

THE CASE FOR EMERGING MARKETS DEBT HARD CURRENCY



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The value of an investment and the income from it can fall as well as rise and you may not get back the amount originally invested.

AT A GLANCE

Key Takeaways

- ▶ Institutional investors face the challenge of capturing yield, diversification, and growth from their fixed income allocations. Over time, EM government bonds have provided investors with higher yields and differentiated returns relative to DMs, showing modest correlation to global equities and global bonds.
- ▶ The EM hard currency (HC) debt universe spans around 70-80 countries that are subject to different economic cycles and are at varying stages of economic development, resulting in a diverse set of fundamental drivers.
- ▶ Hard currency emerging markets debt (HC EMD) offers the potential to isolate some of the EMD return drivers, helping institutional investors with asset allocation. Focused credit analysis can be rewarded, as country allocation and security selection can help to capture alpha in EMD.

Over the past two decades, the emerging markets debt (EMD) universe has grown substantially, encompassing three key investible areas: hard currency (HC) sovereign bonds, HC corporate bonds, and local currency (LC) sovereign bonds. HC sovereign and corporate indices are predominantly comprised of US dollar-denominated bonds issued by EM sovereigns and companies, respectively. LC sovereign indices represent local (domestic) currency denominated debt issued by EM governments. The universe based on these sub-asset classes is US\$16.8 trillion¹. This represents a material portion of fixed income markets.

Figure 1: Emerging markets debt characteristics

Characteristics	HC Sovereign	LC Sovereign	HC EM Corporate	Global Aggregate	US IG Corporate	US HY Corporate
Effective duration (years)	6.9	5	5	7	7.4	4.2
Yield-to-worst (%)	8.19	6.83	6.88	2.6	4.39	7.73
Number of issuers	168	20	803	3,103	1,277	925
Number of countries/ issuer domiciles	69	20	60	71	47	22
Average credit rating	BB+	BBB+	BBB-	AA	A-	B+

Source: Bloomberg, 31 July 2022. Hard currency sovereign = J.P. Morgan EMBI Global Diversified Index; Local currency sovereign = J.P. Morgan GBI-EM Global Diversified Index; Corporate credit = J.P. Morgan CEMBI Broad Diversified Index; Global Aggregate = Bloomberg Global Aggregate Index; US IG Corporate = ICE BofA US Corporate Index; US HY corporate = ICE BofA US High Yield Index.

¹Source: J.P. Morgan, total debt stock, June 2022.

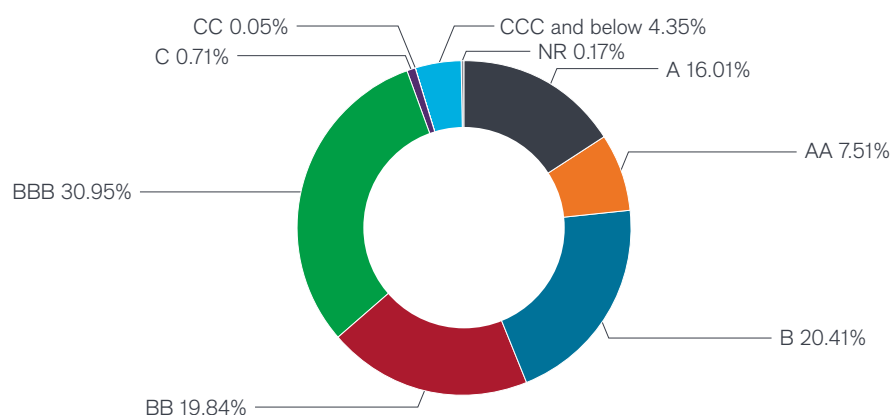
What is hard currency debt?

A hard currency denominated bond is issued by an EM government (or quasi-sovereign) whose interest and capital are denominated in a hard currency – typically US dollars, although other hard currencies can include euro, sterling and yen. As the asset class is driven by the credit risk of lending to the sovereign, it is most comparable in terms of risk factors to corporate credit. Yet, it is also different in that credit risk tends to be overpriced in sovereign HC EMD when comparing the default perception to reality. Historically, average default rates for the asset class have been 1.03% pa². Perceived default risk is higher than actual default risk and often defaults are in smaller frontier markets, while the bigger part of EM has become quite resilient over past decades. While defaults and restructurings do happen, unlike with corporate bankruptcies, the country continues to exist and serve its population going forward. Coupled with the greater involvement of institutions such as the International Monetary Fund (IMF), this creates wider scope for debt negotiation between the country and its creditors.

EMs constitute the bigger share of the global economy, but often institutional portfolios are strikingly under-represented in the asset class. Nevertheless, European institutional investors, for example, are increasingly allocating to EMD given its relative attractiveness compared to other growth-orientated fixed income sectors³.



Figure 2: Diverse risk profiles in HC



Source: J.P. Morgan, 31 August 2022. Ratings breakdown of the J.P. Morgan EMBI Global Diversified Index, the EM hard currency sovereign index.

²Source: J.P. Morgan, 1 January 2003 to 31 August 2022. EMBIG default rate notionally weighted. Note: Although Ukraine is not being treated as a defaulted issuer in the EMBIG, we are factoring it into the rate due to the restructuring, as credit default swaps were triggered.

³Source: Mercer Asset Allocation Survey, 2021.

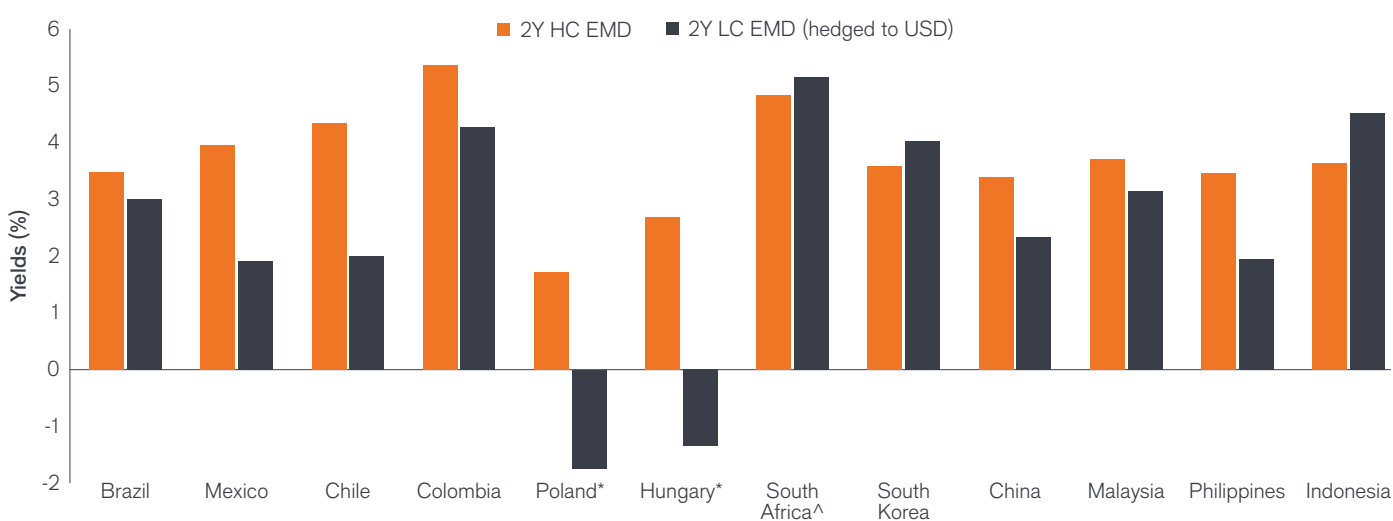
Capturing higher yields with less volatility

Typically, EM asset classes potentially offer higher yields and long-term returns compared to DMs. Some of the highest yields in EM can be found in sovereign markets. According to HSBC, on an FX hedged basis, most EM local bond yields for 2- and 10-year tenors offer lower yields than comparable HC debt, particularly among high yielders, reflecting higher FX volatility and costs for currency hedging. Seeking to eliminate the currency risk in LC EMD (to make it comparable to HC), materially lowers the yield and long-term return potential, but also significantly reduces realised volatility.

Over the past decade, HC EMD has delivered attractive returns to LC debt with less severe drawdowns. Following the

May 2013 “Taper Tantrum”, for example, LC EMD fell 29.3% from May 2013 to its trough in September 2015 and has not yet fully recovered (ie. for total returns to recover that loss). In comparison, HC EMD reached a trough much earlier (August 2013) falling just 9.6% and fully recovered losses nine months later⁴. The subsequent end of quantitative easing and rate lift-off in the US aggravated returns for LC and highlights that EM FX tends to perform in longer cycles. During the US hiking cycle in 2018 which incorporated quantitative tightening (QT), LC had a maximum drawdown of 13.8%, more than double the 5.5% drawdown for HC⁵. Both asset classes experienced similar drawdowns during the Global Financial Crisis and the outbreak of the COVID crisis in early 2020.

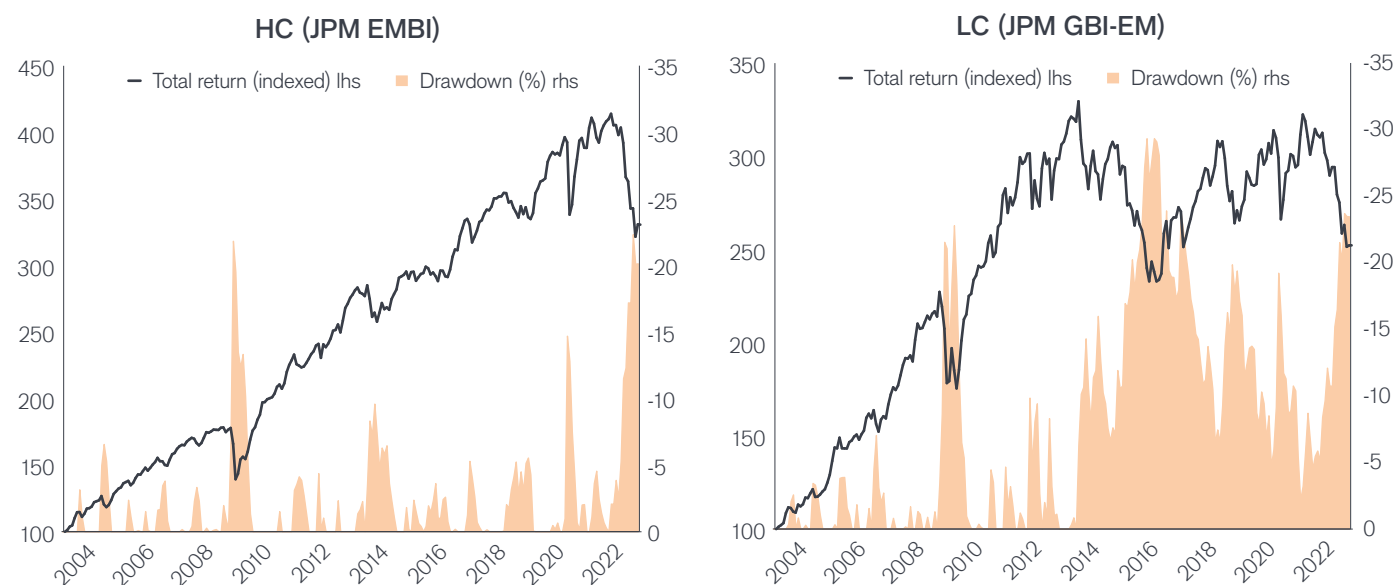
Figure 3: Higher yields on hedged basis available in HC universe



Source: Bloomberg, HSBC, 25 July 2022.

*FX hedged to EUR is computed. ^SAGB 10.5 Dec 2026 bond is used for LCD, benchmark 2Y or 3Y LC govt bonds are used for other EMs.

Figure 4 and 5: Total returns and drawdowns



Source: J.P. Morgan, 31 December 2002 to 31 July 2022. Returns are in US dollars.

⁴Source: Bloomberg, indices as per Figure 4 and 5, returns in US dollars, using monthly data.

⁵Source: Bloomberg, indices as per Figure 4 and 5, returns in US dollars, using monthly data showing max drawdowns peak to trough between 31 December 2017 and 31 December 2018.

Past performance does not predict future returns

Maximising diversification

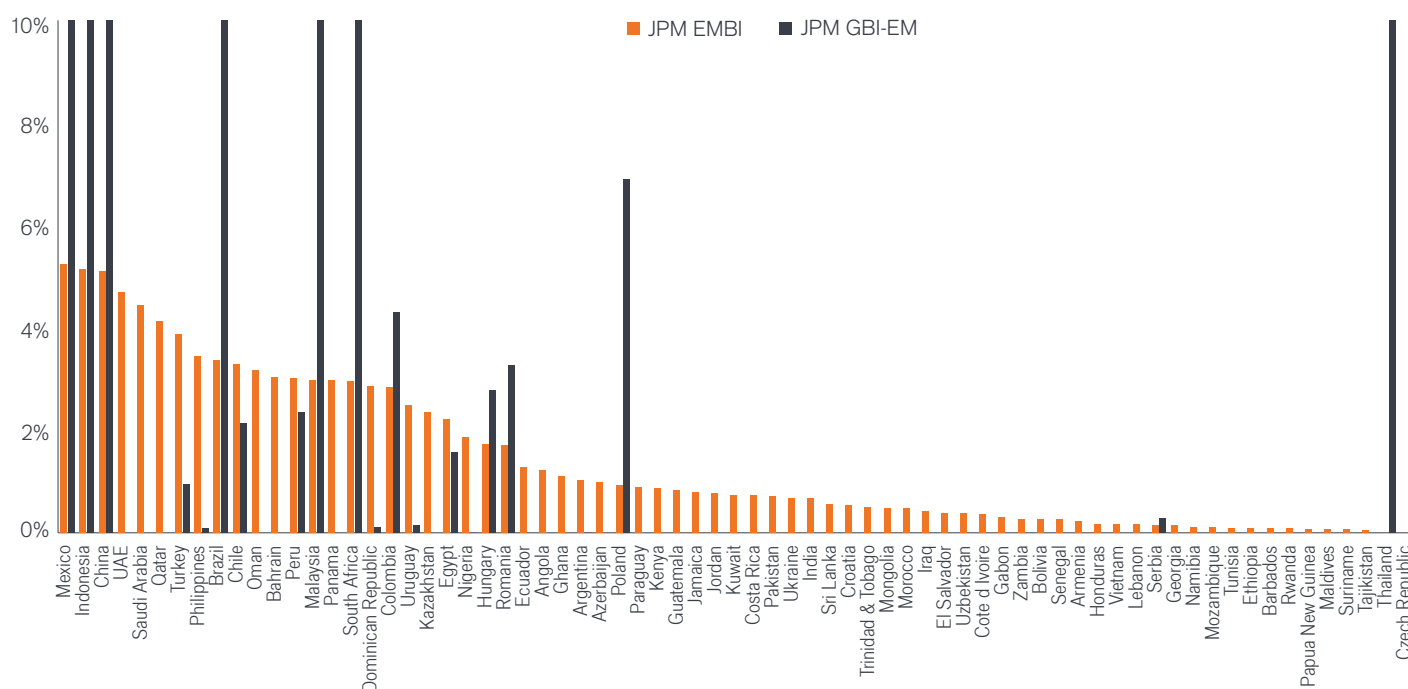
Public debt has increased in EMs since the pandemic outbreak, as countries offered fiscal support to households and companies to shore up their economies. The average public-debt-to-GDP ratio in EMs rose to a record 67% in 2021 from about 52% before the pandemic. DMs, in comparison, saw this ratio rise by slightly more from 103% to 120%.⁶ According to the IMF, the public-debt-to-GDP ratio could continue to grow in several EMs over the medium term to support economic growth. This means that the HC universe is expected to grow, but it also infers that the dispersion in performance between countries could increase and country allocation will likely be key to returns.

While the HC sovereign universe (US\$1.5 trillion) is smaller than its LC equivalent (US\$12.7 trillion)⁷, this disguises the broad country and issuer mix that allows for maximising the diversification potential of EM. HC EMD represented by the widely followed J.P. Morgan EMBI Global Diversified Index features around 170 issuers across almost 70 countries. LC EMD, represented by the J.P. Morgan GBI-EM Global Diversified Index, can be difficult for offshore investors to access. This drastically concentrates the index to only 20 countries (and 20 issuers), with the largest 10 making up

nearly 90% of the index (the equivalent is just over 40% in the HC index). On a broader basis, China makes up 30% of the MSCI Emerging Markets Index and 10% of the LC index compared to just 5% in the HC index⁸. Given the inability for offshore investors to invest, large EM economies like India, most of the countries in Central America excluding Mexico, and all countries in the Middle East are inaccessible and are thus excluded entirely from LC indices.

Over time, as emerging countries develop a higher level of political and economic stability, they are able to issue more LC debt and reduce reliance on external debt (HC) financing. Moreover, as populations age and savings increase, the development of domestic pension systems necessitates a growing market in home currency debt to meet those future liabilities. In general, the EMD HC universe contains more smaller and less-researched countries, including those in regions such as Africa. This creates ample opportunities to capitalise on the market inefficiencies arising from the behavioural bias that is inherent in EM. The HC universe is also evenly split between high yield (HY) and investment grade (IG), offering scope to capture different risk profiles.

Figure 6: A broader country and issuer mix in HC



Source: J.P. Morgan, 31 July 2022. J.P. Morgan EMBI = EM hard currency sovereign. J.P. Morgan GBI-EM = EM local currency sovereign.

While LC markets tend to attract domestic investors, foreign investor participation in HC EMD is a positive for market resilience and liquidity as it increases investor diversity. As global liquidity shrinks (with central banks engaging in QT), it is worth noting that liquidity conditions impact risk premiums as they influence transactional costs and investor sentiment. This is key, as price action in the sovereign credit market can sometimes be more a function of liquidity than fundamentals.

⁶Source: IMF, Global Financial Stability report, April 2022.

⁷Source Total debt stock, J.P. Morgan, June 2022.

⁸Source: J.P. Morgan, MSCI, 31 July 2022.

The different performance of the sub-asset classes below highlights how EMD offers diversification by region and factor, with more exposure to the “growth” factor. However, this comes with greater volatility than other fixed income segments, such as the DM IG space. While justified by the fact that EMs generally have less political and economic stability than DMs, we believe such periods of risk aversion and idiosyncratic events can offer opportunities to enhance returns from mispricing.

The long-term returns and risks of HC EMD have historically been higher than global bonds and DM IG, and second only to HY. When compared to EM equities, HC EMD returns have been lower but delivered with less than half the volatility.

Long-term correlations between EM debt and other asset classes, such as global bonds and equities have been modest, offering diversification potential. Understanding the factor exposures is also important. While there are a few exceptions, EM sovereign debt does not offer the ‘safe haven’ characteristics associated with core developed government markets. That said, typically credit spreads and the underlying Treasury yields are negatively correlated, stabilising total returns during positive and negative markets. In a risk-off environment, the underlying Treasury yield becomes a buffer, limiting a total return loss and vice versa in risk-on markets. The exception to this rule of thumb is when inflation is the culprit causing the rise in risk aversion.

Figure 7: Asset class returns and volatility

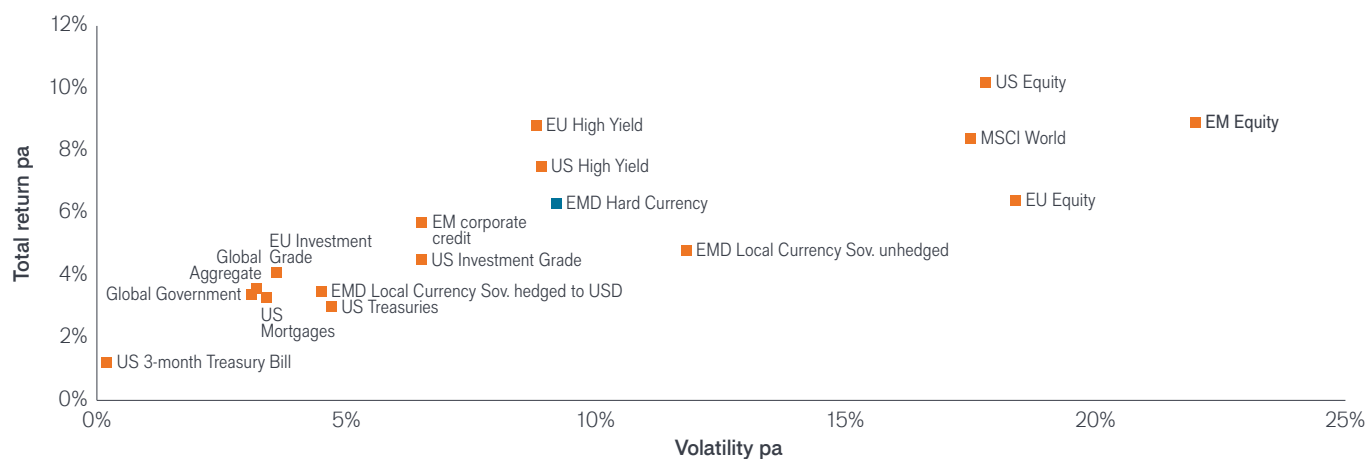


Figure 8: Correlations between asset class returns

	EMD HC	EMD LC unhedged	EMD LC hedged	US Mortgages	US Treasuries	Global Government	Global Aggregate	US IG
EMD HC	1.00	0.78	0.78	0.43	0.29	0.34	0.48	0.62
EMD Local Unhedged	0.78	1.00	0.83	0.35	0.17	0.21	0.32	0.43
EMD Local Hedged	0.78	0.83	1.00	0.51	0.41	0.46	0.55	0.58
CEMBI	0.85	0.68	0.76	0.52	0.39	0.42	0.57	0.73

	EU IG	US HY	EU HY	MSCI World	US Equity	EU Equity	EM Equity	US 3-month Treasury Bill
EMD HC	0.53	0.73	0.68	0.61	0.57	0.54	0.66	0.05
EMD Local Unhedged	0.36	0.62	0.57	0.66	0.57	0.53	0.78	0.09
EMD Local Hedged	0.49	0.59	0.55	0.46	0.43	0.41	0.57	0.14
CEMBI	0.67	0.77	0.78	0.48	0.45	0.40	0.55	0.07

Source: Bloomberg, 31 July 2022. 3 January 2003-31 July 2022. Returns are in US dollars or hedged to US dollars. EM hard currency sovereign= J.P. Morgan EMBI Global Diversified Index. EM local currency sovereign = J.P. Morgan GBI-EM Global Diversified Index. EM corporate credit = J.P. Morgan CEMBI Broad Diversified Index. US Mortgages = Bloomberg US MBS Index; US Treasuries = Bloomberg US Treasury Index; Global Government = Bloomberg Global Aggregate - Government Index (USD hedged); Global Aggregate = Bloomberg Global Aggregate Index (USD hedged); US IG = Bloomberg US Corporates Index; EU IG = Bloomberg EuroAgg Corporate Index (USD hedged); US HY = Bloomberg US Corporate High Yield Index; EU HY= Bloomberg Pan-European High Yield Index (USD hedged); US Equity = S&P500 Total return index; EU Equity = MSCI Europe net Total return; EM Equity = MSCI Emerging Net Total Return USD Index; US Treasury Bill = Bloomberg US Treasury Bills 1-3M Index.

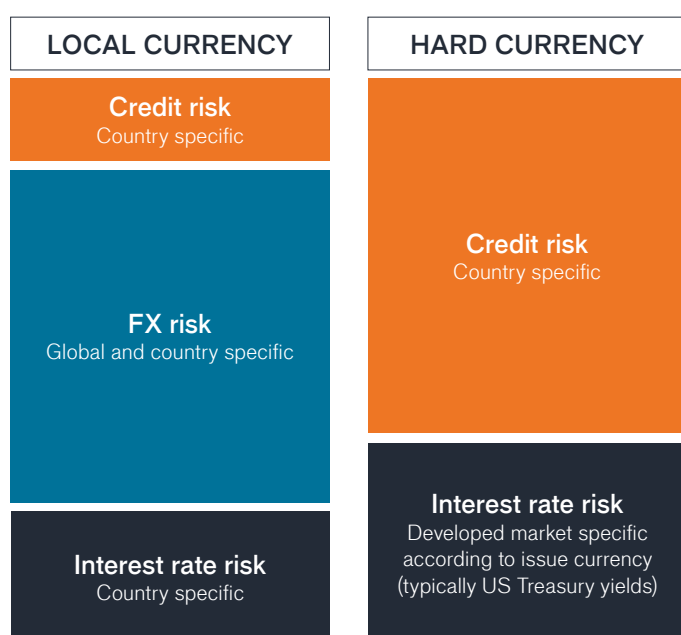
Past performance does not predict future returns.

Capturing different return drivers

EMs are by their nature subject to swings in risk sentiment and to external economic and geopolitical shocks. The sheer breadth of the HC EMD universe – from highly-rated countries in the Middle East to lower-rated ones in sub-Saharan Africa and Latin America – means economies are at various stages of development, resulting in different sensitivities to factors such as food/energy prices. We believe this wide range of characteristics can create opportunities for enhanced returns through active management as markets overreact in the short term to news flow.

Alongside whether economies are tilted towards manufacturing or services, commodity price dynamics increase divergence in performance and capital flows in EM. Depending on whether countries are net commodity importers or exporters as countries' terms of trade – the ratio of the price of exports to the price of imports – has deteriorated or improved. As beneficiaries of US dollar revenues, commodity exporting countries benefit from higher prices and commodities tend to be a key driver of EM sovereign returns, but this relationship varies over time. High-beta debt can be a significant factor during times of risk aversion, for example.

Figure 9: LC versus HC return drivers



Source: Janus Henderson Investors. Stylised example for illustrative purposes only.

In summary, the EMD universe is impacted by a host of factors beyond fundamental drivers of credit risk, including those influencing broader global market sentiment, capital flows and so on. Looking at the asset class through the lens of risk factors, the drivers of returns in HC and LC bonds are quite different:

- As HC EMD is generally issued in US dollars, the bond yield is a function of i) the US Treasury rate and ii) a credit spread reflecting the higher credit risk for the EM issuer. As such, HC EMD is relatively more exposed to the pricing of higher credit risk premium (such as with increasing recession risks and market volatility/risk aversion) as a larger proportion of return is determined by credit risk.
- While LC EMD may also be affected by the repricing of the credit risk premium, the main drivers of return are local interest rates and FX risk, stemming from moves in the local currency versus the US dollar.
- EM FX returns are affected by US Treasury volatility and it is this variation that matters more than rate levels, as this higher volatility is magnified in EM⁹. While higher sovereign credit risk tends to be reflected in higher rates in bonds, FX movements also tend to be highly correlated with the credit risk premium¹⁰, with higher premiums associated with weaker FX.



Currency moves have a direct impact on LC EMD returns on a day-to-day basis. In HC, the effect is more indirect and not linear. While a depreciation of the local currency versus the US dollar (in which the debt repayments are made) makes it more expensive to service and can lead to wider credit spreads, the currency moves need to be large and sustained (e.g., a period of financial crisis in a country) for that to last.

⁹Source: HSBC, June 2022.

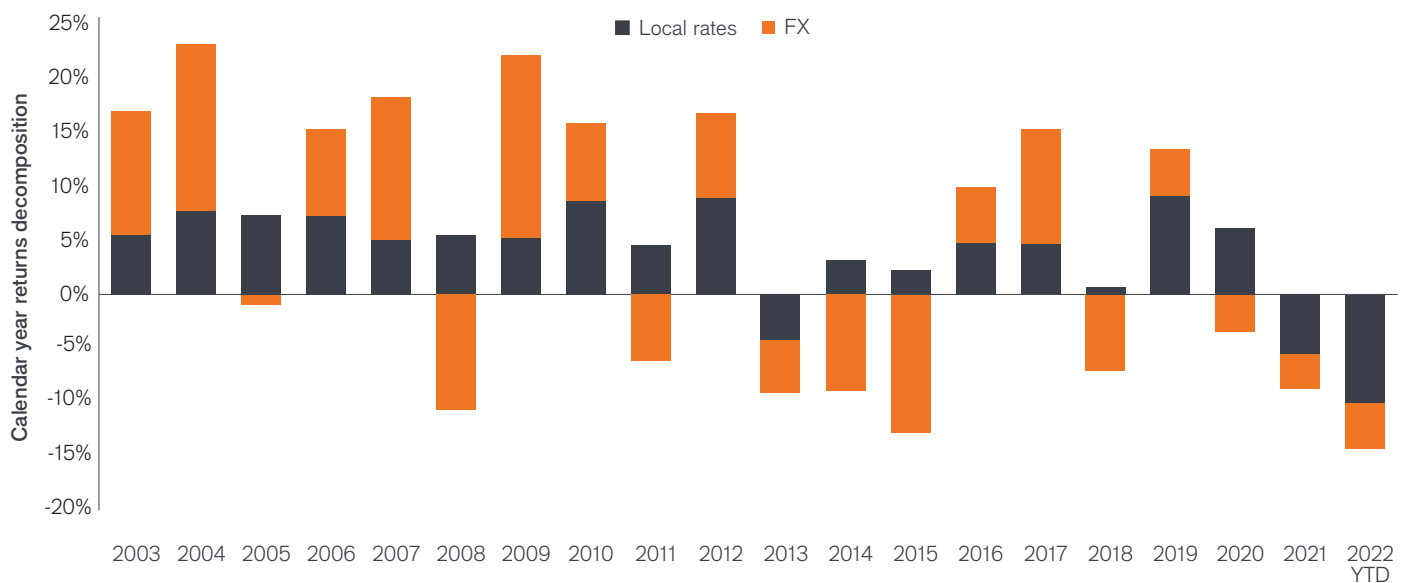
¹⁰Source: Bloomberg, HSBC, 4 August 2022.

FX can have an outsized impact on LC returns

While FX risk can be influenced by idiosyncratic and domestic factors, exogenous macroeconomic factors – such as relative rate and currency differentials between EM countries and the US, global growth dynamics, and capital flow in and out the country (balance of payments) – are also key. Particularly against a backdrop of global tightening in financial conditions, countries with weaker external positions (and current account deficits) are more susceptible to currency weakness, as they are more reliant upon portfolio inflows or external borrowing denominated in a foreign currency (as explained earlier).

Exposing portfolios to such FX risk therefore adds an additional layer of complexity and dynamics to consider. It can have an outsized impact on portfolio performance, as shown by comparing the local hedged to local unhedged returns with the difference attributable to currency effects.

Figure 10: FX risk has an outsized impact on returns



Source: Bloomberg, 17 August 2022. Indices used: J.P. Morgan GBI-EM Global Diversified Unhedged USD and J.P. Morgan GBI-EM Global Diversified Hedged USD, total returns in US dollars. Note: Local rates return represented by the total return on the J.P. Morgan GBI-EM Global Diversified Composite USD hedged Index. The FX return represents the difference between the return on the J.P. Morgan GBI-EM Global Diversified Composite Unhedged Index and the J.P. Morgan GBI-EM Global Diversified Composite USD Hedged Index.

Past performance does not predict future returns.

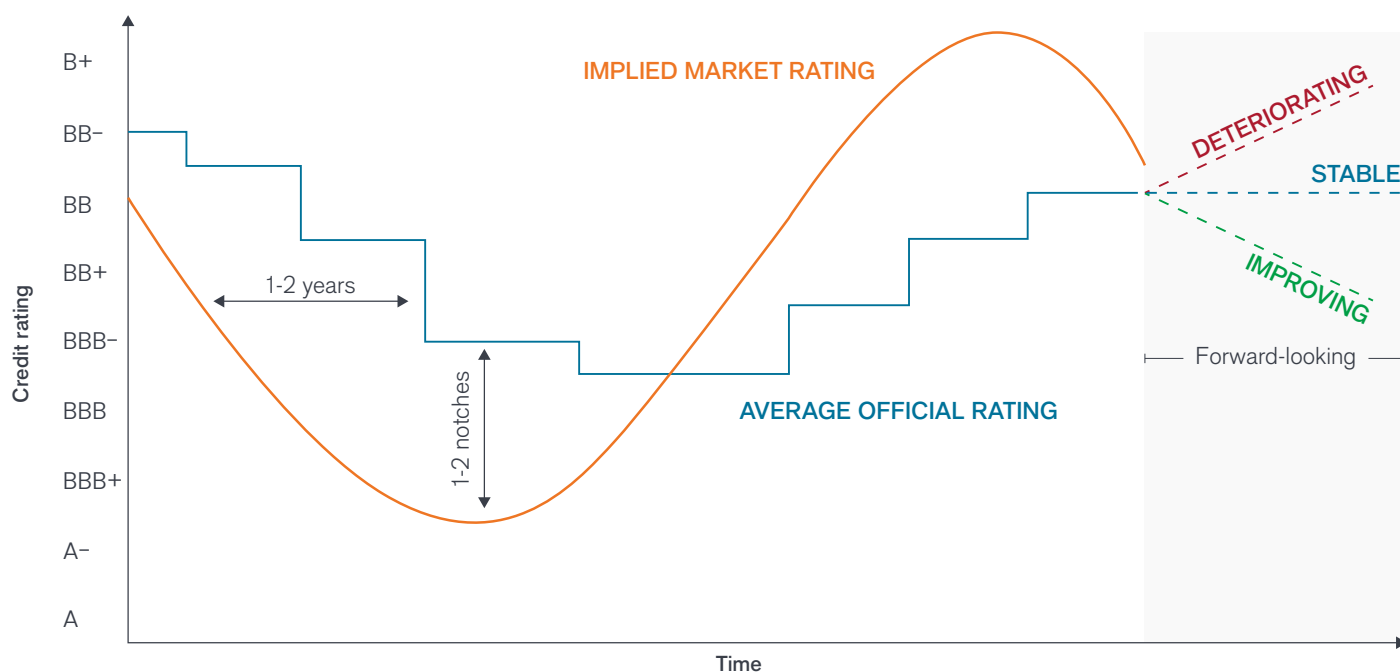
Measuring sovereign credit risk

The diverse dynamics in EMs pose a challenge when allocating to the universe in making relative comparisons to inform investment decisions. Amid the global tightening cycle, higher sovereign borrowing rates could drive debt sustainability concerns. Given slower global growth and a challenged fiscal outlook alongside more expensive refinancing, this highlights the need to cast a wide net when measuring sovereign credit risk given the myriad factors involved:

- ▶ Hard economic variables – such as inflation, GDP, public debt, fiscal and current account balance, external debt, debt service ratio, and foreign reserves – are some of the factors influencing sovereign credit risk.
- ▶ Governance – different measures of governance are important to understand sovereign credit risk.
- ▶ More slow-moving structural factors indicating the resilience and potential of an EM economy (e.g., demographics like age dependency, innovation, inequality, climate change vulnerability, and human skills score) are, in our view, some of the other drivers of sovereign credit risk.

To understand sovereign credit risk, one can analyse either historic defaults, sovereign market spreads or sovereign ratings. The systematic information within these measures can offer key empirical input to better understand sovereign credit risk at the individual country level. We believe using market-based indicators, such as spreads or yields, is problematic, as these indicators are influenced by a host of factors, such as global risk sentiment. Actual historical defaults provide little empirical value due to their somewhat infrequent nature. Our systematic analytical framework therefore rests on the empirical evidence found in historical ratings. Ratings tend to move relatively slowly with some embedded trend – indicative of a slow-moving core component of sovereign credit risk – and lag the market by a year or two. However, markets tend to be too optimistic in rewarding good stories and too pessimistic in punishing bad stories, creating opportunities to capture alpha from this mispricing.

Figure 11: Markets over- and under-estimate sovereign credit risk in upgrade and downgrade cycles



Source: Janus Henderson Investors. For illustrative purposes only.

Governance is key to sovereign credit risk

As evidenced through empirical data, governance is one of the key drivers of sovereign credit risk. Ratings are highly correlated with different levels of governance issues, such as strength of a policy framework, institutional quality, economic freedom, corruption perception and policy quality. The World Bank governance indicators have amassed enough EM coverage over time, and we believe the most important ones are the rule of law¹¹, political stability, and regulatory quality. The potential for reform is significant, but much progress has been made in recent decades in terms of economic policy quality. Most EMs now have similar policy frameworks to DMs, including independent central banks targeting inflation, floating exchange rates and more rules-based fiscal policy frameworks.

¹¹Rule of law captures perceptions of the extent to which agents have confidence in and abide by the rules of society, and in particular the quality of contract enforcement, property rights, the police, and the courts, as well as the likelihood of crime and violence (World Bank).

In the past, environmental factors have not been material in analysing sovereign risk. This is changing as the physical and economic impacts of climate change and resource constraints become more evident. Post the pandemic, social issues have come into focus as inequality, human rights, access to healthcare and education have risen in importance among the populace and policymakers. As EMs rely more on external inflows, some countries are issuing green, social and Sustainable Development Goal (SDG) bonds. Mexico and Benin were the first to launch SDG bonds in 2020 and 2021, respectively.

Human capital is a key driver of economic growth and high inflationary pressures have the potential to hurt and incense the populace, particularly among the poorest countries. Given their lower fiscal flexibility, EM governments have more constraints around their policy response in mending their economies. When times are tough, the populace are less likely to accept corruption and tend to have higher expectations for their countries' governance standards. Ergo governments are incentivised to improve governance so their social safety net is preserved. The social risk premium could thus become more important in EM going forward.

Building diversification in portfolios comes from taking advantage of the different political cycles, economic policy stances and reform cycles available in EM.

Janus Henderson Emerging Markets Debt Hard Currency Team



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Bent has 36 years of financial industry experience.



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Alpha compares risk-adjusted performance relative to an index. Positive alpha means outperformance on a risk-adjusted basis.

Bloomberg Global Aggregate Index is a flagship measure of global investment grade debt from twenty-four local currency markets. This multi-currency benchmark includes treasury, government-related, corporate and securitized fixed-rate bonds from both developed and emerging markets issuers.

Correlation measures the degree to which two variables move in relation to each other. A value of 1.0 implies movement in parallel, -1.0 implies movement in opposite directions, and 0.0 implies no relationship.

Credit quality ratings are measured on a scale that generally ranges from Aaa (highest) to C (lowest).

Credit Spread is the difference in yield between securities with similar maturity but different credit quality. Widening spreads generally indicate deteriorating creditworthiness of corporate borrowers, and narrowing indicate improving.

Diversification neither assures a profit nor eliminates the risk of experiencing investment losses.

Duration measures a bond price's sensitivity to changes in interest rates. The longer a bond's duration, the higher its sensitivity to changes in interest rates and vice versa.

Emerging market investments have historically been subject to significant gains and/or losses. As such, returns may be subject to volatility.

Fixed income securities are subject to interest rate, inflation, credit and default risk. The bond market is volatile. As interest rates rise, bond prices usually fall, and vice versa. The return of principal is not guaranteed, and prices may decline if an issuer fails to make timely payments or its credit strength weakens.

ICE BofA US Corporate Index tracks the performance of U.S. dollar denominated investment grade corporate debt publicly issued in the US domestic market.

ICE BofA US High Yield Index tracks the performance of U.S. dollar denominated below investment grade corporate debt publicly issued in the U.S. domestic market.

JP Morgan CEMBI Broad Diversified Index tracks the performance of US dollar-denominated bonds issued by emerging market corporate entities.

JP Morgan EMBI Global Diversified Index is a uniquely-weighted version of the JP Morgan EMBI Global Index. It limits the weights of those index countries with larger debt stocks by only including specified portions of these countries' eligible current face amounts of debt outstanding. The countries covered are identical to those covered by the JP Morgan EMBI Global Index which tracks total returns for U.S.-dollar denominated debt instruments issued by emerging market sovereign and quasi-sovereign entities: Brady bonds, loans, Eurobonds.

JP Morgan GBI-EM Global Diversified tracks the performance of bonds issued by emerging market governments and denominated in the local currency of the issuer.

MSCI Emerging Markets IndexSM reflects the equity market performance of emerging markets.

Quantitative Easing (QE) is a government monetary policy occasionally used to increase the money supply by buying government securities or other securities from the market

Quantitative Tightening (QT) is a contractionary monetary policy tool applied by central banks to decrease the amount of liquidity or money supply in the economy.

Volatility measures risk using the dispersion of returns for a given investment.

Yield to worst (YTW) is the lowest yield a bond can achieve provided the issuer does not default and accounts for any applicable call feature (ie, the issuer can call the bond back at a date specified in advance). At a portfolio level, this statistic represents the weighted average YTW for all the underlying issues.

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