



Local currency EMD - Why it might be time to reconsider an active allocation

An allocation to emerging market debt (EMD) can offer investors a range of potential benefits in the context of their broader portfolios – not least its low correlation with other sub-asset classes of fixed income. The growth dynamics and strengthening economic fundamentals of many emerging market (EM) countries are attractive to investors seeking growth, income and diversification.

We discuss the possible benefits of an active allocation to local currency EMD. These include access to a wider source of returns, the ability to gain off-benchmark exposure, allowing a more deliberate allocation of capital, and the capacity to use multiple levers to capture different drivers of return and manage risk.

As the asset class has developed, it has become increasingly appealing to a broader investor base. Issuance has increased, thereby improving liquidity. Yield curves have become more developed, allowing active investors to add value via positioning across different maturities. As both of these factors have improved, the ownership mix has diversified, with a greater balance between foreign and domestic owners. Indeed, the establishment of a developed local currency EM bond market and the effective management of interest rate policy are key indications of a country's ongoing economic development. Local currency EM

Emerging markets are volatile and may suffer from liquidity problems.

sovereign bond issuance has grown to almost US\$8 trillion, representing 42% of the total EMD universe, and governments have increasingly favoured issuing debt in local currency; 93% of the total EM sovereign debt stock today is denominated in local currencies.¹ The rationale for a strategic allocation to local currency EMD is therefore strong; but how best to manage such exposure? An allocation to passive or smart beta strategies can provide an effective and low-cost way to access the broad market. However, these approaches can lead to exposure biased towards countries that are increasing their level of indebtedness, and can also restrict opportunities to capture relative value through market movement. Interest rate and exchange rate volatility can at times be high. Below, we highlight the potential benefits of an active approach.

Access to a wider source of returns

Perhaps the most important point is that adopting an active strategy to gain access to local currency EMD provides investors with the broadest possible investable universe.

Certain benchmarks restrict the opportunity set available due to construction methodologies and constraints; this is logical, and indeed serves to facilitate active management by providing a useful reference point for risk management. However, a large proportion of the investable universe – close to 90% – is excluded as a result. This can be to the detriment of passive investors, as they are (perhaps unintentionally) restricted to exposure to only a limited sub-set of the local currency debt market, which has been pre-selected by the benchmark providers.

In December 2017, the combined market for sovereign, corporate and inflation-linked local currency EMD stood at US\$15.8 trillion. In comparison, the market value of the JPMorgan GBI-EM Broad Index was US\$2.3 trillion, while the JPMorgan GBI-EM Global Diversified Index represented only US\$893 billion.²

Bonds eligible for the JPMorgan GBI-EM Global Index represent only 15% of total local currency sovereign debt stock. China and India alone, neither of which is eligible for inclusion, account for 39% of local currency sovereign debt stock. Foreign ownership levels in these markets is low, in part driven by their exclusion from the JPMorgan GBI-EM Global Diversified Index; foreign ownership of local currency government bonds is 2.2% in China and 4.6% in India, compared with 26.5% for emerging markets as a whole.¹

Takeaway #1: an expanded opportunity set creates a more diversified asset class and could offer active investors increased and more varied sources of alpha

A more deliberate allocation of capital

The starting point for the construction of an EMD benchmark remains the level of sovereign debt outstanding; exposure is typically to those countries with the most outstanding debt. While the diversification method applied by JPMorgan in its Global Diversified index mitigates this to a point, the level of debt remains its foundation and the index provider's diversification methodology could even be considered to be an 'active' decision of itself.

Past results are not a guarantee of future results.

¹ As at March 2018. Source: JPMorgan EM Local Markets Guide, May 2018

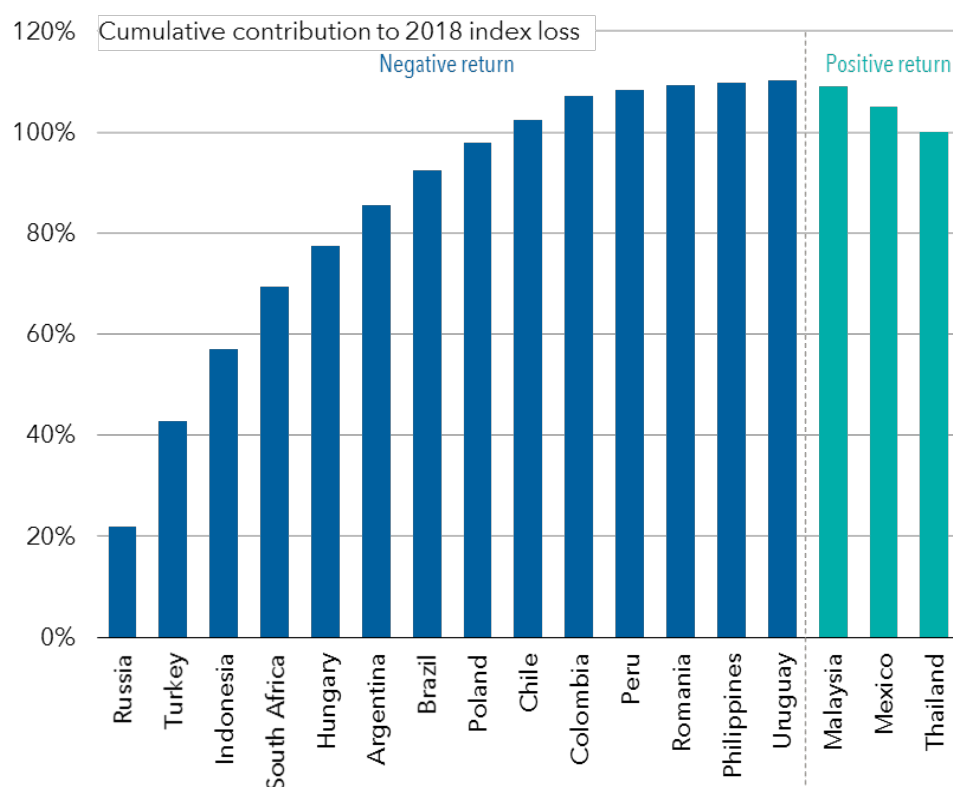
² As at 31 December 2017. Source: JPMorgan

Furthermore, as index composition evolves and is rebalanced over time, so the exposure provided by a passive strategy will shift accordingly. A passive investor therefore has limited control over the composition of exposure taken.

Chart 1 demonstrates the contribution to index returns of countries in the JPMorgan GBI-EM Global Diversified Index, for 2018. The index returned -6.2% over this period. This illustrates how a select number of countries can dominate returns over a particular time period, and how important it becomes to effectively manage exposure to those countries. Four countries collectively contributed to just under 70% of the index return during the year, with positive returns generated by only Malaysia, Mexico and Thailand.

Chart 1: Cumulative contribution to index returns in 2018

Almost 70% of index return in 2018 was driven by just four countries³



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On a related note, the movement of countries into and out of both emerging market and global bond indices can have dramatic effects on the balance of market demand and supply.

Having already been added to global bond indices as a reflection of efforts to increase foreign investors' accessibility to the market and reduce quotas, it is probable that China will be added to investable versions of the local currency EMD indices in 2019. As active investors we have been increasing our focus on the local currency China market and the various mechanisms available to hedge currency exposure in order to most efficiently capture exposure and manage risk. JPMorgan estimates that China's initial weight in the Global Diversified index will be 7%, and that this will likely move towards the 10% cap over time. Building experience of investing in this market now not only offers potential benefits regarding portfolio construction, but also means investors could be

Forecasts shown for illustrative purposes only.

³ As at 31 December 2018. Contributions are shown in US dollar terms. Index represents JPMorgan GBI-EM Global Diversified Index. Source: Bloomberg

better placed to harness returns as the country is brought into the index and flows pick up.

Equally important is the impact on existing benchmark constituents of China's addition to the index; as other countries' weightings are decreased it is probable that demand will soften, which could present further opportunities and inefficiencies for agile active managers to exploit.

Takeaway #2: active management enables an investor to be selective and deliberate in the mix of exposure taken, and to manage this through periods of higher or reduced volatility

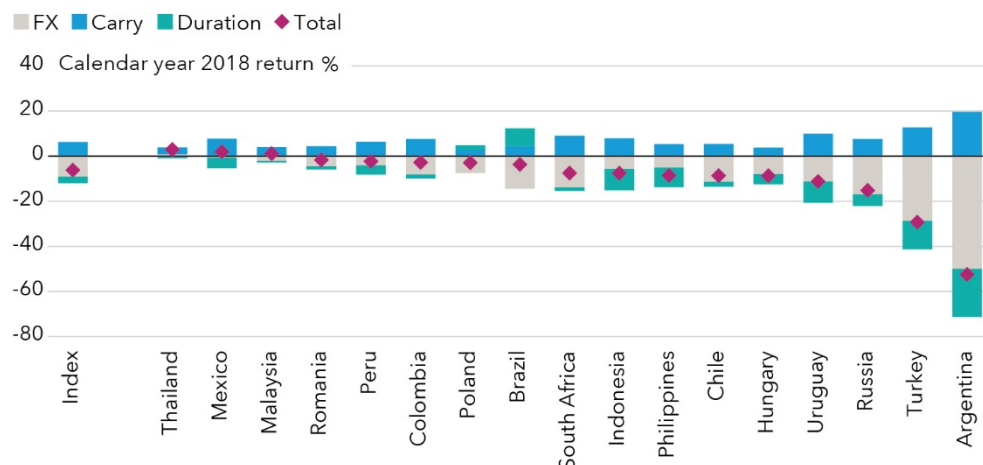
Ability to use multiple levers to capture different drivers of return and manage risk

Local currency debt returns are driven by both duration and currency risk. An active approach can allow investors to separate and isolate these risks. While it might be expected that common factors would drive returns in both, there has been a divergence between the bond and currency components of the JPMorgan GBI-EM Global Diversified Index in recent years.

Chart 2 illustrates that a significant portion of negative return experienced by the index in 2018 has been due to currency depreciation. The precise mix of returns has also varied between markets, with foreign exchange (FX) having the biggest impact on returns in Argentina and Turkey.

Chart 2: While drivers of return vary by market, FX generally had a major impact across EMD in 2018

Influence of bond and currency elements on EMD total return in 2018⁴



Having the ability to take currency hedging positions on a case-by-case basis enables the investor to capture currency appreciation, manage exposure and mitigate potential depreciation.

Even if a manager expects weakness in a particular currency, it still may not be the best approach to hedge because of the cost. A strongly positive view on a bond market combined with a moderately negative view on the currency may be more conducive to unhedged local exposure. A fully hedged or unhedged strategy would not always give the optimal outcome given the variation of returns within EM.

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⁴ As at 31 December 2018. JPMorgan GBI-EM Global Diversified Index. Source: Bloomberg

Countries' yield curves develop at a different pace and exhibit differing shapes through shifting market conditions. By using derivatives in certain markets, investors can gain exposure to a country's bonds and effectively use the interest rate curve as an additional source of return. Interest rate swaps, for example, allow active investors to increase or reduce exposure to different parts of a country's yield curve without taking other risks, including currency or sovereign risk (although the investor would have counterparty risk). Active investors can also use interest rate swaps as a substitute for less liquid local currency bonds or bonds with restrictions on trading.

Takeaway #3: dynamic management of currency, curve and maturity provides active investors with more levers to pull to generate alpha

Capital Group's approach to EM local currency debt

It is important to think carefully about how best to gain exposure to this increasingly sophisticated market. In order to fully understand each market and assess which countries to allocate to and which to avoid, it is essential to conduct in-depth, fundamental research into individual countries' rates and currencies, framed in the context of the global macro environment. As the opportunity set has developed, a deep understanding of market technicals and trading strategies can further complement fundamental research to enable successful market execution and can have a significant impact on return. Similarly, robust risk management is essential.

At Capital Group, we believe an active investment approach that is aware of the benchmark but not beholden to it, and draws on extensive research with disciplined risk control, affords investors the greatest opportunity to generate strong risk-adjusted returns through shifting volatility regimes.

Risk factors you should consider before investing:

- **The value of investments and income from them can go down as well as up and you may lose some or all of your initial investment.**
- **If the currency in which you invest strengthens against the currency in which the underlying investments of the fund are made, the value of your investment will decrease.**
- **Depending on the strategy, risks may be associated with investing in emerging markets and/or high-yield securities; emerging markets are volatile and may suffer from liquidity problems.**

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