

EMERGING MARKET LOCAL DEBT: A SEASONAL OPPORTUNITY

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So far this year, emerging market (EM) bonds, currencies and equities have outperformed many corresponding U.S. asset classes. The EM rally stands in marked contrast to EM disappointments in January the past three years and is all the more surprising given struggles in both Mexico and Turkey. Investors can now look forward to an investment window that recently has been characterized by EM outperformance and strong absolute returns. Over the last 11 years (the inception of the local debt index¹), the three-month investment window from February 1 through April 30 has, on average, produced the strongest returns for EM assets, in particular EM local debt and EM equities,² and generated the fewest and the smallest shortfalls.

As seen in the table below, EM performance within the February-through-April window is distinct from other three-month investment windows. EM local debt, [corporate](#),³ [USD-based sovereigns](#)⁴ and equities all post their most consistent performance during the window. While other windows tend to be lifted by greater one-time gains, the gains during the early spring period tend to be consistent, and losses are less frequent and shallower in scope.

EM Asset Returns and U.S. Benchmark Average Returns over Rolling Three-Month Calendar Windows for Horizons Ending 3/31/06–12/31/16

Rolling 3-Month Returns Ending	EM Local Debt	EM Local Debt (FX)	EM Corporates	EM USD Sovereigns	EM Equities	U.S. IG Corporates	U.S. High-Yield Corporates	S&P 500
November–January	-0.5%	-2.8%	1.7%	0.8%	-2.6%	2.1%	1.4%	0.1%
December–February	1.1%	-1.0%	2.0%	1.9%	0.1%	1.9%	3.5%	0.5%
January–March	2.7%	0.6%	2.6%	2.4%	2.6%	1.1%	3.1%	2.1%
February–April	5.6%	3.2%	3.3%	4.0%	9.0%	1.5%	4.6%	5.8%
March–May	2.9%	0.8%	3.0%	2.5%	7.0%	1.3%	4.5%	5.4%
April–June	1.5%	0.2%	2.2%	1.7%	2.4%	1.5%	3.1%	1.3%
May–July	0.5%	-1.0%	2.0%	1.7%	0.3%	1.7%	1.3%	0.6%
June–August	1.4%	-0.7%	2.2%	2.9%	-0.4%	2.3%	1.2%	0.3%
July–September	0.9%	-1.7%	1.4%	2.6%	0.9%	1.9%	1.5%	2.0%
August–October	0.0%	-2.1%	-0.1%	1.1%	0.2%	0.7%	0.8%	1.2%
September–November	-0.4%	-2.2%	-0.7%	-0.2%	0.5%	0.1%	-0.6%	2.5%
October–December	0.2%	-1.8%	0.2%	0.5%	1.2%	0.9%	0.6%	3.3%
Rank	1	1	1	1	1	7	1	1

Sources: EM local debt and FX returns represented by the J.P. Morgan GBI-EM Global Diversified Index. EM Corporates and EM USD Sovereigns proxied by the J.P. Morgan CEMBI Broad Index and J.P. Morgan EMBI Global Index. EM Equities represented by the total returns of the MSCI Emerging Markets Index in USD terms. The Bloomberg Barclays U.S. High Yield 2% Capped Index and the Bloomberg Barclays U.S. Aggregate Index represent the remaining asset classes. IG = investment grade. Past performance is not indicative of future results. You cannot invest directly in an index.

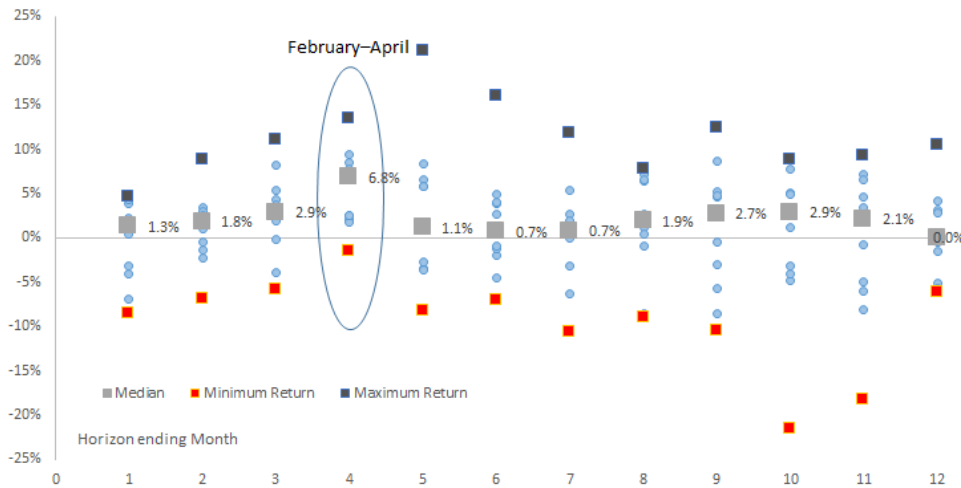
For definitions of indexes in the chart, visit our [glossary](#).

A Spotlight on EM Local Debt

Among the bond sectors, EM local debt shines brightest during this period, generating substantial excess returns versus EM corporate and EM USD sovereigns. Positive contribution from [foreign exchange \(FX\)](#) is a significant piece of this excess return performance. The local bond returns are robust but still lag both EM corporate and USD-denominated

sovereign bonds in isolation. In particular, the falling rate environment has been a very supportive tailwind for much longer-duration USD sovereign debt market proxies. The estimated 3% boost from FX gains pushes local debt to the fore.

EM Local Debt: Distribution of Returns for Rolling Three-Month Windows (1/1/06–12/31/06)



Sources: WisdomTree, J.P. Morgan. EM foreign exchange returns are represented by the currency returns of the J.P. Morgan GBI-EM Global Diversified Index. Past performance is not indicative of future results. You cannot invest directly in an index.

The strength in local debt and currency performance was also broad-based. On an aggregate level, each region (Latin America, Europe, Africa and Asia) registered its best average performance during the February –through-April window. 65% of the individual countries posted their best average returns during this window. This number grows to 80% if you expand it to the top two windows. On a given year, 80% of the countries represented by local debt issuers typically produced positive returns.

EM local debt has also outperformed relative to U.S. high-yield debt, U.S. [investment-grade](#) corporates and the [Bloomberg Barclays U.S. Aggregate Index \(the Agg\)](#) during this period. The sole negative February-through-April return period for EM local debt was a loss of 1.4% in 2015; the other 10 were positive. 2015 was also the only February-through-April window in which the Agg outperformed EM local debt.

Average Excess Returns of EM Local Debt versus Other Fixed Income Assets, Rolling Three-Month Periods for Horizons Ending 3/31/06–12/31/17

Excess Returns, Rolling 3-Month Period	EM Local vs. EM Corp	EM Local vs. EM USD	EM Local vs. U.S. Agg	EM Local vs. U.S. IG Corp	EM Local vs. U.S. HY	EM Local vs. U.S. Treasury	EM Corp vs. IG Corp	EM Corp vs. U.S. HY
November–January	-2.2%	-1.3%	-2.1%	-2.5%	-1.9%	-2.1%	-0.3%	0.3%
December–February	-1.0%	-0.9%	0.0%	-0.8%	-2.4%	0.4%	0.1%	-1.5%
January–March	0.1%	0.3%	1.6%	1.6%	-0.4%	1.9%	1.5%	-0.5%
February–April	2.2%	1.5%	4.6%	4.1%	1.0%	5.2%	1.8%	-1.2%
March–May	-0.1%	0.4%	2.1%	1.6%	-1.6%	2.7%	1.8%	-1.4%
April–June	-0.7%	-0.2%	0.8%	0.0%	-1.6%	1.1%	0.7%	-0.9%
May–July	-1.5%	-1.2%	-0.5%	-1.2%	-0.9%	-0.5%	0.3%	0.6%
June–August	-0.7%	-1.4%	-0.2%	-0.8%	0.2%	-0.4%	-0.1%	0.9%
July–September	-0.4%	-1.7%	-0.9%	-1.0%	-0.5%	-1.2%	-0.6%	-0.1%
August–October	0.1%	-1.0%	-1.1%	-0.6%	-0.8%	-1.4%	-0.7%	-0.9%
September–November	0.2%	-0.2%	-1.3%	-0.5%	0.2%	-1.7%	-0.8%	0.0%
October–December	0.0%	-0.3%	-0.4%	-0.7%	-0.4%	-0.4%	-0.7%	-0.4%
Rank For February - April Window	1	1	1	1	1	1	1	10

Sources: WisdomTree, J.P. Morgan, Bloomberg. Returns presented by proxies described above for EM and U.S. asset classes. Bloomberg Barclays U.S. Treasury Index represents U.S. Treasuries. Past performance is not indicative of future results. You cannot invest directly in an index. IG = investment grade. HY = high yield.

Catalysts and Potential Investment Implications

What is behind this? A couple of reasons come to mind. In the last few years, U.S. economic momentum slipped sharply in the first quarter, reducing expectations for Federal Reserve vigor and pressuring the dollar against most currencies.⁵ Indeed, the United States dollar has tended to fall in value against both emerging market and developed market currencies during this 11-year period. Dollar weakness typically correlates with higher commodity prices, which lends support to some of the commodity-intensive EM countries. (The [Bloomberg Commodity Index](#) also enjoyed its strongest returns in the February-through-April window over the 11-year period.) Currency performance in Russia, Colombia, South Africa and Brazil, are significant contributors in the February-through-April anomaly. Anxiety about the future trajectory of Chinese growth has been a constant source of concern before Chinese New Year in January, yet seems to dissipate in the months immediately thereafter. The smaller drawdowns in this window (relative to other three-month horizons) also suggest the absence of a significant risk event. Interest rates were largely well behaved, and credit spreads have tightened in the first four months of many of the last 10 years.

Unfortunately, it does end rather quickly. Over the last 11 years, May has commonly produced a sharp setback for EM FX, and returns over the May-through-July period have tended to be relatively modest for local debt (average is .5%; median return is .7%).

Still the February-through-April period has provided a seasonal window to tactically increase exposure to non-U.S. assets. Among EM debt options, it has been a window in which EM local debt has traditionally shined relative to both other EM debt options and domestic fixed income options. Despite the strength of recent performance, local debt yields could offer a considerable cushion relative to other credit products, including U.S. high yield. EM fundamentals have been gaining strength and are steadily outpacing those of developed market countries. Relative to 2013, EM economies are not nearly as extended, with fiscal budgets and trade balance in much better shape. The concept of emerging markets having a thicker skin than in years past seems appropriate given the recovery we have seen in fundamentals, and the February-through-April window could offer an opportunity to take advantage.

¹As measured by the [J.P. Morgan GBI-EM Global Diversified Index](#). Inception: 12/1/05.

²As measured by the [MSCI Emerging Markets Index](#).

³As proxied by the [J.P. Morgan Corporate Emerging Market Bond Index – Broad \(CEMBI Broad\)](#).

⁴As proxied by the [J.P. Morgan Emerging Market Bond Index – Global \(EMBI Global\)](#).

⁵Source: Bloomberg, as of 1/31/17.

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DEFINITIONS

Corporate Bonds : a debt security issued by a corporation.

EM USD Sovereigns : Debt denominated in U.S. dollars issued by emerging market governments.

Foreign Exchange (FOREX, FX) : The exchange of one currency for another, or the conversion of one currency into another currency.

Investment Grade : A rating given to a municipal or corporate bond. It is a relatively favorable rating by either Moody's or Standard & Poor's indicating a higher chance an issuer performs interest and principal obligations as promised by the terms of the debt issuance.

Bloomberg U.S. Aggregate Bond Index : Represents the investment-grade, U.S. dollar-denominated, fixed-rate taxable bond market, including Treasuries, government-related and corporate securities, as well as mortgage and asset backed securities.

Bloomberg Commodity Spot Index : formerly known as Dow Jones-UBS Commodity Spot Index (DJUBSSP), tracks the spot prices of a broadly diversified basket of commodities that comprise the total return index.

JP Morgan GBI-EM Global Diversified Index : tracks the performance of local currency debt issued by emerging market governments, whose debt is accessible by most of the international investor base. The index incorporates a constrained market-capitalization methodology in which individual issuer exposures are capped at 10%, (with the excess distributed to smaller issuers) for greater diversification among issuing governments.

MSCI Emerging Markets Index : a broad market cap-weighted Index showing performance of equities across 23 emerging market countries defined as "emerging markets" by MSCI.

JP Morgan CEMBI Broad Index : a market capitalization weighted index consisting of US dollar-denominated Emerging Market corporate bonds. The index serves as a global corporate benchmark representing Asia, Latin America, Europe and Middle East / Africa. US dollar-denominated corporate issues from index-eligible countries are narrowed further by only including issues with more than \$300m current face outstanding and at least five years to maturity (at the time of inclusion into the index).

JP Morgan Emerging Markets Bond Index Global (EMBI Global) : The JPMorgan Emerging Markets Bond Index Global (EMBI Global) tracks total returns for US dollar-denominated debt instruments issued by emerging market sovereign and quasi-sovereign entities including Brady bonds, loans, Eurobonds.