Emerging Market Local Currency Review

3rd Quarter 2018

Leonardo Da Costa, CFA • *Director, Portfolio Manager, First Trust Global Portfolios Limited*

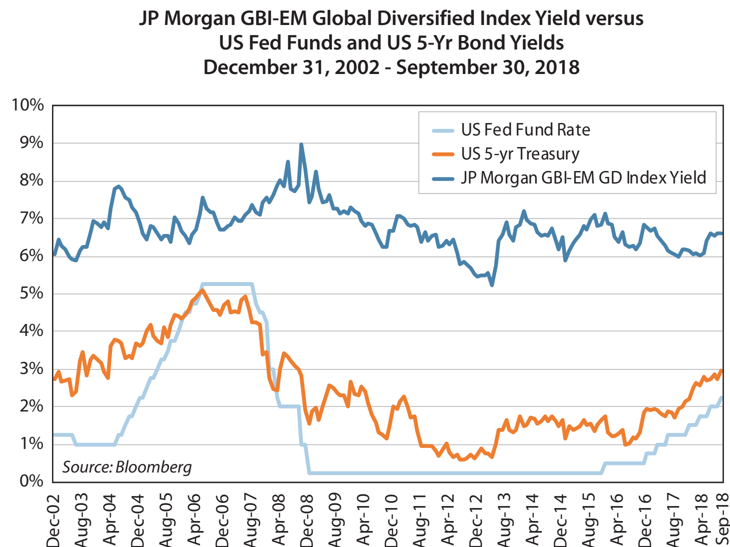
The weakness continued in emerging markets for the third quarter as the JP Morgan GBI-EM Global Diversified Index (the "Index") fell -1.83%. The yield on the Index rose 3 basis points (bps) over the quarter to 6.62% while similar duration 5-yr maturity US Treasury bond yields rose 22 basis points to 2.95%.

Although yields rose modestly for the emerging market (EM) asset class, the return from local currency bonds was positive over the quarter at 0.24% due to the high carry earned on the index. Weaker emerging market currencies versus the US dollar drove the volatility over the period. Emerging market currencies contributed -2.06% to the Index return over the period.

The continued rise in US Treasury yields is a concern for fixed income investors especially when comparing US domestic fixed income to global fixed income opportunities. With rising US Treasury yields the spread between international bond yields and US domestic yields compress. The less attractive pick-up in yield on the face of it shows that foreign bonds are now more expensive or less of a value proposition, however, that may overlook some of the benefits of diversifying globally when it comes to fixed income.

For example, when looking at emerging market domestic treasuries the spread of the Index over 5-yr US treasuries is currently at 367 bps and the average of that spread since the Index's inception (Dec 31, 2002) has been 432 bps. Does that mean emerging market bonds are now a poor place to allocate to? Not necessarily, if you consider that the last time US Fed Funds rates were at 2.25% and heading higher was in December 2004. Back then 5-yr US treasuries were yielding 3.61% and the Index yield was at 6.86% for a spread of 325 bps, lower than where we are currently (Chart 1). The subsequent period from December 2004 to December 2007 was a very opportune time to be invested in emerging market domestic treasuries with the Index returning an annualized 13.1% during that 3-year period.

Chart 1: **Emerging Market Yield Differentials**



What drove the strength in emerging markets from December 2004 - December 2007 were the strong growth rates we saw in EM economies despite the continued Federal Reserve (Fed) rate hikes. And notably the yield on the Index never bore much relationship to US Treasury yields over that period. This highlights two points 1) keep a close eye on emerging market growth as that is a more significant indicator for the asset class return than US Treasury yields or Fed Fund hikes and 2) emerging market domestic bonds aid diversification in fixed income as their yields don't appear to move in tandem with US Treasury yields.

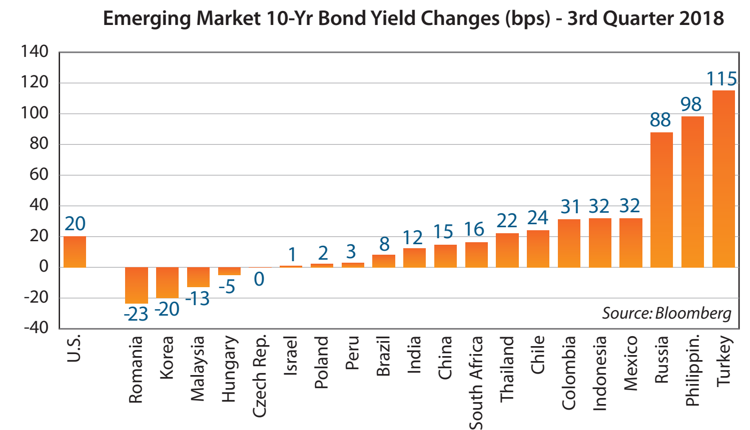
Market Review:

Emerging Market Treasury Bond Yields:

The yield on the Index was relatively unchanged over the quarter, although that masks some significant changes across a handful of markets like Turkey, where 10-yr maturity bond yields rose by 115 bps. Looking beyond the few countries in stress the yield moves over the quarter were more moderate.

Ten-year maturity yields also rose sharply in the Philippines (+98 bps) and Russia (+88 bps) while they fell in Romania (-23 bps), Korea (-20 bps) and Malaysia (-13 bps). The spread in yield performance across countries again demonstrates the impact of having multiple yield curve exposures in the index. While some yields are falling others are rising, highlighting one of the benefits of diversifying across global yield curves, in our opinion.

Chart 2: **Snapshot of EM Interest Rate Moves over the Quarter**



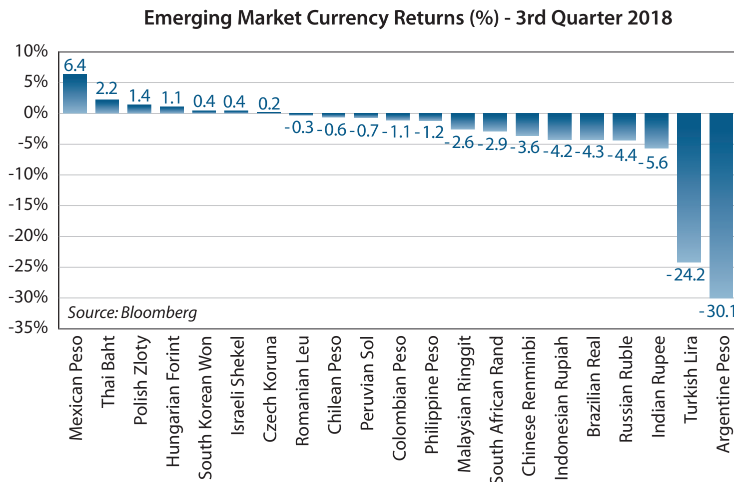
Emerging Market Currencies:

Emerging market currencies, on the whole, were weaker versus the US dollar over the period with the currency component of the Index falling 2.1%. The US Dollar was stronger against most currencies as the US Dollar index rose 0.70%.

We saw sharply negative returns for Turkey and Argentina as both suffered through monetary crisis events. The Turkish Lira fell -24.2% and the Argentinian Peso fell -30.1% versus the US dollar. The crisis in these two countries drove sentiment more broadly against emerging market assets however the stress they were experiencing was very atypical of the broader universe. Most other emerging market central banks run prudent and sensible monetary policies and we don't view these isolated events as being systematic for the asset class.

Excluding those two currencies, the spread of returns from EM currencies was significantly less volatile. The Indian Rupee, Russian Ruble and Brazilian Real were all weaker while the Mexican Peso, Thai Baht and Polish Zloty were stronger. These examples highlight the continued differentiation that is occurring across emerging markets as the top and bottom performers (excluding Turkey and Argentina) were spread relatively evenly across the major global regions.

Chart 3: **Snapshot of EM Currency Moves over the Quarter**

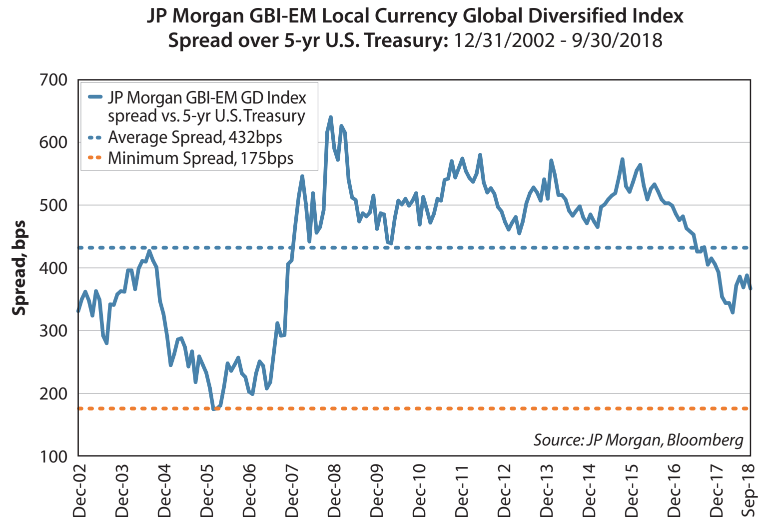


Outlook:

As previously cited the spread between the Index yield and similar duration 5-yr US Treasuries contracted over the period, from 386 bps to 367 bps, largely driven by higher US Treasury yields. Although this yield spread is lower than the long-term average it may still present good value as it is wider than the last time US interest rates were this high and meaningfully wider than the tights of 175 bps seen before the financial crisis.

Emerging market currencies are now also significantly undervalued versus the US dollar following dollar strength year-to-date, based on our purchasing power parity valuation measures.

Chart 4: **Average Emerging Market debt spreads**



We continue to see emerging market economic fundamentals as being robust although growth expectations have dropped from earlier in the year. The Markit Emerging Markets Manufacturing PMI was 50.3 at the end of September, still in expansionary territory but lower than the 52.2 reading we saw at the beginning of the year. The latest IMF World Economic Outlook projects global growth of 3.73% in 2018, with Emerging Market and Developing Economies projected to grow at 4.68%.

The cheaper valuation may provide an attractive entry point into the asset class for investors with a positive long-term view on emerging markets. Our long-term outlook on emerging markets remains positive where we continue to expect stronger growth rates, improving productivity and lower debt levels as compared to advanced economies.

The JP Morgan Government Bond Index-Emerging Markets tracks local currency bonds issued by emerging market governments.

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