RBC BlueBay Asset Management

EM local currency debt

The case for broadening the investment universe

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The recent resurgence of interest in emerging markets ("EM") local currency markets presents a conundrum for investors – the universe offers diversification, strong pockets of liquidity and compelling alpha opportunities. So, why has it been so difficult to deliver positive performance on a consistent basis in the asset class? Should investors stay away for fear of getting burned again?

We argue that the traditional 'beta' measures for evaluating the asset class are misleading and, in fact, when viewing the opportunity set through a wider lens, the prospect of generating attractive returns with a lower volatility profile is much higher than conventional wisdom might suggest. Indeed, this would even have been the case in the last 10 years, despite it being a period of a strong USD and volatile returns amongst local currency portfolios.

Viewing the market through today's lens

The EM local currency market is a vast, rapidly growing universe. The asset class in its broadest form covers over 80% of the global EM debt universe, with local capital markets in varying stages of development. The range includes countries that are more mature, with a full scope of liquid cash and derivative instruments, to markets that are considered 'frontier', embarking on a long and difficult process of opening up their capital accounts and deepening their local markets to attract foreign capital. Opportunities for diversification are vast, with a multitude of sovereign and corporate issuers, inflation-linked and nominal debt, free floating to managed or pegged currencies.

Despite the breadth of the opportunity set, the most commonly used index – the JPM GBI-EM Global Diversified index – reflects only a very specific subset of the universe, limited to only the larger, more liquid markets. The price for limiting the benchmark to this subset, however, is that it has become a very concentrated and highly volatile point of reference for the market. Indeed, this detracts from the very specific diversification benefits which draw investors to this asset class in the first place.

As a result, many investors worry about the performance prospects and volatility of this asset class, given the benchmark reference point has historically shown a very low Sharpe ratio. We would argue that this fear is misplaced, and that the volatility in the market and in performance are actually a reflection of the beta represented by the benchmark, rather than the true investment opportunity.

For this reason, we believe there is a strong case for broadening the investment universe – this would allow investors to capture the true diversification benefits offered by the asset class, by selecting from the full range of markets and instruments to create a portfolio containing the best risk-adjusted return opportunities. Broadening the scope would also pave the way for more effective strategies to mitigate risk at different points of the investment cycle. Our analysis shows that this approach offers a superior way to extract value from the universe and provide better investment opportunities to our clients. To this end we would advocate retaining the mainstream index as a reference point but allowing more flexibility through running a higher tracking error and effectively taking a total return approach to investing in the EM local asset class.

The case for broadening the investment universe in EM local currency debt

Over the last decade, the EM local currency universe has seen significant growth (Figure 1a), and we have witnessed a number of EM sovereigns develop their domestic capital markets, a move which has generally provided easier access to foreign capital. This, in turn, has helped create a domestic yield curve that can serve as a benchmark against which domestic corporates and quasi-sovereign issuers can issue debt in local currency-denominated instruments.

This development, however, has not led to the broadening and further diversification of the local currency indices that international investors have tended to reference as a benchmark for their EM local investments. Indeed, although the local currency universe has surpassed USD23 trillion equivalent in assets, the mainstream JPM GBI-EM local sovereign index and the ICE local non-sovereign index each still only capture and account for ~USD4 trillion equivalent, under 20% of the actual universe. This represents only 20-25 countries out of more than 75, and 20 currencies out of closer to 40 investable currencies, not to mention bypassing key market instruments (Figure 1b). These are material considerations when evaluating the beta of the asset class; using a narrow definition can be misleading in terms of capturing the true opportunity and understanding the behaviour of the asset class.

Figure 1a: Significant growth of total debt stock over the past few years

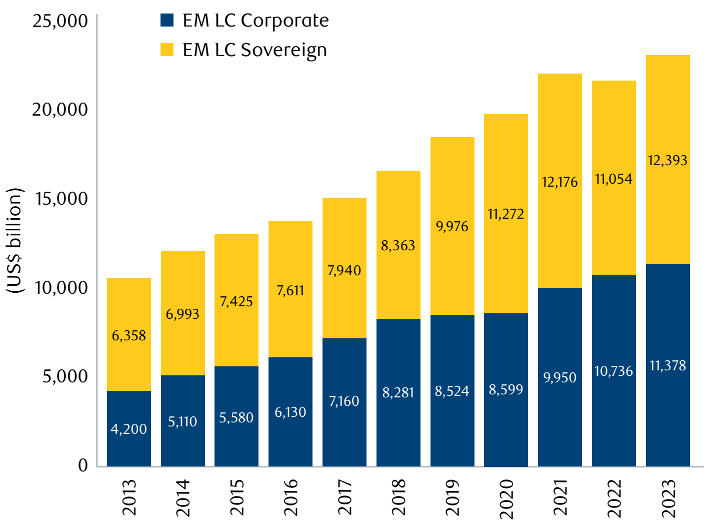


Figure 1b: EM local currency universe

- EM local currency universe is close to USD24 trillion in size.
- The JPM GBI Index captures approximately 10% of this universe – with only 6 currencies making up 50% of the index risk, this drives a significant component of the market beta.

GBI-EM Global/Diversified	
Market cap. GBI-EM Global	US$3.7 trillion
Number of Issuers	20
Number of Instruments	308
Number of Countries	20

Source: JPMorgan, RBC GAM, as at 31 December 2023.

Development of additional segments of the EM local market

Looking beyond the vanilla fixed rate, nominal sovereign bond universe, we would highlight developments in the broader local currency universe that offer significant diversification potential; in a world where volatility is high, diversity is king. The aforementioned ICE local non-sovereign index – which contains only the euroclearable component of the local currency corporate bond market – has seen significant growth and diversification over the last decade (Figure 2).

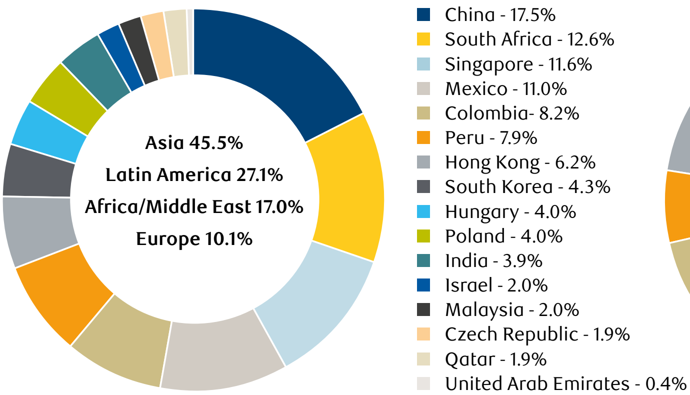
> **"In a world where volatility is high, diversity is king."**

The index was launched in 2014 with a market value of USD150 billion equivalent and now captures closer to USD600 billion equivalent in market value. With a greater weighting to Asian issuers and currencies – and thus greater exposure to more managed currencies – this index has shown a far superior Sharpe ratio to the mainstream GBI-EM index. This index also offers far stronger duration protection (only ~3years in duration), and yield buffers compared to the traditional sovereign universe (~180bps spread to underlying sovereigns). This premium is notable, given this is an investment grade-rated asset class on the index level.

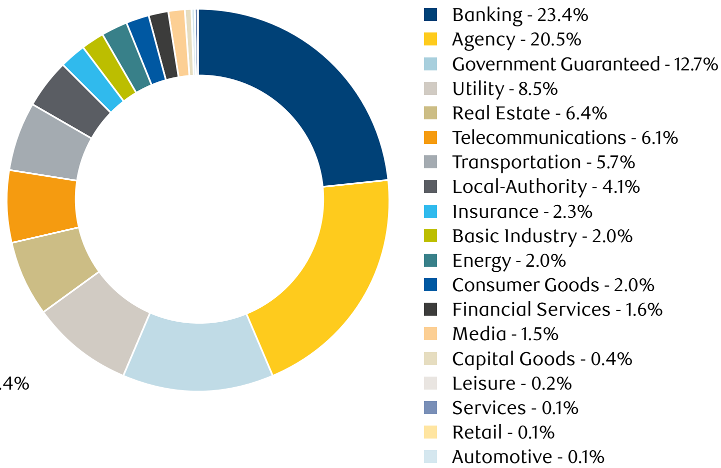
Figure 2: Index/asset class characteristics

USD600bn+ opportunity set	138 companies	8.55% average yield	3.11yrs duration
19 sectors	16 countries	BBB2 rating	~60% Investment grade

Regional split



Industry split



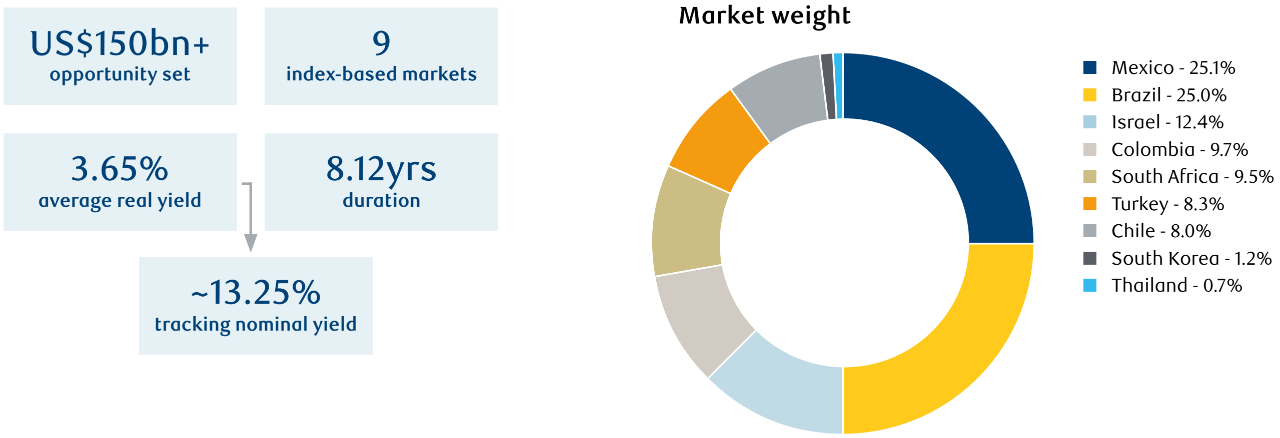
Source: Bloomberg, BofA, as at 31 December 2023. Please note that the Investment Grade figure is based on internal estimates.

Accessing a range of instruments

Another interesting asset base within the local currency space is the inflation-linked and floating rate bond universe, which offers excellent diversification tools in a high inflationary and rising interest rate world. This is particularly relevant, given the inherent risks that fixed rate nominal bonds are subject to and the pass-through to inflation from the currency risk component of the asset class. Figure 3 shows the index characteristics of the local currency inflation-linked bond universe.

The benefits of inflation-linked protection are clear, with the Bloomberg EM inflation-linked index having generated outperformance of 17.5% relative to the local GBI-EM fixed rate index from January 2022 to December 2023 (Figure 4). Not surprisingly (given the aggressive rise in inflation) this index also generated a positive absolute return in the calendar year of 2022 (+3.78%) whilst most asset classes from traditional fixed income through to equity markets lost between 10-20% in 2022.

Figure 3: Index characteristics and market weight

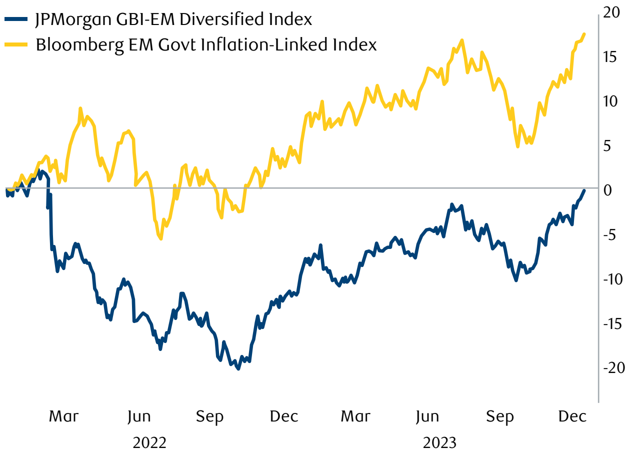


Source: Bloomberg, as at 31 December 2023. Please note that 'tracking nominal yield' is based on internal estimates.

We should note that due to the inflation challenges that many of these EM have faced over the years, a number of these countries already have deep inflation-linked bond markets. Indeed, some countries have been issuing inflation-linked debt far longer than they have been issuing fixed rate nominal bonds. These bonds – and therefore this index – are generally very long duration in nature, particularly as buyers in this space tend to be predominantly domestic pension funds and insurers.

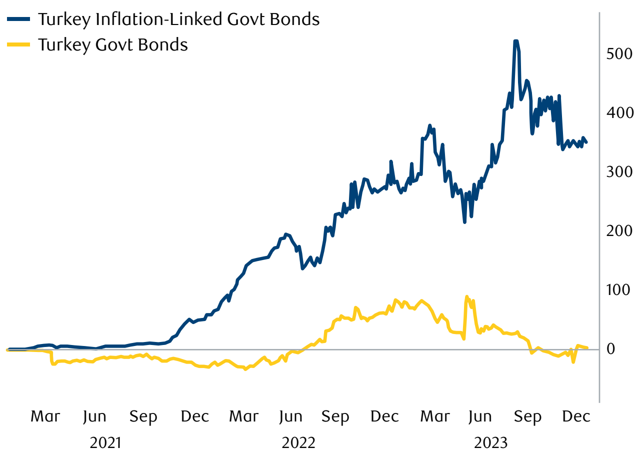
This diversification benefit is even more obvious when focusing on individual markets, Turkey being a good recent example. Here, inflation-linked assets have been an excellent investment during the recent period of extreme policy unorthodoxy, having generated annualised 65% total TRY returns over three years (Figure 5). With Turkish lira hedging costs averaging between 30-40% during this period, Turkish inflation-linked bonds generated outsized hedged returns in USD terms.

Figure 4: Bloomberg EM inflation-linked index relative to local GBI-EM fixed rate index



Source: Bloomberg, RBC GAM, as at 31 December 2023.

Figure 5: Returns of Turkish inflation-linked assets



Source: Bloomberg, RBC GAM, as at 31 December 2023.

Geographical diversification

The growth of the perceived 'frontier' local markets (Figure 6) offers further interesting diversification characteristics to the traditional EM liquid sovereign bond markets, having delivered very steady, volatility-adjusted returns in the first three years, following the inception of the FTSE index data in 2018. During the past one and a half years, the high global inflation and tightening liquidity conditions have put pressure on countries with elevated funding needs and managed currencies. Nevertheless, this is a component of the market which, with careful selection, can offer strong alpha return opportunities when the domestic idiosyncratic stories are positive and the macro market environment is relatively stable.

> **"During the past one and a half years, the high inflation and tightening global liquidity conditions have put pressure on countries with elevated funding needs and managed currencies."**

This sector of the market should continue to grow, with more EM countries looking to deepen their own domestic capital markets. Their objective is to reduce reliance on funding internationally through hard currencies and avoid unwanted FX exposure and risks to their own debt sustainability.

Figure 6: Index characteristics and market weight

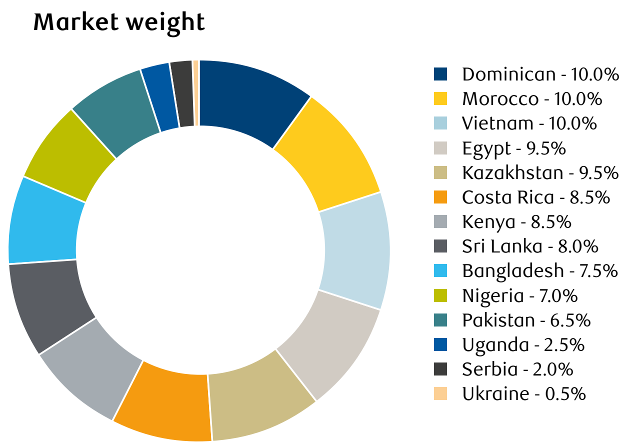
USD250bn+
opportunity set

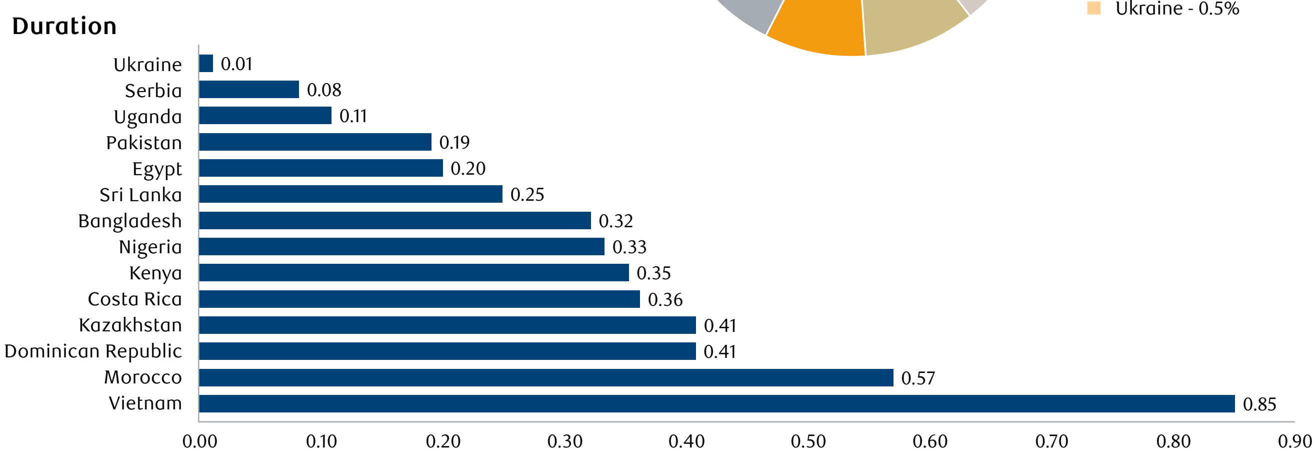
14+
additional markets

12.20%
average yield

4.45yrs
duration

BB-
rating





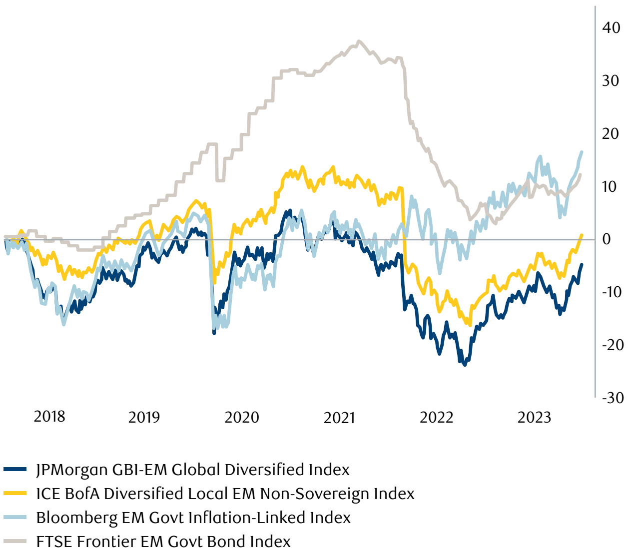
Source: FTSE, as at 31 October 2023.

Portfolio benefits of broadening exposure

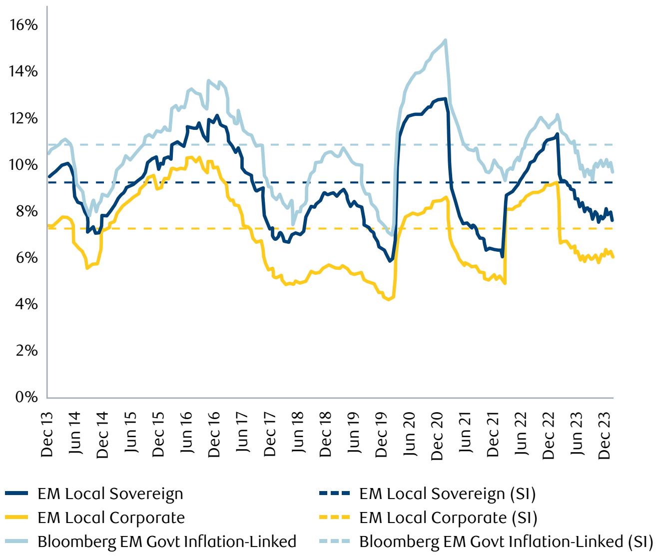
Looking across the four subcomponents of the entire EM local currency universe, we find an asset class filled with inherent diversification and natural cyclical opportunities, depending on the macro market environment. Historically, these markets have each offered different return profiles and underlying volatility at an index level (Figure 7) and within themselves (Figure 8).

Figure 7: Return and volatility profiles

Return: 2018 – 2023



Volatility: 2013 – 2023



Returns in GBI-EM are gross of tax, with ~35bps per annum tax implications, whereas LOCL has no such tax implications (all Euroclearable).

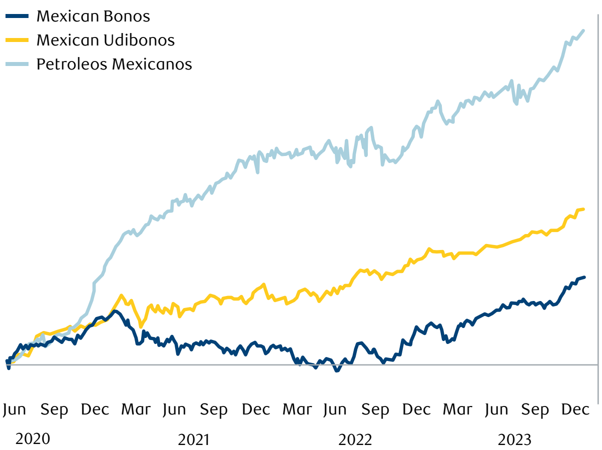
Source: Bloomberg, RBC GAM, as at 31 December 2023.

The benefits of diversification are derived not just through the asset channel, but also very specifically through a more diversified FX portfolio. The reality of the widely-tracked GBI-EM local sovereign index is that six countries have a maximum 10% capped weighting on an index level. As a result, these six currencies are driving 60% of the FX beta returns of the asset class, as represented by the index.

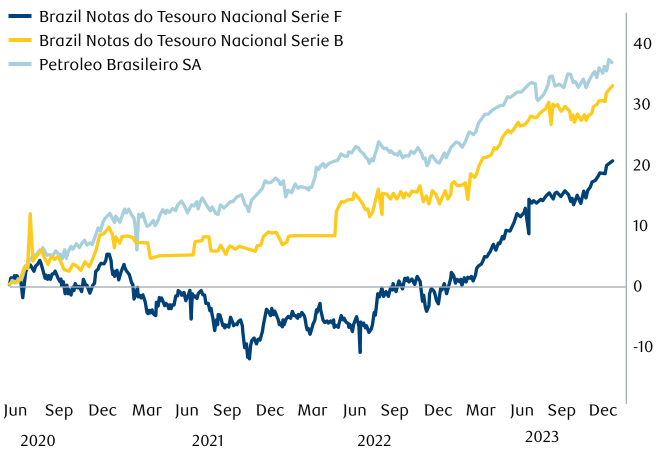
With broadly 35-40 investable currencies across the EM universe, the concentrated nature of the index's FX beta returns presents a far more volatile picture than the full universe would suggest, primarily because of its focus on the bigger FX markets where underlying currencies are far more volatile.

Figure 8: Mexico and Brazil – sovereign nominal and inflation bonds

Mexico: sovereign nominal and inflation bonds versus Pemex



Brazil: sovereign nominal and inflation bonds versus Petrobras



Source: Bloomberg, RBC GAM, as at 31 December 2023.

As an alternative approach, we show in Figure 9 what the total returns (spot and FX carry) of an equally weighted FX only portfolio across the *entire* investable universe would have been over the last 12 years and compare this to the total returns of a GBI-EM focused FX portfolio. We can see that during the down years, the diversified portfolio consistently outperformed the GBI-EM FX index by an average 4.69%. The diversified portfolio still captured the upside during the positive years, underperforming the GBI-EM by only 0.67% on average. Interestingly, the portfolio would have generated positive absolute performance over this period, an especially remarkable outcome, given that it would have occurred during a decade of a very strong USD bull run. This brings us to the current market, where the USD is – by most methodologies – between 5-15% overvalued (Figure 10).

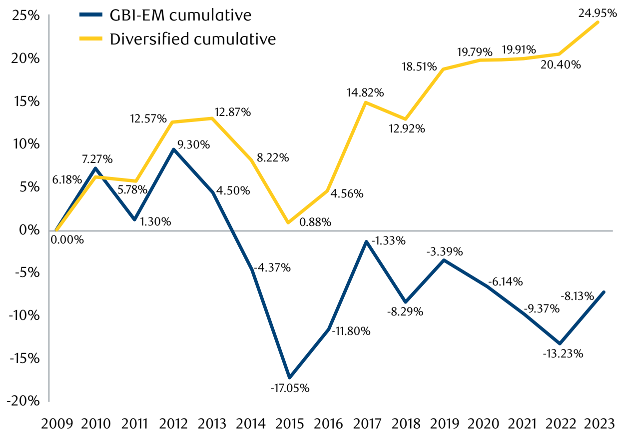
> "Strong understanding of the macro dynamics, combined with robust bottom-up credit analysis, can allow for an improved return profile with lower volatility throughout the cycle."

Investors can reap the benefits of local markets

Although many would like to capitalise on the local EM investment opportunity, investors today are forced to choose between several imperfect beta category options when selecting the benchmark that they will reference. Our observation is that the limitations of these beta categories can often hinder their ability to generate positive returns throughout the cycle. We argue that despite the absence of a benchmark that captures the broader opportunity set, portfolio managers would benefit from seeking investment opportunities across the universe, extending beyond the constraints of their chosen benchmark.

To this end, extending exposure to the full set of countries, the higher-grade corporate sector, or other inflation-linked or floating rate instruments will allow managers to build portfolios that avoid the pitfalls associated with overly concentrated exposures. Indeed, portfolio construction that allows for a higher tracking error in a benchmarked portfolio, or effectively taking a total return approach to asset selection, should allow investors to take advantage of precisely the benefits that draw them to the local currency asset class without compromising their other portfolio objectives. Instead, strong understanding of the macro dynamics, combined with robust bottom-up credit analysis, can allow for an improved return profile with lower volatility throughout the cycle.

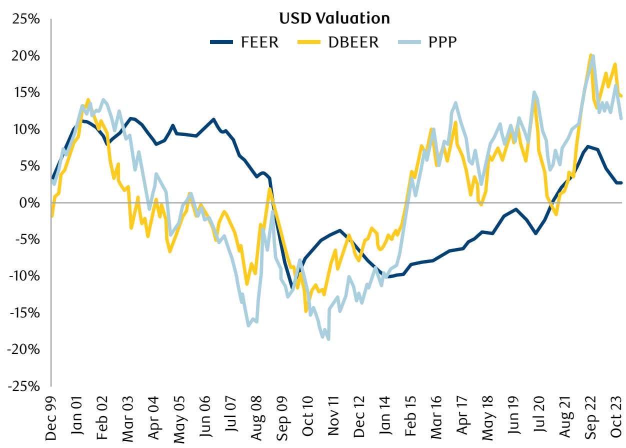
Figure 9: Diversified FX portfolio versus GBI-EM index



	GBI-EM	GBI-EM cumulative	Diversified	Diversified cumulative
2009	0.00%	0.00%	0.00%	0.00%
2010	7.27%	7.27%	6.18%	6.18%
2011	-5.97%	1.30%	-0.40%	5.78%
2012	8.00%	9.30%	6.79%	12.57%
2013	-4.80%	4.50%	0.30%	12.87%
2014	-8.87%	-4.37%	-4.65%	8.22%
2015	-12.68%	-17.05%	-7.34%	0.88%
2016	5.25%	-11.80%	3.68%	4.56%
2017	10.47%	-1.33%	10.26%	14.82%
2018	-6.96%	-8.29%	-1.90%	12.92%
2019	4.90%	-3.39%	5.59%	18.51%
2020	-2.75%	-6.14%	1.28%	19.79%
2021	-3.23%	-9.37%	0.12%	19.91%
2022	-3.86%	-13.23%	0.49%	20.40%
2023	5.10%	-8.13%	4.55%	24.95%

GBI total return	-8.13%
Diversified total return	24.95%
Beta outperformance	33.08%
Annualised beta outperformance	2.36%
Down years outperforming	8/8 100%
Up years outperforming	1/6 17%
Average beta outperformance in down years	4.69%
Average beta outperformance in up years	-0.67%

Figure 10: The USD is – by most methodologies – between 5-15% overvalued



Source: RBC GAM, as at 31 December 2023.

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