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The Shifting Dynamics in Emerging Markets Local Currency Investing

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- Investors have largely shunned investing in Emerging Markets Local Currency (EMLC) debt in the past years, but the sector's dynamics have recently shifted in a more constructive direction.
- In this paper, we examine how FX has affected EMLC returns over the past several years and factors to consider in hedging decisions.
- Correlations between FX and local rates declined over the course of three phases, and we believe they will likely remain near these lower levels going forward.
- The return profile of the asset class is more balanced between currency and term premium, and it offers investors a diverse opportunity set ranging from long-duration, high-quality bonds to shorter tenor, high-yielding assets with attractive carry and roll-down characteristics.

The historic lows in government bond yields is one of the more visible hallmarks of synchronized global easing in monetary policies over the past two years. As central banks grappled with the fallout from the Covid-19 pandemic, several turned to unconventional policies as well. The combination of the lower policy rates and changes in central banks' reaction functions created a paradigm shift for alpha generation in EM local currency (EMLC) debt.

On paper, EMLC is an enticing asset class in today's reach for yield environment. It consists of relatively high-yielding assets, offers long-duration bonds in several high-quality countries, and presents geographic diversity across the quality spectrum. Yet, flows into the asset class have lagged those of other fixed income assets—some with similar or even less attractive attributes—in the past decade. So why have some investors, particularly those seeking yield and duration, such as pension funds and other liability-driven buyers, seemingly ignored the sector?

We believe the biggest reason is due to EMLC's historically unbalanced return profile. Gaining exposure to EM currencies (EMFX) with high interest-rate differentials to DM currencies is one of the primary reasons to invest in EMLC. Yet, since 2013's Taper Tantrum, the performance of EMFX consistently lagged the performance of the U.S. dollar, and the uninspiring returns came with high realized volatility. And given the high level of correlation between EMFX and rates, currencies became the predominant source of risk when investing in EMLC. Extending duration amid relatively flat yield curves could not offset the FX risk. For example, the yield differential between 5-year and 10-year bonds in most countries was around 25-50 bps in 2013-2019 with FX volatility ranging from 10-15%.

The breakdown of EMLC returns in Figure 1 provides several points of context regarding the sector's performance since 2003.

1. Of the eight years where EMFX returns were negative, seven saw negative returns on the overall benchmark EMLC index, as carry and price gains were unable to offset the EMFX depreciation against the dollar.[1] This pattern has existed since index inception in the early 2000s with 2005 being the sole exception.
2. The magnitude of drawdowns in years of FX depreciation exceeded the magnitude of gains in years of FX appreciation.
3. EMFX has experienced low risk-adjusted returns, dragging the overall risk-adjusted returns of EMLC lower as well.
4. Carry contributed more to the total return than price appreciation; therefore, the yield in the sector remains a key driver of overall returns, which is the case for most fixed income assets.
5. The correlation between EMFX and yields has mostly been positive; in years when EMFX depreciated, bond yields tended to rise and significantly so in periods when the currencies depreciated by more than 5%. However, this correlation has not always held, e.g. in 2020, 2014, 2011, 2008, and 2005.

Given the high level of correlation between EMFX and rates, currencies became the predominant source of risk when investing in EMLC.

Figure 1: EMLC Annual Return Breakdown

	Beg. Of Year Index Yield	Returns			
		Index (USD)	FX	Price	Carry
2020	5.22	-6.32%	-11.16%	1.33%	4.11%
2019	6.46	13.47%	1.00%	6.04%	6.06%
2018	6.14	-6.21%	-9.10%	-2.95%	6.20%
2017	6.79	15.21%	5.78%	2.63%	6.17%
2016	7.13	9.94%	0.54%	3.03%	6.19%
2015	6.50	-14.92%	-17.62%	-3.04%	6.43%
2014	6.85	-5.72%	-12.84%	1.65%	6.44%
2013	5.45	-8.98%	-8.72%	-6.33%	6.31%
2012	6.57	16.76%	2.68%	7.02%	6.39%
2011	6.69	-1.75%	-9.39%	1.80%	6.54%
2010	7.30	15.68%	3.82%	4.27%	6.95%
2009	7.45	21.98%	10.59%	2.93%	7.25%
2008	7.56	-5.22%	-14.48%	3.35%	7.32%
2007	6.72	18.11%	10.72%	-0.03%	6.67%
2006	6.68	15.22%	6.22%	2.00%	6.38%
2005	6.86	6.27%	-4.35%	4.53%	6.38%
2004	6.88	22.97%	10.03%	4.64%	6.91%
2003	6.04	16.92%	9.09%	-0.39%	7.57%

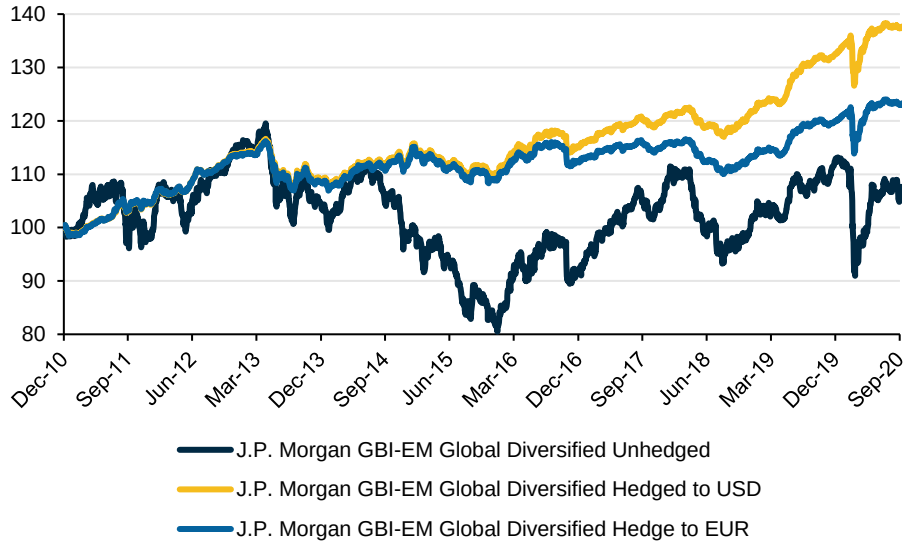
Source: J.P. Morgan and Bloomberg as of 9/30/2020

1 The EMLC index referenced throughout the paper refers to the J.P. Morgan GBI-EM Global Diversified Index.

Hedging FX Risk

The influence of currencies on EMLC returns raises the question of the performance when the currency risk is hedged. Figure 2 shows that hedging currency risk in dollars and euros historically reduced return volatility and led to a higher total return from 2011 to 2020.

Figure 2: The Effect of Hedging EMLC in Dollars and Euros (12/31/2010=100)



Source: Bloomberg as of September 30, 2020

Unhedged exposure provides the potential for additional returns in a world where we believe the Federal Reserve is implicitly pursuing a weaker U.S. dollar policy via their new flexible inflation targeting framework.

So why are EM local currency mandates typically unhedged, despite the higher information ratio of hedged local bonds? Simply put, it is because the cost of hedging has been too high. Furthermore, FX supports the carry opportunities across the EMLC sector.

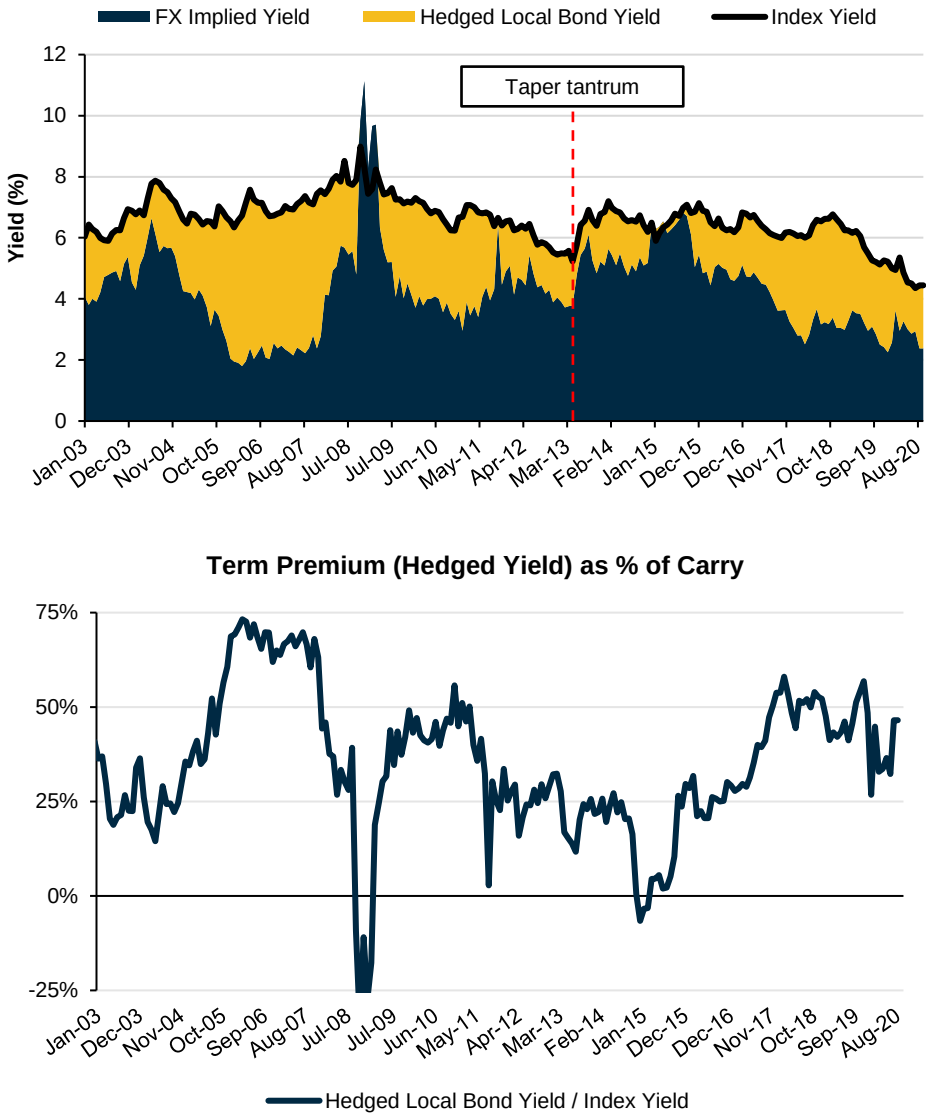
Figure 3 shows the yield on the benchmark index, which represents the carry in EMLC, broken into FX and hedged bond yield components. The five years after Taper Tantrum were unusual given that the vast majority of carry was from FX instead of yields, and hedging (or selling) EMFX for any significant period would have generated large negative carry due to the high interest-rate differentials between EM and DM. For example, in June 2013, the nominal yield on the index was 6.4% with FX contributing 5.4 percentage points and term premium (represented by hedged bond yields) only contributing 1.0 percentage point.

If we think about spot FX as the front end of an emerging market country's local bond curve, we conclude that, for most of the previous decade, FX positioning was the driving factor behind alpha generation in EMLC. FX yields were relatively high, and the yield pickup from extending duration into longer bonds was relatively low, or even negative in certain periods. Hedging was always a secondary consideration, as the relatively high carry of EMFX provided one of the main attractions for the asset class.

Since mid-2018, the return profile has become more balanced as approximately 50% of the index yield has come from currency exposure and 50% has come from term premium (bottom panel of Figure 3). A balanced return profile enhances the flexibility of portfolio construction considering the benefits of treating currency and duration decisions independently, which provides investors with attractive optionality from two distinct perspectives: 1) hedged exposure now provides attractive yields relative to other global fixed income sectors; and 2) if currency exposure is preferred, unhedged exposure provides the potential for additional

returns in a world where we believe the Federal Reserve is implicitly pursuing a weaker U.S. dollar policy via their new flexible inflation targeting framework.

Figure 3: Composition of EMLC Yield and Contribution of Term Premium and FX to Index Yield



Countries can quickly migrate between high to low correlations very quickly as monetary and fiscal decision frameworks change.

Source: PGIM Fixed Income, J.P. Morgan, Bloomberg. As of September 30, 2020.

Pre- and Post-Covid Correlations Between FX and Rates

While cost of hedging FX risk has fallen dramatically, the decline itself alone is insufficient to dictate a decision on whether to hedge FX risk. The correlation between FX and rates also plays a significant role. Although FX and local rates are positively correlated, the relationship is dynamic—correlations tend to spike during sharp market selloffs and revert to more benign levels during less-volatile periods. Furthermore, the correlation between FX and rates is different in each country, which reflects the diversity across the asset class.

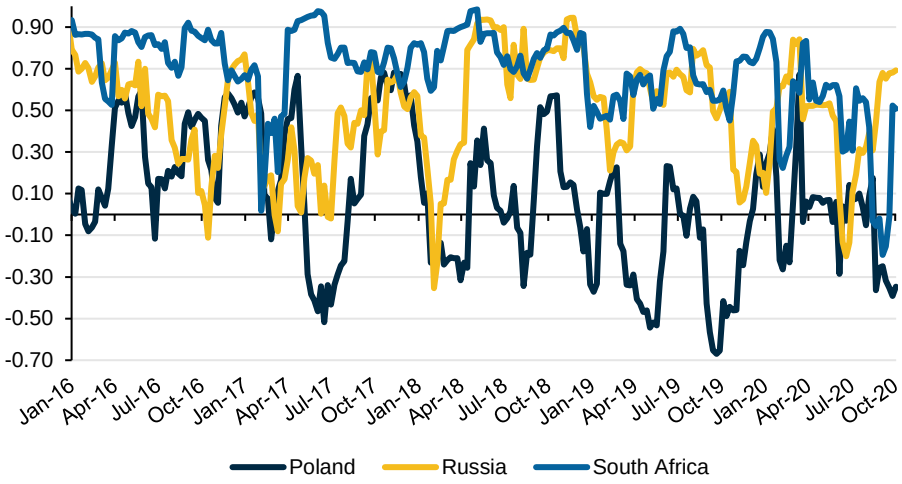
The benchmark index contains countries with credit ratings ranging from AA (e.g. Chile and Czech Republic) down to BB (e.g. Brazil, South Africa, and Turkey). Typically, lower-rated countries, such as South Africa, have greater vulnerabilities and reliance on external financing, leading to higher correlation between their FX and bond yields (see Figure 4). With

correlations up to 0.8 and FX comprising the majority of the total return on local bonds, asset managers historically viewed trades in South African rates and FX similarly, leading them to either invest in unhedged local bonds or in derivative markets.

Meanwhile, higher-quality countries, such as Poland, have near zero correlations between rates and currencies over the long-term. This allows asset managers to more easily separate FX and rate positioning decisions. That said, Figure 4 shows that these correlations change over time. Russia, for example, is traditionally viewed as a higher-yielding country, with the 2014 ruble selloff from geopolitical turmoil still fresh in many investors' minds. However, Russian assets were considered safe haven assets within EM for much of 2020, and FX/rate correlations in local Russian markets moved lower in mid-2020 before reverting as geopolitical tension resurfaced. These examples demonstrate that countries can quickly migrate between high to low correlations as monetary and fiscal decision frameworks change.

Figure 4: Trailing 12-week Correlation Between FX and Local Rates for Poland, Russia, and South Africa

Correlations in the post-Covid world have declined to the lowest levels in the past two years.



Source: PGIM Fixed Income and J.P. Morgan as of October 2, 2020.

Market conditions can also play a significant role in correlation levels across the sector. For example, correlations spiked in Q1 2020 when all risk assets sold off in response to the effects from the Covid pandemic. In the subsequent rally, correlations reversed, with many countries experiencing negative correlations between the performance of FX and local rates. As Figure 5 shows, correlations in the post-Covid world have declined to the lowest levels in the past two years. Correlations even turned negative in several low-yielding countries, such as Chile, Czech Republic, China, and Malaysia. In high-yielding countries, such as Turkey, Mexico, Indonesia, Russia, and South Africa, the performance of local rates and FX has diverged more than they have in the past.

Figure 5: Comparing Pre- and Post-Covid FX & Rate Correlation (trailing 12-weeks; Pre-Covid: 2016 through February 2020; post-Covid: March 2020 through September 2020**)**

	Brazil	Chile	China	Colombia	Czech	Hungary	Indo
Pre-Covid	0.55	0.09	-0.06	0.42	0.01	0.05	0.60
Post-Covid	0.39	-0.27	-0.56	0.46	-0.44	-0.07	0.36

	Malay	Mexico	Peru	Poland	Russia	South Africa	Thailand	Turkey
Pre-Covid	0.48	0.50	0.37	0.09	0.50	0.73	0.25	0.60
Post-Covid	-0.17	0.03	0.09	-0.10	0.38	0.27	0.02	0.58

Low Yielder
High Yielder

Source: PGIM Fixed Income. Figure 5 shows the correlation of J.P. Morgan GBI-EM Global Diversified country yields vs. spot FX rates of the respective countries, using weekly data thru 10/2/2020.

The bullish U.S. dollar cycle may be waning after more than a decade of relative strength.

Three Phases of Falling Correlations...But Will They Stay Low?

The correlations between EMFX and rates declined over the course of three phases since the onset of the Covid pandemic and the paradigm shift in central banking. Similar to DM central banks, the major disinflationary shock led EM central banks to cut rates aggressively and engage in unconventional monetary policies, which resulted in weaker FX and lower bond yields across the respective curves. The first phase occurred in late March to early April 2020 as EM central banks aggressively cut policy rates, and as a result, most EM bond curves bull-steepened and currencies depreciated. This reaction function was expected in high-quality names, such as Poland, Czech, and Chile, but even high-yielding countries, such as South Africa, Turkey, and Brazil, followed suit. In the second phase, which started once the Fed backstopped various asset markets in the U.S., EM central banks initiated a wave of unconventional policies that supported the back end of EMLC yield curves. EM currencies appreciated and curves bull flattened as a result. The sector is currently in its third phase of mixed performance against the U.S. dollar, and most EM curves are witnessing a mild bear steepening. For example, most 5- to 10-year bond curves are in the 75 bps range with FX volatility of less than 10%.

After FX and rate correlations hit historical lows in late June/July, correlations rose slightly in August. While we expect that the correlations have bottomed out, we also believe that a jump in levels is unlikely from here. With wide output gaps and below-target inflation, most EM and DM central banks will be reluctant to adjust their policy accommodation. Uncertainty around inflation is reflected in market pricing of forward rate curves, with most countries pricing in modest rate hikes over the next two to five years. While the term premia beyond five to 10 years is steep, this is a function of idiosyncratic country risks also being relatively high in comparison to the past few years.

Some the factors that could derail our expectations include a sharp surge in inflation that forces central banks to reverse monetary easing and hike rates aggressively; a steeply rising deficit-debt spiral that leads to major credit downgrades; or geopolitical tensions due to

renewed trade conflicts. However, we assign low probabilities to these factors under the current macro backdrop where DM central banks are on an extended hold, and the bullish U.S. dollar cycle may be waning after more than a decade of relative strength. Even if we are wrong on our low-correlation hypothesis, the low-implied yields in EMFX means that it is less costly to hedge currency risk, thus having a minimal impact on returns.

Concluding Thoughts

For years, investors have shunned EMLC. The prior critiques that "returns are too low" or "volatility is too high" has evolved into the critique that "yields are at historic lows." However, asset allocation decisions are often made on a relative, rather than an absolute, basis, and EMLC yields remain attractive relative to other fixed income sectors (see Figure 6).

Figure 6: Yield and Duration of EMLC in Comparison to Global Spread Sectors

Sector	Index	Yield to Worst	Duration	Yield/Duration
EM HC	EMBI Global	4.81	8.29	0.58
EM Corps	CEMBI Broad	4.06	5.02	0.81
EM LC	GBI-EM Global Div.	4.48	5.37	0.83
EM LC (40% China)	Barclays EM Local Currency	3.24	7.06	0.46
Global Credit BBB	Barclays Global Credit Baa	1.89	7.16	0.26
Global HY	Barclays Global HY	5.94	4.27	1.39
Global Fixed Income	Barclays Global Agg.	0.90	7.36	0.12
Global Credit	Barclays Global Credit	2.17	6.83	0.32

Source: PGIM Fixed Income, Bloomberg Barclays, and J.P. Morgan

Furthermore, the case for a weaker U.S. dollar has strengthened amid the Federal Reserve's new inflation regime and overvaluation in the currency. China's introduction into the J.P. Morgan GBI-EM index and other major fixed income indices, such as the Barclays Global Aggregate, has gradually improved the average credit quality of major EMLC indices, which bodes well for perception of the asset class across the broader fixed income investor base.

In addition, the return profile for EMLC has become more balanced between currency and term premium yields. And lower hedging costs enables more bifurcated currency and interest-rate decisions, leading to greater portfolio diversification. Therefore, actively managed local bond portfolios can take advantage of the shifting dynamics within the asset class and offer clients a diverse mix of high-quality long-duration bonds along with shorter-maturity, high-yielding assets with attractive carry and roll profiles. As a result, we expect flows into the sector to increase going forward as EMLC becomes a strategic piece of asset allocation decisions.

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Source(s) of data (unless otherwise noted): PGIM Fixed Income as of October 2020.

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