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Emerging market local currency bonds: Diversification and stability

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ABSTRACT

We examine the dynamics of emerging market (EM) local currency government bond yields for the last decade and a half as well as for three different phases (January 2000–December 2007, January 2008–April 2013, and since May 2013). We show that domestic factors have anchored EM local currency government bond yields, increasing the potential diversification benefit. Moreover, these yields have become relatively resilient to global risk aversion shocks. Yet, EM local currency government bond yields have been affected partly by very low US Treasury yields and are susceptible to the latter's increases.

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1. Introduction

The period since the middle of 2009, when the global economy started to emerge from the Lehman-shock, has been marked by two rather distinct developments. The first was the fact that after the euro area debt crisis in 2010, capital inflows into emerging market economies (EMEs) not only held steady but increased despite risk aversion having risen significantly. Foreign investors' appetite was particularly strong for emerging market (EM) local currency denominated bonds. As the left hand-panel of Graph 1 shows, cumulative net inflows to mutual funds dedicated to EM bonds grew from a little over $20 billion at the end of December 2009 to a peak of $180 billion at the end of May 2013. Around half of those inflows were directed to local currency-denominated bonds. The right-hand panel shows that, during this period of relatively high risk aversion, the

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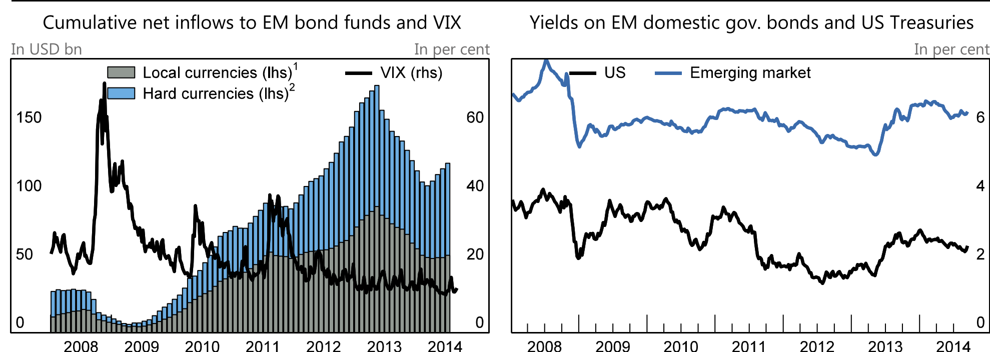

[1] Inflows to EM dedicated bond funds investing 75% or more in local currency debt. [2] Inflows to EM dedicated bond funds investing 75% or more in debt denominated in the major currencies (US dollar, euro, etc). Including inflows to EM dedicated "blended" bond funds (a combination of both local currency and hard currency), which represent a small share of the total.

Sources: Bloomberg; EPFR; JP Morgan.

Graph 1. Indicators of emerging market bonds and external factors.

yields on EM local currency government bonds typically fell and tracked closely the US Treasury yield, widely accepted as the "risk-free" global benchmark yield.

A second phase began at around May 2013 — after the release of strong US labour market data, comments by Federal Reserve officials were interpreted by investors as signals that the central bank would soon slow the pace of asset purchases and end its quantitative easing policy. Cumulative net inflows to EM bonds fell for 10 successive months (Graph 1, left-hand panel) and their yields spiked to very high levels (Graph 1, right-hand panel).

The two developments raise a question as to what drives foreign investors' appetite for EM local currency government bonds. Historically, increased risk aversion and tighter global monetary conditions tended to reduce capital flows into EM debt products (Eichengreen and Mody, 2000; IMF, 2004; González-Rozada and Levy-Yeyati, 2008). However, it appears that over the past several years, EM local currency government bond yields have been moving more in tandem with US Treasury yields than risk aversion.

The question is intrinsically linked to the prospects for EM local currency bonds to become an asset class of their own. One view is that foreign investors' demand for EM local currency bonds has risen because institutional investors have diversified their portfolio in favour of assets expected to offer higher risk-adjusted returns (IMF, 2011). EMEs that enjoy strong economic growth and balance sheet positions provide attractive investment opportunities to investors. In addition, over the past decade, EMEs have developed domestic bond markets as they have improved domestic institutions, macroeconomic and monetary policies and market infrastructure (BIS, 2002, 2012a, 2012b; Claessens et al., 2007; Gagnon, 2014; Goldstein and Turner, 2004; Montoro and Rojas-Suarez, 2012).

Consistent with this view, there has been a steady – apparently structural – increase in the foreign ownership of EM local currency bonds in the past decade.[2] In addition, a number of EMEs have now their local currency government bonds included in the major global bond indices.[3] Echoing a positive view, the Committee on the Global Financial System (2007) argued that "… because local currency bonds represent

[2] For instance, at the beginning of the 2000s foreign investors accounted for less than 1% of the total stock of local currency government bonds in most EMEs (the exception was Hungary where this share was 47%). However, by 2010 this share had risen to 30% in Indonesia, 18–22% in Mexico and Malaysia, 14% in Brazil and 10% in Korea.

[3] Domestic government bonds issued in five EMEs are currently included in the widely used Citigroup World Government Bond Index (WGBI), which consists of government bonds issued by 23 countries. These are Malaysia (included in 2007), Mexico (2010), Poland (2003), Singapore (2005), and South Africa (2012). The market weights for most of the EMEs are in the range of 0.4–0.6%, comparable to those of Finland or Ireland, but much smaller than those of Japan or the US.

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