UNDER THE SPOTLIGHT:

Local vs hard currency emerging market debt ETFs

Local emerging market debt:
From de-dollarisation to diversification
Xtrackers by DWS

Is now the time for local emerging market debt ETFs?
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Local emerging market debt: From de-dollarisation to diversification

Less correlated with other parts of the bond market

Author: Tom Eckett

Local currency emerging market debt (EMD) ETFs are important building blocks in fund selectors' portfolios due to their diversification benefits and the attractive yields on offer.

Central banks across developed markets are heading towards the end of their tightening cycles, especially in the US, a huge boon for local EMD ETFs that will no longer face the structural headwind of a strong US dollar.

Coupled with a more encouraging inflation picture across emerging markets makes this an interesting time for fund selectors to be looking at local EMD.

As a result, ETF Stream's editor Tom Eckett spoke to DWS's senior Xtrackers product specialists Timur Shaymardanov and Lukas Ahnert to find out why now is the time for local currency EMD ETFs and the advantages of passive implementation.

What are the recent trends in the emerging markets fixed income ETF space?

Emerging market (EM) local currency government bonds have made a strong comeback this year, outperforming EM hard currency bonds by 2.5% and developed markets counterparts by over 7% in the first 9 months of 2023. After a decade of underperformance, the latest market cycle casts a new light on this asset class. In the first nine months of 2023, EM local asset class enjoyed solid inflows, while the USD denominated EMD ETFs grappled with outflows.

Despite the attractive and inherently diversifying characteristics of EM local bonds, they remain significantly underrepresented in the portfolios of many global investors. This under-representation is straightforward to observe in both global equity and fixed income portfolios – only 11% of the global EQ benchmark is made up of EM assets. On the fixed income side, the disparity is only slightly better, with around 13% of the global fixed income benchmark exposed to EM. As a result, foreign ownership of the overall local currency debt is estimated at less than 15%, with significant differences across countries. These statistics highlight a remarkable disconnect between portfolio representation and economic reality, with EM countries accounting for 30% of global GDP and half of its growth.

EM local investors had a rough decade behind them. Is this trend to continue or could this time be different?

At the moment the mildly positive investor sentiment may seem anecdotal, but we are also observing three major trends which should help EM local over the longer term:

1. Developed market interest rate cycle is topping out. As of today, expectations point to a moderate policy rate path until year end, both in the US as well as Europe. Therefore, one of the dominant headwinds to the EM local bonds might be fading. In the recent past the speed and intensity of developed market central banks hikes – 4% in Europe and Australia and 5% in the US in less than 18 months – undermined the attractiveness of emerging market local currency bonds.

2. Low EM-DM inflation differential show that inflation in EM has recently been low relative to DM economies, even dipping below the US inflation rate in 2021. As a result, EM bonds have become more attractive on a real yield basis. Several large issuers, such as Brazil or Mexico, are now offering ample yield above the current and expected rate of inflation.

3. Stability and recovery in EM currencies is last but not the least important aspect. The currencies of many emerging markets have been stable or gaining some ground. As "US dollar-strength" fades, EM currencies may recover from their multi-decade low reached in the fall of 2022.

What are the main risk drivers in EM local versus the more popular EM hard currency exposures?

A closer look at EM hard currency and EM local currency indices reveals that the overall country exposure differs significantly. For example, the JPMorgan EMBI Global Diversified index covers a group of up to 70 countries, while the JPMorgan GBI-EM Global Diversified index includes only 20 countries. Looking deeper, two things stand out. First, the EM local currency indices and their underlying countries are more closely aligned to EM equity indices, a fact that many global multi-asset allocators will appreciate in aligning country risks. Second, although local currency debt is commonly perceived as riskier, the underlying selection of countries shows a higher degree of development, as frontier markets do not have the privilege to attract sufficient interest in local currency debt and are tied to issuing hard currency debt. This is also reflected in the two-notch better rating of local currency debt indices over hard currency.

Although both EM hard currency debt and local currency debt are government bonds, only local debt is effectively priced the way that DM government bonds are priced. EM hard currency debt on the other hand is not only priced in US dollars or other hard currencies but would also be priced on the US dollar curve – making it effectively a spread asset like any US dollar corporate or high yield bond. The credit spread here reflects the sovereign default risk.

At the same time, outright defaults are rather infrequent on EM local debt, although debt deflation via inflation and currency depreciation remains a risk. Hence, FX is by far the largest risk driver of the EM local asset class.

Interest rates or duration component is second largest risk driver in both local and hard currency EM debt. The fact that EM local-currency debt is exposed to domestic EM yield curves, which will have both different paths between them as well as lower duration on average, helps to manage interest rate risk concerns significantly. EM local interest rate risk is therefore not only lower but also less correlated with traditional fixed income allocations.

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Overall, EM local and EM hard currency solutions have similar levels of absolute risk. However, as noted above, the various drivers will usually show little correlation between EM and DM.

Which other important aspects of the EM local asset class should investors be aware of?

In the context of portfolio applications, there is a unique feature of EM local government bond markets that is particularly relevant for fixed-income-constrained investors. EM local bonds are typically the closest instrument to equities.

Considering a slightly higher level of volatility (half of EQs) compared to other fixed income indices, EM local bonds have offered the highest correlation and beta to the MSCI EM index over the past five years compared to other fixed income instruments. Combined with the right timing, this instrument deserves more attention from active asset allocators.

Are broad diversified exposures the only way to invest in EM Local?

Recent developments have not only changed the face of emerging market economies but also transformed the investability and accessibility of the local debt market. The traditional perception of emerging market local debt as a predominantly active investment area is shifting as passive adoption rates increase. This shift is particularly notable in the context of China. Assets in passive vehicles in Europe alone peaked at over $14bn, as investors shifted exposure to China following its inclusion into major EM indices of Bloomberg and JP Morgan as well as the addition to FTSE Russell's World Government Bond index. The appeal lies in the desire for true benchmark "building block" exposure to local debt markets while benefitting from rule-based diversification limits that mitigate concentration risk in a market prone to idiosyncratic risk. As such, passive EM local debt is best viewed as an add-on to a portfolio rather than a core component.

In this respect, both China and India demonstrated a robust track record. This is due to the increasing decoupling of major EM growth centres, especially India and China, from their developed market counterparts. Here, investors can benefit from country-specific opportunities such as China's still pending stimulus and probable yuan recovery after its policy shift in late 2022. Similarly, India is poised for future growth as the world's most populous country, whose GDP already surpass that of the UK in 2022, enjoys tailwinds from robust exports and digitalisation. Inclusion of India into major benchmarks is already on the way.

For investors, this means that the effective utilisation of these non-core fixed income portfolio building blocks could potentially reduce the volatility of global government bond portfolios significantly by incorporating exposure to at least one of those countries.

Is now the time for local emerging market debt ETFs?

One of the fixed income exposures that could immensely profit from the Fed's hiking cycle coming to an end

Author: Tom Eckett

Getting exposure to emerging market debt (EMD) via hard currencies such as the US dollar has traditionally been the more popular choice for investors, however, this has shifted in 2023.

According to data from DWS and Bloomberg, investors across the globe have poured over $600m into local-denominated EMD UCITS ETFs in the first nine months of the year while hard-currency EMD UCITS ETFs registered outflows of over $600m.

The improving investor sentiment towards local EMD ETFs has been driven by a number of ongoing factors at play including the slowdown in inflation across emerging markets, developed market central banks coming to an end of their tightening cycles as well as JP Morgan's plans to include India in its flagship EM local index.

Out of those, the direction of US interest rates could have the most major implications for emerging markets and their currencies which are disproportionately impacted by a rising US dollar, as highlighted by the International Monetary Fund (IMF).

"Emerging market economies tend to suffer disproportionately across key metrics: worsening credit availability, diminished capital inflows, tighter monetary policy on impact and bigger stock market declines," the IMF said.

However, as of beginning of October, virtually no further Fed rate hikes are expected by markets. "Developed market interest rate cycle is topping out," Timur Shaymardanov, senior product specialist at DWS, told ETF Stream. "Therefore, one of the dominant headwinds to local-currency EMD ETFs might be fading."

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Hard vs local EMD

While hard and local-currency EMD ETFs offer similar exposure in terms of regions, there are some significant differences fund selectors need to be aware of.

Hard-currency EMD tends to be issued in US dollars or euros which means they are more akin to corporate bonds with the US interest rates and credit spreads of the EM issuer being the two main risk drivers. Those bonds tend to be less volatile (in their face currency) due to the lack of exposure to local currency risk.

Over the past two years, however, non-US dollar investors in hard-currency EMD have been exposed to similarly high volatility levels versus local EMD due to significant fluctuations in non-US dollar currencies such as sterling or yen.

Meanwhile, domestic inflation, which mostly drives FX rates, and interest rates are the key drivers of local EMD risks and returns, an advantage considering that emerging markets are now more diversified and less dependent on revenues from commodities.

As a result, local-currency EMD has outperformed hard-currency EMD by almost 3% between January and September and by 6.5% over last two years.

Overall, local-currency EMD is less correlated to other parts of the fixed income market which could make them more attractive in the right market environment.

India has emerged as another source of positive momentum in local EMD very recently. It is set to be gradually included in JP Morgan's flagship local EMD index from June 2024 and could be a potential future winner of deglobalisation and friend-shoring.

The Xtrackers India Government Bond UCITS ETF (XIGB) is one way to gain an early exposure to a market that has opened-up access in foreign investors in recent years. XIGB tracks the J.P. Morgan India Government Fully Accessible Route (FAR) Bond index which offers exposure to India government bonds.

Finally, the ETF wrapper is an attractive and efficient vehicle for fund selectors as it offers diversification benefits by incorporating single emerging market countries within a broad index exposure.

This means investors are less exposed to idiosyncratic blow-ups – a typical risk in emerging markets – when using ETFs versus single countries or when an active manager makes specific bets.

Tom Eckett is editor of ETF Stream