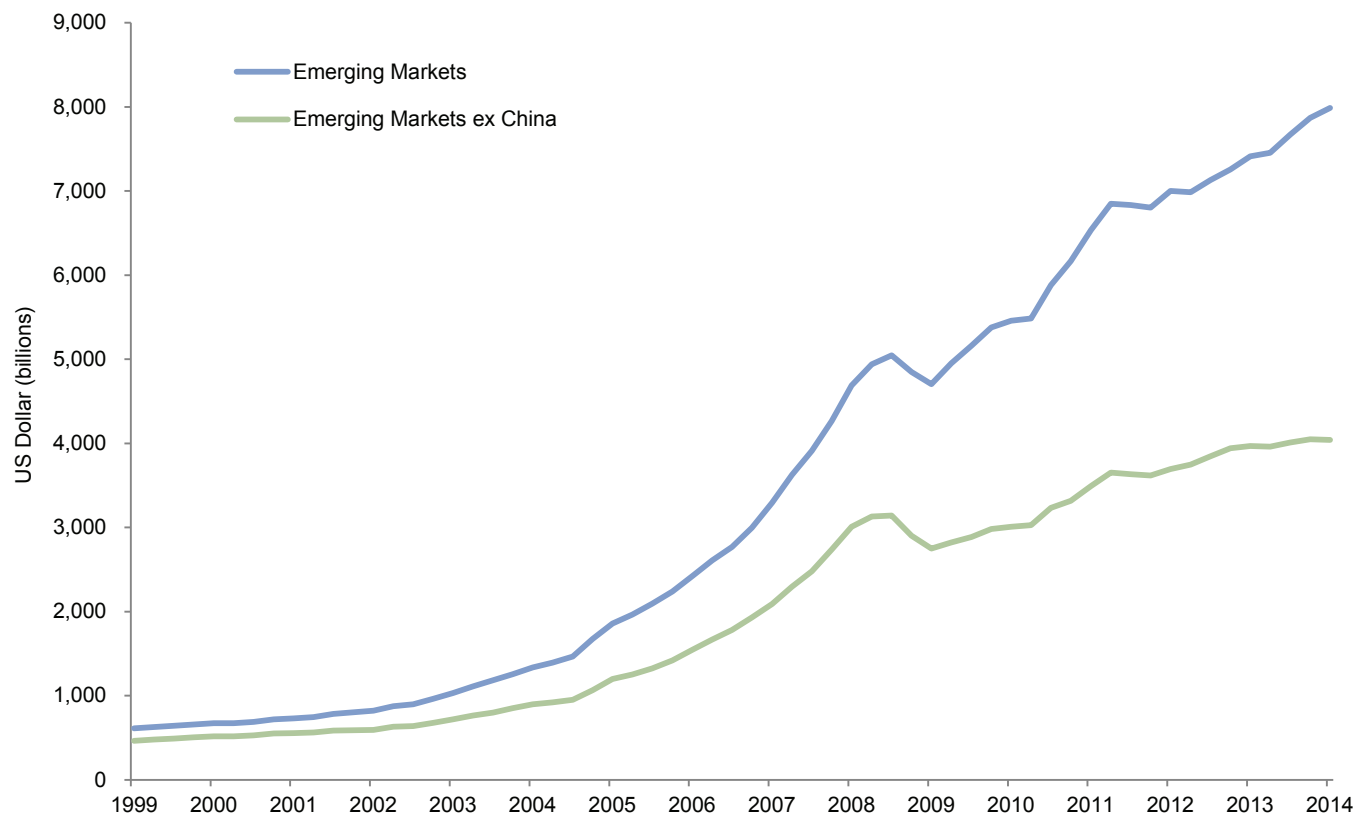


Foreign currency reserve accumulation for EM countries has slowed excluding China, which effectively is forced to buy US dollars as part of its strategy to maintain a favorable exchange rate (Figure 4). Slower reserve accumulation may reflect reduced competitiveness for some exporters (and thus reduced dollar revenues) but also efforts by countries to try to prop up local currencies (by selling dollars and buying local FX) when rate hikes and other measures were failing. Slower reserve accumulation for emerging markets in aggregate conceals dispersion across different regions; some Asian

exporters are seeing reserves *grow* as they buy dollars to try to push down local currencies.

Despite last year's panic many EM countries, including most of the so-called Fragile 5 (Brazil, India, Indonesia, South Africa, and Turkey) have been able to close current account deficits, though progress may prove fleeting and Brazil continues to struggle. Even where improvement has been seen, however, implications for foreign debt investors are nuanced; Indian sovereign bonds, for example, are excluded from most major EM debt indexes and portfolios.

**Figure 4. Foreign Exchange Reserves**  
First Quarter 1999 – First Quarter 2014

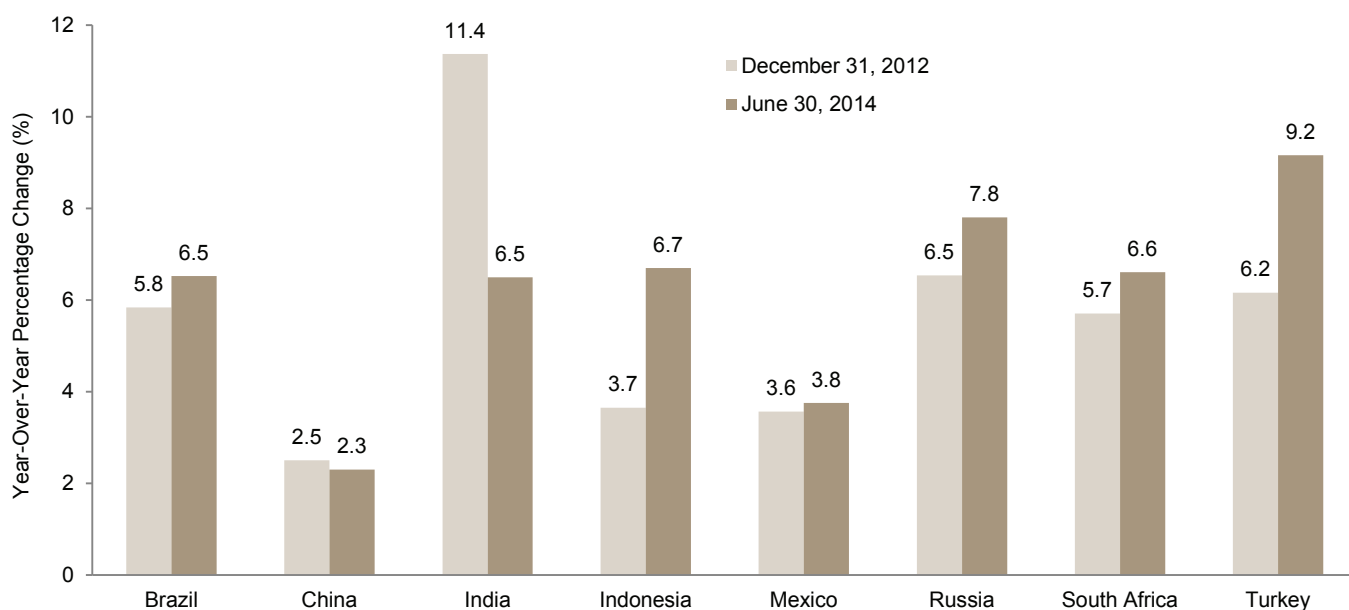


Monetary policy choices entail trade-offs with important implications for foreign investors. Higher real interest rates can help attract capital and boost local currencies (or at least discourage further outflows), but also can cause growth to stall by making credit more expensive. Weaker currencies can encourage exports and thus help close current account deficits (as can import restrictions), though benefits can be offset if inflation means real exchange rates are not falling as quickly. In aggregate, emerging markets have seen inflationary pressures fall in recent years. However, this is because rising price pressures in some large issuers of local currency sovereign debt (including Brazil, Russia, South Africa, and Turkey) have been offset by subdued price pressures in Asian countries like China and

India (note that bonds from these two countries are not typically represented in local currency sovereign debt portfolios) (Figure 5).

The longer-term trend in EM credit ratings has been steadily upward—over 60% of EM sovereign debt has an investment-grade rating compared to around 40% before the global financial crisis, according to J.P. Morgan. However, in recent months, rating agencies have taken a more cautious view on EM sovereigns, with both Brazil and Russia receiving downgrades. Rating downgrades can reflect political risks as much as credit fundamentals; Russia, with large foreign currency reserves and sovereign debt/GDP of less than 10%, seems unlikely to be pushed by market forces to default.

Figure 5. Emerging Markets Inflation



## Technicals

Technicals for EM fixed income have improved but remain mixed. On the demand side, headlines suggested that EM fixed income markets suffered substantial outflows since the tapering scare, but a deeper dive offers a more nuanced perspective. EPFR data, which reflect mutual fund flows globally (but are most indicative of developed markets retail investor demand) indicate that around \$75 billion cumulatively was withdrawn from EM debt mutual funds and exchange-traded funds from June 2013 through

March 2014 (Figure 6). These flows coincided with the poor performance of various EM fixed income assets over the period. Flows turned positive in April and the first half of 2014 saw net inflows of around \$5 billion; cumulative year-to-date levels are still well below similar periods in previous years, according to J.P. Morgan. EPFR data also show that institutional investors have proven much less skittish than retail, resisting the urge to sell just when performance was bottoming at the end of 2013. Contrasting with the EPFR data are so-called portfolio

Figure 6. Emerging Markets Fund Flows  
December 31, 2001 – July 31, 2014

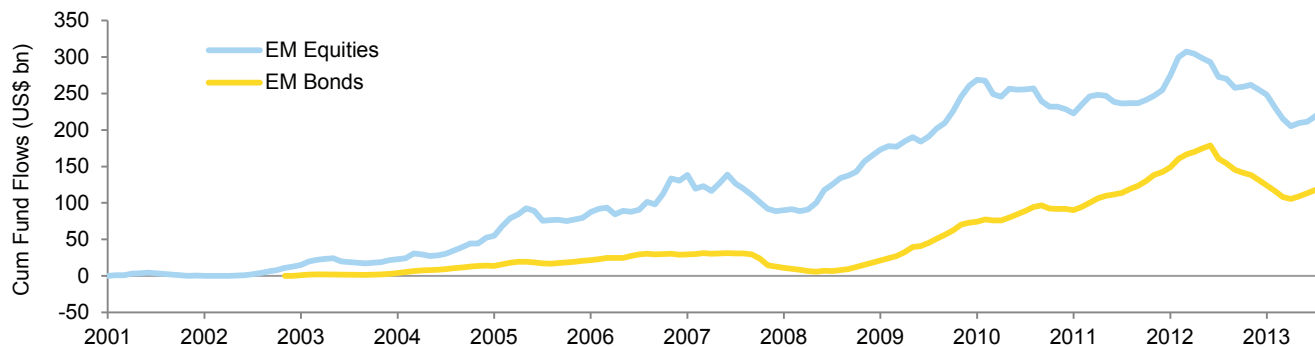


Figure 7. Emerging Markets Portfolio Flow  
2001–13



flow data, which the International Monetary Fund (IMF) assembles from individual country reports (these are part of its balance of payment calculations) (Figure 7). According to this dataset (which does reflect both debt and equity flows, but more importantly demand from *all types of investors globally*), inflows dropped in 2013 yet were still positive to the tune of over \$200 billion.

The falling net supply of US credit-related assets given deleveraging and the decline of the structured finance market have boosted demand for higher-yielding assets like EM debt. According to J.P. Morgan, in 2014 the supply of US\$-denominated credit products (including EM sovereign and corporate debt) may be “just” \$648 billion, down roughly two-thirds from 2007 levels. Though purchases are being pared back, for now the Federal Reserve continues to do its part via ongoing quantitative easing and purchases of mortgage-backed securities. Meanwhile, central banks in Japan and the Eurozone seem firmly committed to extremely dovish monetary policy, which increases the appeal of higher-yielding EM debt. Looking ahead, limited EM bond supply may also support prices; for example, EM sovereigns and corporates have already completed two-thirds of their expected 2014 US\$-denominated borrowing and sovereigns may issue as little as \$10 billion on a net basis over the remainder of the year.

Other supply/demand factors are less encouraging. Although many EM countries have weaned themselves from hard currency borrowing, some remain highly reliant on

external demand for their debt. According to J.P. Morgan, foreigners own as much as 40% of outstanding local government debt issued by countries like Indonesia, Malaysia, Poland, and South Africa. As outstanding EM debt volumes have grown and foreign owners play an increasingly important role across asset classes (e.g., corporate and sovereign), liquidity has generally not kept pace and thus markets have become more volatile. IMF research suggests that EM bond spreads widened as much in the weeks following last year’s taper tantrum as they did in the weeks following the Lehman Brothers bankruptcy in 2008. A separate analysis by the International Institute of Finance indicates that bid/ask spreads for generic EM sovereign bonds are now 8 bps, more than double the level seen before the financial crisis, also suggesting liquidity has become more constrained. Regulatory reform including Basel III and the Volcker rule is part of the problem as it limits the ability and willingness of Wall Street firms to hold inventories and make markets in EM debt.

## Valuations and Advice

**EM Currencies.** EM currencies appear undervalued using metrics like purchasing power parity but fairly or even overvalued according to others like the real effective exchange rate (adjusted for inflation). While the predictive power of any of these metrics in the short term is dubious, we are neutral on the asset class as a whole given that the low yields on short-term EM debt instruments will cap subsequent carry and appreciation (as a proxy, the main J.P. Morgan ELM+ currency

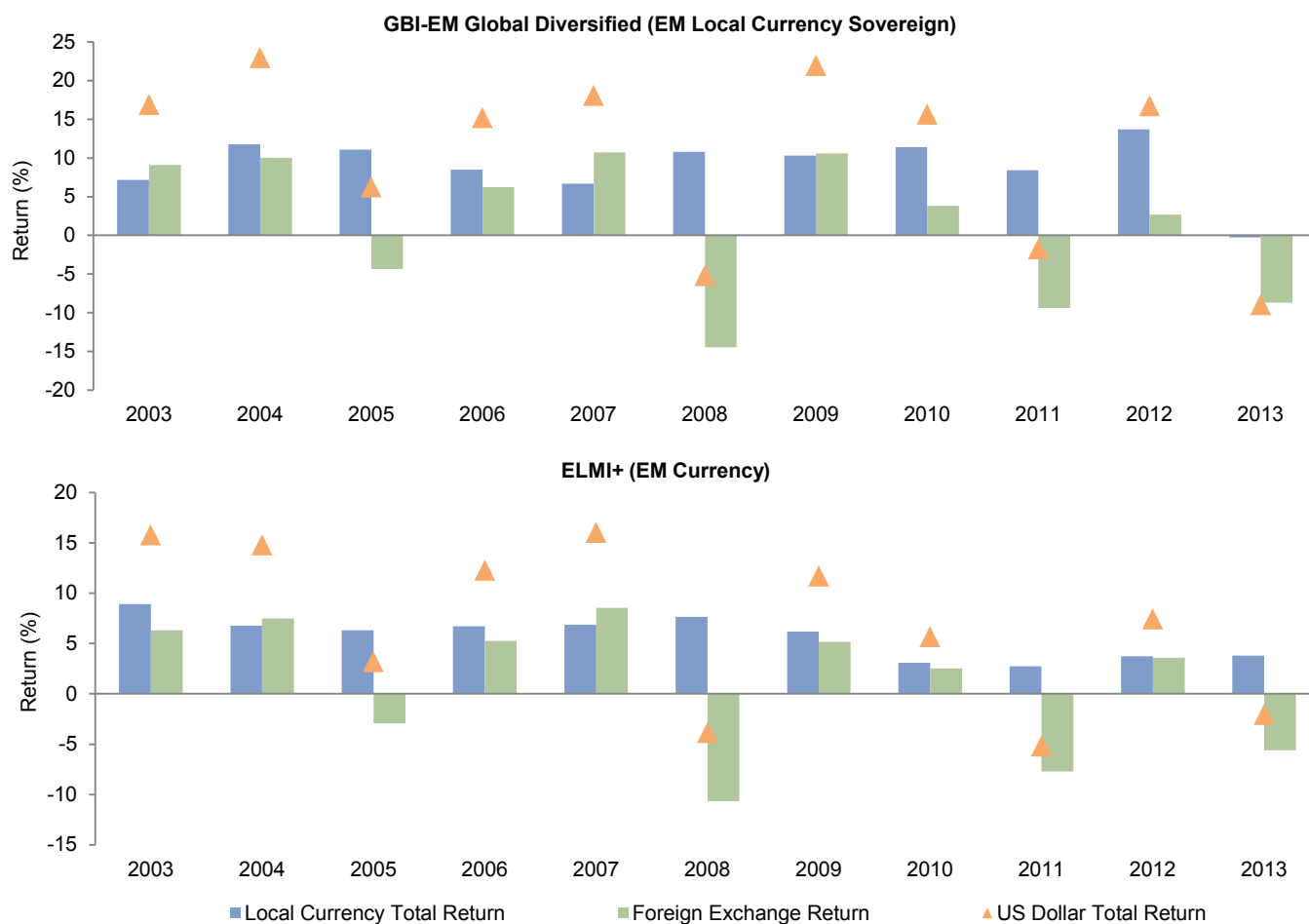




index yields just 3.1%). Whether skilled managers can generate alpha via currency selection seems ambiguous (note the lackluster returns of many currency and macro hedge funds in recent years); what we *do* know is that most of the index return for EM currencies historically has come from *carry*, not appreciation (Figure 8). Recent returns in local currency for the main index (without exchange rate adjustment) have actually been

*higher* than those in US dollars as EM currencies on average have actually *depreciated* against the US dollar. High levels of local EM inflation over the past decade may mean some EM currencies had appreciated too much against the US dollar in real terms and compromised the competitiveness of some economies, raising the prospect that some central banks will take measures to weaken currencies further.

Figure 8. J.P. Morgan Index Return Attribution 2003–13





While there is a dispersion of valuations across EM currencies and thus generalizations about currency fundamentals are difficult, the EM currency index offers slightly different exposures than those of other EM bond indexes. Around 55% of index exposure comes from Asia, including countries like China, South Korea, and Taiwan, which have fairly sound fundamentals but offer low yields. This reflects several dynamics, one of which is that currencies are more accessible to foreign investors than local currency debt in several countries.

**Local Currency Sovereign Debt.** The main local currency EM sovereign bond index (the J.P. Morgan GBI-EM Global Diversified Index) currently yields 6.58%, which translates to roughly a 420 bp spread above comparable maturity US Treasuries. More relevant for investors is the index real yield of 1.92%, which is around 90 bps below its historical average (Figure 9). The difference between the two is explained by relatively large index weightings for countries like Brazil, Russia, South Africa, and Turkey, which offer high nominal yields but also suffer from high inflation. The positive index real yield also masks considerable dispersion across issuers; for example, while real yields on Brazilian bonds are high, those in many other countries are low or negative. Given the limited number of attractive opportunities in the space and soft fundamentals in many countries, we are neutral on the asset class and consider it fairly valued; however, we concede positive EM real yields may appear attractive relative to those on offer in the United States and other developed countries.

**Hard Currency Sovereign Debt.** EM hard currency (US\$ denominated) sovereign debt offers a way for investors to get exposure to the average credit quality of EM countries while avoiding currency and local rate volatility. The yield on the J.P. Morgan EMBI Global Diversified Index sits at just 5.1%, almost 200 bps below its historical average (Figure 10); a 90 bp decline in 2014 has helped generate a healthy 9.1% return for investors given its relatively long duration (around seven years). With some interruption, yields have been steadily declining on this index for several years. On a five-year basis, hard currency debt has outperformed all other EM asset classes including equities. Hard currency debt also offers ample diversification opportunities (there are around 60 different countries in the main index) and funds tend not to have the same large exposures to emerging Europe, the Middle East & Africa that have weighed on local currency debt. However, diversification can cut both ways in a market hungry for yield. To highlight just one of numerous signs of over-exuberance in the market, in June Ecuador (which has defaulted twice in the last decade) returned to the bond market to an enthusiastic reception by investors the day after a US Supreme Court ruling reminded investors that Argentina's record \$95 billion default in 2001 was not entirely bedded down. While the current 254 bp credit spread is not significantly below its historical average, given that low yields will cap subsequent returns we don't recommend that investors increase exposure to hard currency debt.

Figure 9. GBI-EM Global Diversified Yield

December 31, 2002 – July 31, 2014

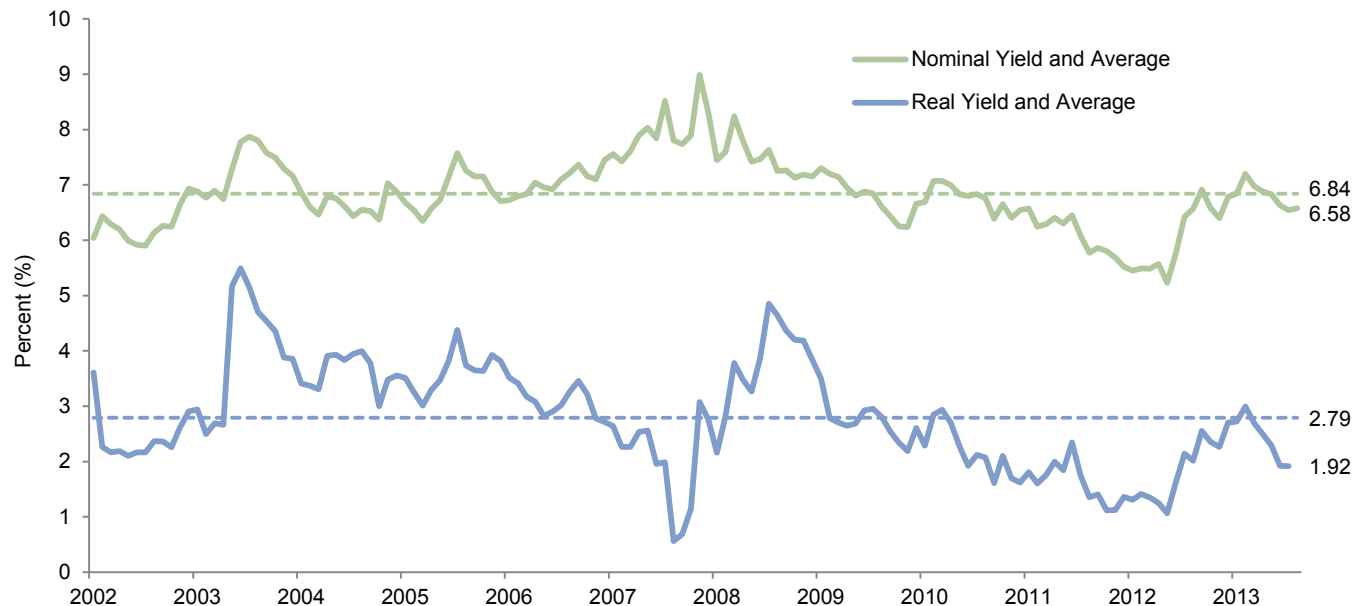


Figure 10. EMBI Global Diversified Yield and Spread

April 30, 2003 – July 31, 2014

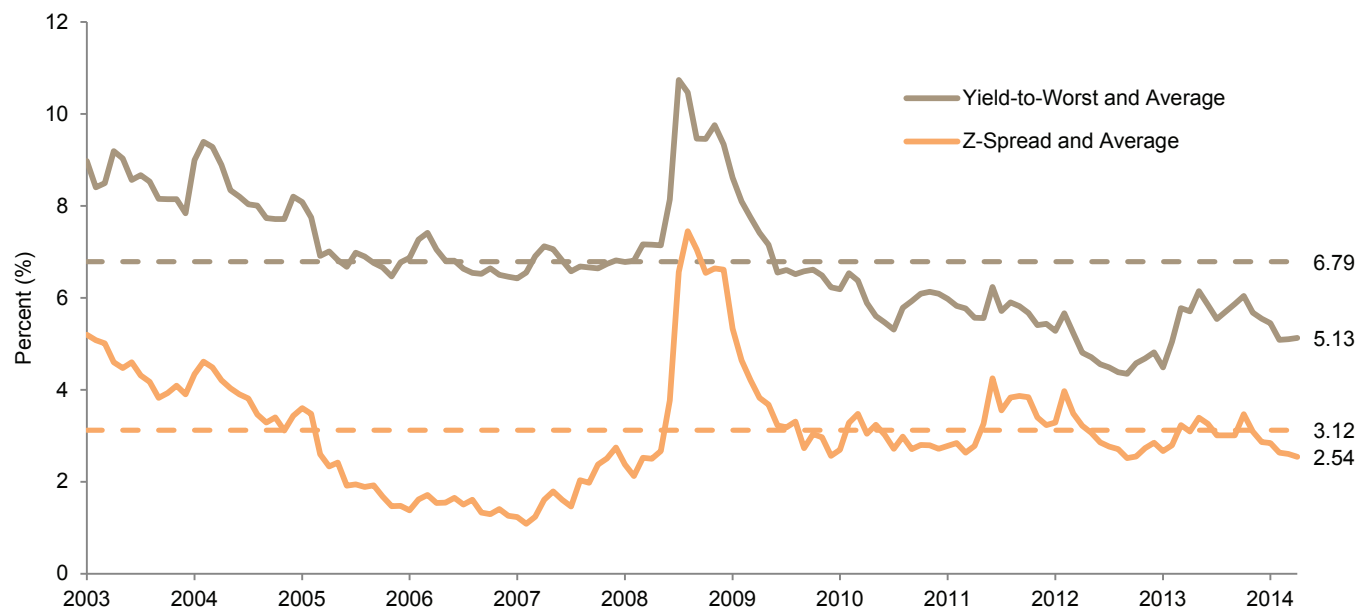


Figure 11. Correlation Matrix: Fixed Income and Equity Indexes  
December 31, 2002 – July 31, 2014

	J.P. Morgan						
	ELMI + (US\$)	ELMI + (LC)	EMBI Global Diversified (US\$)	GBI-EM Global Diversified (US\$)	GBI-EM Global Diversified (LC)	CEMBI Broad Diversified (US\$)	MSCI EM (LC)
J.P. Morgan ELMI + (US\$)	1.00						
J.P. Morgan ELMI + (LC)	0.21	1.00					
J.P. Morgan EMBI Global Diversified (US\$)	0.68	0.28	1.00				
J.P. Morgan GBI-EM Global Diversified (US\$)	0.94	0.24	0.79	1.00			
J.P. Morgan GBI-EM Global Diversified (LC)	0.51	0.34	0.74	0.75	1.00		
J.P. Morgan CEMBI Broad Diversified (US\$)	0.63	0.24	0.92	0.71	0.62	1.00	
MSCI EM (LC)	0.70	0.14	0.62	0.69	0.40	0.61	1.00
Barclays Global HY (US\$)	0.71	0.14	0.83	0.74	0.49	0.83	0.72
Barclays Global Aggregate (US\$)	0.66	0.23	0.64	0.67	0.55	0.58	0.31
Barclays US HY (US\$)	0.59	0.09	0.74	0.64	0.43	0.75	0.67
Barclays US Treasuries (US\$)	0.01	0.15	0.30	0.12	0.40	0.24	-0.21
S&P 500 (US\$)	0.69	-0.06	0.56	0.65	0.34	0.57	0.77

## Concluding Thoughts

There are a variety of motivations for investing in EM debt, including attractive risk-adjusted returns and the desire to diversify either EM exposures or broad fixed income portfolios. Most EM fixed income assets are not currently priced to achieve these objectives and the diversification benefits offer little compensation. EM currencies do have a low correlation with EM equities (Figure 11), in part because they have returned less than half what EM equities have earned over the past decade. Given low yields and stretched valuations in some instances, EM currencies also seem unlikely to generate future returns in line with other diversifying assets like credit hedge funds. Hard currency sovereign bonds are highly correlated with US high-yield bonds given underlying US Treasury exposure;

probably not coincidentally, both currently offer similar yields and are overvalued.

Local currency EM debt offers the best relative valuations within EM fixed income, but this is not to suggest that investors increase exposure. Real yields are low on a historical basis and potential returns for offshore investors could be impacted by geopolitical concerns (Turkey and Russia), inflation (Brazil), and growth (South Africa). Putting aside our reservations about the beta of EM debt, some open-mandate EM debt managers have managed to significantly outperform the various EM debt indexes (and EM equities) in recent years, and these deserve consideration for diversifying portfolios. For any investors thinking about EM debt as a growth driver, other assets like EM equities are currently priced to generate higher absolute returns. ■

## Contributors

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## Exhibit Notes

### Fixed Income and Equity Trailing Returns

Sources: Barclays, J.P. Morgan Securities, Inc., MSCI Inc., and Thomson Reuters Datastream. MSCI data provided "as is" without any express or implied warranties.

Notes: Data are monthly. "EM Currencies" represented by the JPM ELMI+ Index, "EM LC Debt" by the JPM GBI-EM Global Diversified Index, "EM US\$ Debt" by the JPM EMBI Global Diversified Index, "Global HY Bonds" by the Barclays Global High Yield Index, "EM Equities" by the MSCI EM Index, and "DM Equities" by the MSCI World Index. EM US\$ Debt and Global HY Bonds are only available in US dollars.

### Change in Exchange Rates Over the Past Three Years

Source: Thomson Reuters Datastream.

Notes: Three-year maximum and minimum calculations use monthly data compared to the average exchange rate at July 31, 2011. For example, at its lowest monthly point in the past three years, the *real* had fallen 36% versus the July 31, 2011, value. Year-to-date, the *real* has appreciated 4.1%.

### Gross Government Debt (as a Percentage of GDP)

Sources: Oxford Economics and Thomson Datastream.

Notes: Data are annual. Data for Brazil, India, Malaysia, South Africa, and Thailand forecast from second quarter 2014, data for China, Hungary, and Poland forecast from first quarter 2014, data for Indonesia forecast from fourth quarter 2013, data for Mexico forecast from second quarter 2013, data for Turkey forecast from first quarter 2013, and data for Russia forecast from third quarter 2012.

### Foreign Exchange Reserves

Sources: International Monetary Fund - COFER database, People's Bank of China, and Thomson Datastream.

Note: Data are quarterly.

### Emerging Markets Inflation

Source: Thomson Reuters Datastream.

### Emerging Markets Fund Flows

Source: EPFR Global.

Notes: Data are monthly. EM bond data start November 30, 2003.

### Emerging Markets Portfolio Flow

Source: International Monetary Fund.

Notes: Data are annual. Portfolio investment represents gross capital inflows.

### J.P. Morgan Index Return Attribution

Sources: J.P. Morgan Securities, Inc. and Thomson Datastream.

### GBI-EM Global Diversified Yield

Sources: J.P. Morgan Securities, Inc. and Thomson Reuters Datastream.

Notes: Real yield is a weighted average of the real yields for each of the underlying countries in the GBI-EM Global Diversified Index. The country level real yield is calculated by subtracting the trailing 12-month inflation from the nominal yield for each country. Real yield as of June 30. Inflation data for Poland, Russia, and South Africa as of May 31, and Nigeria inflation data as of March 31.

### EMBI Global Diversified Yield and Spread

Source: J.P. Morgan Securities, Inc.

Note: The Z-spread is a constant spread that makes the price of a security equal to the present value of its cash flows when added to the yield at each point on the spot rate Treasury curve where a cash flow is received.

### Correlation Matrix: Fixed Income and Equity Indexes

Sources: Barclays, J.P. Morgan Securities, Inc., MSCI Inc., and Thomas Reuters Datastream. MSCI data provided "as is" without any express or implied warranties.

Note: Data are monthly.



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