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Emerging-Markets Debt: A New World in Fixed Income

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EMERGING-MARKETS ARE BACK ON THE RISE

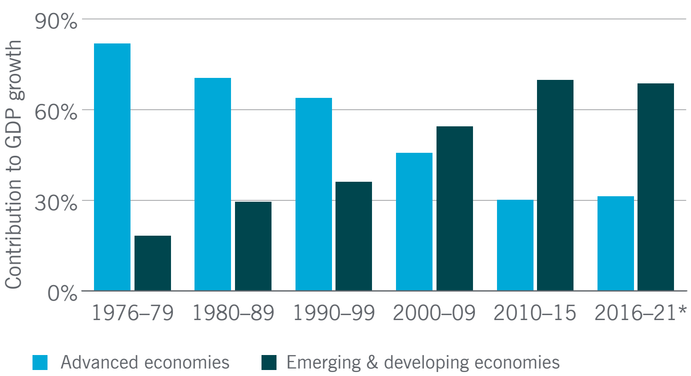
Emerging-markets (EM) are driving global growth — with more favorable demographics, improving governance, and rapid financial development. Developed-market (DM) GDP is expected to increase by only 2% in 2017, while EM should expand by a more robust 4.6%.[1] This growth premium of EM over DM, which bottomed at 2.1% in 2015, should average 3.1% over the next five years. EM accounted for nearly 70% of the rise in global GDP from 2010-2015, a ratio it is expected to maintain for the foreseeable future (Figure 1).[2] Eighty-five percent of the world's population and 90% of people under the age of 30 live in EM countries, supporting higher levels of growth well beyond the end of this decade.[3]

EXECUTIVE SUMMARY

- Emerging-markets debt is a multi-faceted asset class that tends to be underrepresented in U.S. institutional portfolios.
- After several years of struggles, emerging economies are back on the rise and expected to outgrow their developed-markets counterparts by more than 3% per year over the balance of this decade.
- Years of progress toward better governance and mature financial markets have allowed emerging-markets debt to establish deeper and broader support from investors.
- Emerging-markets debt is issued in dozens of currencies by both sovereign governments and corporations, giving it a built-in diversification benefit.
- We believe skilled active management is the best approach for investing in emerging-markets debt, given the asset class's innate diversity and the difficulty in accessing its full breadth through benchmarks.

EM countries are also benefiting from a general improvement in governance over the past few decades. Many developing nations have liberalized their capital markets through privatization of state-run enterprises, the alleviation of restrictions on foreign investors, and the development of retirement markets and pension funds. Monetary and fiscal authorities have used previous crises to establish independent central banks and more market-based currency regimes, while also tightening their balance sheets. The ratio of debt to GDP (including government, financial, and corporate securities) is far lower in EM (69%) than in DM (172%).[4]

Figure 1 – EM economies now providing the bulk of global output growth



Source: IMF, "World Economic Outlook", April 2017.
* IMF Forecast

Economic modernization has come hand-in-hand with financial development, producing more sustainable markets by broadening EM's institutional investor base and expanding the size and breadth of financial products available. This has attracted foreign investors not just from the U.S. but also from other EM countries. As a result, EM economies are now less dependent on DM but increasingly interconnected with one another.

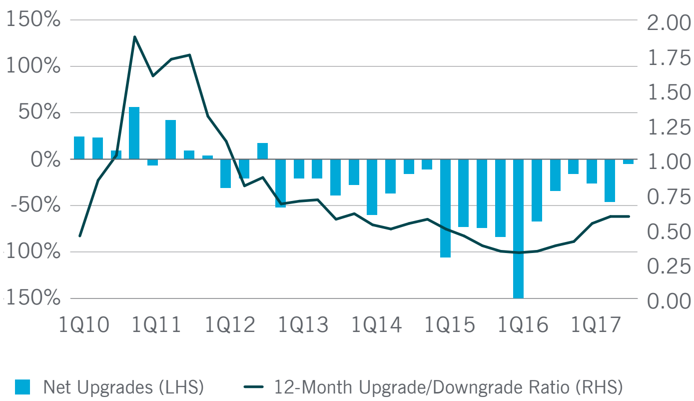
Growing investor interest in EM is reflected in broader coverage of these markets in international benchmark indices. Back in 1999, the JP Morgan Emerging-markets Bond Index - Global (EMBI Global) included 27 countries.[5] Today, it contains 66.[6] Still, the EM fixed-income universe remains underrepresented: EM accounts for 60% of global GDP but makes up just 11% of global bond markets.[7] Furthermore, less than 10% of all EM fixed income is represented in the major EM, fixed-income benchmarks. And EMD accounts for just 5-6% of the total market value of broad global bond market indices like the Bloomberg Barclays Global Aggregate.[8]

WHAT ARE THE RISKS?

The risks of EMD investing fall into two main categories: broad macroeconomic risk, which is largely external, and idiosyncratic risks affecting single countries or regions. The first type of risk was most apparent in 2008, when DM experienced a financial crisis that tipped most large economies into recession. While the crisis originated in developed markets, EM currencies and stock prices fell while credit spreads rose, as investors withdrew money from risky assets.

EM experienced a different external shock beginning in 2013 (Figure 2), when a sudden rise in U.S. interest rates — known as the "taper tantrum"— caused EM currencies to plummet. Their struggles magnified when oil prices began a 20-month, 75% decline in 2014, putting sovereign and corporate issues reliant on energy sales under pressure as credit spreads rose. The sharp rise in the U.S. dollar during this period also negatively affected local-currency bond returns. Today, a repeat of either of these scenarios seems unlikely given the weaker level of most EM currencies since 2014 and the stronger global economic outlook.

Figure 2 – Credit outlook improving for EM corporate securities



Source: JPMorgan, August 2017.

Another external risk that has cropped up recently has been the move toward trade protectionism in some DM. Speculation that the U.S. might adopt more restrictive trade policies led to a sharp but brief selloff in EM currencies following the November 2016 U.S. election. Most, however, have recovered from those losses and then some, as specific protectionist policies have been slow to take shape.

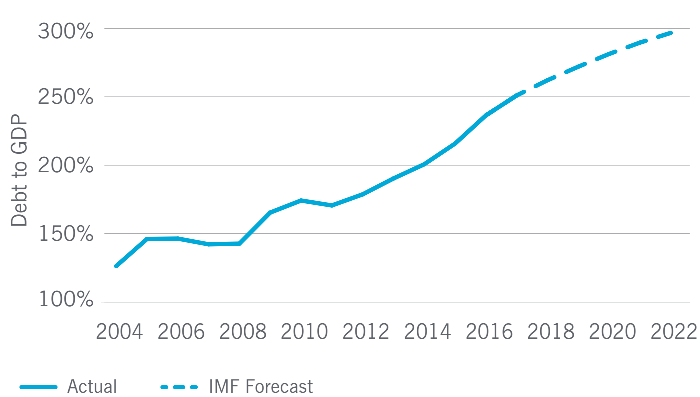
While external risks have claimed their share of headlines, EMD risks associated with individual countries have also been a focus for investors. With 66 countries included in the EMBI Global benchmark, there's been no shortage of idiosyncratic risk (e.g., Venezuela, Brazil, South Africa, and Turkey). Fortunately, as EM economies have become increasingly flexible, severe crises have been less frequent — and the potential for single-country risk to affect the entire EMD landscape has fallen. Even so, avoiding possible flashpoints remains a core function of an EMD portfolio manager. Research and risk mitigation are crucial benefits of active management.

China's growing debt

As the largest EM economy and issuer of debt, China and its risks deserve special mention. China's rising debt level — increasing twice as quickly as its economy — has grown from 150% of GDP in 2008 to over 250%[9] today and will likely increase further in the next few years according to the IMF (Figure 3). The "good news" for EMD investors is that most of this debt is owed by either state-owned-enterprises or companies in state-sponsored sectors such as construction and property, or is tied to local government and infrastructure spending. All of these segments are considered critical and in a crisis likely to be ably backed by the central government. While China allowed a struggling company to default for the first time in 2015 and was recently downgraded, to A1, by Moody's Investor Services for the first time since 1989, its overall corporate default rate remains low at 0.1% (versus 2% in the U.S.).[10]

Though unlikely, in our view, a financial crisis originating out of China today could spark one of two contagion scenarios: directly, via counterparty risk from Chinese companies, or indirectly, by tainting sentiment across EM. We believe China could easily manage a solution with affected counterparties in the event of a domestic banking crisis, given its sufficient assets to cover debt. Indirectly, however, market fear over an internal Chinese event could spread, potentially leading to a pullback in foreign investment affecting other EM countries. This in turn could threaten EM currencies and bond prices. Active management that diversifies across regions, issuers, and currencies mitigates the risk of contagion.

Figure 3 – China's overall debt is growing faster than its economy



Source: International Monetary Fund, Haver, Nuveen, July 2017.

WHERE DOES EMD FIT IN A PORTFOLIO?

Although EMD tends to be underrepresented in institutional portfolios, the potential for higher yield and diversification benefits make a strong case for inclusion.

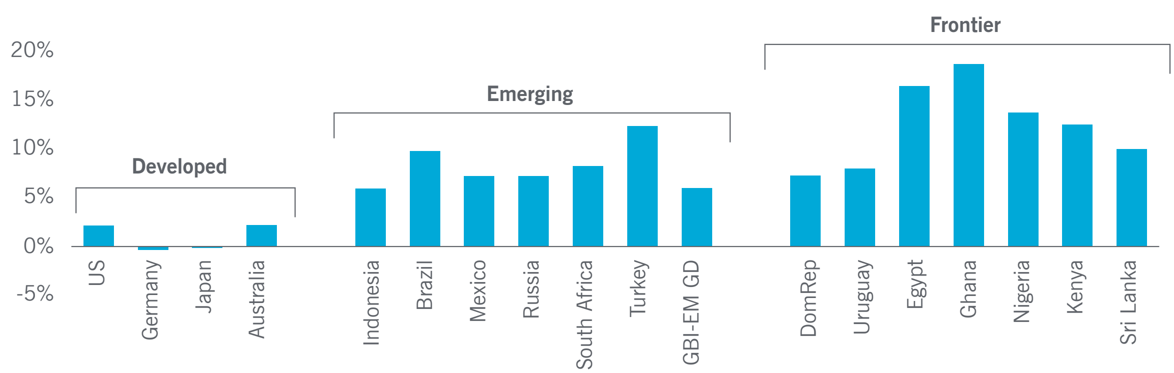
Currency effect

Although EMD securities may be denominated in hard currencies (e.g., the U.S. dollar, euro, and yen), most outstanding EM debt is in local currencies, as shown earlier in Figure 1. Local-currency bond returns hinge on both the price of the underlying bond and the value of its currency of denomination versus the U.S. dollar. While currency risk typically causes local debt to trade with higher volatility than its dollar-denominated counterpart, the benefit to investors is apparent in the higher yields available, particularly as one looks to less-developed frontier markets (See Figure 4).

Diversification benefits

Diversity across a range of security types and characteristics is one of EMD's defining features. For example, returns on local and hard-currency debt do not always move in tandem, providing a built-in low-correlation benefit that can improve the asset class' risk-adjusted return. Dollar-denominated EMD, for example, trades based on the issuer's creditworthiness, but is also sensitive to changes in U.S. interest rates, whereas prices of local bonds move according to changes in local rates and currencies. Figure 5 shows historical summary statistics for several major EMD indices. Combining these three indices in an equal-weighted blend has provided efficient risk-adjusted returns that are uncorrelated with U.S. interest rates — a desirable and currently elusive characteristic in fixed-income markets.

Figure 4 – Large jumps in sovereign yield moving from DM to EM to Frontier



Source: Bloomberg, December 13, 2017.

Figure 5 – Emerging-market debt returns have been efficient and uncorrelated to U.S. interest rates

2003-2017	EMBI GD	CEMBI Div	GBI-EM GD	Blend	Global Agg	MSCI World
Annual Return	8.93%	5.07%	6.20%	6.88%	4.26%	8.52%
Standard Deviation	8.19%	10.50%	13.13%	9.45%	2.71%	14.54%
Sharpe	0.91	0.34	0.36	0.57	1.04	0.48
Correlation to 10-year U.S. Treasury yield	-0.32	0.05	0.06	-0.05	-0.88	0.25
Correlation to Russell 3000 Index	0.61	0.55	0.58	0.65	0.00	1.00

Source: Bloomberg, JPMorgan, January 2003 – June 2017. The EMBI Global Diversified, JPMorgan CEMBI Diversified Index, and JPMorgan GBI-EM Global Diversified Index measure the performance of sovereign USD-denominated bonds, corporate USD-denominated bonds, and EM bonds measured in local currencies, respectively.

Quality and compensation for risk

In general, EM sovereign and corporate debt issuers carry lower credit ratings than, for example, DM governments like the U.S., Japan or Germany. As a result, when a country like Indonesia issues debt in U.S. dollars, it offers a higher yield than similar maturity U.S. Treasuries. Nonetheless, the majority (58%) of the securities in the Bloomberg-Barclays EM Aggregate are rated BBB- or better, which qualifies as investment grade. Even with this higher average credit rating, EMD trades with yields that are higher than global high yield, all of which is rated BB+ or below, by definition.

We would not recommend exchanging a high-quality bond portfolio for one consisting entirely of EMD. Our recent research indicates that devoting one-quarter of a bond allocation to EMD has historically led to higher returns over time.[11] In periods of rising interest rates, an allocation to EMD had a particularly positive effect on risk-adjusted returns.

BECAUSE TRACKING EMD BENCHMARKS IS TRICKY, CONSIDER ACTIVE MANAGEMENT

EMD is a challenging asset class in which to invest using a passive strategy. Even the broadest indices fail to capture a significant portion of the $20+ trillion in outstanding EM debt. The diversity of issuers and the limited liquidity in certain parts of the asset class has led to significant tracking error between passive EMD portfolios and their benchmarks. For example, the largest EMD exchange-traded fund (ETF) lagged its benchmark by more than 1% per year from 2012-2016.[12] In contrast, during that time, major ETFs tracking other benchmarks such as the Bloomberg Barclays U.S. Aggregate Bond Index delivered annual performance within a few basis points of their more-liquid benchmarks.

Experienced managers can improve upon passive investing by taking advantage of the broad and diverse EMD universe. They can employ greater selectivity within the benchmark through diligent credit research and well-considered macroeconomic views. Beyond that, they can invest in the vast majority of securities that are not found in the leading benchmarks, including most EM corporate debt and local-currency bonds. Active managers can also adopt thorough risk controls that indices, by definition, do not employ. Lastly — and this is easy to forget during a period in which EMD benchmark returns have been stellar — we believe an active approach will better protect principal when those same indices are struggling.

THE OPPORTUNITY IN EMD TODAY

The same characteristics that make EMD an attractive addition to a portfolio have helped it outpace every other segment of the global fixed-income market by a wide margin in 2017. The widening gap between EM and DM economic growth, appreciating EM currencies, and liberalizing financial markets are beneficial in both the short and long term. Therefore, we believe now is still a good time to add judiciously to the asset class, keeping in mind the importance of active management in light of the recent rally.

After an unsteady recovery in the wake of the global financial crisis of 2008, EM economic growth has finally resumed, and corporations in the developing world are boosting earnings at their fastest pace since the initial recovery in 2009. Perhaps more importantly, EM companies' balance sheets are improving, reflected in the dramatic slowdown in credit-ratings downgrades following a rocky period in the beginning of this decade. Experience tells us that investor flows tend to move into EM assets during these periods of acceleration, supporting asset prices even after they've risen considerably.

As recently as two years ago, EM countries faced an unpleasant combination of high inflation from rapidly depreciating currencies and weak domestic growth. Thanks to a variety of factors both internal (lower inflation) and external (a weaker U.S. dollar), circumstances have improved. Central banks from Brazil to

Indonesia have now been able to cut interest rates without experiencing capital outflows or rapid currency depreciation. With expectations for further monetary easing in EM, we believe local-currency bonds — whose prices increase as EM interest rates fall — present a particularly compelling opportunity.

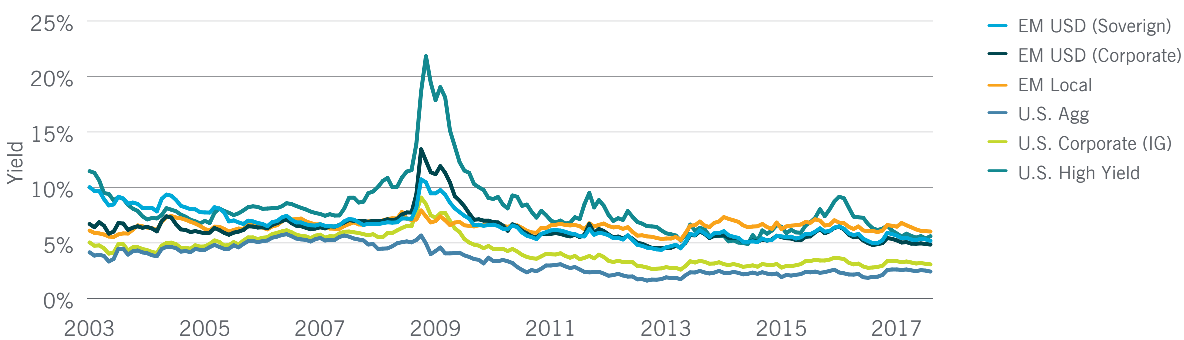
We also cannot ignore that with interest rates in DM still near historic lows (Figure 6), the search for yield will continue to support EMD in the near term. As always, selectivity is key. Less-developed frontier markets typically have smaller bond markets, but their economies are collectively expected to grow by more than 5% in both 2017 and 2018. For example, we see moderating inflation in the Dominican Republic over the past few years as a sign that the country's debt may merit greater inclusion in a portfolio.

WRAPPING UP: A COMPELLING ASSET CLASS FOR A LOW-YIELD WORLD

As an underrepresented asset class in most global benchmarks, EMD is systematically under-owned by institutional investors. We believe it can enhance a portfolio's risk-adjusted returns in almost any environment. While DM economies remain mired in a period of low interest rates, a higher allocation to EMD, despite its attendant risks, still makes sense, in our view.

At the moment, with EM balance sheets stronger than they've been in years and growth on the rise, EMD looks especially attractive. Investors should ideally obtain exposure to the full breadth and depth of the asset class, embracing the diversity that has led to superior returns over time. Based on both EMD's strong long-term track record and the availability of experienced managers to potentially add value relative to the prevailing EMD benchmarks, we believe an active investment approach is best suited to this asset class.

Figure 6 – EMD yields are still attractive against U.S. debt



Source: JPMorgan, Bloomberg, as of 8/31/17.

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