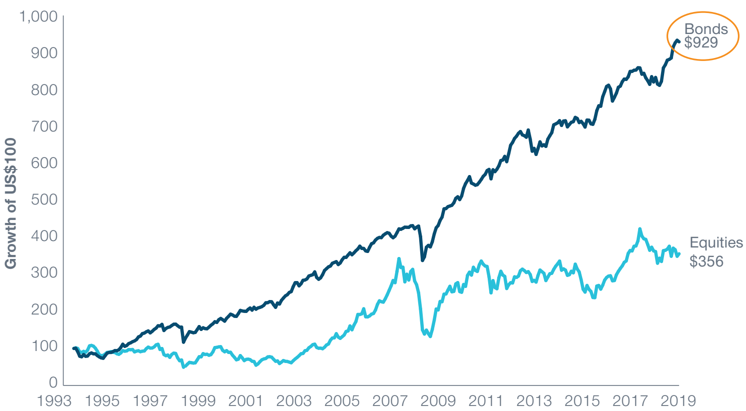
EM DEBT REVEALS ITS STRENGTH AS A GROWTH ASSET

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

INVEST WITH CONFIDENCE®

T. Rowe Price focuses on delivering investment management excellence that investors can rely on—now and over the long term.

To learn more, please visit troweprice.com.

Additional Disclosures

Information has been obtained from sources believed to be reliable but J.P. Morgan does not warrant its completeness or accuracy. The index is used with permission. The Index may not be copied, used, or distributed without J.P. Morgan's prior written approval.

MSCI and its affiliates and third party sources and providers (collectively, "MSCI") makes no express or implied warranties or representations and shall have no liability whatsoever with respect to any MSCI data contained herein. The MSCI data may not be further redistributed or used as a basis for other indices or any securities or financial products. This report is not approved, reviewed, or produced by MSCI. Historical MSCI data and analysis should not be taken as an indication or guarantee of any future performance analysis, forecast or prediction. None of the MSCI data is intended to constitute investment advice or a recommendation to make (or refrain from making) any kind of investment decision and may not be relied on as such.

Important Information

This material is being furnished for general informational purposes only. The material does not constitute or undertake to give advice of any nature, including fiduciary investment advice, and prospective investors are recommended to seek independent legal, financial and tax advice before making any investment decision. T. Rowe Price group of companies including T. Rowe Price Associates, Inc. and/or its affiliates receive revenue from T. Rowe Price investment products and services. Past performance is not a reliable indicator of future performance. The value of an investment and any income from it can go down as well as up. Investors may get back less than the amount invested.

The material does not constitute a distribution, an offer, an invitation, a personal or general recommendation or solicitation to sell or buy any securities in any jurisdiction or to conduct any particular investment activity. The material has not been reviewed by any regulatory authority in any jurisdiction.

Information and opinions presented have been obtained or derived from sources believed to be reliable and current; however, we cannot guarantee the sources' accuracy or completeness. There is no guarantee that any forecasts made will come to pass. The views contained herein are as of the date written and are subject to change without notice; these views may differ from those of other T. Rowe Price group companies and/or associates. Under no circumstances should the material, in whole or in part, be copied or redistributed without consent from T. Rowe Price.

The material is not intended for use by persons in jurisdictions which prohibit or restrict the distribution of the material and in certain countries the material is provided upon specific request. It is not intended for distribution to retail investors in any jurisdiction.

Australia—Issued in Australia by T. Rowe Price Australia Limited (ABN: 13 620 668 895 and AFSL: 503741), Level 50, Governor Phillip Tower, 1 Farrer Place, Suite 50B, Sydney, NSW 2000, Australia. For Wholesale Clients only.

DIFC—Issued in the Dubai International Financial Centre by T. Rowe Price International Ltd. This material is communicated on behalf of T. Rowe Price International Ltd. by its representative office which is regulated by the Dubai Financial Services Authority. For Professional Clients only.

EEA ex-UK—Unless indicated otherwise this material is issued and approved by T. Rowe Price (Luxembourg) Management S.à r.l. 35 Boulevard du Prince Henri L-1724 Luxembourg which is authorised and regulated by the Luxembourg Commission de Surveillance du Secteur Financier. For Professional Clients only.

Hong Kong—Issued in Hong Kong by T. Rowe Price Hong Kong Limited, 6/F, Chater House, 8 Connaught Road Central, Hong Kong. T. Rowe Price Hong Kong Limited is licensed and regulated by the Securities & Futures Commission. For Professional Investors only.

New Zealand—Issued in New Zealand by T. Rowe Price Australia Limited (ABN: 13 620 668 895 and AFSL: 503741), Level 50, Governor Phillip Tower, 1 Farrer Place, Suite 50B, Sydney, NSW 2000, Australia. No Interests are offered to the public. Accordingly, the Interests may not, directly or indirectly, be offered, sold or delivered in New Zealand, nor may any offering document or advertisement in relation to any offer of the Interests be distributed in New Zealand, other than in circumstances where there is no contravention of the Financial Markets Conduct Act 2013.

Singapore—Issued in Singapore by T. Rowe Price Singapore Private Ltd., No. 501 Orchard Rd, #10-02 Wheelock Place, Singapore 238880. T. Rowe Price Singapore Private Ltd. is licensed and regulated by the Monetary Authority of Singapore. For Institutional and Accredited Investors only.

Switzerland—Issued in Switzerland by T. Rowe Price (Switzerland) GmbH, Talstrasse 65, 6th Floor, 8001 Zurich, Switzerland. For Qualified Investors only.

UK—This material is issued and approved by T. Rowe Price International Ltd, 60 Queen Victoria Street, London, EC4N 4TZ which is authorised and regulated by the UK Financial Conduct Authority. For Professional Clients only.

C6JD3LU7Z
201910-992375
LE49938