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## Emerging Markets Local Currency Debt: Capitalizing on Improved Sovereign Fundamentals

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### Summary

Emerging markets local currency-denominated debt is a large and liquid asset class that we believe represents some of the most creditworthy emerging market sovereigns, offers two distinct sources of return (currency and local bond yields), and provides the potential to generate equity-like returns without taking on direct equity risk. In our opinion, the sizeable growth differentials between emerging market countries and the developed world will continue to serve as a magnet for capital flows into emerging markets. These capital inflows should augment appreciation pressures on many emerging market currencies, especially in the context of a global economic recovery. Reflecting the persistently positive term premium of local yield curves, emerging market government bonds have provided a better way to get emerging market currency exposure than currency forwards. Bond managers, however, may selectively use currency forwards in those situations where the currency is attractive but not prospective duration returns.

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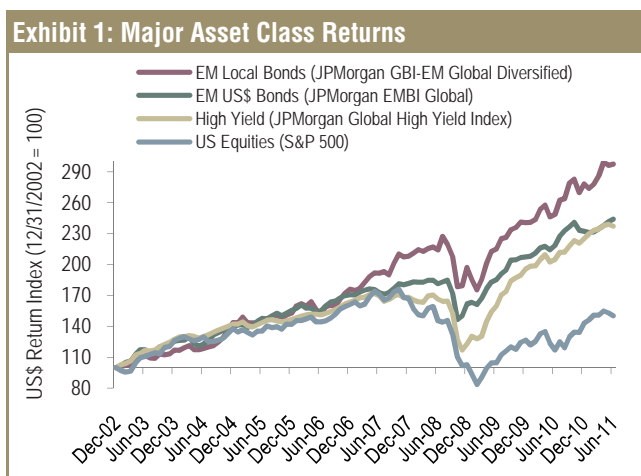
## EMLCD: Capitalizing on Improved Sovereign Fundamentals

### A Return to Simplicity

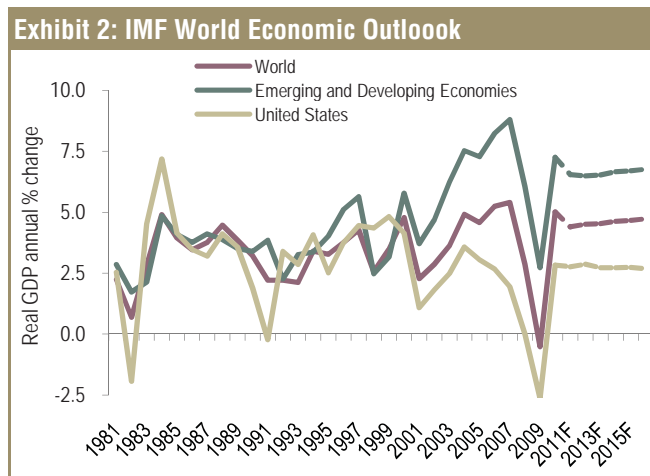
Survivors of a train crash invariably emerge dazed and confused, and so it is not surprising that investors may have been in that state after a financial markets crash that raised fears of a 1930s style depression. The debt markets have been at the center of the maelstrom and the catalyst itself was the collapse of the asset-backed securities market that had shrouded its shortcomings behind such a veil of complexity that the rating agencies and even some of the most sophisticated institutional investors managed to delude themselves on the risks. The reaction against such misleading complexity may be a much greater demand for simplicity in investment instruments with transparent drivers and risks that can be analyzed in a straightforward manner. Portfolio managers will also be held more accountable for straying away from their original mandates, especially if out-of-the-benchmark forays are into assets with structurally different risk and liquidity characteristics. In short, we believe that investors will likely want to “disentangle” portfolios and demand better clarification of the underlying exposures. This is especially true of fixed income portfolios that can encompass instruments and asset classes spanning the entire risk/return spectrum and that can also vary dramatically in liquidity and complexity.

The investable emerging markets debt (EMD) universe consists predominantly of simple and liquid sovereign bonds (although the size of the emerging market corporate debt market is growing) that offer the potential of relatively high returns and at least some diversification benefits, especially for portfolios already exposed to G3 (US, EU, and Japan) equity and corporate credit risks. Importantly, EMD itself now consists of two asset classes – local currency-denominated bonds and the more traditional USD-denominated debt – each containing distinct risk exposures and thus offering distinct sources of return. In our opinion, investors will be better served by making explicit recognition of local currency bonds as a separate asset class and awarding mandates to managers on that basis – as a result of their own view on how local currency bonds fit in their strategic asset allocation.

Both EMD asset classes were literally the last “dominos” to fall as the global financial crisis intensified in late 2008 (see Exhibit 1). The relative resilience of EMD was due to both the improved creditworthiness of most emerging markets sovereign issuers and the positive growth differentials between emerging markets and the G3 (see Exhibit 2). These two facts are likely to ensure that EMD may be well supported going forward.



Source: Bloomberg as of June 30, 2011  
Please see disclosures at the end of document for index definitions.



Source: International Monetary Fund (IMF) World Economic Outlook (WEO) April 30, 2011  
F = Forecast

### Capturing the Growth Differential

2008 saw many decry the idea that emerging markets are decoupled from the developed world and it is clear that emerging markets (EM) were certainly not immune to the global shock that emanated from the US. Despite this, most EM economies have decoupled, but not in the sense of being isolated from the developed economies, which is certainly not the case in an increasingly interlinked global economy. But rather, EM economies, on average, are experiencing a much higher growth than the developed markets can achieve (see Exhibit 2), and we believe this positive growth differential is a long-term sustainable phenomenon driven by the lower starting base of the emerging market economies, their more competitive cost structures, and—at least in some cases—a more supportive demographic profile.

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There are a number of ways to attempt to take advantage of these growth differentials. EM equities certainly provide some exposure to EM economies, but they also have corporate risks bundled in. The improvements seen in emerging markets during the last decade have been primarily at the sovereign level (e.g., lower public debt ratios, higher foreign exchange reserves, more competent monetary policy, etc. See Exhibits 3 – 5). Investors are less likely to find similar improvements at the corporate level in areas such as protection of minority investors, timely disclosures, better managerial incentives, and other aspects of good corporate governance. In addition, publicly listed companies comprising the stock market may not always constitute a representative sample of the economy that would enable equity investors to take advantage of the country's growth potential. This is true especially in emerging markets. Finally, valuation levels—what is already priced in—matter a lot. These factors may explain, for example, why some studies have failed to find a strong relationship between economic growth rates and equity returns.

Exhibit 3: Emerging Markets Foreign Debt (% of Exports)\*

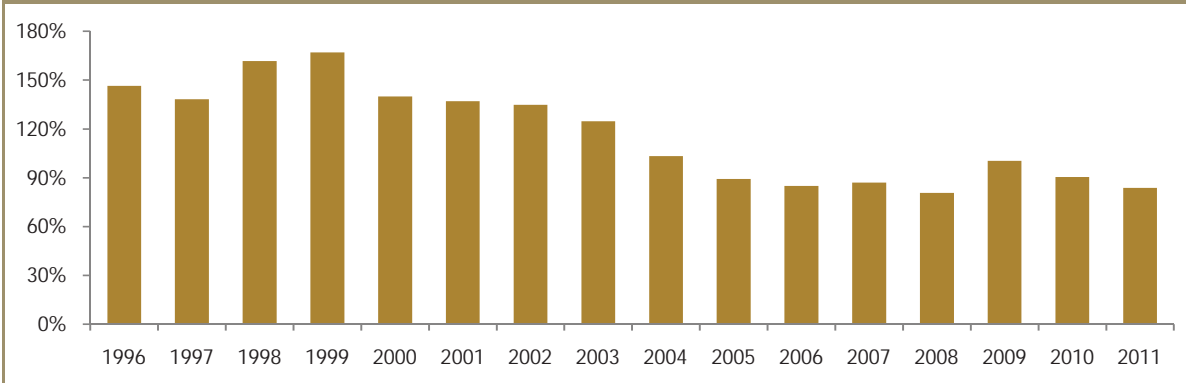


Exhibit 4: Emerging Markets Foreign Exchange Reserves (US\$ bn)\*

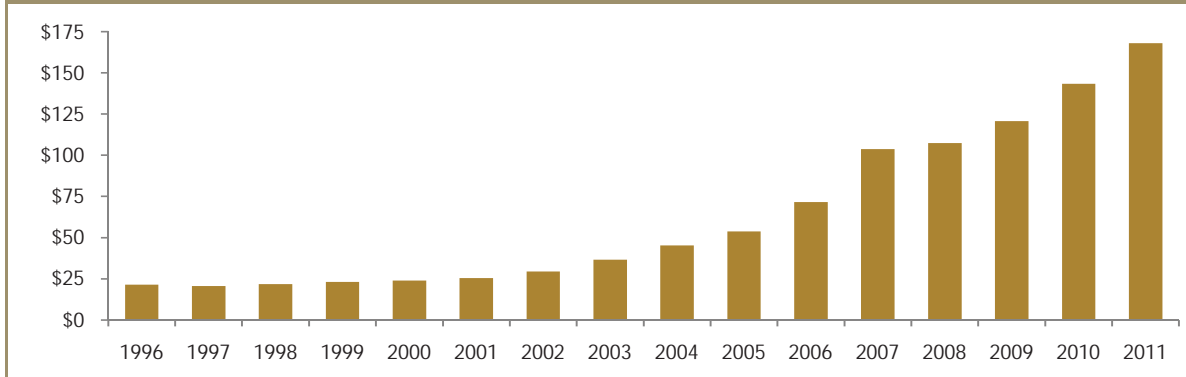
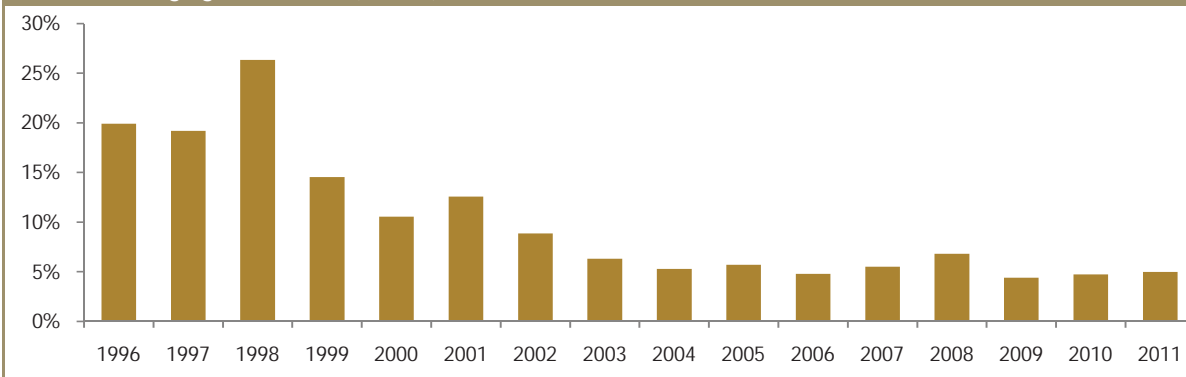


Exhibit 5: Emerging Markets CPI (% YOY)\*

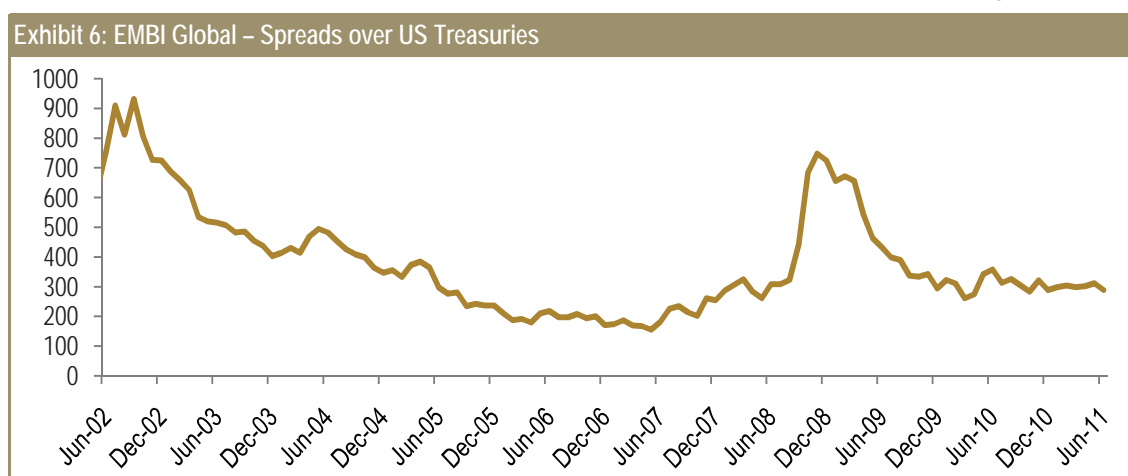


Source: Standish and JPMorgan as of June 30, 2011.

\* Market cap weighted averages for countries in the JP Morgan GI-EM Global Diversified.

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Historically, the best way of capitalizing on the improved sovereign fundamentals in the emerging markets has been their dollar-denominated sovereign debt or quasi-sovereign debt issued by state-controlled entities such as Gazprom in Russia, Pemex in Mexico, etc.\* Just as it is the case with corporate bonds in G3, returns on US dollar-denominated sovereign debt are driven by levels of, as well as changes in, spreads over US Treasuries on top of the underlying US Treasury yields. During the decade up to 2008, dollar-denominated EMD outperformed most other major asset classes, fueled by a powerful combination of decreasing treasury yields and tightening spreads. Over this period, the average credit ratings of EM countries included in the JP Morgan Emerging Markets Bond Index (EMBI) benchmarks for US dollar-denominated debt has steadily risen now investment grade. The financial crash meant that spreads dramatically widened in the flight to US Treasuries, but in 2009 spreads equally dramatically tightened to reach levels similar to those seen before the Lehman collapse (see Exhibit 6). At these levels, they appear still reasonable (i.e., providing adequate compensation for potential default losses) but not astonishingly attractive. Having exposure to US dollar-dominated debt makes sense if you think spreads will tighten further or stay unchanged. However, US dollar-denominated debt now represents a lower risk, lower return asset class that, in contrast to its historical experience, is unlikely to deliver double digit returns in the future.



Source: JPMorgan based on the Emerging Markets Bond Index Global (EMBI Global) as of June 30, 2011.

Within the last decade an additional set of opportunities has evolved for taking advantage of EM growth differentials. This opportunity set is represented by local-currency-denominated bonds, which offer investors two distinct sources of return, currency and duration. At present, local bonds provide the most direct and attractive way to capitalize on the improved EM sovereign fundamentals.

### The Rise of Local Currency Debt

In 2002, EMD was largely US dollar-denominated with more than half of total market capitalization in US dollar bonds as measured by JPMorgan. When EM sovereigns needed to raise capital, most had little choice but to issue bonds denominated in foreign currencies, primarily in US dollars. Hyperinflation and the occasional high-profile currency crisis had made both local and foreign investors wary of exposure to assets denominated in EM currencies. What has happened since then is that the size of the US dollar marketplace has grown to over \$400 billion (as reflected by EMBI Global), while local-currency-denominated bonds, represented by the JP Morgan Government Bond Index – Emerging Markets Global (GBI-EM Global) have expanded much more dramatically to just under \$1 trillion, as of May 2011, or approximately two-thirds of the investable EMD market. (The EM corporate debt market, measured by JPMorgan CEMBI, is now around \$200 billion.) This can be attributed, in part, to governments of many EM countries moving their economies onto a much firmer financial footing. In particular, central banks have had considerable success in fighting the hyperinflation that had long ravaged local investment returns. Most EM countries reduced the risk of sudden catastrophic currency crises by transitioning from fixed to more flexible and even completely floating exchange rate regimes, which are less prone to sudden and severe devaluations. The result has been a generalized improvement in sovereign creditworthiness and an increase in investor appetite for assets denominated in local currencies.

Mexico provides a good illustration of the development of local debt markets and also of the obstacles that needed to be

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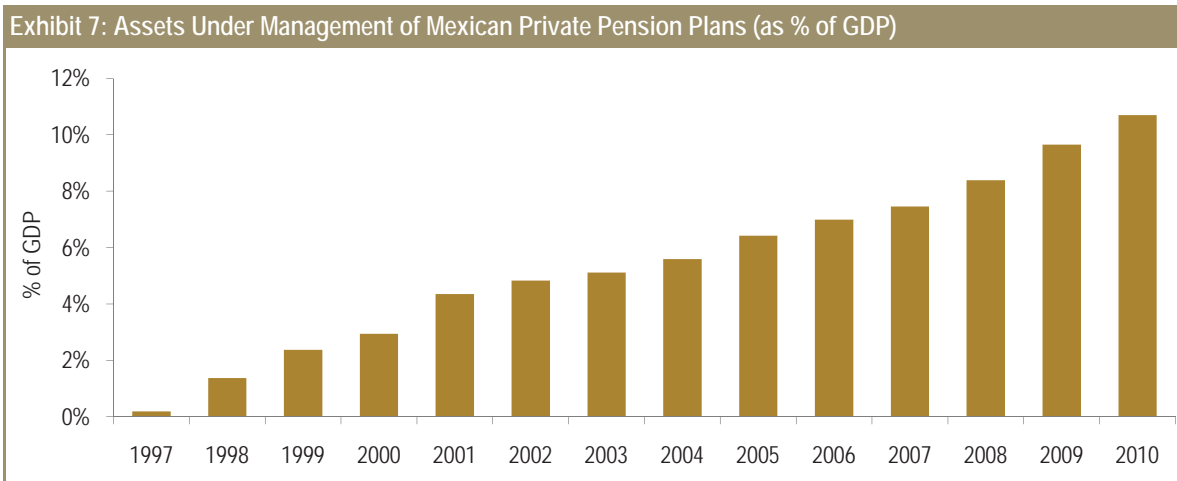
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overcome for the markets to flourish. In 1996, Mexico had an inflation rate of 50%, which although it fell dramatically, was still significant at approximately 10% in 2000. Since then, it has come down to single digits. This success in fighting hyperinflation has been the primary factor enabling Mexico and other EM countries to extend the maturity profile of their local currency bond markets. While higher inflation is always a possibility, the risk of a return to hyperinflation is unlikely in most emerging markets for two reasons. First, politicians have learned that hyperinflation damages their chances of re-election and second, most central banks have become technically more capable and politically more independent, enhancing their credibility.

### Growing Local Demand

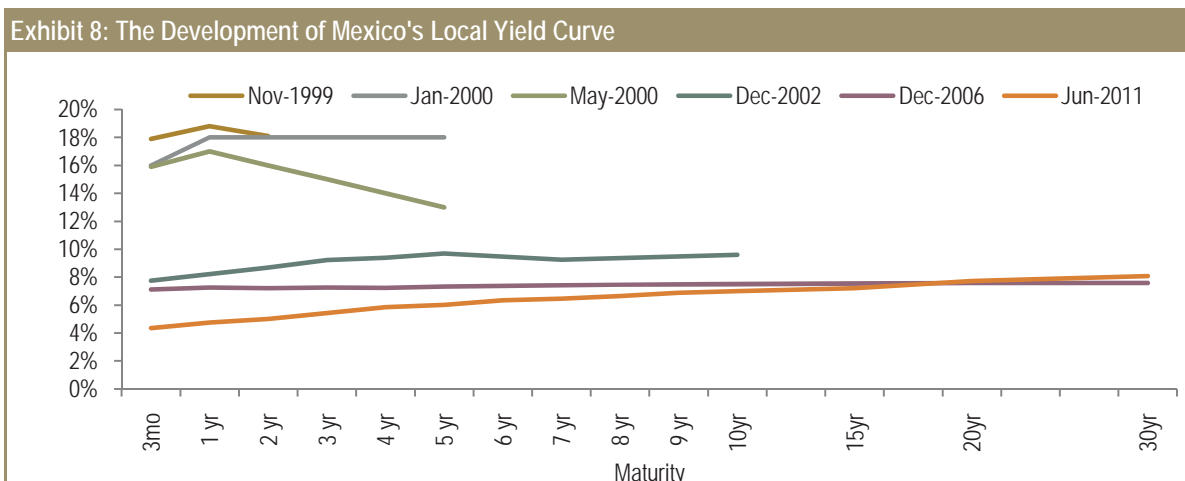
In addition, the natural buyers of local-currency debt are local financial institutions, and these were generally underdeveloped until recently, while the countries' poor creditworthiness deterred foreign investors from purchasing local-currency debt as well. Importantly, the rapid expansion of pension funds in EM countries themselves has generated consistent demand for local bonds. Financial stability has allowed the development of domestic financial institutions, such as private pension systems, mutual funds and insurance companies, which have become a very important part of the market and provide a significant local bid. For instance, Mexico introduced private pension plans in 1997 and these have grown from zero assets under management in mid-1997 to approximately 10% of Mexican GDP at the end of 2010 (see Exhibit 7).

About 66% of those assets are invested in local government debt. By managing inflation, improving sovereign credit quality,



Source: JPMorgan, Standish as of December 31, 2010.

and building up local institutions, Mexico and other EM countries have greatly aided their local-currency debt markets. This improvement can be seen in the maturity spectrum of the country's local debt market. A decade ago, Mexico was only able to issue debt at two-year maturities with a high coupon. Since then, Mexico has gradually been able to extend the maturity of its debt and build up its local yield curve out to a maturity of 30 years (see Exhibit 8).



Source: JPMorgan, Standish as of June 30, 2011

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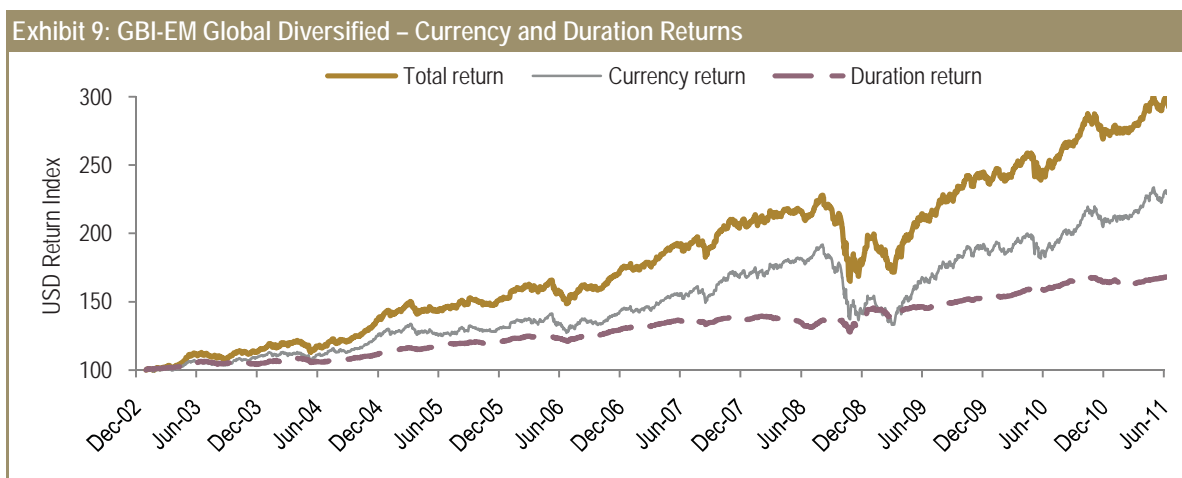
In this way, EM economies have been able to match the currency of their liabilities with that of their assets and revenues. The global financial crisis of 2008 may have given pause to these positive trends, but it has not reversed them. In fact, these trends constitute a kind of self-perpetuating virtuous cycle. With more buyers for local bonds, EM governments have reduced unnecessary exposure to exchange rate risk by issuing more debt in local currencies and with increasingly longer maturities. Reduced reliance on USD-denominated debt and on short-term borrowing has led, in turn, to improved debt profiles, further gains in creditworthiness, and interest from additional investors.

### Distinct Return Drivers

For foreign investors, local-currency bonds represent investment in both currencies and local interest rates. Historically, currency returns have provided the major contribution to total return of local bonds, although duration risk has been a steady contributor as well.

The two return drivers of local bonds (currency and duration risk) are distinct from the drivers of spreads of US dollar-denominated debt over US Treasuries. Spreads have two components: an expected loss component (probability of default multiplied by an expected loss) and a risk premium, which some refer to as a liquidity premium, that represents compensation for not just liquidity but also for the uncertainty of credit outcomes. The huge rise in spreads that occurred post-Lehman represented a general rise in risk premiums across all asset classes – independent of changes in expected losses – although some deterioration in country fundamentals also increased the expected loss spread by raising the expected probability of default.

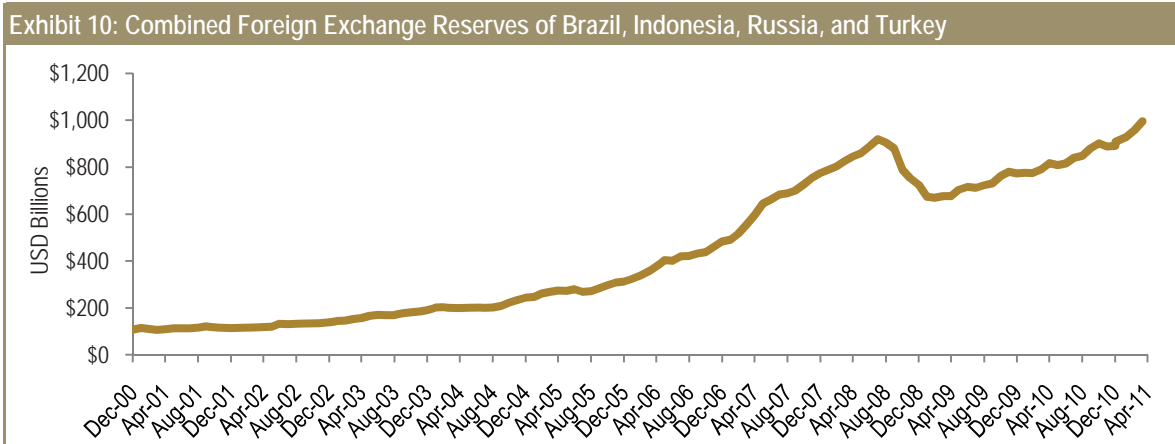
In contrast, currencies are driven by the supply and demand conditions, which may or may not be correlated with the global credit risk premia. Thus, for example, for one full year following the beginning of the credit crisis in June 2007, hard currency inflows into EM continued to exert appreciation pressure on their exchange rates (see Exhibit 9). This ended abruptly when the global financial crisis escalated around the time of the Lehman collapse in September 2008. Some local currencies are still weaker, at least in nominal terms, than where they were trading prior to the Lehman debacle, so there is still the potential to catch up as the global economy recovers and increases demand for EM exports, both manufactured



Source: JPMorgan based on the Government Bond Index-Emerging Markets (GBI-EM) Global Diversified as of June 30, 2011

goods and commodities. Importantly, we expect the persistent growth differentials between EM and G3 to continue serving as a magnet for capital flows into emerging markets. These capital inflows should augment the appreciation pressures on many EM currencies. Standish estimates that the average core balance for emerging market countries – a conservative measure of the balance of payments outlook focusing on less volatile flows (i.e. net foreign direct investment plus current account balance) – is positive and will remain so at least for the next several years. The net extra supply of hard currency (dollars, euros, yen, etc.) is conspicuously manifesting itself in the foreign exchange reserves of EM countries, which by now are not only sizeable but are also beginning to grow again following the dip in the second half of last year (see Exhibit 10). In other words, at least several central banks of EM countries are intervening again by selling their own currency to buy foreign assets. However, in most cases, we believe they are just “smoothing volatility” —slowing the pace of adjustment, rather than preventing their local currency from appreciating beyond a certain level.

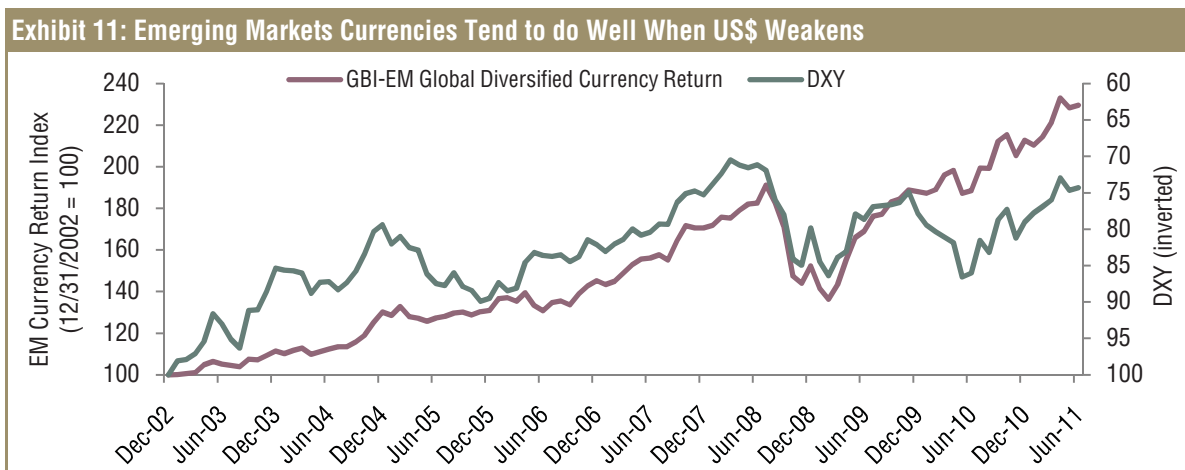
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Source: Bloomberg as of January 31, 2011

It is also worth considering the viability of the US dollar in the long run. EM currencies tend to do well when the US dollar weakens against major currencies (see Exhibit 11). It helps directly because the local-currency-denominated EMD indices contain an exposure to central European countries whose currencies such as the Polish zloty are trading primarily against the euro. If the zloty is unchanged against the euro, and if the euro strengthens, then the zloty strengthens against the US dollar. In addition, there is an indirect effect of the US dollar's weakness on other currencies that are trading primarily against the dollar such as the Brazilian real and the Malaysian ringgit. For example, while the Brazilian real trades against the dollar, its economy is much more diversified in terms of its export destinations, with Europe comparable to the US in value. When the US dollar weakens against the euro, it generally allows the Brazilian real to strengthen incrementally against the US dollar without sacrificing its competitiveness in trade-weighted terms. The corollary of this is that a rebounding US dollar can hurt EM currencies and the extent of the damage depends on the conditions under which the rebound occurs. When the US dollar strengthened against the euro, post Lehman, it reflected the fact that the US malaise had spread to Europe and as a result, would lead to a global recession. This was clearly negative for emerging market currencies.

A major reason for why the US dollar rallied as the global financial crisis escalated in the second half of 2008 is that it is the world's reserve currency, which benefits in the "flight-to-quality" environment. This is ironic because the US has been at the epicentre of the financial crisis. However, since 2008 Standish has seen more signs that central banks and private investors are diversifying away from the US dollar. This has benefited many EM currencies for the reasons outlined above, especially in the environment of a global economic recovery.



Source: Bloomberg as of June 30, 2011. Note: DXY measures the general international value of the USD by average the exchange rates between the USD and six major world currencies. The decrease in DXY indicates the weaker USD.

### Currency or Duration Exposure?

All of this begs the question of whether it would be better just to gain an exposure to a diversified portfolio of EM currencies through the use of currency forward exchange contracts. In this regard, it is important to point out that currency-hedged returns in local bonds have historically produced a steady positive contribution, indicating that local bonds have outperformed currency forwards (see Exhibit 9 isolating duration returns of local currency-denominated bonds). Above all, this

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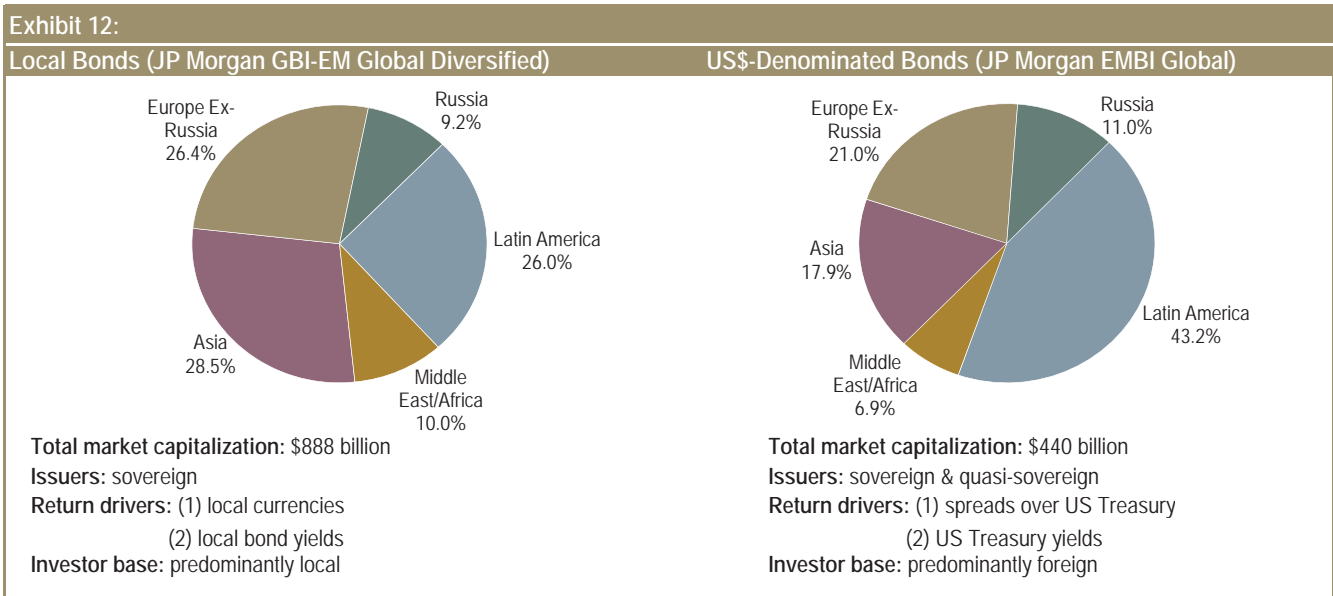
outperformance reflects the positive term premium of local yield curves. Indeed, the disadvantage of currency forwards is that they reflect short-term interest rates and, as a result, there is no duration exposure and no possibility of benefiting from higher bond yields along the yield curve. For bond managers, however, the use of currency forwards enables them to invest in countries where the currency is attractive but not prospective duration returns. Conversely, in countries where duration looks attractive but the currency does not, managers can invest in local currency-denominated bonds while hedging the currency.

Just as currencies and spreads do not necessarily move in tandem, local bond yields have their own unique drivers. The fact that yields on debt denominated in local currencies are relatively high is primarily a function of inflationary expectations rather than creditworthiness. Indeed, the average credit quality of countries represented in the widely-followed JPMorgan GBI-EM benchmarks for local bonds is solidly investment grade. This is not a coincidence as to be included in the GBI-EM benchmark an emerging market country needs to have a relatively well-developed local fixed income market, which is unlikely if the country is suffering from poor creditworthiness.

Also, from the perspective of local investors who dominate local-currency bond markets, the government bonds often represent the safest instruments available in their own currency. As the global economy recovers, inflationary pressures may increase. However, if inflation starts to become a concern in a local-currency bond fund, then, in addition to the greater reliance on currency forwards, the option exists of shifting to inflation-linked bonds, which are available in at least several emerging market countries (e.g., Brazil, Mexico, Turkey). This choice between nominal bonds and inflation-linked bonds depends on the assessment of breakeven rates relative to long-term inflation forecasts.

### The Future Opportunities in EMD Lie in Local Currency Debt

EMD should be regarded as consisting of two separate asset classes: local-currency-denominated bonds and USD-denominated debt (see Exhibit 12). Dollar-denominated debt is a credit asset class akin to corporate bonds in G3, which has now graduated to a somewhat lower risk, lower return status reflecting the improvement of the average credit quality to just one notch below investment grade. Local-currency debt is an asset class that represents some of the highest-rated EM countries, offers two distinct sources of return (currency and local bond yields), and provides the potential to generate equity-like returns without taking on direct equity risk. Prospective returns from local bonds are supported both by their relatively high yields and by the potential for their currencies to appreciate. The diversification benefits of EM local-currency debt may be further enhanced by the steady bid for long-dated local fixed income instruments from rapidly growing pension plans domiciled in EM countries themselves. Pension plans and other institutional investors in Europe, Asia, and the US now have discovered the local currency asset class as well.



Source: JPMorgan as of June 30, 2011.

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Alexander is Managing Director of Emerging Market Strategies and Senior Portfolio Manager responsible for managing all emerging market debt portfolios. He joined Standish from Putnam Investments, where he was Senior Vice President and Portfolio Manager for emerging market debt. Prior to that, he was Emerging Market Sovereign Analyst at Citibank in New York. Alexander received an Honors Diploma from Moscow State Institute for International Relations. He has a PhD in International Relations from the University of Illinois and was a post-doctoral fellow at Harvard University. He holds the CFA® designation and has 14 years of investment experience. Alexander's research on emerging market debt and other areas of fixed income has been published in the leading finance journals, including *The Journal of Portfolio Management*, *The Journal of Fixed Income*, and *The Journal of Investing*.

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<sup>1</sup> *JP Morgan Government Bond Index-Emerging Markets (GBI-EM): The GBI-EM is JPMorgan's registered name for the first comprehensive, global local emerging markets index, and consists of regularly traded, liquid fixed-rate, domestic currency government bonds to which international investors can gain exposure. Variations of the index are available to allow investors to select the most appropriate benchmark for their objectives.*

<sup>2</sup> *JP Morgan Emerging Markets Bond Index (EMBI): The EMBI benchmarks are JPMorgan's registered name for the indices that track total returns for US-dollar-denominated debt instruments issued by emerging market sovereign and quasi-sovereign entities.*

<sup>3</sup> *The JP Morgan Global High Yield Index is an unmanaged index used to mirror the investable universe of the US-dollar-denominated global high yield corporate debt market .*

<sup>4</sup> *The S&P 500 is an index consisting of 500 US stocks chosen for market size, and liquidity, among other factors. The S&P 500 is designed to reflect the performance of the large-cap universe.*

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