US rates are rising: what's next for emerging market bonds?

Blended approach to emerging market bonds most resilient to US rate rises

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For years, fixed-income investors have used emerging market (EM) bonds to diversify their portfolios and lift yields. From 1 January 2008 to 31 December 2017, for example, hard-currency EM bonds returned an average 7.29% per annum, while local-currency EM bonds produced on average 3.69% each year – in USD terms –, much higher than the returns on developed-market bonds. Over that same timeframe, 10-year US Treasury yields fell from around 3.60% in early 2008 to historical lows in 2016.

However, US rates are now on the increase, and many investors wonder if EM bonds can hold their own. To answer that question, we analysed the available data on how a range of EM debt responds to US interest-rate rises, looked into the reasons why some EM bonds are less closely tied to US rates than in the past, and tested an active portfolio that includes a blend of hard and local currency government debt and corporate bonds.

EM bond markets are broader and deeper

Since the EM currency crisis of 1998, many developing countries have adopted policies to cope with external shocks: some have introduced greater exchange-rate flexibility to deal with trade imbalances; others have removed subsidies (the abolition of petrol subsidies in Indonesia is a recent example); and many have streamlined their public sectors.

Stronger EM economies since 1998 have coincided with a broader offering of EM bonds and an increased role for EM currencies.

Over the past decade, EM governments have issued increasing volumes of local-currency debt, which has reduced the risk of currency mismatches for the issuer. The stock of EM government issues in hard currency increased by around US$380 bn between 2010 and 2016, but EM governments issued nearly US$3 trn in local-currency debt during that time.

In 2017, sales of EM debt with maturities of 10 years or more hit a record high of more than US$500 bn for the first time, allowing for more stable financing with lower amounts due in any single year, reducing the risk of issuers facing debt distress.

The market for corporate EM bonds has taken giant strides too. Amounts outstanding, issued by firms with operations predominantly in emerging markets, increased from just over US$700 bn in 2010 to over US$2.3 trn in 2017[1].

Decoupling from the dollar

Domestically, the decoupling of emerging markets' banking systems from the US dollar has also been an important trend.

Banks in many emerging markets used to conduct a significant proportion of their local business in US dollars or other hard currencies. They did so because hard-currency interest rates were lower and because foreign currencies were more stable than local tender. But using US dollars exposed these banks to exchange-rate and interest-rate volatility, and often led to financial crises. Many EM countries have now cut back the domestic use of hard currencies ("de-dollarisation") in favor of local, domestic currencies.

Why these changes matter to investors

Economic growth, including the development of strong domestic financial markets, and de-dollarisation mean that EM financial markets and **some parts of the EM bond universe are now less correlated to US interest rates than in the past.** As a result, it is likely that **rising US rates will have less of an impact on EM bonds than some investors fear, based on their experiences in the 1990s or 2000s.**

Blended, actively-managed portfolios deal best with rising rates

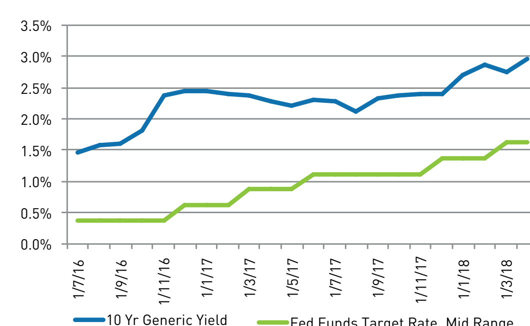
Taking into account these significant changes in the emerging market debt landscape, we compared a blended EM Bond portfolio – based on Franklin Templeton Emerging Market Debt Opportunities strategy[2] – to other EM fixed-income portfolios. We established that **emerging market debt portfolios can achieve superior long-term risk/reward outcomes when blending hard-currency and local-currency EM debt, and when corporate EM debt is included.** Indeed, our blended portfolio had the lowest correlation to core fixed-income portfolios of government bonds.

The blended strategy continues to capture the high yields that are typical of EM bonds: at the end of June 2018, the yield-to-maturity on the composite stood at 9.50%. This compares to the yield-to-maturity on JP Morgan's EMBI Global Diversified index of 6.26%; both were significantly higher than yields on bonds in developed markets.

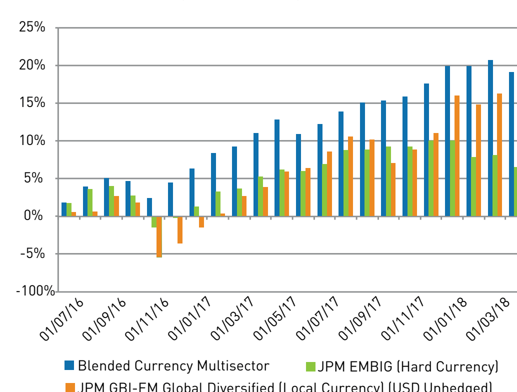
The value of taking an active approach

Most of the EM bond portfolios we manage diverge significantly from the most popular benchmarks. This so-called "active allocation" has the potential to improve investment outcomes because it allows our investors to exploit the increasingly diverse nature of EM debt. For example, an active approach allows investors to own bonds from smaller markets such as Uganda, Ghana, Georgia or Kazakhstan.

Rising rate environment #1: July 2016 – present rates



EM debt returns (cumulative)



Source: Bloomberg. Blended Currency Multisector portfolio is represented by Franklin Emerging Market Debt composite US$ Gross. Local-currency EM sovereigns are represented by the JP Morgan GBI-EM Broad Diversified Index; hard-currency sovereigns are represented by the JP Morgan EMBI Global Diversified (US$ based) Index

By the same token, investors can underweight markets that dominate traditional indices or avoid them altogether.

In contrast to a benchmark-driven approach, an active approach can also include types of securities that wouldn't qualify for index inclusion. This includes fully-fungible government obligations such as floating-rate instruments, loan securitisations or warrants.

As a result, an active approach can also result in lower correlations with US Treasuries and other traditional bonds.

Franklin Templeton's active approach to emerging markets debt is a bottom-up, multi-sector investment style that uses fundamental analysis on a country-by-country basis. The table above shows the results of back-testing the approach against the rising rates scenario from July 2016 to the present, and demonstrates that an active strategy of blending hard-currency and local-currency bonds can lead to sustained outperformance.

FOOTNOTES

[1] Source: Bank of America Merrill Lynch GEMs FI Strategy Viewpoint, 12 July 2017

[2] Blended EM bond portfolio is represented by Franklin Templeton Emerging Market Debt Opportunities composite US$ Gross. As of June 2018, the composite composition in terms of currency was 30.8% local currency and 69.2% hard currency. Composition in terms of issuers was 61.4% sovereigns, 18.9% quasi-sovereigns and 17.6% corporates.

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