

EM LOCAL DEBT: AN UPDATED FRAMEWORK FOR UNDERSTANDING TOTAL RETURNS

Bradley Krom — Head of U.S. Research
08/19/2016

Generally speaking, since mid-2011, investing in emerging markets (EM) has generally been a source of frustration and negative performance. While some markets have been able to hold serve, the period was generally marred by a painful combination of U.S. dollar strength, a downshift in global growth and a persistent (and at times rapid) decline in commodity prices. However, performance since February 2016 has shown a marked turnaround in the asset class. In light of this reversal of fortune, we seek to quantify the risk investors are taking in emerging market fixed income. **In EM, Yield Is Only a Starting Point** By way of review, Bond Math 101 tells us that the best estimator of a fixed income investment's nominal total return is simply the starting yield. Buy the bond, collect the [coupon](#) payments, have your principal returned at [maturity](#). Unfortunately, in the case of fixed income denominated in foreign currencies, yield is only a starting point. For U.S.-based investors, the initial price they pay for the bond, the interceding coupon payments and the ultimate amount repaid at maturity depend on the path of the U.S. dollar's value against the foreign currency. As a result, assumptions about total returns and the [volatility](#) of your investment experience depend heavily on your view of the dollar. From the early 2000s up through the global financial crisis, investing abroad typically meant three positive sources of return: high levels of income, rising asset prices and appreciating foreign currencies. In fact, investors in EM local debt doubled their total returns on a cumulative basis, an astounding 108% against a still respectable 54% by bearing foreign currency risk.¹ However, since the start of 2008, the exact opposite has occurred. Owning emerging market local debt [unhedged](#) has cost investors nearly 75% in relative performance. With currency having such a dramatic impact on total returns, how can investors possibly know if taking on [currency risk](#) will ultimately lead to higher returns?

Quantifying EM Currency Risk In my view, one of the primary advantages of owning emerging market fixed income (compared to equities) is that if we make a few key assumptions, we have a fairly good idea about the implicit bets being made in our portfolio. Below, we seek to compare the total returns of investing in a [5-Year U.S. Treasury note](#) vs. investing in a 5-year government bond in an emerging market.

Country/Region	Yield to Maturity	5-Year Holding Period Return	Cumulative Depreciation Hurdle	5-Year Trailing FX Performance
U.S.	1.02%	5.1%	-	-
GBI-EM	6.18%	30.9%	-25.7%	-38.3%
Asia				
China	2.58%	12.9%	-7.8%	-3.0%
India	7.05%	35.2%	-30.1%	-34.0%
Indonesia	6.70%	33.5%	-28.4%	-35.1%
Malaysia	3.20%	16.0%	-10.9%	-27.0%
Philippines	2.63%	13.2%	-8.0%	-10.6%
S. Korea	1.24%	6.2%	-1.1%	-5.3%
Thailand	1.73%	8.7%	-3.6%	-14.4%
Europe, Middle East & Africa				
Hungary	1.96%	9.8%	-4.7%	-32.8%
Nigeria	15.40%	77.0%	-71.9%	-51.5%
Poland	2.27%	11.4%	-6.3%	-28.8%
Romania	2.32%	11.6%	-6.5%	-26.3%
Russia	8.70%	43.5%	-38.4%	-58.1%
S. Africa	8.10%	40.5%	-35.4%	-51.8%
Turkey	9.37%	46.9%	-41.7%	-43.5%
Latin America				
Brazil	11.92%	59.6%	-54.5%	-52.3%
Chile	4.11%	20.6%	-15.4%	-30.2%
Colombia	7.27%	36.4%	-31.2%	-42.1%
Mexico	5.62%	28.1%	-23.0%	-37.4%
Peru	4.94%	24.7%	-19.6%	-18.3%

Source: Bloomberg, as of 7/29/16. Past performance is not indicative of future results.

The table above shows that due to higher [interest rates](#) in many emerging market countries, foreign currencies would need to depreciate nearly 26% over the next five years for investors to be indifferent between owning a U.S. Treasury bond and EM local debt. While this may appear like an appealing bet, EM currencies have actually declined by over 38% in the past five years, resulting in underperformance of EM local debt compared to Treasuries. In our view, investors would need to experience declines of a similar magnitude in order for performance to rival the previous five years, a period of performance that ranks at the lowest levels of the history of the asset class. In sum, higher-yielding bond markets could provide an additional cushion to help weather declines in foreign currencies against the U.S. dollar. However, a large number of these countries also have meaningful exposure to commodities, which may further complicate the view of their underlying economic strength. While yields in many Asian countries are relatively low compared to other emerging markets, the [credit quality](#) of these countries, combined with their comparatively stable currencies, has led to comparatively attractive total returns over the past five years, despite losses in other regions. Ultimately it may be possible for foreign currencies to weaken at a faster pace than the total returns generated from higher interest rates. However, we believe that starting to consider increasing allocations to emerging market debt could yield positive returns for investors focused on the longer-term trend of emerging market growth. While we remain committed to allocations in many emerging markets for the long run, we thought it prudent to re-examine the investment assumptions being made in locally denominated emerging market fixed income. ¹Source: J.P. Morgan, 12/31/02–12/31/07.

Important Risks Related to this Article

Investing in emerging markets has been a source of frustration and negative performance since mid-2011. However, performance since February 2016 has shown a marked turnaround.

For standardized performance and the most recent month-end performance click [here](#) NOTE, this material is intended for electronic use only. Individuals who intend to print and physically deliver to an investor must print the monthly performance report to accompany this blog.

For more investing insights, check out our [Economic & Market Outlook](#)

View the online version of this article [here](#).

IMPORTANT INFORMATION

U.S. investors only: Click [here](#) to obtain a WisdomTree ETF prospectus which contains investment objectives, risks, charges, expenses, and other information; read and consider carefully before investing.

There are risks involved with investing, including possible loss of principal. Foreign investing involves currency, political and economic risk. Funds focusing on a single country, sector and/or funds that emphasize investments in smaller companies may experience greater price volatility. Investments in emerging markets, currency, fixed income and alternative investments include additional risks. Please see prospectus for discussion of risks.

Past performance is not indicative of future results. This material contains the opinions of the author, which are subject to change, and should not to be considered or interpreted as a recommendation to participate in any particular trading strategy, or deemed to be an offer or sale of any investment product and it should not be relied on as such. There is no guarantee that any strategies discussed will work under all market conditions. This material represents an assessment of the market environment at a specific time and is not intended to be a forecast of future events or a guarantee of future results. This material should not be relied upon as research or investment advice regarding any security in particular. The user of this information assumes the entire risk of any use made of the information provided herein. Neither WisdomTree nor its affiliates, nor Foreside Fund Services, LLC, or its affiliates provide tax or legal advice. Investors seeking tax or legal advice should consult their tax or legal advisor. Unless expressly stated otherwise the opinions, interpretations or findings expressed herein do not necessarily represent the views of WisdomTree or any of its affiliates.

The MSCI information may only be used for your internal use, may not be reproduced or re-disseminated in any form and may not be used as a basis for or component of any financial instruments or products or indexes. None of the MSCI information is intended to constitute investment advice or a recommendation to make (or refrain from making) any kind of investment decision and may not be relied on as such. Historical data and analysis should not be taken as an indication or guarantee of any future performance analysis, forecast or prediction. The MSCI information is provided on an "as is" basis and the user of this information assumes the entire risk of any use made of this information. MSCI, each of its affiliates and each entity involved in compiling, computing or creating any MSCI information (collectively, the "MSCI Parties") expressly disclaims all warranties. With respect to this information, in no event shall any MSCI Party have any liability for any direct, indirect, special, incidental, punitive, consequential (including loss profits) or any other damages (www.msci.com)

Jonathan Steinberg, Jeremy Schwartz, Rick Harper, Christopher Gannatti, Bradley Krom, Tripp Zimmerman, Michael Barrer, Anita Rausch, Kevin Flanagan, Brendan Loftus, Joseph Tenaglia, Jeff Weniger, Matt Wagner, Alejandro Saltiel, Ryan Krystopowicz, Kara Marciscano, Jianing Wu, Brian Manby and Scott Welch are registered representatives of Foreside Fund Services, LLC.

WisdomTree Funds are distributed by Foreside Fund Services, LLC, in the U.S. only.

You cannot invest directly in an index.

DEFINITIONS

Yield : The income return on an investment. Refers to the interest or dividends received from a security that is typically expressed annually as a percentage of the market or face value.

Coupon : The annual interest rate stated on a bond when it's issued. The coupon is typically paid semiannually. This is also referred to as the "coupon rate" or "coupon percent rate."

Maturity : The amount of time until a loan is repaid.

Volatility : A measure of the dispersion of actual returns around a particular average level.

Unhedged : Strategy that includes the performance of both the underlying asset as well as the currency in which it is denominated. The performance of the currency can either help or hurt the total return experienced.

Currency risk : the risk that an investment will decline in value due to a change in foreign exchange rates.

U.S. 5 Year Treasury Note : A debt obligation issued by the United States government that matures in 5 years.

Interest rates : The rate at which interest is paid by a borrower for the use of money.

Credit quality : A measure of a borrower's potential risk of default.