

WHERE WE SEE THE GREATEST OPPORTUNITIES IN EMERGING MARKET FIXED INCOME: PART II

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09/25/2013

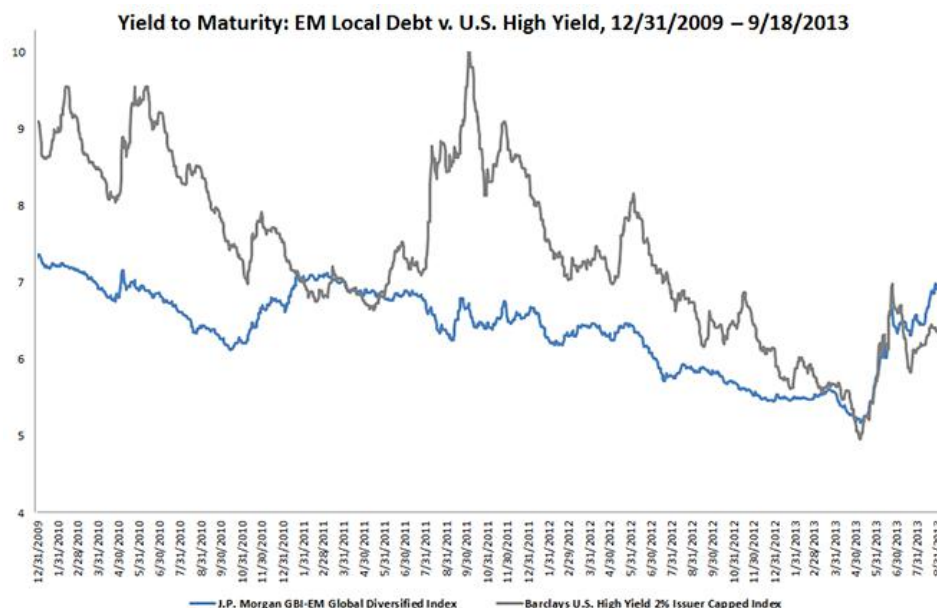
• Even after the Federal Reserve's (Fed) recent policy surprise, 7 out of 20 emerging market (EM) currencies are trading at lower levels than before the Federal Reserve's 1st [quantitative easing](#) announcement¹ • While some countries face external headwinds, many EM countries were able to navigate the market volatility quite well • With yields above 6.5%, EM local debt currently appears attractively priced on an absolute basis² • On September 3, 2013, EM local debt was out-yielding U.S. high yield by the most significant margin in history³ • A pick up in Chinese economic momentum also offers a much firmer backdrop for the broader emerging markets In part II of [our series](#) on investing in emerging market fixed income, we shift our focus from EM corporate debt to locally denominated fixed income, substituting currency risk for [corporate credit](#) risk in emerging markets. Although the market environment has proven particularly difficult—in fact, in the past five months local currency debt has generated the worst performance of all but one period in history—we believe that the most recent sell-off has created value in currencies as well as interest rates across many emerging markets. In light of recent guidance by the Federal Reserve, we believe that emerging markets could recapture an increasing percentage of investor flows and reverse the recent losses sparked by fears of “tapering”. **How We Got Here** After weaker economic data from key emerging markets disappointed investors, the law of unintended consequences reared its head due to comments by Federal Reserve Chairman Ben Bernanke. The possibility of a decline in the pace of Fed bond buying was cited as the primary catalyst for currency weakness and surging bond yields in emerging markets. Economies that once benefitted from foreign investor flows have underperformed since flows began to reverse. However, we believe that those moves had overshot. With the recent FOMC meeting serving as a catalyst, we believe that locally denominated fixed income appears as an attractive way to play a less “hawkish” Fed.

Cumulative Impact of Quantitative Easing		QE1	QE2	QE3
		11/25/08 – 9/18/13	11/3/10 – 9/18/13	9/13/12 – 9/18/13
U.S. 10 Year Treasury Yield Difference	9/18/2013	-0.42%	0.12%	0.96%
CURRENCY	TICKER			
South Korean won	KRW	38.90%	2.66%	4.34%
Chilean peso	CLP	35.11%	-2.47%	-5.77%
Colombian peso	COP	21.61%	-3.65%	-5.91%
Indonesian rupiah	IDR	11.71%	-21.25%	-15.23%
Chinese yuan	CNY	11.52%	9.09%	3.41%
Taiwanese dollar	TWD	12.27%	2.37%	-0.16%
Philippine peso	PHP	13.66%	-2.39%	-4.12%
Malaysian ringgit	MYR	11.96%	-4.59%	-4.71%
Peruvian new sol	PEN	12.39%	1.45%	-5.59%
Thai baht	THB	12.20%	-4.92%	-1.26%
Mexican peso	MXN	4.53%	-3.26%	1.24%
Brazilian real	BRL	5.89%	-22.70%	-7.57%
South African rand	ZAR	2.53%	-28.37%	-14.07%
Polish zloty	PLN	-5.95%	-10.23%	1.82%
Hungarian forint	HUF	-8.95%	-11.95%	-0.88%
Romanian leu	RON	-11.22%	-7.45%	5.62%
Russian ruble	RUB	-15.61%	-4.45%	-3.22%
Turkish lira	TRY	-19.86%	-27.98%	-7.63%
Indian rupee	INR	-21.13%	-30.02%	-12.57%
Nigerian naira	NGN	-27.23%	-7.32%	-2.59%
AVERAGE		4.22%	-8.87%	-3.74%

Source: Bloomberg, September 18, 2013
Past performance is not indicative of future results.

As shown in the table above,

EM currencies, on average, are only modestly positive on a net basis since the depths of the global financial crisis. All told, the Federal Reserve has expanded its [balance sheet](#) by nearly \$3 trillion; today, the U.S. dollar is stronger against seven out of twenty emerging market currencies. While we acknowledge that growth has slowed in many emerging markets as of late, we believe that current exchange rates do not accurately reflect the long-term potential of many of these economies. In many instances, EM currencies are now trading at multi-year lows against the U.S. dollar. Additionally, with only a single exception (the Chinese yuan), EM currencies continue to trade well off their high water marks set in 2006. **Emerging Market Interest Rates** In a similar vein as EM currencies, EM interest rates appear attractive at current levels. As U.S. interest rates touched 3% for the first time in several years, EM rates approached the 7% mark for the first time in three years. At these levels, we believe that emerging markets currently strike an attractive balance between risk and reward. As compared to EM corporate credit, which has exposure to U.S. interest rates, investors in local debt are substituting currency risk (and volatility) plus local interest rate risk. As we noted in a [recent blog post](#), we believe that once the market has acclimated to an eventual Fed tapering, emerging market interest rates will increasingly be influenced by domestic factors as opposed to U.S. policy. However, with rates rising significantly in advance of a Fed tapering that has yet to materialize, we believe EM assets are attractively priced. At present, the investable universe of emerging market local debt is rated 93% [investment grade](#).⁴ With some emerging markets being upgraded as recently as May 2013, we believe that only a select few pose a risk of a credit rating downgrade. However, as shown in the graph below, EM local debt was recently offering the largest yield advantage compared to U.S. high



yield in history. Source: J.P. Morgan, Barclays, Bloomberg, September 18, 2013

For

definitions of terms and indexes in the chart, please visit our [Glossary](#). **Volatility** Compared to traditional [U.S. Treasury Bonds](#), "opportunistic fixed income," such as emerging market local debt, has a much different volatility profile. For many investors, investing in bonds with equity-like growth elements is a comparatively new undertaking. In light of recent market developments, we believe that volatility is going to be increasing for nearly all asset classes, including fixed income. However, there is a major distinction between volatility and solvency risk. The recent volatility in the asset class has largely been attributable to movements in emerging market currencies. But unlike past periods of rapid currency depreciation, emerging market economies have taken made significant strides to reduce their external vulnerabilities. At present, an overwhelming number of emerging market countries have significant levels of [foreign exchange reserves](#). These reserves can either be converted from U.S. dollars to support/dampen the volatility of their exchange rates or be used to directly finance their government. **Outlook: Being Paid to Wait** Ultimately, we believe EM local debt is attractively priced at current levels. However, there is always the possibility that market volatility may persist as the U.S. struggles to provide appropriate guidance on the future path of interest rates. At current yields, we believe that EM local debt provides an attractive level of [carry](#) that may help dampen future volatility associated with locally denominated fixed income. ¹Source: Bloomberg, September 18, 2013 ²Source: J.P. Morgan, Bloomberg, September 18, 2013 ³Source: WisdomTree, J.P. Morgan, Bloomberg ⁴J.P. Morgan, August 31, 2013

Important Risks Related to this Article

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DEFINITIONS

Quantitative Easing (QE) : A government monetary policy occasionally used to increase the money supply by buying government securities or other securities from the market. Quantitative easing increases the money supply by flooding financial institutions with capital, in an effort to promote increased lending and liquidity.

Corporate Credit : compensation associated with the risk of lending to a corporation.

Balance sheet : refers to the cash and cash equivalents part of the Current Assets on a firms balance sheet and cash available for purchasing new position.

Investment grade : An investment grade is a rating that signifies a municipal or corporate bond presents a relatively low risk of default.

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

U.S. Treasury Bond : a debt security issued by the United States government.

Foreign exchange reserves : The total balance of foreign currency deposits and bonds held by a central bank or monetary authority.

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