

There has been a tremendous amount of market volatility over the past three years. But unlike the 1994 Tequila Crisis, the 1996 Asian crisis, the 1998 Russian crisis, and the 2001 Argentine default, the current market turmoil was rooted in developed market instability rather than in emerging markets. Against this background, local currency bonds appear particularly interesting to us.

Figure 1: Correlations of major asset classes

Index	JPM EMBIG	JPM GBI EM Global Diversified	JPM GBI	MSCI Emerging Market	Barclays US Treasury	Barclays US Corporate High Yield	S&P 500
EM "hard" currency bonds (JPM EMBIG)	1						
EM local currency bonds (JPM GBI EM Global Diversified)	0.79	1					
Global bonds (JPM GBI)	0.45	0.52	1				
EM equities (MSCI Emerging Market Index)	0.65	0.77	0.21	1			
US Treasuries (Barclays US Treasury Index)	0.34	0.19	0.66	-0.15	1		
US High Yield (Barclays US Corporate High Yield Index)	0.76	0.66	0.14	0.69	-0.19	1	
US equities (S&P 500)	0.61	0.7	0.18	0.82	-0.15	0.72	1

Source: Zephyr. Data from Jan 2003 to May 2010.

Credit profile of emerging markets is better

In 2009, emerging markets grew 2.5% while developed markets contracted by 3.2%¹. Emerging market economies proved to be more resilient partly because they were not at the epicenter of the US financial crisis and also because of their strong trend growth. This growth has been driven by a broadening middle class and rising investment and productivity. In 2010 as well, emerging markets are expected to grow 6.8%, faster than the 2.6% expected for developed markets¹. Emerging market inflation is also on relatively sound footing. Over the last two decades, it has generally been low and stable. This moderation relative to the high and volatile inflation levels of the 1980s is due partly to a strengthened focus of central banks on containing inflation. The experience of sharp inflation during the 1980s and the subsequent political consequences forced many emerging market countries to invoke greater discipline in their monetary policy. In some cases, this discipline has included adopting inflation-targeted regimes¹.

In addition, the credit profile of emerging markets today is often better than it is in developed markets. For example, budget deficits and public debt levels are lower in emerging markets than they are in developed markets. In 2009, fiscal deficits in the emerging markets reached about 4% of GDP, compared to about 9% in developed markets².

Meanwhile, the public debt/GDP ratio was 37% for emerging markets, compared to 90% for developed markets². Moreover, the debt/GDP ratio for developed markets is expected to rise, while it is likely to remain stable or improve for emerging markets². This difference in trends is due primarily to the response of developed markets to the recent financial crisis, implementing significantly more aggressive debt-financed stimulus programs. This stimulus consisted of higher spending at the same time that tax revenues were falling sharply as a result of contracting or slower-growth GDP.

Bond market consequences

The strength in emerging market fundamentals is reflected in the market's average credit rating. The JP Morgan Emerging Markets Bond Index Global - the external debt benchmark - has an average rating of BB+. The JP Morgan Global Bond Index Emerging Markets - the local currency benchmark - has an average rating of BBB+. The difference in the ratings flows from the fact that emerging markets can more easily control their ability to repay their local currency debt by, for example, printing currency or inflating their way out of a debt trap as a last resort.

As emerging market debt ratings rise toward investment grade, a much broader group of investors will be able to gain exposure to these markets. For example, Mexico will be included in Citibank's local currency-focused World Government Bond Index (WGBI) in October. Meanwhile, Greece was recently removed from the WGBI after being downgraded to junk status, highlighting the blurring distinction between emerging and developed markets.

Additionally, as a result of fiscal and debt dynamics, there will be more bond issuance out of developed markets than there will be from emerging markets. At the same time as the relative bond issuance for emerging markets is decreasing, there is likely to be growing demand for emerging market bonds as investors seek diversification and become more cautious about holding developed market bonds. The resulting supply/demand dynamics means a better technical position for emerging market bonds compared with developed market bonds.

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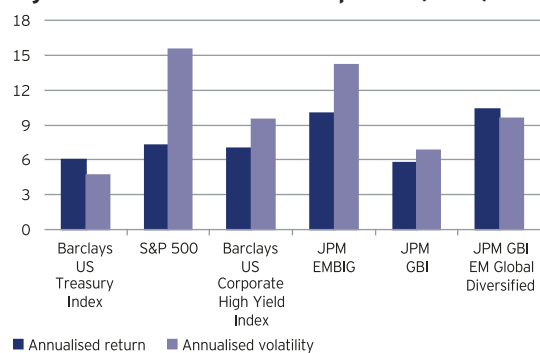
1 Source: IMF World Economic Outlook Update, July 2010.
2 Source: IMF World Economic Outlook, April 2010.

Emerging markets local currency bonds - opportunities after the crisis?

August 2010

Market Insights

Figure 2: Risk and Return in comparison (Index)



Source: Zephyr. Data as at May 2010 (JPM GBI EM Global Diversified from January 2003, all others from January 1994).

Figure 3: Sharpe ratios in comparison (Index)



Source: Zephyr. Data from January 2003 to May 2010.

What makes local currency bonds particularly interesting?

In our view, local currency bonds in particular can play a valuable role in a balanced portfolio for the following reasons:

A large market: Emerging markets local currency debt capitalization has been growing steadily and is now about triple the size of emerging markets' hard currency debt markets.⁶ Many countries have well-developed yield curves extending out 30 years. The liquidity of local currency debt is also improving as bid-offer spreads have narrowed and the volume of debt traded continues to rise. Nevertheless, liquidity can be mixed. In some markets (e.g. Eastern Europe, Mexico, Brazil) local debt market liquidity is fairly high, while in others (e.g. smaller Latin American and Asian markets, Sub-Saharan Africa), liquidity is still lower than in the external debt market. These factors remain important for investors to consider when looking at local currency debt.

Diversification: The correlation of the JPM GBI Emerging Market index with other asset classes, especially US Treasuries, shows that local currency bonds can add diversification to an overall portfolio (Figure 1). Additionally, the correlations between the different emerging market currencies as well as between the bonds issued by different countries are often low, allowing for additional diversification of risk. Volatile currencies such as the South African rand and Turkish lira exhibit strong correlations to one another, but have very low correlations to low-volatility currencies as the Malaysian ringgit or Russian ruble. Yields may also exhibit low correlations. While some emerging market central banks are hiking interest rates, others may have an easing bias. In contrast, when debt issues are denominated in US dollars, the correlation with US Treasuries is much higher, as are the correlations among these emerging market countries.

Risk/reward: Historically, a diversified basket of emerging market local currency debt has shown lower volatility and higher returns than that of emerging markets hard currency debt (Figure 2). In addition, over the long term, the Sharpe Ratio for this local currency basket is higher than that of the S&P 500, US Treasuries, US high yield and emerging market equities (Figure 3).

Conclusion

The numerous emerging market crises in the 1990s were a critical impetus for reforms that left emerging markets better positioned for the recent global financial crisis. After the 1990s, more emerging markets moved to floating exchange rate regimes, strengthened their financial systems and the independence of their central banks, while reducing reliance on foreign borrowing.

Though emerging markets did post negative returns during the height of the global credit crisis, their stronger fundamentals helped them weather the crisis and recover more quickly than developed markets. This is not to say that emerging markets do not have risks. Important risks include lower levels of transparency, weaker institutions and a higher risk of regulatory, legal, or policy changes. Moreover, one might question whether emerging markets can prosper as the economies of developed markets contract.

Our view is that emerging markets are not one dimensional. Each has characteristics that might allow them to perform well under certain market conditions. While emerging markets would generally tend to perform better if developed markets are on a stable footing, there are important differences among them. Some countries' economies may be much more resilient in response to a developed market slowdown, while others may compensate investors well for the level of risk involved. We believe that understanding these risks can help active emerging market investors navigate the market and produce alpha.

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