EMERGING MARKET DEBT

Accessing local markets in emerging market debt

Emerging market local currency debt offers investors access to local markets, but with several crucial differences to hard currency debt – local currency debt is less volatile and can provide investors with the upside from real currency appreciation, write Rob Drijkoningen, Martijn Oosterwoud, Bart van der Made

Emerging market debt (EMD) is a rapidly evolving asset class. With the very strong performances in this asset class over the last few years, interest from investors has risen substantially.

The type of emerging markets debt that most investors are familiar with is EMD hard currency. Over the last few years, however, interest in debt issued in the local currencies of the emerging markets countries has grown substantially. ING Investment Management was one of the first asset managers to launch a dedicated emerging markets local currency fund.

HARD CURRENCY

The hard currency variant is debt of emerging market countries issued in US dollar, euro or yen. The emerging markets hard currency (EMD HC) debt gives investors access to the credit risk of emerging markets.

The return on this debt is determined by the US dollar risk-free debt (US Treasuries) plus a credit spread. The size of this credit spread, and therefore the relative performance versus the risk-free US dollar investments, will to a large extent be determined by the prospects for the investors to receive both the coupons and the redemption of the specific bonds.

Due to the beneficial fundamental developments for most emerging markets countries, these credit spreads have tightened substantially over the last few years. This effect has encouraged a lot of investors to find alternative ways to participate of the successes of emerging versus developed markets.

LOCAL CURRENCY

Another way to get exposure to emerging markets is by investing in emerging markets local currency (EMD LC) debt. This actually comprises two sub-categories: EM local government debt exposure and EM exchange rate (EM FX) exposure.

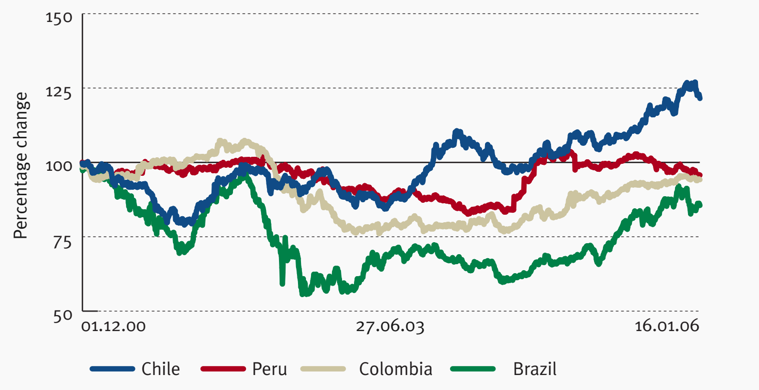
EM local government debt gives access to credit risk like EMD HC, but through the local debt credit spread. While this credit risk is much like the EMD HC credit risk, there are differences. In distressed situations these differences are determined by political and economic considerations that can sway the government to default on one category but not the other. In normal times the differences are determined mainly by market characteristics: is easy access for foreign investors available? Are withholding taxes in place? Can local investors easily invest abroad? And so on.

EM FX exposure gives access to the combination of currency risk premium and real currency appreciation or depreciation. This is a different type of exposure from a credit spread. In developing countries with high creditworthiness and low credit spreads, the upside due to credit improvement is very limited. The continuing economic development will then mostly translate into real currency appreciation and development of other asset classes in the country such as equities and real estate.

A practical example of this effect can be seen in the convergence countries of central Europe where credit spreads have practically disappeared, but real appreciation of the currency is a strong medium-term trend. EMD LC with its combination of local government debt and FX exposure is ideally suited to provide exposure to this trend.

By adding EMD LC to their fixed income portfolio, investors will therefore get broader

Figure one: emerging market debt diversification



Source: LATAM Real Effective Exchange Rate indices

ING added value in EMD LC

- ING has a longstanding track-record on EMD LC alongside that of EMD HC. This dates back to late 1998 when its was one of the first to launch a dedicated EMD LC product.

  ING's EMD LC funds are managed by an experienced multi-site team. With representation in the three major time-zones, the team has access to local news and interprets it in a global context. The EMD LC funds have a strong track record with three-years rolling information-ratios consistently close to 1. We believe that is the result of the managers' expertise combined with a well-developed investment process. Risk management tools and performance attribution tools have been developed in-house to make the risks and drivers of performance transparent.

  Further, our optimal funding framework analyses the sensitivity of the index and the portfolio with respect to the US dollar, the yen and the euro. This allows us to manage the fund neutral to movements in these currencies and to hedge out any unwanted US dollar exposure for euro-based investors.

exposure to the development of emerging markets.

FUNDAMENTALS

For most investors, the primary reason to invest in local currency markets is to get exposure to the very strong fundamental developments within emerging markets. Improving fundamentals of emerging markets will be reflected in reduced credit spreads, reflecting the reduction in default risk. At the same time, these will generate appreciating real exchange rates, reflecting the strength of the underlying economies.

Stronger fiscal policies and well-behaved monetary policies will generally increase domestic investment as well as attracting foreign capital. In turn, this will result in building productive capacity which will generate higher growth, better current account balances and capital inflows. These developments will be reflected in real exchange rates appreciating.

On top of the above, interest rates tend to be much higher than in developed markets. To some extent, this reflects a higher risk premium, which is related to higher default risk, higher volatility and higher inflation. However, as policies remain well-behaved, these three factors will generally decline, creating another way of capitalising upon the potential of emerging markets.

VOLATILITY

EMD LC as an asset class is less volatile than EMD HC. Over the past five years the ELMI+ volatility was 4.9 per cent versus 7.8 per cent for the EMBI Global Diversified. US Treasury bonds showed 5.3 per cent volatility in that period. Historical risk-adjusted returns on the ELMI+ are high, which we attribute to excessively high currency risk premiums on EM FX. The low volatility of EMD LC surprises many investors, as local currency bonds are considered higher risk than hard currency bonds. The low volatility is not only due to the ELMI+ low duration, but also due to the fact that a lot of volatility of currencies cancel out against each other (intra-asset class correlations are low). Furthermore, the correlation of EMD LC with US-Treasuries and global bonds is very low, 0.1 in both cases on a five-year basis.

DIVERSIFICATION

As such, the actual distribution of emerging markets local currency returns is remarkably well behaved.

Despite the fact that, typically, risky asset classes tend to show fat tails and negative skew, the distribution of returns over the last 10 years or more does not significantly deviate from a normal distribution and does not exhibit negative skew.

The actual behaviour of EMD LC in times of stress is not disheartening. Investors generally fear that in times of stress when diversification is needed most, correlations shoot up and diversification disappears. When focusing on several crisis periods, the correlation of the currency in duress, with currencies outside its region remains at all times low. Furthermore, in some cases correlations with currencies inside the same region go down and sometimes up, but never reach an uncomfortable 0.7 or higher.

Do note that these statistical properties relate to EMD LC as an

Emerging market debt – local currency v hard currency in focus

- Economic exposure – Emerging markets hard currency debt gives investors access to the credit risk of emerging markets – determined by the US dollar risk-free debt (US Treasuries) plus a credit spread. EMD LC comprises two sub-categories: EM local government debt exposure and EM exchange rate (EM FX) exposure.

  EM local government debt gives access to credit risk like EM HC, but through the local debt credit spread.

  EM FX exposure gives access to the combination of currency risk premium and real currency appreciation or depreciation. This is a different type of exposure from a credit spread.
- Volatility and diversification – EMD LC as an asset class is less volatile than EMD HC. Over the past five years the ELMI+ volatility was 4.9 per cent versus 7.8 per cent for the EMBI Global Diversified. US Treasury bonds showed 5.3 per cent volatility in that period.

  Historical risk-adjusted returns on the ELMI+ are high, which we attribute to high currency risk premiums on EM FX. The low volatility of EMD LC surprises many investors, as local currency bonds are considered higher risk than hard currency bonds.
- Regional exposure – The LC index is more geared towards Eastern Europe and Asia whereas HC is more exposed to Latin America.

  ING's EMD LC fund has 40 per cent in Eastern Europe, 28 per cent in Latin America, 17 per cent in Asia and 11 per cent in Middle East and Africa. Our EMD HC exposure is 52 per cent Latin America, 27 per cent Eastern Europe, 14 per cent Asia and 3 per cent Middle East and Africa.

Figure two: currency correlation

	average correlation within region	average correlation outside region
Argentina crisis		
Latam (1 Oct 2001 - 29 Mar 2002)	0.36	0.03
Latam (1 Jul 1997 - 31 Dec 2002)	0.49	0.05
Indonesia crisis		
Asia (3 Nov 1997 - 30 Jan 1998)	0.56	0.13
Asia (1 Jul 1997 - 31 Dec 2002)	0.33	0.05
Rouble crisis		
Asia (3 Nov 1997 - 30 Jan 1998)	0.24	0.11
Asia (1 Jul 1997 - 31 Dec 2002)	0.45	0.05
Brazil crisis		
Latam (4 Jan 1999 - 31 Mar 1999)	0.56	0.24
Latam (1 Jul 1997 - 31 Dec 2002)	0.49	0.05

Source: ING Investment Management

asset class. EMD HC funds that also allocate to EMD LC will typically select a limited number of the riskier LC positions. Such a strategy will therefore have to be analysed separately for its risk characteristics.

BANDWAGON EFFECTS

As the interest in EMD LC by investors has increased, market participants have dedicated more resources to assisting in investing in these markets. This signals the move of EMD LC towards a more mainstream asset class. This move has only just begun and still has a long way to go. On the plus side the additional information on the asset class will bring more investors to look at EMD LC which is necessary for the further development of the asset class.

However, it also means that some of the desirable properties of EMD LC are being reduced. Over the last year, EMD LC has become more correlated to other risky asset classes and local debt markets have become more efficient. On the plus side that means that liquidity has also improved making it easier to change positions in EMD LC.

Another indicator of the increased attention is the development of indices for local markets. Only last year, the leading index provider for emerging market bonds, JP Morgan, introduced a local currency index, the GBI-EM index. This means that investors now have better opportunities to monitor the performance of asset managers active in the asset class.

ALPHA OPPORTUNITIES

Over the past year we have seen increasing interest from EM governments to develop their local bond markets. Besides the benefit of developing well-functioning local capital markets, governments are keen to borrow in their own currency to provide better insulation from external economic shocks.

As these local bond markets are new and unfamiliar to investors they are likely to provide opportunities. While the markets are developed, risk premiums and liquidity premiums will come down. Furthermore, mis-pricing of risk is more likely in new markets. Analysis finds that the comparable credit risk premium in most LC markets is currently higher than it is in the more developed EMD HC markets.

Flows on global FX markets are dominated by actors that are not out to maximise returns. International trade flows typically aim to minimise exchange rate risk, and while flows like tourism may be sensitive to large FX fluctuations, they do not take smaller deviations into their considerations. Only an estimated 10 per cent to 30 per cent of actors on the FX markets are optimising investors. As such, there are opportunities to add value in active management, especially in the less liquid EM FX markets.

STRONG CASE

Allocating to emerging markets local currency provides a very promising opportunity to benefit from the positive underlying fundamental trends in many of the emerging countries. The favourable risk reward characteristics, low volatility with high returns, further strengthen the case to be invested in this asset class.

As serious interest from international investors for this asset class is in its early stages and growing rapidly, we expect strong growth for this asset class.