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ASSET MANAGEMENT

Emerging markets local currency-denominated debt is a relatively large and liquid asset class that represents some of the most creditworthy emerging market sovereigns, offers two distinct sources of return (currency and local bond yields), and provides the potential to generate equity-like returns without taking on direct equity risk. We expect the sizeable growth differentials between emerging market countries and the developed world to continue serving as a magnet for capital flows into emerging markets. These capital inflows should augment appreciation pressures on many emerging market currencies, especially in the context of a global economic recovery. Reflecting the persistently positive term premium of local yield curves, emerging market government bonds have provided a better way to get emerging market currency exposure than currency forwards. Bond managers, however, may selectively use currency forwards in those situations where the currency is attractive but not prospective duration returns.

EMERGING MARKETS LOCAL CURRENCY DEBT:

Capitalizing on Improved Sovereign Fundamentals

By
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Director of Emerging Market Strategies

STANDISH

A return to simplicity

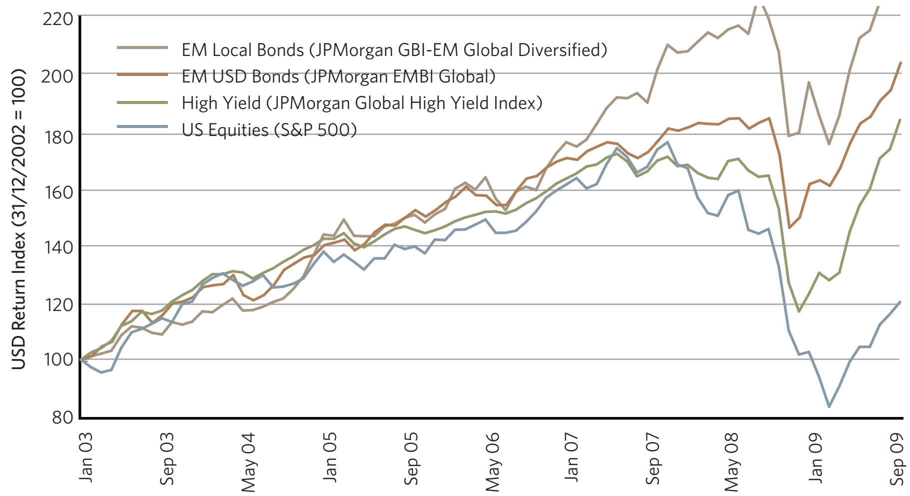
Survivors of a train crash invariably emerge dazed and confused, and so it is not surprising that investors may have been in that state after a financial markets crash that raised fears of a 1930s style depression. The debt markets have been at the centre of the maelstrom and the catalyst itself was the collapse of the asset backed securities market that had shrouded its shortcomings behind such a veil of complexity that the rating agencies and even some of the most sophisticated institutional investors managed to delude themselves on the risks. The reaction against such misleading complexity will be a much greater demand for simplicity in investment instruments with transparent drivers and risks that can be analysed in a straightforward manner. Portfolio managers will also be held more accountable for straying away from their original mandates, especially if out-of-the-benchmark forays are into assets with structurally different risk and liquidity characteristics. In short, investors will demand to "disentangle" portfolios and demand better clarification of the underlying exposures. This is especially true of fixed income portfolios that can encompass instruments and asset classes spanning the entire risk/return spectrum and that can also vary dramatically in liquidity and complexity.

Emerging market debt (EMD) consists predominantly of simple and liquid sovereign bonds that offer the potential of relatively high returns and at least some diversification benefits, especially for portfolios already exposed to G3 equity and corporate credit risks. Importantly, EMD itself now consists of two asset classes – local currency-denominated bonds and the more traditional

USD-denominated debt – each containing distinct risk exposures and thus offering distinct sources of return. Investors will be better served by making explicit recognition of local currency bonds as a separate asset class and awarding mandates to managers on that basis – as a result of their own view on how local currency bonds fit in their strategic asset allocation. There is little evidence to suggest that EMD managers can add alpha through tactically switching between the two asset classes within a portfolio (otherwise the "blended" funds would have been at the top of the EMD universe). Moreover, mixing the two asset classes introduces an added and unnecessary layer of randomness that can not be easily modelled in an asset allocation study.

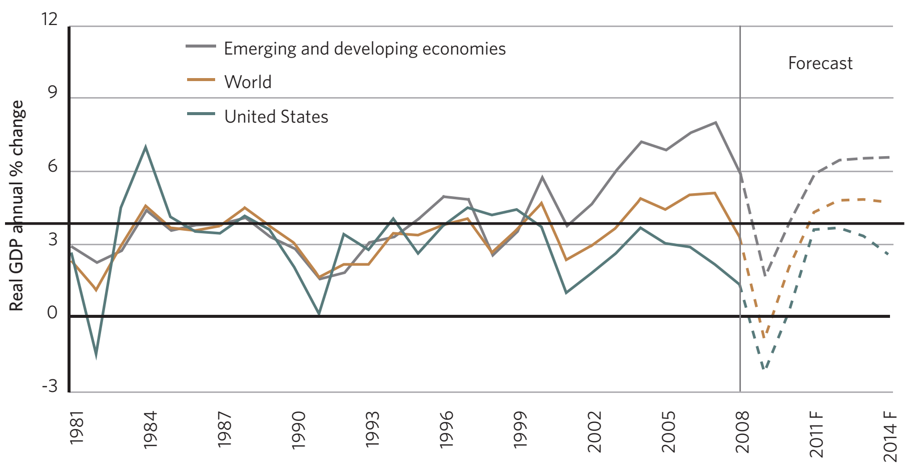
Both EMD asset classes were literally the last "dominos" to fall as the global financial crisis intensified in late 2008. The relative resilience of EMD was due to both the improved creditworthiness of most emerging markets sovereign issuers and the positive growth differentials between emerging markets and the G3. These two facts will ensure that EMD should be well supported going forward.

MAJOR ASSET CLASS RETURNS



Source: Bloomberg as at 30 September 2009.

IMF WORLD ECONOMIC OUTLOOK



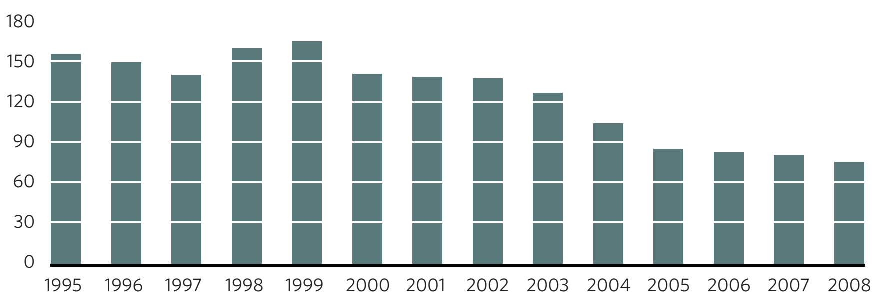
Source: International Monetary Fund (IMF) World Economic Outlook (WEO) 30 April 2009. F – Forecast.

Capturing the growth differential

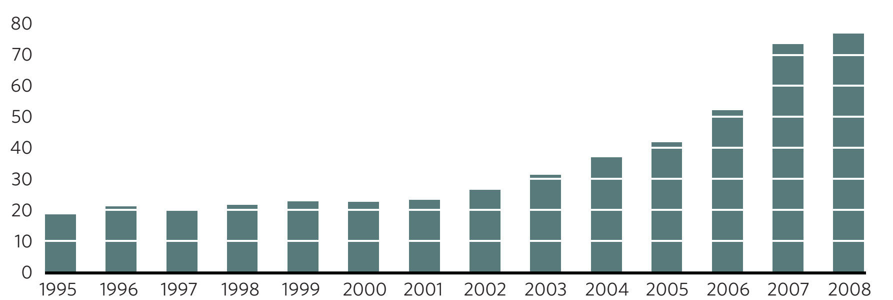
The last year has seen many decry the idea that emerging markets are decoupled from the developed world and it is clear that emerging markets were certainly not immune to the global shock that emanated from the US. Despite this, most emerging market economies definitely are decoupled, but not in the sense of being isolated from the developed economies, which is certainly not the case in an increasingly interlinked global economy. But rather, emerging market economies, on average, are experiencing a much higher growth than the developed markets can achieve, and this positive growth differential is a long-term sustainable phenomenon driven by the underlying characteristics of the economies and the demographics of the populations.

There are a number of ways to take advantage of these growth differentials. Emerging market equities certainly do provide exposure to emerging market economies, but they also have corporate risks bundled in. The improvements seen in emerging markets during the last decade have been primarily at the sovereign level (e.g. lower public debt ratios, higher foreign exchange reserves, more competent monetary policy etc) and you would be hard pressed to find

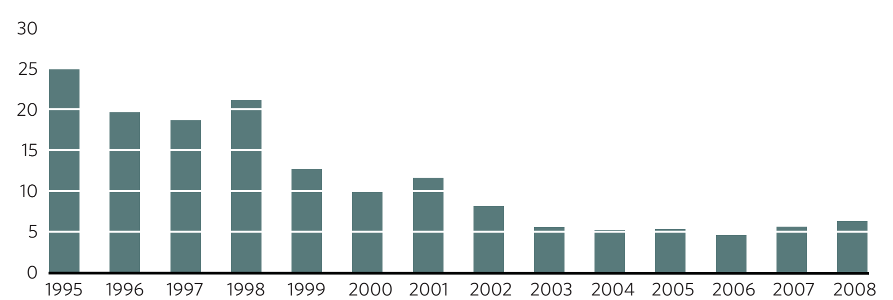
EMERGING MARKETS FOREIGN DEBT (% OF EXPORTS)*



EMERGING MARKETS FOREIGN EXCHANGE RESERVES (US$ BN)*



EMERGING MARKETS CPI (% YOY)*



Source: Standish as of at December 2008.
*Market cap weight averages for countries in the JPMorgan GBI-EM Global Diversified.

similar improvements at the corporate level in areas such as protection of minority investors, timely disclosures, better managerial incentives and other aspects of good corporate governance. The same argument applies for EM corporate bonds which, on top of micro-level risks, tend to suffer from lesser liquidity than sovereign issues.

Historically, the best way of capitalizing on the improved sovereign fundamentals in the emerging markets has been their dollar denominated sovereign debt or quasi-sovereign debt issued by state-controlled entities such as Gazprom in Russia, Pemex in Mexico etc. Just as it is the case with corporate bonds in G3, returns on dollar denominated sovereign debt are driven by levels of, as well as changes in, spreads over US treasuries on top of the underlying US treasury yields. During the decade up to 2008, dollar denominated EMD outperformed most other major asset classes, driven by a powerful combination of decreasing treasury yields and tightening spreads. Over this period, credit ratings of emerging market countries included in the JPMorgan EMBI benchmarks for USD-denominated debt have steadily risen to current levels where the average is just one notch below investment grade. The financial crash meant that spreads dramatically widened in the flight to US treasuries, but recent months have seen spreads equally dramatically tighten to reach levels similar to those seen pre the Lehman collapse. At these levels, they appear still reasonable (i.e. providing more than adequate compensation for potential default losses) but not astonishingly attractive. Having exposure to dollar dominated debt makes sense if you think spreads will tighten further or stay unchanged, but dollar denominated debt now represents a lower risk, lower return asset class that, in contrast to its historical experience, is unlikely to deliver double digit returns in the future.

EMERGING MARKETS US$ DEBT: SPREADS OVER US TREASURIES

Source: JPMorgan as at 30 September 2009.

Within the last decade an additional set of opportunities has evolved for taking advantage of emerging market growth differentials. This opportunity set is represented by local currency-denominated bonds which offer investors two distinct sources of return. At present, local bonds provide the most direct and attractive way to capitalize on the improved emerging market sovereign fundamentals.

The rise of local currency debt

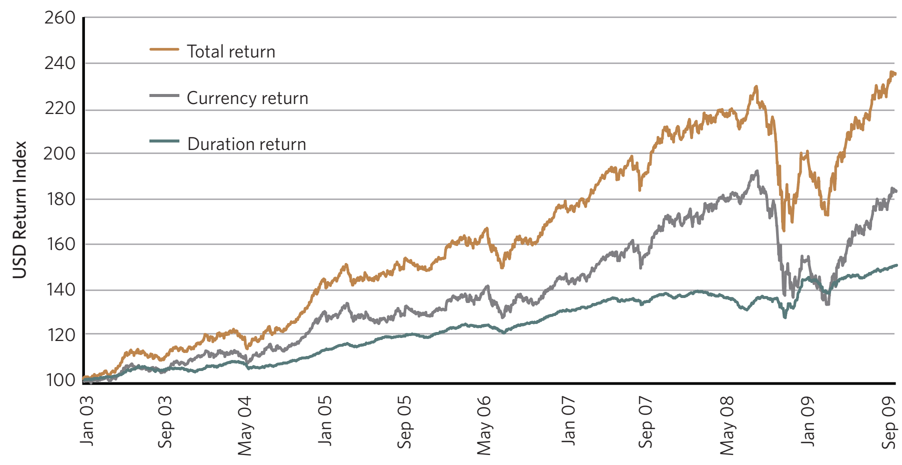
In 2002, EMD was largely dollar denominated with 60% of total market capitalisation in dollar bonds. When emerging market sovereigns needed to raise capital, most had little choice but to issue bonds denominated in foreign currencies, primarily in US dollars. Hyperinflation and the occasional high-profile currency crisis had made both local and foreign investors wary of exposure to assets denominated in emerging market currencies. What has happened since then, is that the size of the dollar marketplace has remained relatively constant at about US$250-US$300bn, whilst local currency denominated bonds, represented by the JP Morgan Government Bond Index – Emerging Markets Global (GBI-EM Global) are approaching US$600bn, or two thirds of the market. The reason for this is that governments of many emerging market countries have moved their economies onto a much firmer financial footing. In particular, central banks have had considerable success in fighting the hyperinflation that had long ravaged local investment returns. Most emerging market countries have also reduced the risk of catastrophic currency crises by transitioning from fixed to more flexible and even completely floating exchange rate regimes, which are less prone to sudden and severe devaluations. The result has been a generalized improvement in sovereign creditworthiness and an increase in investor appetite for assets denominated in local currencies.

Mexico provides a good illustration of the development of local debt markets and also of the obstacles that needed to be overcome for the markets to flourish. In 1996, Mexico had an inflation rate of 50%, which although it fell dramatically, was still significant at approximately10% in 2000. Since then, it has come down to single digits and this success in fighting hyperinflation has been the primary factor enabling Mexico and other emerging market countries to extend the maturity profile of their local currency bond markets. Whilst higher inflation is always a possibility, a return to hyperinflation is unlikely in most emerging markets for two reasons. Firstly, politicians have learned that hyperinflation damages their chances of re-election and secondly, most central banks have become technically more capable and politically more independent, enhancing their credibility. In addition, the natural buyers of local currency debt are local financial institutions, and these were generally underdeveloped until recently, whilst the countries' poor creditworthiness deterred foreign investors from purchasing local currency debt as well. By controlling inflation, improving sovereign credit quality and building up local institutions, Mexico and other emerging market countries have greatly aided their local currency debt markets.

This improvement can be seen in the maturity spectrum of the country's local debt market. A decade ago, Mexico was only able to issue debt at two-year maturities with a high coupon. Since then, Mexico has gradually been able to extend the maturity of its debt and build up its local yield curve out to a maturity of 30 years. In this way, emerging markets have been able to match the currency of their liabilities with that of their assets and revenues. The global financial crisis of 2008 may have given pause to these positive trends, but it has not reversed them. In fact, these trends constitute a kind of self-perpetuating virtuous cycle. With more buyers for local bonds, emerging market governments have reduced unnecessary exposure to exchange rate risk by issuing more debt in local currencies and with increasingly longer maturities. Reduced reliance on USD-denominated debt and on short-term borrowing has led, in turn, to improved debt profiles, further gains in creditworthiness, and interest from additional investors. Importantly, the rapid expansion of pension funds in emerging market countries themselves has generated consistent demand for local bonds.

For foreign investors, local currency bonds represent investment in both currencies and local interest rates. Historically, currency returns have provided the major contribution to total return of local bonds, although duration risk has been a steady contributor as well.

EMERGING MARKETS LOCAL CURRENCY BONDS: CURRENCY AND DURATION RETURNS

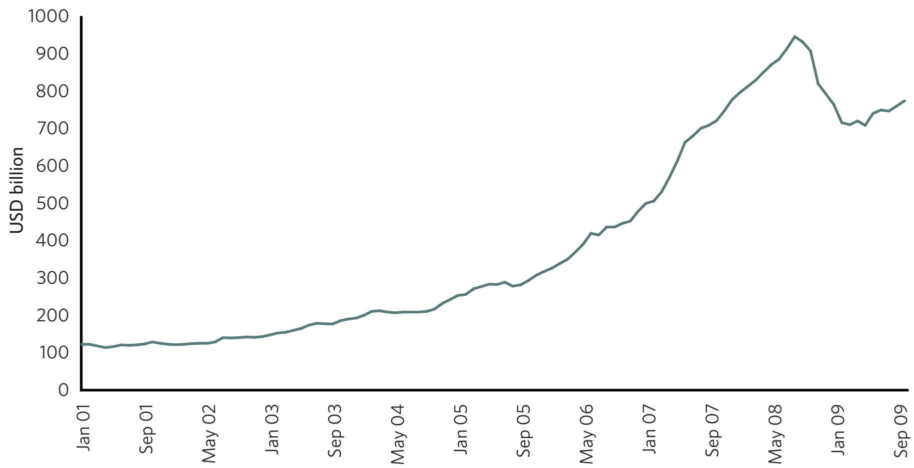


Source: JPMorgan as at 30 September 2009.

The two local currency return drivers (currency and duration risk) are distinct from the drivers of spreads of dollar denominated debt over US treasuries. Spreads have two components: an expected loss component (probability of default multiplied by an expected loss) and a risk premium, which some refer to as a liquidity premium, which represents compensation for not just liquidity but also for the uncertainty of credit outcomes. The huge rise in spreads that occurred post-Lehman mainly represented a general rise in risk premiums across all asset classes, independent of changes in expected losses, although deterioration in country fundamentals also increased the expected loss spread by raising the expected probability of default.

In contrast, currencies are driven by the supply and demand conditions which may or may not be correlated with the global credit risk premia. Thus, for example, for one full year following the beginning of the credit crisis in June 2007, hard currency inflows into emerging markets continued to exert appreciation pressure on their exchange rates. This ended abruptly when the global financial crisis escalated around the time of the Lehman collapse in September 2008. Most local currencies are still 10-15% weaker than they were 12 months ago, so there is still the potential to catch up as the global economy recovers and creates increasing demand for emerging market exports, both manufactured goods and commodities. Importantly, we expect the persistent growth differentials between EM and G3 to continue serving as a magnet for capital flows into emerging markets. These capital inflows should augment the appreciation pressures on many emerging market currencies. We estimate that the average core balance for emerging market countries – a conservative measure of the balance of payments outlook focusing on less volatile flows – is positive and will remain so at least for the next several years. The net extra supply of hard currency (dollars, euros, yen, etc.) is conspicuously manifesting itself in the foreign exchange reserves of emerging market countries which by now are not only sizeable but are also beginning to grow again following the dip in the second half of last year. In other words, at least several central banks of emerging market countries are intervening again by selling their own currency to buy foreign assets. However, in most cases, they are just "smoothing volatility" – slowing the pace of adjustment, rather than preventing their local currency from appreciating beyond a certain level.

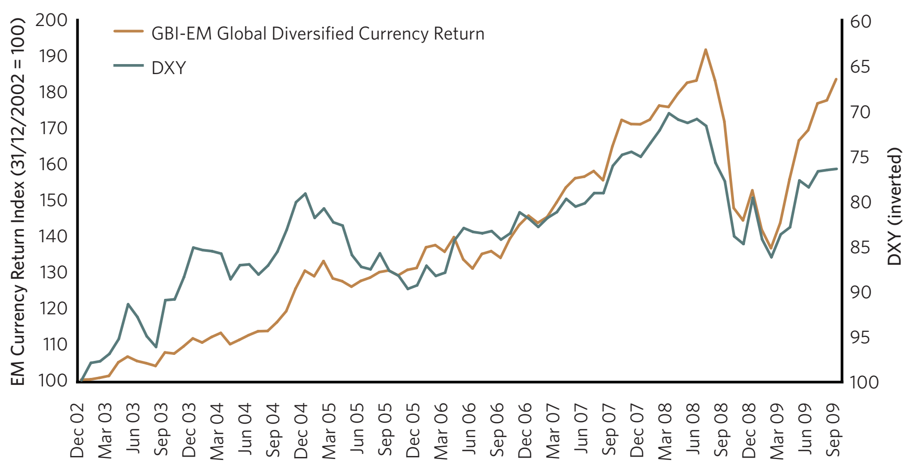
COMBINED FOREIGN EXCHANGE RESERVES OF BRAZIL, INDONESIA, RUSSIA AND TURKEY



Source: Bloomberg as at 30 September 2009.

It is also worth considering the viability of the US dollar in the long run. Emerging market currencies do well when the dollar weakens against major currencies. It helps directly because the local currency denominated EMD indices contain an exposure to central European countries whose currencies such as the Polish zloty are trading primarily against the euro – if the zloty is unchanged against the euro, then if the euro strengthens, then the zloty strengthens against the dollar. In addition, there is an indirect effect of the dollar's weakness on other currencies that are trading primarily against the dollar such as the Brazilian real and the Malaysian ringgit. For example, whilst the Brazilian real trades against the dollar, its economy is much more diversified in terms of its export destinations, with Europe comparable to the US in value. When the dollar weakens against the euro, it allows the Brazilian real to strengthen incrementally against the dollar

EM CURRENCIES TEND TO DO WELL WHEN US DOLLAR WEAKENS



Source: Bloomberg, Standish as at 30 September 2009.
Note: DXY measures the general international value of the USD by averaging the exchange rates between the USD and 6 major world currencies. The decrease in DXY indicates the weaker USD.

without sacrificing its competitiveness in trade-weighted terms. The corollary of this is that a rebounding dollar can hurt emerging market currencies and the extent of the damage depends on the conditions under which the rebound occurs. When the dollar strengthened against the euro, post Lehman, it reflected the fact that the US malaise had spread to Europe and as a result, would lead onto a global recession.

A major reason for why the dollar has held up so well in the recent turmoil has been because it is the world's reserve currency which benefits in the "flight-to quality" environment. This is ironic because the US has been at the epicentre of the financial crisis. However, we are now seeing more signs that central banks and private investors are diversifying away from the dollar. This should benefit many EM currencies for the reasons outlined above, especially if the pressure on US dollar coincides with the beginning of a global recovery.

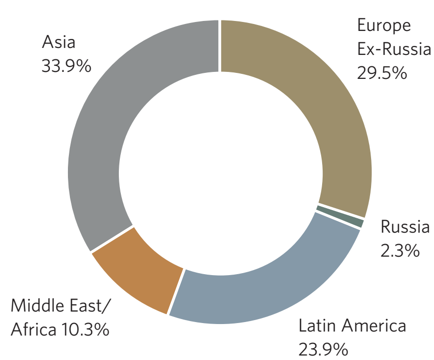
One question that does arise given this is whether it would be better just to gain an exposure to a diversified portfolio of emerging market currencies through the use of currency forward exchange contracts. In this regard, it is important to point out that currency hedged returns in local bonds have historically produced a steady positive contribution, suggesting that local bonds have outperformed currency forwards (see the chart on page 6). Above all, this outperformance reflects the positive term premium of local yield curves. Indeed, the disadvantage of currency forwards is that they reflect short term interest rates and as a result, there is no duration exposure and no possibility of benefiting from higher bond yields along the yield curve. For bond managers, however, the use of currency forwards does enable them to invest in countries where the currency is attractive but not prospective duration returns. Conversely, in countries where duration looks attractive but the currency does not, managers can invest in local currency-denominated bonds while hedging the currency.

Just as currencies and spreads do not necessarily move in tandem, local bond yields have their own unique drivers. The fact that yields on debt denominated in local currencies are relatively high is primarily a function of inflationary expectations rather than creditworthiness. Indeed, the average credit quality of countries represented in the widely followed JPMorgan GBI-EM benchmarks for local bonds is solidly investment grade. This is not a coincidence as to be included in the GBI-EM benchmark an emerging market country has to have a relatively well-developed local fixed income market which, in turn, is unlikely if the country is suffering from poor creditworthiness. Also, from the perspective of local investors who dominate local currency bond markets, the government bonds often represent the safest instruments available in their own currency. As the global economy recovers, inflationary pressures may increase, but if inflation does start becoming a concern in a local currency bond fund, then, in addition to the greater reliance on currency forwards, the option exists of shifting to inflation-linked bonds which are available in at least several emerging market countries. This choice between nominal bonds and inflation-linked bonds depends on the assessment of breakeven rates relative to long-term inflation forecasts.

The future opportunities in EMD lie in local currency debt

EMD should be regarded as consisting of two distinct asset classes: local currency-denominated bonds and USD-denominated debt. Dollar denominated debt is a credit asset class akin to corporate bonds in G3, which has now graduated to a somewhat lower risk, lower return status reflecting the improvement of the average credit quality to just one notch below investment grade. Local currency debt is an asset class that represents some of the highest-rated emerging market countries, offers two distinct sources of return (currency and local bond yields), and provides the potential to generate equity-like returns without taking on direct equity risk. Prospective returns from local bonds are supported both by their relatively high yields and by the potential for their currencies to appreciate. The diversification benefits of emerging market local currency debt are further enhanced by the steady bid for long-dated local fixed income instruments from rapidly growing pension plans domiciled in emerging market countries themselves. Pension plans and other institutional investors in Europe, Asia, and the US now seem to have discovered the local currency asset class as well.

LOCAL BONDS (GBI – EM GLOBAL DIVERSIFIED)



Market capitalization: US$625 bn

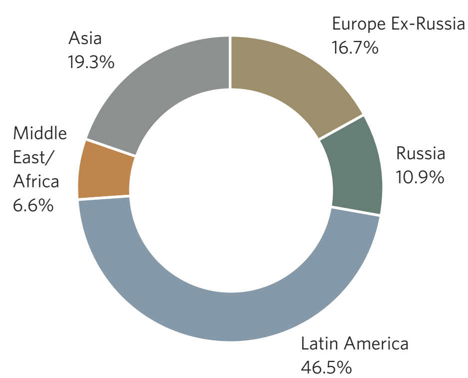
Average rating: A-

Return drivers:
(1) Local currencies
(2) Local bond yields

Investor base: predominantly local

Source: Standish and JPMorgan as at 30 September 2009.

US$-DENOMINATED BONDS (EMBI GLOBAL)



Market capitalization: US$326 bn

Average rating: BB+

Return drivers:
(1) Spreads over US Treasuries
(2) US Treasury yields

Investor base: predominantly foreign

Source: Standish and JPMorgan as at 30 September 2009.

BNY Mellon Asset Management

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Blackfriars Asset Management Limited
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BNY Mellon Beta Management
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Hamon Investment Group
Ivy Asset Management LLC
Mellon Capital Management Corporation
Mellon Global Alternative Investments
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