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TIAA
GLOBAL ASSET MANAGEMENT

Investing in EM local currency debt markets

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Executive summary

- Emerging Market (EM) local market debt offers a distinct and growing investment opportunity within the wider EM asset class, representing a $10 trillion universe of securities and about two-thirds of EM debt trading volume.
- Attractive yield in EM local markets compared with developed markets along with potential for diversification, not only globally but also regionally, can provide an alpha generation tool for global portfolios.
- Investing in EM local markets requires specialized investment skills given the nuances associated with each market and the unique risks inherent in the asset class.
- After significant underperformance of EM local markets since 2013, we believe there is a compelling case that this may be about to reverse in the near future.

A growing asset class

Emerging markets are sometimes considered a monolithic asset class although there are distinct opportunities within and across emerging market countries. At the sovereign level, it is important to distinguish between "external debt" (EXD), which is EM sovereign debt denominated in U.S. dollars or other hard currency[1], and "local market debt," which is EM sovereign debt denominated in the issuers' local currency, or local market debt.[2]

The EM local currency debt market is now a greater than $10 trillion universe that accounts for more than 75% of outstanding EM debt and close to two-thirds of EM debt trading volumes. The EM local currency debt market has grown tremendously in recent years as countries took advantage of a growing pool of domestic institutional investors and yield-hungry foreign investors, helping push borrowing costs lower. According to Moody's, local currency sovereign debt grew by an average of over 14% annually from 2000-2014, a considerable jump compared to the more modest 2.3% average growth of foreign currency sovereign debt, during the same period. The largest increase occurred in Asia where EM local currency debt grew by eight times over that period.

1. In this piece we focus on USD denominated bonds although EM sovereigns have been frequent issuers in other hard currencies such as the Japanese Yen and the Euro.
2. In addition, at the company level there is EM equity markets and also EM corporate debt, most often denominated in USD (or other hard currency).

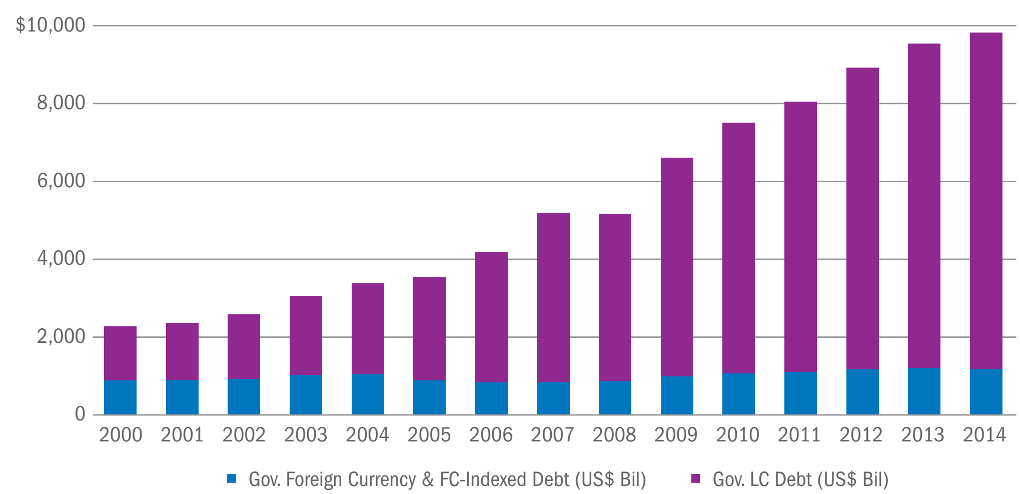
The local currency portion of sovereign debt has grown from about 50% in 2000 to about 75% in 2015 which has helped improve local market depth and financial stability in many emerging economies.

The expansion of EM local markets as an asset class for international investors has allowed EM sovereigns to largely escape the so-called “original sin” of debt, where a local government issues debt in a currency other than its own, a practice that contributed to previous EM debt crises. When a country issues in its own currency, currency risk is passed from the sovereign issuer to the foreign investor, thus reducing the sovereign issuer’s currency mismatch and improving its overall creditworthiness. Furthermore, this gives local governments the potential to issue bonds at more attractive yields while simultaneously building domestic financial markets to meet growing local demand. As a result of the growth in the asset class, the local currency portion of sovereign debt has grown from about 50% in 2000 to about 75% in 2015 (see Figure 1), which has helped improve local market depth and financial stability in many emerging economies.

Local investor base provides depth for foreigners to enter

The growth of local debt markets was driven in large part by the growing domestic investors’ (including banks, insurance companies and pension funds) demand for assets that match their funding currency. Local insurance companies and pension fund assets under management stood at nearly $6 trillion in 2014. Pension funds alone have grown from $964 billion in 2005

Figure 1: Bulk of recent issuance turned to local markets



Source: Moody’s

to $2.4 trillion at the end of 2013 (as shown in Figure 2). In many EM countries pension systems are still growing and subject to ongoing reforms that are expected to promote continued growth of pension fund assets. From the local markets' perspective, a diverse domestic investor base serves as a consistent buyer of its debt even in downtimes, whereas foreign participation is a more recent phenomenon. The diversity of domestic investors is shown below in Figure 3. Local markets with a deeper and broader onshore investor base tend to be more resilient to market pressures although in some countries strong and improving fundamentals can keep local markets well anchored even with high levels of foreign participation. It is important to keep in mind that government issued bonds serve as a risk free asset for local investors. So as US pension and insurance funds are natural buyers of US Treasuries similar circumstances occur in EM local markets. In turn the governments have also been able to extend the local yield curves to match local pension domestic currency liabilities.

Figure 2: EM local pension fund assets on the rise

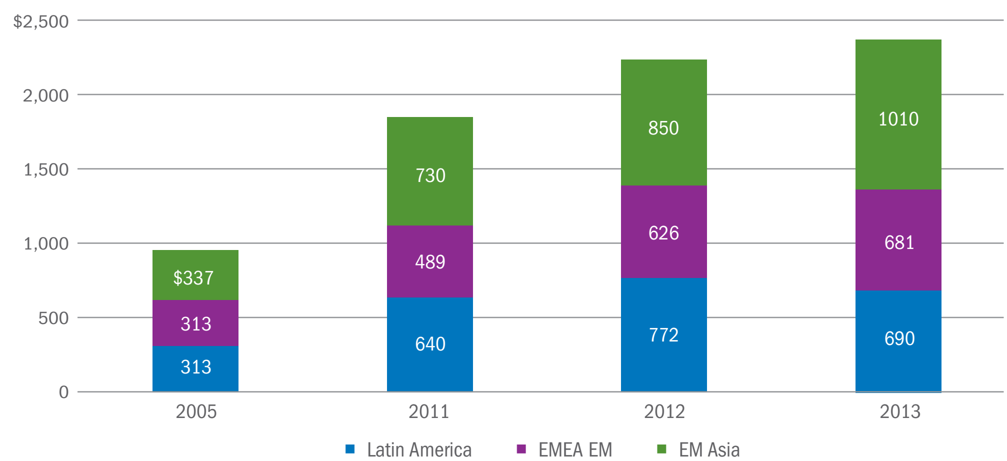
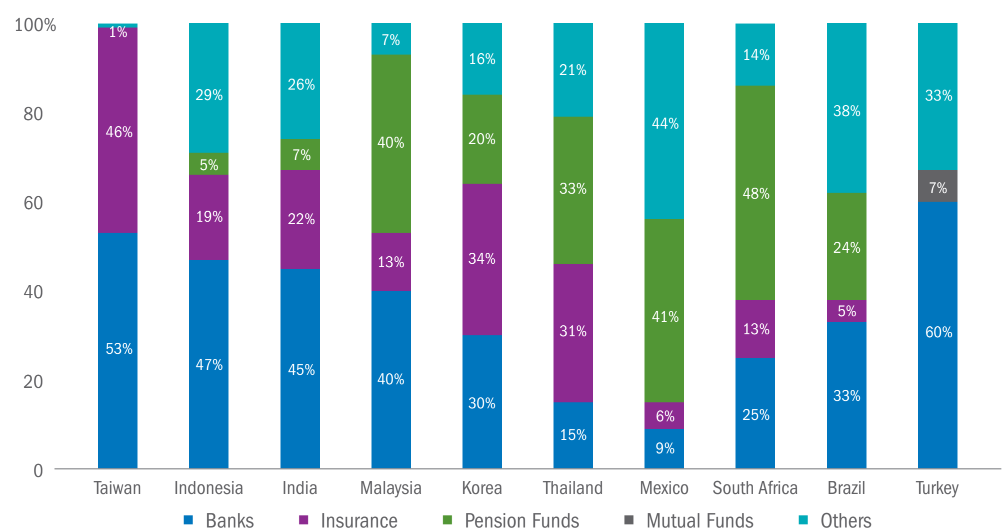


Figure 3: Domestic investor base varies by country



Source: JP Morgan

In addition to substantial yield pick-up, diversification benefits are another attractive feature of EM local debt markets.

The main allure for foreign investors to EM local market debt is an attractive yield differential vis-à-vis developed markets and even compared to EM EXD[3]. Figure 4 below shows that in advanced economies some government bonds are offering negative yields, compared to double-digit yields that can be found in several EM local markets.

Figure 4: EM local 10-year bond yields are more attractive than the developed world

Source: Bloomberg, data shows 10-year nominal bond yields (as of March 9, 2016).

In addition to the substantial yield pick-up offered by EM local debt markets, the diversification benefits are another attractive feature of the asset class. In fact, global fixed income managers regularly turn to EM local debt markets to provide their investors with the opportunity to outperform and diversify away from traditional markets such as G3 Treasury bonds, investment grade and high yield corporate bonds.

Within the asset class there are also sources of diversification. In particular, varying economic cycles across emerging market countries result in local fixed income markets often not moving in sync with other local assets such as equities or commodities, even with regional peers where the local monetary policy is the dominant driver of yields.

Different sources of return for foreigners involved in EM local markets can provide further diversification opportunities. These sources of return include: 1) income as derived by local interest rates 2) price appreciation/depreciation and 3) currency movements. Some of the

3. The main index for EXD is the JP Morgan Emerging Markets Bond Index (EMBI) Global Diversified which is comprised of issuers in 64 countries. The main local market index, the JP Morgan Global Bond Index-EM series (GBI-EM) Global Diversified Index contains 15 countries. The GBI-EM index is comprised of regularly traded, liquid fixed coupon, local currency government bonds to which international investors can gain exposure

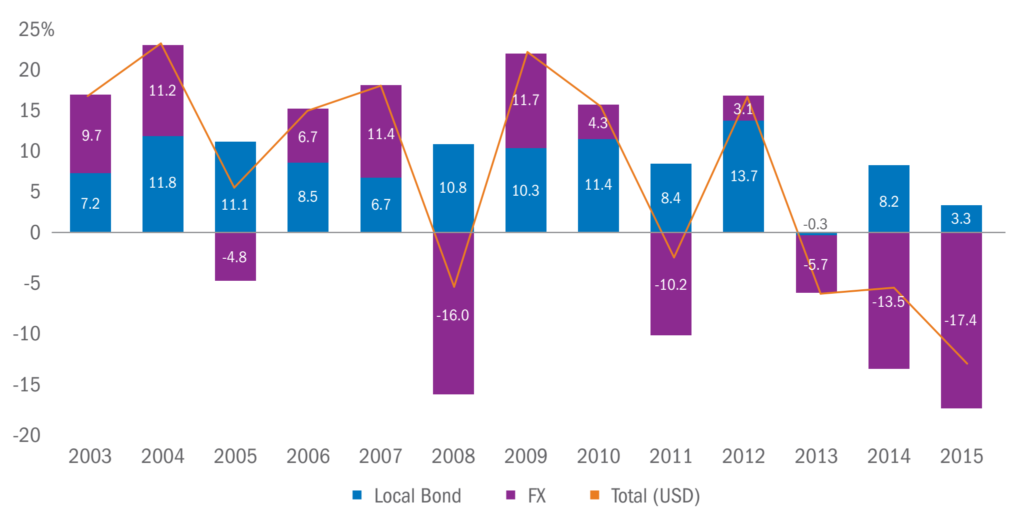
components, such as the currency, may be moving in a similar trend as has been the case recently for emerging markets against the greenback. However, the other components of return may move differently across emerging market countries due to domestic factors thus allowing investors to diversify sources of return. The existence of these different drivers also creates opportunities to target returns in each of the categories and potentially hedging exposure to others.

Investing in local markets requires specialized analysis to mitigate risks and uncover opportunities

Investors must keep in mind that while EM local markets provide compelling investment return and diversification opportunities, they can also exhibit higher volatility than other fixed income markets. The most notable source of volatility comes from currency volatility which can either enhance or erode performance for foreign investors. At the moment, EM FX valuations appear less stretched with EM currencies showing less room to depreciate from a fundamental standpoint. It is also important to understand that exchange rate fluctuations are not only a factor of global market sentiment with a high correlation to EM growth and equities, but also subject to policy decisions of local authorities. For example, the decision by Chinese authorities to allow the yuan (CNY) to depreciate in August 2015 was not only market driven but also reflected a policy decision by Chinese authorities.

Another key risk, not unrelated to currency depreciation is inflation. Local governments may face the temptation to increase monetary supply and thereby induce inflation as a means to reduce debt levels. For a domestic investor in local markets this reduces the purchasing power of the return on their investment. For foreign investors this could also result in further local currency depreciation.

Figure 5: Local currency returns have been resilient



Based on GBI-EM Index a comprehensive global emerging markets index of local government bond debt.
Source: JP Morgan

Market access, taxation and regulatory regimes, and trading liquidity are all important factors that can impact returns and must be properly evaluated by investors.

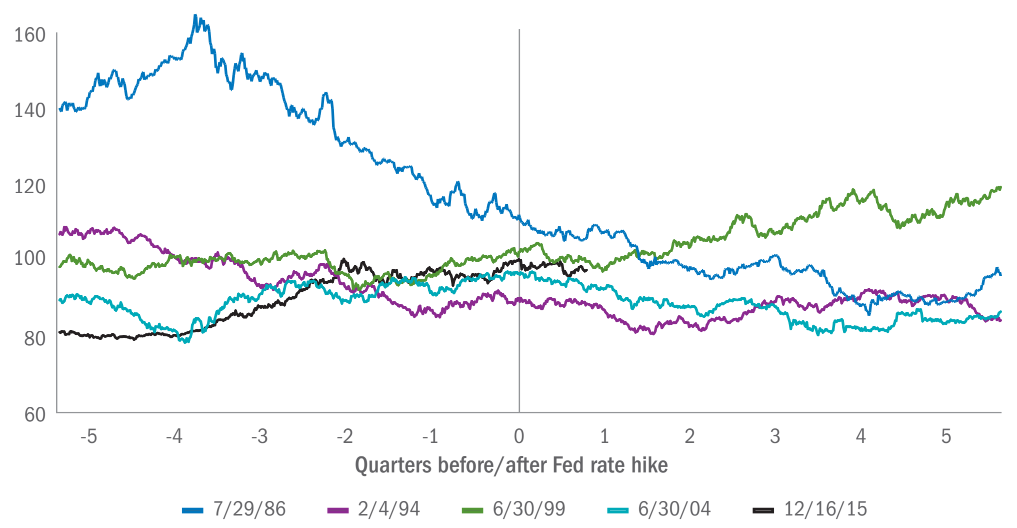
Keeping abreast of these developments at the country levels requires dedicated and specialized analysis. Monetary policy conducted by a central bank, including the management of the exchange rate, is a key determinant of asset prices in local markets. For example, central banks in Latin America such as Brazil are maintaining a tight policy stance with high interest rates due to high inflation while in Asia central banks such as that of Indonesia have begun cutting rates in 2016. Additionally investors must be cognizant of the interaction between fiscal and monetary policy together with balance of payments that could weigh on the monetary policy stance. By comparison, EXD primarily trades at a spread differential relative to U.S. Treasury yields, which reflects a government's capacity to pay its external debt.

Moreover, the rules of engagement differ among emerging market countries. EM local markets require close surveillance of frequent economic and news events, an understanding of the local investor base, and political risk. Market access, taxation and regulatory regimes, and trading liquidity are all important factors that can impact returns and must be properly evaluated by investors. Additionally, the product offerings available in each domestic market may vary allowing for investors to capitalize on various factors of return. Government debt may include indexed (often to inflation), fixed or floating rate bonds. The availability of swaps and other derivatives may also vary which in turn impacts hedging strategies.

Approaching a turning point

Local returns have largely been resilient to the turbulence in international financial markets with only one occurrence of a small loss since 2003. However, for foreign investors it is the FX depreciation that has caused significant losses (see Figure 5 above). All together the EM local debt market asset class has lost over 20% since the 2013 taper tantrum, a decline driven in large part by the U.S. dollar bull run, but with large divergences among emerging market countries. History suggests that the dollar rally is nearing the end and EM currencies will remain steady, after the recent Fed hike (see Figure 6).

Figure 6: USD typically fizzles after Fed rate hikes – DXY Index

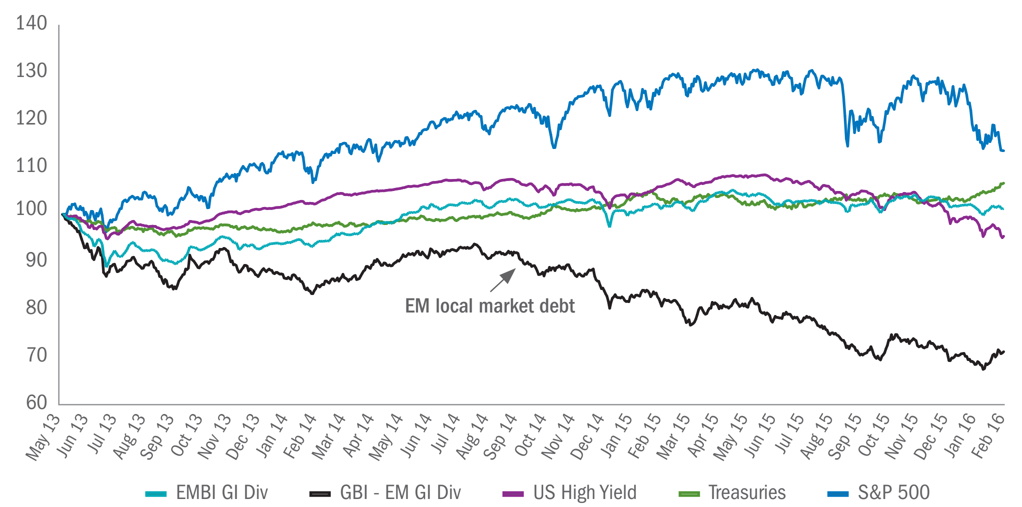


The U.S. Dollar Index(DXY) indicates the general international value of the USD. The DXY does this by averaging the exchange rates between the USD and major world currencies. DXY Index Source: Bloomberg, Horizontal axis indicates quarters before/after rate hike

Of the four past Fed rate hike cycles, only in 1999 did the U.S. dollar continue to strengthen with any conviction after the initial rate hike and one can argue that this was more due to extraordinary factors at the time that contributed to greater risk aversion (e.g. Asian Financial Crisis, Russia/LTCM crisis, introduction of the Euro). As is often the case for emerging markets facing external shocks, currency depreciation has made the initial strides on the path towards growth. The fact that a big adjustment in emerging market currencies has already taken place suggests that opportunities in EM local market debt await domestic and foreign investors alike. However, just as in 1999, one must be cognizant of the external and structural risks that could exacerbate the EM currency selloff further, particularly as the world globalizes and becomes more connected. A current example of this is China's growth and debt issues filtering through and negatively impacting both commodity and trade-focused economies.

Other asset classes, including high yield bonds, commodities and equities also experienced losses since May 2013. Of the major asset classes, only US equities have posted a meaningful positive return over the period, as shown in Figure 7. From the emerging market perspective, ongoing structural improvements in EM economies have prevented a meaningful selloff from escalating to a complete market meltdown. These structural improvements include the stockpiling of foreign exchange reserves, a deleveraging of the public sector and the aforementioned improvement in the debt profile away from foreign currency liabilities.

Figure 7: EM local market valuation appears compelling after underperforming since May 2013



May 9,2013 = 100 Source: Bloomberg,

History suggests that recent US dollar appreciation is peaking and setting the stage for more stable and/ or appreciating EM currencies.

Conclusion: A peaking dollar and higher yields create compelling opportunities in EM local currency debt

History suggests that recent US dollar appreciation is peaking and setting the stage for more stable and/or appreciating EM currencies. The more attractive EM currency valuations, coupled with higher yields, offer a compelling investment opportunity in EM local currency debt. Furthermore, the structural improvements and the diverse and growing domestic investor base provide added support to EM local currency markets. The key near-term hurdle we are watching is clarity on growth in emerging market economies. We see signs of "green shoots" of growing economic activity taking root across the EM landscape. Further materialization of these signs of growth could be a significant positive signal for the asset class.

While EM local currency offers diversification and higher yields, an investor needs to remember not all EM local markets are created equal given different domestic economic and policy drivers. Central banks are often faced with unique economic challenges from region-to-region. Additionally, given the higher volatility of the asset class, an experienced team of investment professionals with the scale and capabilities of TIAA Investments is best positioned to manage the risks in EM local markets effectively.

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