Previously Investec
Asset Management

Emerging market debt in an Australian context

January 2021

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Established in South Africa in 1991, as Investec Asset Management, the firm started offering domestic investments in an emerging market. In 2020, almost three decades of organic growth later, the firm demerged from Investec Group and became Ninety One. Today the firm offers distinctive active strategies across equities, fixed income, multi-asset and alternatives to institutions, advisors and individual investors around the world.

Investment involves risk.

fast

The fast view

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- With Australian yields finally succumbing to the low yields experienced by other developed markets, the spread to emerging market debt has widened. At the time of writing, emerging market debt yields over 4% more than Australian government debt.
- The yield per unit of historic volatility an Australian investor could achieve is around **2.5 times higher** in emerging market debt than it is in Australian government debt.
- In this low-yield environment we believe that Australian investors will be forced to look for higher yielding alternatives. Diversification will be key and, due to the high correlation of the Australian dollar to emerging market assets, emerging market debt, with its relatively high yield, should be a strong consideration.
- The Australian dollar acts as a natural hedge for Australian's investing in emerging markets which puts Australian investors in an advantageous position compared to other developed market investors.
- Investors can further improve the risk-return profile, we believe, by hedging out any USD exposure in an emerging market debt portfolio. Historically a partial USD/AUD hedge has reduced volatility and drawdowns.

view

The benefits of being an Australian investor

When it comes to investing in emerging market emerging market debt, Australian investors find themselves in an enviable position compared to other developed markets due to the currency's high correlation to emerging market debt currency. The commodity-like features of the Australian dollar mean that it performs in many ways just like an emerging market currency or asset would – it does well when commodities do well, when the world is growing and when China is flourishing. Of course, it also underperforms when the outlook for the global economy looks bleak. But viewed from an Australian context, this high correlation is an advantage when investing in emerging market debt because often **during periods of emerging market weakness, the effect of a correspondingly weak Australian dollar will buffer returns for Australian investors**. Put another way, the Australian dollar acts as a natural hedge for Australian's investing in emerging markets, and a cheap hedge at that, which puts Australian investors in an advantageous position.

Table 1: Correlations of various DM currencies with emerging market debt (EMD)[1]

	AUD	NZD	NOK	CAD	EUR	CHF	GBP	JPY
Hard Currency EMD	63.1%	53.5%	56.0%	55.9%	44.5%	33.4%	33.3%	9.8%
Local Currency EMD	80.0%	70.2%	70.1%	65.5%	64.8%	54.4%	47.1%	15.9%
'EMD' - 50/50 Blend	77.0%	66.7%	67.7%	64.8%	59.4%	48.1%	43.6%	14.1%

Figures 1 and 2 show that often over periods of negative returns from emerging market debt[2] (measured in USD), the Australian dollar has delivered even worse returns (Figure 1). Thus, once translated into Australian dollars, emerging market debt will have delivered positive returns. This can be seen in Figure 2 which shows the rolling 12-month returns for emerging market debt in AUD.

> Since 2012 emerging market debt measured in Australian dollars has rarely delivered a 12-month period of negative returns.

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1. Source: Ninety One, JPMorgan. Monthly data, from Jan 2003 to June 2020. Hard Currency EMD = JPMorgan EMBI GD; Local Currency EMD = JPMorgan GBI-EM GD. EMD = a 50%/50% weighting of Local and Hard Currency EMD with monthly rebalancing.
2. For the analysis of this paper we consider emerging market debt to be a a 50%/50% weighting of Local and Hard Currency EMD with monthly rebalancing. Hard Currency EMD = JPMorgan EMBI GD; Local Currency EMD = JPMorgan GBI-EM GD.

Figure 1: Rolling 12-months returns of EMD (in USD) and the Australian dollar showing the high correlation[3]

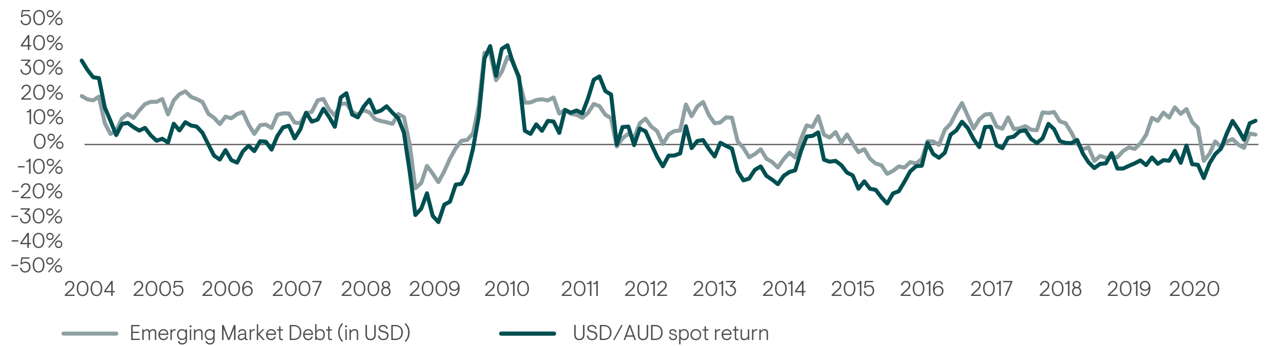
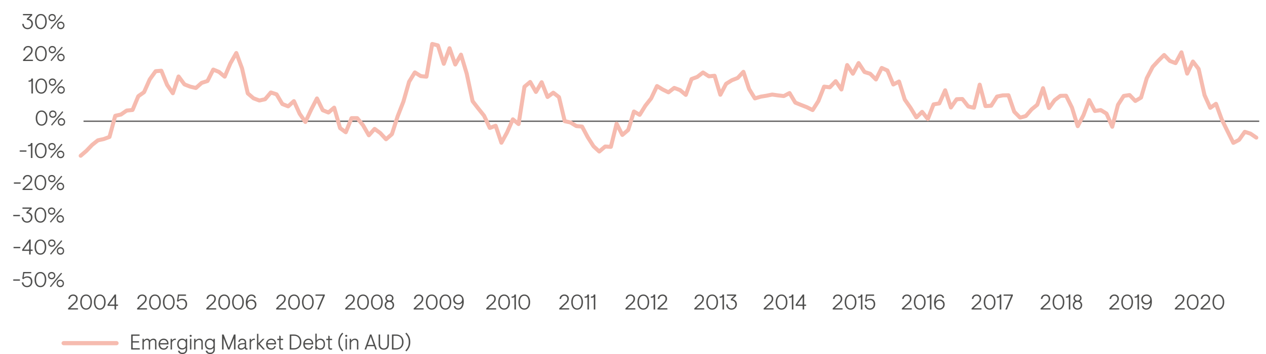


Figure 2: Rolling 12-month returns of EMD now measured in Australian dollars[4]



The volatility of 2020 has again been an incredible demonstration of the performance of emerging market debt for Australian investors. In the first quarter of the year emerging market debt fell 14.3% in US dollars, but dropped only 1.8% in Australian dollars. The opposite was true, though, in the second quarter as emerging market debt recovered 11.0% in US dollars but fell a further 1.4% in Australian dollars. The net result, though, has still been better overall returns for Australian investors, and with much lower volatility too.

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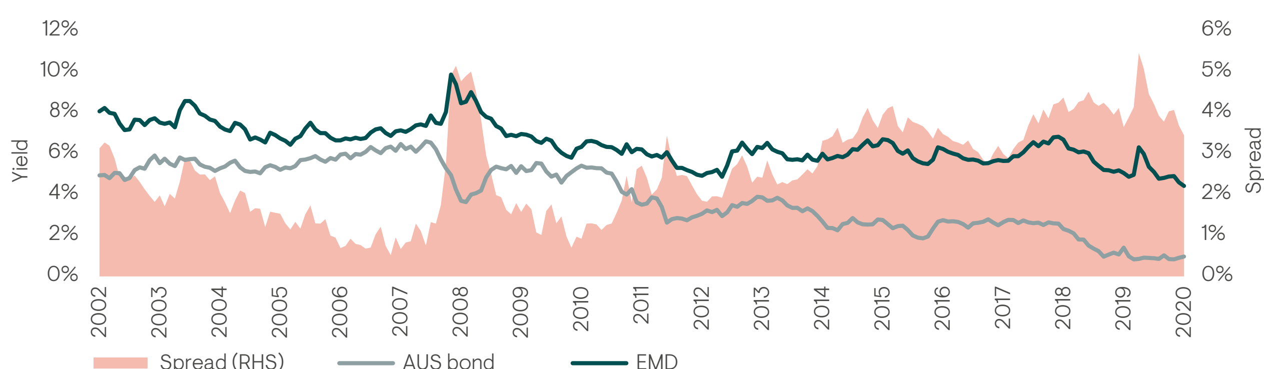
3. Source: Bloomberg, JPMorgan, Ninety One calculations. EMD = a 50%/50% weighting of Local and Hard Currency EMD with monthly rebalancing. Hard Currency EMD = JPMorgan EMBI GD; Local Currency EMD = JPMorgan GBI-EM GD.
4. Source: Bloomberg, JPMorgan, Ninety One calculations. EMD = a 50%/50% weighting of Local and Hard Currency EMD with monthly rebalancing. Hard Currency EMD = JPMorgan EMBI GD; Local Currency EMD = JPMorgan GBI-EM GD.

Yields which more than compensate for volatility

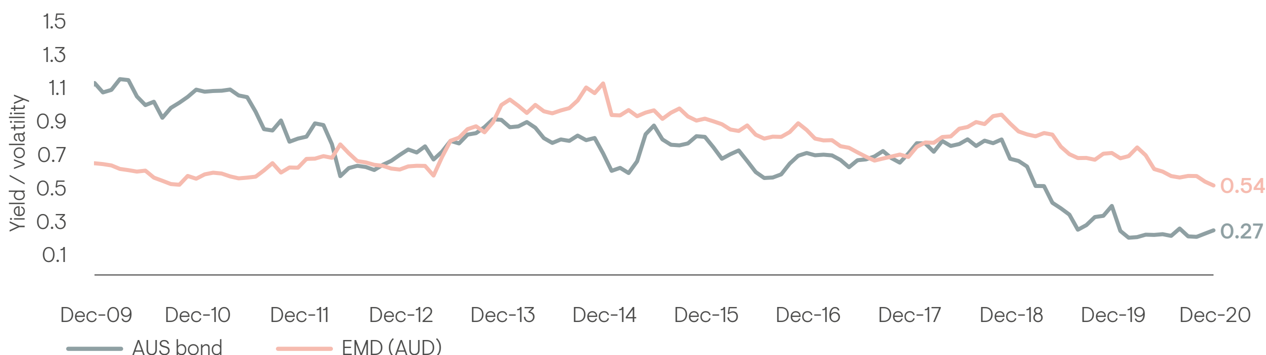
While Australian assets may demonstrate a high correlation to emerging market debt, they do not carry the same yields. The slowing Australian economy dragged yields lower in 2019 and in 2020, with the advent of COVID-19, the yield on the JPMorgan Australian Bond index fell below 1% and at the end of 2020, has only just crept above the 1% mark. Emerging market yields have also fallen, but not nearly to the same extent. As figure 3 shows, since 2013 the yield on emerging market debt has ranged between 5-7%. As a result, the spread between emerging market debt and Australian debt is near the highs at over 4%.

Figure 3: Yields on EMD, Australian bonds, and the spread differential[5]



It is certainly true that emerging market debt carries more risk. Emerging market debt is more volatile than sovereign developed market debt and thus it should demand a higher yield. However, for Australian investors the benefit of investing from Australian dollars is that the volatility of emerging market debt is lower than it would be for any other developed market investor. If we then consider the level of yield on offer in emerging market debt, there is significantly more compensation for risk than there is in Australian government debt. Figure 4 shows that the current yield relative to the historic volatility of emerging market debt is **2 times higher** than the same measure for Australian government debt.

Figure 4: Yields relative to volatility, showing that the yield-per-unit-of-volatility is currently almost 2 times higher for EMD[6]



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5 & 6. Source: Bloomberg, JPMorgan, Ninety One calculations. EMD = a 50%/50% weighting of Local and Hard Currency EMD with monthly rebalancing. Hard Currency EMD = JPMorgan EMBI GD; Local Currency EMD = JPMorgan GBI-EM GD. AUS Bonds = JPMorgan GBI Australia index.

Further improving the return profile through hedging

A further consideration for non-USD emerging market debt investors is whether or not to hedge the USD currency exposure brought on through investing in emerging market debt. For an Australian investor, this would mean hedging the USD/AUD exposure by selling US dollars and buying Australian dollars.

Having already explained the attractive benefits of investing in emerging market debt from Australian dollars, it may now appear strange to discuss hedging that exposure. But the reality is that in our emerging market debt mix of 50% hard currency emerging market debt and 50% local currency emerging market debt, the benefit of investing from Australian dollars is really felt on the local currency debt side. Referring back to Table 1, the correlation of local currency emerging market debt to the Australian dollar was much higher than it was for hard currency emerging market debt. In fact, the volatility of hard currency debt is higher when measured in Australian dollars than it is when measured in US dollars. Since we would prefer to achieve the best risk-adjusted returns, hedging the USD exposure back to AUD has historically been very beneficial.

In Table 2 we consider the impact on a portfolio's risk-return characteristics of hedging a portion of the portfolio's USD exposure. Figure 5 shows the same data. Historically, by increasing the portion of the portfolio which is hedged, investors have been able to increase returns on the portfolio. At the same time, as the hedge ratio has increased towards 50%, the volatility of the portfolio has dropped. However, above 50% the volatility has begun to rise again which makes sense because above 50% the hedge begins to negate the positive effect of investing in emerging market Local Currency debt from Australian dollars.

Table 2: Returns and volatility for EMD in AUD, at various hedge ratios[7]

Hedge ratio	0%	25%	50%	75%	100%
Average return	6.6%	7.1%	7.5%	7.8%	8.0%
Average vol	8.0%	6.3%	6.1%	7.6%	10.0%
Average ret/vol	0.83	1.13	1.22	1.02	0.79

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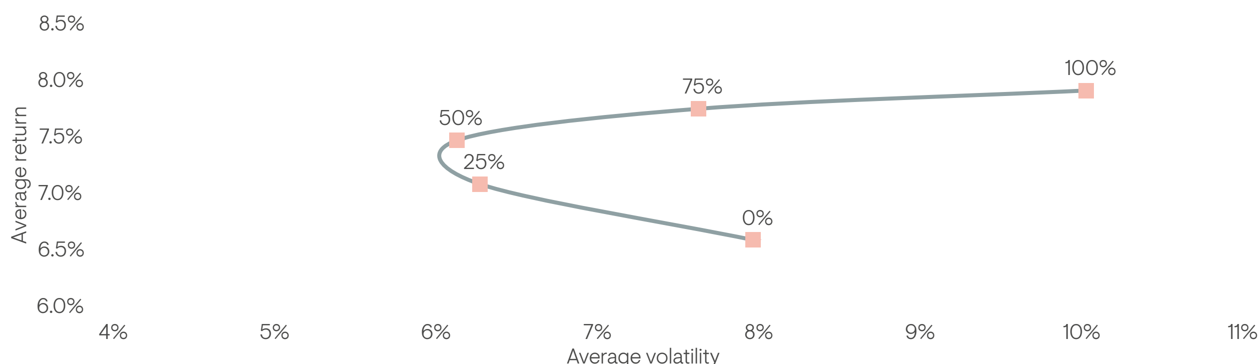
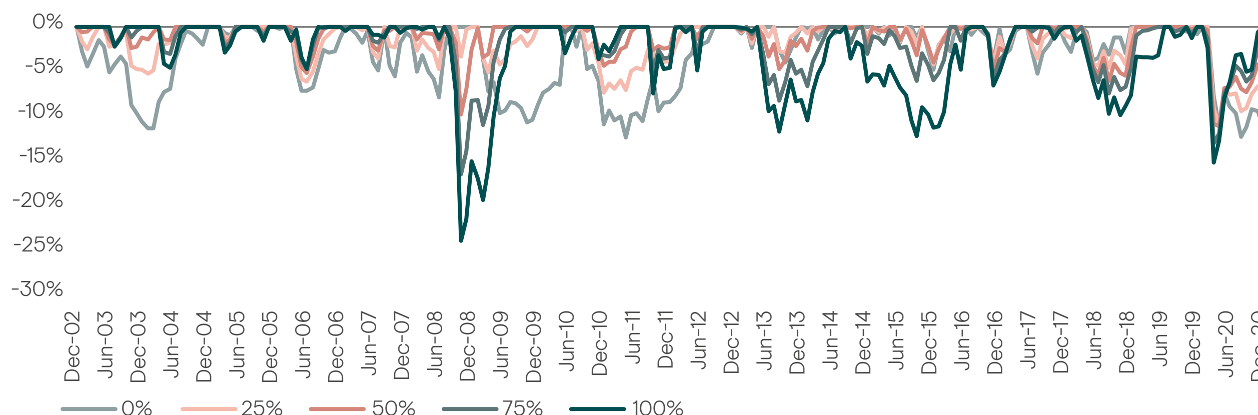
7. Source: Bloomberg, JPMorgan, Ninety One calculations. EMD = a 50%/50% weighting of Local and Hard Currency EMD with monthly rebalancing. Hard Currency EMD = JPMorgan EMBI GD; Local Currency EMD = JPMorgan GBI-EM GD. Table shows the average 5-year annualised returns and volatilities across the period January 2003 to Dec 2021.

Figure 5: Average 5-year EMD returns vs. volatility for various USD/AUD hedge ratios ranging from no hedging to 100%[8]



Hedging the USD exposure in emerging market debt has also historically reduced drawdowns for Australian investors. This can be seen in figure 6 where, historically, drawdowns have been largest when the portfolio is either entirely unhedged or 100% hedged. A 50% hedge has typically reduced drawdowns, which helps long-term returns and improves the risk-return profile.

Figure 6: Drawdowns for EMD at various hedge ratios[9]



As the analysis in this paper is conducted on a backward-looking basis, it is important to highlight that historically Australian dollar short-term yields have been higher than US short-term yields. This positive yield differential (known as carry) has benefitted the historic hedging strategy. Over the 2002-2018 period this yield differential was around 2%, meaning a 50%-hedged strategy earned an additional 1% return over and above the unhedged solution. This was not the case in 2018-19 when the US Federal Reserve hiked rates resulting in negative carry. Consequently, hedging cost Australian investors around 0.5% during this period. In 2020, the US Federal Reserve drastically cut rates so that they are now on par with Australian rates. As such, for now, there is very little cost to hedging the US dollar exposure.

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8. Source: Bloomberg, JPMorgan, Ninety One calculations. EMD = a 50%/50% weighting of Local and Hard Currency EMD with monthly rebalancing. Hard Currency EMD = JPMorgan EMBI GD; Local Currency EMD = JPMorgan GBI-EM GD. Chart shows the average 5-year annualised returns and volatilities across the period January 2003 to June 2020.
9. Source: Bloomberg, JPMorgan, Ninety One calculations. EMD = a 50%/50% weighting of Local and Hard Currency EMD with monthly rebalancing. Hard Currency EMD = JPMorgan EMBI GD; Local Currency EMD = JPMorgan GBI-EM GD. Chart shows the peak to trough drawdowns across the period January 2003 to June 2020 using monthly data.

Conclusion

In the persistent low-yield environment we believe that Australian investors will start to look for higher yielding alternatives. Diversification will be key and, due to the high correlation of the Australian dollar to emerging market assets, emerging market debt, with its relatively high yield, should be a strong consideration. Investors can further improve the risk-return profile of an emerging market debt investment by partially hedging any USD exposure brought in through an allocation to emerging market hard currency debt. Typically a partial AUD/USD hedge has reduced volatility and drawdowns, and we would expect to see the same effect going forward.

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