The Evolution of Emerging Market Debt

Emerging market debt has evolved over the past two decades from a small market of USD-denominated sovereign debt to a diverse mix of local and hard currency sovereign and corporate debt totaling more than $2 trillion. Risks of large-scale defaults have declined, but interest rate risk has risen for USD-denominated debt. For local currency bonds, currency risk has been transferred to the investor. Active management is a key to risk reduction as emerging markets face political and economic challenges and currency depreciation.

Investors have been focused on emerging market (EM) debt for some time, and the asset class has posted strong double-digit returns for three of the past five years. Substantial amounts of investor capital have been poured into the emerging market debt markets during the past decade as improvements in credit quality and liquidity have taken hold. Emerging market bonds have delivered equity-like returns with less volatility and have had low correlations with US fixed income over the 1994–2012 time horizon, according to Philips, Yoon, DiJoseph, Tolani, Donaldson, and Schlanger (2013). In recent years, emerging market debt has served as an alluring alternative for fixed-income investors contending with historically low US bond yields.

After a selloff in EM debt in 2013, the asset class has quickly moved from being one that investors favor to one that may be keeping them awake at night. Signs of economic weakness in China have caused emerging market growth concerns based on weaker exports, and easing of the stimulus by the US Federal Reserve has led to concerns that capital will be diverted into US bonds based on higher interest rates. Argentina, which has had policy and political issues, is grappling with surging inflation and a plummeting peso, whereas such countries as Brazil and Turkey are experiencing depreciating currencies, large current account deficits, and political instability.

OVERVIEW OF EM DEBT: WHAT HAS CHANGED?
The EM debt market originated a little over two decades ago with the introduction of USD-denominated Latin American bonds. The asset class has since evolved into a multifaceted, diverse mix of sovereign and corporate bonds issued in both local currencies and hard currencies (the US dollar or the euro). Emerging market debt is issued by countries in Latin America, Eastern Europe, Africa, Russia, the Middle East, and Asia (ex Japan). The vast majority of the growth in emerging market debt has been in local currency sovereign debt and USD-denominated corporate debt.

During the past decade, the local currency sovereign debt universe, as measured by the JP Morgan Government Bond Index-Emerging Markets (GBI-EM) Global Diversified, grew from less than $200 billion to nearly $1 trillion and is now the largest sector of the EM debt market for cross-border investors. The EM corporate debt market, as measured by the JP Morgan Corporate Emerging Market Bond Index (CEMBI) Broad, has grown by more than 13 times, from just over $50 billion at year-end 2003 to more than $700 billion as of year-end 2013. In contrast, the USD-denominated sovereign debt market, as measured by the JP Morgan Emerging Market Bond Index (EMBI) Global, has little more than doubled since 2003 to $586 billion as of 31 December 2013.

Structural changes in the asset class have led to changes in primary risk factors. In the earlier days of USD-denominated sovereign debt, when developing country currencies were commonly pegged to the US dollar, asset/liability mismatches occurred when countries with depreciating currencies were forced to repay their debt with expensive dollars, creating surging debt burdens and balance-of-payment crises. Seasoned fixed-income
investors will remember the Mexican peso debacle in 1994, the Thai baht crisis of 1997, and Argentina’s debt default in 2002. Investors suffered steep losses even though the bonds were denominated in US dollars. Many emerging market countries have since enacted policies to moderate inflation, strengthen their balance sheets, and become more stable politically. Favorable demographics, productivity gains, and exports to an expanding global economy have led to higher GDP growth rates and far lower debt-to-GDP ratios compared with those of developed countries. Many EMs are now able to issue debt in their local currencies, promoting greater fiscal and monetary flexibility. As the composition of the investor base has expanded, countries are also able to issue debt in longer tenors, in both local currency- and USD-denominated debt, which reduces their need to rely on short-term borrowing.

Credit risk, or default risk, is still a predominant risk for USD-denominated sovereign debt, but the risk of the severe crises of the past has declined over the years with structural changes. “The risks in these markets are moving away from the typical distressed debt scenarios that investors have seen in the past,” says Phillip Nelson, CFA, research consultant at NEPC, LLC, an independent investment consulting firm. “Apart from a country like Argentina, that type of default risk is unlikely.” One primary risk that is increasing is US interest rate risk. Countries are able to issue longer-dated debt than in the past, and longer-maturity bonds are more sensitive to interest rate movements. Despite being issued in dollars, these bonds can still be widely affected by local currency movements. As an extreme example, Argentina’s USD bonds, which had a positive return of 1.14% in December 2013, lost 12.25% in January 2014 after the country sharply devalued its currency.

The popularity of local currency debt has introduced an entirely new set of risk factors to the EM debt market. Currencies can be highly volatile, and exchange rates are notoriously hard to predict. Currency movements tend to be driven by investor flows and often deviate from perceived fundamental values for long periods of time, sometimes years. “Bonds and currencies have different risks,” says David Hinman, CFA, managing director and chief investment officer at SW Asset Management, LLC, an investment firm specializing in EM debt. “Movements in the local currency market will overwhelm any type of bond characteristics,” he notes. Investors can choose to reduce the risk of currency volatility in local currency bonds through hedging, but hedging is costly and may lower returns. Hedging also reduces the diversification benefits of currency exposure; unhedged, the correlation between USD bonds and emerging market bonds is quite low. To compensate investors for assuming currency risk, as well as other local market risks, local currency sovereign bonds offer higher yields than USD-denominated sovereign bonds.

Investors navigating local currency EM debt markets should avoid countries that lack macroeconomic stability, have weak creditor rights, or are growing too rapidly, according to Burger, Warnock, and Warnock (2012). Investors should also keep an eye on developing currency mismatches, which have historically served as red flags. Countries or regions where a significant portion of bonds are denominated in hard currency are highly susceptible to currency depreciation. Emerging markets with low inflation volatility and strong legal rights for creditors have better-developed local currency markets. In general, countries that issue debt in their local currencies have better credit profiles than countries issuing debt in hard currencies; nearly 60% of the local currency debt issues in the Barclays EM Local Currency Government Bond Index are rated A or higher, 36% are rated Baa, and only 5% have a non-investment-grade rating as of 31 December 2013. In comparison, approximately two-thirds of hard currency sovereign debt in the Barclays EM USD Sovereign Bond Index is rated investment grade and 28% is rated below investment grade. The high-quality credit profile of the local currency issuers coupled with the diversification benefits stemming from low correlations with US fixed income has fueled investor appetite for this EM debt sector.

Growth in the emerging market USD-denominated corporate debt market has likewise been propelled by a marked increase in credit quality during the past 15 years. “A little-known fact about the dollar-denominated, non-convertible emerging market corporate debt market is that two-thirds of it is investment grade, and 26% of it is rated A or higher,” says Hinman, citing data from the Credit Suisse Emerging Market Corporate Index as of 31 December 2013. Despite the improvements in credit quality, EM corporate bonds still carry unique risks relative to US corporate bonds. “Emerging market corporates have risks that US corporate bonds don’t have—namely, currency risk,” Hinman says. “Even if the bonds are denominated in US dollars, there is occasionally a mismatch in the levered capital structure of the company’s revenues or debt.”
Country risk is also an important factor in emerging market corporate debt. “If there is a military coup in the country and capital controls are put into place, an investor can lose money on those bonds even if the manager is ‘right on the credit,’” he says. Hinman advises approaching the investment valuation process from a variety of angles. “We have a view on the country, the currency, and the credit; those are the three C’s of what we look at. We spend a lot of time assessing the macroeconomic outlook as well as analyzing individual credit risk.”

More commonplace risks that investors should be aware of include liquidity and overexposure risks. Liquidity varies according to issuer, but liquidity for the asset class as a whole has declined since the onset of the financial crisis in 2008 because broker/dealers have reduced their inventory in emerging market debt. Despite its tremendous growth in the past 10 years, the asset class is still small compared with the aggregate bond universe, and investor flows can more easily affect valuations. Investors should also be mindful of overexposure in EM issuers. USD-denominated, investment-grade sovereign and corporate bonds that meet certain size and maturity criteria are included in the widely used Barclays Aggregate Bond Index and in dedicated EM indices. Investors who have mandates in emerging market debt as well as the Barclays Aggregate universe may find they own the same bonds in more than one portfolio. The same issuers may also be found in EM debt and equity portfolios, which increases idiosyncratic risk because EM corporate debt returns have historically been highly correlated with those of EM equities.

**ACTIVE MANAGEMENT IS KEY**

Emerging market debt is an asset class ideally suited for active management. A key argument for active management centers on concentration of country risk in the indices, as well as the dispersion of credit quality, which ranges from high grade to high yield. The JP Morgan suite of emerging market debt indices generally serves as the industry standard for investor benchmarks. “In 2013, Indonesia, South Africa, Brazil, and Turkey provided a dominant share of the volatility of the local currency index,” says Nelson. “There’s plenty of opportunity for active management and to think outside of those four countries. It makes sense to have a strategy that can tactically rotate among the markets that are less volatile or have better return prospects.”

The market-cap-weighted EMBI contains significant risk biases. The top 10 issuers constitute a majority of the index’s weight. Venezuela, one of the riskiest countries in the index, was recently the third-largest issuer in the index. Higher weightings for riskier issuers is a problem not uncommon to market-cap-weighted fixed-income indices, where the most prolific issuers are often of lower credit quality and heavily indebted. The EMBI Global Diversified Bond Index lowers this risk by placing caps on issuer weights.

One decision investors may not have to make is the choice between investing in hard currency or local currency bonds. Over the period 1 July 2008–31 December 2012, Philips et al. (2013) found that hard currency and local currency bonds have very different annualized returns and standard deviations. Local currency returns are more volatile during the study period for 10 of the 11 countries studied. The authors conclude, “Hard currency and local currency denominated bonds are not substitutes for each other” (p. 12).

Performance evaluation becomes more complex when the unmanaged benchmark portfolio does not serve as a good reference portfolio. Risk metrics such as tracking error, which measures how far a portfolio’s returns deviate from the benchmark index returns, are less useful for performance assessment on a relative basis. Large degrees of tracking error can be acceptable—and even preferred—when managers are expected to rein in risk relative to a benchmark index that has large constituent weightings.

Evaluating emerging market debt managers differs from evaluating traditional debt managers. “Manager evaluation is much more qualitative compared with traditional core fixed-income manager evaluation,” says Nelson. “The relative statistics are important, but for tactical mandates in emerging market debt, it is more important to focus on absolute risk measures. Peer analysis can also be helpful.” The information ratio is useful for evaluating beta exposure, whereas the Sharpe ratio is more useful for tactical mandates, according to Nelson. Absolute risk measures include total volatility measures, peak-to-trough measures, and an analysis of the manager’s underlying sources of risk (for example, currency risk, country selection, or nonbenchmark holdings).

**ASSET CLASS OUTLOOK**

Emerging markets are facing their greatest challenges since the financial crisis. “Going forward, the biggest risks are flows in and out of the markets, which directly impact currency volatility, and how the countries manage..."
their inflation and growth dynamics,” says Nelson. “Politics also matters in these countries. Of the 10 largest emerging markets, many are having an election within the next 12 months.”

Because the investable universe is relatively small and less liquid compared with the overall fixed-income universe, EM debt is particularly sensitive to investor demand. Burger, Warnock, and Warnock (2012) suggest investors keep an eye on investability measures shown to be linked to greater US investor demand, which should be supportive of investor flows. Such measures include an open capital account, better market structure, and a larger local institutional investor base. Reduced capital flows and persistently high or volatile inflation are key risks to local currency–denominated debt. Much of this sector’s historically high returns came from currency appreciation relative to the US dollar, a return driver that is unlikely to be present for many of the EM countries in the near term, according to Hinman. “We are more dollar-centric than we have been in a long time,” he says.

The recent increase in US interest rates poses additional risks to emerging market debt. Rising US rates make US fixed income more attractive to investors. The rise in rates may not only cause investors to reallocate funds to US markets but will also cause prices on long-maturity EM debt to fall.

Overall, emerging market countries should be assessed individually because each has unique risks and opportunities. As Argentina struggles with rampant inflation and its largest currency crisis in more than a decade, South Korea maintains a strong balance sheet and a high credit rating. Despite the turmoil in the asset class, emerging market debt is predicted to gain nearly $50 billion in net capital inflows during 2014, according to eVestment (2014), which would make the asset class the largest recipient of investor flows among traditional debt and equity asset classes.

“Structurally, over the long term, the growth prospects and the demographics are better than those in the developed world,” says Nelson. “In the near term, a select group of countries is experiencing a short-term balance-of-payments crisis. A tactical approach that rotates among the countries that are less volatile or have better return prospects is the best way to manage through the volatility. Those who are moving in and out of the markets and trying to time when the rebound occurs will find it very difficult.”

REFERENCES


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