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MARKET COMMENTARY

Ashmore

Emerging Markets Local Currency bonds – the stars are aligned

By Gustavo Medeiros and Romain Bocket

Emerging markets local currency bonds have started the year on a strong note. The JP Morgan GBI-EM Global Diversified index is up 14.7% year to date, outperforming the JP Morgan EMBI Global Diversified by 140bps and the Barclays Global Agg. by close to 500bps. The strong performance after an extremely poor period between May-2013 and Dec-2015 is now leading many investors to ask whether it is the right time to add or if the rally is already over. We believe this is only the beginning of a longer period of recovery for EM local markets.

In this piece, we explore fundamental, valuation and positioning aspects supporting the case for local currency bonds. Finally, we explore the question of timing, comparing the current environment to previous episodes on the asset class. We believe the case is strong and the time is now.

Adjustment

The current opportunity is rooted in the extremely painful adjustment in Emerging Markets (EM) local markets over the past three years. When Ben Bernanke announced that the Fed would start tapering in May 2013, the risk premium in the US Treasury curve quickly rose by 100-150 basis points, leading to a similar or bigger impact in other global bond markets. This increased the cost of finance everywhere, including in EM countries, in particular to the ones that benefited the most from the previous expansion in liquidity.

From 2009, EM were benefiting from strong capital flows as expansionary policies (notably in China) led to increased demand for commodities, infrastructure, machinery and other goods produced by EM countries. This allowed a strong boom in credit for many countries.

From 2013 however, faced with tighter liquidity conditions, EM countries were forced to undertake strong adjustment. Freely floating currencies were allowed to depreciate at a double-digit annualised pace, which pushed up inflation expectations and in turn forced some central banks to increase interest rates in order to limit the pass-through of tradable goods to inflation. In most EM countries, however, inflation remained low due to credible central banks and in many others inflation declined outright due to the cyclical slowdown caused by tighter credit conditions.

Tighter liquidity onshore and offshore and lower terms of trade due to the decline in commodity prices produced an economic double-whammy, leading many finance ministries to respond prudently by tightening fiscal policies to keep debt levels in check. At the same time, lower global GDP growth, beggar-thy-neighbour currency devaluations in Europe and Japan and protectionist policies led to a slowdown in global trade, which meant that, despite weaker currencies, EM countries found it challenging to increase exports. Hence, the required external adjustment was even larger than normal with imports being reduced far more than in normal cycles, leading to a recessionary external adjustment. All of this exacerbated capital outflows, which in turn tightened financial conditions further.

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In spite of all the pain, EM economies have displayed a good degree of resilience. Defaults and balance of payment crisis, commonly observed in previous episodes of liquidity contraction to EM, have been extremely rare since 2013.

In addition to the orthodox monetary and fiscal response observed in many EM countries, structural improvements were also brewing as better politicians were elected to power (or provisionally assumed power) and technocrats were appointed who set out to implement important reform efforts in a number of countries. The structural adjustments started earlier in countries like Mexico, Indonesia and India, but have since taken root in Argentina, Brazil, Peru and others. Of course, there are other countries in a much less clear-cut transition, but governments have been generally improving economic policy over the last three years in the majority of EM countries.

Valuations

The combination of a market sell-off and serious adjustment on the part of EM governments has created a serious value opportunity. Not only have EM currencies depreciated to close to their 20-year lows, but bond yields have also increased to the highest levels since the 2008 crisis, in real as well as nominal terms. Relative to US real interest rates, yields of Emerging Markets local bonds on the GBI EM GD currently trade close to

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all-time highs. Commodity prices have stabilised as producers have started to reduce capacity to cope with lower prices. In this tighter supply scenario, any attempt to expand infrastructure investment in the developed world is likely to lead to higher prices, favouring EM producers.

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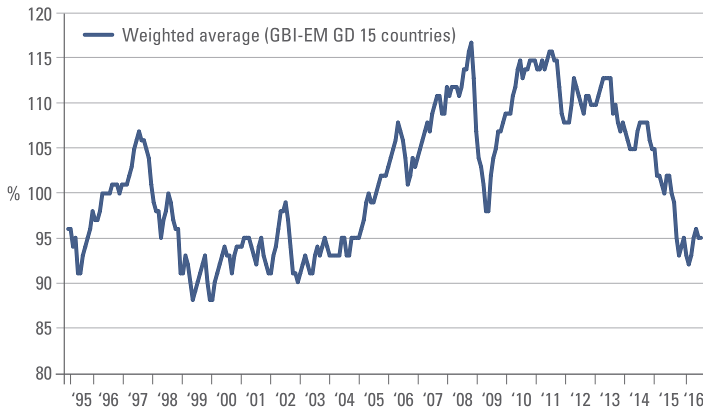
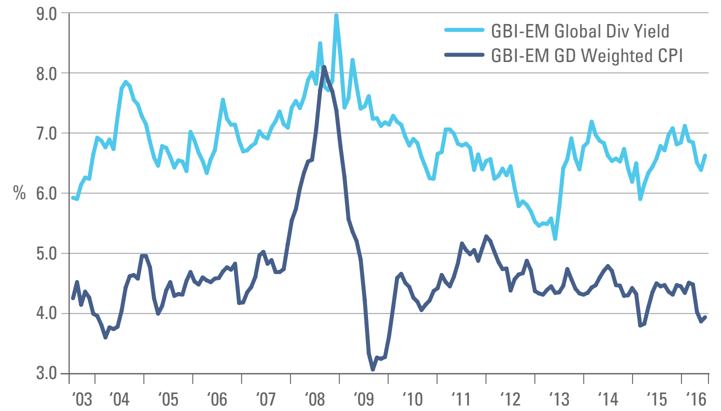
Fig 1: **Emerging Markets REER since 1994 (BIS data)**



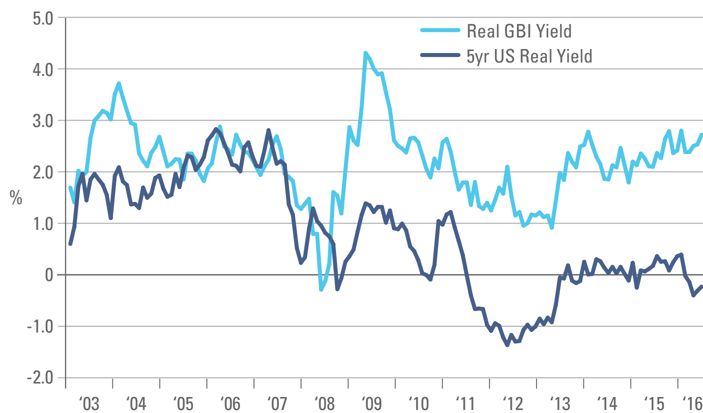
Source: BIS, JP Morgan, Ashmore.

Fig 2: **EM Nominal Yields vs Inflation**



Source: JP Morgan, Bloomberg, Ashmore.

Fig 3: **Real Yields EM vs US**



Source: JP Morgan, Bloomberg, Ashmore.

Fig 4: **Real Yield Differential (EM – US)**

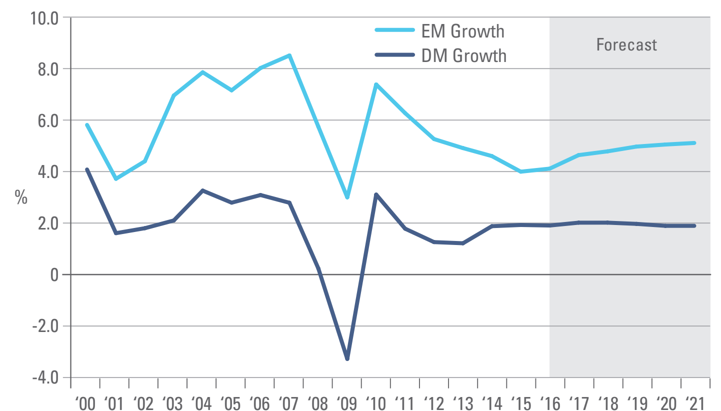
Source: JP Morgan, Bloomberg, Ashmore.

Fundamental backdrop

EM fundamentals are improving swiftly both in absolute and relative terms to DM. Better policies, more credible policy makers and in some cases very solid economic reforms are pushing confidence up. This will boost GDP growth in EM at a time when growth in DM is continuously being downgraded. With growing inequality, increasing political uncertainties and xenophobia there are grounds to fear policies that hurt growth, including measures to curb immigration and trade.

Of even greater concern, the expansionary phases of central bank monetary policies in developed economies are getting exhausted, limited by the zero lower bound interest rate and the diminishing returns on asset purchase policies. This threatens the single most important element supporting returns in developed markets.

Fig 5: **GDP Growth: EM vs DM**



Source: IMF World Economic Outlook, April 2016.

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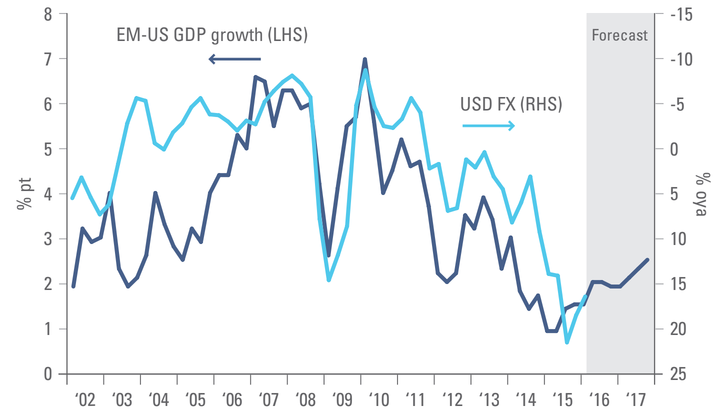
EM central banks, in contrast, have plenty of room to ease monetary policy, to the extent that inflation continues to decline and the fiscal consolidation process allows the private sector to expand more freely, meaning lower real interest rates will be accompanied by a better investment environment, which is also bullish for local currencies.

Better policies... will boost GDP growth in EM at a time when growth in DM is continuously being downgraded

Fig 6: **EM Growth Differential vs USD FX**



Source: JP Morgan.

Positioning

Tighter liquidity conditions and lower asset prices led to large capital outflows from EM in recent years. Developed world investors chased the S&P 500 and developed market assets as the growth differential between EM and DM tightened (although EM growth never fell below twice the rate of growth in developed economies). With EM growth outperforming DM growth vis-à-vis expectations the EM growth premium is now increasing again. The monetary policies that artificially inflated asset prices in DM are also running out of steam. In that environment, we believe inflows to EM will resume.

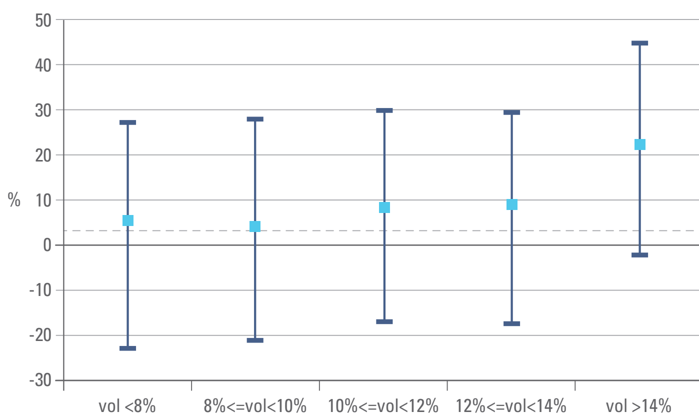
Obviously, investing in local bonds is not just about value, it is also about timing. The differential between interest rates (carry) plays a role, but volatility is also an important variable. When risk aversion is increasing investors reduce exposure, leading to negative mark-to-market on 'carry' trades, including EM local currency bonds. In order to get a good grasp on the timing question, we have back-tested returns in EM local bonds for different levels of volatility. In particular, we have measured future returns to the GBI EM GD index twelve months after episodes of low, medium and high volatility in the previous month.

The results strongly corroborate our long-standing philosophy that value investing works well in EM local markets. We find that investors who add exposure during bouts of volatility have greater upside, lower downside and better average returns than investors, who 'chase' the market by buying when all is well. Figure 7 illustrates this point. Each vertical bar shows maximum, minimum and average returns (vertical axis) over twelve months for given levels of volatility (horizontal axis).

Merits of value investing notwithstanding, the reality is that flows often follow positive performance, so momentum plays a role when investing in local currency. In figure 8, we therefore repeat the analysis above, but with the innovation of imposing a rule that investors can only put money to work when the GBI-EM GD index is above its 50 and 200 days moving averages. This limits purchase time to periods with positive market momentum.

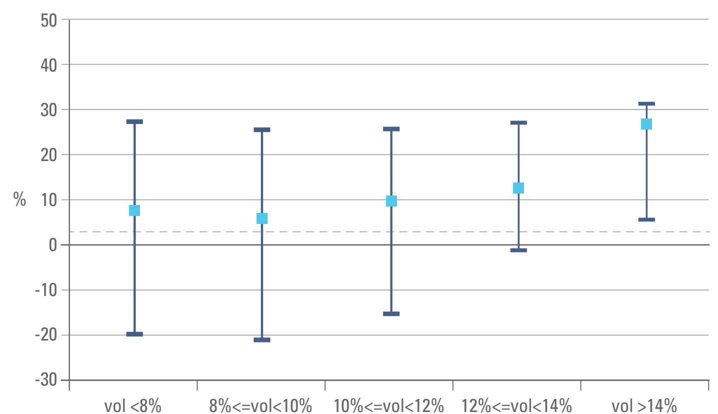
We find that investors who add exposure during periods when volatility is above 10% significantly reduced downside risk and harvested better average returns in the following year. But we

Fig 7: **Range of next 12 months return (Maximum, Average and Minimum) at various level of GBI-EM GD Volatility**



Source: Bloomberg, Ashmore.

Fig 8: **Range of next 12 months return (Maximum, Average and Minimum) at various level of GBI-EM GD Volatility, when index is above its moving averages (50d and 200d)**



Source: Bloomberg, Ashmore.

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find that it is particularly powerful to invest when volatility hit extreme levels (above 14%). Episodes of high volatility and positive momentum are extremely rare – they occur less than 0.5% of the time periods in our sample, which goes back to the inception of the index.

In light of the above, it is extremely intriguing to us that as at 22 July 2016, the GBI-EM GD index was not just trading above its 50 and 200 days moving averages – implying good momentum – but the previous one month volatility was also above 14%. This has only happened twice in the past, namely during the 2009 and late 2011 recoveries. More generally the downside risk has been lower and average return higher when the index was trading above its moving averages while volatility was above 12%, as illustrated in figure 8.

EM volatility declined since Brexit, but the uncertainty about the actions of the US Federal Reserve and Bank of Japan together with low activity during summer holidays have kept the US dollar slightly bid, so local currency returns have been relatively flat in recent weeks. Hence, we think the attractive opportunity created by the fortunate constellation of volatility and momentum remains intact, especially for those concerned about timing.

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Summary and Conclusion

EM local bonds offer compelling valuations, yielding more than 6.2% per year, strong and improving fundamentals with increased growth differentials versus DM and are under owned after three years of relentless outflows.

We believe local bonds will deliver strong risk adjusted returns in the medium to long term, and for investors concerned with timing, we're in a particularly strong environment as the asset class currently displays a combination of strong value and momentum.

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