

UNLOCKING OPPORTUNITIES: EXPLORING THE POTENTIAL OF EMERGING LOCAL CURRENCY BONDS

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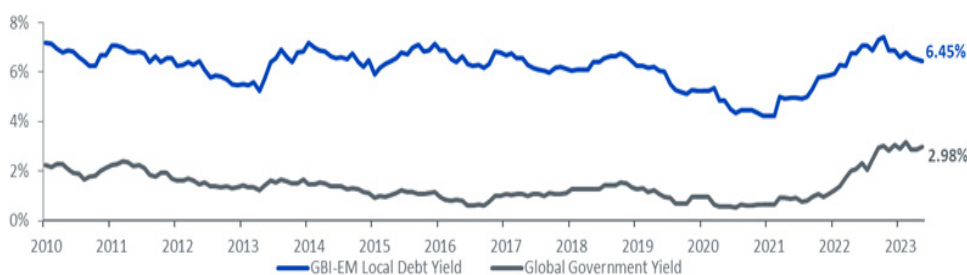
"I never invest my money in [emerging markets \(EM\)](#). EM is just an inferior asset class to high yield." This is what a senior colleague told me angrily, in response to my suggestion of allocating to EM in an investment committee meeting years ago. I had just started my career in the financial industry and was in learn-everything-from-veteran-professionals mode. However, I'm glad that advice didn't make its way to my principals of investing rulebook. Putting aside that this advice would violate rule #1 of investing (don't put all your eggs in one basket), it would have made me close my eyes to one of the most attractive fixed income asset classes of today's environment: EM local currency and specifically sovereign/semi-sovereign bonds.

Breaking Down the Return

The risk and return profiles of EM local currency bonds are influenced by two factors, namely local [interest rates](#) and fluctuations in currency value. The component related to local interest rates encompasses both the yield earned from holding the bond (commonly referred to as [carry](#)) and the potential price appreciation or depreciation resulting from changes in local interest rates. This makes EM local currency bonds unique, in the sense that they have an inherent diversifier (in most instances a country's local currency will move in opposite direction to its interest rates).

Over time, yields on EM local currency bonds have consistently exhibited a notable premium compared to government bonds issued by more developed governments. And this is while 87% of the weight of the index is in countries with investment-grade ratings by Moody's (this figure is 79% based on S&P and Fitch, with the only difference being South Africa, which is rated as Baa3 by Moody's and BB+ by the other two).

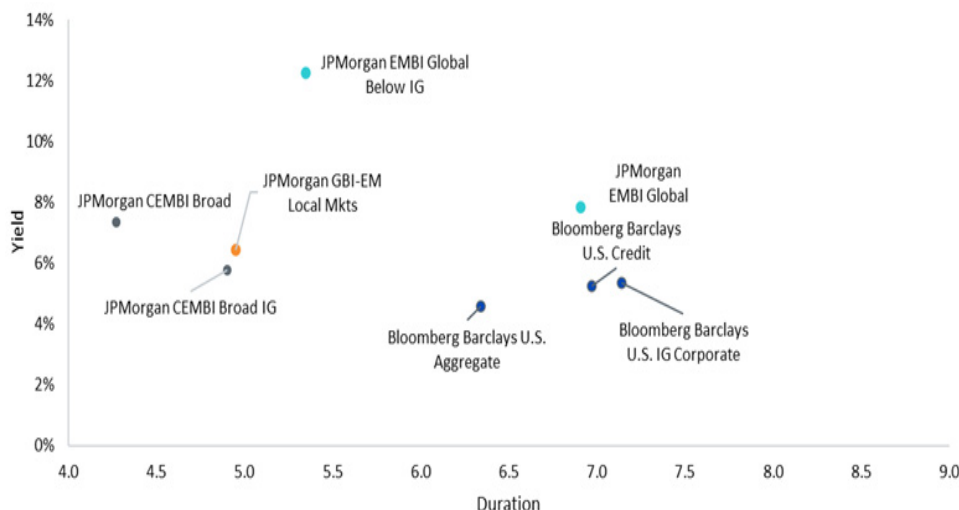
EM and EM Local Debt Yields



Sources: Bloomberg, JP Morgan, as of most recent available data on 05/31/23. Past performance is not indicative of future results. "DM" stands for developed markets. You cannot invest directly in an index. GBI-EM Local Debt Yield represented by J.P. Morgan GBI-EM Global Diversified Index. Global Government Yield represented by the yield of the Bloomberg Global Aggregate Government Index. Real Yields represent yields after adjusting for year-over-year inflation rates.

Also, this increased yield and carry associated with EM local currency debt come with a lower sensitivity to interest rate movements ([duration](#)) when compared to other asset classes within the fixed income spectrum.

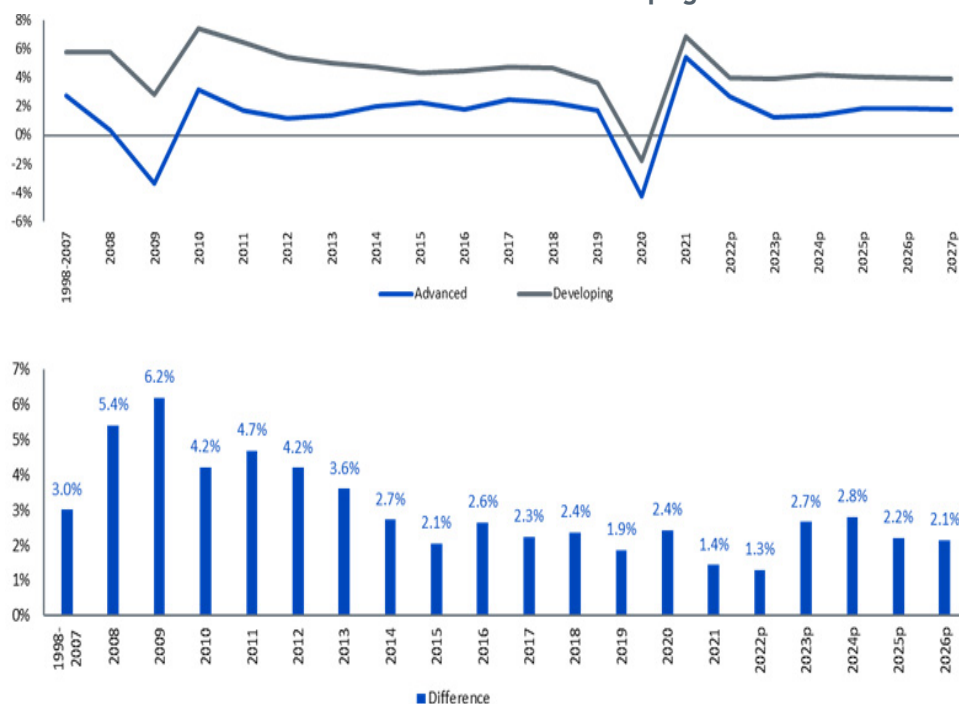
Yield vs. Effective Duration



Sources: JP Morgan, Bloomberg, as of 05/31/23. Past performance is not indicative of futures results. You cannot invest directly in an Index.

What's even more interesting is that the enhanced yield offered by EM countries is accompanied by stronger fundamentals than developed markets, as evidenced by metrics such as [debt-to-GDP ratios](#) and improving economic growth.

GDP Growth Differential between Advanced and Developing Countries



Source: IMF, "p" represents projected figures, as of latest available information on 04/30/22. Past performance is not indicative of future results.

In terms of [inflation](#) in EM countries, their [central banks](#) took proactive measures by raising rates earlier than their counterparts in developed markets, aiming to combat inflation more forcefully. As a result, there has been a consistent and widespread decline in EM headline inflation. This [disinflationary](#) trend is also supported by the decrease in global [commodity](#) prices, as well as the slower economic activity due to lagged effect of [monetary tightening](#). As a result, average real yield for EM local debt has stayed attractive compared to DM debt, albeit not as much as before. However, it is important to note that there are certain countries in the J.P. Morgan GBI-EM index that deviate significantly from the overall inflation figures. Among these countries, Turkey consistently reports the highest inflation rates. Nevertheless, due to its relatively small weight in the index, its contribution to the overall inflation and subsequent real yield calculations remains limited. Conversely, Eastern European countries, particularly Poland and Hungary, have a notable impact on the

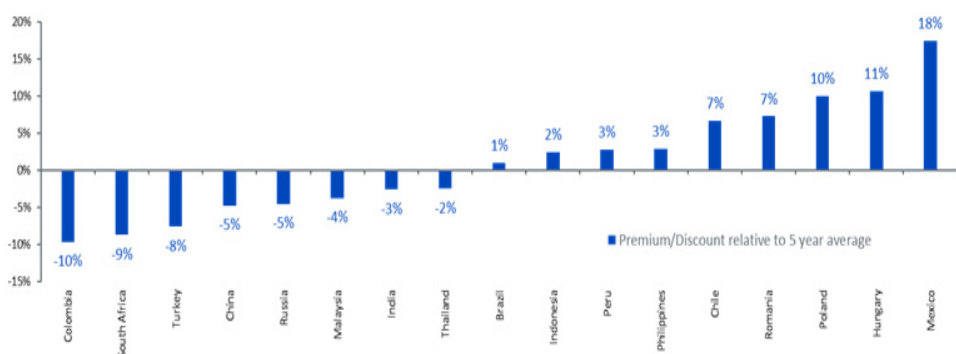
overall inflation and consequently on the calculation of real yields, given their elevated inflation rates and relatively higher weight in the index. In fact, if we were to exclude these two countries, the real yield for May 2023 would increase from -1.97% to +0.28%.

Yields for EM and DM Debt after Inflation



Sources: Bloomberg, JP Morgan, as of most recent available data on 05/31/23. Past performance is not indicative of future results. "DM" stands for developed markets. You cannot invest directly in an index. GBI-EM Local Debt Yield represented by J.P. Morgan GBI-EM Global Diversified Index. Global Government Yield represented by the yield of the Bloomberg Global Aggregate Government Index. Real Yields represent yields after adjusting for year over year inflation rates.

It's not a secret that EM currencies have had a rough time in the past several years, mainly due to the strength of the greenback. However, we believe that EM currencies are bound to have positive performance in the near future due to different factors. The China re-opening will provide a boon for EM local currencies. Also, because of several years of underperformance, and even after the recent surge, they remain undervalued compared to historical levels.



Source: Bloomberg, as of 05/31/23. "REER" represents real effective exchange rate. Past performance is not indicative of future results. Z score: a measure of how many standard deviations below or above the population mean a raw score is.

Conclusion

Like any other asset class, there is a risk involved with investing in EM local currency debt. A more severe economic downturn in the U.S. would pose significant challenges for EM. However, this is not our base case, and we believe a mild [recession](#) in the U.S. (soft landing), coupled with sustained momentum in China, would establish a favorable backdrop for the continued positive performance of EM local debt. Currency appreciation and carry would act as the primary driving forces in this scenario. In spite of its recent outperformance, we maintain the view that valuations remain reasonable, potentially lending resilience in the event of a broader global economic slowdown.

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.

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DEFINITIONS

Emerging market : Characterized by greater market access and less potential for operational risks when compared to frontier markets, which leads to a larger base of potentially eligible investors.

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

Carry : The amount of return that accrues from investing in fixed income or currency forward contracts.

Duration : A measure of a bond's sensitivity to changes in interest rates. The weighted average accounts for the various durations of the bonds purchased as well as the proportion of the total government bond portfolio that they make up.

Debt to gross domestic product (GDP) : the debt-to-GDP ratio is the ratio between a country's government debt and its gross domestic product (GDP).

Inflation : Characterized by rising price levels.

Central bank : Refers to the the monetary authority of any country.

Disinflation : Term used to describe instances of slowing inflation, different from deflation in that price levels are still increasing overall, just at a slower rate.

Commodity : A raw material or primary agricultural product that can be bought and sold.

Monetary tightening : A course of action undertaken by the Federal Reserve to constrict spending in an economy that is seen to be growing too quickly or to curb inflation when it is rising too fast.

Recession : two consecutive quarters of negative GDP growth, characterized generally by a slowing economy and higher unemployment.