ALTIS Flash Report

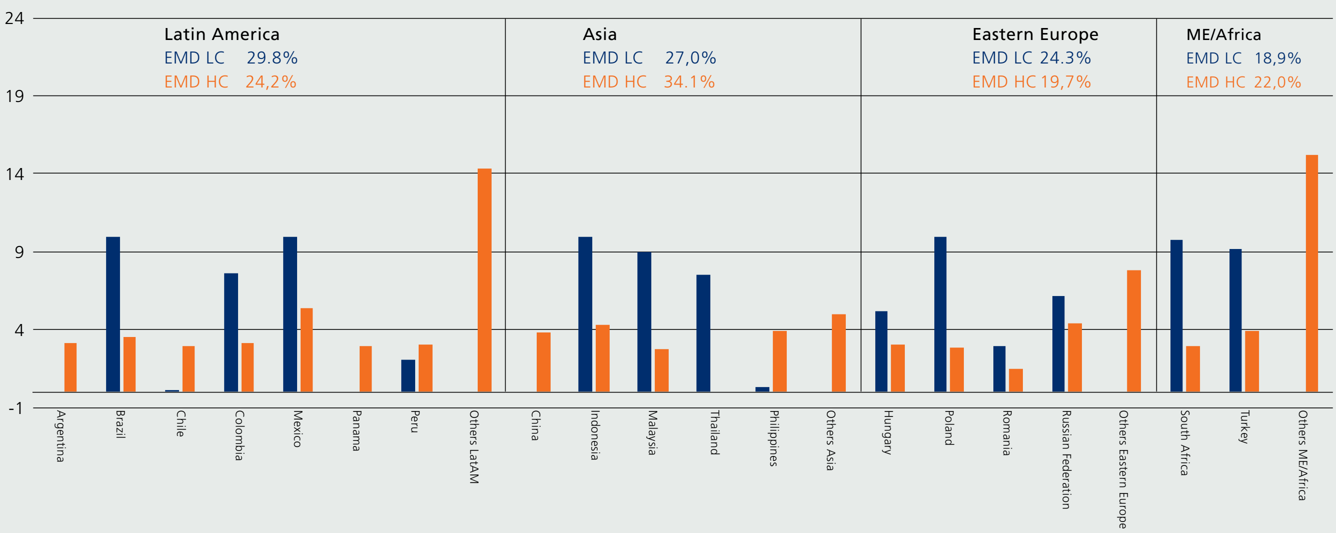
How to balance local currency versus hard currency in Emerging Market Debt

Within the asset class Emerging Market Debt (EMD), Altis distinguishes two sub-categories: (semi) government bonds of emerging countries in US dollars (Emerging Market Debt Hard Currency, or EMD HC) and government bonds of emerging countries issued in local currencies (Emerging Market Debt Local Currency, or EMD LC). In this Altis Flashreport we will first identify and compare the key characteristics of EMD HC and EMD LC. We will also discuss our strategic weightings of these sub-categories within an allocation to EMD. Next we will elaborate on the 2016 returns of the two sub-categories. To conclude, we will explain why we currently recommend an allocation within EMD that is consistent with the strategic weightings.

About Altis

Altis Investment Management is a specialist in selecting and monitoring asset managers. We construct investment portfolios that cover a wide range of asset classes. These portfolios are assembled from an efficient combination of both active investment specialists and passive investment instruments. The manager selection is based on continuous qualitative and quantitative analysis, supported by a unique monitoring system that analyses all underlying exposures of the most relevant asset managers. The selection process results in a list of recommended managers in almost all asset classes and market segments.

Regional breakdown for EMD LC & EMD HC



■ Country weightings JPMorgan EMBI Global Diversified (EMD HC)
■ JPMorgan GBI EM Global Diversified (EMD LC) as per 31 December 2016.

Source: Altis, Factset, JPMorgan

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Table: How to balance local currency versus hard currency in Emerging Market Debt			
Diversification benefits by diversifying across sub-categories within EMD			
Allocation to EMD sub-categories EMD HC and EMD LC			
EMD HC	0%	40%	100%
EMD LC	100%	60%	0%
EMD HC risk and return sources			
Risk premium emerging markets (spread)	0.0%	3.7%	9.3%
Long-term US interest rate	0.0%	2.2%	5.6%
EMD LC risk and return sources			
Local currency movements versus US dollar	7.1%	4.2%	0.0%
Local rates	4.4%	2.6%	0.0%
Risk EMD Allocation			
Total risk (volatility) without diversification	11.4%	13.0%	15.0%
Diversification	-2.3%	-5.2%	-6.4%
Total risk (volatility)	9.2%	7.8%	8.6%

Source: JPMorgan, NNIP ICS. Period: 2003 to August 2016.

Characteristics of EMD LC and EMD HC

EMD is a relatively young asset class. The sub-category EMD HC emerged in the late 80s, while EMD LC did not develop until the beginning of this century (2003). But EMD LC has grown rapidly, making it a larger sub-category than EMD HC (by market capitalization)[1]. The EMD LC index consists of only 15 countries, two of which together account for less than 0.5% of the index. The seven most important countries (Indonesia, Mexico, Poland, Brazil, Turkey, Malaysia and South Africa) account for ~70% of the index. The EMD HC index consists of 65 countries and the distribution is more balanced. The following chart shows the weightings of the most important countries. The smaller EMD HC countries are clustered by region.

Within EMD LC, local rates and local currencies are the two sources of risk and return, with currencies clearly being the dominant one. Within EMD HC, the risk premium or spread is the most important source of risk and return, followed at a distance by the second source of risk and return within this sub-category, being long-term US rates. The different return and risk factors within EMD HC and LC are only weakly and sometimes even negatively correlated. A favorable consequence is that in the allocation to EMD both the total risk and the exposure to a single source of risk and return can be reduced by incorporating both EMD HC and EMD LC. The following table shows that an allocation to EMD of 40% EMD HC and 60% EMD LC results in a reduction of total risk (volatility).

In our model portfolio we have a strategic allocation of 40% EMD HC and 60% EMD LC. Our main considerations are:

- Diversification of countries
- Diversification of sources of risk and return
- Historical return analysis confirms significant diversification benefits

Market developments EMD

EMD LC has had a few challenging years: 2013 (-12.6%) and 2015 (-5.2%). Numerous emerging market currencies depreciated sharply against the US dollar in response to the much lower commodity prices. In 2016, local currencies such as the Brazilian Real and Russian Ruble rallied, partly due to the recovery in oil prices. Compared to EMD LC, the sub-category EMD HC has been less volatile in recent years.

We often see that European institutional investors fully hedge the EUR-USD currency risk exposure within EMD HC, while they do not hedge the currency risk exposure within EMD LC. This is our starting point as well. After the US presidential election, the US dollar appreciated sharply against the euro. Because of this US dollar rally, EMD HC returns over 2016 (hedged) in euros lagged EMD LC: 8.3% for EMD HC, hedged, versus 13.2% for EMD LC[2].

Over a 10-year period, the cumulative returns in euros of EMD HC (hedged) and EMD LC are actually more or less in line[3]. However, the risk in terms of volatility is also high for both sub-categories: around 10% per year[4]. In recent years, the volatility of EMD LC has been higher due to the volatility of currencies.

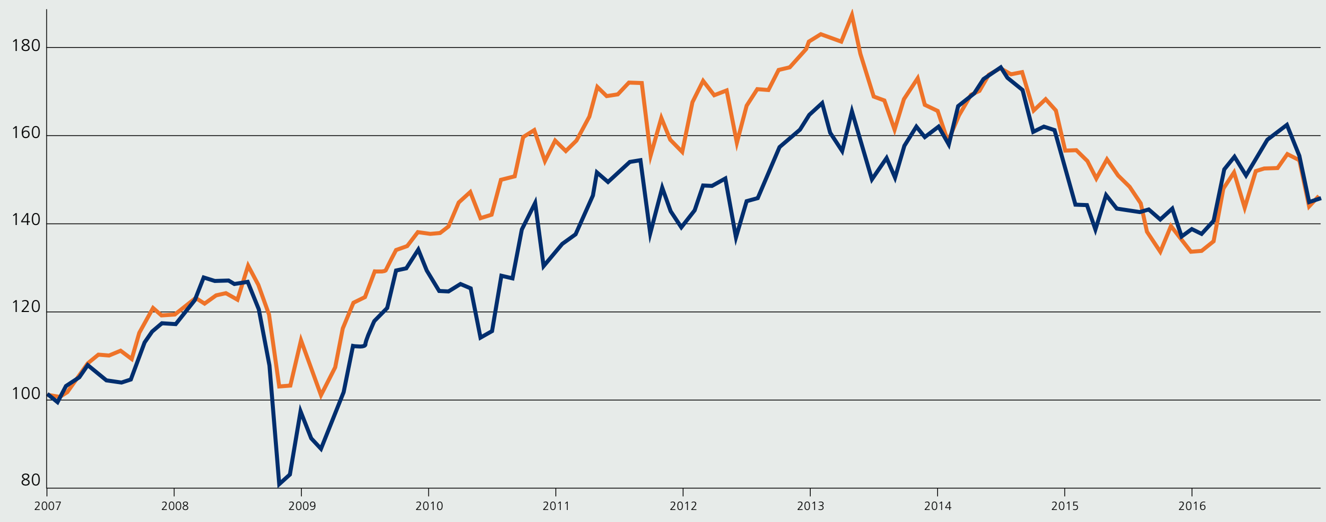
1 As per the end of December, the market capitalization of EMD HC was USD 445 billion and the market capitalization of EMD LC was USD 707 billion, measured on the basis of, respectively, the JP Morgan EMBI Global Diversified index and the JP Morgan GBI Global Diversified index. These are by far the most widely used indices for EMD HC and EMD LC.

2 The return over 2016 measured in US dollars amounted to 10.2% for EMD HC and 9.9% for EMD LC

3 The mean (arithmetic average) euro return of EMD HC (hedged) over this period was 6.1%, similar to the EMD LC return of 6.2%.

4 9.3% for EMD HC (hedged) versus 9.7% for EMD LC, in euros

Chart: 10-year cumulative return of EMD HC (hedged) and EMD LC, in euros



Source: Altis, Factset, JPMorgan. Period: 2007 to 2016

Within our model portfolio, we may dynamically deviate from the strategic ratio of 40% EMD HC and 60% EMD LC. Based on current market conditions, we currently have a neutral position however;

- The yield of EMD LC is currently somewhat higher than EMD HC. This difference, however, is not exceptionally large in ahistorical context[5]
- The spread (risk premium) of EMD HC[6] is also fairly in line with the multi-year average
- In contrast, the valuations of emerging market currencies are still below the multi-year average. But in recent years, currencies have been the main source of volatility in EMD LC. If we compare the currency valuations with the higher risk, we do not find them particularly attractive.

Conclusion

In this persistently low yield environment, we note that the Emerging Market Debt asset class still attracts a high level of interest from institutional investors. A diversification between EMD HC and EMD LC within the Emerging Market Debt asset class offers diversification benefits, in terms of diversification across countries sources of risk and return. We assess the attractiveness of the two sub-categories as fairly balanced.

5 5.8% for EMD HC, 6.8% for EMD LC, as per end of December 2016
6 ~340 basis points as per end of December 2016