

## In focus

# The essential guide to investing in emerging market debt

February 2021

Institutional investors have long held strategic allocations to emerging market debt (EMD). The challenges faced by emerging markets (EM) over the last decade may have cooled investor enthusiasm somewhat. But as developed market (DM) yields have continued to drift ever lower, the interest in higher-yielding EM bonds is on the rise.

However, the way that some investors approach EMD is not always optimal. Depending on whether investors are looking for simple yield enhancement, or to diversify core fixed income exposure, the appropriate strategy can be very different. In this paper, we explain the size and the structure of the EM debt universe and the nuances of investing in EMD.

US dollar denominated EMD, or hard currency EMD, can provide yield enhancement, but it falls short on diversification and liquidity. Local currency EMD, the largest part of the global EMD market, is more liquid and a better diversifier. And within local EMD, the greatest value is in EM currencies, but this value is not uniform and varies considerably by country.

Investing in EMD can be risky. As we show, adopting a flexible, unconstrained approach with the capability to avoid certain countries can help to mitigate some of the risk.

With large parts of the world still suffering the impact of the Covid-19 pandemic, bond investors continue to scramble for yield, as developed market (DM) bond yields have fallen to record low levels. The reality is that as at the end of 2020, the Bloomberg Barclays G7 Treasury Index yield was close to zero at 0.2% (Figure 1, blue line) and \$16 trillion of global debt was trading at negative yields. To make matters worse, the duration of DM government bonds increased further in 2020 (Figure 1, green line). It would now take only a small increase in yields to lead to significant losses for price-sensitive investors.

In addition, many asset classes have become increasingly correlated, making it harder for investors to build genuinely diversified portfolios. And for non-US dollar investors, the recent weakness in the US dollar and the prospect of further decline adds another layer of complexity.

In this environment, EMD deserves more attention than it has received. It can meet the criteria of many investors – yield enhancement, diversification, and liquidity – but the way that most investors have accessed the asset class is sub-optimal. The overwhelming bias towards hard currency dollar-denominated bonds falls short on the second two of those criteria.

Furthermore, many investors unnecessarily constrain themselves to only investing in bonds which are included in mainstream benchmark indices. This ignores the tremendous, and accessible, opportunity set that exists out of those indices. An EMD allocation has the potential to add significant value, but only if it is approached in the right way.



**Kristjan Mee**  
Strategist, Research  
and Analytics

**Figure 1: Record low yields and record high duration of developed market government bonds**



Source: Refinitiv Datastream. Data as at 31 December 2020.

### EMD is one of the biggest parts of the fixed income universe

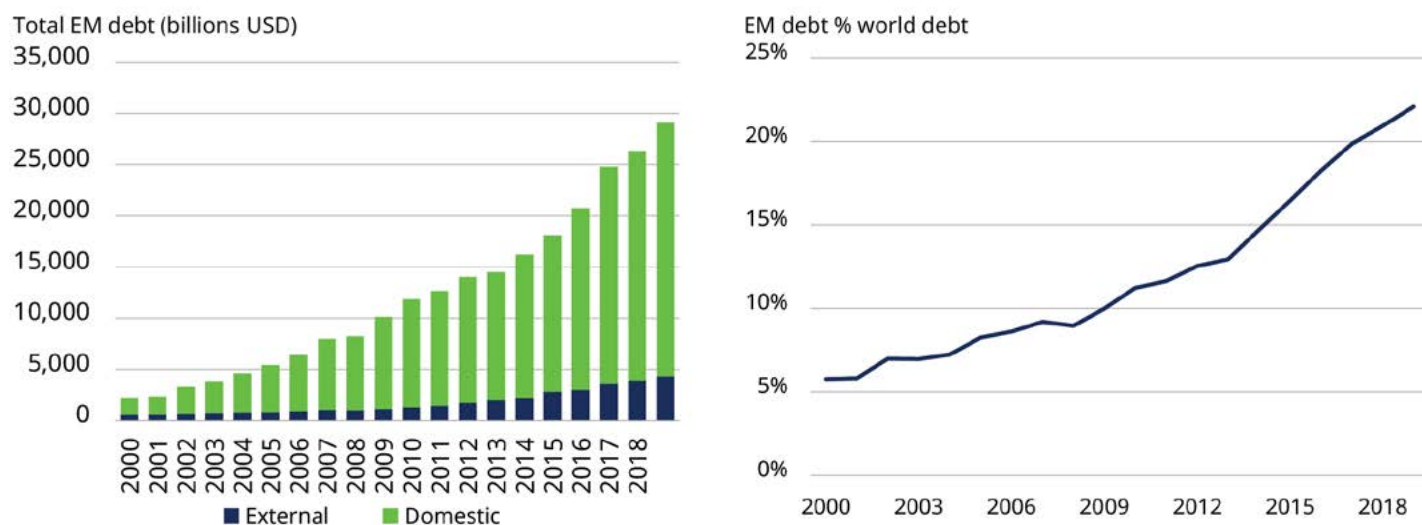
Today, EMD is still viewed as somewhat of a niche asset class. However, based on the size of the market alone, it is far from that. The total value of EMD outstanding at the end of 2019 was just over \$29 trillion, making up 22% of world debt (Figure 2). This share has grown rapidly, increasing from just 10% a decade ago. However, despite this fast growth, EMD's share of the global debt market is still relatively low; considering that EM GDP is 41% of world GDP, and is expected to rise to 45% by 2024<sup>1</sup>.

The \$29 trillion EM debt pool is comprised of \$24.8 trillion (85%) of domestic, or local currency, debt and \$4.3 trillion (15%) of external, or hard currency, debt (Figure 3). Given the bias many portfolios have towards hard currency EMD, it may surprise some readers to learn that the local EMD market is so much larger. And, as explained in more detail later, much more liquid (higher trading volumes and lower transaction costs).

Since 2011 the share of local EMD has been falling slightly, but this is related to the significant weakness in a number of EM currencies. This reduces the value of outstanding debt when expressed in USD terms, as has been done in the chart below.

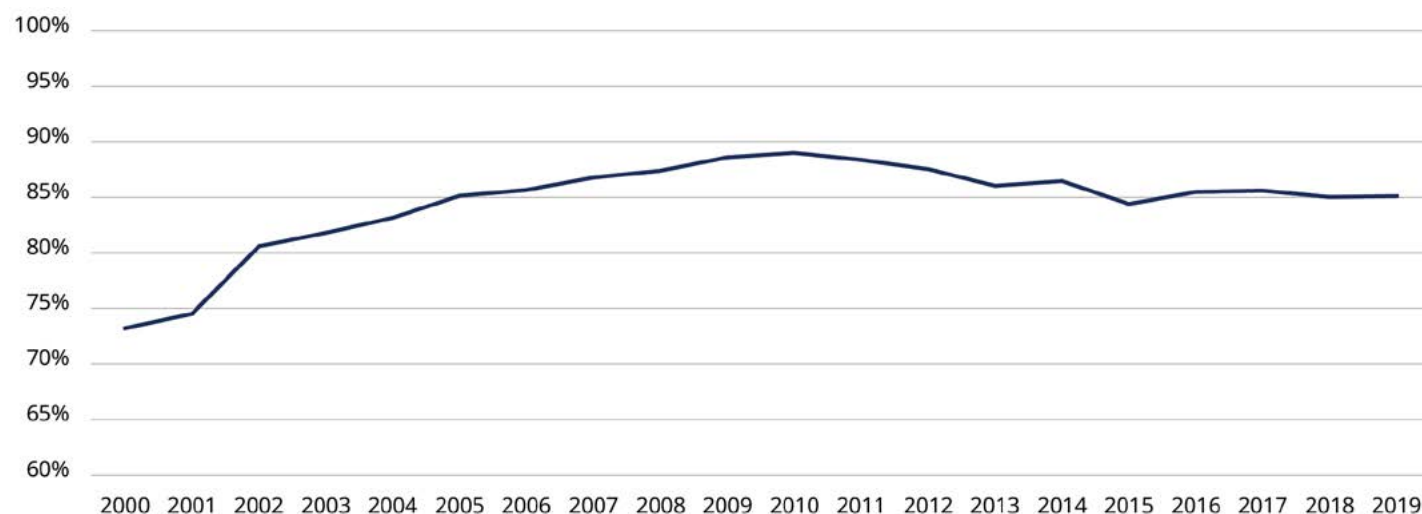
Looking ahead, the share of local debt could start to increase again, as more countries develop domestic bond markets to reduce their reliance on external funding. Please see the boxed section on the next page on the change in how EM countries borrow. Also, a recovery in EM currencies would automatically lead to a higher share of local debt when expressed in USD terms.

**Figure 2: Size and structure of EMD universe**



Source: BofA Merrill Lynch Global Research, BIS, Bloomberg. Data as at 31 December 2019.

**Figure 3: Domestic (local) debt % of total EM debt, USD terms**



Source: Source: BofA Merrill Lynch Global Research, BIS, Bloomberg. Data as at 31 December 2019.

<sup>1</sup> Source: The IMF. Data as at 13 October 2020.

### The change in how EM countries borrow

In the 1990s, many EM countries and companies were heavily reliant on external financing. This came to a head in the 1997 Asian Financial Crisis when sharp falls in currencies made large foreign currency liabilities untenable, and exposed the risks involved with relying on external funding. As Figure 3 shows, the situation has evolved considerably since the turn of the century.

Over time, more countries have started to issue local currency bonds and develop domestic bond markets in order to reduce their reliance on external funding. For example, Thailand, a country at the epicentre of the 1997 Asian Crisis, now finances itself almost entirely through local currency bonds. Major EM countries that are still heavily dependent on foreign funding, such as Turkey and Argentina, are now an exception rather than a rule.

For these countries, better utilisation of domestic savings is crucial for well-functioning local bond markets. Greater local currency borrowing enables foreign investment flows to have less of an impact on borrowing costs and sentiment, allowing central banks to cut interest rates in recessions. This shift would benefit the countries as well as investors of local currency bonds in these countries.

The developments with inflation in EM have supported the move towards local currency borrowing. As Figure 4 shows, apart from a brief spike in 2008, EM inflation has been on a downward path since the beginning of the century. This moderation means that investors now require a lower inflation premium, making local currency borrowing more affordable.

**Figure 4: Lower inflation has led to a reduced inflation premium in local currency EM bonds**



To 31 December 2020. Source: Bloomberg, Schroders.

The move towards local currency borrowing has reaped benefits for EM countries in the Covid-19 crisis. In early 2020, during the height of the pandemic, a number of EM central banks cut interest rates, despite their currencies falling at the time. For countries with substantial foreign currency borrowing, such a strategy would be untenable, because of the danger of a currency mismatch (their weaker currencies would make foreign currency borrowings more expensive to service).

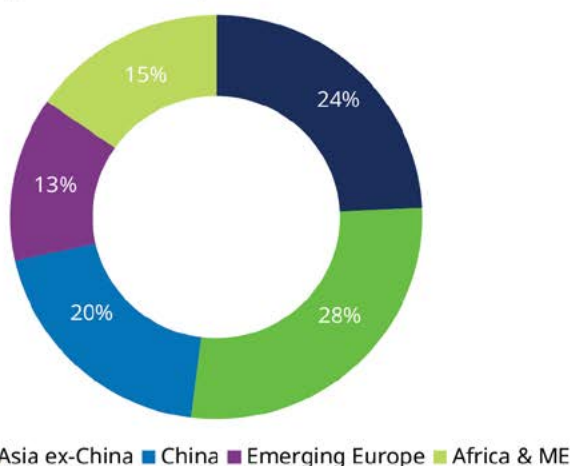
Despite growing local currency borrowing in EM, the hard currency market remains an important source of funding for smaller EM countries that lack well-developed domestic markets. Selling bonds to international investors is often the only way that these countries can borrow.

The \$4.3 trillion hard currency EM debt market is split between \$1.3 trillion sovereign and \$3 trillion corporate debt. The former is the smallest part of the EMD universe but is most widely owned by international investors. Looking at the regions, Asia is the largest region with China alone representing 20% of all tradable debt (Figure 5). Mexico and Brazil are the two largest Latin American issuers.

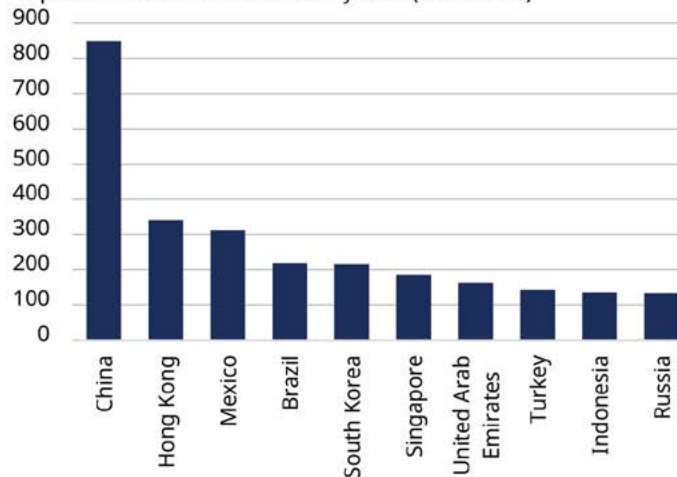
In contrast, the \$24.8 trillion local currency debt market debt is roughly equally split between sovereign and corporate debt. Geographically, local EMD is even more heavily skewed towards Asia and China. Asia represents 78% and China 57% of all local currency tradable debt. However, that does not mean that other local bond markets are small. For example, Brazil, South Korea and India have large domestic bond markets that are each in excess of a trillion US dollars in size.

**Figure 5: Asia dominates in both hard and local currency EMD**

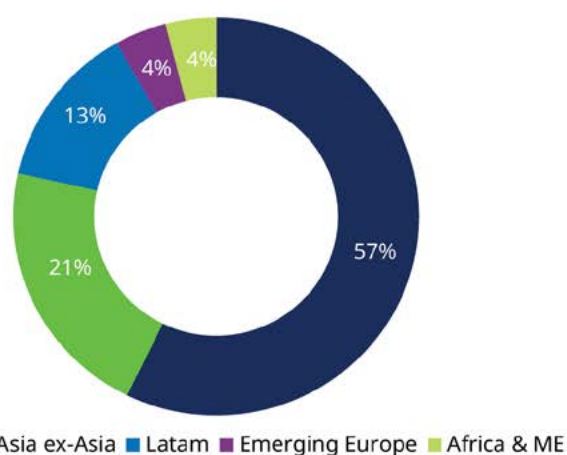
Hard currency tradable debt regional breakdown



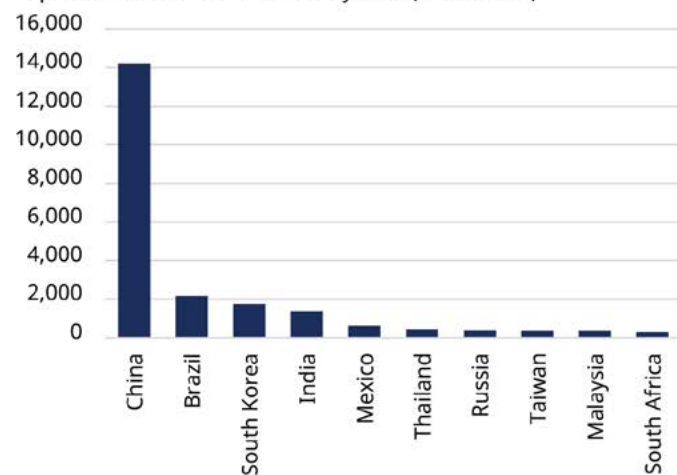
Top countries with hard currency debt (billion USD)



Local currency tradable debt regional breakdown



Top countries with local currency debt (billion USD)



Source: BofA Merrill Lynch Global Research, BIS, Bloomberg. Data as at 31 December 2019.

**Issues with index coverage in EMD**

The J.P. Morgan suite of EM bond indices is the most common set of benchmarks in EMD, and forms the basis for the vast majority of investors' allocations. However, only a small part of the \$29 trillion EMD debt stock is included in these indices. The discrepancy is especially large in local currency debt. The reason a bond is not included in an index usually comes down to access limitations on foreign investment. However, that does not have to mean that a market is completely closed to foreigners. For example, while India is not part of the most popular EMD local index, Indian government bonds can still be purchased by foreign investors under certain conditions<sup>2</sup>.

Furthermore, both hard and local currency EM debt markets are skewed towards larger countries. To avoid excessive concentration, J.P. Morgan also publishes diversified versions of their indices, where the maximum country weight is 10%. This improves the regional distribution but results in a smaller proportion of the overall market being included. As a result, the combined market value of three diversified EMD indices is less than \$3 trillion, a fraction of the \$29 trillion EM debt outstanding (Figure 6).

**Figure 6: Index coverage in EMD varies considerably**

Bn of dollars	Hard sovereign	Hard corporate	Local	Total
All outstanding	1,368	2,966	24,805	29,139
J.P. Morgan EMD Index	1,327	1,248	2,050	4,625
J.P. Morgan EMD Diversified Index	750	583	1,374	2,707

Source: BofA Merrill Lynch Global Research, BIS, Bloomberg, JP Morgan. EMD debt outstanding as at 31 December 2019. J.P. Morgan indices' market values as at 31 December 2020.

<sup>2</sup> Foreign investors have to apply for a licence to purchase Indian government bonds. Although obtaining this licence is relatively straightforward, it makes Indian bonds not "Euroclearable" and not eligible for inclusion in global bond indices.



With 74 members, the main hard currency sovereign bond benchmark, the J.P. Morgan EMBI Global Diversified Index, has the best coverage in EMD. This means that investors have access to almost the full opportunity set. The downside of broad coverage is that the index has a long tail of high-yielding frontier countries. As explained above, it is easier for these countries, that often lack a proper domestic bond market to sell dollar bonds. Even though they are small in terms of market size, they can have a significant impact on returns due to large swings in the prices of their bonds.

The main EM local currency debt benchmark, the J.P. Morgan GBI-EM Global Diversified Index, has only 19 members. The latest addition was China, after Chinese government bonds were added to the index over the course of 2020. Nonetheless, the index will

still exclude some major Asian countries, such as Taiwan, South Korea and India. In addition, there are some countries that used to be part of the index, but which are currently excluded. For example Nigeria and Argentina were excluded in 2015 and 2019 respectively after enacting capital controls.

Even though the coverage is likely to improve over time, with Egypt and Ukraine potentially added to the index next, it will still be far from the full opportunity set. Finally, the \$12.7 trillion EM corporate local debt market is completely excluded. Because of these reasons, benchmark EMD indices are not necessarily the most efficient or desirable way to gain exposure to EMD. They unnecessarily exclude a big part of the opportunity set.

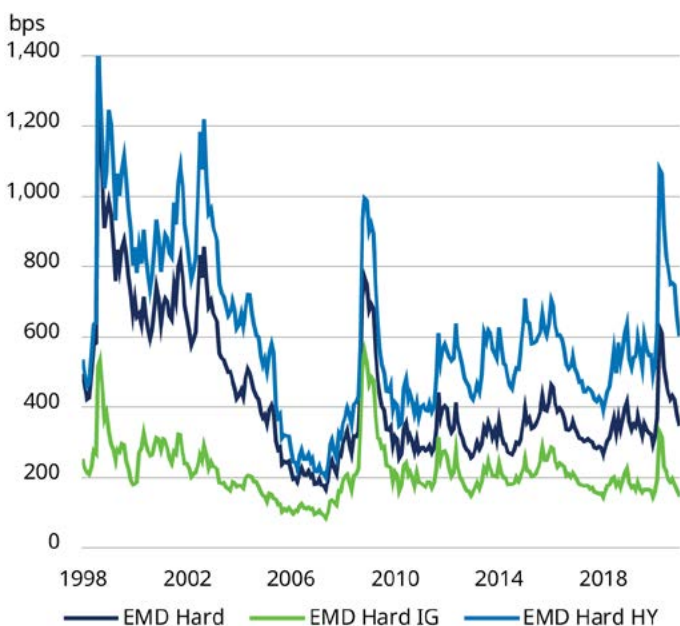
**Note that in the remainder of this document we at times make reference to data based on benchmark indices. This has been done to illustrate key points and draw broad conclusions on EMD. However, it is important to note the points above about this only being a snapshot of the overall universe and not fully representative of all available opportunities.**

### Hard currency EMD: a two-tier market

Hard currency EM debt has performed well over the last decade, delivering 6.3% average annual return<sup>3</sup>. Importantly, this figure has been affected by the fall in US Treasury yields, providing a powerful tailwind for dollar EM bonds. At the same time, there has been significantly more volatility in hard currency spreads.

Similarly to DM corporate bond spreads, the spreads of hard currency EM bonds shot higher in March 2020 at the onset of the Covid-19 pandemic. The subsequent reversal in spreads has been as spectacular, although not universal (Figure 7). The investment grade (IG) part of the EMD hard currency index has now fully reversed the spread widening. Even though the spreads of the high yield (HY) bonds have come down as well, they are still 120 basis points (bps) wider compared to pre-Covid and 190bps wider compared to early 2018.

**Figure 7: Spreads of HY hard currency EM bonds are relatively elevated**



Source: J.P. Morgan. Data as at 31 December 2020. Based on the J.P. Morgan EMBI Global Diversified Index.

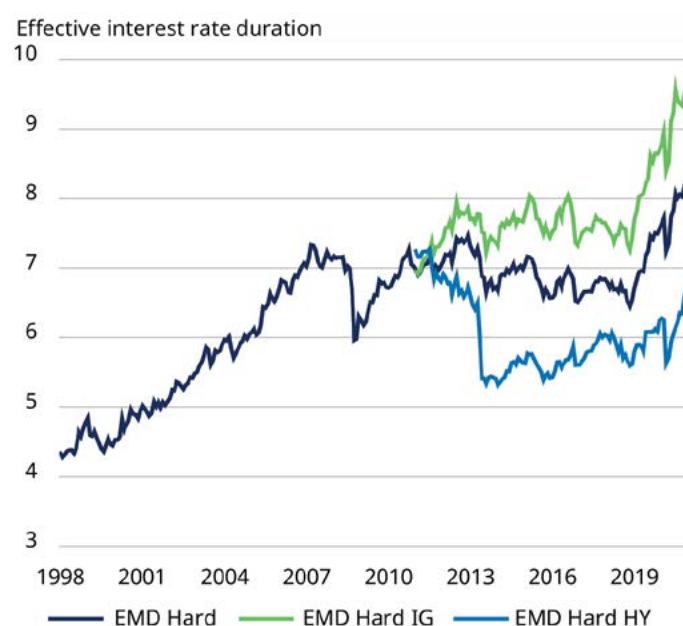
There were some high profile credit events in 2020. Lebanon, Argentina, Ecuador and Zambia either failed to make interest payments on their bonds or renegotiated the terms of their bond contracts. These four cases were idiosyncratic in nature and not directly caused by Covid-19. Still, they are a reminder of the risks in the diverse sovereign hard currency debt universe.

These distressed issuers aside, the spreads of a number HY countries are still significantly higher compared to pre-pandemic. Some countries, such as Sri Lanka, Suriname and Belize, trade at excess of 1,000bps. Should the world economy recover in 2021, these bonds could offer value for investors.

### Elevated duration of low-yielding hard currency bonds

The different characteristics of IG and HY hard currency EM bonds also have a major bearing for broader portfolio construction considerations.

**Figure 8: Duration of hard currency EM bonds has increased sharply**



Source: J.P. Morgan. Data as at 31 December 2020.

<sup>3</sup> Source: Refinitiv Datastream. Based on J.P. Morgan EMBI Global Diversified Index. Data to 31 December 2020. Past performance is not a guide to future performance and may not be repeated.

Because of the fall in yields and increase in the average maturity of bonds, the duration of the EMBI Global Diversified Index has increased sharply since 2018, from 6.5 to 8.3 years (Figure 8). However, the increase has been more extreme in the IG part of the index, which now has a duration of 9.5 years. As a result, investment grade hard currency EM bonds carry increasingly high interest rate risk.

Furthermore, the IG part of the index is much more correlated with DM government bonds (Figure 9). The correlation of HY bonds, on the other hand, has fallen sharply over the last two years, reflecting idiosyncratic issues in a number of HY countries. Greater duration and high correlation make hard currency IG bond returns more dependent on the direction of DM bond yields, thus reducing the diversification potential.

While the Federal Reserve (Fed) has promised not to increase short-term interest rates any time soon, the Fed has less of control on the long end of the yield curve. A steeper US yield curve could spell trouble for the total returns of high duration hard currency EM bonds. Perhaps in the the same way that EM currency weakness has weighed on the returns of local currency EM bonds, as explained in a minute.

**Figure 9: EMD Hard rolling 3-year correlation with DM bonds**



Source: Schroders, J.P. Morgan, Barclays. Data as at 31 December 2020. DM bonds are the Bloomberg Barclays G7 Treasury Index.

Taking account of valuations and diversification potential within hard currency EMD, investors seeking higher yields and diversification potential are being forced to move down the credit risk spectrum, into the sub-investment grade part of the market.

However, capitalising on these opportunities is not always easy. Smaller, frontier HY countries are less liquid and have higher trading costs (see page 10), meaning that poor liquidity conditions could prevent investors from fully capturing the large price movements in these bonds. Investors have to be very selective in their approach. Portfolios which are geared towards higher yielding hard currency bonds are exposed to several other important risks besides price risk.

This does not mean that hard EMD has no place in portfolios today. As it offers a spread over US Treasuries, it can be thought of as a complement to DM corporate bond exposure. While the

spread of the sovereign index has fallen, it is still some way off the all-time low reached in 2007, especially in HY bonds. In addition, stronger EM growth could lead to even lower spreads.

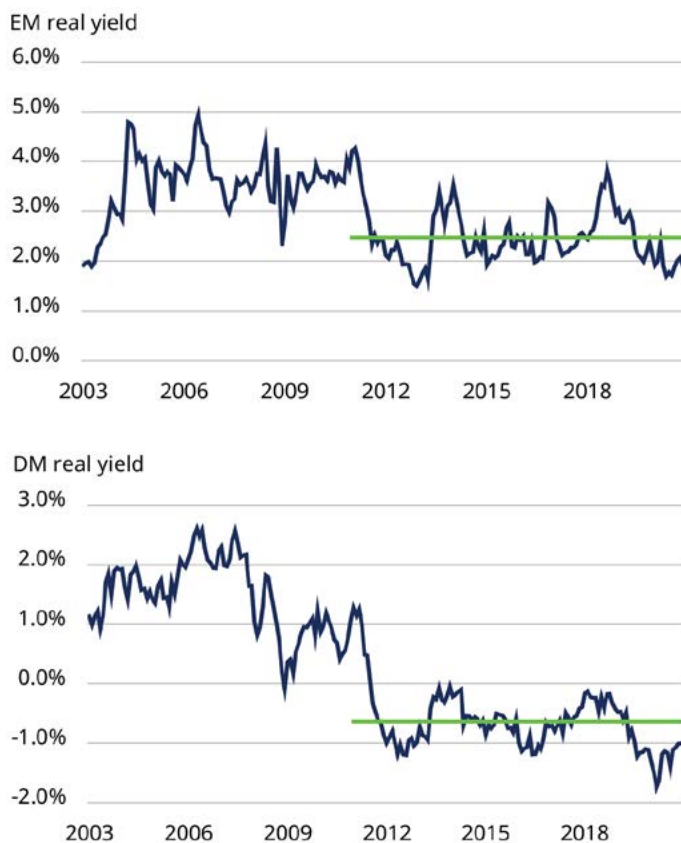
However, for investors who are looking for ways to diversify their core fixed income exposure, there are currently better opportunities in local EMD.

### Local EMD offers better diversification and more attractive valuations

The return drivers of hard currency EM debt are relatively straightforward. The risk-free component of all bonds is driven by the yields of US government bonds, while the spread component reflects the riskiness of each individual issuer. What drives the returns of local currency EM bonds is less clear-cut.

Historically, EM countries have had to pay higher real yields on their local currency bonds to compensate for the greater risk of inflation, which would erode the nominal yield of a bond. Since January 2011, the average ex-ante EM real yield has been 2.5%, far above the average DM real yield of -0.6% over the same period (Figure 10).

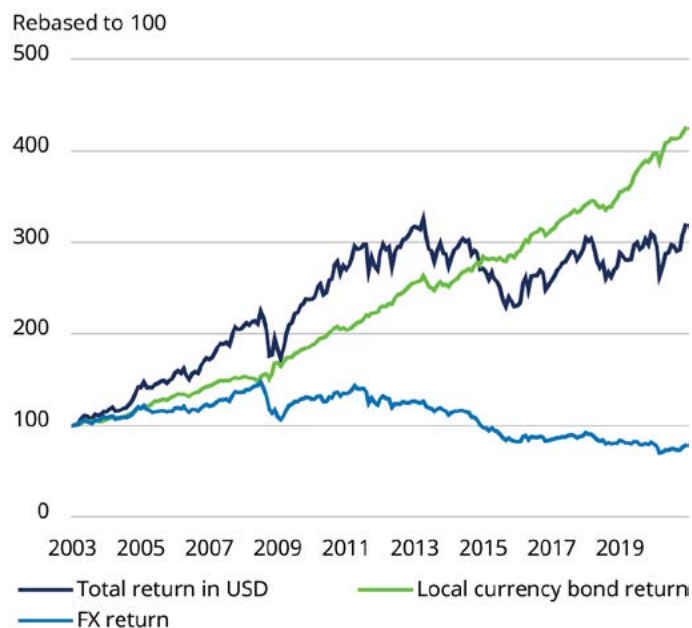
**Figure 10: EM countries have had significantly higher ex-ante real yields than DM countries**



Source: Schroders, J.P. Morgan. Data as at 31 December 2020. EM real yield is weighted average of individual JPM GBI-EM index nominal yields deflated by annual core inflation. DM real yield is 5Y government bond yields of US, UK, Eurozone, Japan deflated by annual core inflation, weighted by the size of individual government bond market.

However, despite local currency EMD offering a consistently positive real yield, the US dollar total return of the JPM GBI-EM Global Diversified index has been close zero since 2013 (Figure 11, blue line). Higher real yields have not resulted in superior performance compared to DM bonds. This is because EM currencies have depreciated significantly since 2011 (light blue line), thus cancelling out the substantial local currency bond return (green line).

**Figure 11: Components of EMD Local index total return**



Past performance is not a guide to future performance and may not be repeated.  
Source: J.P. Morgan. Data as at 31 December 2020. Based on the J.P. Morgan GBI-EM Global Diversified index.

What has caused this extended period of EM currency weakness? In short, it mainly results from the build up of external imbalances in EM over the years. Between 2005 and 2015, except for a brief period after the financial crisis, the weighted average EM current account was in a sizable deficit (Figure 12). Up until 2011, foreign investors were willing to fund this deficit, helping to keep EM currencies stable. However, as sentiment soured and inflows waned, EM currencies started to weaken.

Currency depreciation is often a cure for external imbalances. All other things equal, a weaker currency makes exports more competitive and imports more expensive, reducing the current account deficit. Unfortunately, currency depreciation alone was not enough to clear the imbalances in EM. A number of countries had to go through significant economic crises to finally reduce their deficits via a collapse in imports. By the end of 2019, the EM current account deficit had narrowed to close to zero.

While most EM countries have been hit hard by the Covid-19 pandemic, the crisis has actually been supportive of EM external balances. A number of countries, such as Mexico or South Africa, saw their the current account balance swing positive for the first time in a long time. As a result, the EM current account balance is now decisively in surplus.

On the other side of the ledger, the strength of the US dollar over the last decade has been a double-whammy for EM currencies. Looking ahead, it is likely that the dollar's long period of strength has come to an end. Please see the boxed section on why some key structural drivers have started to turn against the greenback.

## Structural forces turning against the US dollar

After a long period of strength for the US dollar, it started to weaken in the second half of 2020. Many investors are now wondering if this could be the beginning of a trend that could see it weaken more substantially. We believe there are three key developments that are becoming a major headwind for the dollar and could lead to further weakening of the greenback:

### Increasing US trade imbalances

Even though the US current account deficit was relatively stable between 2015-2020, it was only so because increasing US oil production reduced the deficit in oil. Excluding oil, the current account deficit has increased significantly, as US imports have increased much faster than exports. Very expansive US fiscal policy in response to the Covid-19 pandemic has now accentuated the trade imbalances. The US current account fell to a deficit of 3.4% of GDP in the third quarter of 2020, the largest since 2008. The trend continued in the fourth quarter with the US registering a record monthly trade deficit of \$86 billion in November.

Instead of reducing imbalances, as has often been the case in past crises, the Covid-19 shock has increased them. And a rapid widening of the current account deficit has tended to be associated with periods of notable dollar weakness.

### Large structural budget deficit

The US budget deficit was a record 16% of GDP in 2020. While the cyclical component of the budget deficit should narrow once the effects of the pandemic subside, the non-cyclical or structural deficit is likely to remain substantial. This is because the share of mandatory spending, the budget outlays required by law, such as funding of Social Security and Medicare, has increased considerably since 2008. Given the ageing population in the US, these pressures will only intensify.

The US Federal Reserve (Fed) has promised to keep interest rates low and could theoretically even fix parts of the yield curve to curtail the rise in long-term bond yields. Consequently, foreign investors, faced with deteriorating fiscal dynamics, and in the absence of higher bond yields, would likely need a lower dollar to incentivise them to purchase US bonds.

### Possible end of American exceptionalism

In the last decade, the US dollar has been buoyed by the notion of American exceptionalism. The US economy outperformed the rest of the developed world and US bonds have been carrying higher yields. However, because the Fed has cut US interest rates to zero and the US economy has been particularly scarred by the pandemic, American exceptionalism has been called into question. Thus, it is possible that some of the inflows will reverse.

How big are the potential outflows? Decades of current account deficits means that the US has built up a large net liability to the rest of the world, standing at \$13 trillion or 67% of GDP. Foreigners own \$42 trillion of US assets while US residents own just \$29 trillion of foreign assets. This liability has become significantly more negative in the last ten years, highlighting the danger from a possible reversal in appetite for US assets.

For more detailed explanation, please see: [Are the US dollar's days of dominance done?](#)

**Figure 12: Weighted average EM current account balance**

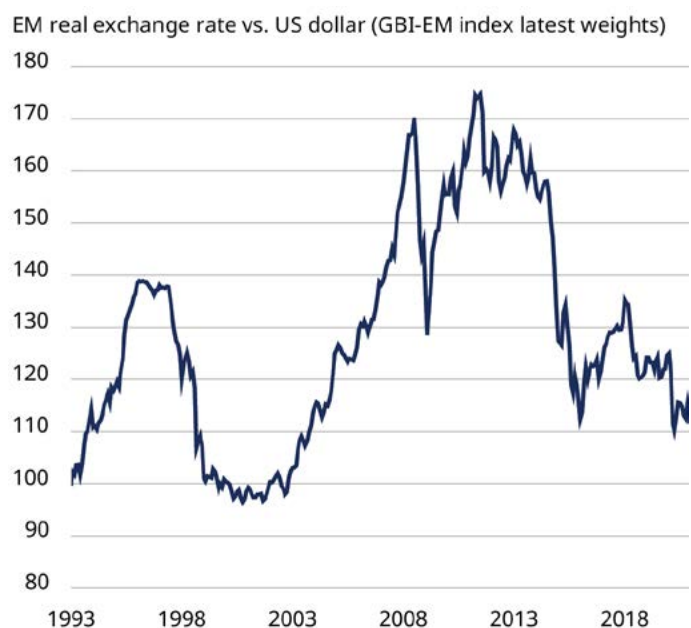


Source: Schroders, Refinitiv Datastream, J.P. Morgan. Data as at Q3 2020. Weighted average is based on the historical weights of the JPM GBI-EM index.

How much value is there in EM currencies? In nominal terms, the currencies of the countries part of the J.P. Morgan GBI-EM Global Diversified index have fallen by around 50% since 2011. Even after accounting for higher inflation in EM, EM currencies have still depreciated significantly. The weighted average EM real exchange rate (based on the latest GBI-EM index weights) has fallen more than 35% (Figure 13).

Looking at individual EM currencies (Figure A, Appendix), the real exchange rates in some cases are back to mid-1990s levels, implying extreme undervaluation. Because of that, EM currencies perhaps offer the greatest value in the current environment, where most assets are historically expensive.

**Figure 13: EM currencies are cheap compared to their history**



Source: Schroders, J.P. Morgan, Refinitiv Datastream. Data as at 31 December 2020. Real exchange rate is nominal dollar exchange rate deflated by CPI index of each EM country vs US. Individual exchange rates are weighted by the latest J.P. Morgan GBI-EM Global Diversified Country weights.

**Country selection is crucial in local currency EMD**

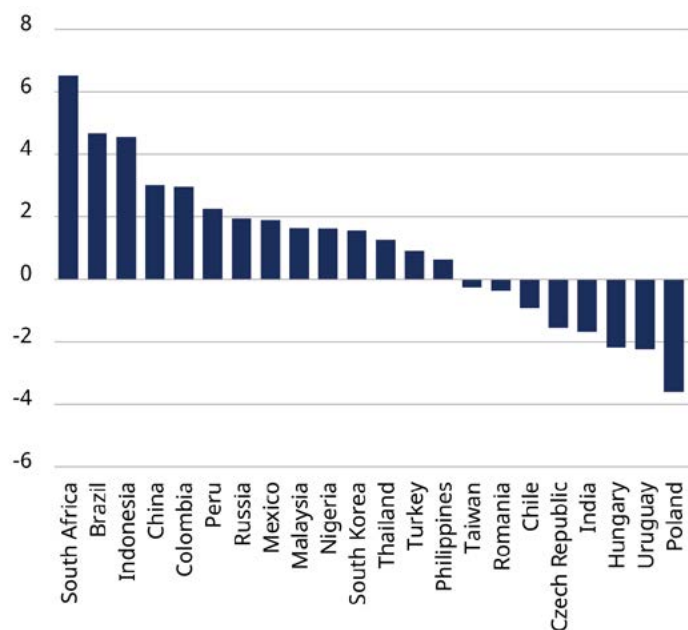
Even though EM local currency bonds on average offer a positive real yield, there is great variability between the real yields of individual countries (Figure 14). Eastern European countries, such as Poland, Hungary and the Czech Republic, are trading at significantly negative real yields, being highly influenced by the negative yields in the euro area. In addition, more developed Asian countries, such as Taiwan or South Korea, have low or even negative real yields.

Because of that, investors might be better off to look for opportunities in higher-yielding parts of the local EMD universe. For example, the bonds of Mexico, Indonesia, Russia and South Africa still offer sizable positive real yields.

In addition, the yield curves of a number of higher-yielding EM countries are very steep, as measured by the difference between 10-year and 2-year government bond yields (Figure 15). The steep yield curves allow a strategy of “rolling down the yield curve”, where longer-dated bonds are bought and sold well before the maturity. As long as the yield curve remains upward-sloping, these bonds will gain value just by the passing of time.

Nonetheless, investors need to remain vigilant, as inflation and growth dynamics in these countries can change quickly. High foreign investor participation in some of these high-yielding markets means that bouts of volatility are relatively frequent. This is despite the fact that EM central banks have recently taken a more activist approach to dampen volatility. Because of this, a flexible approach is better suited to capture the potential in these high-yielding countries

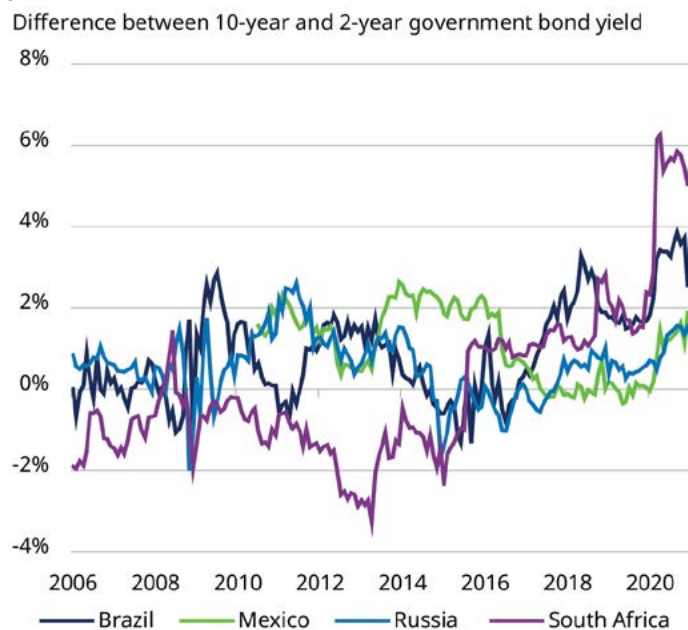
**Figure 14: Wide dispersion in EM real yields**



Source: Refinitiv Datastream. Data as at December 31 2020. JPM GBI-EM index nominal yield deflated by annual core inflation. Taiwan yield is ICE BAML index yield.



**Figure 15: A number of EM countries have very steep yield curves**



Source: Refinitiv Datastream. Data as at 31 December 2020.

**The relationship between bond yields and currencies**

When it comes to investing in local EMD, an additional currency-related factor demands attention. In developed countries, the correlation between bonds and currencies is usually negative, meaning that higher bond yields lead to stronger currencies (as “hot money” flows are drawn in by the prospect of higher yields). However, the opposite is true, on average, in EM. A sell-off in the bond market often coincides with a sell-off in the currency (Figure 16).

**Figure 16: JPM GBI-EM Global Diversified index correlation between principal and FX return (rolling 3 years)**



Source: Schroders, J.P. Morgan. Data as at 31 December 2020.

Importantly, this correlation is not uniform from country to country. As a result, investors can benefit from taking varying bond and currency exposures depending on the conditions. For example, sometimes seeking exposure to an EM currency but not its bond market, or sometimes just taking bond exposure (with the currency exposure hedged out), and sometimes seeking exposure to both.

A good example is Poland. As mentioned previously, Polish sovereign debt has an extremely negative real yield, limiting the extent that yields could fall. However, the prospects are likely better on the currency side, as the Polish Zloty has fallen 27% against the US dollar in real terms since 2011. Hence, it could be useful to take only currency exposure via FX forwards.

Finally, while cheapness does not guarantee positive returns, exposure to EM currencies also allows investors to diversify their core fixed income exposure. EM currencies have a lower correlation with DM bonds than hard currency sovereign bonds and the USD returns of local currency bonds (Figure 17).

**Figure 17: Index coverage in EMD varies considerably**

	G7 Treasuries	Hard sovereign	Local bond in USD	EM FX
G7 Treasuries	x			
Hard sovereign	0.27	x		
Local in USD	0.27	0.81	x	
EM currencies	0.18	0.79	0.97	x

Source: Schroders, J.P. Morgan, Barclays, Data as at 31 December 2020.

**Better market microstructure in local EMD**

How do hard and local currency EMD debt markets compare in terms of underlying market characteristics? There are a number of factors that make the local EMD market attractive for international investors.

First and foremost, much better liquidity conditions. The presence of market participants with varying objectives - local investors, foreign investors, central banks and commercial banks - means that the markets are more balanced in terms of demand and supply. The hard currency market, on the other hand, is dominated by foreign investors. There is no one to balance the market when the flows become very one-sided, especially in bonds of smaller issuers.

Figure 18 shows the average daily trading volume of external debt, local debt and FX forwards in major EM countries. In almost every case, the trading volume of local debt far exceeds the volume of external debt; and is a multiple of it in many cases. The average daily trading volume is greatest in FX forwards. This market is used for currency hedging by various market participants, making it very liquid.

Moreover, in the last 10 years, the liquidity in hard EMD, especially secondary market liquidity, has deteriorated considerably. For example, volume traded as a proportion of hard currency EM debt stock has fallen from 150% in 2010 to only around 50% in 2019 (Figure 19). Liquidity is even worse for smaller, frontier country issuers. These bonds trade infrequently, and often with a large bid-ask spread.

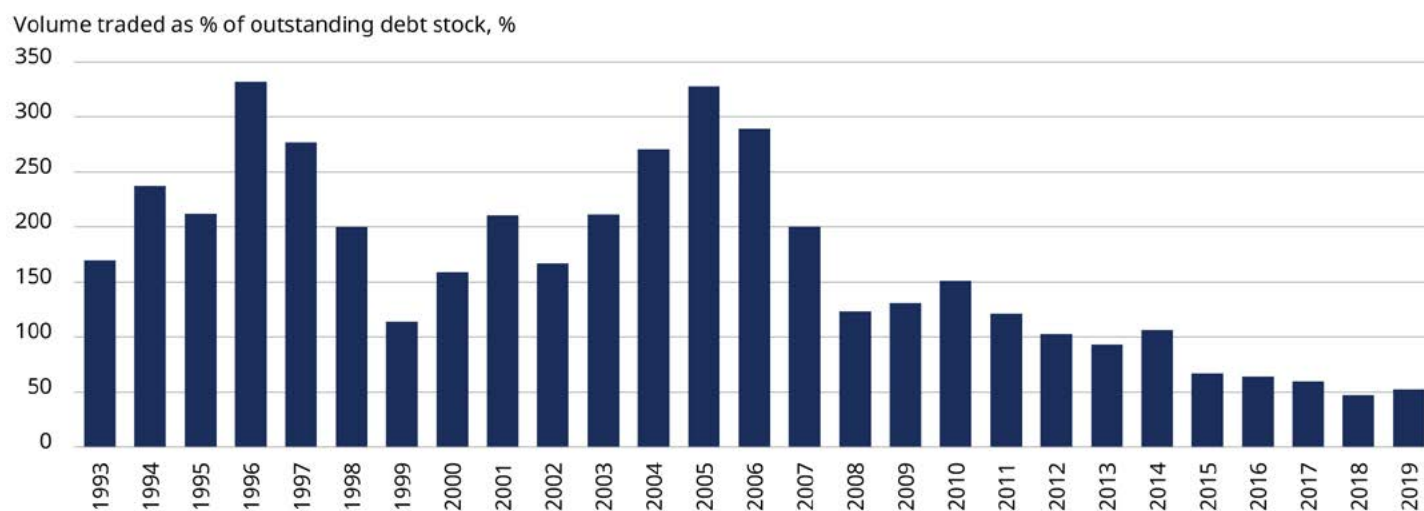
**Figure 18: Average daily trading volume (millions \$)**

	External	Local	FX
Mexico	364	1,191	7,000
Indonesia	235	816	700
Brazil	265	535	4,000
Russia	194	322	15,500
Colombia	205	390	600
South Africa	149	2,128	3,500
Poland	80	516	2,000
Hungary	43	419	1,000
Chile	103	89	750
Malaysia	4	483	500

For illustrative purposes only.

Source: Schroders, BIS, Bloomberg, HSBC, JPM, SCB, EMTA, Deutsche Bank. Data as of 31 December 2020. We have included these countries since they have relatively large and liquid bond and currency markets.

**Figure 19: Deteriorating secondary market liquidity conditions in hard EMD**



Source: BAML, EMTA, Schroders. Data as of 31 December 2019.

**Figure 20: Cost of buying or selling Brazilian local and external debt, and FX**

	FX	Local	External
Notional	\$1,000,000	\$1,000,000	\$1,000,000
Cost	\$500	\$150	\$1,995

For illustrative purposes only.

Source: BIS, Bloomberg, Citi, HSBC, JP Morgan, Schroders, and Standard Chartered Bank. Data as of 31 December 2020.

Given the differences in trading volume, it is no surprise that the cost of trading varies greatly. We have used Brazil as an example in Figure 20, as Brazil is a well-developed market for bonds and FX forwards. The expected cost of trading (in the form of half the bid-ask spread) of \$1 million notional external bonds, local bonds and FX forwards is \$1,995, \$150 and \$500 respectively. The lower trading costs mean that local currency bonds and currencies are better suited for tactical positioning than external bonds.

### The different ways to access EMD

Investors looking to benefit from the opportunities in EMD have to decide how to access the asset class. We highlight here the four most common approaches. With each approach there are positive and negative aspects. In general, there is a trade-off between the ease of implication and the flexibility offered by a strategy.

A passive strategy, either through an index fund or an Exchange Traded Fund (ETF) is generally the cheapest option. However, the cheapness could come at a price. Looking at the two most popular ETFs tracking J.P. Morgan hard and local currency EMD indices, over the last five years, they have underperformed the

benchmarks by 0.51% and 0.66% per annum respectively<sup>4</sup>. This highlights the issues with passive in EMD, as liquidity conditions and trading costs could hamper the effort of index replication. Furthermore, while a passive allocation could seem as a less risky option, it often can be more risky, because of the full exposure to problematic countries.

Next, looking at the first of three active approaches, hiring separate benchmark-relative managers for hard and local EMD can be a logical option. The main advantage is ease of implementation. Active strategies also enable managers to express views on environmental, social and governance (ESG) issues; an integral component to most investment approaches today. However, a major disadvantage is a relatively rigid hard/local EMD split. Changes cannot always be made in a timely manner and large deviations are not usually feasible.

Instead of employing separate hard and local managers, investors could opt for a single manager to run both strategies. This greatly adds flexibility in the sense that the manager can set and vary the allocation between hard and local currency debt. However, while having the ability to take active positions across countries and different types of bonds, managers usually cannot deviate too much from the benchmarks. For example, a manager is unlikely to completely exclude Turkey since it is 10% of the EMD local index. The extent of this flexibility depends on the specifics of each individual fund.

Finally, investors who have the most flexibility and are willing to diverge from the indices, may be best served by total or absolute return strategies. These allows managers to completely exclude certain countries and types of bonds, or invest in countries that are not part of benchmark indices. The downside is that absolute return managers rarely capture the full upside in EMD. There is also greater reliance on manager skill to generate returns.

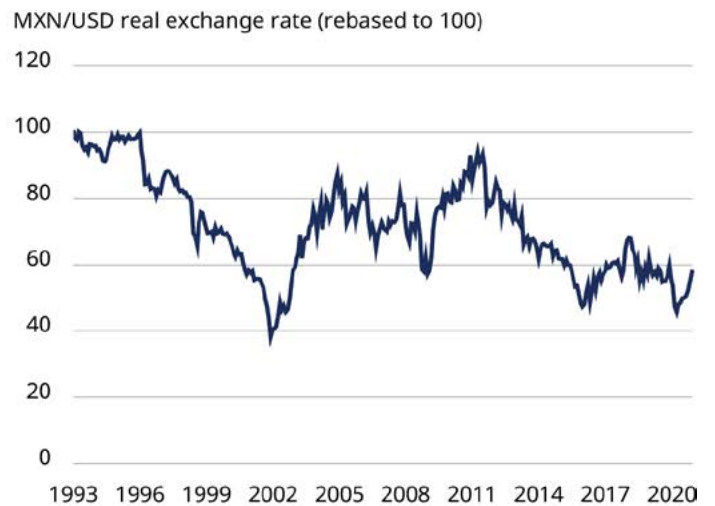
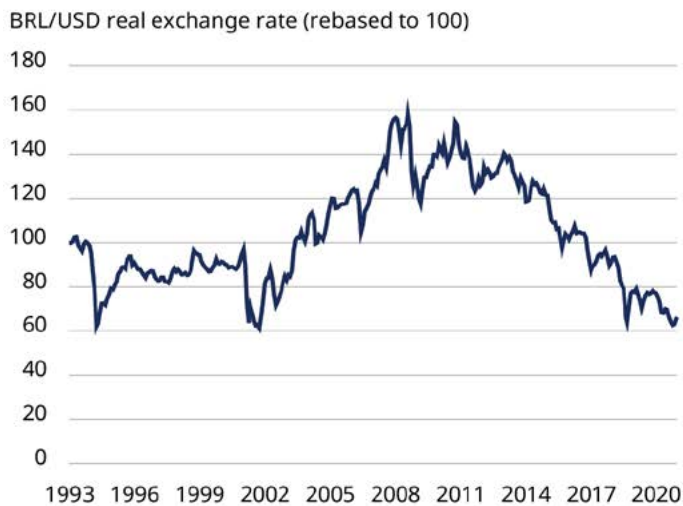
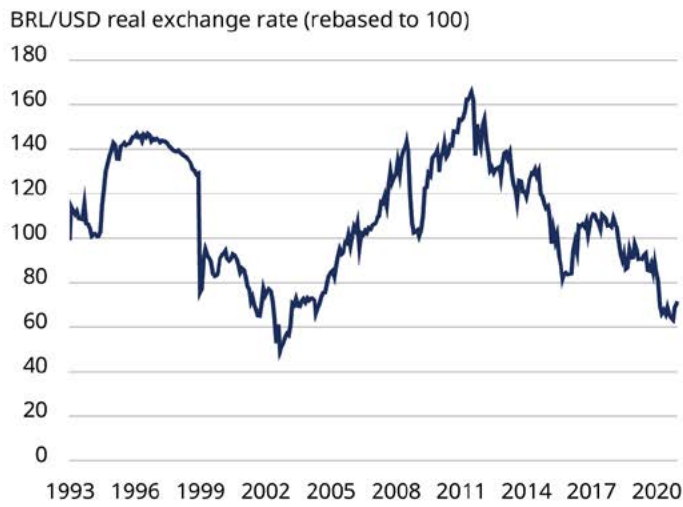
## The key takeaways

- EMD can be a useful addition to portfolios as core bond yields have fallen to record lows. Still, investors need to understand the different nature of hard and local currency bonds. While hard currency EMD can provide yield enhancement, it falls short on diversification and liquidity. Local currency bonds, on the other hand, are more liquid and are better diversifiers. They are also the largest part of the market, although investors need to look beyond benchmark indices to access the full opportunity set.**
- Within local EMD, the value is not uniform. As EM countries vary, so do the yields of the bonds. In this environment, countries with positive real yields are a better starting point. Furthermore, the greatest value is in EM currencies, that have depreciated substantially since 2011.**
- As accidents happen in EM, investors who have the flexibility are best served by opting for an unconstrained strategy that has the capability to exclude certain countries.**

<sup>4</sup> Source: iShares. Data as at 31 December 2020. The ETFs are iShares J.P. Morgan USD Emerging Markets Bond ETF and iShares J.P. Morgan EM Local Currency Bond ETF. Past performance is not a guide to future performance and may not be repeated.

# Appendix

Figure A: Some EM currencies are as cheap as they were in the mid-1990s



Source: Schroders, Refinitiv Datastream. Data as at 31 December 2020. Real exchange rate is nominal dollar exchange rate deflated by CPI index of each EM country vs US.



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