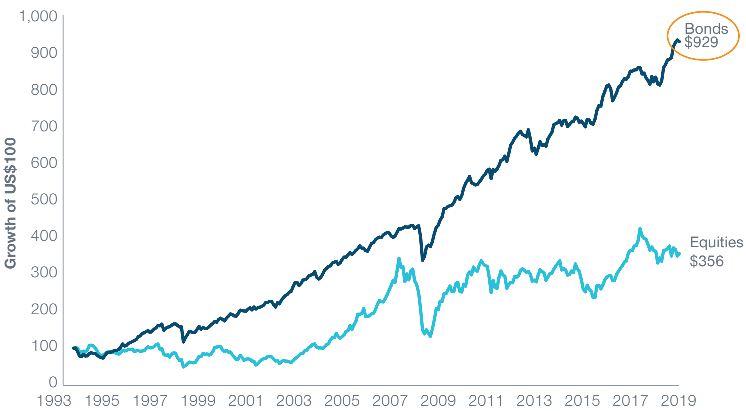
EM DEBT REVEALS ITS STRENGTH AS A GROWTH ASSET

Ben Robins
Portfolio Specialist

Investors seeking growth should focus on equities, and investors seeking stability should buy government bonds – or at least that's the common assumption. But in emerging markets (EM), history tells a radically different story. Over the past 30 years, hard-currency government bonds have delivered far more growth than equities. Why is this, and what are the implications?

The chart shows the cumulative performances of the JP Morgan EMBI Global Diversified bond index and the MSCI Emerging Markets equity index since the end of 1993. US$100 invested in equities at the beginning of the period would have more than trebled over time, but an investment in bonds would have grown more than nine-fold.

Figure 1: Growth of US$100 in Emerging Market Bonds and Equities
31 December 1993 – 30 September 2019



Past performance is not a reliable indicator of future performance.
Source: Bonds: JP Morgan EMBI Global Diversified Index; Equities: MSCI Emerging Markets Index. JP Morgan, MSCI.

THE EMERGING
EDGE

Notice the smoother trajectory of the bond index. The chart spans several major market events including the Asian and Russian crises of the 1990s and the Global Financial Crisis. At times of market stress, bonds fell by significantly less than equities (2008 is a case in point). These smaller setbacks have allowed a more powerful compounding effect for bonds, resulting in the outperformance we've seen.

There are three key differences accounting for bonds' lower volatility and smaller capital losses, and these relate to currency, issuer and income.

1. **Hedged vs. unhedged currency exposure:** The bond index is a hard currency index, hedged to US dollars. The equity index is not currency hedged, so it carries EM local currency risk. EM currencies can be rewarding, but they are also volatile. Taking purely passive index exposure to local currency assets has not paid off in recent decades, largely due to a strong upward trend in the US dollar: EM currencies have depreciated by roughly 20% against the dollar since 2003.[1] (One takeaway from this, in our view, is not necessarily that local currency investments should be avoided, but that they should be actively managed and selected to control potential volatility.)

2. **Government vs. corporate issuers:** The bond index consists of government and government-related debt, whereas the issuers in the equity index are companies. Countries generally have less bankruptcy risk than companies, and governments' capacity to keep up their bond interest payments is supported by their ability to raise funds via taxes.

3. **Coupon vs. dividend income.** EM hard-currency sovereign debt has generated a significant portion of its returns from coupon payments, which are a more stable source of returns than capital appreciation, and a more stable source of income returns than equity dividends.

INVESTMENT IMPLICATIONS

This does not imply that investors should shun EM equities. In the right environment, equities have the potential to outperform EM debt and other asset classes. What it does suggest is that passive index exposure is not the best way to invest. We believe that significantly better outcomes can be achieved using active management to mitigate the risks, and to select the best growth and dividend opportunities from the large and diverse pool of EM equities available.

The benefits of EM hard currency debt still apply, in our view. Coupons remain attractive relative to those in developed markets. In terms of credit quality, we have seen a trend of structural reforms in much of the EM world, and we see that continuing. And, while there may be periods where local currencies outperform on a country-by-country basis, we expect the overall weakness and volatility of local currency markets to continue in the longer term, so hard-currency EM exposure still makes sense.

In short, we believe that investors searching for the best risk-adjusted returns should still look actively at both equity and fixed income issuers. But they should remember that there is more to hard currency EM debt than just stability: it is also potentially a powerful source of long-term growth.

[1] Source: J.P. Morgan, as of August 30, 2019

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