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Attractive yields for emerging markets bonds in local currencies

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On 17 October 2018, ERSTE BOND LOCAL EMERGING celebrated its 10th anniversary – a perfect time to have a closer look at the asset class “Emerging markets bonds in local currency”.

What is the distinctive feature of bond funds that invest in the local currencies of emerging markets?

The interesting bit about the fund is the fact that it exclusively invests in issuers from the emerging markets. Among them are, for example, government bonds from Central and East European countries such as Hungary and Poland, Asian issuers such as Thailand and Malaysia, Latin America, the Middle East, and Africa.

The bonds are quoted in the respective local currency, such as in Mexican peso, Brazilian real, Polish zloty, or South African rand. The foreign exchange risk associated with the investment is deliberately not hedged. The benefit for the euro investor is the fact that the coupon and interest rates tend to be much higher in those countries. The additional risk the investor assumes stems from the elevated price fluctuations that result from it.

Turbulent start ten years ago

Despite the fact that the fund was launched in the wake of the Lehman Brothers collapse (15 September 2008) and amid a great deal of uncertainty on the markets, from our point of view it was the next logical step to expand the line of products for emerging markets government bonds.

While back then we were among the first providers, the asset class has meanwhile established itself and has become a fixed component of many asset allocations.

The asset class continues to grow as new countries such as China, Serbia, and African countries are becoming investable

While the investment universe ten years ago consisted of 15 countries with an average interest rate sensitivity of 4.2%*), the fund management team nowadays has bonds from 19 countries with an average interest rate sensitivity of 5.1%*) at its disposal. The rising interest rate sensitivity is testament to the maturing of the existing investment spectrum and the ability of some countries to issue bonds at increasingly long maturities in local currency, which allows for the harmonisation of the project life that is being funded and the respective bond maturity. This is positive for the respective domestic banking sector and companies which base their financing in local currency on the yield curve with its wide range of maturities. The larger number of countries and the rising interest rate sensitivity bear witness to the rapid development of this asset class.

And the next countries are already around the corner, the biggest one being China. As third-largest local market worldwide – and by far biggest local emerging market – China would further boost the relevance of this asset class and thus the interest international investors show.

Other countries such as Egypt, Kazakhstan, Nigeria, and Serbia are also candidates.

Changes in financing structure

The fact that increasing volumes of the public budget are financed in local currency is a positive development from the investor’s point of view. In addition to the birth of a new asset class, “emerging markets bonds in local currency”, as top investment opportunity, the various countries benefit from a lower degree of dependence on US dollar finance.

The ratio of local currency debt to foreign currency debt is also an important indicator for evaluating the financial structure of the respective budget from an investor’s perspective.

Comparison of the market value of emerging markets bonds in local currency to emerging markets bonds in hard currency 2002-2018

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If the aggregate amount of debt is within a reasonable realm, which is the case in most emerging economies, this development has positive repercussions on bond spreads. It means that financing becomes cheaper for these countries.

Yield and currency determine the attractiveness of this asset class

The assessment of how attractive emerging markets bonds in local currency are is based on two factors:

1. **Yield** **)**:**

While even the absolute yield of almost 6.75% sounds attractive **), it always has to be put into the context of the risk-free return to see it for what it is.

For euro investors, we use the 10Y German government bond to this end and calculate the spread (i.e. yield differential). At the moment, this differential amounts to almost 625bps (i.e. 6.25 percentage points) – an attractive level even by historical standards.

Emerging markets bond yields and the spread on German government bonds (2008-2018)

Emerging markets bond yields and the spread on German government bonds (2008-2018)

Source: Bloomberg; data as of 15 October 2018; the key ratio "yield" is the average yield of the assets reflected by an index or held in a portfolio prior to fees resulting from the hedging of foreign currency risks; please bear in mind that the yield of an assets is not the same as its performance. It also does not take into account any fees diminishing return such as the management fee or individual account or depositary fees.

This is where the traditional euro bond investor (i.e. government bonds or corporate bonds) can wrap up their analysis, seeing as no foreign exchange risk is involved.

In case of emerging markets local currency bonds and ERSTE BOND LOCAL EMERGING, the attractiveness of the second component – i.e. the currency – also has to be taken into consideration. It can be regarded as opportunity as well, i.e. not only as risk.

2. **Currency:**

A typical indicator for local currencies are real effective exchange rates. They do not only reflect changes in market prices, but also in the relative price level. Therefore, they are used as long-term indicator for the competitiveness of a country.

On the basis of this indicator, we do not see any form of overvaluation of emerging markets local currencies at the moment.

Real effective exchange rates of selected countries 1994 - 2018

Real effective exchange rates of selected countries 1994 – 2018

It is important to point out that the currency component introduces a high level of volatility into a portfolio. To the traditional bond investor, this is a new experience and it worries some of them, seeing as it leads to an increase in portfolio volatility.

The currency volatility can also be seen as opportunity, given that short- and medium-term investment opportunities can be seized by active management, even if the overall investment strategy of the fund focuses on long-term gains in net asset value.

Conclusion:

In the long run, an investor benefits from the higher yield level of these bonds. The price the investor pays for the higher yield is the increase in risk, which is particularly influenced by the sometimes strong fluctuations. At the moment, the yields of these bonds are attractive for investors who are prepared to assume risk, especially by comparison with German or Austrian government bonds.

Interesting for investors:

Investment funds with higher levels of volatility such as this one are suitable for savings plans. By investing constant amounts at regular intervals, the investor can achieve a lower average purchase price than for a one-off purchase. For more information, please visit: s Fonds Plan.

*) Modified Duration = interest sensitivity of a bond; it specifies the change as percentage of the price in the event of an absolute change in yields of 1 percentage point; calculated on the basis of a global emerging markets bond index (JP Morgan).

**)The key ratio "yield" is the average yield of the assets reflected by an index or held in a portfolio prior to fees resulting from the hedging of foreign currency risks; please bear in mind that the yield of an assets is not the same as its performance. It also does not take into account any fees diminishing return such as the management fee or individual account or depositary fees; data as of 15 October 2018; source: Bloomberg

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