

Has Covid-19 Thrown Up Value in the Local Currency Emerging Market Debt Universe?

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The local currency emerging market debt asset class had a strong positive return in 2019. Despite the fears of a global slowdown part way through last year, investors in the asset class enjoyed a 13.5%¹ return in USD unhedged terms. The impact of Covid-19 however has negatively affected the asset class this year. Risk aversion and uncertainty have swept through markets as investors and policy makers have grappled with the short and long run consequences of the virus. Emerging markets have been caught up in that dislocation, prompting some to question the value on offer in this segment of the fixed income market. As the dust settles and the picture becomes clearer, we find an asset class with valuations near historic lows. As the solid economic fundamentals underpinning the countries within this universe are likely to remain intact (notwithstanding the various stimulus packages), we believe that the asset class currently looks extremely attractive.

Returns

The local currency emerging market debt asset class suffered a large negative return in the first quarter of 2020. The -15.2% decline was the largest quarterly fall in the JP Morgan GBI-EM Global Diversified Index since its inception in 2003 (in USD unhedged terms). It is important to separate the sources of return when looking at local currency debt and differentiate between the return from bonds and that from currencies. Arguably, this is one of the key things which sets the asset class apart from some of the other fixed income sub-asset classes, such as corporate credit. Historically the separate bond and currency return streams have not been highly correlated, with a correlation of 0.55. The currency element is also more volatile than the underlying bond component. Annualised monthly volatility of the currency component of the benchmark at 9% is just under three times that of the underlying bond markets, at 3.5%. Intriguingly, the latter compares favourably with the volatility of the US Treasury market (4.1%), and for that matter, the likes of the German bund (3.7%) and Australian government bond (3.8%) markets².

When we decompose the 15.2% first quarter decline, we see a meaningful divergence in returns between emerging market bonds and currency, both in aggregate, and at the individual country level (see Chart 1 below). As is the normal pattern in this asset class, at times of stress emerging market currencies bear the brunt of the sell-off (and hence the higher volatility noted above), whereas bonds are somewhat more defensive. This pattern was repeated in the first quarter of 2020. While some individual countries were more exposed to their own unique and identifiable issues, the bond component of the JPM GBI-EM Global Diversified index declined by -1.4% in the first quarter of 2020 (in USD hedged terms). This was a particularly strong performance given the scale of the economic disruption caused by the crisis. It also stands in contrast to the -13.5% decline in the bond component of the global high yield index³ and the -4.2% fall in the global investment grade corporate bond index⁴ (both in USD hedged terms).

¹ JPM GBI-EM Global Diversified USD Unhedged Index

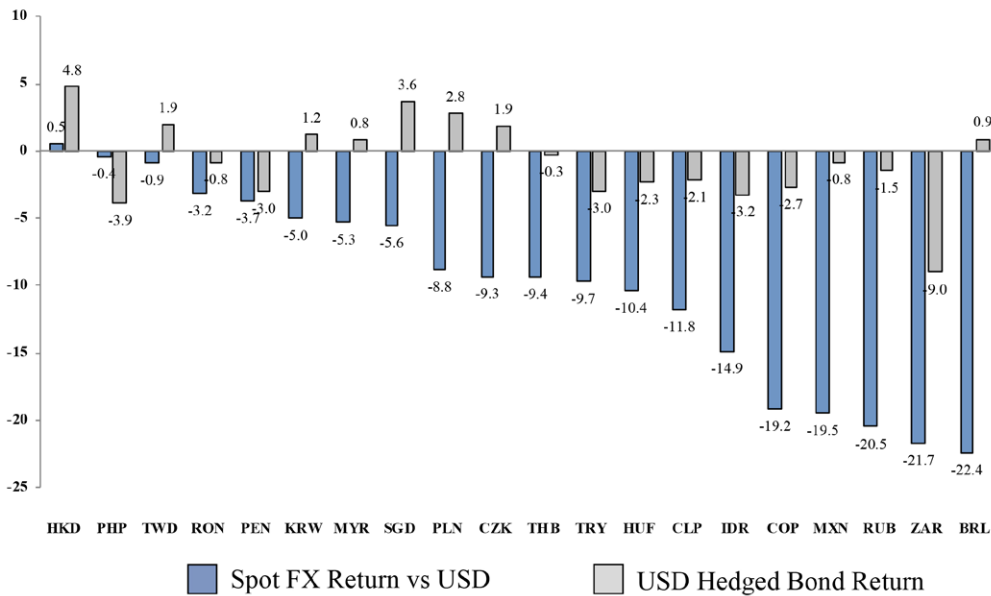
² All bond volatility data referenced here uses 3 year monthly US dollar hedged return data to end April 2020. The US, Germany and Australian data is sourced from the country components of the FTSE World Government Bond Index. The EM benchmark data is sourced from the JP Morgan GBI-EM Global Diversified Index. We note the approximate 1.5 years shorter duration of the EM index may flatter the comparison but doesn't materially detract from the main point.

³ ICE BofA Global High Yield USD Hedged Index

⁴ ICE BofA Global Corporate Bond USD Hedged Index



Chart 1: Q1 2020 Return Breakdown



Source: JP Morgan, Colchester

Part of the reason for this comparative strength in local market debt is the improvement in many emerging market countries' balance sheets and macro-economic policy frameworks over the past twenty years or so. Many have reduced their external liabilities by lowering the outstanding balance of foreign denominated debt (for example denominated in US dollars) and issued debt in local currency. The increased issuance in locally denominated debt has given rise to local pension funds and other institutions who are able and willing to buy their domestic government bonds during periods of significant risk aversion. In much the same way that a US Treasury or Australian dollar denominated government bond is the risk-free asset of choice in the US and Australia respectively, Mexican peso and Thai baht denominated domestic government debt have increasingly become the risk-free asset of choice in Mexico and Thailand for domestic asset owners.

While nominal yields in a number of these markets backed up in the first quarter, many provided defensive returns for foreign investors in USD hedged terms (see Chart 1). Polish, Malaysian and Czech bonds, for example, all provided positive USD hedged returns and negative correlation with "risk assets." Other bond markets delivered slightly negative returns. The resilience of these local bond markets in the face of an adverse shock is a characteristic typically associated with developed market government bonds. This relative stability is increasingly becoming a feature of many of the local currency emerging bond markets that are represented in the JP Morgan GBI-EM Global Diversified Bond index.

In contrast, emerging market currencies were negatively impacted by the "virus shock" in the first quarter, compounded in some instances by the sharp decline in oil and other commodity prices. In aggregate, the currency component of the local market debt index declined by -14.3%⁵ versus the USD in the first quarter. There was far greater dispersion across the emerging market currency universe than that observed on the bond side, with those currencies believed to be more exposed to commodities being more adversely impacted. The marked difference in bond and currency returns highlights the importance of managing both risks, but also hints at the potential diversification benefits to be had when combining both within a diversified portfolio.

⁵ JPM GBI-EM Global Diversified FX Return in USD Index



Current Valuations

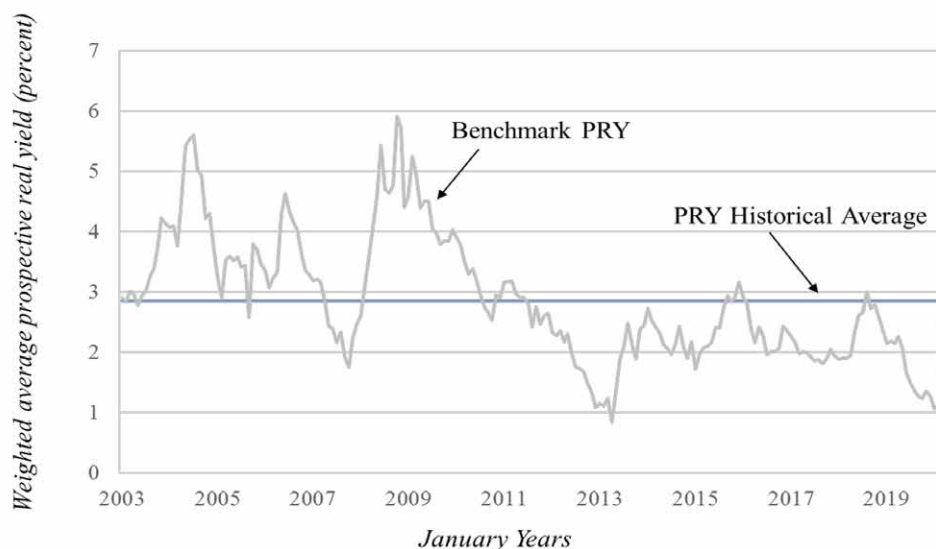
To assess the attractiveness of the asset class today, we can look at the real yield and real exchange rate valuations on offer in absolute terms and relative to history. Combining the two provides an assessment of the current potential of the asset class.

- Bond Valuations

Colchester's primary valuation metric for bonds is the prospective real yield (PRY), using an in-house inflation forecast rate which is discounted from that country's nominal yield. We supplement this with an assessment of the country's financial soundness, focusing primarily on the governments balance sheet, debt sustainability, etc., but also factoring in the level of governance, rule of law, respect for property rights, social and environmental factors. While our inflation forecasts are underpinned by lagged money and credit growth, we also factor in changes in commodity prices, movements in the nominal currency and some measure of capacity or output gap. The virus induced adverse demand/supply shock and large decline in the price of oil (which fell two-thirds in the first quarter of 2020) and other commodities prompted us to revise our inflation forecasts lower within our emerging market universe. The large fall in the exchange rate in some countries tempered that revision, but the pass through to domestic inflation of such exchange rate depreciations has declined markedly over the past decade. In part, this decline has been driven by both greater competitiveness and increased central bank credibility arising from the widespread adoption of inflation targeting regimes that largely have successfully anchored domestic inflation expectations. While the impact of recent currency moves will vary across countries, we anticipate the large decline in the price of oil and other commodity prices and generalised negative demand shock associated with the virus, will dominate inflation in the near term.

The resulting decline in our inflation forecasts and rise in nominal yields in some markets has seen an increase in the overall attractiveness of emerging market bonds on a prospective real yield basis (see Chart 2 below). Whilst below the long-term average prospective real yield since inception of the index in 2003, the benchmark PRY currently sits around the average of the post Global Financial Crisis period. The rise in prospective real yields has also increased the attractiveness of benchmark local market bonds relative to developed market bonds. Offering an approximate 2.5% real yield enhancement today, this is a healthy premium compared with history (See Chart 3).

Chart 2: Benchmark Prospective Real Yield

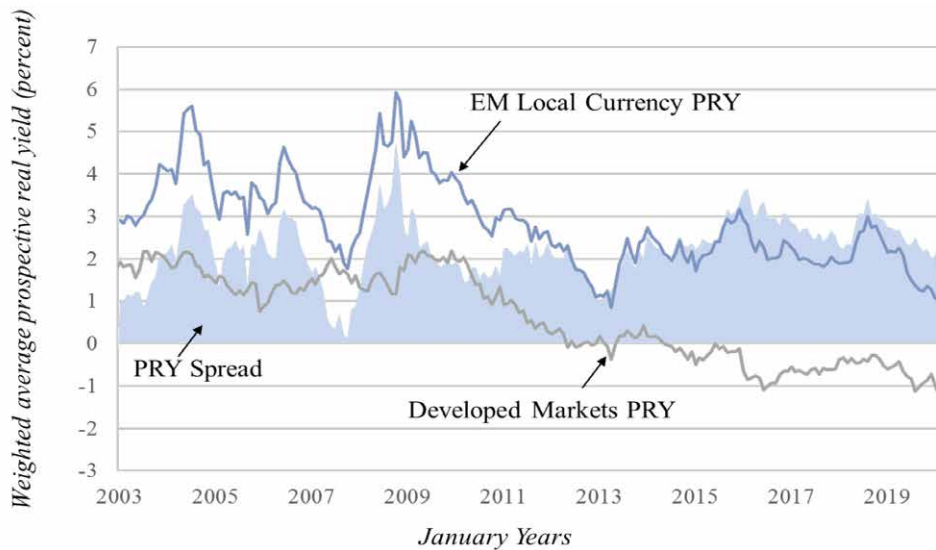


Notes: Prospective Real yield is the 10yr nominal yield in each market, minus Colchester's forecast of inflation where available. Otherwise market index yield to maturity or (known) next 12 months' consumer price inflation is substituted - Data as at 30th April 2020

Benchmark is the JP Morgan GBI-EM Global Diversified index (USD Unhedged).



Chart 3: Benchmark Prospective Real Yield



Notes: Prospective Real yield is the 10yr nominal yield in each market, minus Colchester's forecast of inflation where available. Otherwise market index yield to maturity or (known) next 12 months' consumer price inflation is substituted - Data as at 30th April 2020

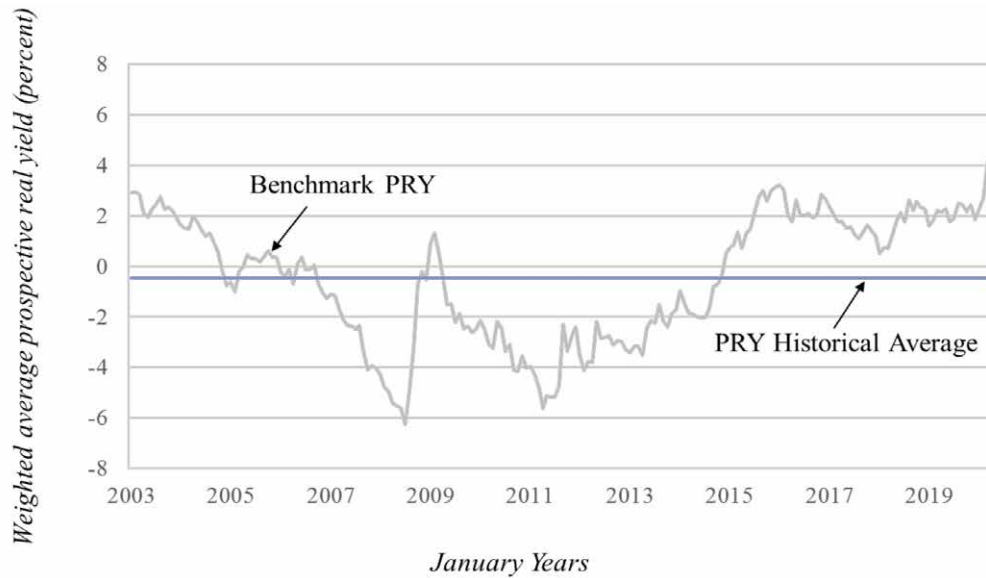
Benchmark for EM Local Currency is the JP Morgan GBI-EM Global Diversified index (USD Unhedged), and for Developed Markets is the FTSE World Government Bond Index (USD Unhedged), formerly the Citigroup World Government Bond Index (USD Unhedged).

- Currency Valuations

Colchester's primary valuation metric for currencies is an estimate of their real exchange rate – or purchasing power parity (PPP). We supplement this with an assessment of the country's balance sheet, level of governance, social and environmental factors (ESG), and short-term real interest rate differentials (i.e. "real carry"). Notwithstanding these other factors, our estimate of the real exchange rate provides a useful approximation of the value on offer in an individual currency, as well as at the aggregate portfolio level. Prior to the sell-off in March 2020, emerging market currencies were already trading at attractive levels of valuation versus the US dollar according to our real exchange rate valuation estimates. As shown in Chart 4, even before the crisis, real exchange rates of emerging market currencies comprising the benchmark were trading at historically cheap levels versus the USD. The sharp nominal exchange rate depreciations that occurred in a number of these currencies at the time of the crisis has now driven the value on offer in the currency component to historical undervaluation levels in real exchange rate terms versus the US dollar. Assuming - as the empirical evidence suggests - an average 5 year mean version in the real exchange rate back to fair value, this suggests that there is now an even larger positive expected return from holding emerging currencies versus the US dollar over the medium-term. Emerging market currencies, along with a number of developed world currencies, were meaningfully undervalued against the US dollar before the virus shock, the resulting dislocation and uncertainty has made them even more attractive for a USD based investor.



Chart 4: Benchmark Currency Valuation



Currency is translated into an equivalent real yield by dividing portfolio or benchmark aggregate real exchange rate undervaluation (versus the USD) by 5. This assumes a 5 year reversion to fair value. An undervalued currency has a positive value and an overvalued currency a negative - Data as at 30th April 2020.

Benchmark is the JP Morgan GBI-EM Global Diversified index (USD Unhedged)

- Combined Valuation

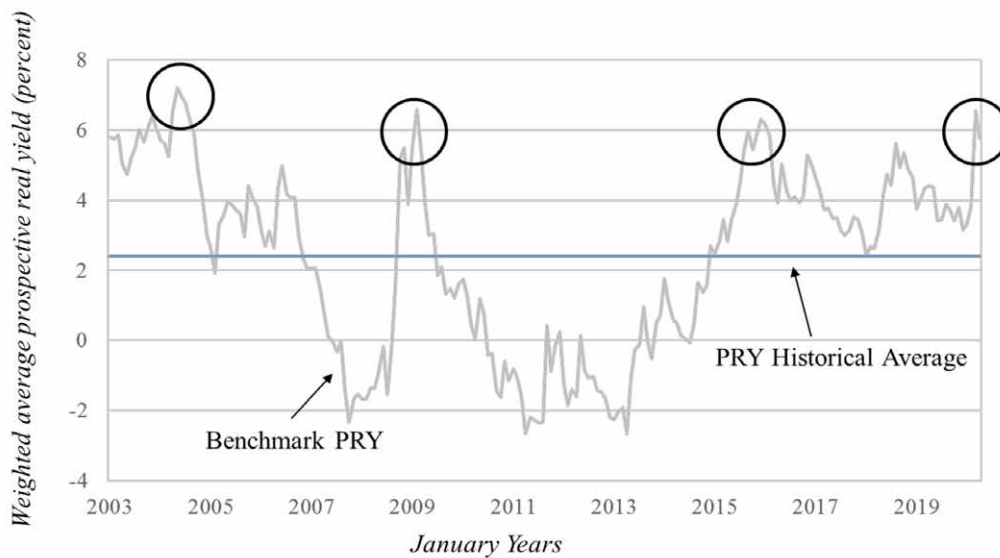
Combining the prospective real yield bond and the real exchange rate valuations together to produce an aggregate PRY for the benchmark in Chart 5 suggests that we are now at levels only seen a few times historically. The value on offer in the local currency asset class today is on a par with that seen at the depths of the Global Financial Crisis in 2009 and most recently in 2015 when US dollar strength combined with some idiosyncratic country issues to produce compelling value in the space. The average benchmark total return in the two years following the three previous episodes of similar extreme valuation - June 2004, January 2009 and September 2015 - was +33.7%⁶.

The dislocation in markets in response to the virus has also increased the dispersion between the real yields and real exchange rates of the countries within the local market debt opportunity set, thereby increasing active management opportunities. Accordingly, we believe that we can build an appropriately diversified portfolio that offers a higher prospective real yield than that currently offered by the benchmark.

⁶ The total return on the JP Morgan GBI-EM Global Diversified Index (unhedged USD) between June 2004 and June 2006 was 27.7%, between January 2009 and January 2011 was 47.7% and between September 2015 and September 2017 was 25.6%.



Chart 5: Benchmark Combined PRY



Combined of bond prospective real yield (10yr nominal yield in each market, minus Colchester's forecast of inflation) and currency real yield (equivalent real yield by dividing portfolio or benchmark aggregate real exchange rate undervaluation (versus the USD) by 5) - Data as 30th April 2020

Benchmark is the JP Morgan GBI-EM Global Diversified index (USD Unhedged)

As noted above, the real yield and real exchange on offer are not the only factors that we believe are important when looking at investment opportunities in the emerging market opportunity set. Balance sheet strength, credit ratings and other risk factors also need to be considered.

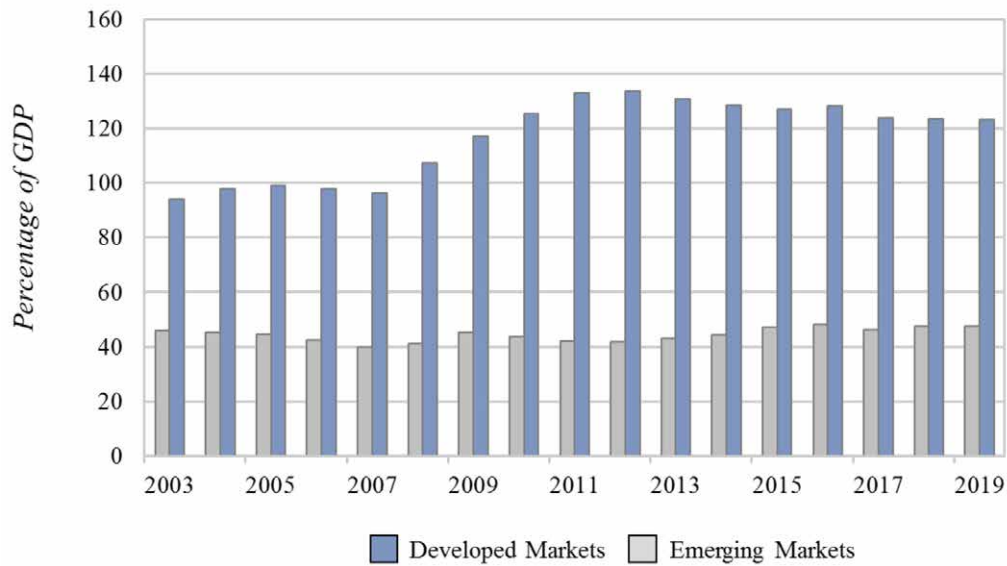
Balance Sheets

Valuations must be viewed within the context of the fundamentals. In other words, are the declines in currency values and increase in real yields occurring for justifiable reasons? In short, the answer would appear to be 'no' when looking at the emerging market universe in aggregate.

Going into the pandemic, emerging markets as a whole were arguably on a more stable footing than developed market peers on several metrics. Looking at debt-to-GDP ratios for example, shows that emerging markets had less than half as much debt as developed markets (see Chart 6). Furthermore, the relatively lower increase in government debt in emerging markets over the last 10 years or so highlights their more cautious approach to macro-economic management and the widespread adoption of generally prudent and orthodox policies.



Chart 6: Index-Weighted Government Debt Levels



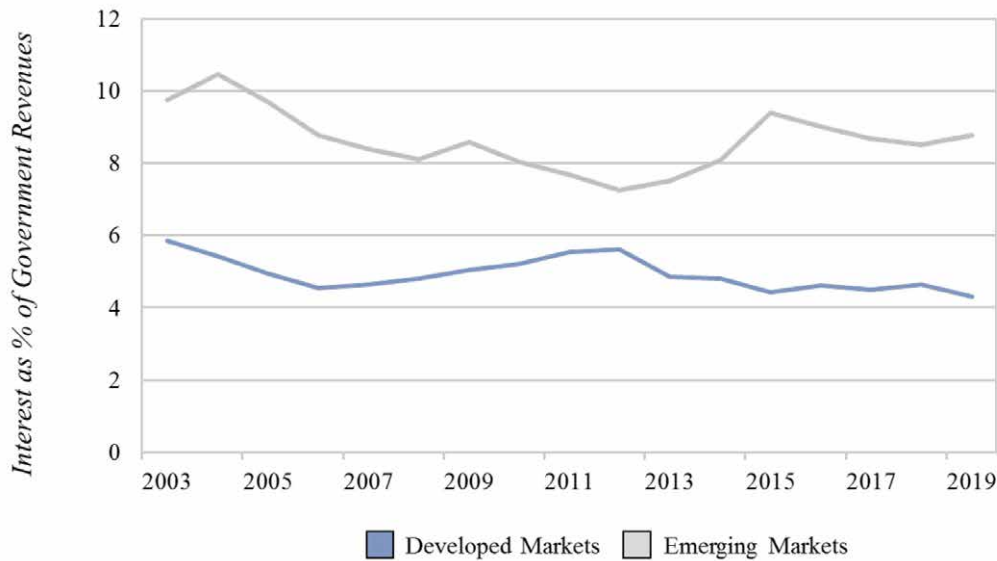
Notes: Developed Markets is the country-weighted average of the FTSE World Government Bond Index (USD Unhedged), formerly Citigroup World Government Bond Index (USD Unhedged) constituents. Emerging Markets is the country-weighted average of the JP Morgan GBI-EM Global Diversified Index (USD Unhedged) constituents.

Source: FTSE Russell, JP Morgan, IMF.

On the other hand, despite lower debt levels, emerging markets still suffer from higher debt servicing costs as a share of government revenues compared with developed markets (see Chart 7). This reflects both higher domestic interest rates and lower Government revenues than those in the developed world. Government revenues in emerging markets are on average less than 30% of GDP, whereas in developed markets Government revenues are above 40% on average. A number of factors account for this difference, such as lower tax levels, larger 'grey market' segments of the economy and poor tax collection overall. Many emerging countries continue to work on improving these issues, which are structural in nature. Perversely low revenue collection may be viewed as a long-term structural positive as it provides an opportunity for Governments to increase fiscal resources by broadening the tax base and improving compliance and collection. The move over the past 10 years to introduce sales taxes and to broaden tax collection in a number of emerging markets is consistent with this drive to improve fiscal sustainability.



Chart 7: Index-Weighted Debt Servicing Costs



Notes: Developed Markets is the country-weighted average of the FTSE World Government Bond Index (USD Unhedged), formerly Citigroup World Government Bond Index (USD Unhedged) constituents. Emerging Markets is the country-weighted average of the JP Morgan GBI-EM Global Diversified Index (USD Unhedged) constituents.

Source: FTSE Russell, JP Morgan, IMF.

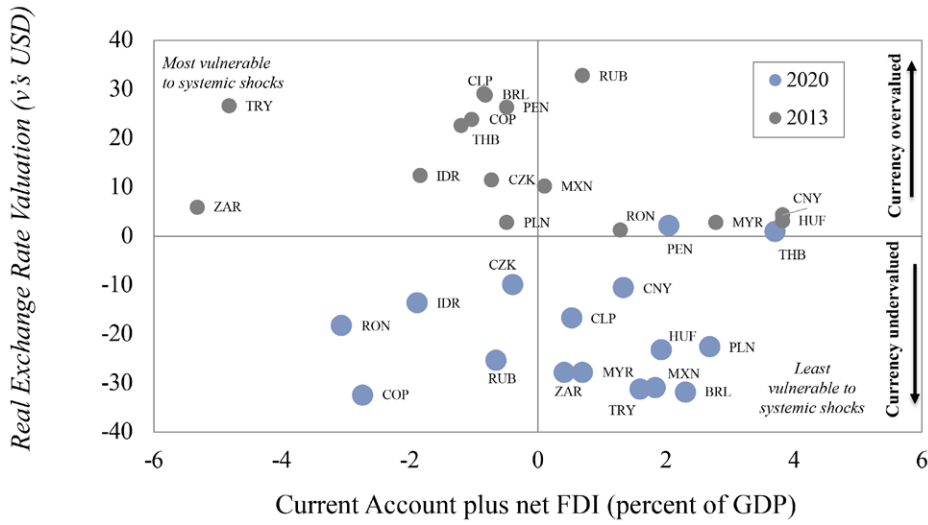
The external position of many emerging markets also looks comparatively solid. Whilst a number of metrics may be considered when assessing a country's external vulnerability, a particularly useful one is the sum of the current account balance plus net foreign direct investment (FDI). A deficit on the current account of the balance of payments implies a country is investing more than it is saving and the financing shortfall needs to be funded from outside the country. FDI tends to be a more stable and long-term source of funding as it includes mergers and acquisitions, the building of new facilities, investment in infrastructure, the reinvestment of profits, etc. - all decisions that typically are not reversed quickly. It is therefore reasonable to exclude FDI – i.e. add it back to the current account - when considering a country's dependency on short term capital flows and hence potential vulnerability. A remaining deficit on the current account after adding back net FDI, therefore suggests that a country is relying on "portfolio" inflows into stocks and bonds to finance the shortfall. Such "investment decisions" are often shorter term in nature, potentially increasing the vulnerability of a country to capital outflow.

History also shows that countries with more overvalued currencies tend to be more exposed to an adjustment and reversal in capital flows. Combining both elements in Chart 8 provides a useful overview of the potential vulnerability of a country. In simple terms, the greater the need for foreign capital and the more overvalued a country's real exchange rate (top left-hand quadrant), the more exposed or vulnerable that country is. The opposite holds true in the bottom right hand quadrant.

Surveying the landscape today in Chart 8 it is readily apparent that most emerging markets are in the less vulnerable quadrant with undervalued exchange rates and little to no dependency on short term capital inflows (blue dots). Furthermore, it is notable that there has been a meaningful improvement compared with 7 years ago (the grey dots).



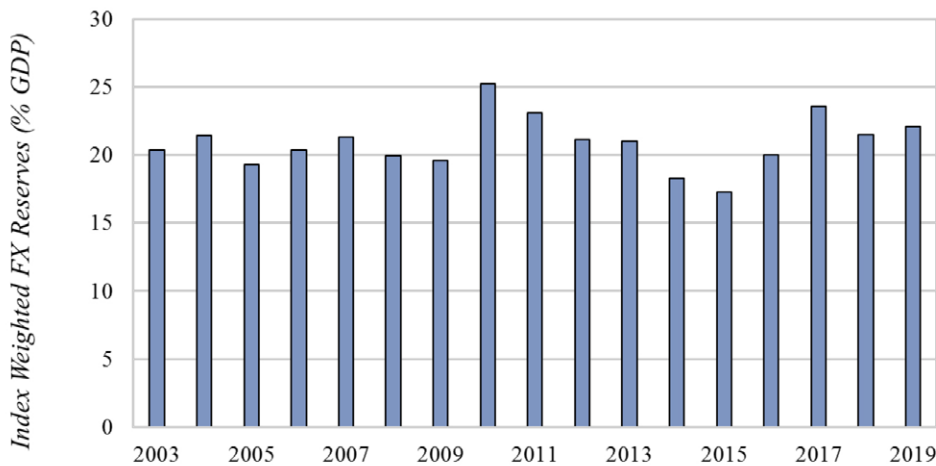
Chart 8: Real Exchange Rate and Current Account



Source: IMF, World Bank, Colchester Global Investors as of 31st March 2020

In many respects, this improvement in fundamentals during a period of real exchange rate depreciation highlights the changes in policies in many emerging markets, such as improvements in the ease of doing business to attract foreign capital, the widespread adoption of more prudent macro and fiscal policies, and even the approach to currency management. In particular, the near universal shift towards flexible exchange rates has taken the burden off Government balance sheets to absorb market volatility at times of stress, or to accommodate shocks. Similarly, the shift towards domestic funding has significantly reduced the dependency on foreign currency debt and meaningfully lowered the sensitivity of government balance sheets to exchange rate movements. Together this has allowed the currency to act as a shock absorber for the economy without resulting in significant balance sheet impairment. The sell-off of the Russian ruble in 2014-15 and the Brazilian real in 2015, in response to country specific issues are two examples of this approach. This has enhanced overall macro stability and can be seen in the stability of emerging market reserves as a percentage of GDP (see Chart 9). The days of countries using their resources to intervene in foreign exchange markets to fruitlessly "defend" their currency appears to have passed.

Chart 9: Index-Weighted EM FX Reserves



Note: Emerging Markets FX Reserves is the country-weighted average of the JP Morgan GBI-EM Global Diversified Index (USD Unhedged) constituents.

Source: JP Morgan, IMF, December 2019.



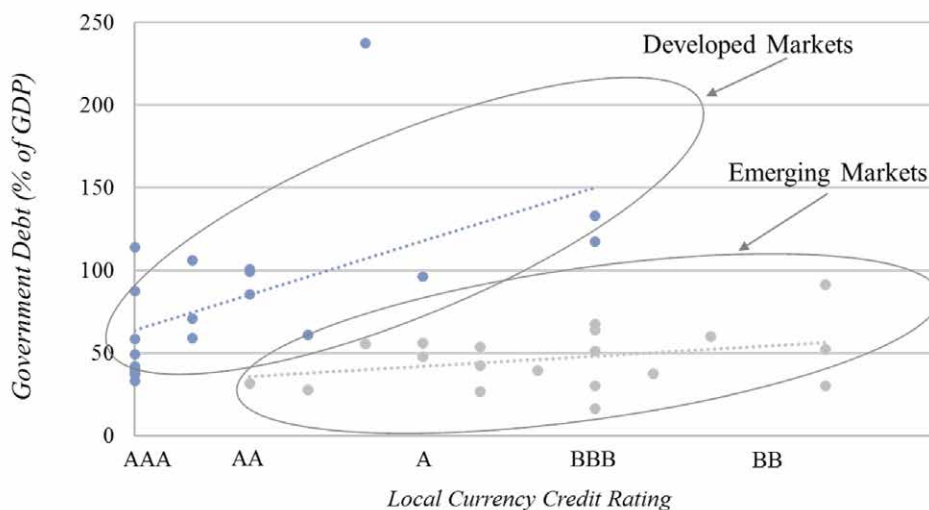
Rating Downgrade Worries

The credit rating profile of the local currency emerging market debt asset class has remained at a healthy average of BBB+ for the past several years⁷. However, given the emergency Covid-19 fiscal packages and the associated growth slowdown, several rating agencies have recently acted quickly to downgrade several issuers in the universe such as Mexico, Colombia and South Africa. In contrast, countries in the developed world like the United States and the United Kingdom have not yet had their credit ratings altered⁸ despite spending and pledging upwards of 11% and 19% of GDP respectively (to date, and counting) to help their economies weather the pandemic. In comparison, the Mexican and the South African government spending and support packages have amounted to a paltry 1.1% and 0.6% of GDP (to date).

The question then becomes, is this downgrading warranted? Are rating agencies being unfair on emerging markets relative to developed markets, especially when all countries, developed and emerging alike, will experience a slowdown in growth at a time when government spending is increasing sharply to support economies during this downturn. In other words, most country balance sheets will see a deterioration. This has also been noted by Fitch Ratings⁹ who stated that for the first time nearly all sovereign issuers they cover will experience a deterioration in their fiscal balances compared to a year ago. Commensurate with this, government debt levels will increase in almost all countries.

From a purely 'quantitative' aspect, looking at some of the various balance sheet metrics, it is difficult to understand how some emerging countries can be rated lower than some of their developed market peers. Clearly you would expect the level of a sovereign's debt to be a key factor. While there is a relationship between debt levels and ratings, as seen in Chart 10, there is a clear differentiation between developed markets and emerging markets. Emerging markets are currently rated lower at the same level of debt across the board, all else being the same.

Chart 10: Government Debt vs Credit Ratings



Source: Standard and Poor's, IMF Data as at December 2019.

⁷ The BBB+ rating referred to here is the Standard & Poor's Local Currency Rating weighted average of those counties in the JP Morgan GBI-EM Global Diversified Index (USD Unhedged) as calculated by Colchester.

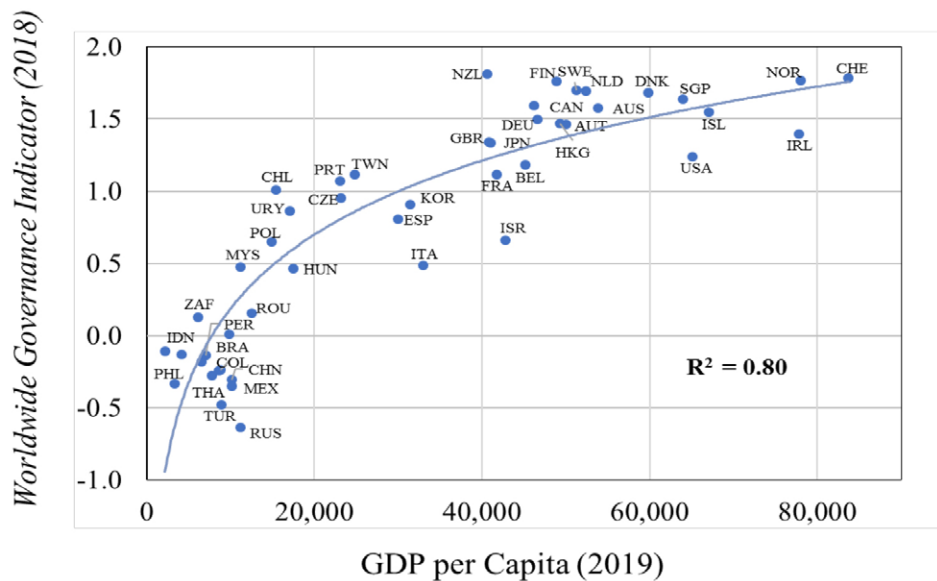
⁸ As per Standard & Poor's as at end April 2020.

⁹ Fitch Ratings "Global Fiscal Deterioration Amid Coronavirus", 24 April 2020.



This is not entirely a revelation, and whilst many debt metrics point to emerging markets being relatively better off than developed markets, other attributes can explain this differentiation. Indeed, one explanation for the difference lies amongst 'qualitative' factors. This encompasses things like a country's historical precedent, the consistency of policy, the social-political willingness to undertake necessary adjustments and the level of governance, which includes things such as the control of corruption and rule of law. Emerging markets tend to have lower levels of governance compared to developed markets, and as shown in Chart 11, this is associated with poorer per-capita economic outcomes. This traditionally is seen as a weakness by the rating agencies.

Chart 11: Governance and Per Capita GDP



Sources: IMF, World Bank, Colchester Global Investors; Worldwide Governance indicators 2018 whereby -2.5 is weak governance ranking and +2.5 the best governance ranking. Indicators represent the average ranking and are equally weighted.

At Colchester, as part of our balance sheet assessment for all countries, not only governance, but also an assessment of environmental and social factors plays a part in understanding a country's financial stability. Rather than acting as a 'negative screen', we assess the quantitative aspects of a country's balance sheet against risks and weaknesses that we may identify amongst the various ESG factors. In this context, many emerging markets within our investable universe do see a lower financial stability score than they might otherwise have. Overall however, despite the virus induced deterioration in the fiscal metrics, we believe that the balance sheets of most countries within the emerging market universe remain sound. Rating agencies may continue to downgrade across the sector, but the fundamentals are not pointing towards a meaningful increase in the risk of default. On the contrary, the benchmark is solidly "investment grade" and is likely to remain so in the absence of a further global melt-down.



Summary

While the real yields of emerging market bonds have returned to near their long-term average historical valuations, emerging market currencies are currently extremely undervalued in USD terms. This gives the asset class an added source of potential return. It also results in the valuation of the overall local currency emerging market debt asset class today being close to historical levels of undervaluation. Historically this level of valuation has proved to be extremely attractive.

Clearly there are some credit quality differences between the emerging and developed market sovereign bond asset classes, and each has its own place in client portfolios. However, it is important to highlight the balance sheet strengths and weaknesses of each. For both markets, government debt levels are likely to continue to increase for some time due to the fiscal support provided by most governments to try arrest the economic fallout from the impact of the virus. This is unlikely to disproportionately weaken balance sheets in the emerging markets. To the extent that all countries will be looking for higher nominal GDP growth to stabilise and reduce debt levels once temporary and emergency spending measures are removed, those with younger growing populations are likely to fair better. Historically the emerging markets have exhibited consistently higher nominal GDP growth rates than those seen in the aging developed world. In addition, there is ample room for emerging market yields – both nominal and real – to compress further towards those in the developed world, lowering debt servicing costs for emerging market governments over time. Nonetheless there remain some good reasons for the difference in credit ratings between the developed and emerging world. However, the differences may not be as large as some perceive and on balance, most countries within the emerging market universe should weather the Covid storm.



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