



*Emerging Market Sovereign Debt  
Opportunities and Outlook for 2021*

*23 March 2021*

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# 1. Introduction to Emerging Market Debt

# INTRODUCTION TO EMERGING MARKET DEBT

- Emerging Market Debt is made up of;
  - Foreign currency denominated sovereign bonds
  - Local currency denominated sovereign bonds
  - Corporate bonds
- The standard index for the foreign i.e. hard currency asset class is the JP Morgan EMBI. This was launched in the early 1990's with 14 countries, and now contains 73.
- The local currency standard is the JP Morgan GBI-EM, launched in 2005. This index contains 19 countries.

# INTRODUCTION TO EMERGING MARKET DEBT

- Local Currency Universe is materially larger at 2.1trn USD (JP Morgan GBI-EM Global market cap) and this does not include markets such as Egypt or India.
- The Hard Currency Universe is 1.3trn USD (market cap of the JP Morgan EMBI Global).

## Index Characteristics

	JP Morgan GBI-EM GD	JP Morgan EMBI GD
Yield to Maturity	4.71%	5.08%
Average Coupon	5.44%	5.28%
Modified Duration (yrs)	5.28	7.94
Average Credit Rating	BBB+	BBB-

Source: JP Morgan, Colchester Global Investors. Correct as of 28<sup>th</sup> February 2021. Global Diversified (GD) version of each index used.



# INTRODUCTION TO EMERGING MARKET DEBT

*Hard Currency EM Debt has outperformed Local Currency historically, both have outperformed IG corporate debt and Developed Market government debt:*

	Annualised Return	Annualised Volatility
Global Equities	9.14%	15.11%
US High Yield debt	8.34%	9.14%
Hard Currency EM debt	8.17%	8.60%
Local Currency EM debt (USD unhedged)	6.72%	11.86%
US Corporate debt	5.65%	5.83%
Global Corporate Debt	5.27%	6.52%
Local Currency EM debt (USD hedged)	4.79%	4.26%
Global IG Government debt (USD hedged)	4.21%	2.96%
Global IG Government debt (USD unhedged)	4.18%	6.35%
US Treasuries	3.82%	4.25%

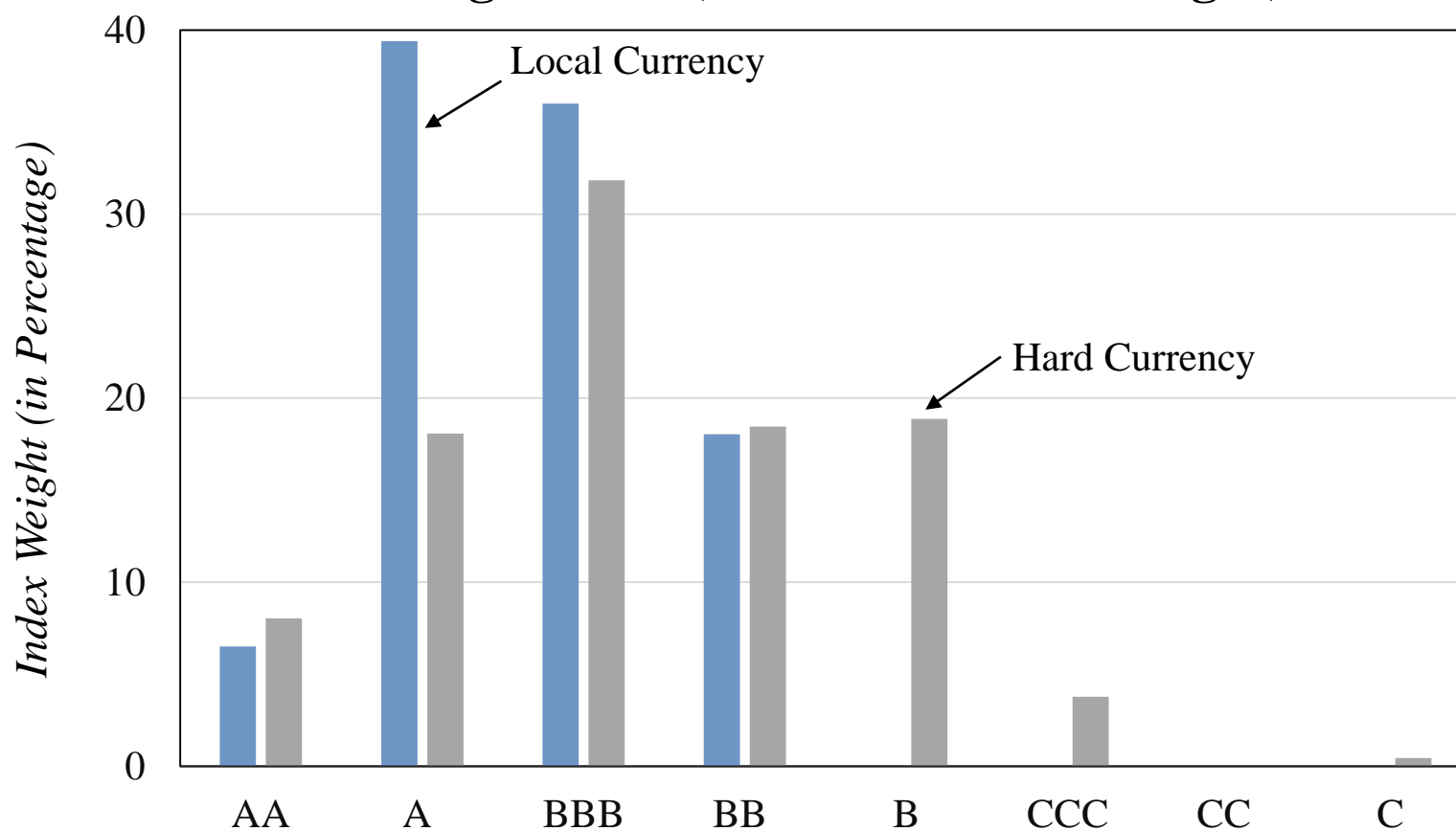
Source: Bloomberg, Colchester Global Investors. Returns in USD terms (unhedged unless stated otherwise) for period from 31/12/2002 to 31/12/2020.

Indices used: MSCI World Total Return USD Index, FTSE World Government Bond Index, FTSE US GBI, JP Morgan GBI-EM Global Diversified Index, ICE BofA Global Corporate Bond Index, Bloomberg Barclays US Corporate Bond Index, JP Morgan EMBI Global Diversified Index, ICE BofA US High Yield Index.

# INTRODUCTION TO EMERGING MARKET DEBT

*Local currency debt typically higher rated:*

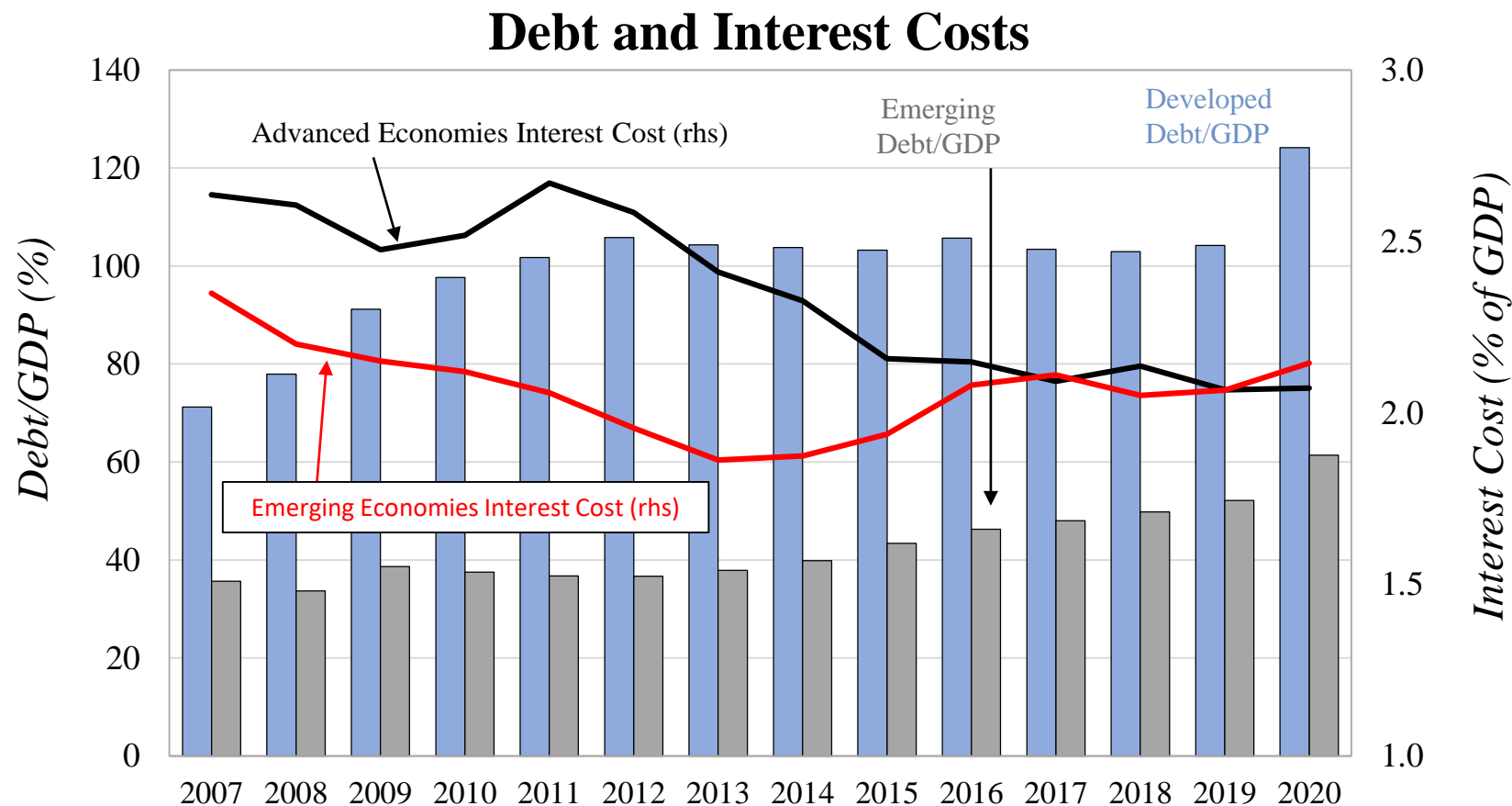
## Credit Rating Profile (Percent of index weight)



Source: JP Morgan, Bloomberg. As at 31/12/2020. Rating is highest of S&P, Moody's and Fitch, where available. The local currency rating is used for the local currency index (JP Morgan GBI-EM GD) and the foreign currency rating for the hard currency index (JP Morgan EMBI GD).

# INTRODUCTION TO EMERGING MARKET DEBT

*Debt levels and interest costs in EM under upward pressure due to Covid but are manageable in most cases:*

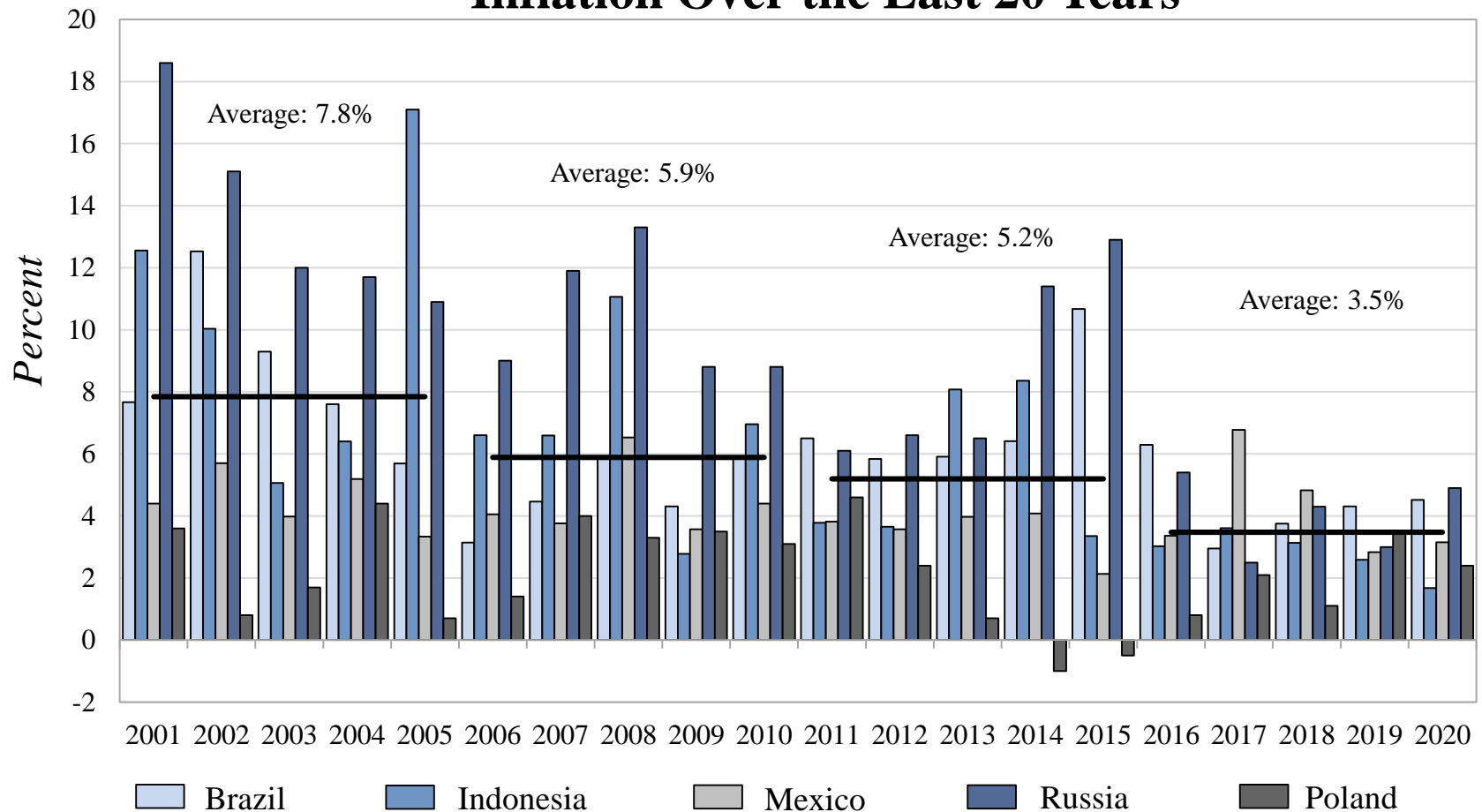


Source: IMF World Economic Outlook October 2020, IMF Fiscal Monitor October 2020.

# INTRODUCTION TO EMERGING MARKET DEBT

*Inflation has structurally declined:*

## Inflation Over the Last 20 Years



Source: Official Sources, further information upon request.

## **2. The role of EMD in a Diversified Portfolio**

## EMERGING MARKET DEBT

*EM debt (Local and Hard Currency) positively correlated to equities, but not as much as High Yield. Local Currency EMD offers somewhat better diversification relative to other Fixed Income sectors compared to Hard Currency:*

### Historical Return Correlations of Fixed Income Sectors

	Global Equities	WGBI	WGBI (USD hedged)	US Treasuries	LC EMD	LC EMD (USD hedged)	Global Corporates	US Corporates	EMBI	US High Yield
Global Equities	1.00									
WGBI	0.16	1.00								
WGBI (USD hedged)	-0.25	0.58	1.00							
US Treasuries	-0.41	0.56	0.87	1.00						
LC EMD	0.64	0.57	0.06	-0.06	1.00					
LC EMD (USD hedged)	0.37	0.56	0.44	0.34	0.81	1.00				
Global Corporates	0.64	0.71	0.33	0.17	0.76	0.67	1.00			
US Corporates	0.40	0.59	0.60	0.44	0.53	0.66	0.86	1.00		
EMBI	0.63	0.49	0.23	0.03	0.80	0.73	0.84	0.76	1.00	
US High Yield	0.81	0.28	-0.04	-0.25	0.68	0.49	0.78	0.66	0.81	1.00

Source: Bloomberg, Colchester Global Investors. Returns in USD terms (unhedged unless stated otherwise) for period from 31/12/2010 to 31/12/2020.

Indices used: MSCI World Total Return USD Index, FTSE World Government Bond Index, FTSE US GBI, JP Morgan GBI-EM Global Diversified Index, ICE BofA Global Corporate Bond Index, Bloomberg Barclays US Corporate Bond Index, JP Morgan EMBI Global Diversified Index, ICE BofA US High Yield Index.

## EMERGING MARKET DEBT

*At equivalent Credit Ratings, Default Rates have been higher in Foreign Currency Sovereign Debt than Local Currency:*

### **Sovereign Cumulative 5yr Average Default Rates, 1975-2019 (%)**

<b>Rating</b>	<b>Foreign Currency</b>	<b>Local Currency*</b>
<b>AAA</b>	0.00	0.00
<b>AA</b>	0.00	0.00
<b>A</b>	1.62	1.57
<b>BBB</b>	2.13	1.45
<b>BB</b>	4.25	2.9
<b>B</b>	14.34	5.87
<b>CCC/CC</b>	54.23	30.53

Source: S&P, 2019 Annual Sovereign Default and Rating Transition Study, May 2020.

\*1993-2019 for Local Currency.

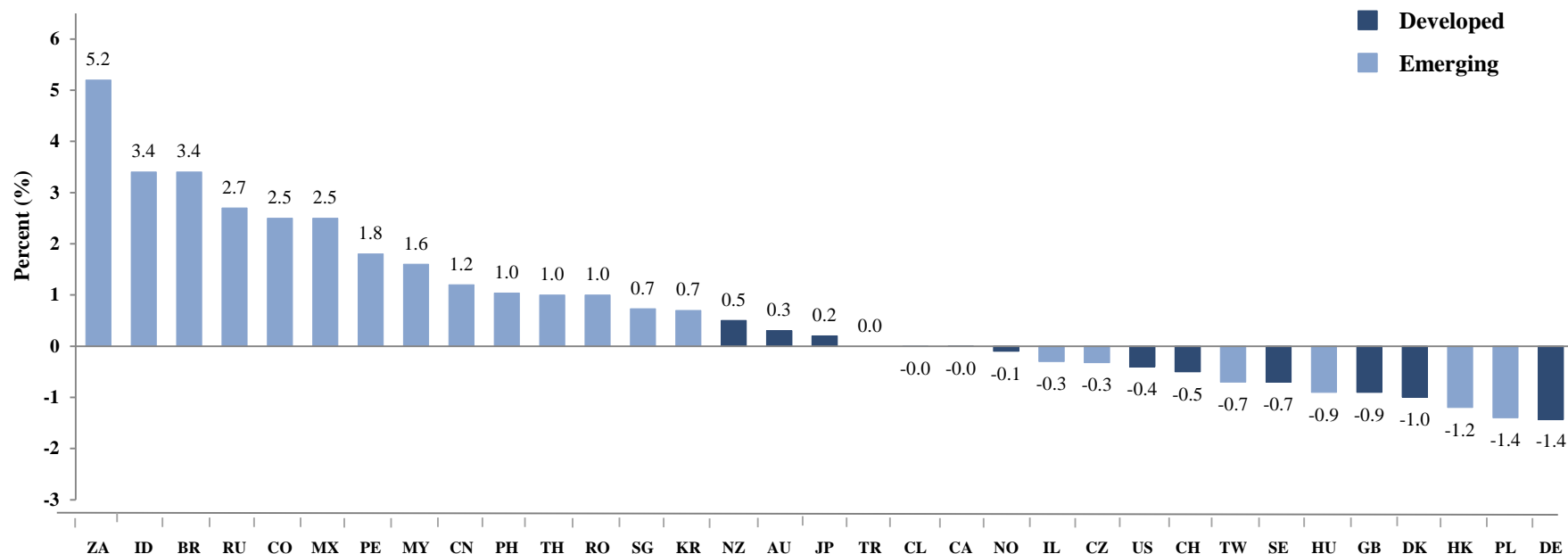
### **3. Valuations – comparing Hard and Local Currency**



# VALUATIONS – LOCAL CURRENCY EMD

## Real Yields equal 10 year market yield less Colchester inflation forecasts

February 2021



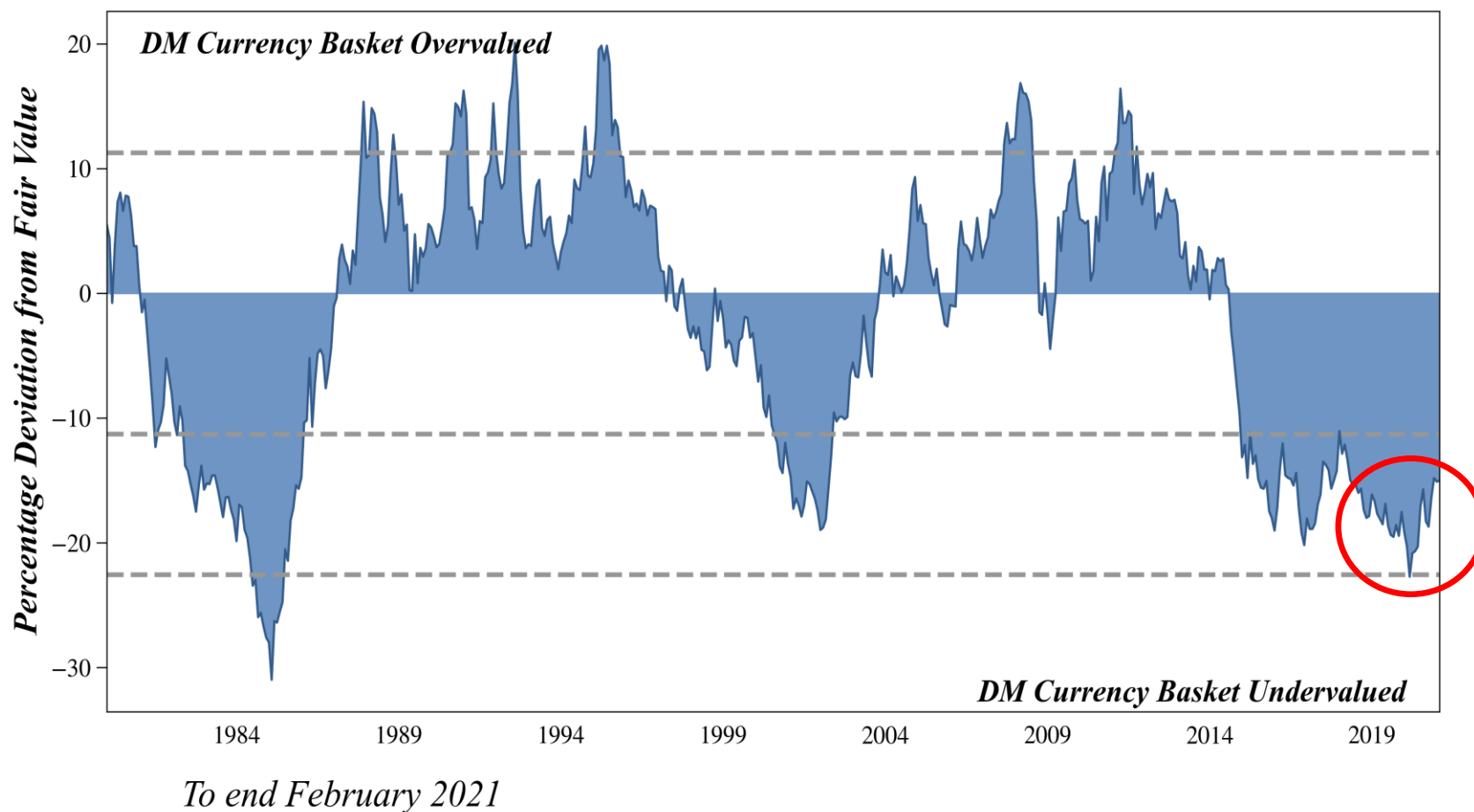
<b>AU</b>	Australia	<b>CO</b>	Colombia	<b>HU</b>	Hungary	<b>MY</b>	Malaysia	<b>RO</b>	Romania	<b>TW</b>	Taiwan
<b>BR</b>	Brazil	<b>CZ</b>	Czech Republic	<b>ID</b>	Indonesia	<b>NO</b>	Norway	<b>RU</b>	Russia	<b>US</b>	United States
<b>CA</b>	Canada	<b>DK</b>	Denmark	<b>IL</b>	Israel	<b>NZ</b>	New Zealand	<b>SE</b>	Sweden	<b>ZA</b>	South Africa
<b>CH</b>	Switzerland	<b>DE</b>	Germany	<b>JP</b>	Japan	<b>PE</b>	Peru	<b>SG</b>	Singapore		
<b>CL</b>	Chile	<b>GB</b>	United Kingdom	<b>KR</b>	Korea	<b>PH</b>	Philippines	<b>TH</b>	Thailand		
<b>CN</b>	China	<b>HK</b>	Hong Kong	<b>MX</b>	Mexico	<b>PL</b>	Poland	<b>TR</b>	Turkey		

### Notes:

1. The prospective real yield for the 10 year sector is shown here for representational purposes. Colchester values up the 2, 5, 10 and 20 year sectors of the yield curve when valuing a country. The final portfolio reflects the value on offer in these individual yield curve points.
2. The expected real yield for Euroland is calculated based on the 10 year German Bund yield and the Colchester forecast for inflation in the Eurozone.
3. Source: Colchester Global Investors, individual Central Bank CPI and PPI data, and Bloomberg

## VALUATIONS – LOCAL CURRENCY EMD

### DM Currency Basket - United States Dollar Real Exchange Rate

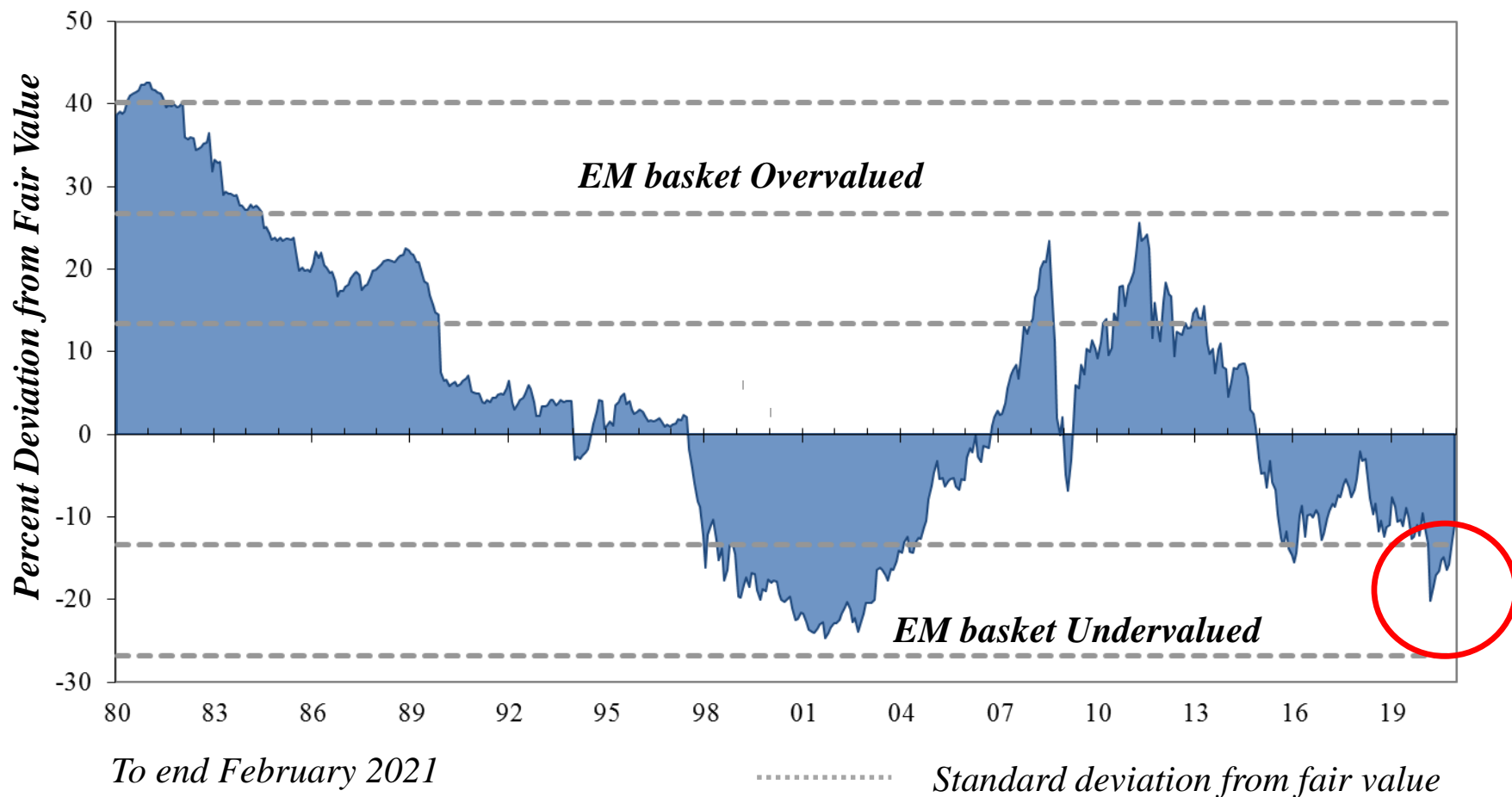


*Note: The grey bands represent multiples of the standard deviation, with the innermost bands representing 1 and -1 standard deviation.*

*DM Currency Basket is the equally weighted real exchange estimate of the Euro, Japanese Yen, British Pound, Canadian Dollar, Norwegian Krone.*

*Source: Colchester Global Investors, individual Central Bank CPI and PPI data, Bloomberg and WMReuters exchange rates*

## Index weighted EM Currency – US Dollar Real Exchange Rate



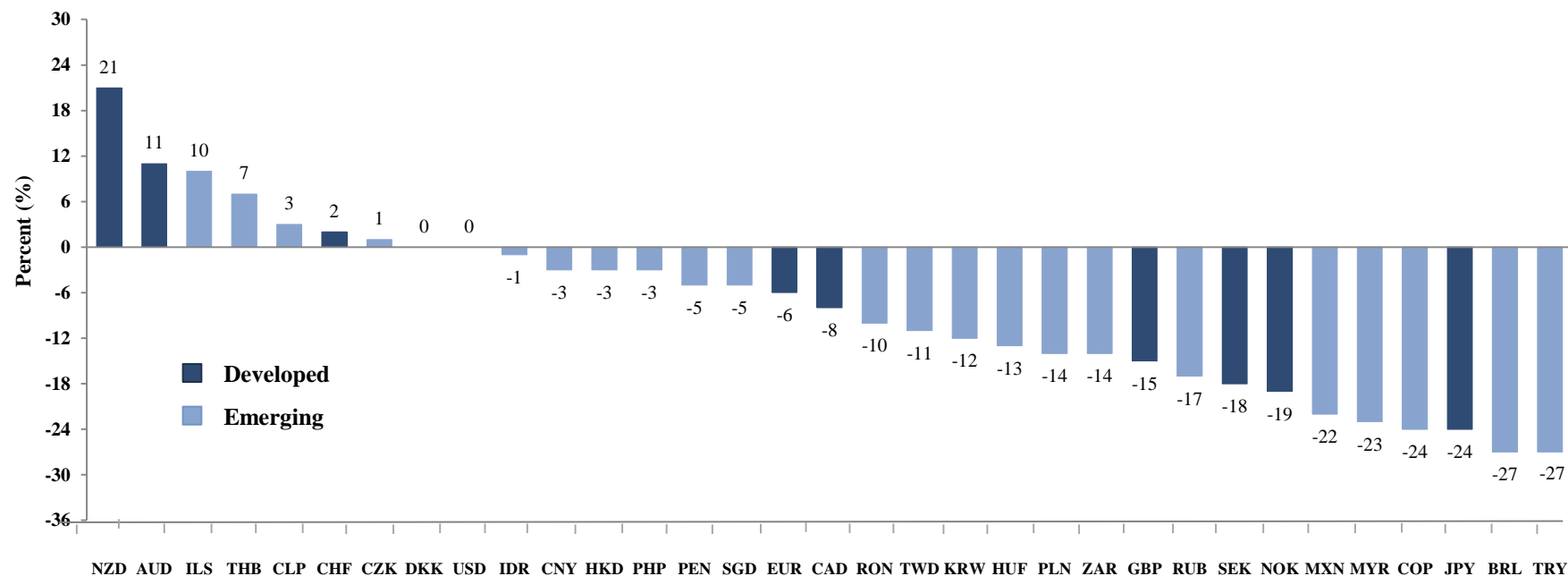
Source: Colchester Global Investors, individual Central Bank CPI and PPI data, Bloomberg, JP Morgan, WM Reuters.

Index weights are those of the JP Morgan GBI-EM Global Diversified Index.

# VALUATIONS – LOCAL CURRENCY EMD

## Real FX versus USD

February 2021

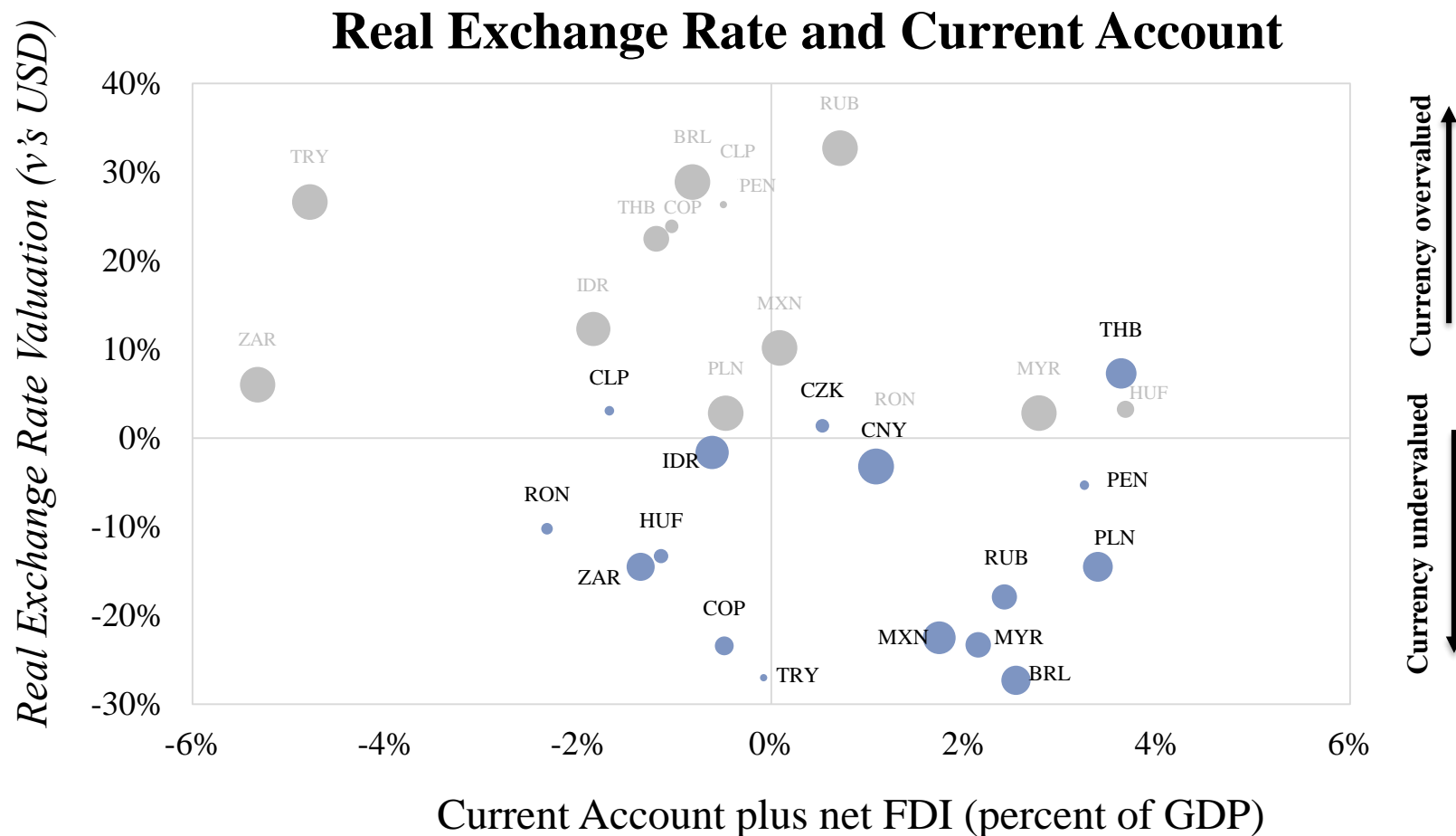


<b>AUD</b> Australian Dollar	<b>COP</b> Colombian Peso	<b>HUF</b> Hungarian Forint	<b>MYR</b> Malaysian Ringgit	<b>RON</b> Romanian Leu	<b>TWD</b> Taiwan Dollar
<b>BRL</b> Brazilian Real	<b>CZK</b> Czech Koruna	<b>IDR</b> Indonesian Rupiah	<b>NOK</b> Norwegian Krone	<b>RUB</b> Russian Ruble	<b>USD</b> United States Dollar
<b>CAD</b> Canadian Dollar	<b>DKK</b> Danish Krone	<b>ILS</b> Israeli New Shekel	<b>NZD</b> New Zealand Dollar	<b>SEK</b> Swedish Krona	<b>ZAR</b> South Africa Rand
<b>CHF</b> Swiss Franc	<b>EUR</b> Euro	<b>JPY</b> Japanese Yen	<b>PEN</b> Peruvian Sol	<b>SGD</b> Singapore Dollar	
<b>CLP</b> Chilean Peso	<b>GBP</b> Great British Pound	<b>KRW</b> Korean Won	<b>PHP</b> Philippine Peso	<b>THB</b> Thai Baht	
<b>CNY</b> Chinese Renminbi	<b>HKD</b> Hong Kong Dollar	<b>MXN</b> Mexican Peso	<b>PLN</b> Polish Zloty	<b>TRY</b> Turkish Lira	

Source: Colchester Global Investors, individual Central Bank CPI and PPI data, Bloomberg, and WMReuters

## VALUATIONS – LOCAL CURRENCY EMD

*EM Currency valuations and fundamentals have improved since 2013:*

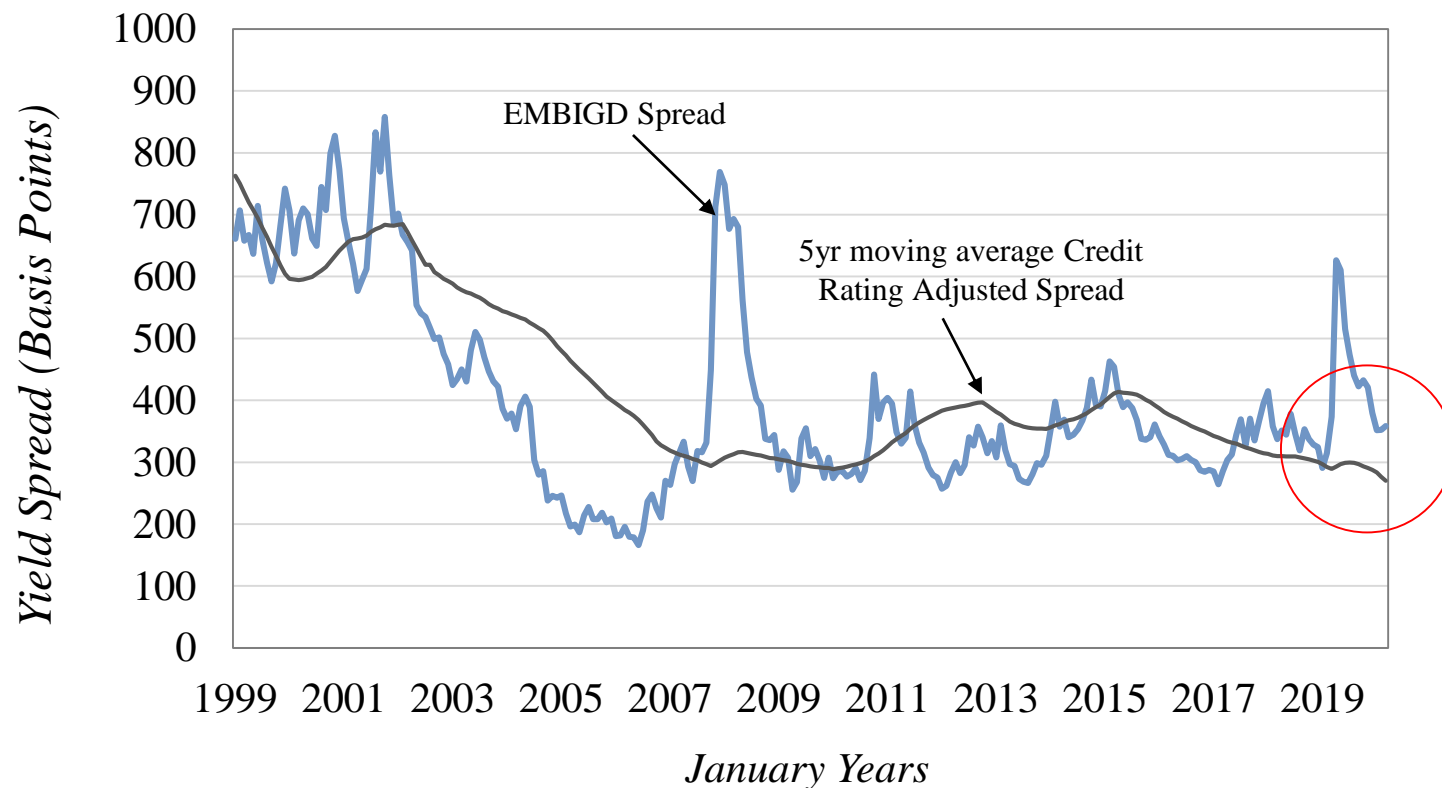


Source: IMF, World Bank, Colchester Global Investors as of May 2013 and February 2021.

## VALUATIONS – HARD CURRENCY EMD

*Index Spread around 60bps wider than average rating spread:*

### JP Morgan EMBIGD Index Yield Spread

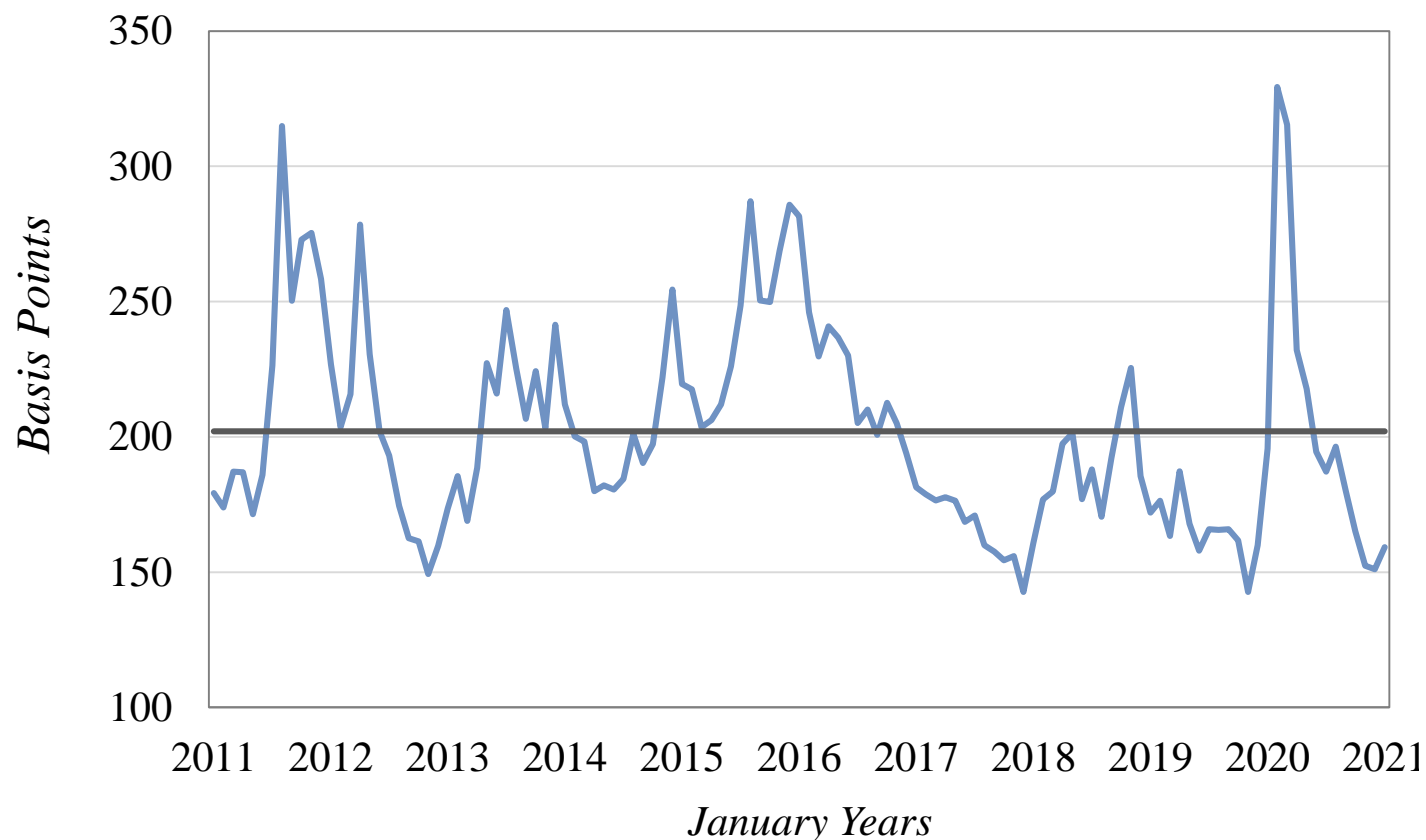


Source: JP Morgan, Bloomberg, Colchester Global Investors. Data from December 1999 to February 2021. The "Spread" is over US Treasuries.

## VALUATIONS – HARD CURRENCY EMD

*Investment Grade spreads close to the tightest in past 10 years:*

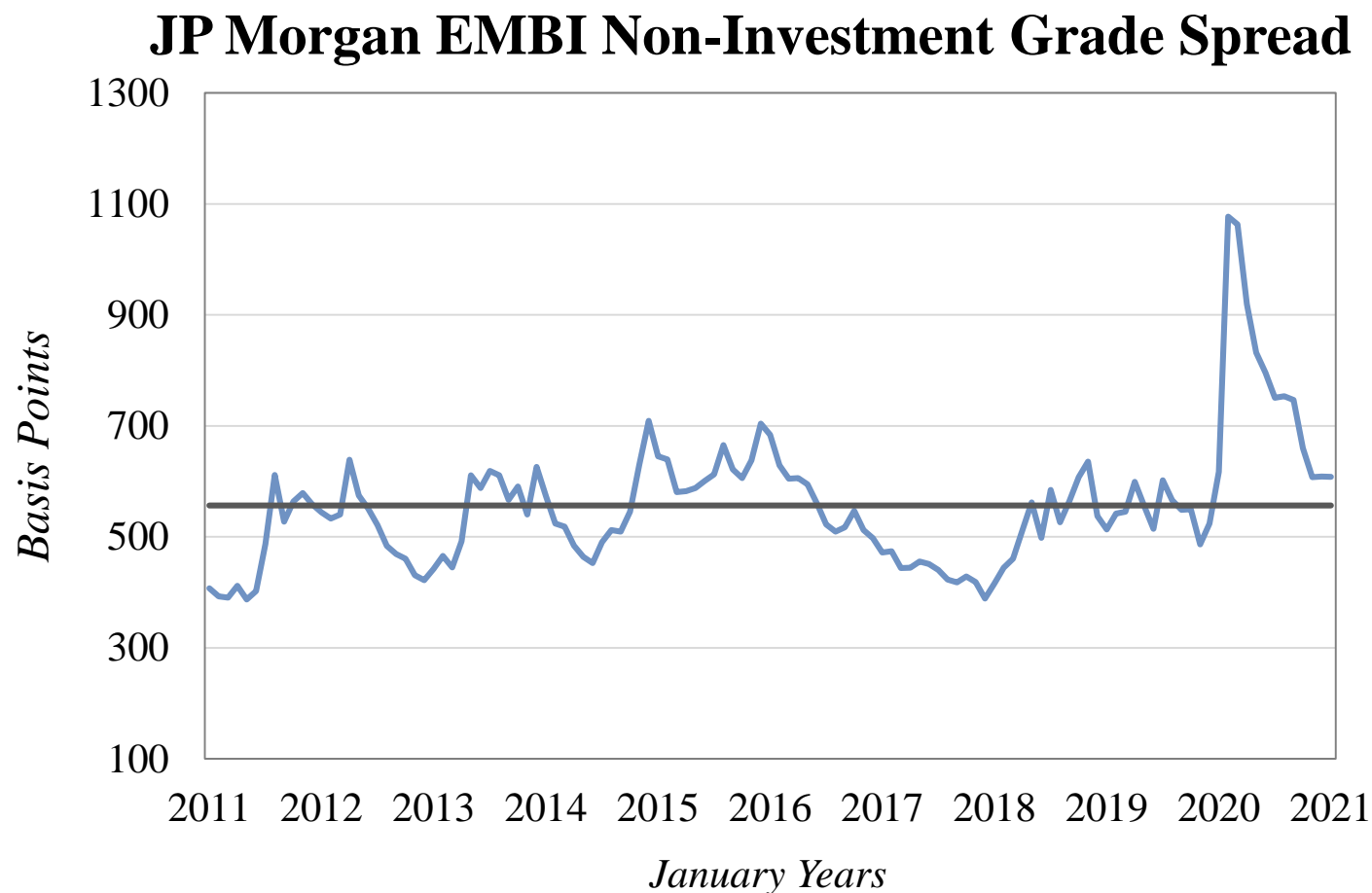
### JP Morgan EMBI Investment Grade Spread



Source: JP Morgan, Bloomberg. Data from 28/02/2011 to 28/02/2021. Grey line shows the average over the period.

## VALUATIONS – HARD CURRENCY EMD

*But Non-Investment Grade Spreads above 10yr average:*



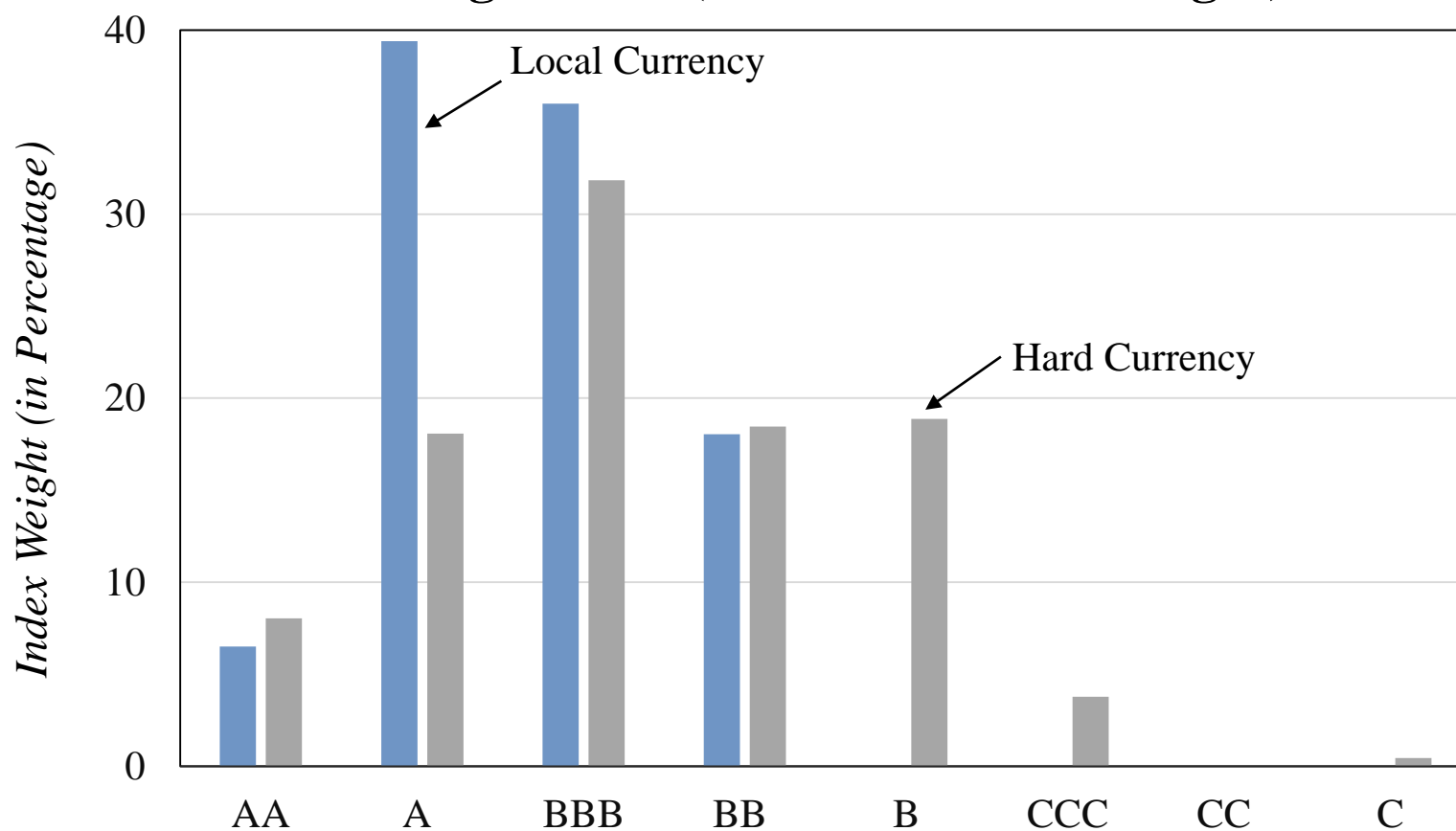
Source: JP Morgan, Bloomberg. Data from 28/02/2011 to 28/02/2021. Grey line shows the average over the period.



## VALUATIONS – HARD CURRENCY EMD

*Hard Currency Index contains more exposure to lower credits:*

### Credit Rating Profile (Percent of index weight)



Source: JP Morgan, Bloomberg. As at 31/12/2020. Rating is highest of S&P, Moody's and Fitch, where available. The local currency rating is used for the local currency index (JP Morgan GBI-EM GD) and the foreign currency rating for the hard currency index (JP Morgan EMBI GD).

## 4. Conclusions

## CONCLUSIONS

- Local and hard currency EM sovereign debt need to be considered as separate asset classes with different characteristics.
- The local currency universe is larger and growing more rapidly than the hard currency space, and offers a higher average credit quality.
- Hard currency has historically generated higher returns than local currency EM debt, but EM currencies currently undervalued relative to the US dollar.



**Please send your queries to**

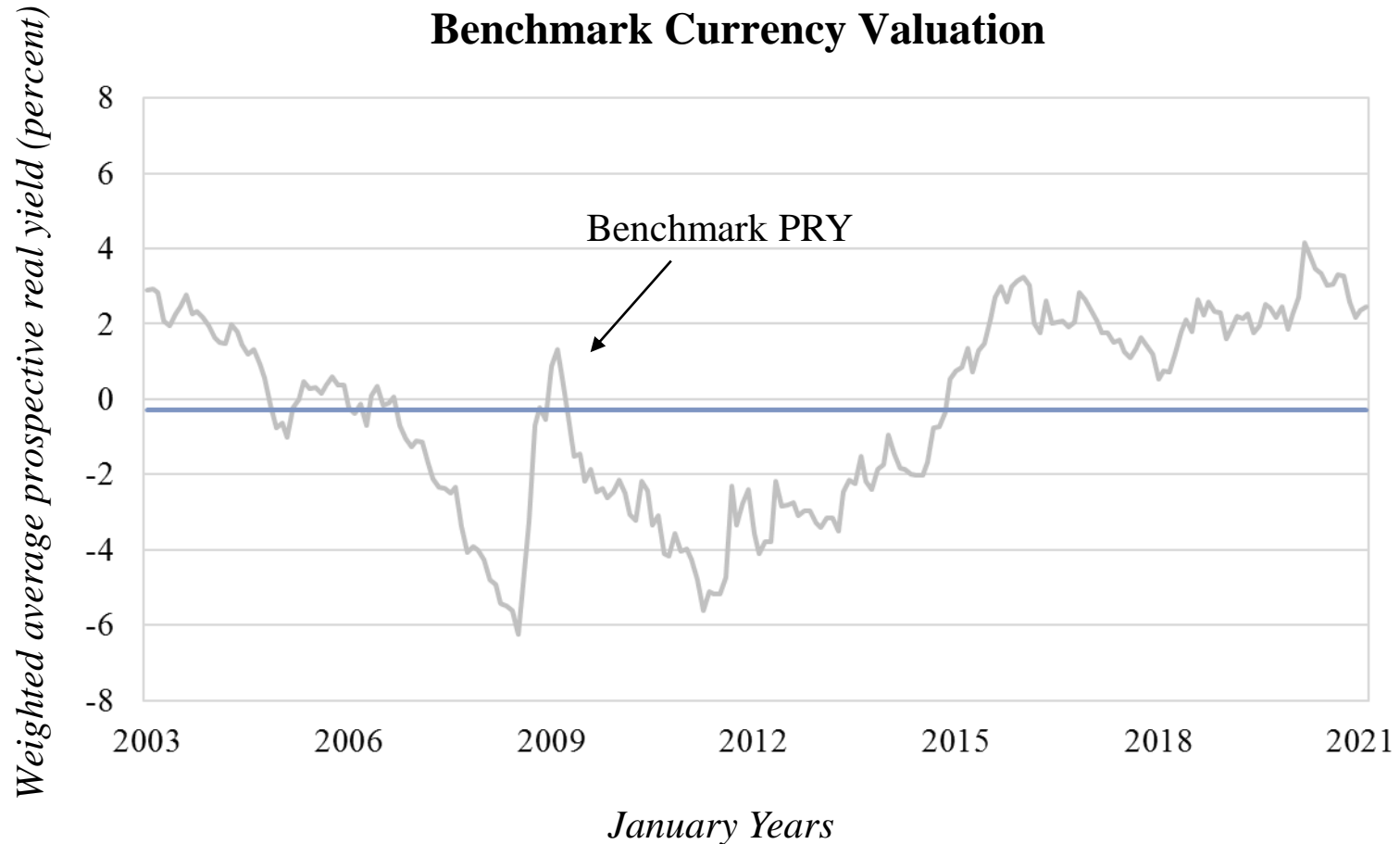
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## 5. Appendix

# PROSPECTIVE REAL YIELD

*Currency - Benchmark PRY:*

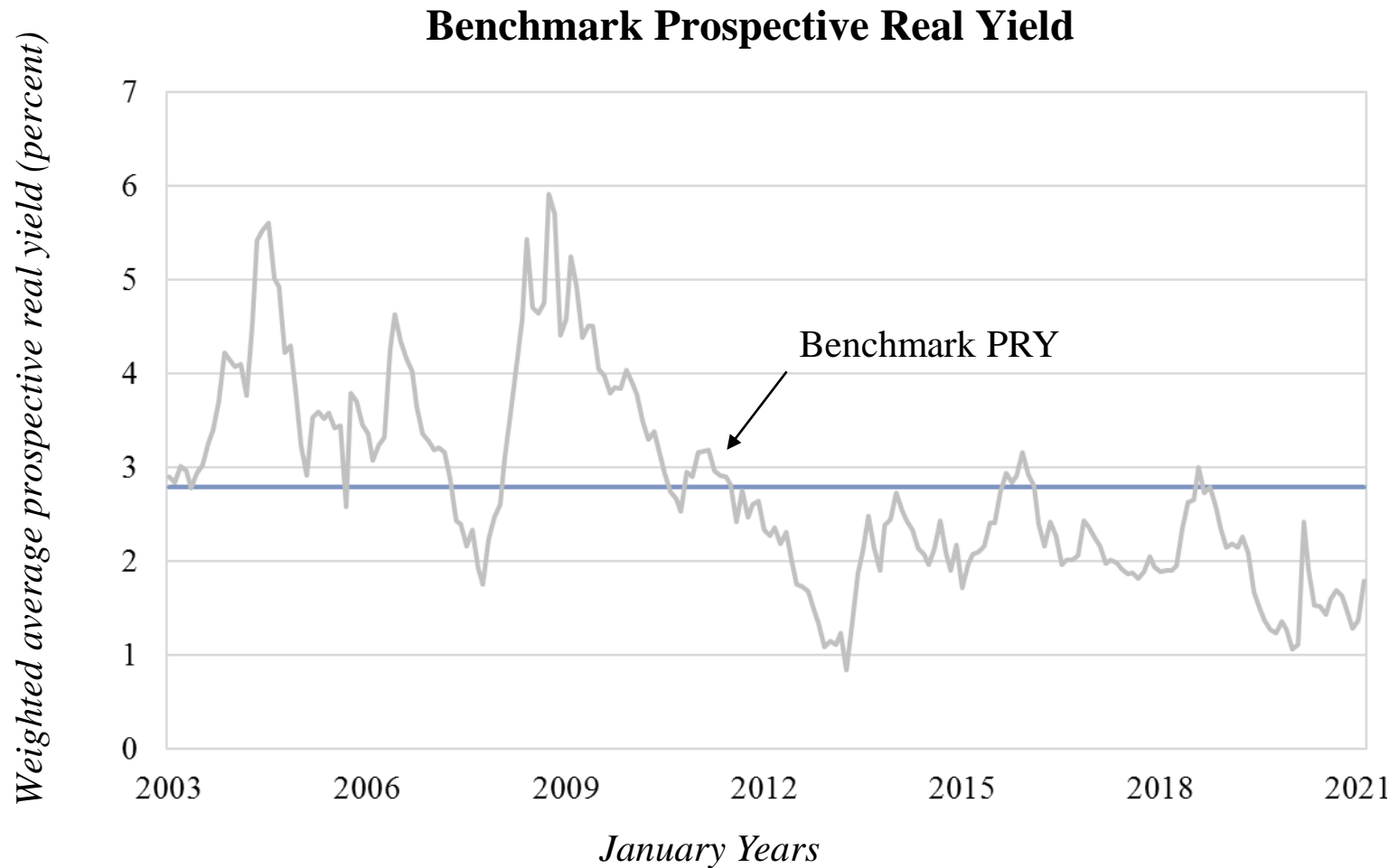


*Currency is translated into an equivalent real yield by dividing portfolio or benchmark aggregate real exchange rate undervaluation (versus the USD) by 5. This assumes a 5 year reversion to fair value. An undervalued currency has a positive value and an overvalued currency a negative - Data as at end February 2021.*

*Benchmark is the JP Morgan GBI-EM Global Diversified index.*

# PROSPECTIVE REAL YIELD

*Bonds - Benchmark PRY:*

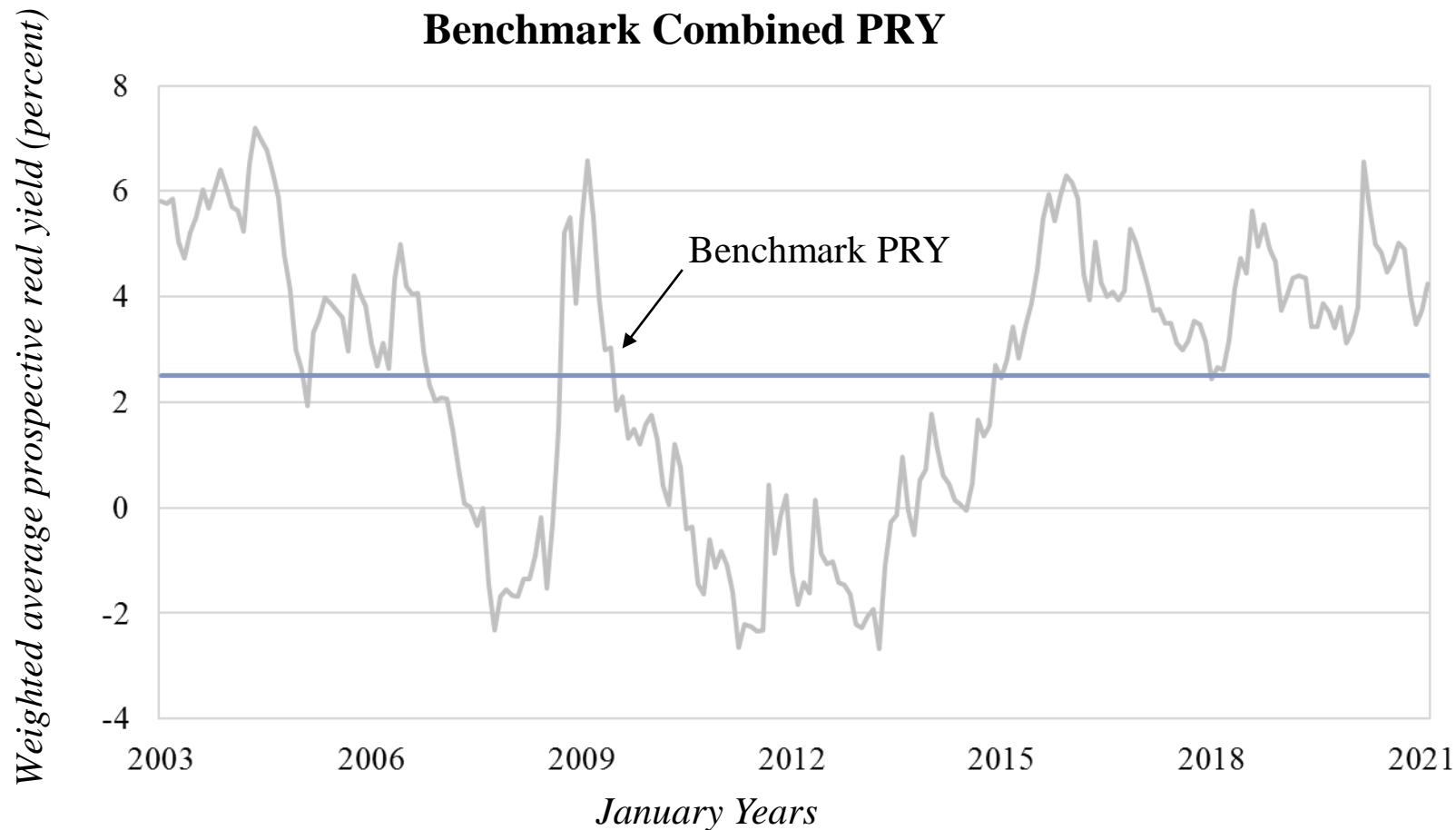


*Notes: Prospective Real yield is the 10yr nominal yield in each market, minus Colchester's forecast of inflation where available. Otherwise market index yield to maturity or (known) next 12 months' consumer price inflation is substituted - Data as at end February 2021.*

*Benchmark is the JP Morgan GBI-EM Global Diversified index.*

# PROSPECTIVE REAL YIELD

*Combined - Benchmark PRY:*



*Combined of bond prospective real yield (10yr nominal yield in each market, minus Colchester's forecast of inflation) and currency real yield (equivalent real yield by dividing portfolio or benchmark aggregate real exchange rate undervaluation (versus the USD) by 5) - Data as at end February 2021.*

*Benchmark is the JP Morgan GBI-EM Global Diversified index.*



## BIOGRAPHIES – Introducing and Guest Speakers



**Cian O'Brien, MSc, CFA**

*Senior Investment Officer*

Cian is a Senior Investment Officer at Colchester Global Investors and has been with the firm since 2013. Cian manages both developed and emerging market bond portfolios and conducts sovereign balance sheet research at the firm. He began his career in 2002 with the Central Bank of Ireland before moving into asset management with Bank of Ireland Asset Management. In 2011 he joined State Street Global Advisors (SSgA) in London where he was a senior portfolio manager on the active global fixed income team. Cian graduated from University College Cork with a degree in Commerce and German, before obtaining a Masters in Investment and Treasury from Dublin City University. He is a CFA charterholder and a member of the CFA Society of the UK.



**Mark Capstick, BA (Hons)**

*Investment Officer*

Mark is an Investment Officer at Colchester Global Investors and has been with the firm since June 2016. Mark started his career in 1998 and has managed bonds and currencies since 2000. Prior to joining Colchester, Mark was an Emerging Market Bond and Currency Investment Manager at Fischer, Francis, Trees & Watts (FFTW), starting in 2012. Before FFTW, Mark was a Fund Manager at Rexiter Capital Management, a subsidiary of State Street Global Advisors (SSgA). While there he was responsible for the analysis and management of Asian fixed income and currency investments for Rexiter's emerging markets fixed income products. He joined Rexiter in November 2006 from SSgA where he worked as an Investment Manager in SSgA's Global Fixed Income group, focusing on 'developed world economies,' most notably those in the dollar bloc. In 2003 and 2004 Mark worked in Singapore and assisted in building the first local currency denominated Asian bond fund. Mark earned a BA (Hons) in Financial Services from Manchester Metropolitan University.



**Analia Giachino, BA, M.Fin.**

*Product Specialist*

Analia is a Product Specialist within the Marketing and Client Services team, based in Montevideo, and joined the firm in March 2020. Analia assists with the firm's marketing and business development efforts in the Latin American and US offshore markets. Analia has a background in Advisory and Investment Analysis having led the Advisory and Investment Analysis team at PAM Global Investors for several years and more recently the Research team at Puente Corredor de Bolsa in the Southern Cone. She also held sales roles at Commerzbank Spain, Man Investments in London and EFG and BBVA banks in Uruguay. Analia lectures as Professor on Asset Pricing and Financial Analysis at the Universidad de Montevideo and holds a BA in Economics from Universidad de la República and a Master in Financial Analysis from Universidad Carlos III de Madrid.