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Ashmore

Local Currency Bonds: the stars are still aligned

Gustavo Medeiros and Jan Dehn

Six months ago we outlined the reasons for turning bullish on Emerging Markets (EM) local currency bonds for the first time since the Taper Tantrum of 2013.[1] Since then, the election of Donald Trump led to an increase in volatility, particularly in Mexico, but Trump-related uncertainty was not enough to derail the asset class. Instead, local currency bonds gained further momentum in line with growing expectations of reflationary policies in the US.

This Market Commentary has two objectives. Firstly, we update the outlook for EM local currency bonds by drawing up return scenarios for the next five years. We think the case remains strong and urge investors to take notice. Secondly, we outline the outlook for the US dollar, which obviously matters a great deal for returns in EM local markets. Our base case is that the Dollar will decline gently over the next few years barring extremely positive growth in the US or extremely bad political events in Europe. This backdrop should be supportive for EM local markets.

Two potential sources of arbitrage in EM dollar debt

The return to local currency bonds over the medium term depends on inflation differentials with the rest of the world and the outlook for currencies. The performance of EM currencies versus the US Dollar is particularly important, because most investors fund in Dollars and most have been massively underweight EM local markets up to this point.

Inflation differentials are an important consideration in evaluating return prospects in EM local markets. Between April 2011 and January 2017 EM currencies declined from 140.4 to 82.2 or 41.4% – see chart below.

Fig 1: **EM nominal exchange rates**

Source: Ashmore, Bloomberg, JP Morgan.

Adjusted for inflation differentials, however, EM currencies declined from 116.9 to 93, which is equivalent to a 20.5% depreciation. The difference between the nominal and inflation-adjusted, or real, exchange rates is due to differences in inflation in the countries comprising the GBI index and their main trading partners. This differential averaged 3.6% per year over the period in question.

> Inflation differentials may begin to favour EM again. Inflation is declining in a number of EM countries, particularly those which have implemented reforms in recent years

Most investors fund in Dollars, so the inflation differential with the US and EM FX performance versus the Greenback is particularly relevant to investors in EM local currency bonds. The chart below shows how the EM-US inflation differential has evolved since 2002.[2] Low levels of US inflation have recently pushed down the differential, which means that less nominal depreciation will be needed to preserve relative competitiveness in EM, all else even.

Looking forward, however, the inflation differential may begin to favour EM again. Inflation is declining in a number of EM countries, particularly those which have implemented reforms in recent years. Brazilian inflation collapsed from 10.8% in early 2016 to close to 5% today and is likely to decline further, fuelling discussion about a potential reduction in the central bank's 4.5% inflation target from 2019 onwards. Declining inflation is also being observed in Argentina, Colombia, Peru, Chile, Russia and India, while price pressures are very subdued in South Africa. The main inflationary pressures are observed in low yielding 'DM-like' EM economies, such as Poland, Hungary, Czech Republic, China, Hong Kong, Singapore, Thailand and Malaysia. But here inflation remains well contained and since inflation is falling faster in the former group than it is rising in the latter the overall inflation indices in EM are declining.

[1] See *"Emerging Markets Local Currency bonds – the stars are aligned"*, Market Commentary, 3 August 2016.
[2] Ideally inflation differentials are calculated using tradable goods, but for simplicity's sake we use CPI indices.

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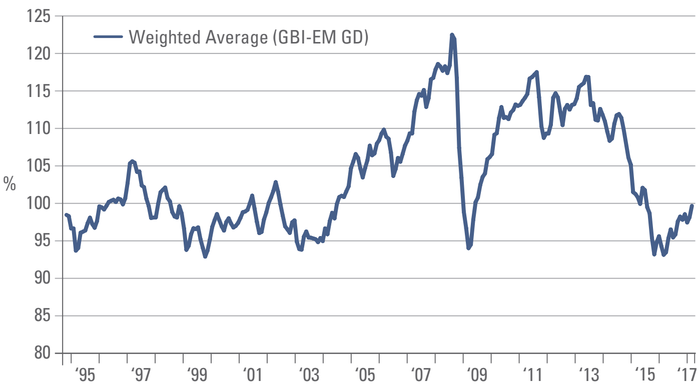
Fig 2: **US-EM inflation differentials based on headline CPI**

Source: Ashmore, Bloomberg.

Unlike inflation differentials, EM REERs are currently close to their all-time lows in Dollar terms – see chart below. This means that despite higher relative inflation rates, EM currencies still have a lot of potential upside before real exchange rates begin to impact long term competitiveness adversely. Returns over the next five years – a reasonable time-horizon for long term investors and conveniently the same duration as the GBI-EM GD – will ultimately depend on the inflation differential and the level of REER over this horizon.

Fig 3: **EM real effective exchange rates**



Source: Ashmore, Bloomberg, BIS.

If we assume that EM REERs must gravitate towards the long-term average of 105 (currently at 97.4) and that total return comprises carry plus annualised real appreciation minus the EM-US inflation differential, the following return scenarios will apply over the next five years. The figures refer to average returns in Dollar terms per year.

EM inflation	US Inflation scenarios					
	0.0%	1.0%	2.0%	3.0%	4.0%	5.0%
2.0%	5.68%	6.68%	7.68%	8.68%	9.68%	10.68%
3.0%	4.68%	5.68%	6.68%	7.68%	8.68%	9.68%
4.0%	3.68%	4.68%	5.68%	6.68%	7.68%	8.68%
5.0%	2.68%	3.68%	4.68%	5.68%	6.68%	7.68%
6.0%	1.68%	2.68%	3.68%	4.68%	5.68%	6.68%
7.0%	0.68%	1.68%	2.68%	3.68%	4.68%	5.68%

Source: Ashmore.

The table below examines the sensitivity of annualised returns to changes in levels of real exchange rates and inflation differentials, also over the next five years:

REER		Inflation differential		
		Bull	Base	Bear
		1%	2%	3%
Low	93	4.27%	3.27%	2.27%
Average	105	6.68%	5.68%	4.68%
High	122.8	10.25%	9.25%	8.25%

Source: Ashmore.

EM REERs are currently close to all-time lows in Dollar terms, so EM currencies have room for upside before REERs begin to impact long term competitiveness adversely

The Dollar backdrop

The outlook for the US dollar remains a key consideration for investors in EM local markets. In the long term, we believe that the US Dollar is overvalued. Monetary policy divergence between the Fed and the rest of the world has been an ongoing theme since the Taper Tantrum and the Dollar now looks very expensive in real terms. The richness of the Dollar has not escaped the attention of the Trump Administration based on several recent statements. Ultimately, a weaker US Dollar would be a far more efficient way to encourage an American industrial renaissance and reduce current account deficits than protectionism.[3] Moral suasion may not be enough to bring the Greenback down, but rising inflation in the context of deeply negative real policy rates and material tax cuts under a renewed fiscal stimulus push could have the desired effect. The risk of a lower Dollar is rising and there is therefore a compelling case for diversifying away from large concentrations in the Dollar, especially at the current valuations.

Having said that, the global market place is likely to continue serving up surprises, including risk-aversion events, which may lead to temporary spikes in the Dollar. Most of these shocks will emanate from developed economies, such as Fed hikes, Trump tweets, European elections and other issues. These events will dominate the headlines to the point that investors may refrain from pursuing even compelling value opportunities, especially in EM. This would be wrong. EM local markets have outperformed developed markets over the past twelve months despite material potential EM risk-off events such as Brexit and Trump's election. This speaks volumes about positioning and the strength of the value proposition; there are simply not very many sellers around at these very attractive levels.

[3] See *"Weak Dollar Policy"*, The Emerging View, February 2017 and *"Trump and EM"*, The Emerging View, January 2017.

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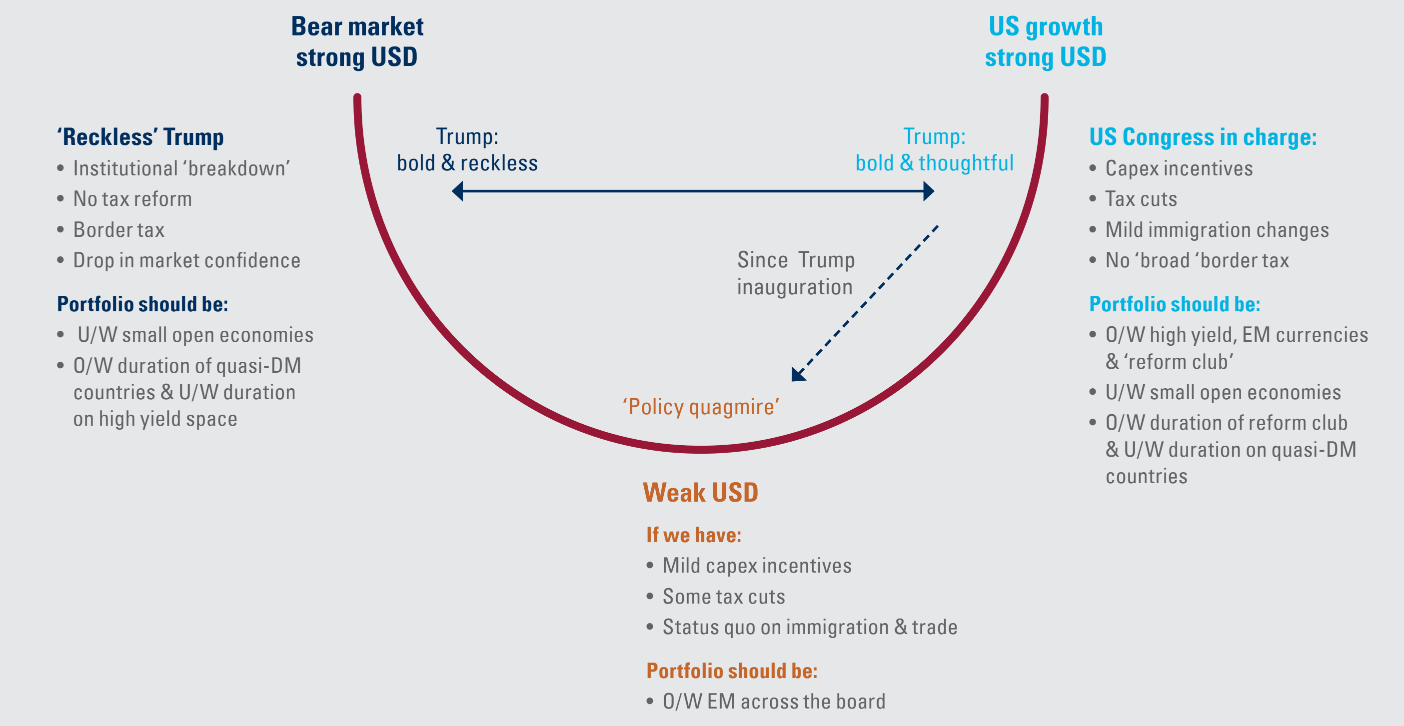
Despite Dollar richness, there is every chance that the Dollar could surprise to the upside in the short term, especially against G3 currencies. Given the enormous uncertainties that surround the political and economic scenarios in developed economies, any volatility in the G3 space could impact EM currencies too. The Dollar would likely rise against both the EUR and the JPY in two possible scenarios:

1. If the US economic outlook improves materially, US capital spending accelerates and economic and political developments in Europe do not look exceedingly worrisome
2. In a double-bearish scenario of reckless policy initiatives in the US such as trade wars, a major clampdown on immigration and poor tax reform combined with severe disruptions in one or more core European countries (far-right parties ascending to power in the Netherlands, France and Germany).

These extreme scenarios are not our base case. There is already growing evidence that Trump's worst excesses are being contained by institutional checks and balances, while mainstream political parties still look likely to hold on to power in Europe, aided in part by fears arising from the Brexit and Trump shocks. If our base case comes to pass then the US dollar has more downside than upside on account of poor technicals and unattractive valuation.

The tendency for the Dollar to gain in extreme scenarios and to weaken in middling scenarios has been labelled 'the Dollar Smile' by Stephen Jen, a former Morgan Stanley currency analyst. The Dollar Smile is summarised in figure 4 below.

Fig 4: **Short term USD Smile: Trump & Congress**



Conclusion

The case for investing in EM local bonds right now is strong and rests on four pillars:

1) attractive currency valuations;

2) high real interest rates both vis-à-vis past real yields and versus US rates;

3) structural reforms in a number of EM countries; and

4) upside growth surprises amidst benign inflation due to still-considerable spare capacity.

In addition, the Dollar is expensive and should decline barring very extreme outcomes pertaining to US growth or European politics.

EM local markets today have extremely high real interest rates and a number of EM central banks are likely to embark on extended easing cycles even if the US hikes rates and the EU embarks on tapering. The potential for capital inflows is large. By contrast, fixed income in developed markets may well suffer outright losses and outflows.

Some EM currencies have already moved from severely undervalued towards fairer valuations, such as the BRL and the RUB. Others, however, still linger deep in undervalued territory, including MXN and TRY. We see many opportunities for active managers to harvest good returns over and above those generated by the overall attractiveness of the EM fixed income asset class.

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