

The best entry point for External debt in more than two years

By Jan Dehn and Romain Bocket

A recent pullback in markets has produced the best entry point for more than two years in EM fixed income. We believe the optimal allocation to external debt is now close to 100% in the context of a Global Ag portfolio, USD-hedged or unhedged.

Introduction

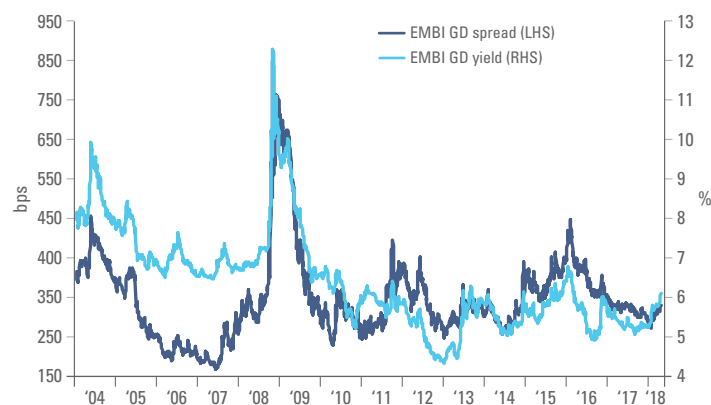
A combination of temporary and non-Emerging Markets (EM) factors have triggered a pullback in EM external debt over the last few weeks. This pullback constitutes the best entry point for several years, in our view. None of the factors behind the sell-off, which include profit-taking, rising US Treasury yields, trade war fears and geopolitical concerns should change the generally strong outlook for EM external debt over the next few years.

Given the recent rise in yield and very low volatility, we establish that the optimal allocation to EM external debt within an unhedged Global Ag portfolio is currently 100% in favour of EM external debt. The optimal allocation to EM external debt in a USD-hedged Global Ag portfolio is 99%. These allocations are high compared to optimal allocations of 78% and 22% respectively to the portfolios since 2004, reflecting the magnitude of the current opportunity.

The opportunity in EM external debt

EM sovereign Dollar-denominated government bonds are a USD 1trn fixed income asset class comprising some 67 sovereign issuers plus associated quasi-sovereign issuers. The benchmark index is the JP Morgan EMBI GD. EM sovereign Dollar bonds currently trade with yield of 6.10% and a spread of 312bps over Treasuries (Figure 1). This compares to a spread of just 164bps in 2007 prior to the Developed Markets Crisis of 2008/2009, when the Fed funds rate was 5.25%. Besides, the EMBI GD index today has more than twice the number of constituent countries compared to ten years ago. In other words, EM external debt today pays nearly twice the spread, while being twice as diversified, relative to pre-crisis. We think the asset class is cheap.¹

Fig 1: Sovereign blended spread and yield for EMBI GD (bps)



Source: Ashmore, Bloomberg, JP Morgan.

Just how cheap can be illustrated using standard portfolio management techniques. Figure 2 shows the optimal allocations to EM external debt in a simple portfolio comprising EMBI GD and the unhedged Global Ag. On a forward-looking basis, the optimal allocation to EMBI GD in a portfolio with the unhedged Global Ag is currently 100%. This is due to a combination of much higher yields (6.1% versus 2.0%) and significantly lower volatility (2.9% versus 4.0%). Even though the low correlation (38.1%) is a mitigating factor for the Global Ag, the case for EMBI GD is currently so strong that this factor does not matter.

How does this optimal allocation compare to past periods? The current optimal allocation to the EMBI GD of 100% is higher than the optimal allocation over the long-term (since 2004) of 78%. However, optimal allocations have varied considerably over time due to market volatility. In the past year, for example, the optimal allocation to EM external debt declined to 0%, but this is unusual. The optimal allocations to EMBI GD were 93%, 100% and 79% over the past 3 years, 5 years and 10 years, respectively. In a historical context, the current opportunity is therefore very good, albeit not entirely unique. In our view markets are likely to erode away this opportunity in short order.

Fig 2: Optimal allocations to EMBI in an unhedged Global Ag portfolio

	Portfolio Statistic	EMBI GD	Unhedged Global AG	Correlation
Forward-looking	YTM	6.1%	2.0%	38.1%
	1-yr vol	2.9%	4.0%	
	Efficient weight	100%	0%	
Since inception (1 Jan '04)	Return	7.2%	3.4%	27.8%
	Volatility	5.7%	5.3%	
	Efficient weight	78%	22%	
10 years	Return	6.7%	2.6%	25.3%
	Volatility	6.1%	5.3%	
	Efficient weight	79%	21%	
5 years	Return	3.6%	0.9%	31.3%
	Volatility	4.7%	5.0%	
	Efficient weight	100%	0%	
3 years	Return	4.6%	2.2%	30.4%
	Volatility	4.2%	5.1%	
	Efficient weight	93%	7%	
1 year	Return	0.8%	3.7%	38.1%
	Volatility	2.9%	4.0%	
	Efficient weight	0%	100%	

Source: Ashmore, Bloomberg, JP Morgan.

¹ See 'EM risk-free return', The Emerging View, 3 October 2017.

The unhedged Global Ag includes local currency bonds, which introduces FX volatility from the perspective of a Dollar-based investor. By contrast, the EMBI GD is a pure Dollar-denominated index. To remove this distortion arising from FX exposure, Figure 3 presents optimal allocations to EMBI GD within the context of the USD-hedged Global Ag portfolio. The change to a USD-hedged Global Ag naturally lowers the volatility of returns of the Global Ag and increases the correlation with EMBI GD. As a result, the optimal allocation to the EMBI GD naturally declines. Indeed, over the full period from 2004 to today investors should have had 22% of the combined portfolio invested in EM external debt compared to 78% in the unhedged case. The optimal allocation to EM external debt has also been volatile in the context of the USD-hedged portfolio, ranging from a low of 0% over the past year to a high of 49% over the last three years. However, on a forward-looking basis (meaning using current yields and the volatility and correlation over the past twelve months) the optimal allocation to EM external debt is a whopping 99%.

Fig 3: Optimal allocations to EMBI in a USD-hedged Global Ag portfolio

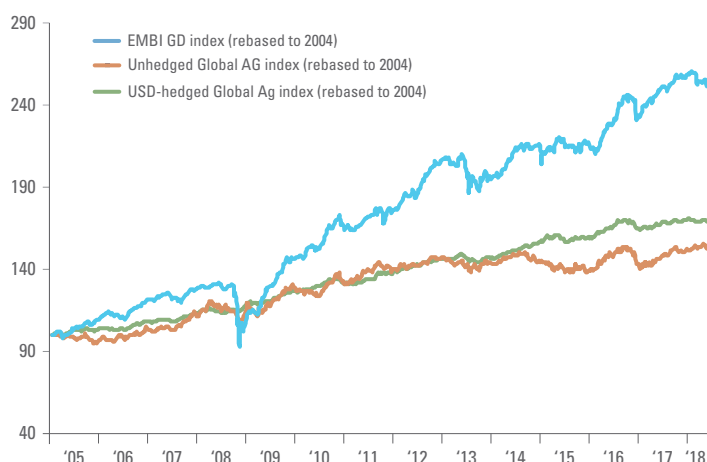
	Portfolio Statistic	EMBI GD	Unhedged Global AG	Correlation
Forward-looking	YTM	6.1%	2.0%	49.0%
	1-yr vol	2.9%	1.8%	
	Efficient weight	99%	1%	
Since inception (1 Jan '04)	Return	7.2%	4.0%	20.9%
	Volatility	5.7%	2.4%	
	Efficient weight	22%	78%	
10 years	Return	6.7%	4.0%	14.7%
	Volatility	6.1%	2.4%	
	Efficient weight	19%	81%	
5 years	Return	3.6%	2.6%	38.3%
	Volatility	4.7%	2.3%	
	Efficient weight	17%	83%	
3 years	Return	4.6%	2.1%	34.2%
	Volatility	4.2%	2.4%	
	Efficient weight	49%	51%	
1 year	Return	0.8%	1.4%	49.0%
	Volatility	2.9%	1.8%	
	Efficient weight	0%	100%	

Source: Ashmore, Bloomberg, JP Morgan.

The long-term case for EM external debt

Investors will also be interested in the type of performance they can expect over the longer-term. Figure 4 therefore presents long-term index performances for EM external debt and hedged and unhedged versions of the Global Ag indices. Clearly, EM external debt has delivered more return than the Global Ag indices over time, but EM critics will point out that the external debt has also been more risky, judging by the evidently higher volatility of the EMBI GD relative to the Global Ag indices.

Fig 4: EMBI GD vs Global Ag (hedged and unhedged)



Source: Ashmore, Bloomberg, JP Morgan.

However, we think investors should bear in mind the inefficiencies in the EM asset classes. Many investors knee-jerk sell their EM exposures every time a bout of risk aversion hits the markets, regardless of the fundamental situation, such as ability and willingness to pay, which determines default risk. Indeed, actual sovereign stresses have been considerably lower than the price action would imply. Figure 5 shows the actual sovereign defaults in EM going back to 2001 as well as the associated losses (in bps). The table also shows how much investors have been paid in yield by being invested in EM external debt over this period, before and after subtracting default-related losses. In spread terms, investors have been paid a *de facto* risk free spread over Treasuries, that is, the spread after subtracting all default-related losses, of 359bps per year. In other words, investors have been paid more than twice as much as US Treasuries each year. This is why EM external debt has outperformed the S&P 500 by some 20% over the past quarter of a century.

Fig 5: Actual losses in EM external debt

	Payout to investors (bps)	
	1998-2018	Average per annum
EM 'risk free spread'	7,545	359
EM net of defaults (bps)	15,027	716
US 10yr bond (bps)	7,483	356

Default episodes (cost in bps)	
Argentina 2001	483
Ecuador 2008	125
Ivory Coast 2011	61
Belize 2012	10
Argentina 2014	92
Ukraine 2015	63
Mozambique 2017	7
Venezuela 2018	154

Source: Ashmore, Bloomberg, JP Morgan.

Conclusion

Investors are currently worried about rising Treasury yields, trade wars and geopolitical tensions. These concerns have predictably led to a pullback in EM fixed income, including external debt. Trade wars and geopolitical tension are unlikely to impact the ability and/or willingness of EM sovereigns to pay.² Instead, the main impact is likely to be on investor behaviour.

The resulting temporary weakness in prices should, in our view, be ruthlessly exploited by buying the dip. Right now EM external debt is extremely attractive compared to the Global Ag with optimal allocations at or close to 100%. Granted, rising Treasury yields will have a dampening impact on the performance of EM external debt, but at current spreads there is a healthy cushion compared to previous periods with far higher US yields. In fact, we believe EM countries will cope far better in a rising US yield environment than most of the credits in the Global Ag.

Our expectation is that EM should deliver some 30% in Dollar terms over the 2017-2021 period.

² See why here: [‘The limits of protectionism’](#), Market Commentary, 4 April 2018.

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