CIBC ASSET MANAGEMENT

EMERGING MARKET LOCAL DEBT: EXPANDING FIXED INCOME INVESTMENT OPPORTUNITIES

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Read time: 10 minutes

- **Key takeaways:** Investors face relatively low expected returns to traditional public market asset classes, as well as heightened inflation and recession fears. Collectively, these represent headwinds to the performance of a traditional balanced portfolio.
- Mitigating these headwinds requires investors to increase portfolio breadth and diversification by embracing unique and persistent sources of returns.
- Emerging market local currency debt appears to fit the bill, and represents an opportunity for attractive expected returns that compensate investors for accepting exposure to idiosyncratic economic, political and liquidity risks.

Exploring new fixed income investment opportunities

Outside of Canada, developed market (DM) large-cap equity valuations and expected returns remain relatively unattractive. DM government bond yields have risen to more attractive levels but are still low by historical standards. Inflation remains relatively high and sticky, and recession risks are elevated. These are important headwinds to the performance of a traditional balanced portfolio focused on public equity and core fixed income.

Expected portfolio performance can be improved by increasing investment breadth. This requires investors to identify additional distinct and diversifying sources of return. Potential options include new asset classes not currently encompassed by an investor's portfolio; unique opportunities within existing asset classes; and increased geographic diversification. Emerging market (EM) debt is an increasingly accessible opportunity that allows investors to exploit all three of these additional investment options.

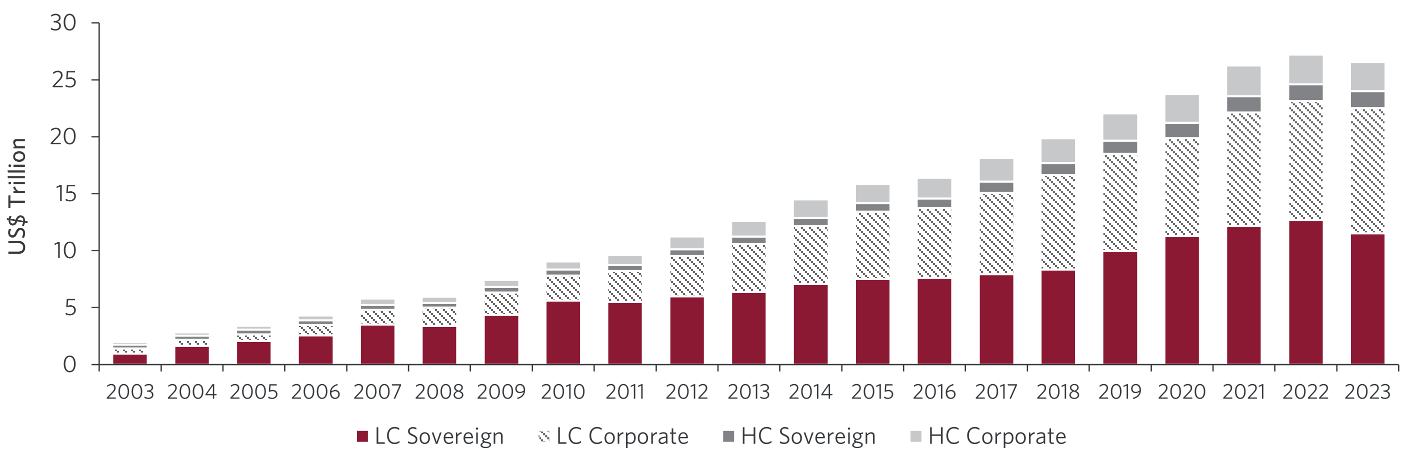
Relatively few investors currently invest in EM debt. Those investors who already do can expect to be rewarded for extending out along the fixed income yield curve and accepting exposure to the additional risks inherent in EM debt. These risks include idiosyncratic economic, political, and liquidity risks associated with individual EM countries. And with countries across the globe often at different stages of the economic cycle, geographic diversification accessible through an allocation to EM debt helps add another layer of expected return to portfolio performance.

Emerging market debt is a growing asset class

The number of individual country EM bond markets has doubled since 2009 and now totals 50.[1] Concurrently, the amount of EM debt outstanding has risen strongly, reaching $26.5 trillion in April 2023.[2] This includes local currency and hard currency debt (typically in U.S. dollars) issued by sovereign governments and locally domiciled corporates. The EM debt market is already much bigger than the global high-yield market. And yet, further substantial growth is likely as outstanding EM debt has failed to keep pace with the growth of EM countries' share of World GDP; EM local sovereign debt constitutes only 15% of the global government bond market, whereas emerging markets represent 43% of World GDP. Deepening liquidity will provide investors with an increasing opportunity to participate in this asset class.

Nowadays, most EM debt is issued in the local currency of the issuing government or corporation (Chart 1). This was not always the case. In the early days of the asset class, few EM central banks enjoyed a reputation for monetary policy credibility. This led investors to demand debt denominated in U.S. dollars (USD), and occasionally Euro, to minimize the risk inflation would undermine the value of their assets.

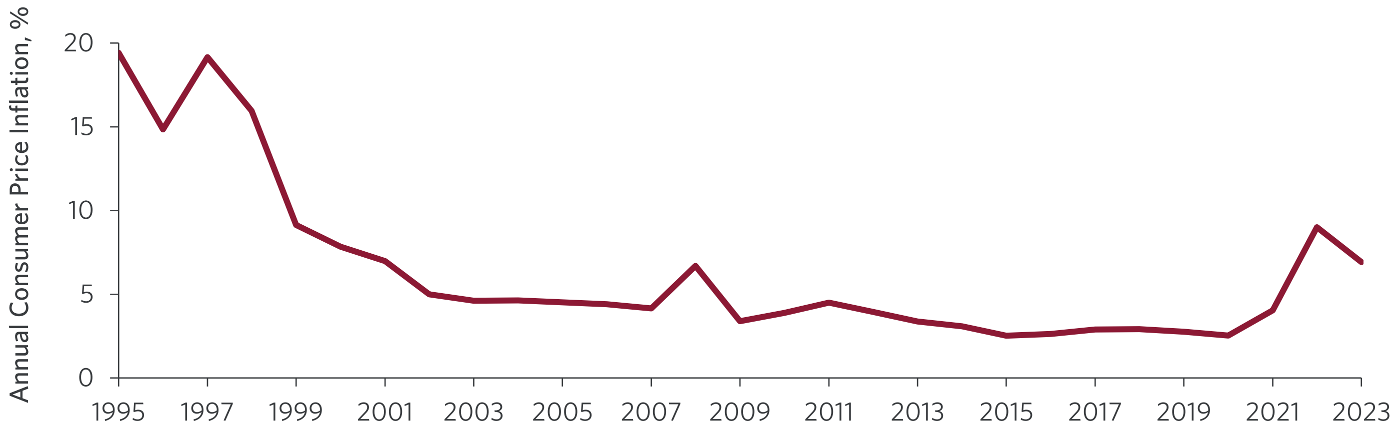
Chart 1 – EM Debt is increasingly dominated by local currency issuance



The information was prepared by CIBC Asset Management Inc. using the following third-party service providers' data: J.P. Morgan. LC = Local Currency; HC = Hard Currency. Data as at April 30, 2023.

The situation is different today. Many EM central banks have been granted monetary policy goal independence by domestic governments in the pursuit of low and stable inflation. They use this new independence to earn credibility with investors by delivering on their mandates (Chart 2). Over the last couple of years inflation has risen, initially in response to post-Covid supply constraints and then generally strong demand. Policy tightening by many EM central banks in response pre-empted similar actions in developed market countries and underscored the commitment to maintain this hard-won credibility.

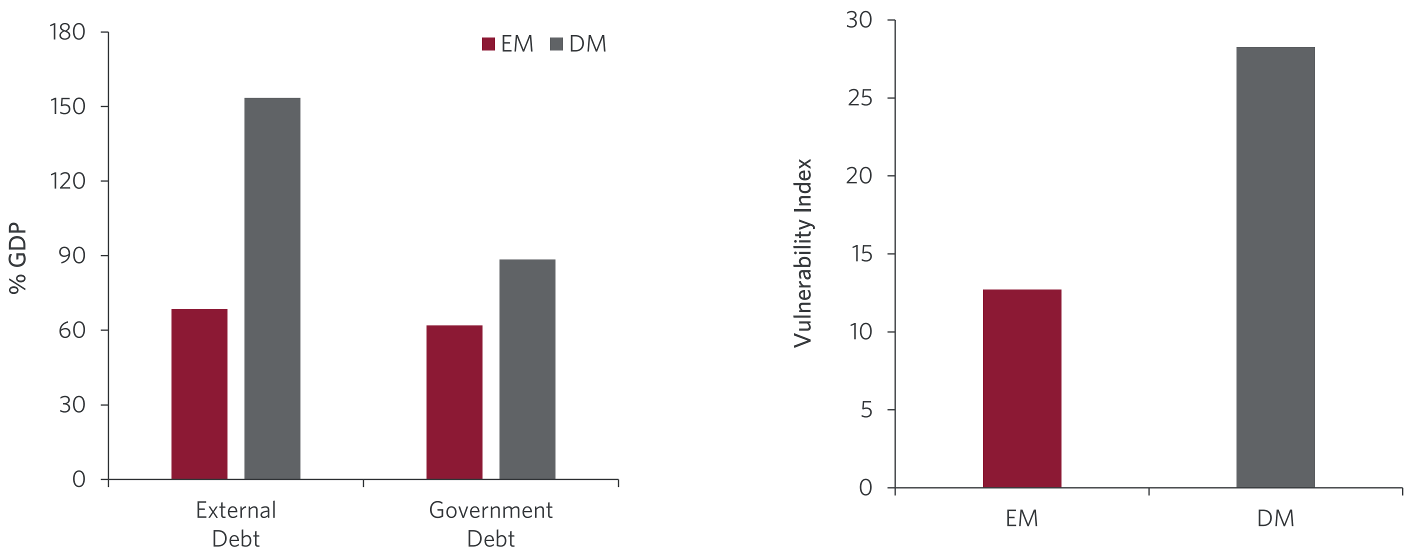
Chart 2 – EM Inflation has trended lower, despite a temporary pick-up in 2022, consistent with increasing central bank policy credibility



The information was prepared by CIBC Asset Management Inc. using the following third-party service providers' data: IMF, Bloomberg. Maximum sample 1995 – 2023 (June). Series calculated as an average of consumer price inflation for the following countries: Brazil; Chile; China; Colombia; Czechia; Hungary; India; Indonesia; Malaysia; Mexico; Peru; Philippines; Poland; Romania; Thailand.

Monetary credibility has been established concurrent to the adoption by many EM governments of more responsible fiscal policies. Other economic fundamentals—including import reserve coverage, current account balances, and debt/GDP ratios—have also improved relative to DM countries. This further enhances broad macroeconomic policy credibility in many EM countries (Chart 3). It has allowed domestic governments and corporations to issue debt predominantly in local currencies, with yields substantially lower than earlier decades.

Chart 3 – Long-term EM economic fundamentals appear attractive relative to DM counterparts



The information was prepared by CIBC Asset Management Inc. using the following third-party service providers' data: Bloomberg, Refinitiv Datastream. Weighted Average composite index of selected indicators of long-term country financial and economic soundness for select EM and DM countries. Lower values indicate more attractive fundamentals in the left-hand chart and less vulnerability in the right-hand chart. Data as at March 2023.

EM countries aren't a homogeneous bloc (Chart 4). And not all EM countries have gained policy credibility. Turkey and Russia are two noteworthy exceptions. As with all asset classes, it's important to rigorously evaluate individual investment opportunities to ensure accepting exposure to inherent risks will be rewarded with an adequate expected return.

Chart 4 – Low pairwise correlations emphasize EM countries are not a homogeneous bloc

Average pairwise monthly EM local bond country return correlations

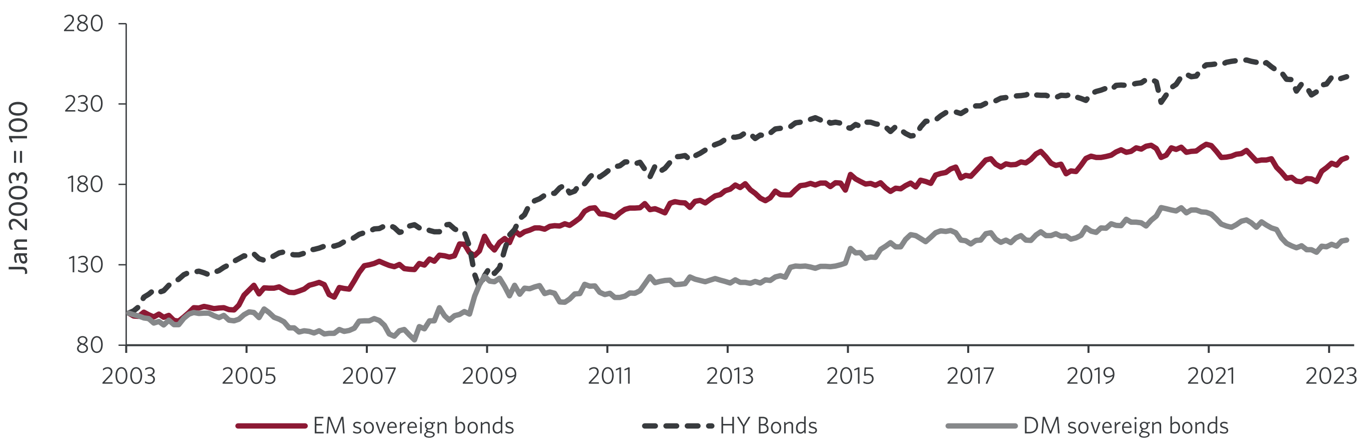
	BR	CL	CN	CO	CZ	DO	EG	ID	MY	PE	PH	SR	TH	TR
Brazil (BR)	1.00													
Chile (CL)	0.32	1.00												
China (CN)	-0.33	-0.03	1.00											
Colombia (CO)	0.40	0.41	-0.05	1.00										
Czechia (CZ)	-0.09	-0.23	0.30	0.01	1.00									
Dominican Republic (DO)	-0.38	-0.19	0.47	-0.12	0.38	1.00								
Egypt (EG)	0.44	0.31	-0.23	0.53	0.01	-0.06	1.00							
Indonesia (ID)	0.31	0.44	0.01	0.41	-0.01	-0.15	0.47	1.00						
Malaysia (MY)	0.19	0.47	0.06	0.40	-0.04	0.09	0.25	0.35	1.00					
Peru (PE)	0.35	0.29	-0.21	0.54	0.13	-0.23	0.56	0.38	0.27	1.00				
Philippines (PH)	0.04	0.33	0.29	0.35	0.22	0.01	0.13	0.32	0.36	0.12	1.00			
Serbia (SR)	-0.07	0.30	0.50	0.32	0.37	0.31	0.21	0.18	0.23	0.25	0.75	1.00		
Thailand (TH)	0.28	0.41	0.02	0.49	0.02	-0.07	0.42	0.66	0.32	0.36	0.30	0.25	1.00	
Turkey (TR)	0.25	0.15	0.01	0.14	0.03	0.13	0.27	0.02	0.13	0.14	0.00	0.02	0.17	1.00

The information was prepared by CIBC Asset Management Inc. using the following third-party service providers' data: Bloomberg. Sample: January 2011 to April 2023 or the latest available. All data expressed in Canadian Dollars. Countries in the correlation matrix represent a subset of the EM bond universe.

Emerging markets deliver attractive historical and expected performance

Historical returns to EM bonds have been attractive relative to DM bonds (Chart 5). Drawdowns associated with EM bonds have been shallower than either DM or global high-yield bonds (Chart 6). Over the long term, as measured by the Sharpe ratio, investors have been compensated for accepting the additional risks associated with investing in EM debt.

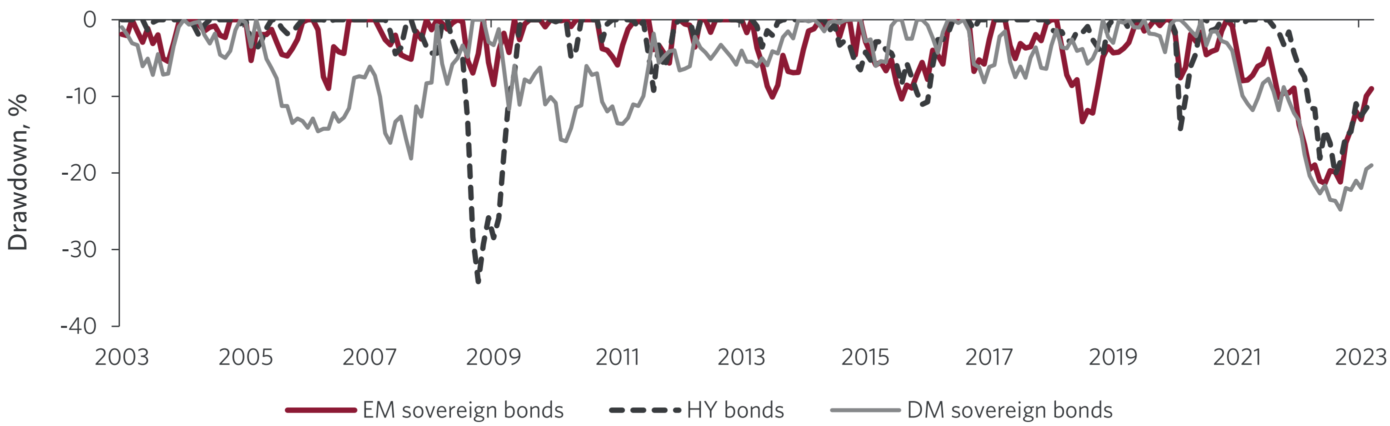
Chart 5 – Historical returns to EM debt have exceeded core developed market sovereign bonds



Description	EM sovereign bonds	HY bonds	DM sovereign bonds
Return	4.8%	7.3%	2.2%
Volatility	9.1%	9.8%	9.2%
Sharpe ratio	0.52	0.74	0.24

The information was prepared by CIBC Asset Management Inc. using the following third-party service providers' data: Bloomberg. Sample: January 2003 to April 2023. Emerging Market Sovereign Bonds: J.P. Morgan GBI-EM Global Diversified Index, High-Yield Bonds: ICE BofA Global High-Yield Index, Developed Market Sovereign Bonds: FTSE World Government Bonds Index. All data expressed in Canadian Dollars. HY = high yield.

Chart 6 – EM bond drawdowns have typically been shallower than global HY bonds

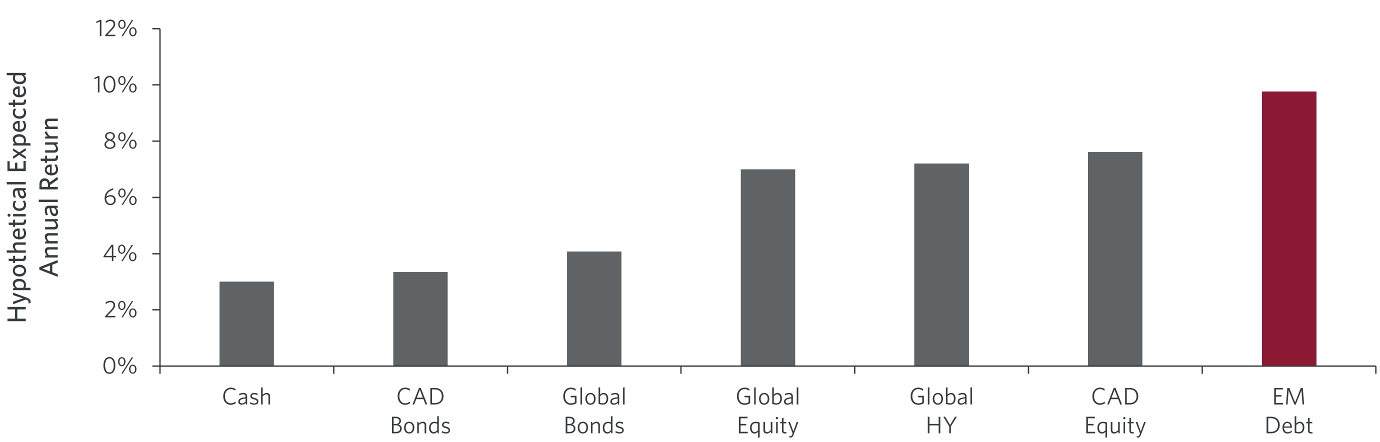


	EM sovereign bonds	HY bonds	DM sovereign bonds
Largest 1-month drawdown	-6.7%	-17.3%	-5.7%
Maximum drawdown	-21.3%	-34.2%	-24.8%
Longest underperformance (months)	24	24	60

The information was prepared by CIBC Asset Management Inc. using the following third-party service providers' data: Bloomberg. Sample: January 2003 to April 2023. Emerging Market Sovereign Bonds: J.P. Morgan GBI-EM Global Diversified Index, High-Yield Bonds: ICE BofA Global High-Yield Index, Developed Market Sovereign Bonds: FTSE World Government Bonds Index. All data expressed in Canadian Dollars.

We expect EM debt to continue offering relatively attractive, diversifying returns (Chart 7). Fewer investors participate in this asset class than in core fixed income and large-cap public equity. This allows market inefficiencies to persist, which in turn provides the opportunity for investors—including CIBC Asset Management—to harvest an attractive asset class expected return. In the case of EM local debt, this expected return compensates investors for accepting exposure to idiosyncratic economic, political, and liquidity risks associated with EM countries. Relatively high expected returns are also consistent with high trend GDP growth rates in many EM countries that reflect a mix of strong productivity and plentiful labour.

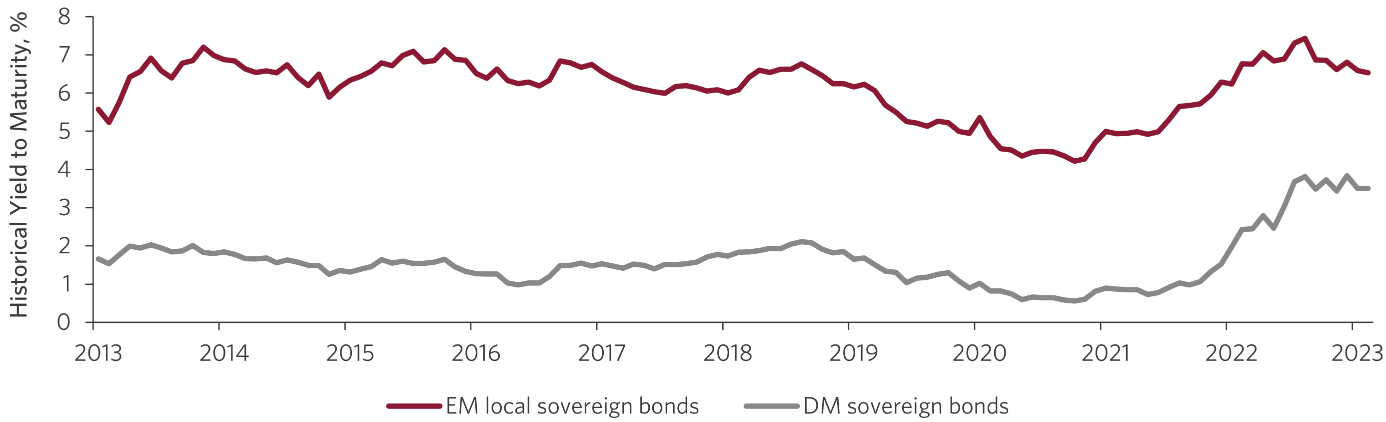
Chart 7 – Expected returns favour a portfolio allocation to EM debt



The information was prepared by CIBC Asset Management Inc. using the following third-party service providers' data: Bloomberg; Refinitiv Datastream. Data as at March 31, 2023. HY = High-yield. This hypothetical scenario is shown for illustrative purposes only and is not indicative of future results. Please refer to the Disclaimer page for further information. Methodology for calculation of expected returns available at CIBC AM 2023 Long Term Market Returns.

To better understand the source of this expected return, we break it down into its principal components: yield and currency appreciation. Although the average level of yields attached to EM local debt has trended lower over time, it remains relatively attractive compared to investment grade sovereign bonds (Chart 8).

Chart 8 – EM local debt yield spread

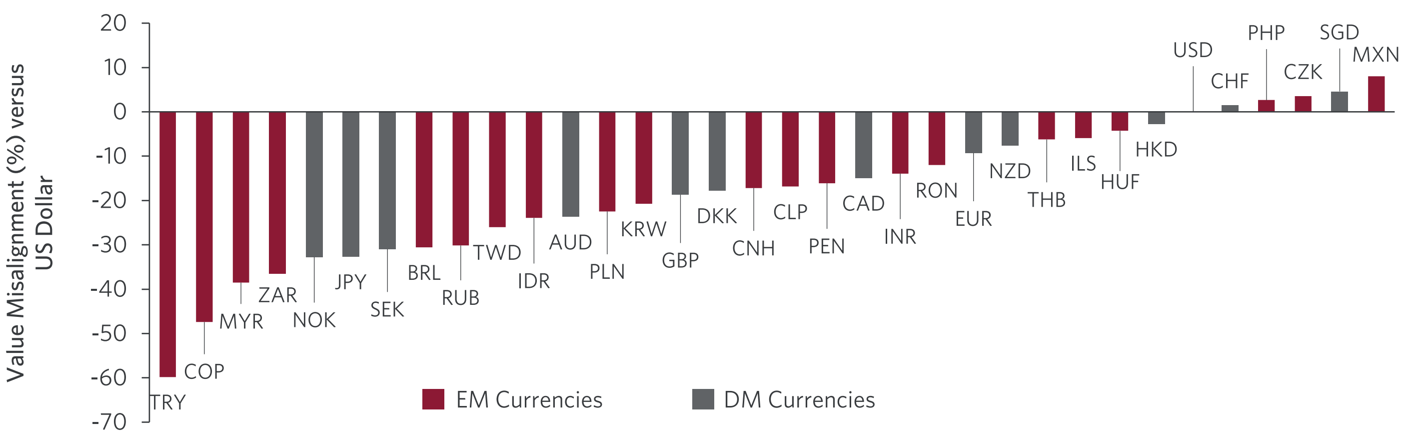


The information was prepared by CIBC Asset Management Inc. using the following third-party service providers' data: Bloomberg LLC. Data as at April 30, 2023. Emerging Market Local Bonds: J.P. Morgan GBI-EM Global Diversified Index, Developed Market Sovereign Bonds: Bloomberg Global Aggregate - Developed Markets Index.

Many currencies in the EM investment universe appear undervalued versus USD (Chart 9). This will provide a source of positive return as exchange rates revert back to fair value.

Chart 9 – Many emerging market currencies appear undervalued versus USD

Estimated deviation of currencies from fair value



The information was prepared by CIBC Asset Management Inc. using the following third-party service providers' data: Refinitiv Datastream. For illustration only. The chart reports the estimated Value misalignment of currencies in the CIBC Asset Management currency universe versus the US dollar, in percent. Data as at March 31, 2023.

Emerging market debt diversifies an investment portfolio

A strategic allocation to EM local currency debt also offers the opportunity to enhance expected portfolio performance by adding more diversification (Chart 10). The average historical correlation of EM debt with traditional DM bonds and public equities is relatively low. As is the correlation between returns to local and hard currency EM debt, EM debt and EM equities, and between countries within the EM local debt universe. Low inter-country correlations reflect differences in economic structure across emerging markets—including commodity exposure. Many EM countries are important commodity exporters, but some including India, are net importers of commodities. Differences in economic infrastructure—for instance, between the contribution of manufacturing and services to each country's GDP—as well as the extent of trade openness and myriad idiosyncratic country risk factors also contribute to the diversification opportunity presented by EM debt.

Chart 10 – Attractive average and conditional asset class pairwise correlations

Emerging market local bond correlations

EM local debt correlation with:	Sample average	During periods of Canadian equity drawdown
EM hard currency bonds	0.66	0.66
EM corporate bonds	0.54	0.53
Emerging market equity	0.65	0.49
Canadian sovereign bonds	0.45	0.31
Global sovereign bonds	0.49	0.41
Global high yield bonds	0.45	0.46
Leverage loans	0.31	0.26
Commercial mortgages	0.38	0.38
Canadian equity	0.24	0.35
U.S. equity	0.24	0.23
International equity	0.48	0.26

The information was prepared by CIBC Asset Management Inc. using the following third-party service providers' data: Bloomberg. Sample is from January 2011 to April 2023. Emerging Market (EM) Bonds: J.P. Morgan GBI-EM Global Diversified Index, Canadian Equities: S&P TSX Index, US Equities: S&P 500 Index, International Equities: MSCI EAFE Index, EM Equity: MSCI EM Index, Canadian Bonds: FTSE Canada Universe Bond Index, Floating Rate Notes: Renaissance Floating Rate Income Fund, Global Bonds: Bloomberg GlobalAgg Index, Global High-Yield Bonds: Bloomberg Global High-Yield Index, EM Corporate Bonds: J.P. Morgan CEMBI Broad Composite Index, EM Hard Currency Bonds: J.P. Morgan EMBI Global Diversified Composite. "EAFE" is a registered trademark of MSCI Inc., used under license. All data expressed in Canadian Dollars. Conditional correlations measured in periods when S&P TSX Index monthly returns are negative.

Conclusion

Maximizing investment breadth is key to achieving long-term performance goals. This requires including as many distinct and rewarded risks into portfolios as possible, subject to investor constraints. EM local currency debt fits the bill.

Investors willing to move further out along the fixed income risk spectrum into opportunities such as EM debt can expect to be rewarded with an attractive and diversifying standalone strategic return. Persistent EM market inefficiencies suggest this strategic return can be further enhanced through the implementation of active, benchmark-relative positions by skilled portfolio managers.

At CIBC Asset Management, our Multi-Asset and Currency Management team has a long history of investing in emerging market countries utilizing our active currency and global bond capabilities. We recently launched the CIBC Emerging Markets Local Currency Bond fund, encompassing both active debt and currency investment decision-making. This fund represents a natural extension of the team's capabilities and a complementary addition to our existing set of macro-based investment solutions.

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About CIBC Asset Management

At CIBC Asset Management, we believe every customized investment solution begins with research and rigour. We specialize in a variety of investment solutions such as equities, fixed income, currency management, liability-driven investments, asset allocation and responsible investments.

Across a spectrum of investment solutions, we commit to best-in-class research. Dedicated sector and regional analysts focus on industry research and security-specific idea generation. Our investment professionals leverage deep and diverse expertise by sharing proprietary research across asset class teams. By sharing insight across asset class teams, we maximize opportunities to add value to our client portfolios.

We provide our clients with our research insights and expertise on industry issues and themes that matter most to them.

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[1] J.P. Morgan (2022), EM Local Markets Guide. 13th Edition. September.

[2] Bank for International Settlements (BIS), Summary of Debt Outstanding, April 2023.