

An Emerging Asset Class: The Case for Emerging Markets Local Currency Debt

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Twenty years ago, few investors would have considered emerging market sovereign debt as a viable investment option. Political instability, social unrest, and economic turmoil were *status quo* for many emerging market countries. With upgraded infrastructure, stronger property rights laws, and increased political and economic stability, emerging market countries have grown tremendously over the last two decades. They currently account for 2 of the top 5, 4 of the top 10, and 8 of the top 20 countries by GDP.<sup>1</sup>

As emerging market economies have evolved, so have their credit markets. During a time of distress and negative real yields for many developed economies, this evolution has prompted investors to consider emerging market debt as an investment option that is not only viable but attractive. However, the first question facing an investor in emerging market sovereign debt is whether to invest in U.S. dollar denominated debt or local currency denominated debt. In this paper, we explore the differences between the two and describe the benefits that come with local currency emerging market sovereign debt. We will refer to emerging market sovereign local currency debt as “local currency debt” and emerging market sovereign U.S. dollar denominated debt as “USD debt”.

## LOCAL CURRENCY DEBT VS. USD DEBT ISSUANCE

International borrowers generally prefer to issue debt in their local currency rather than in U.S. dollars. Having a liability denominated in another currency can be disastrous if the issuer’s domestic economy suffers from inflation or undergoes currency devaluation, as Argentina did in the economic crisis of 1999–2002. Historically, issuing debt in U.S. dollars was the only option available to emerging market countries, because few investors were willing to bear the risks associated with investing in local currency debt. Now that their economies have become more stable, emerging market currency risk—which can, of course, be hedged—is somewhat less concerning. Indeed, given central banks’ efforts to significantly increase money supply in developed economies during the current economic cycle, the monetary discipline of central bankers in emerging markets challenge our previously held views regarding the relative risk of emerging market currency vs. developed markets.

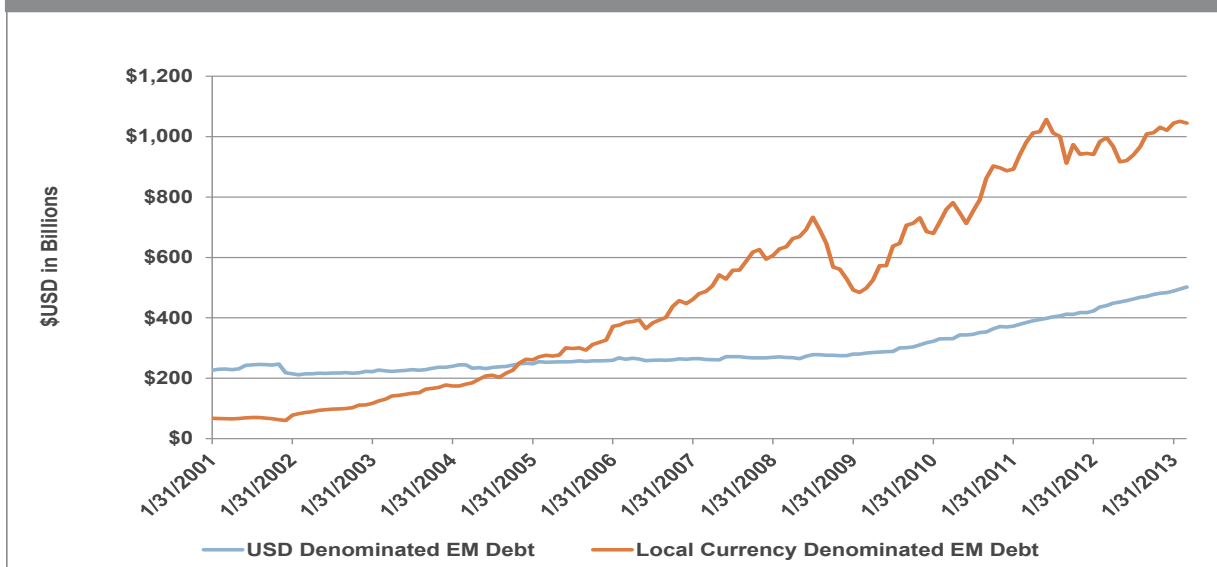
**Figure 1** displays the amount of outstanding emerging market debt in U.S. dollars and local currency since 2001. The amount of outstanding debt issued in local currency has increased dramatically over that time, surpassing USD debt in 2005 and totaling over a trillion dollars as of March 31, 2013. The local currency debt market is now over twice the size of the USD debt market, with correspondingly greater liquidity and higher investment capacity.

## CREDIT QUALITY

A second characteristic of local currency debt is the issuers’ perceived creditworthiness. Given that most countries naturally prefer issuing debt in local currency, the improving economic conditions in many emerging markets have created a self-selection process in which the more stable countries increasingly issue debt in local currency, while the less stable continue to issue debt denominated pri-

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FIGURE 1: LOCAL CURRENCY DEBT ISSUANCE VS. USD DEBT ISSUANCE



Based on par outstanding of J.P. Morgan EMBI Global (USD Debt) and J.P. Morgan GBI-EM (local currency debt).

Source: Research Affiliates, LLC, based on data from Bloomberg.

marily in USD. Accordingly, local currency debt indices reflect better credit quality than USD debt indices. **Table 1** provides the weighted average credit quality for the J.P. Morgan EMBI Global Index (USD debt) and the J.P. Morgan GBI-EM Index (local currency debt) as of March 31, 2013. Issuers whose securities belong to the local currency debt index have a weighted average credit quality rating of A-/BBB+ while those in the index of USD debt are rated BBB-/BB+.

Table 1 also lists several countries within each index that issue some debt in U.S. dollars and some debt in local currency. The credit rating for debt issued in local currency consistently ranks higher than USD debt issued by the same country. It's important to remember that credit ratings are solely a measure of default risk. Governments can reduce local currency debt obligations by increasing the money supply—"turning on the printing press"—as long as they are willing to bear the likely inflationary results. In the words of Standard & Poor's Rating Services, "Sovereign local-currency ratings can be higher than sovereign foreign-currency ratings because local-currency creditworthiness may be supported by the unique powers that sovereigns possess within their own borders, including issuance of the local currency and regulatory control of the domestic financial system."<sup>2</sup>

Thus, while sovereign local currency debt is exposed to inflation risk, it is less likely to enter technical default because the issuer failed to make timely principal and interest payments. In contrast, when a sovereign uses another country's currency, it both takes on the risk of adverse foreign exchange rate movements as well as the loss of flexibility to repay the debt with cheaper money. Consequently, the risk of default is greater with USD debt.

TABLE 1. CREDIT QUALITY OF LOCAL CURRENCY DEBT VS. USD DEBT		
	J.P. MORGAN EMBI GLOBAL (USD DEBT)	J.P. MORGAN GBI-EM (LOCAL CURRENCY DEBT)
Brazil	BBB	A-
Mexico	BBB	A-
Poland	A-	A
South Africa	BBB	A-
Malaysia	A-	A
Russia	BBB	BBB+
Turkey	BB+	BBB
Indonesia	BB+	BB+
Thailand	BBB+	A-
Hungary	BB	BB
Colombia	BBB	BBB+
Peru	BBB	BBB+
Index Weighted Avg. Credit Rating	BBB-/BB+	A-/BBB+

Source: Research Affiliates, LLC, based on data from Bloomberg.

## LOCAL CURRENCY DEBT VS. USD DEBT RETURNS

Since its inception in 2002, the J.P. Morgan GBI EM Bond Index has outperformed the J.P. Morgan EMBI Global Index by approximately 1.5% per year in U.S. dollar terms (see **Table 2**). However, this higher performance comes with higher volatility. The higher volatility is a result of the fact that, for a U.S. investor, there are two sources of return for the local currency index: a return on the bonds in the index and a currency return. The USD debt index is composed of a bond return only.

If emerging market currencies collectively appreciate against the U.S. dollar, investors holding local currency debt stand to benefit from both sources of return. Although it is beyond the scope of this paper to explore the outlook in any detail, there are reasons to believe that emerging market currencies will appreciate over the coming decade. The United States currently has a debt-to-GDP ratio

TABLE 2. PERFORMANCE COMPARISON AS OF MARCH 31, 2013					
	1-YEAR	3-YEAR	5-YEAR	10-YEAR	SINCE 2002
<b>Annualized Return</b>					
J.P. Morgan EMBI Global (USD Debt)	10.44%	10.55%	9.81%	10.59%	11.20%
J.P. Morgan GBI-EM (Local Currency Debt)	6.85%	7.69%	7.16%	11.08%	12.68%
<b>Annualized Standard Deviation</b>					
J.P. Morgan EMBI Global (USD Debt)	6.69%	6.72%	10.72%	8.87%	9.25%
J.P. Morgan GBI-EM (Local Currency Debt)	11.98%	13.01%	14.80%	12.38%	11.98%

Source: Research Affiliates, LLC, based on data from Bloomberg.

greater than 100%,<sup>3</sup> and it has been shown that large debt burdens lead to slower GDP growth.<sup>4</sup> Many developed countries are actively engaged in keeping nominal interest rates low and real yields negative as a mechanism to decrease the real value of debt (with inflation and currency depreciation as potential side effects).<sup>5</sup> Additionally, Arnott and Chaves have explained the effect of demographic trends on GDP growth.<sup>6</sup> Their research describes how the emerging markets are collectively entering a demographic sweet spot in the coming decades. In their analysis, the United States and other developed economies face strong, sustained demographic headwinds in the years ahead.

### CORRELATION WITH INFLATION

From the perspective of a U.S. investor, one of the most important benefits of holding local currency debt is its potential to act as an inflation hedge. It is intuitively sensible to expect emerging market currencies to appreciate when the U.S. economy experiences higher relative inflation. Evidence supports this rational expectation. **Table 3** illustrates the correlation of annual returns on local currency debt and USD debt with annual inflation surprises. (We are measuring unexpected inflation—or inflation shocks, which we define as year-over-year inflation minus year-over-year inflation from one year prior—because bond yields should already incorporate expected inflation.) Compared to the USD debt index, the local currency index has twice the correlation with inflation shocks. Additionally, the local currency index has almost triple the beta with respect to inflation shocks. In other words, for a given inflationary shock, the local index has historically experienced almost three times the return effect registered by the USD index.

**Table 4** shows the impact of this relationship between inflation and U.S. dollar denominated returns on local currency debt: the local currency index has historically performed better during periods of high unexpected inflation. Although the measurement period only includes 96 monthly data points, U.S. inflation shocks appear to be associated with outperformance by the local currency debt index relative to the USD debt index. When unexpected inflation was greater than 2%, the average annualized outperformance was 4.3%, and when unexpected inflation fell between 1.0% and 2.0%, the average annualized outperformance was 8.3%. Conversely, during periods of unexpected deflation, the local debt index underperformed.

TABLE 3: INFLATION CORRELATION		
	J.P. MORGAN EMBI GLOBAL (USD DEBT)	J.P. MORGAN GBI-EM (LC DEBT)
Correlation w/ inflation shocks	25%	55%
Beta w/ inflation shocks	1.07	2.90

Source: Research Affiliates, LLC, based on data from Bloomberg.

**TABLE 4: VALUE ADDED DURING PERIODS OF INFLATION SHOCKS**

INFLATION SHOCK	J.P. MORGAN EMBI GLOBAL (USD DEBT)	J.P. MORGAN GBI-EM (LC DEBT)	VALUE ADDED (LC-USD)
Above or equal to 2.0%	12.7%	17.0%	4.3%
Between 1.0% and 0.0%	10.6%	18.9%	8.3%
Between 0.0% and -1.0%	15.1%	16.0%	0.9%
Between -1.0% and -2.0%	16.9%	13.3%	-3.6%
Equal or below -2.0%	14.6%	8.9%	-5.7%

Average annual returns for the period 1/1/2001-3/31/2013.

Source: Research Affiliates, LLC, based on data from Bloomberg.

## CONCLUSION

Over the last 20 years, numerous emerging market countries—Mexico, Poland, South Africa, and others—have grown economically while establishing greater stability, improving the infrastructure, and strengthening laws to protect property rights. They have also developed substantial credit markets. Although there are still risks to consider, these propitious long term changes support sensible investments in emerging market sovereign debt.

We maintain that local currency debt has decisive advantages over debt that is denominated in U.S. dollars.

- More than twice the size of the USD market, the local currency debt market has correspondingly greater liquidity and higher investment capacity.
- Local currency debt indices reflect better credit quality than USD debt indices.
- There are two potential sources of return for local currency debt indices: a return on the constituent bonds and a currency return.
- For U.S. investors, local currency debt has the potential to serve as a hedge against unexpected inflation.

Although it is a relatively new asset class, emerging market sovereign local currency debt may be a profitable addition to an investor's portfolio.



### ENDNOTES

1. GDP figures as of 2012, based on data from Factset.
2. Standard & Poor's Rating Services, "Sovereign Government Rating Methodology and Assumptions," updated June 24, 2013.
3. Factset. U.S. Debt/GDP ratio as of 12/31/2012 was 103%.
4. Two examples are Cristina Checherita and Philipp Rother, "The Impact of High and Growing Government Debt on Economic Growth: An Empirical Investigation for the Euro Area," European Central Bank Working Paper Series no. 1237 (August 2010); and Carmen M. Reinhart, Vincent R. Reinhart, and Kenneth S. Rogoff, "Debt Overhangs: Past and Present," NBER Working Paper No. 18015 (April 2012).
5. See Shane Shepherd, "Financial Repression: Why It Matters," *Simply Stated*, April 2013.
6. Robert D. Arnott and Denis B. Chaves, "Demographic Changes, Financial Markets, and the Economy." *Financial Analysts Journal*, vol. 68, no. 1 (January/February 2012), 23-46.



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