COLCHESTER®
GLOBAL INVESTORS

Q&A - EM Sovereign Debt

Opportunities and Outlook for 2021

Mark Capstick   Cian O'Brien   Carl Roberts

Yields are rising in the US, what does this mean for Emerging Markets?

Emerging market assets have weakened since the turn of the year with rising yields in the US weighing on local and hard currency bond prices and some depreciation of EM currencies against the US dollar. Rising yields do equate to a tightening of global financial conditions all else being equal, and a strengthening US dollar is often associated with a reversal of capital flows to EM as we observed with the "taper tantrum" in 2013. Nonetheless, we at Colchester believe the current period is not comparable to 2013, for a few reasons:

- *the rise in US yields can largely be attributed to the more positive outlook for the US and global economies, and an associated rise in inflation expectations;*
- *real yields in the US remain close to historical lows, and remain a "push factor" for capital to seek out the more attractive real yields in many of the Emerging Markets;*
- *there is no indication of monetary policy being tightened in the US as the Fed has reiterated its comfort level with the current policy stance; and*
- *the external balance sheets of emerging economies are generally stronger than in 2013, for example more robust current account positions in many cases and a lower reliance on portfolio inflows.*

Real exchange rate valuations of many of the major Emerging Markets have improved relative to those prevailing in 2013, as exchange rates have weakened materially in nominal and real terms since then. With external vulnerabilities having significantly reduced since 2013, this puts many of the Emerging Markets in a much stronger position today to withstand tighter global financial conditions. This is a generalised view of the EM universe, and of course for specific countries (such as Turkey for example) there will be volatility and in instances where policy credibility is weak, or external vulnerabilities large, asset prices and exchange rates may suffer. Nonetheless, in many of the largest Emerging Markets we see opportunities to take advantage of undervalued currencies, combined with robust external balance sheets and credible policy frameworks.

EM currencies have weakened for many years, why don't you think they will continue to depreciate?

The consistent undervaluation of EM currencies in recent years is indeed striking, but does not in itself shift our opinion that such undervaluation will eventually be corrected. In the short term, exchange rates can be volatile and deviate from fundamental "fair value" for significant periods of time. Emerging Markets have certainly been negatively impacted by a series of negative shocks in recent years also, which have contributed to their relative underperformance.

We continue to believe however that the undervaluation of EM exchange rates, combined with a credible policy framework in most instances, will act as "pull factors" for global capital. At the same time, we believe the US dollar to be materially overvalued against most global currencies and the accommodative stance of monetary policy in developed markets is likely to act as a "push factor" for capital to seek higher yields in emerging markets.

The US dollar has been relatively strong for some time, even considering the declines seen in the second half of 2020. This overvaluation may ultimately lead to the beginning of a significant depreciation. Such an eventuality has historically been a good backdrop for Emerging Market assets, both local and hard currency denominated.

What is the impact of Covid-19 on Emerging Market currencies and bond markets?

Vulnerability to crises was previously a feature of many Emerging Market economies, but today that vulnerability is lower, at least for the major issuers of local currency emerging market government bonds. According to Colchester's analysis, the market turmoil and economic contraction associated with the COVID-19 pandemic was met with a strong policy response from central banks in many major Emerging Markets. At least 18 EM central banks launched asset purchase programmes, targeting local currency-denominated sovereign or private sector bonds, with a broadly positive experience. These aggressive policy measures have played a key role in supporting investor sentiment, allowing portfolio flows into many emerging markets to recover in the second half of 2020, thereby supporting domestic capital markets and their currencies. As we have mentioned, some currencies remain undervalued, but this acts as an 'automatic stabiliser' for these economies where over the medium term, undervalued currencies will increase relative competitiveness and attract long-term direct foreign investment.

Are new markets being added to the local currency emerging market indices?

India is the most significant but not the only potential new entrant to the major local currency emerging market indices. Authorities in India launched the "Fully Accessible Route" for foreign investors to access the domestic Indian bond market in 2020 and this has increased the likelihood of index inclusions greatly. India has one of the largest local currency government bond markets amongst EM economies with over USD1trillion[1] outstanding in Indian Government Bonds (IGBs). We are currently in the process of setting up settlement accounts and building the operational capabilities to access the Indian market, as we believe it does offer attractive characteristics within a diversified portfolio of Emerging Market debt.

Other potential entrants to the local currency index over the next few years include Serbia and Egypt. We do expect that the local currency universe will continue to expand as issuers look to increase liquidity and improve access for foreign investors.

You compare the BB Spread to the JP Morgan Emerging Market Bond Index Global Diversified (EMBIGD) spread arguing the EMBIGD is BB rated on average, has this always been the case? Has the average rating of the index changed over time?

The simple, or unweighted, average rating of the JP Morgan EMBIGD has been BB since early 2003, prior to which the average was BB- from at least early 2000. This hard currency index has seen the number of constituent issuers increase significantly over the years, but this shift has not materially impacted the average rating of the universe. Whilst some lower-rated countries have entered the index, we have also seen an improvement in the balance sheet fundamentals of longstanding issuers, as well as the inclusion of several higher-rated countries such as many of the Gulf states.

[1] Source: Bloomberg

Have you further assessed how the EM hard currency sovereign and corporate have performed relative to each other?

As a sovereign bond manager, Colchester does not analyse EM corporate debt in any detail. However, a few observations can be made on the performance and characteristics of the two asset classes.

	Total Return	Annualised Return	Annualised Volatility	Return/Vol
EM Hard Currency Sovereign Bonds	367.1%	8.41%	8.7%	0.97
EM Hard Currency Corporate Bonds	275.8%	7.18%	7.6%	0.95

Source: JP Morgan and Colchester Global Investors. Data from December 2001 to December 2020.
EM Hard Currency Sovereign Bonds refers to the JP Morgan EMBI Global Diversified Index.
EM Hard Currency Corporate Bonds refers to the JP Morgan Corporate EMBI Broad Diversified Index.

Overall, historical returns favour sovereigns over corporates within the hard currency asset class, even on a risk adjusted basis.

Proponents of hard currency corporates will rightly point to the longer duration of the sovereign index, which has lengthened over time from 5.0 years at the start of 2002, to its current 7.9 years, whereas the corporate index has seen a slight decline since its launch in 2002 of 5.6 years to 4.9 years[2]. Given the general trend lower in yields, clearly the sovereign asset class will have benefitted from the higher duration effect.

However, one way to adjust for this duration difference and better compare the two asset classes is to assess the level of spread, in basis points, per year of duration on each index. Doing this, we find that hard currency corporate bonds offer a higher level of spread per year of duration. Despite this, the higher premium offered on EM corporates has not translated into higher performance, as shown in the previous table. Furthermore, the difference between the two asset classes, on a spread per duration series, has remained stable (around 20bps) for the last 10 years, despite an increase in the proportion of high yield bonds in the corporate index, commensurate with the decline in the credit rating of the hard currency corporate bond index from BBB+ at launch in 2007 to its present BBB-[3]. In other words, the corporate index has become relatively riskier over time, but this has not translated into a wider premium on a spread per duration basis, nor have returns materially improved relative to sovereigns.

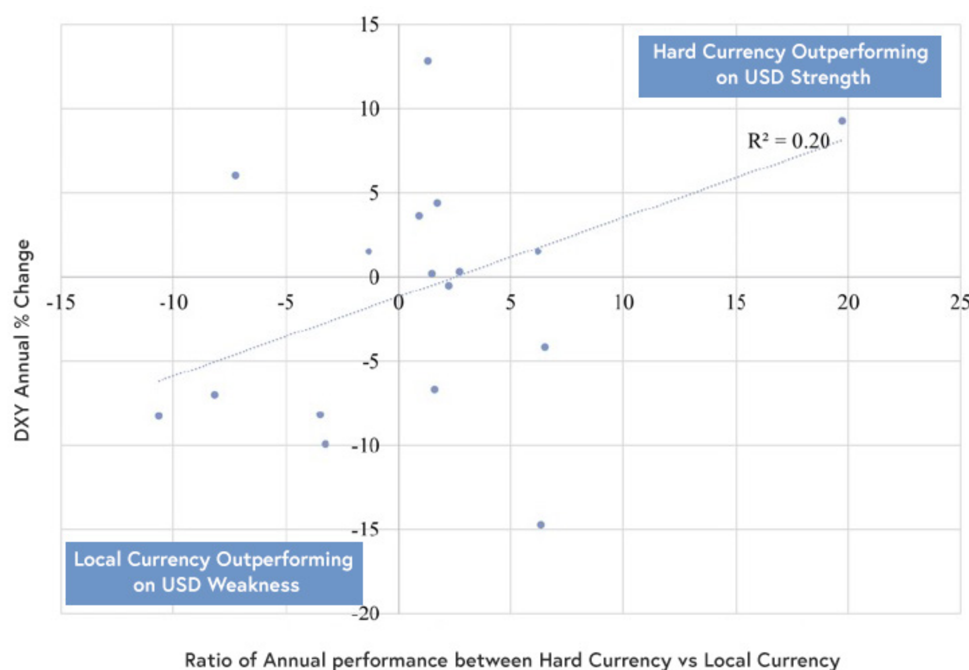
Do you see a dollar weakening trend as being more beneficial to hard currency due to reduced interest payments or local through currency effect?

As shown in the chart below, historically there has been a relationship between movements in the US dollar and the relative performance of hard versus local currency EM government debt. Typically, although not always the case, we see local currency outperforming in an environment of US dollar weakness and vice versa.

[2] Source: JP Morgan. Data as at end Feb 2021. EM Corporate Bonds is the JPMorgan Corporate Emerging Markets Bond Index Broad Diversified (CEMBI Broad Diversified) and EM Sovereign Bonds is the JP Morgan EMBI Global Diversified Index (EMBI GD index)."

[3] Source: JP Morgan. Data as at end Dec 2020. Hard Currency Corporate Bond Index is the JP Morgan Corporate Emerging Markets Bond Index Broad Diversified (CEMBI Broad Diversified).

Chart 1. Relative USD Weakness linked to Outperformance of Local Currency EMD



Source: JP Morgan and Colchester Global Investors. Data is calendar year returns from Dec 2003 to Dec 2020. Hard Currency is the Morgan EMBI Global Diversified Index (EMBI GD index), and Local Currency is the JP Morgan GBI-EM Global Diversified Index in USD Unhedged terms.

Digging a bit deeper however shows that the outperformance of the Local asset class from a weaker USD tends to be driven by an appreciation of EM currencies. When we look at USD hedged returns of EM Local bonds versus Hard Currency bonds, we see a general trend of Hard Currency outperforming EM Local bonds.

With regards to a weaker USD improving debt servicing for a sovereign's Hard Currency debt, certainly an appreciating local currency will tend to make the conversion of domestic revenues into USD less costly, and thus somewhat 'cheaper'. This is one reason why when assessing available liquidity to service its Hard Currency debt, we incorporate the valuation of the country's Real Exchange Rate. However, whilst domestic tax revenues are one source of liquidity, the conversion into USD does require liquid and stable FX markets which is not always the case for smaller and Frontier emerging market economies. Therefore, Colchester looks at several factors when assessing Hard Currency debt serviceability which focus on a country's external liquidity, including the ratio of a country's foreign currency uses relative to its foreign currency resources, and the Terms of Trade.

How long should investors aim to hold exposure to this asset class for?

The investment horizon for emerging market assets is typically slightly longer than for developed market assets, due to their higher volatility, which makes 'market timing' ever more difficult. Asset allocators often take a graduated approach towards allocating to the asset class, to take advantage of improving or reducing valuations. Moreover, value can be realised over a 3-5 year period, which approximately matches a medium to long-term market cycle.

Risk Disclosures

- Unless otherwise stated, this document reflects Colchester Global Investor's ('Colchester') views and opinions as of April 2021. In respect of the products and strategies mentioned in this document, the information is provided for illustrative purposes only and is intended only for professional clients and third-party intermediaries. Colchester makes no representation or warranty as to the accuracy or completeness of the information in this document and disclaims all liability for any direct, indirect, consequential or other losses or damages including loss of profits incurred by you or any third party that may arise from reliance on this document.
- This document is not a financial promotion. Investors should seek professional advice before making an investment. Past performance is no guarantee of future performance and the value of any investment may fall as well as rise. Investment in the products mentioned in this document puts your capital at risk, and you may lose some or all of your investment.
- Prospective investors and clients should be aware that any investment involves a degree of risk. The return of your investment may increase or decrease as a result of currency fluctuations if your investment is made in a currency other than that used in the past performance calculation within this document.
- Unless shown otherwise, all returns are illustrated as gross of fees. Gross returns do not reflect the deduction of fees and expenses, which would inevitably reduce the client's returns. Clients may request net performance results at fees agreed in their Investment Management Agreement or Prospectus/Offering documents at any time. A full performance document in compliance with Global Investment Performance Standards (GIPS ®) is available upon request. Additional information regarding policies and procedures for calculating and reporting returns is also available on request. Nothing in this document should be construed as providing any type of investment, tax or other advice, or be considered a solicitation, recommendation, endorsement or offer to purchase or sell any financial instrument.
- This is not a research report and is not intended as such. Certain information in this document may constitute forward-looking statements. Due to the various uncertainties and actual events, the actual performance of the markets may differ materially from those reflected or contemplated in such forward-looking statements. As a result, clients/investors should not rely on such forward-looking statements in making any investment decisions.
- This document may contain information obtained from third parties, including ratings from credit ratings agencies. Reproduction and distribution of third party content in any form is prohibited, except with the prior written permission of the related third party. Third party content providers do not endorse or recommend the securities or products discussed herein, nor do they guarantee the accuracy, completeness, timeliness or availability of any information, including ratings (negligent or otherwise), regardless of the cause, or for the results obtained from the use of such content. Third party content providers give no express or implied warranties, including, but not limited to, any warranties of merchantability or fitness for a particular purpose or use. Third party content providers shall not be liable for any direct, indirect, incidental, exemplary, compensatory, punitive, special or consequential damages, costs, expenses, legal fees, or losses (including lost income or profits and opportunity costs or losses caused by negligence) in connection with any use of their content, including ratings. Credit ratings are statements of opinions and are not statements of fact or recommendations to purchase, hold or sell securities. They do not address the suitability of securities for investment purposes and should not be relied on as investment advice.
- Information concerning the calculation of statistics used for portfolio characteristics is available upon request. Various industry standards, indices and industry performance comparative data are provided in this document and are detailed where appropriate. These include indices from FTSE, Bloomberg Barclays, MSCI, JP Morgan and ICE. Data is sourced additionally from Bloomberg and Datastream.
- Information has been obtained from sources believed to be reliable but J.P. Morgan does not warrant its completeness or accuracy. The Index is used with permission. The Index may not be copied, used, or distributed without J.P. Morgan's prior written approval. Copyright 2021, J.P. Morgan Chase & Co. All rights reserved.
- There can be no assurance that professionals currently employed by Colchester will continue to be employed by the firm or that a level of experience or past performance is indicative of future performance or success.
- Information about how to make a complaint, any right to compensation and any cancellation rights will be provided to you upon request.

Regulatory Information

- Colchester is an employee owned firm headquartered in London and has regional offices in New York, Singapore and Dubai and a representative office in Sydney, Australia.
- Colchester is authorised and regulated by the Financial Conduct Authority in the United Kingdom. Colchester is also registered with the Securities and Exchange Commission in the USA and is registered as a Commodity Trading Advisor and Commodity Pool Operator with the Commodity Futures Trading Commission.

- Colchester Global Investors Limited is licenced as a financial services provider by the Financial Sector Conduct Authority (licence number 43012) in South Africa.
- Colchester Global Investors Limited is registered with the Securities Commission of The Bahamas, as the investment manager for an investment fund licensed as a Smart Fund model 003, in accordance with the provisions of the Investment Funds Act, 2019.
- Discretionary investment management services and funds are not and will not be marketed in Argentina by means of a public offering, as such term is defined under Section 2 of Law N° 26,831, as amended. No application has been or will be made with the Argentine Comisión Nacional de Valores, the Argentine securities governmental authority, to offer funds or discretionary investment management services in Argentina.
- Colchester Global Investors (Singapore) Pte. Ltd holds a capital markets services licence in fund management issued by the Monetary Authority of Singapore. Colchester Global Investors (Singapore) Pte. Ltd also holds an offshore discretionary investment management services licence issued by the Financial Services Commission of Korea.
- Please note the following in respect of Colchester's regulatory status in Australia: (i) neither Colchester Global Investors Limited nor Colchester Global Investors (Singapore) Pte. Ltd. holds an Australian financial services licence for the provision of certain financial services, and both entities are exempt from the requirement to hold an Australian financial services licence under the Corporations Act 2001 (Cwlth) in respect of the financial services Colchester provides; (ii) Colchester Global Investors Limited is authorised and regulated by the Financial Conduct Authority of the United Kingdom under UK laws, which differ from Australian laws; (iii) Colchester Global Investors (Singapore) Pte. Ltd. is regulated by the Monetary Authority of Singapore under Singapore laws, which differ from Australian laws. Therefore, Australian wholesale clients are not necessarily subject to the same types of legal protections or remedies that they would enjoy if Colchester was directly subject to the Corporations Act. Colchester is entitled to offer its financial services in Australia pursuant to an exemption from the requirement to hold an Australian Financial Services Licence under the Corporations Act, on the basis, among other things, that the clients are "wholesale clients" within the meaning of the Corporations Act.
- Colchester Global Investors Middle East Limited is regulated by the Dubai Financial Services Authority for the provision of Advising on Financial Products and Arranging Deals in Investments. All communications and services are directed at Professional Clients only. Persons other than Professional Clients, such as Retail Clients, are not the intended recipients of Colchester Global Investors Middle East Limited's communications or services. Colchester Global Investors Middle East Limited is a company established in the Dubai International Financial Centre (DIFC) pursuant to the DIFC Companies Law with registration number CL 3239.
- Colchester Global Investors Inc. is a wholly owned subsidiary of Colchester Global Investors Limited. It is not permitted to provide investment advice or otherwise engage in a regulated activity.
- Shares in Colchester funds ("securities") may not be offered or sold to the public in Brazil. Accordingly, the securities have not been and will not be registered with the Brazilian Securities and Exchange Commission (Comissão de Valores Mobiliários, the "CVM"), nor have been submitted to the foregoing agency for approval. Documents relating to the securities, as well as the information contained therein, may not be supplied to the public in Brazil, as the offering of securities is not a public offering of securities in Brazil, nor used in connection with any offer for subscription or sale of securities to the public in Brazil. A seller of the securities may be asked by the purchaser to comply with procedural requirements to evidence previous title to the securities and may be subject to Brazilian tax on capital gains which may be withheld from the sale price. Persons wishing to offer or acquire the securities within Brazil should consult with their own counsel as to the applicability of these registration requirements or any exemption therefrom.
- The Colchester UCITS fund has not and will not be registered in the National Registry of Securities maintained by the National Banking and Securities Commission, and therefore may not be offered or sold publicly in Mexico. The Colchester UCITS fund may be offered or sold to qualified and institutional investors in Mexico, pursuant to the private placement exemption set forth under Article 8 of the Securities Market Law as part of a private offer. These materials do not constitute an offer to purchase securities and should not be viewed as marketing or offering materials.

THIS DOCUMENT IS INTENDED FOR PROFESSIONAL USE ONLY AND IS NOT FOR PUBLIC DISTRIBUTION. IT MAY CONTAIN INFORMATION THAT IS PRIVILEGED, CONFIDENTIAL OR EXEMPT FROM DISCLOSURE UNDER APPLICABLE LAW. IF YOU HAVE RECEIVED THIS COMMUNICATION IN ERROR, PLEASE DISREGARD AND DELETE IT AND DO NOT DISSEMINATE THE CONTENTS TO ANY OTHER PERSON.

THIS DOCUMENT DOES NOT CONSTITUTE A PROSPECTUS OR OFFERING CIRCULAR TO SUBSCRIBE FOR ANY SECURITIES. POTENTIAL INVESTORS MUST REVIEW THE RELEVANT PRODUCT OFFERING DOCUMENTS OR INVESTMENT MANAGEMENT AGREEMENT, AND IN PARTICULAR, THE RISK DISCLOSURES SET OUT THEREIN.