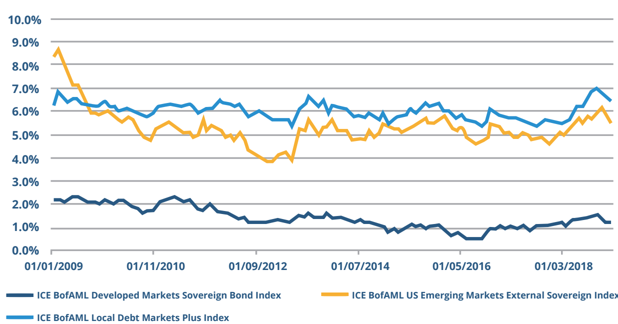
For Professional Advisers Only

A Spotlight On:
Emerging Market Debt

May | 2019

Introduction to Sector

The funds in this sector may invest in the debt of emerging market governments and corporates issued in both hard (developed market) currencies, and local (domestic market) currencies. The yield on these bonds tends to offer a significant premium to the yields available on equivalent debt issued in developed markets as shown in figure 1, although it brings with it commensurate risks.



Source: Bloomberg

Figure 1: Yield pick-up in emerging versus developed market sovereign bonds

Source: FE Analytics

Figure 2: Growth of IA Emerging Market Debt within the IA universe

As the market has grown over recent years it has become an increasingly attractive sector to income-hungry investors. Figure 2 shows the growth of the sector within the wider IA investment universe over the last 14 years.

Sector Nuance

Hard currency government bonds are the oldest part of the market, and are perhaps the best starting point for new investors in these markets. These bonds tend to offer an attractive yield pickup over US Treasuries. They also do not carry any emerging market currency risk, as the bonds are all denominated in either US dollars or euros. The key risk to this sub asset class is credit risk, i.e. the risk that a government's willingness, or ability, to repay debt denominated in a foreign currency comes under pressure.

Local currency government bond markets have seen a huge amount of growth, broadly doubling in size over the last 10 years. They are also the most volatile of the sub asset classes. This is due to the fact that they carry emerging market currency risk as well as government bond risk. These bonds tend to have the highest starting yield to compensate for this increased risk. They are best owned when investors are confident that emerging markets' development prospects are strong or improving.

Country specific risks are considerable within emerging market government bonds as nations have very different political cycles and economic growth drivers. For example, a rise in the price of oil will be beneficial for oil exporters within emerging markets but negative for oil importers. Investors therefore must pick their government bonds carefully and be aware of the varied idiosyncratic risks that are present.

Hard currency corporate bond markets have seen considerable growth in recent years. They also tend to trade with an attractive yield pickup over US Treasuries and also do not carry any currency risk, since the bonds are all denominated in either US dollars or euros. This sub asset class is best owned when economies are expanding, corporate balance sheets are improving and expected defaults are declining.

Recent Sector Performance

Given the clear groupings that can be made in the investment universe, performance is best considered across the three main sub asset classes: hard currency government bonds, hard currency corporate bonds and local currency government bonds.

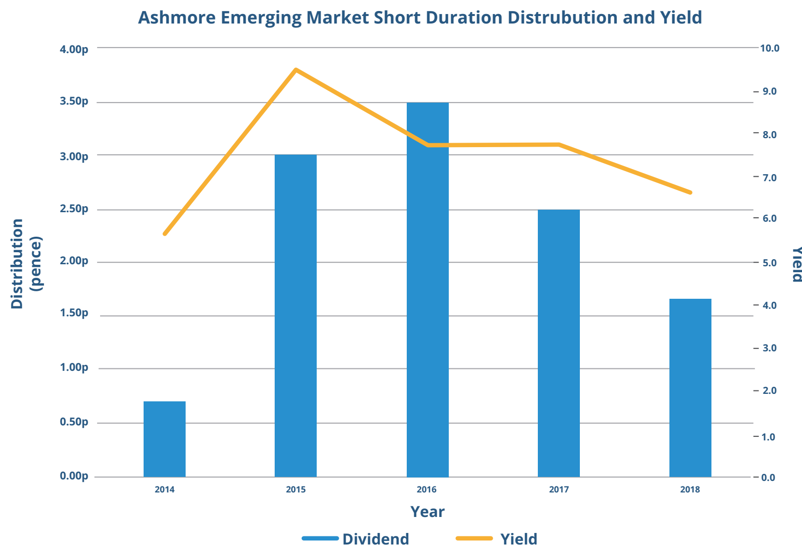
2017 was a good year for all the sub asset classes, as the markets enjoyed an extended grind down in spreads on both government and corporate bonds. The hard currency sovereign and corporate indices did particularly well up 9.1% and 6.8% respectively (in sterling hedged terms) whilst the local currency market was up just over 5% (unhedged in sterling terms).

2018 was a considerably more difficult year for the asset class, as idiosyncratic concerns around the funding prospects of both Argentina and Turkey, along with other geopolitical factors such as sanctions and the threat of trade wars, led to several periods of volatility in the markets. The hard currency government bond market was down 8.4% for the year to the 29th of November, when hedged to sterling, before recovering a little to finish 6% down for the year, whilst the hard currency corporate bond index was down 4.4% and 3.2% at the respective points, again when hedged to sterling. The local currency market was again the most volatile of the markets, but after a rally in the final months of the year finished up around 2% (unhedged in sterling terms).

January 2019 brought positive returns for most markets, and emerging market bonds were no exception with all markets showing significant bounces.

Funds in Focus

Given the broad range of bonds available in the asset class, it is unsurprising that there is also a broad range of funds available. To date, our preferred routes have been to either opt for active managers who have the flexibility to select from the breadth of the available investment options, or to look to specialised managers who target specific outcomes for investors.

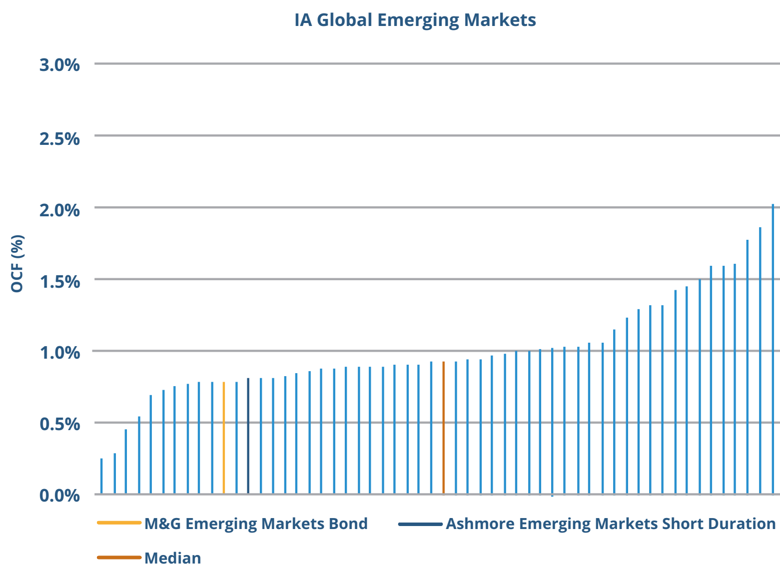


Source: FE Analytics

Figure 3: Ashmore Emerging Markets Short Duration Distribution and Yield chart

For the former we like the M&G Emerging Market Bond fund. This fund has a flexible mandate, allowing it to invest across government and corporate bonds issued in both hard and local emerging market currencies. We believe that this mandate, allowing the manager to take asset allocation decisions across the emerging bond markets, makes sense for many investors, it affords them access to the full opportunity set of this market without having to constantly move their positions around. In short we believe that outsourcing the asset allocation to an expert in the asset class makes sense.

An example of a fund we like in the latter category is the Ashmore Emerging Markets Short Duration fund. This is a relatively straightforward strategy, which looks to buy short-dated, emerging market corporate bonds and hold them to maturity. The bonds will be issued in hard currencies (largely US dollars) and pay attractive coupons, resulting in a relatively high income stream from the fund.



Source: FE Analytics

Figure 4: IA Global Emerging Market Bond OCFs (including the Ashmore Emerging Markets Short Duration fund)

Ongoing charge figures (OCFs) in the sector range from c.0.5% to c.2.7%, with the median OCF at 0.9%. While there can be good reason for investors to pay fees above the median, such as to access experienced managers or more specialist asset classes, we believe that investors should consider whether their fund selection provides them good 'value for money' within this context. Given the team and resources at both M&G and Ashmore, combined with OCFs below the sector median, we believe both funds detailed above offer investors good value for money.

Given the diversity of issuers, bonds and therefore risk in the sector, we do not believe that the sector suits a passive investment strategy. Alongside this, indices can also be dominated by those countries issuing the most debt, regardless of their underlying credit quality, thereby potentially increasing the risk for a passive investor.

Sector Outlook

It is relatively easy to build a bull case for the asset class.

- Yields are at a premium to developed market bonds.
- Current accounts in emerging economies look healthy for many of the major debt issuing countries.
- Corporate leverage appears relatively benign versus developed market peers.
- Central banks in emerging markets have the capacity to cut their, relatively high, interest rates if necessary in order to stimulate their economies in the face of any future economic concern.

That said, the bear case can also be relatively easily constructed.

- Slowing economic growth in developed markets, particularly the US, potentially leading to a slowdown in investment and growth in emerging markets.
- Continual political disruption caused by the rise of populism across both developed and emerging economies.
- The prospect of further trade sanctions and trade barriers globally.
- Concern over the level of public and corporate indebtedness in China.

To our mind, the asset class appears reasonably valued at present and could represent an interesting opportunity for the long term investor, both in terms of income and diversification. However, investors should be aware that the risks in the asset class can be high, and the journey may not always be smooth.

Important Information

This report is for the use of professional advisers only.

It is published by, and remains the copyright of, Square Mile Investment Consulting and Research Ltd ("SM"). Unless agreed by SM, this commentary may only be used by the permitted recipients and shall not be provided to any third parties. SM makes no warranties or representations regarding the accuracy or completeness of the information contained herein. This information represents the views and forecasts of SM at the date of publication but may be subject to change without reference or notification to you. SM does not offer investment advice or make recommendations regarding investments and nothing in this report shall be deemed to constitute financial or investment advice in any way and shall not constitute a regulated activity for the purposes of the Financial Services and Markets Act 2000. This report shall not constitute or be deemed to constitute an invitation or inducement to any person to engage in investment activity. Should you undertake any investment activity based on information contained herein, you do so entirely at your own risk and SM shall have no liability whatsoever for any loss, damage, costs or expenses incurred or suffered by you as a result. The fund's prospectus provides a complete description of the risk factors. Unless indicated, all figures are sourced from Financial Express Ltd. The information in this report is believed to be reliable but its completeness and accuracy is not guaranteed. SM does not accept any responsibility for errors, inaccuracies, omissions or any inconsistencies herein.

SQUARE MILE
INVESTMENT CONSULTING & RESEARCH