Emerging Market Debt – a blended approach

The benefits of focusing on the entire emerging market debt universe

June 2015
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Introduction

Emerging markets – why are they attractive?
Two decades ago, it was a rare occurrence for investors to consider emerging markets (EM) as a viable investment option. Political, social and economic turmoil overshadowed any investment potential that lay within emerging countries.

Today, however, EM currently represent some of the world’s most dynamic growth opportunities. Investing in EM enables investors to tap into the countries driving global growth. Relative to their developed world counterparts, these markets continue to offer a much greater capacity for economic growth.

Fig. 1: EM economies’ annual Gross Domestic Product (GDP)

Why emerging market debt (EMD)?
While investing in EM is traditionally more focussed in the direction of equities, the dimensions of fixed income have grown significantly over the last two decades, and EMD has become a viable asset class in its own right.

As a portfolio asset, EMD exhibits low correlation with conventional fixed income and low to moderate correlation with equities, making it an effective diversifier within your portfolio. Thus in the midst of the current financial state in developed markets (DM), EMD has emerged as an attractive alternative to traditional fixed income.

Fig. 2: EMD yields look more attractive than a year ago

Emerging Markets
EM economies are defined by the International Finance Corporate (IFC) as economies with low to middle per capita income. These economies largely span developing countries in three regions, Asia, Latin America, and CEEMEA (Central Eastern Europe, Middle East and Africa). Emerging economies today are generally characterized by favorable demographics, a strong financial footing and lower levels of debt than their Western counterparts.

Hard currency debt
Debt denominated in U.S. dollars.

Local currency debt
Debt denominated in the country’s local currency.

Emerging Market Corporate bonds are bonds issued from companies in EM regions.
The evolution of emerging market debt

There is no doubt that emerging countries have seen their economic positions improve through a number of hard learnt lessons. Crises experienced by various regions (the Tequila crisis in 1994, the Asian and Russian Crises in 1997/8 and the financial crisis of 2008/9, for example) have played a key role in the evolution of EM economies and, critically, allowed them to mature into global growth engines.

EMD, however, remains a strengthening asset class, attributable to five key drivers: the investment opportunities it continues to present, improved debt dynamics of emerging countries, the significant diversification benefits it provides, the emergence of frontier markets as an increasingly viable investment option, and the positive outlook of EM.

Investment opportunities – EMD has come a long way since Brady bonds were established in 1989. Fewer EMD defaults combined with increased liquidity and primary issuance, which among other factors have contributed to EMD being the best performing subdivision of the global bond market for the past decade.

Stabilizing economies have allowed EM governments to raise more and more of their financing through issuing debt in local currency, which helps to reduce their vulnerability to external shocks. EM hard currency debt and EM local currency debt are two distinct asset classes. The two exhibit different credit quality and regional compositions while responding to different drivers of return. EM local currency debt has explicit exposure to currency and interest rate dynamics.

The emergence of the domestic investor has also played a role in the development of local markets, which in turn has resulted in improved liquidity positions. In addition, the inclusion of local markets such as Mexico in 2010 and South Africa in 2012 into global bond indices has broadened the investor base in these markets. By contrast, hard currency EMD is ultimately a ‘spread product’, meaning it is compared to the yields on other comparable sovereign debt instruments. In this low yield environment, we believe EMD offers an attractive pickup of around +300 basis points over US Treasuries.

Debt dynamics – Supported by stronger fundamentals than developed markets, EM have been able to better withstand the market turbulences of recent years. Debt levels in EM are considerably lower than in developed economies, where unprecedented fiscal deterioration has taken place in recent years. In some cases, unsustainable debt levels will remain a drag on growth in the near future. Government debt levels of developed and emerging economies have demonstrated divergent trends, yet global investors are generally underweight in EMD according to studies by the International Monetary Fund (IMF) and other institutions. Also, as can be seen in figure 3, developed world debt has been rising for many years, meaning there is a debt overhang, something that limits fiscal flexibility, lowers growth potential and increases investor risk.

This improving credit trend is clearly illustrated by rising credit ratings for EM countries. The average credit quality of bonds in the JPM GBI-EM GD local currency index is BBB+.

Significant diversification benefits – EMD, both hard and local currency, offers low correlation to DM and EM equities, suggesting that it has a valuable role to play in portfolio diversification, particularly for portfolios that already have significant stock allocations.

Furthermore, the improved country fundamentals has been reflected in their credit markets to such a degree that it has become the obvious option for risk tolerant investors with a long-term approach looking to diversify their portfolio.

Further emergence of frontier markets – Frontier markets are an important part of the EM story. For a number of years, frontier markets were regarded as a rather one-dimensional story, with growth driven by an abundance of commodity resources. Demand has been sustained, which is good; however, digging deeper, improving country fundamentals have helped to drive growth further – even in those non-resource rich countries. Importantly, growth has been achieved without overheating. Inflation has been relatively well contained, exchange rates have generally stabilized while public sector and external debt levels have roughly halved.

Today, that growth is supported by what is known as the demographic dividend (the labor force is growing faster than the population dependent upon it) combined with infrastructure investment. In turn, this is boosting business activity.

\*Alpha is a measure of performance on a risk-adjusted basis.
The frontier bond market is still in its embryonic stages, however. Investment opportunities are largely dominated by equity markets, and frontier bonds represent only 3.5% of the EMD universe with a small (but growing) dedicated investor base. However, the introduction of the JP Morgan NEXGEM hard currency bond index in December 2011 has brought frontier market bonds more toward the mainstream and stimulated demand. We believe this market will grow in appeal as liquidity and risk premiums decline, much as we have witnessed in the more mainstream EM.

Figure 4: World's fastest growing economies over the next five years

Frontier economies will need time to catch up with their more developed peers, but patient investors stand to benefit over the medium to long term.

Changing perception – Long-term growth expectations in EM are underpinned by strong country fundamentals. These primary elements have resulted in an increasingly appealing yield-to-risk profile relative to their developed counterparts. While the West continues to climb towards 2007 debt and demand levels, most EM are progressing past pre-crisis levels.

The belief that EM economies rely on the stability of the developed world and growth in China is changing. The global disinflation affecting the West and much of developed Asia could provide the "wiggle room" that EM central banks need to aid domestic growth.

Figure 5: Developed market inflation versus emerging market inflation

Source: IMF, October 2014. For illustrative purposes only. Forecasts are offered as opinion and are not reflective of potential performance. Forecasts are not guaranteed and actual events or results may differ materially.
The case for emerging market debt “blended approach”

What type of EMD asset class is most attractive?

Emerging market hard currency sovereign debt, corporate and local currency debt have strong merits as standalone asset classes. However, we believe that a “blended” approach can be an effective way to construct the optimal portfolio, one that offers diversification across a range of different countries and instruments with attractive risk-return characteristics.

The “Blended Approach” is a strategy that we have been managing, and we believe it offers investors attractive risk-return characteristics, as it offers a broad range of countries, instruments and currencies to diversify the portfolio. In recent years, we have continued to reduce our exposure to benchmark bonds given our view on valuations, while rotating into off-benchmark sovereign and quasi-sovereign bonds, U.S. dollar corporate bonds, local currency debt and EM currencies. At times, we will tactically hedge a portion of EM currency (EMFX) exposure back into dollars, although we would seek to maintain the EMFX exposure in order to maximize the higher yields on the local bonds weightings that are subject to change depending on valuations, and will also incorporate our views on the overall risk environment.

The diversified sources of alpha is a key feature of the strategy. It can provide investors with attractive return prospects from risk assets, such as EM foreign exchange, when risk appetite increases, while generating solid returns from high grade hard currency bonds during difficult periods. For example, in 2011 when risk appetite declined due to the European debt crisis.

**Figure 6: Efficient Frontier**

JPM EMBI Global Diversified vs JPM GBI-EM Global Diversified (January 2003 to October 2014)

<table>
<thead>
<tr>
<th>Annualized Return (%)</th>
<th>90% JPM EMBI GD, 10% JPM GBI-EM GD</th>
</tr>
</thead>
<tbody>
<tr>
<td>100% JPM EMBI Glob. Div</td>
<td></td>
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<tr>
<td>100% JPM GBI-EM Glob. Div</td>
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</tbody>
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Source: Aberdeen Asset Management, October 2014.
Note Annualized Return = 11.20%, Annualized Volatility = 8.93%

PAST PERFORMANCE IS NOT AN INDICATION OF FUTURE RESULTS.

JPMorgan GBI-EM Global Diversified Index is a comprehensive global local emerging markets index that consists of regularly traded, liquid fixed-rate, domestic currency.

In our Efficient Frontier analysis, we have found that the optimal EMD portfolio from a risk-return perspective over the past ten years has been one with an allocation of 90% in hard currency bonds and 10% local currency bonds. In contrast, a sovereign hard currency portfolio would have generated a return of 9.47% with 8.61% annualized volatility, while a local currency portfolio would have generated a return of 9.29% with annualized volatility of 11.02%.
Attractions of emerging market hard currency debt

EM sovereign hard currency debt has become an endangered species of sorts as the majority of the largest issuers are no longer issuing external bonds on a net basis.

Forefather of EMD
Symbolic of the move away from the volatile past of EM, nearly the entire stock of “Brady” bonds, peaking at $150 billion in 1994, was retired in 2006 during a period of marked improvement in sovereign credit ratings. This shifted the bulk of their debt financing to their respective local markets, consequently reducing the credit risk of investment grade hard currency sovereign debt.

Development of credit quality
The investment grade portion of the JP Morgan EMBI Global Diversified index has improved dramatically over the last few decades.

While we are not advocating investors should put most of their eggs in an EM investment grade portfolio with 10-year yields on Brazilian and Mexican bonds of 3 to 4.5%, credit risk is relatively low. In contrast, given the strong performance that has been seen in peripheral Europe, emerging market hard currency debt is looking more attractive.

More recently, we have seen an inaugural Eurobond from Kenya and second issues from Senegal, Ivory Coast and Zambia, while Ecuador returned to the market after defaulting on the majority of its obligations in 2008.

Valuations
We have opined that the yield on the investment grade sovereigns in the index is not exactly compelling at 4.3%, unless one is looking to complement their “traditional” government bond portfolio that holds a great portion in much lower yielding bonds. In contrast, the yield on the sub-investment grade sovereigns is 8.2%, reflecting the higher credit risk in countries such as Argentina, Venezuela and Ukraine, while the overall index yield is 5.5%.

The argument for investing in hard currency debt is even stronger when one looks at it in spread terms, which is effectively a measurement of default risk, and more appropriate than Credit Default Swaps (CDS) because most investors are not active participants in the CDS market. At a spread of around +370 basis points over U.S. Treasuries, we believe investors are getting attractively compensated for the low default risk in the asset class.

General improvement in public finances

![Graph showing general improvement in public finances](image)

Source: IMF, January 2015.
For illustrative purposes only.
Note: SSA = Sub-Saharan Africa, MENA = Middle East and North Africa, LATAM = Latin America
Attractions of emerging market local currency debt

EM hard currency investing may have been the big bang that established EMD as a viable investment, but local currency debt now dominates the EMD market.

A significant standalone asset class
With over 90% of the local currency debt index being investment grade, the asset class is a significant constituent of EMD allocations. Investment in local currency debt drives the economy of its respective country. A flourishing domestic bond market catalyzes growth in the local economy and, in turn, improves a country’s individual debt profile, enabling its government to borrow at lower costs and longer maturities than may be possible by issuing bonds in foreign currency. This is a healthy development for EM countries and one that we believe should ultimately translate to positive returns for investors as well.

The steady growth of the local currency universe has resulted in it being a strong standalone asset class.

EM are increasingly using local currency debt to raise capital and have benefited from declining risk premiums. Important steps are being taken within many of these countries to establish (or maintain) liquid local markets, such as the creation of benchmark curves and a liquid bond series, holding regular auctions and buy-backs, and fostering derivative markets.

Figure 8: Local currency yields look even more appealing

Figure 9: Local currency debt issuance versus US$ debt issuance

Widening investor base
EM local currency bonds are becoming increasingly appropriate for a wider range of investors due to their size, growing liquidity and dedicated research platforms. This itself supports valuation and liquidity, creating somewhat of a virtuous cycle.

Historically, local banks and pensions funds dominated local currency bond space, however the institutional investor base has been growing both domestically and overseas providing impetus for further development of the local currency bond market.

The further easing of access to local markets this way will help growth of the asset class overall.
Attractions of emerging market corporate debt

EM corporate debt has grown from being a small asset class that few investors knew much about to a mainstream asset class that we believe warrants further consideration. The story for EM corporates remains compelling. Increased globalization, the burgeoning middle class and the opening up of previously inaccessible markets, such as China, have all played a part in increasing the diversity and depth of investment opportunities in EM corporates.

A mainstream asset class

The EM corporate bond market is one of the fastest growing asset classes, now over $1.5 trillion in size. It recently overtook the U.S. high yield market in terms of outstanding issuance and is double the size of EM external sovereign issuance. The asset class has expanded by 150% over the past five years, driven by record high levels of issuance in the previous three years, and is now firmly an investment grade asset class with 70% of bonds rated as investment grade. This has supported liquidity, while generally pointing to the healthy state of the asset class. In fact, the trading volume of EM corporates now exceeds that of EM sovereign bonds.

Figure 10: The EM corporate bond universe is over $1.5 trillion

EM companies have stronger credit fundamentals than developed market companies

Access to abundant natural resources, the emergent middle class and stronger regulation and financial systems, have combined with fiscal and corporate reforms to significantly improve economic fundamentals for EM corporates. Supported by relatively stronger banking systems, EM companies on the whole have been strengthening their balance sheets and capital positions. EM corporates tend to have lower leverage than comparable companies in the US. This differential remains significant for high-yield issuers in particular.

EM corporate default rates are in line with global corporates

Contrary to popular belief, EM corporates have historically enjoyed consistently lower default rates than developed market asset classes, such as U.S. high yield and Euro high yield. This helps to dispel the previously held perception that this asset class is more risky than other areas of the world. The developed world has experienced unprecedented turmoil in recent years, yet EM companies have been relatively unscathed due to the underlying quality and robust fundamentals of the asset class.
Emerging markets – the perception of risk versus reality

The validity of the negative perception of EM and their economies is becoming increasingly questionable - particularly over the last two decades.

Emerging countries collectively have a debt-to-GDP ratio of some 34% and an annual fiscal deficit of approximately -2.2%. In contrast, developed countries have an average debt to GDP ratio of 115% and an annual fiscal deficit to the tone of -6%. This pattern is likely to remain intact for the foreseeable future because emerging countries not only have growing populations but are themselves growing economies, which means that the revenue base can be sustained.

Of course, we acknowledge that there are particular EM risks, not least those caused by geopolitical influences. However, the facts are that the current default rate in the sovereign EM world is very low, while the DM default rate is increasing.

For a long period of time, it was the opinion of investors that EM are poorly managed - politically and economically - compared to their developed counterparts. However, this is no longer explicitly the case. As EMD grows globally, it’s becoming more diverse.

Sovereign debt, for example, spans a wide spectrum of risks and returns – reflecting the very different political and economic profile of the countries in question – and offers opportunity in both hard and local currency denominated debt. With good research, investors can target and blend various types of EMD to meet their differing requirements. The importance, however, is to do the groundwork.

Source: Aberdeen Asset Management, January 2014. For illustrative purposes only. Hypothetical bonds are used for illustrative purposes only. These hypothetical bonds are meant to illustrate if the country fundamentals warrant us investing in hard currency, local currency and/or corporate bonds. Hypothetical bonds are provided for informational purposes only and should not be deemed as a recommendation to buy or sell. Projections are offered as opinion and are not reflective of potential performance. Projections are not guaranteed and actual events or results may differ materially. No assumptions regarding future performance should be made.

One way to mitigate risk is to do the groundwork
Visiting the country to meet management, to see the operations, and to “kick the tires” is important. We do this at Aberdeen. We never invest in a company without first meeting management and carrying out full due diligence.

Bond covenants also help to mitigate the risk of lack of transparency and corporate governance by legally limiting companies in capital raising decisions and from taking excessive operational risks. Some issues even have cash account management agreements embedded within the bond structure, directing the company’s use of cash. Other bonds have additional security attached which allow specific protections on assets that can be detached solely to repay the bonds in an event of default. It is important to thoroughly analyze the bond and identify these covenants before investing.

Source: Aberdeen Asset Management, January 2014. For illustrative purposes only.

10 year bonds.
Emerging market debt valuations are attractive following the recent spread widening and the rise in real interest rate premiums in local markets.

While the market expects the U.S. to begin the process of interest rate normalization in 2015, disinflationary headwinds in Europe and Japan will ensure liquidity conditions remain favorable for emerging market debt.

The favorable supply dynamics should also support sovereign U.S. dollar bonds.

The trend of weakening emerging market currencies over the last four years will encourage continued improvement in emerging market trade balances, however U.S. dollar strength could continue to weigh on risk assets in the short term.

While further oil price weakness would likely weigh on oil exporting countries, falling inflation will provide emerging market policy makers with more flexibility.

The long-term outlook remains healthy as sovereign balance sheets are much stronger than they were 10 years ago.
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