Viewpoint

# Russell Research

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AUGUST 2012

## The investment case for emerging market debt

In 1973, a global oil crisis reversed the traditional flow of capital as oil-exporting nations began to accumulate vast wealth. Toward the end of the 1970s, their newfound wealth gave some of these emerging market countries the ability to borrow.

During the initial loan years, the borrowings stayed on banks' balance sheets. But after a series of sovereign defaults by many contemporary emerging market countries, a debt crisis began in 1982. Near the end of the decade – in March 1989 – U.S. Treasury Secretary Nicholas Brady announced a debt-relief program that would convert outstanding U.S. bank loans into a variety of new bonds, which became known as Brady bonds.

Since then, the emerging market fixed income universe has continued its expansion. Primary debt issuance has increased, and the market has become more liquid. More recently, loan defaults by emerging markets have been rarer, with fewer crises relative to history. Furthermore, institutional participation increased as the market grew, and after the J.P. Morgan Emerging Market Bond Index, designed to cover U.S. dollar-denominated Brady bonds, loans and Eurobonds, was introduced in 1992.

While Brady bonds initially included only dollar-denominated debt, more recently, emerging market debt increasingly consists of debt issued by more balanced economies in local currencies. To some extent, this reflects emerging economies' resilience in withstanding shocks to the global financial system. Reserves accumulation, improved external debt positions, greater policy autonomy and the more flexible foreign exchange regimes of the constituent economies have all contributed to the maturing of the emerging market debt ("EMD") asset class.

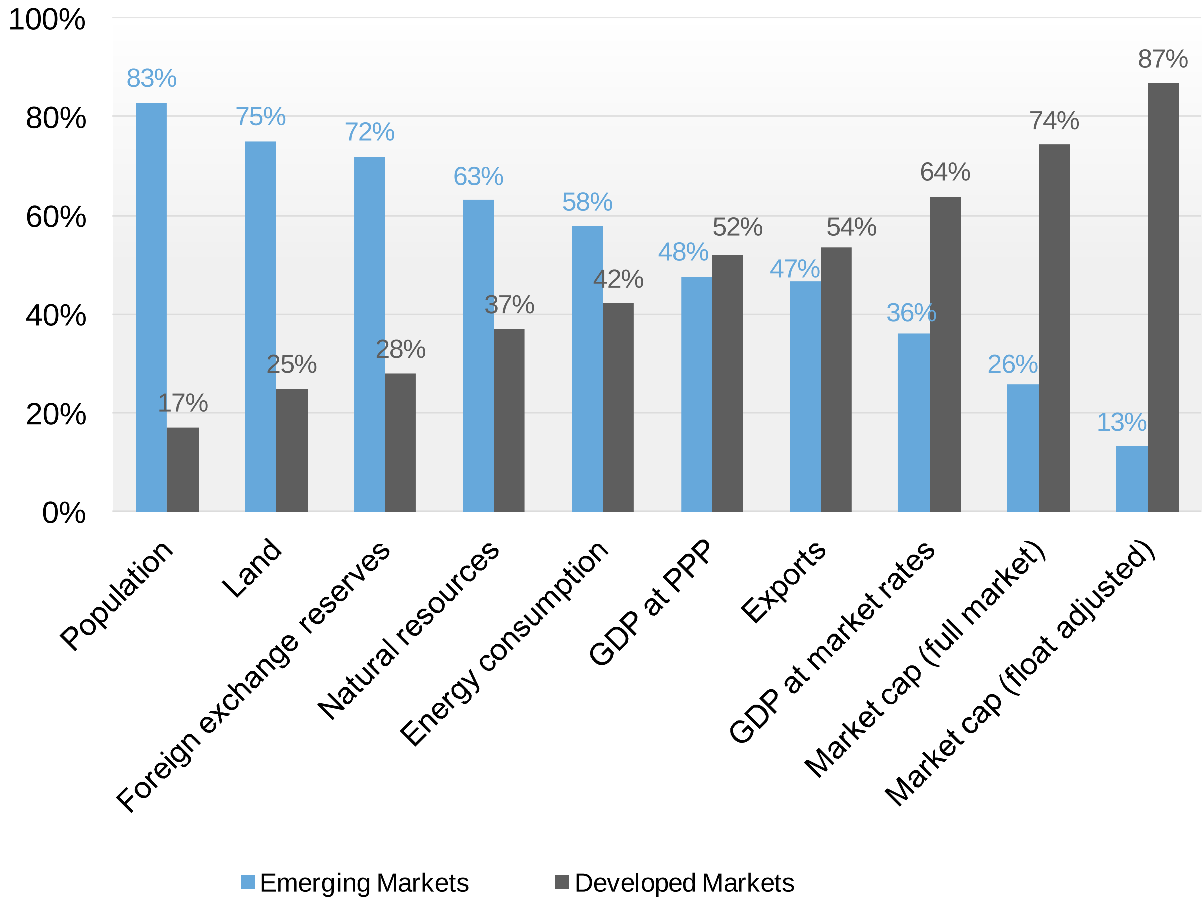
We believe these factors, along with positive supply and demand factors and the secular trend of improvements, make emerging market debt appealing as a long-term strategic asset class.

## Rationale for investing in emerging market debt

After experiencing painful economic contraction during the Asian financial crisis of 1997–1998, many emerging market countries adopted a more disciplined approach to managing their fiscal and monetary policies. Many of these countries fared well during the global financial crisis that occurred 10 years later.

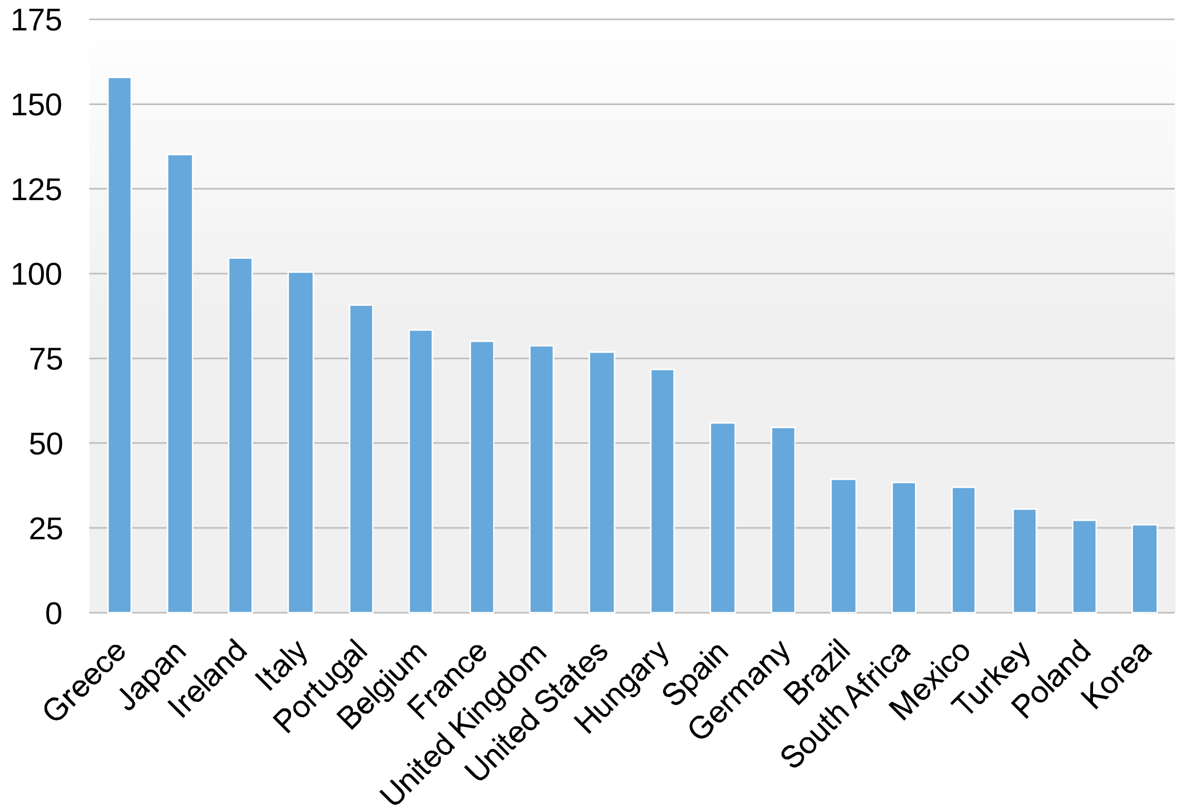
Additionally, long-term prospects are favourable for emerging markets. With 77% of the world's population and 75% of its land mass, they are strongly on a long-term growth path (Exhibit 1). While advanced economies are aging rapidly, emerging economies have younger demographics, and that is expected to be a huge advantage in coming decades. In the short term, they are well positioned to service their debt burdens, given that they have 72% of the world's foreign exchange reserves and low debt burdens relative to their GDPs (Exhibit 2). Many of the emerging market countries have grown faster than most developed countries, and they have accumulated reserves, reduced their debt-to-GDP ratios, diversified their sources of economic growth, and adjusted their fiscal and monetary policies to reduce vulnerabilities to economic shocks and contagion.

Exhibit 1/ Emerging and developed economies as a percentage of world total, as of June 2011




Sources: CSIS, Schroders, BofA Merrill Lynch, BP Statistical Review of World Energy June 2011, CIA World Factbook 2011, IMF World Economic Outlook 2011, MSCI
Data is as of the specified date. Current data may be different.

Exhibit 2/ Estimated 2012 Government Net Debt as % of GDP



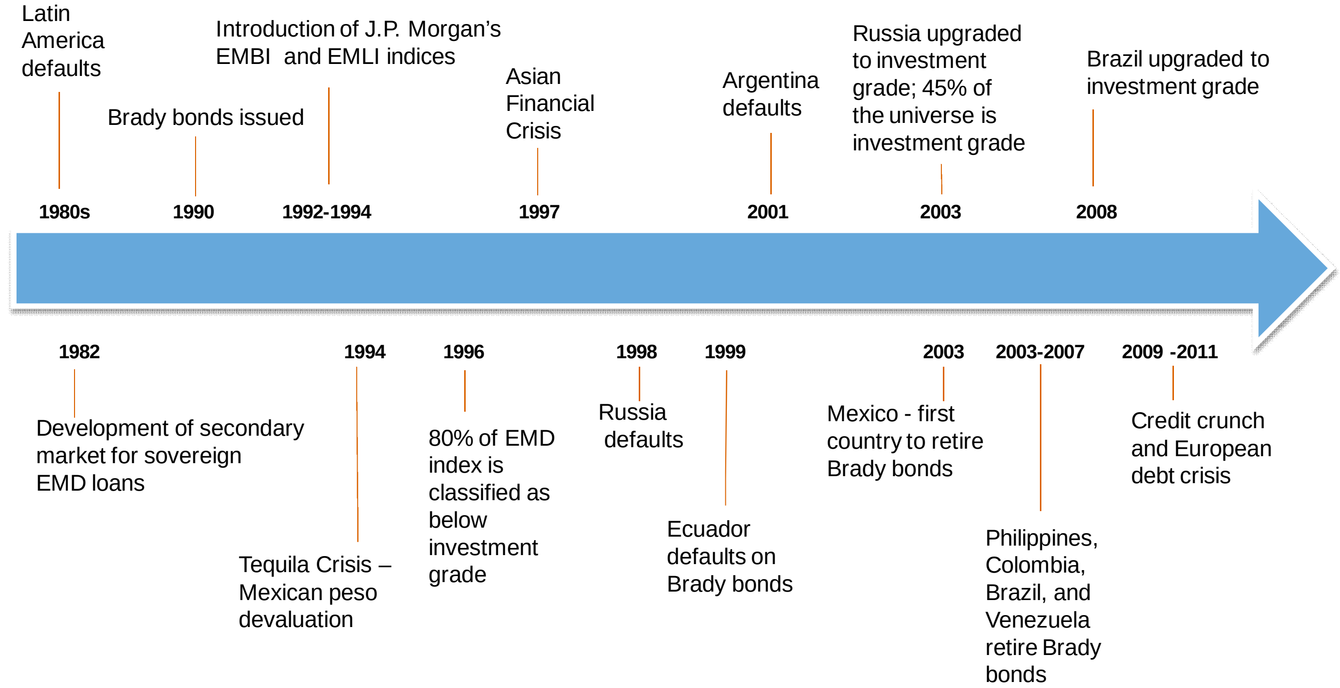

Source: IMF, World Economic Outlook Database, April 2011
Data is as of the specified date. Current data may be different.

## Evolution of EMD market

In the 1980s, many less-developed economies defaulted on their sovereign debt held by global banks. In response, U.S. Treasury Secretary Nicholas Brady introduced a new approach to debt repayment, and the securities that emerged were called Brady bonds. The first Brady Plan agreement was signed in March 1990, when banks exchanged Mexican loans for bonds. Later Brady plans were implemented for Argentina, Brazil, Bulgaria, the Côte d'Ivoire, Costa Rica, Croatia, the Dominican Republic, Ecuador, Jordan, Morocco, Nicaragua, Nigeria, Panama, Peru, the Philippines, Poland, Russia, Slovenia, Uruguay, Venezuela and Vietnam. By 1998, after over a decade of defaults, all major Brady Plan restructurings had been completed, signaling the transformation of emerging market debt from an unsecuritised loan market to a bond market and paving the way for many former debtor nations to reenter the voluntary global capital markets.[1]

[1] This is a compilation from Emerging Market Traders Association and IMF.

Exhibit 3 / Emerging market debt timeline



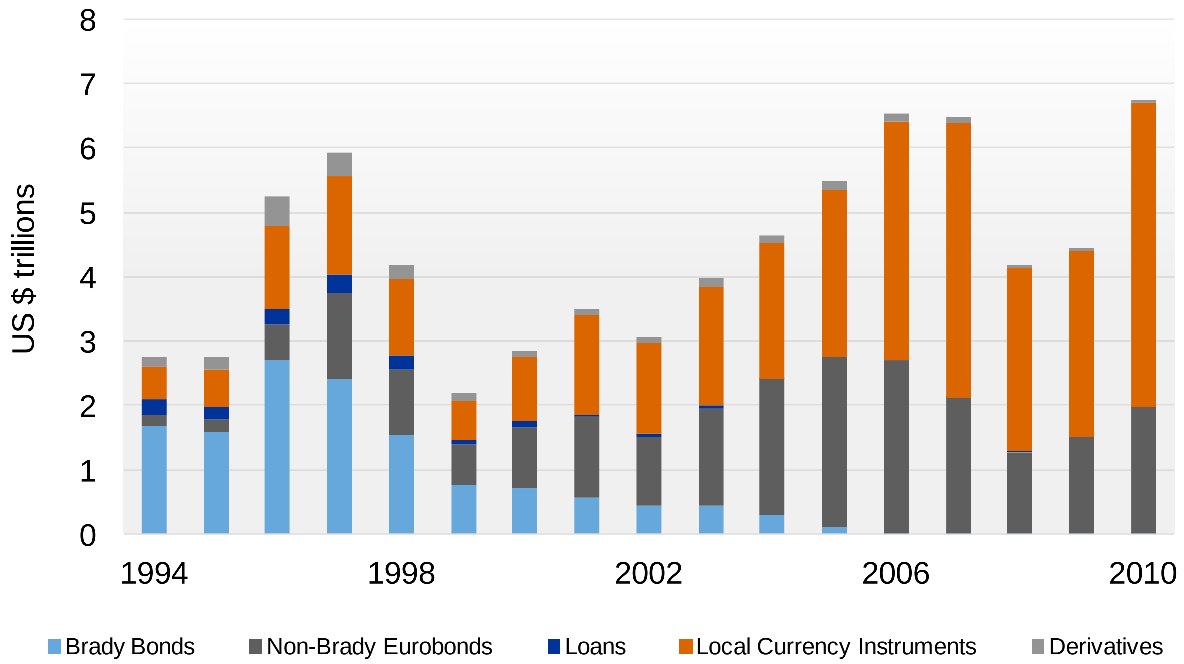

Source: Russell Research

The introduction of the Brady Plan increased liquidity in the EMD universe. According to the Emerging Markets Traders Association, market trading volumes grew rapidly in the 1990s, peaking at $9 trillion in 1997 before falling sharply in response to the Russian default in mid-1998.[2] Confidence returned to the asset class shortly after, as Mexico's credit rating was upgraded to investment grade and Russia successfully completed its "London Club" debt restructuring in 1999–2000.

By 2007, secondary market trading volumes rebounded to about $6.5 trillion, and with the retirement of most Brady bonds, the share of local market instruments in overall EMD trading rose to nearly 66% (Exhibit 4). As investors sought safer investments during the credit crisis of 2008, trading volume fell to $4.2 trillion before rebounding to its highest level ever in 2010: US$6.8 trillion, about 70% in local market instruments.

[2] See EMTA, "EM Background: History and Development," available at http://www.emta.org/template.aspx?id=34, as of April 2012

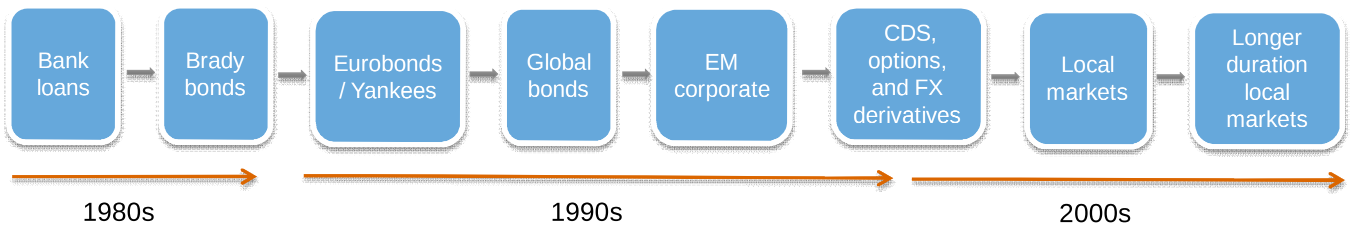
Exhibit 4 / Emerging markets debt trading volume




Source: Emerging Markets Traders Association

In recent years, more sophisticated instruments, including sovereign credit default swaps (CDS) and corporate Eurobonds, have become more liquid and accessible. According to the Emerging Markets Traders Association (EMTA), large banks reported US $1.452 trillion in EM CDS volumes in 2010. Corporate Eurobonds now represent almost half of all Eurobond volumes. Recent developments indicate a larger investor base, as well as growing confidence among EMD investors (Exhibit 5).

Exhibit 5 / Development of the EMD market




Source: EMTA and Russell Research

## Emerging market debt as an asset class

The emerging market debt asset class consists of hard currency bonds, local currency bonds, Eurobonds, traded loans and local market debt instruments issued by sovereign, quasi-sovereign and corporate entities of emerging economies. The universe does not include borrowings from governments or international financial institutions such as the IMF, although loans that are issued in the market and securitised are included.

There is no consistent definition of what makes a country's market "emerging." While some countries, such as Brazil, Chile, China, India, South Africa, Turkey, etc., are currently universally acknowledged as emerging, definitions of others are more discretionary. For instance, the FTSE Group classifies emerging markets on the basis of national income and the development of the market infrastructure, whereas S&P classifies a market as emerging on the basis of national income, financial depth and the existence of discriminatory controls for non-domiciled investors, and on factors such as transparency, market regulation and operational efficiency.

## Indices / Benchmarks

J. P. Morgan's emerging market debt indices are the most commonly used benchmarks for the EMD asset class. Exhibits 6 and 7 list of some of the most commonly used J. P. Morgan indices and the assets benchmarked to them, along with their respective market capitalisations. Improving financial conditions in many emerging market counties have resulted in ratings upgrades by the EMD issuers. All three of the major J. P. Morgan EMD indices now have an investment grade average rating.

Exhibit 6/ J. P. Morgan EMD indices as of December 31, 2011

| | Hard Currency Sovereign | Hard Currency Corporate | Local Currency Bonds |
|---|---|---|---|
| Benchmark | Emerging Markets Bond Index (EMBI GD) | Corporate EM Bond Index (CEMBI Div) | Government Bond Index (GBI-EM GD) |
| Benchmark Description | USD-denominated debt of sovereign/quasi-sovereign issuers | USD-denominated debt issued by corporate entities | Liquid, fixed-rate local currency debt of sovereign issuers |
| Currency Denomination | USD | USD | LC |
| Average Rating (S&P) | BBB- | BBB | BBB+ |
| Benchmark Characteristics | | | |
| Countries | 44 | 30 | 14 |
| Asia (%) | 19.4 | 39.9 | 29.0 |
| Europe (%) | 30.3 | 15.9 | 34.2 |
| Latin America (%) | 39.6 | 29.0 | 26.8 |
| Middle East/Africa (%) | 10.7 | 15.2 | 10.0 |
| Yield | 5.8 | 6.1 | 6.6 |
| Duration | 7.0 | 6.3 | 4.6 |

Source: J.P. Morgan

Exhibit 7 / J. P. Morgan Emerging Market Bond Index market capitalisation as of January 2, 2012

| J.P. Morgan EM Indices | USD (bn) | Top countries holdings in the Index |
|---|---|---|
| Local Market Debt | | |
| GBI-EM | 485 | Mexico, Poland, South Africa, Malaysia, Turkey |
| GBI-EM Global | 782 | Brazil, Mexico, Poland, South Africa, Malaysia |
| GBI-EM Global Diversified | 782 | Brazil, Indonesia, Malaysia, Mexico, Poland, South Africa, Turkey |
| GBI-EM Broad | 1383 | China, Brazil, India, Mexico, Poland |
| External Debt | | |
| EMBI Global Diversified | 274 | Brazil, Mexico, The Philippines, Russia, Indonesia |
| EMBI Global | 457 | Mexico, Russia, Brazil, Venezuela, Turkey |
| Corporate External Debt | | |
| CEMBI Broad Diversified | 209 | Hong Kong, Brazil, Russia, Korea, Mexico |
| CEMBI Broad | 419 | Brazil, Russia, Hong Kong, Mexico, Korea |

Source: J.P. Morgan EMBI December 2011

## Hard currency vs. local currency

As recently as the 1990s, most emerging market economies did not have the ability to issue debt denominated in local currencies, except at the shorter end of domestic yield curves. Countries had to go to the global markets with the support of IMF to raise debt in U.S. dollars or euros. But the situation has changed rapidly in the last decade. With stronger fiscal conditions and better macroeconomic policy implementation, most of the sovereign entities in emerging economies do not raise hard debt anymore. In addition, many countries have loosened restrictions that previously prevented foreign ownership of local currency debt. Thus, it is not surprising that local currency debt is the fastest-growing segment of the overall emerging market debt universe.

Because of improving fiscal conditions in many emerging market countries, the outstanding issuance of external (hard currency) emerging market sovereign debt has been on net decline. However, local currency debt has grown to hold the lion's share of the EMD market, with the corporate component in hard currency growing at a rapid pace. There are also greater opportunity sets in both local currency bonds and corporate hard currency, as they still represent a small portion of the investable universe (Exhibit 8).

Exhibit 8 / EMD index capitalisation and AUM benchmarked against EM Indices (December 31, 2011)

| (USD bn) | Index Market Capitalisation | Total AUM Benchmarked Against EM Indices | Ratio AUM / Index |
|---|---|---|---|
| Sovereign Hard Currency | 457 | 231 | 51% |
| Corporate Hard Currency | 419 | 30 | 7% |
| Local Currency Bonds | 782 | 146 | 19% |

Source: J.P. Morgan

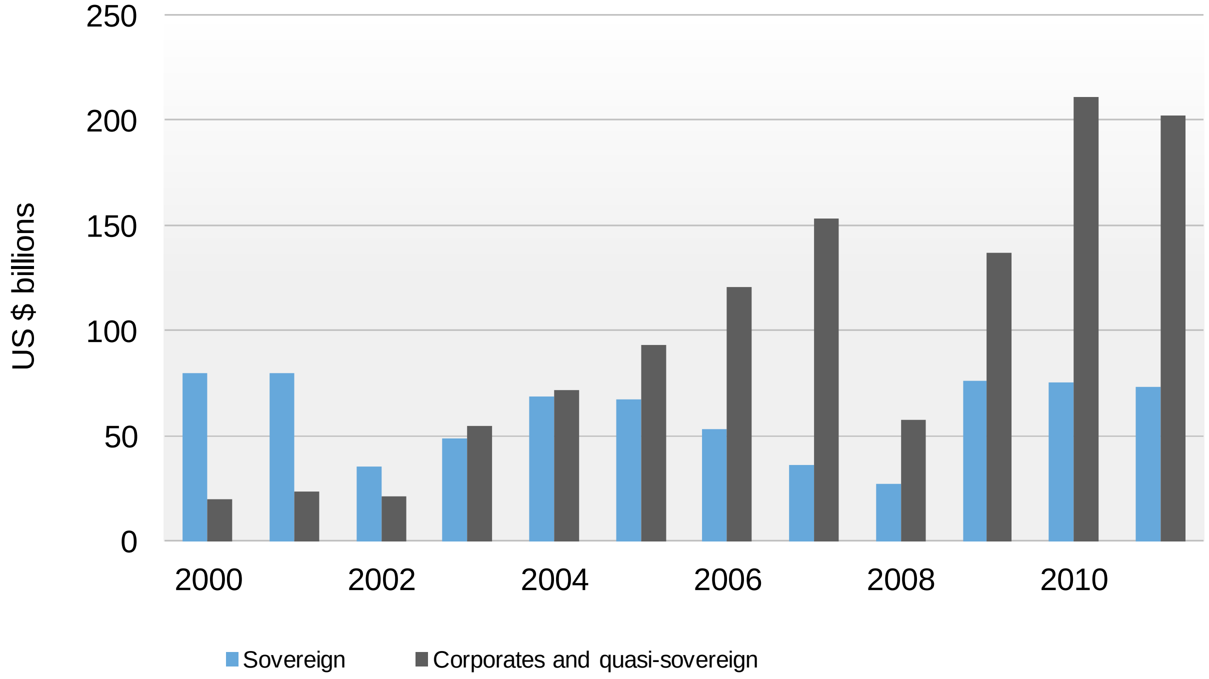
## Corporate EMD

Since 2003, emerging market corporate debt issuance has been approximately twice that of sovereign debt issuance and EM corporate debt has rapidly developed into a significant asset class with primary issuance in the hard currency space (Exhibit 9). Apart from the high growth rates of their domestic economies, EM corporate bonds have become a standalone asset class and have benefited from improved credit quality and declining default rates.

Corporate bonds now constitute the majority of outstanding EM external debt. The liquidity of corporate EM debt, which was a critical issue for institutional investors, has also improved in recent years. The issue sizes of corporate debt have also increased in the last few years.

EM corporations' balance sheets are fundamentally improving, and balance sheet strength was fully tested in 2008 and 2009. Many EM corporations are global-size players who are among the world's lowest-cost producers.  Leverage in both investment-grade and high-yield EM corporate debt is materially lower than leverage in comparable developed market corporates.

Exhibit 9/ Emerging market corporate and sovereign debt issuances, USD bn (2000–2011)

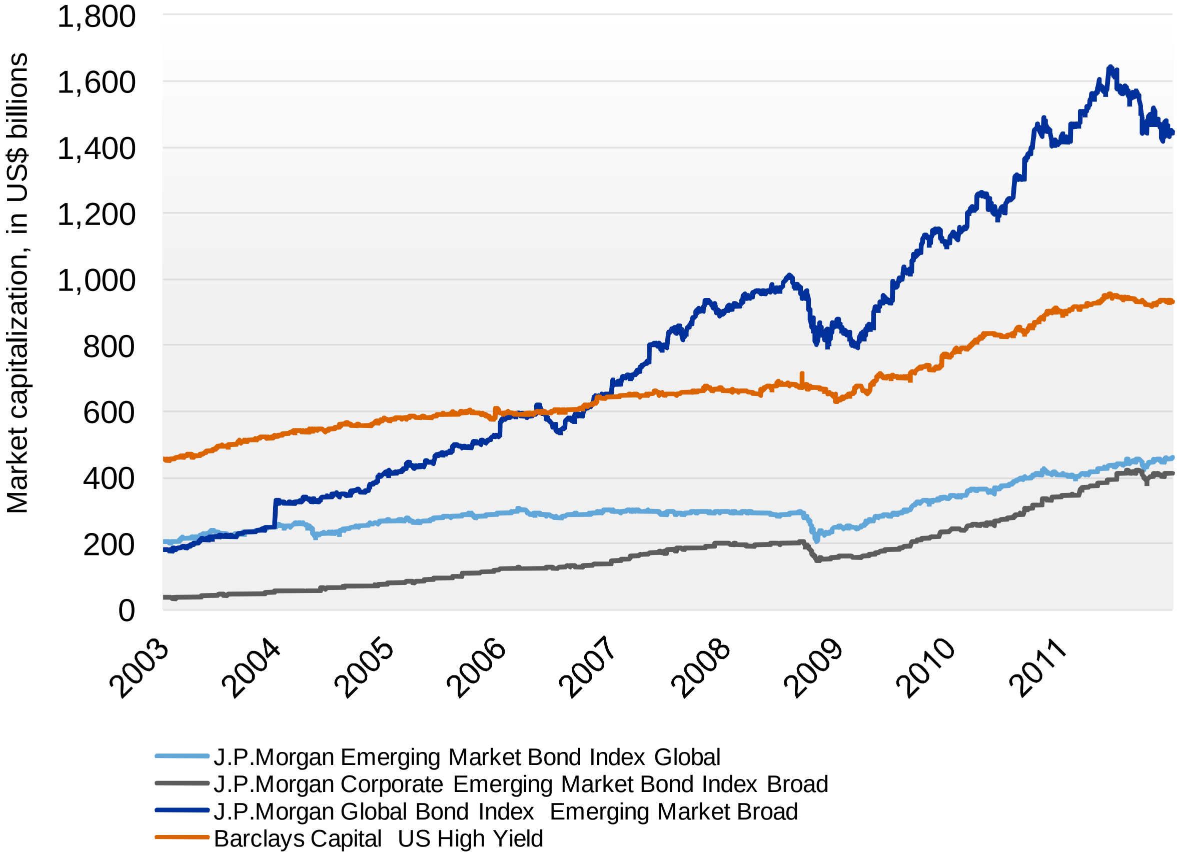



Source: J.P. Morgan

## Deeper and more diversified markets

Emerging markets have evolved over the last decade. The asset class is now deeper and more diversified, with more countries in the benchmarks. Market capitalisation of the local EMD has surpassed the U.S. High Yield market capitalisation (Exhibit 10). Investors can also choose between external debt, local debt, sovereign and quasi-sovereign debt, corporate debt, etc. There is a healthy CDS market as well. In addition, the debt profile of the asset class now has a healthy percentage of investment-grade debt. While the investable universe has grown in recent years, the non-investable universe (non-index market), especially in China and India, has also grown rapidly.

Exhibit 10/ Market capitalisation, in USD bn (2003–2011)




Source: J. P. Morgan, Barclays Capital

A few years ago, the major appeal of emerging market debt as an asset class hinged on its low correlation to other assets, which offered investors opportunities to leverage the potential diversification benefit in a well-constructed portfolio. As Exhibit 11 shows, however, more recently the correlation of EMD with other asset classes has been low to moderate. Yet EMD still provides diversification benefits to a portfolio of short-term Treasuries. Returns in the recent past (post-2008) showed an increase in correlation of external sovereign debt with equity markets and U.S. High Yield indices.

Exhibit 11 / Correlation of J. P. Morgan EMBI GD (external sovereign debt) with other asset classes

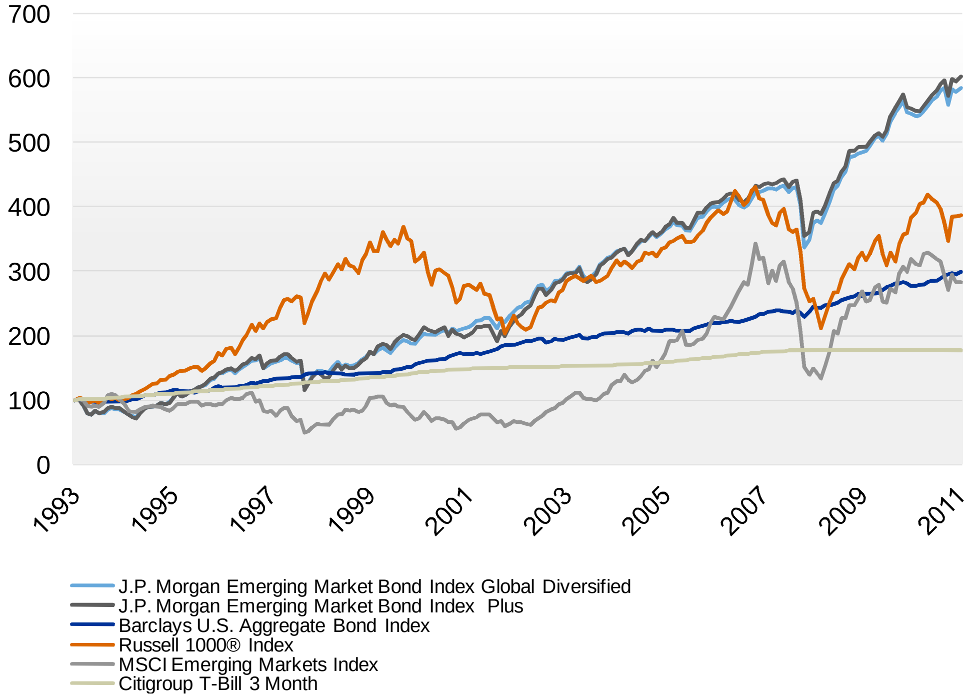
| | JP Morgan Emerging Markets Bond Index Plus | Barclays Capital U.S. Aggregate Bond Index | Barclays Capital Corporate High Yield BB (Ba) Index | Barclays Capital Treasury-Long Term | MSCI Emerging Markets Index | Russell 1000® Index | US Consumer Price Index | Citigroup T-Bill 3 Month |
|---|---|---|---|---|---|---|---|---|
| 1994-2011 | 0.98 | 0.36 | 0.56 | 0.17 | 0.66 | 0.54 | 0.00 | 0.01 |
| 2009-2011 | 0.99 | 0.31 | 0.75 | -0.25 | 0.74 | 0.60 | -0.07 | 0.38 |

Source: J. P. Morgan, Barclays Capital, MSCI, Russell Index, Citigroup

### Returns enhancement

Emerging market debt has consistently outperformed other fixed income asset classes over a long period of time (Exhibit 12). Local market debt (J. P. Morgan ELMI+) was an outperformer until 2003, as the market was very thin and there was much skepticism about local currency money market debt; however, larger issuances of local currency debt have since moderated the returns. Emerging external sovereign debt (J. P. Morgan EMBI GD) has been an outperformer since 2003. There are two possible explanations – demand has outstripped supply, and the fundamentals of the issuers have significantly improved. On the demand side, as emerging market countries improve their fiscal discipline and better manage their economic growth, they accumulate foreign currency reserves and build up their domestic pension plans and sovereign wealth funds, which have become an important source of demand for emerging market assets. On the supply side, the fundamentals of the issuers have also significantly improved, reducing the need to issue additional external debt

Exhibit 12/ Cumulative returns (%) of various asset classes (1994–2011)




Past performance is not a reliable indicator of future performance.

| 1994-2011 | Annualised Returns (%) | Annualised Volatility (standard deviation) |
|---|---|---|
| JP Morgan Emerging Market Bond Index Global Diversified | 11.30 | 13.09 |
| JP Morgan Emerging Market Bond Index Plus | 11.70 | 14.43 |
| Barclays U.S. Aggregate Bond Index | 6.35 | 3.76 |
| Russell 1000® Index | 9.19 | 15.87 |
| MSCI Emerging Markets Index | 9.19 | 24.16 |
| Citigroup T-Bill 3 Month | 3.26 | 0.59 |

For a given issuer, local currency debt is usually expected to have higher yields than bonds denominated in hard currency. This arguably reflects the higher risk of holding emerging market currency. However, very often the so-called “carry trade” (or “forward rate bias”), which describes higher-yielding currencies’ empirical tendency to appreciate against loweryielding ones, can be observed in the emerging market space. High-yielding currencies' tendency to strengthen or depreciate less than implied interest rate differentials makes holding local currency debt appealing. This is further corroborated by recent return characteristics; in the recent past, monthly returns of local currency instruments have been less volatile.

Overall, local currency instruments have better risk/return profiles than hard currency debt, but the higher returns come from currency appreciation, which exposes the portfolio to any currency crisis in emerging markets (as in the Asian financial crisis of 1997). Local currency instruments are thus suitable investment vehicles for those who want a greater exposure to currency risk. However, it can be suitably argued that the currency appreciation is an aftereffect of the overall economic strength of emerging markets.

## Considerations for emerging market debt

It appears that the emerging market debt asset class has, as at this time, priced in better fundamentals, better debt servicing capabilities and the more prudent macroeconomic policies of emerging market economies. Some EM debts trade at much narrower spreads than those of some U.S. states and municipalities, and of much of the indebted peripheral Europe.

There are compelling reasons to consider adding EMD to a fixed income portfolio. The growing strength of emerging market economies is also driving stocks' gains, and that may change the appeal of EM debt in the medium term. Potentially, the market may turn into a lower-risk and lower-return fixed income asset class, much similar to credit-rated debt in developed markets. However, given the recent appreciation in the prices of some of the emerging market debt instruments, it will be imperative to be selective in this growing asset class.

Based on improving macroeconomic fundamentals, emerging market debt may be an attractive asset class to complement both fixed income and equity assets. At present there is not much outstanding external sovereign debt in the market, and amounts are not increasing as rapidly as demand. EMD local currency debt might be appropriate for investors who are looking for currency exposure and who have confidence in the currency appreciation story.

SOURCES

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## Important information



First used: April 2012

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