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Mondrian INVESTMENT PARTNERS

# Local Currency EMD Offers Excellent Value

## Summary

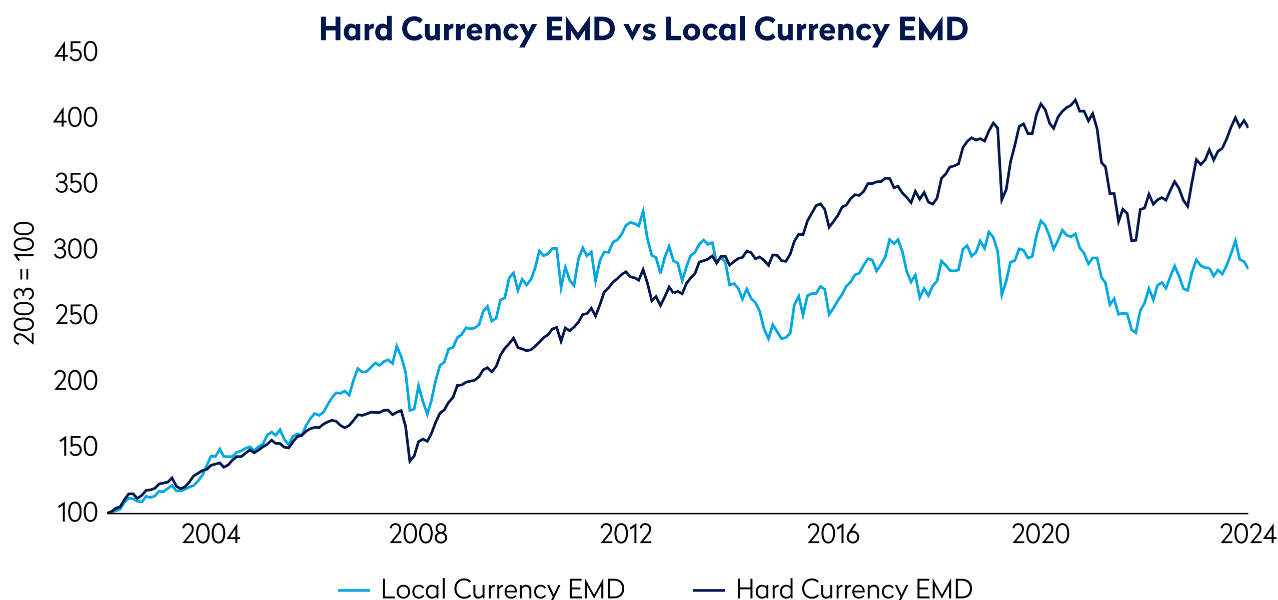

- Emerging Markets Debt (EMD) can broadly be categorized as either hard currency (mostly US dollar based) or local currency (based in the currency of the issuers).
- Over the last decade – one of US dollar strength - dollar-based investors have displayed a preference for Hard Currency EMD.
- However, valuations now suggest that Local Currency EMD is much more attractive.
- The reasons are threefold:
  1. Hard Currency EMD spreads have rarely been as tight, signaling poor value and a mispricing of risk.
  2. Select local currency bond Prospective Real Yields (PRYs) have hardly ever been as high, signaling good value.
  3. The US dollar is overvalued and local currency valuations are generally attractive.
- Moreover, as the opportunity set of local currency issuers has increased over time so has valuation dispersion leading to greater scope for alpha.
- An active allocation to the asset class is recommended and a disciplined, methodical, valuation-based approach has been demonstrated to provide consistent, stable alpha over time.


## The Case for Local Currency EMD

When investing in Emerging Markets Debt (EMD) the first thing one needs to decide is how to allocate between its two principal forms: Local Currency EMD and Hard Currency EMD. Local Currency EMD consists of EM bonds issued in EM currencies (the Mexican peso, Indian rupee etc.), while Hard Currency EMD consists of EM bonds issued in a developed market or hard currency (overwhelmingly the US dollar). These two forms of EMD have such distinct characteristics that they are often considered to be separate asset classes. Returns to local currency EMD are primarily driven by carry from local yields, principal returns due to yield curve shifts (driven in turn by changes in inflation expectations and creditworthiness) and currency returns. Hard Currency EMD, on the other hand, is essentially a credit product offering a yield premium (or spread) over US Treasuries in the case of US dollar denominated debt.

Over the past decade, US dollar-based investors have favored Hard Currency EMD. This is unsurprising, as we have been in a period of dollar strength. The sharp appreciation of the US dollar from 2013 to 2015, as Chart 1 below shows, weighed heavily on Local Currency EMD, scarring dollar-based investors in the asset class. Prior to this period, during the 2000s up to 2013, Local Currency EMD beat Hard Currency EMD handsomely but since then, while the asset class (as represented JP Morgan GBI-EM Global Diversified index) has returned an average of 5.0% per year in local currency terms, the strength of the US dollar has undone that for dollar based investors. Currency is an important component of total return and it is no wonder that the strong US dollar has put many US investors off.

Everything is cyclical though. The relative strength of US dollar denominated assets over the past decade now leaves valuations of hard currency debt highly stretched. International assets in general and Local Currency EMD in particular, on the other hand, look good value. Furthermore, while Hard Currency EMD ostensibly allows the investor to avoid currency risk altogether this is only partially true. While the investor is not immediately exposed to currency fluctuations, hard currency issuers themselves are exposed to currency risk which then becomes hidden in the credit spread and can take time to get passed through to returns. For instance, a sovereign that must service debt in US dollars but whose tax revenues are in local currency bears currency risk. If its currency declines, then that currency risk can be passed on to the end investor in the form of a wider credit spread or *in extremis* forcing the issuer into default - a situation that local currency issuers can avoid. As the dollar rises, Hard Currency EMD in general becomes higher risk.




Source: JP Morgan and Haver Analytics
Local Currency Benchmark: JP Morgan GBI-EM Global Diversified Index
Hard Currency: JP Morgan EMBI Global Diversified Index

Chart 1

## Local Currencies are Good Value

The US REER or Real Effective Exchange Rate (that is, its real exchange rate versus a basket of international currencies) provides a good indication of the US dollar's value. For over 50 years - since the end of the Bretton Woods fixed exchange rate regime in 1973 - its value has been highly cyclical. Chart 2 below shows the US dollar REER as calculated by the Bank for International Settlements (BIS). The BIS calculate a narrow form and broad form. The narrow form, against a basket of developed market peers, goes back to 1973; the broad form, against a wider array of trading partners, goes back to 1994 but it shows a similar picture as the narrow from then on. Both are around two standard deviations from their historic mean values. Of course, it is impossible to predict when the cycle might turn or what the catalyst would be, but the sustained upward draft of the US dollar for more than a decade has put it in a precarious situation. As the chart below shows, the US dollar has only been at such levels of overvaluation on two previous occasions – the mid-1980s and early 2000s. Both were followed by prolonged, multi-year declines.

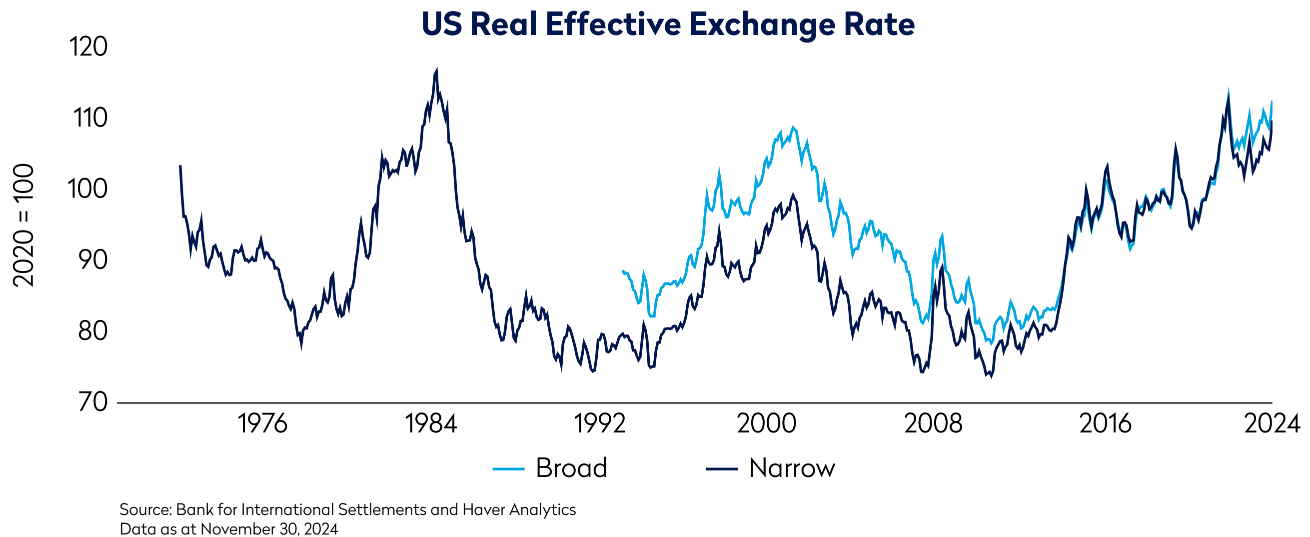



Chart 2

For dollar-based investors, Local currency EM debt would clearly benefit from a fall in the US dollar. This would provide not only additional return to the asset class but also an additional source of alpha as the best valuation currencies can be selected from those on offer. So, while taking currency exposure does create additional risk it provides the opportunity for significant additional return; at present it is a risk worth bearing.

## Hard Currency EMD is Poor Value

The undervaluation of EM currencies is not the only reason to prefer Local Currency EMD to Hard Currency EMD. The remarkable rise of US dollar assets of all stripes over the past several years has carried Hard Currency EMD with it. Hard Currency EMD spreads are close to historic lows for specific levels of risk. For instance, as shown in Chart 3 below, the credit spread for BB-rated Hard Currency EMD has only consistently been this low in the years before the global financial crisis of 2008. Also, as noted earlier, in an era of protracted dollar strength financing hard currency debt becomes more costly and risky for non-dollar issuers so, other things equal, one would expect spreads to be higher. In the years leading up to 2008, the US dollar had been declining and was undervalued. The picture is the same for credit spreads of BBB and single B rated issuers meaning that default risk is arguably being underpriced. In fact, several Hard Currency EMD issuers have already defaulted over the past few years and even more are in distress.

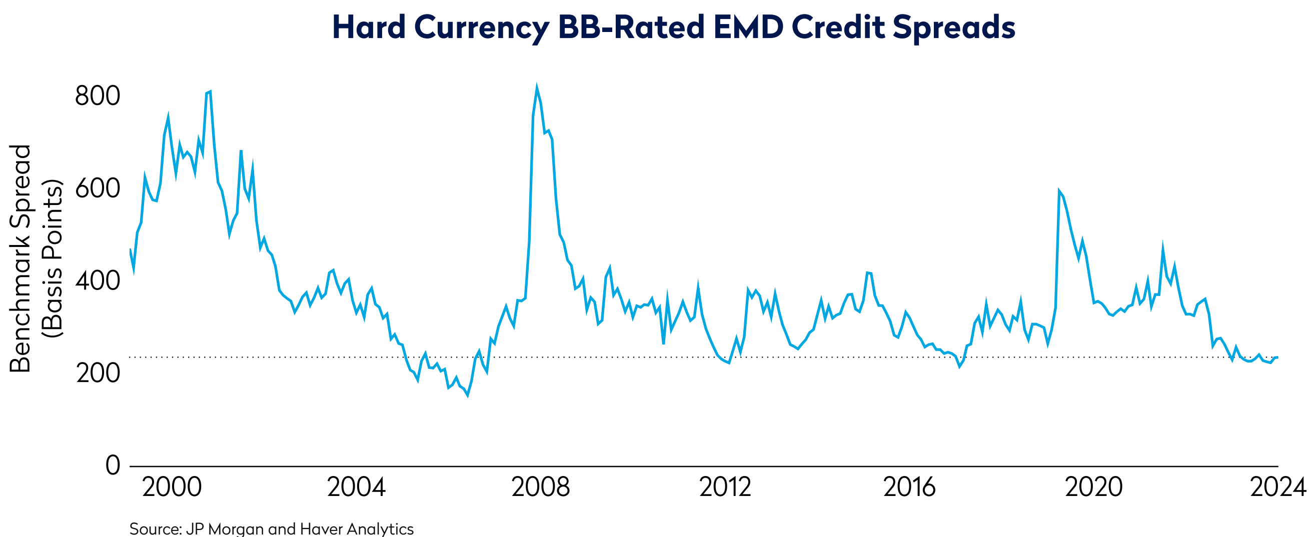



Chart 3

## Local Currency EMD Opportunities Abound

At the same time as generally poor valuations in Hard Currency EMD, bond valuations of many major Local Currency EMD markets have hardly ever provided better opportunities. We determine value among Local Currency EMD markets using a measure we call the Prospective Real Yield or PRY. The PRY is the nominal yield of a sovereign issuer's bonds minus our forecast for inflation and assessment of sovereign credit risk of that market. In other words, it measures how well we believe a bond market is compensating us for inflation and our judgement of sovereign credit risk. PRYs encapsulate a lot of detail – for instance the choice of nominal yield, how inflation is forecast and how sovereign credit risk is judged - but they allow for a disciplined approach to portfolio construction by allocating to markets that maximize overall value subject to a tracking error constraint.

It is difficult to draw conclusions about the value of an asset class as a whole by looking at benchmark averages. This is because the composition and characteristics of benchmarks can change over time. In the case of Local Currency EMD more markets have become investible, leading to a more diversified asset class. This is, in itself, a good thing but the addition of countries such as India and China to the benchmark also means that the dispersion of PRYs has widened over time which only adds to the argument for active management of Local Currency EMD – there is more opportunity to underweight low PRY and overweight high PRY countries in the benchmark.

To highlight the value opportunities in Local Currency EMD we focus on individual opportunities. Currently, two of the best value markets, according to our PRY measure, are Brazil and Mexico. The Brazilian PRY is in excess of 6.0%. This is a level only ever seen in the past in times of crisis and extreme market stress. But now it is a result of an independent central bank intent on maintaining its inflation target and raising rates ahead of peers in a country with record low unemployment.

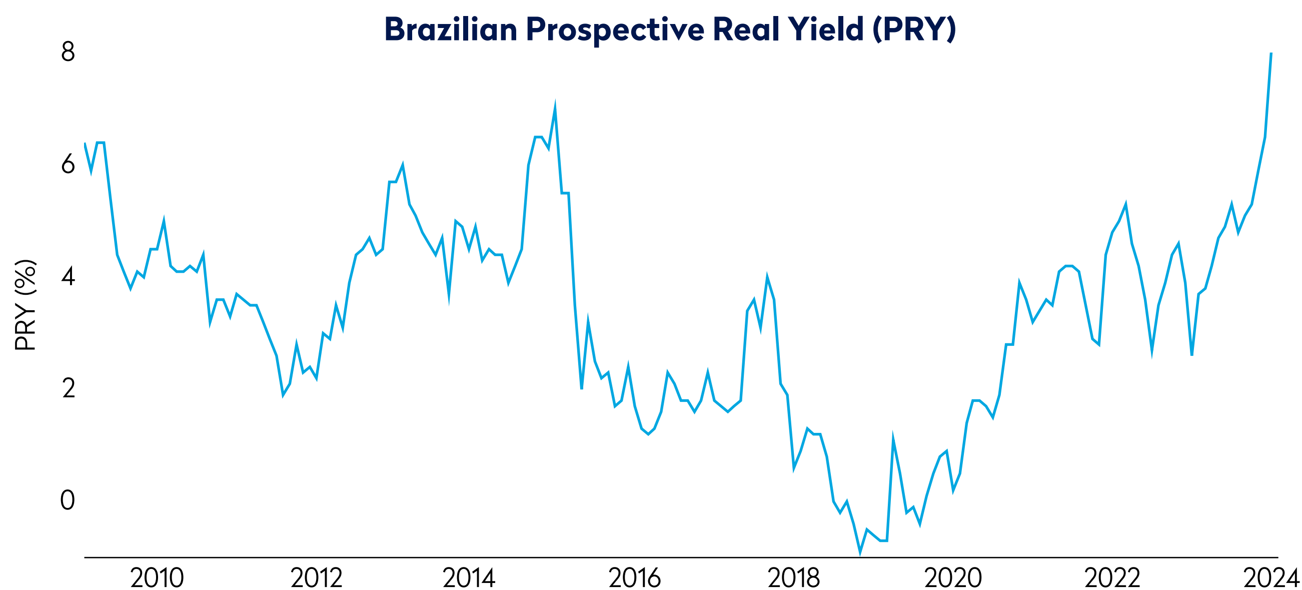
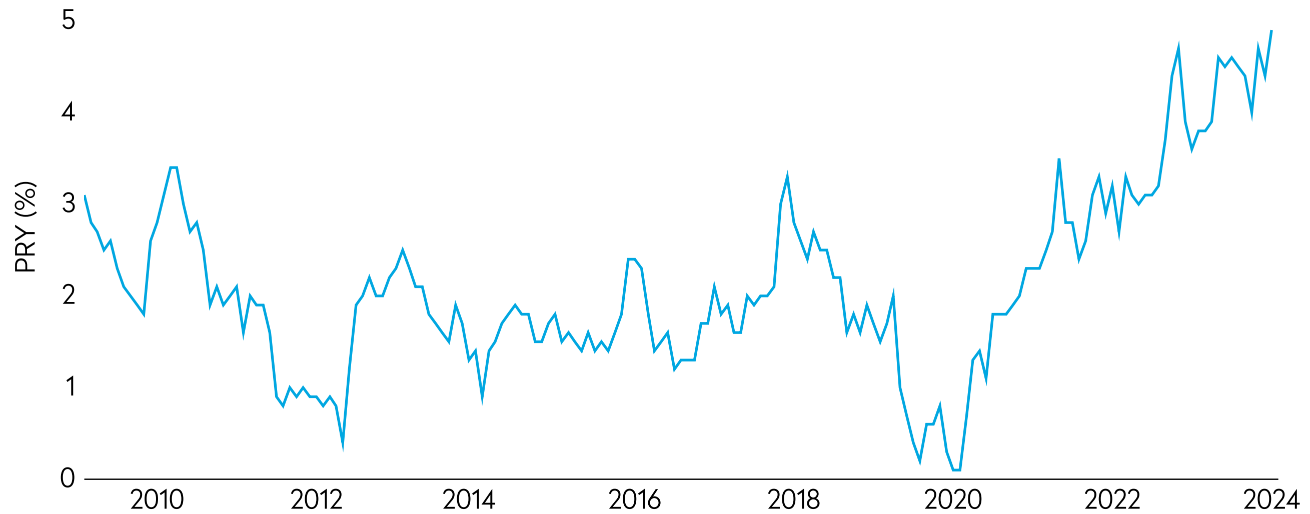



Chart 4

Likewise, the PRY of Mexico has never been higher than recent levels.

**Mexican Prospective Real Yield (PRY)**




Source: Mondrian Investment Partners

Chart 5

As well as having high PRYs, nominal yields are higher in most (not all) local currency markets than their hard currency equivalents. In order to find higher yielding issuers in Hard Currency EMD one has to plumb the depths of credit quality, exposing an allocation to the risk of default.

## Conclusion

The valuation differential between hard currency and Local Currency EMD is difficult to ignore. According to our valuation standards, Local Currency EMD benefits from high PRYs and attractive currency valuations while Hard Currency EMD is tainted by very low credit spreads and an overvalued US dollar.

This suggests that EMD allocations should be tilted in favor of local currency debt. We could be about to see a renaissance in Local Currency EMD for US dollar-based investors.

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