

## Emerging market debt: taking a closer look at the opportunity set



### Market structure: growth of the asset class

According to Bank for International Settlements (BIS) data, the market capitalisation of emerging market debt reached a new high of US\$7.9 trillion in 2008, or roughly the size of the US Treasury and European government bond markets. Domestic debt accounts for approximately 84% of total emerging market debt outstanding, with the majority of US\$6.7 trillion issued by governments. In contrast, total sovereign external debt outstanding is around US\$500 billion, and has been surpassed in recent years by corporate debt issuance, with over US\$700 billion outstanding.

By all accounts, the growth of local currency debt should remain intact in the coming years, with many countries now focusing their liability management on developing domestic bond markets. Relying on the BIS figures, however, can be somewhat misleading, in that three countries (China, Korea and Brazil) comprise 63% of the debt. China has a closed capital account, therefore access to the domestic market for offshore investors is effectively closed. There are some questions about whether Korea should be defined as an "emerging market" as the country has essentially graduated from the external debt benchmark index. Brazil is a core market for offshore investors, offering both the capacity and liquidity in conventional as well as inflation-linked bonds.

A more applicable market capitalisation of local currency debt would be the JP Morgan GBI-EM Global Diversified index, which encapsulates the broadest investable universe of domestic government bonds. The index is the first comprehensive, global local emerging markets index, and consists of regularly traded, liquid fixed-rate, domestic currency government bonds to which international investors can gain exposure. The GBI-EM GD does not include China or India, which would be captured in the GBI-EM Broad index. Like China, India also has a closed capital account, although investors can gain limited access to local currency debt via government approval for qualified institutional investors. Total market capitalisation of the GBI-EM GD is currently US\$650 billion, with Brazil the largest component in the index with US\$142 billion, followed by Mexico and Poland at around US\$95 billion. South Africa, Turkey, Hungary, Indonesia, Thailand and Malaysia are other significant issuers in the index. There are a total of 13 countries in the GBI-EM GD, with a maximum 10% country weighting. The weighted rating of the index is BBB+. The index does not include quasi-sovereigns or corporate issuers.

The JP Morgan EMBI Global indices are the benchmarks for sovereign external debt. The EMBI Global index tracks total returns for US dollar-denominated debt instruments issued by emerging market sovereign and quasi-sovereign issuers. The EMBI Global Diversified index is a uniquely-weighted version of the EMBI Global, and limits the weights of those index countries with larger debt stocks by only including specified portions of these countries' eligible current face amounts of debt outstanding. Market capitalisation for the EMBIG is US\$367 billion, and US\$230 billion for the EMBIGD. We think the latter is a more appropriate benchmark for hard currency debt. The weighted average rating for the index is BBB-.

Over half of the total domestic debt issues are from Asian countries. In contrast, the distribution of external debt is more balanced, with the three main regions - Asia, Latin America and Emerging Europe - making up around 30% each of the index.

The size of the emerging market corporate bond market has increased in recent years with issuance almost double the amount of new sovereign issuance. The market capitalisation of emerging market corporates is now approximately US\$620 billion according to JP Morgan, or around 20% of the global bond market. More than two-thirds of the bonds are investment grade.

For more details on emerging market corporate debt, please refer to Aberdeen's Emerging Market Corporate Bonds Primer published in May 2010.

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### Investment strategy: time to go local

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Over the past year we have seen growing interest in local currency debt, which offers higher yields compared to hard currency debt. Brazil is a good example for increasing allocation to local currency debt. The current yield on Brazil's US\$ 10-year benchmark bond is around 4.75%, which is unlikely to decline further in the absence of a continued decline in US Treasury yields. In contrast, Brazil's 10-year local currency benchmark bond is yielding around 12.5%, with a real yield of over 7% that should decline to around 4% over the medium-term. The comparison between hard currency and local currency debt in countries such as Mexico, South Africa and Indonesia also supports the case for going local.

The favourable risk reward characteristics further strengthen the case to be invested in local currency debt. There was a time when bouts of global risk aversion would weigh on local rate markets, prompting a defensive monetary policy response. The past two years, however, have demonstrated this is no longer the case, with local rates dictated primarily by domestic inflation expectations and monetary policy. During the height of the global crisis, policy rates and bond yields in local markets such as Brazil, Turkey and Indonesia fell sharply. In the most recent period of global risk aversion in May 2010, Mexico and Brazil rates saw healthy declines, providing further evidence that emerging rate markets are behaving more like G-10 markets these days. We believe yields have the potential to decline further in the medium to long-term given the more favourable fiscal and debt trends in the emerging world.

Despite the best intentions of policy makers, we would anticipate emerging market currencies to appreciate over the medium to long-term, enhancing the returns on local currency debt. We would expect to see continued strong net inflows into emerging markets in the coming years, reflecting the secular improvements in the developing world. Concerns over the outlook for advanced economies should also prompt further flows to emerging markets, further strengthening the case for going local.

### Aberdeen Emerging Market Debt team

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