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Emerging Markets

MANAGING CURRENCY VOLATILITY IN EMERGING MARKET LOCAL DEBT

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KEY POINTS

- Emerging market (EM) local debt has traditionally been a volatile sector, largely because of currency movements.
- This is particularly a problem as EM currencies can deviate from “fair value” for an extended period.
- One way to hedge against currency risk is by adopting relative value strategies, which seek to take advantage of price differentials between pairs or sets of currencies.
- Combined with careful security selection within the bond element of the portfolio, relative value strategies can help to deliver smoother, more predictable returns.

Allocations to emerging market (EM) local debt strategies have surged over the past year on the back of improving fundamentals, comparatively high yields, and a weaker U.S. dollar. In this complex and sometimes inefficient asset class, getting currency decisions right can be a make-or-break factor for investors. One way to navigate volatility in the local currency markets is to apply a relative value approach.

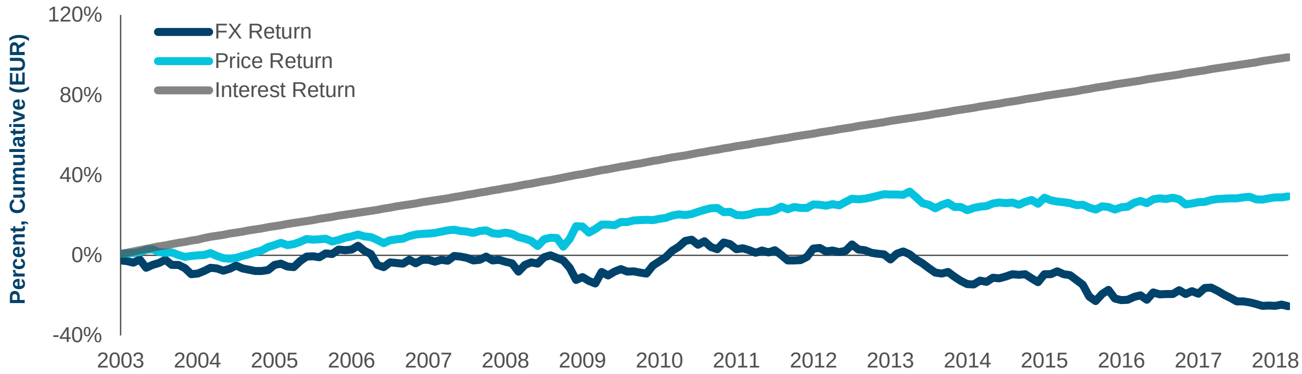
A TRADITIONALLY VOLATILE SECTOR

EM local debt is traditionally a volatile asset class. To understand why, it helps disaggregate the asset class’s returns into their three components: coupons, price appreciation/depreciation, and currency movements. Figure 1 breaks down the returns of the J.P. Morgan GBI-EM Diversified Index from January 2003 to March 2018 in euro terms. Coupon returns were, unsurprisingly, very steady; price returns were more volatile but still followed a fairly consistent upward course over the period; currency returns, however, were highly volatile—and composed the bulk of the overall index’s volatility.

Figures 2A and 2B focuses on the same data over the past decade, providing an indication of how currency volatility can detract from the performance of EM local debt. It shows that, for U.S.-based investors, the strength of the U.S. dollar over the past 10 years would have significantly detracted from the performance of an index-based EM local debt portfolio.

Figure 1: **The GBI-EM Diversified Index's Three Sources of Return (EUR)**

As of March 30, 2018



Past performance is not a reliable indicator of future performance.
Source: J.P. Morgan.

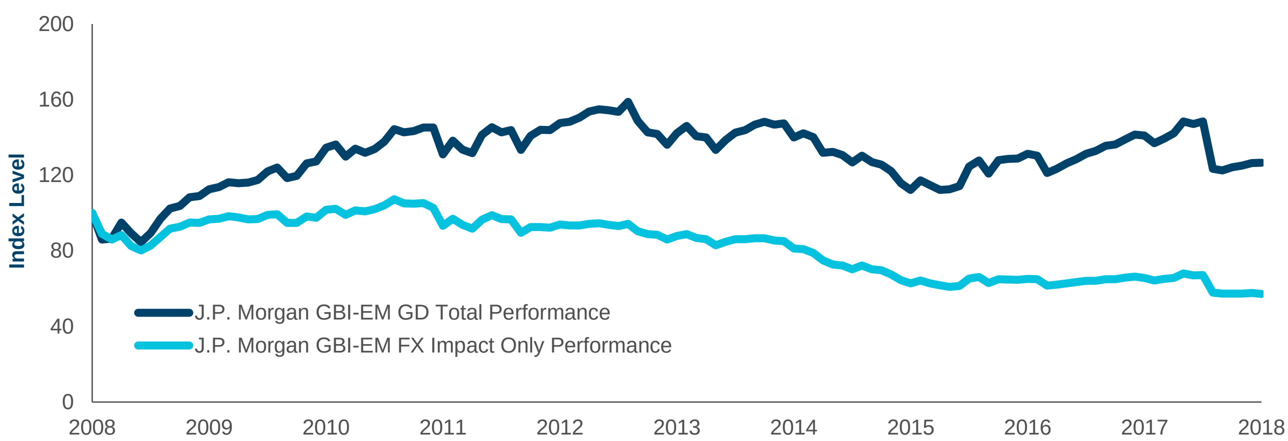
Currency has had less of a negative impact for euro- and sterling-based investors, but the principle remains that it is a risk that needs to be carefully managed.

Indeed, it may help investors to think of EM local debt as essentially comprising two different elements—a relatively high-yielding, low-duration bond portfolio and a volatile currency stream. At any given time, an investor may hold different views on the potentially differing prospects of the bond and currency markets and wish to manage them separately. As the currency element of the portfolio is the most volatile, it will typically offer the best opportunities to reduce risk as well as enhance returns, which in turn will determine the stability of returns over the long term.

A major challenge with currency investing is that the information ratio (the ratio of active returns to the volatility of those returns) available for a given currency can be low over a long period. This is because currency valuations can deviate from their fair value for a long time, meaning that a valuation-based assessment on a given currency can be "wrong" for an extended time horizon. Over the past 10 years, the information ratio for U.S.-based investors in EM local debt was just 0.4 (i.e., four units of return to 10 units of risk), whereas in euro terms it was 0.77—hence the relative underperformance of EM local debt in U.S. dollar terms.

Figure 2A: **Weekly Cumulative Performance of J.P. Morgan GBI-EM Diversified Index**

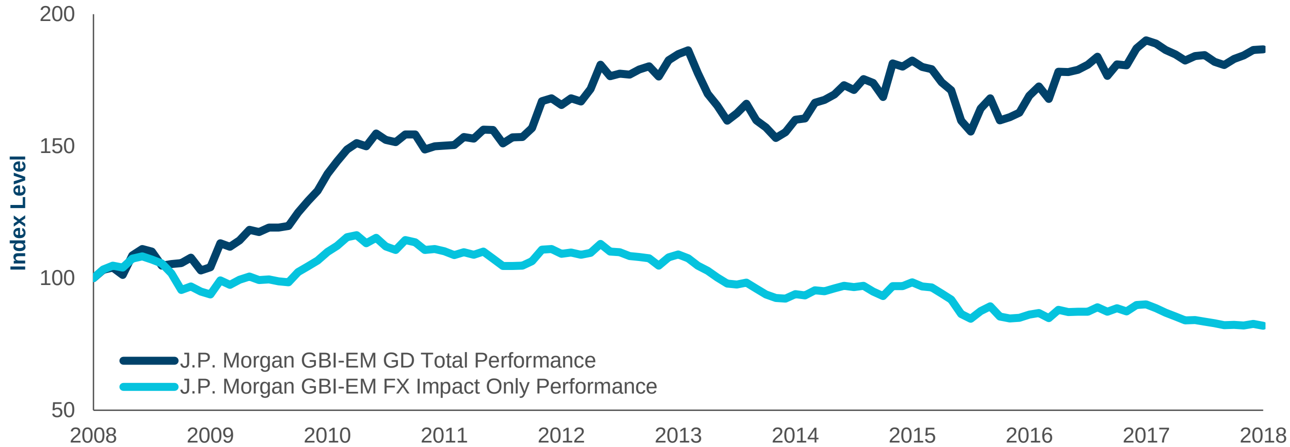
March 2008 to March 2018, in USD



Past performance is not a reliable indicator of future performance.
Source: J.P. Morgan.

Figure 2B: **Weekly Cumulative Performance of J.P. Morgan GBI-EM Diversified Index**

March 2008 to March 2018, in EUR



Past performance is not a reliable indicator of future performance.

Source: J.P. Morgan.

RELATIVE VALUE STRATEGIES IN ACTION

One way to create a better risk/reward ratio is to use relative value strategies, which seek to take advantage of price differentials between pairs or sets of currencies. There are a number of potential approaches to using relative value when managing currencies in EM local debt.

One approach would be to adopt a long position in a currency with a strong idiosyncratic return potential and pair it with a short position in another currency that shares some related risk factors but is less fundamentally attractive. For example, a bullish idiosyncratic view on the Mexican peso might be hedged with the Canadian dollar. Both have high correlations to the U.S. dollar—and therefore to U.S. growth, trade, and risk appetite—and sensitivity to oil. If a development in the U.S. is considered to be either beneficial or harmful for the Mexican peso, it is likely to have a similar effect on the Canadian dollar. Therefore, if a long position in one of these currencies is matched with a short position in the other, idiosyncratic alpha can be captured in the peso while hedging some of the systematic risks.

By actively managing currency exposure, rather than passively focusing on beta, it is possible to dampen the volatility of currency returns from allocations to EM local debt.

Another example would be to play relative value within a bloc—for example, between two historically similar currencies in the same region whose valuations and/or fundamental outlooks have diverged. The Polish zloty and the Romanian leu, for example, have traditionally had similar valuations and similar return drivers, but in recent months the leu had underperformed the zloty and is currently much more attractively valued. Given the historically close relationship between the two currencies, we would expect deviations to ease; and short-term disparities such as this can be a good source of alpha.

It is also possible to pair currencies from two regions with very different prospects, using the weaker currency to fund a position in the stronger currency. You might, for example, believe that the opportunity set in Asia is stronger than that in Latin America. You could then purchase a higher-beta, growth-oriented currency in Asia and fund it through an underweight or short position in a growth-oriented, higher-beta position in a Latin American currency. Another way of undertaking this kind of relative value strategy would be to use a low-yielding developed market currency to fund a long position in an emerging market currency that you believe has strong fundamental prospects.

DELIVERING SMOOTHER RETURNS IN A VOLATILE TIME

By actively managing currency exposure, rather than passively focusing on beta, it is possible to dampen the volatility of currency returns from allocations to EM local debt. Combined with careful security selection within the bond element of the portfolio, this can help to deliver smoother, more predictable returns from an asset class not always regarded as a reliable deliverer of consistent returns. At a time when the global economy is transitioning from quantitative easing to quantitative tightening, with spikes in volatility likely to become a more regular occurrence, strategies such as these, which seek to generate strong, uncorrelated returns, can be a highly useful tool to have in a broad portfolio.

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