PGIM FIXED INCOME
PERSPECTIVES

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LOCO FOR EMERGING MARKETS LOCAL DEBT AND FX

Significant developed market policy accommodation, including quantitative easing, has been a part of the prevailing emerging market investment landscape since the Global Financial Crisis (GFC). And, as the developed market central banks spent much of the last five plus years competing amongst themselves to drive rates lower while fighting the spread of global disinflation, a portion of the global fixed income market had to lose out.

Step forward EM and, in particular, the current account deficit countries reliant on foreign funding. With the status of EM FX reserves well below that of their developed market counterparts, their respective asset markets were forced to adjust.

Adjust how exactly? With higher real yields and weaker real-effective exchange rates, which were accompanied by policy actions designed to enhance fiscal policy settings—spending curbs, removal of energy-price subsidies, and higher tax revenues, etc.—thereby adding to the appeal of local markets. These steps also kept foreign investors engaged, which helped stabilize external imbalances.

Now, after posting solid total returns and generally outperforming most other major credit indices between January 2016 through the end of Q3 2017,[1] investors still question if EM local currency bonds can continue to post relatively strong returns and outperform, particularly against a backdrop where many developed market central banks are tightening monetary policy.

While recognizing the factors that caused turbulence within the local EM markets leading up to 2016—in particular, concerns over China's 2015 mini-Yuan devaluation, tighter U.S. monetary policy, and sliding commodity prices—we contend that conditions remain ripe for emerging market local rates and EMFX to continue their relatively strong performance.

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[1]Past performance is not a guarantee or a reliable indicator of future results.

SECTION 1: THE THREE PHASES OF THE BAD OLD DAYS

The attractive valuations currently found within emerging market local bonds and currencies stem from many EM countries being forced to better align both their external and internal balance sheets between May 2011 and January 2016. During this period, EM countries faced some harsh new realities: the end of China's manufacturing, industrial, and commodity boom; the end of exceptionally accommodative monetary policy in the United States; and the push for weaker exchange rates(notably in Japan and the euro zone) among developed market countries. This new environment took almost five years to develop and can be split into three phases.

PHASE 1: MAY 2011 THROUGH APRIL 2013—CHINA'S MANUFACTURING SLOWDOWN

After China's 2009 fiscal stimulus started to wane, the manufacturing and industrial sectors began to slow down, resulting in the second big commodity decline in over a decade. China also began to export deflation to the global economy as its annualized rate of producer price inflation plunged comfortably into negative territory for the first time since 2009. Against this backdrop, EM exports, global trade, and EM growth all slowed, and commodity exporters saw their terms of trade and current account balances deteriorate to unsustainable levels.

However, real effective exchange rates (REERs) weakened only mildly as capital was still attracted to the emerging markets given the attractive total-return potential of long duration local bonds in the global disinflationary environment. Indeed, the return on the rates component of the JP Morgan GBI-EM Global Diversified Index USD funded (GBI) was very strong during this phase (with the yield on the GBI index falling 170 bps to an all-time low), driven by global disinflation and the Federal Reserve's highly accommodative monetary policy that depressed U.S. real yields deeply into negative territory. What is not widely recognized is that while the GBI index hit an all-time high in May 2013, the winds of change had already started to blow as the return on the currency component of the index and the value of REERs peaked in May 2011.

PHASE 2: MAY 2013 THROUGH MAY 2014—FED TAPERS U.S. DOLLAR LIQUIDITY

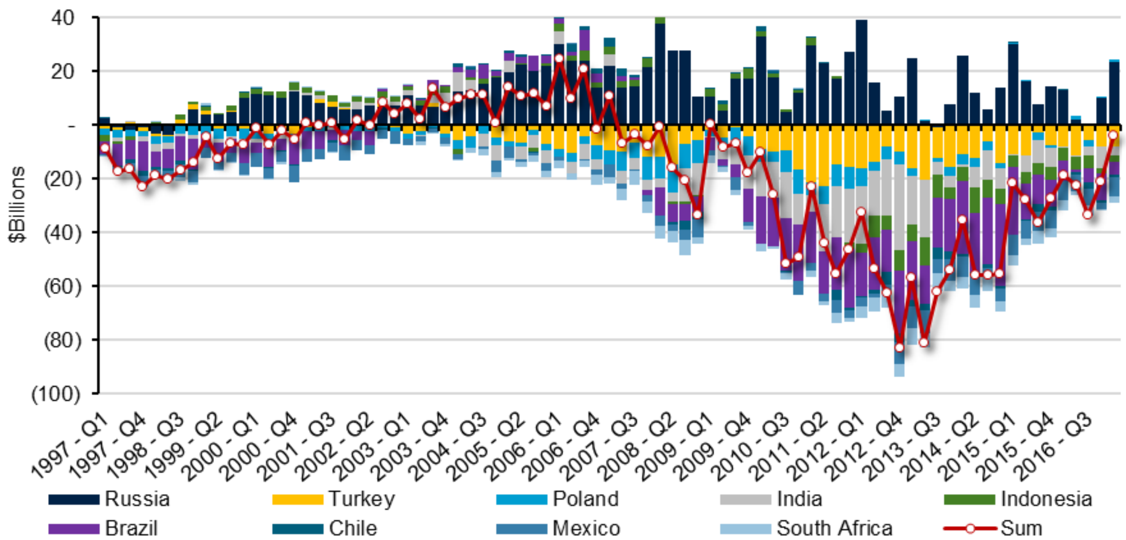
In the spring of 2013, Fed Chairman Ben Bernanke signaled that the Fed was considering tapering its third QE program. This sent a shock through the market considering that the Fed's fall 2012 QE announcement made no mention of an expiration date—unlike the previous two programs—and inflation remained low. This prompted the steepest rise in U.S. real yields since the 2008 GFC as U.S. real and nominal interest rates climbed nearly 170 bps and 150 bps, respectively. Global capital, much of which was parked in the emerging markets, now flocked to the suddenly more attractive yields in the U.S. Countries with deep current account deficits and historically low real rates were now displaced as foreign capital fled, pushing up interest rates and weakening real effective exchange rates. Funding current account deficits became more difficult as investors demanded higher risk premiums in the form of higher interest rates and cheaper currencies. Policymakers in certain countries—such as Indonesia and India—took action and hiked interest rates to control the rise in inflation pass-through from currency weakness and to improve current accounts. Some countries also implemented structural reforms to further improve macro imbalances and build policy credibility in the eyes of investors.

Hiking interest rates and implementing politically difficult structural reforms amid capital outflows and tighter U.S. liquidity only exacerbated the growth slowdown. The differentiation of emerging market countries also came into play as some countries—particularly in Eastern Europe and Asia—with little macro imbalances were positioned to conduct anti-cyclical monetary policy. In these cases, interest rates were cut and central banks and governments welcomed the currency weakness amid slowing growth and low levels of inflation.

PHASE 3: JUNE 2014 THROUGH JANUARY 2016—BEGGAR THY NEIGHBOR AND CAPITULATION

In June 2014, concerned over the low level of inflation, ECB Chairman Mario Draghi introduced a raft of measures designed to stimulate the euro zone economy, including unprecedented negative interest rates and long-term, low-cost loans to banks. This placed the ECB in lockstep with the Bank of Japan—central banks for the third and fourth largest economies in the world, respectively—in operating under an extremely accommodative monetary regime (all the while the Fed was moving in the opposite direction), thus creating one of the most acute monetary policy divergences in G-3 in history. This caused the U.S. dollar to surge against the euro, and the global economy was hit with another disinflationary wave as the euro zone exported disinflation via a weaker currency. The disinflation triggered another commodity decline, particularly in oil prices, and EM commodity exporters' terms of trade balances deteriorated further. Reminiscent of Phase Two, EM capital outflows once again accelerated and real effective exchange rates approached 2008 crisis lows as EM growth declined to the lowest level since 2001. Inflation—notably in Latin American countries with high inflation pass-throughs from FX—continued to rise and central banks kept hiking interest rates as a result. Meanwhile, some countries that needed to reign in macro imbalances implemented structural reforms. Nevertheless, current account balances began to steadily improve, which was a leading indicator that economies had adjusted to the new environment.

FIGURE 1: CURRENT ACCOUNT BALANCES



Source: Haver Analytics as of March 31, 2017

SECTION 2: THE SUN ALSO RISES—DEEP VALUE, LOWER RISKS, AND ECONOMIC RECOVERY

In the wake of "the bad old days," the turbulent alignment during the three phases created deep value in both EM local bonds and currencies. Given that markets have a peculiar tendency to overshoot on both the upside and downside of valuations, the improvement in EM current accounts (as observed in Figure 1) has led to historically attractive absolute and relative real yields as well as competitive REERs.

Indeed, the equal weighted REER is near its historical average after generally trending downward since early 2013 as observed in Figure 2. At these levels, EM REERs are conducive to growth in the tradeable sector rather than acting as an uncompetitive impediment to growth.

FIGURE 2: EQUAL WEIGHTED EM REAL EFFECTIVE

EXCHANGE RATES

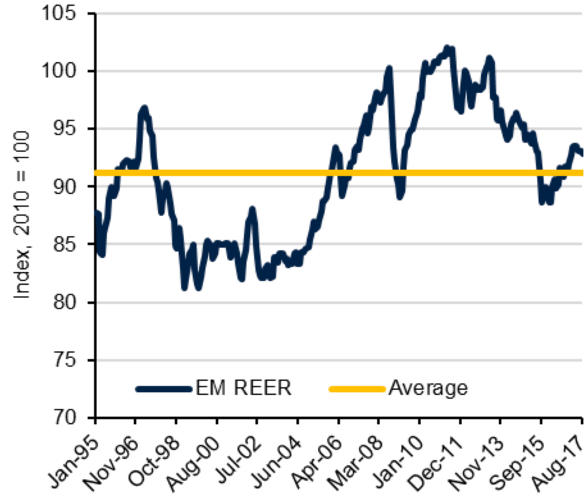
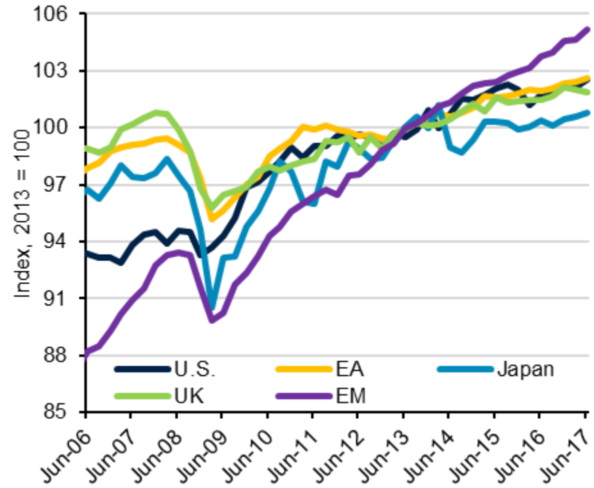


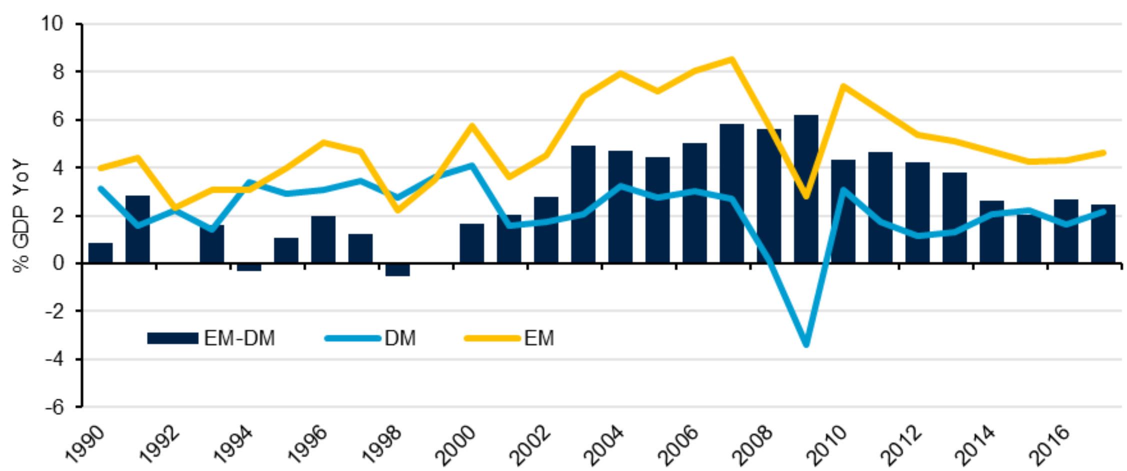
FIGURE 3: REAL LABOR PRODUCTIVITY



Source: Haver Analytics as of September 30, 2017.

Our view is that REERs should rise over time given the persistently high productivity and GDP growth in EM relative to DM as highlighted by Figure 3 on the preceding page and Figure 4 immediately below.

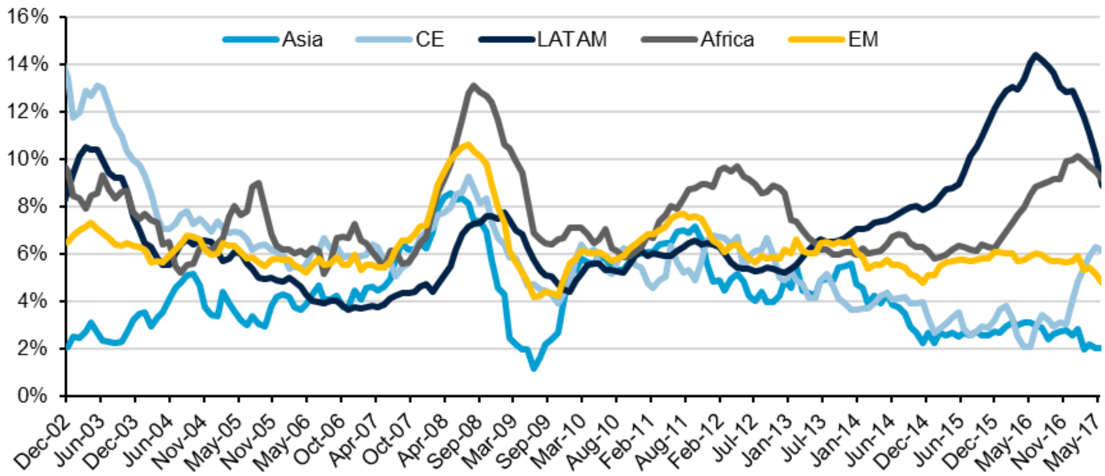
FIGURE 4: EM VS. DM GROWTH DIFFERENTIAL



Source: International Monetary Fund as of September 30, 2017

The compelling value in EM local bonds and currencies is present when risks are materially lower. That said, external balance sheet vulnerabilities are lower via improvement in current accounts and relatively high ratios of foreign exchange reserves to short-term external debt . Additionally, internal balance sheets are on the mend via structural reforms and orthodox monetary policy that raised real interest rates, slowed leveraging, and brought inflation under control (as seen in the CPI trends in Figure 5), thus sowing the seeds for a boost in investment confidence. Lastly, after a dramatic growth slowdown when certain larger countries, such as Brazil, Russia, and South Africa, experienced recessions, growth is recovering and expected to maintain momentum given that many economies remain at the beginning stage of their expansions.

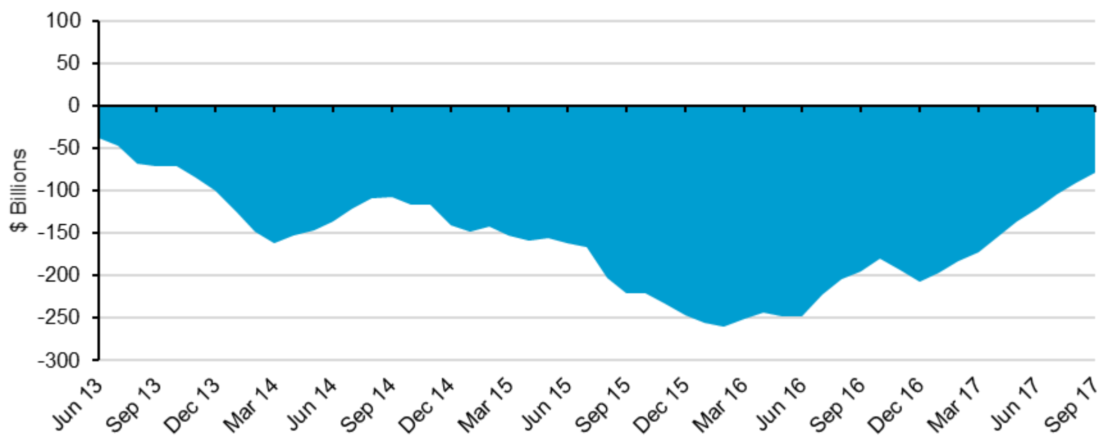
FIGURE 5: EM CPI



Source: Haver Analytics as of September 30, 2017

The technical position of the market appears to be in solid shape as well. Record capital outflows took place from 2013-2015, particularly from retail accounts, as investors fled the deteriorating economic and technical pictures in EM en masse. Since then, however, investors have steadily put capital back into EM.

FIGURE 6: CUMULATIVE EM EQUITY AND LOCAL CURRENCY DEBT FLOWS



Source: EPFR as of September 30, 2017

We're also in an environment where DM fundamentals are healthy, yet valuations remain unimpressive—strikingly so in certain G-3 interest-rate complexes where short-end real yields continue to linger in negative territory.

The main macro risk to our constructive outlook for local currency bonds is the same one that triggered Phase Two of emerging markets local assets' poor performance: the Fed. Our base case for the Federal Reserve is a gradual hiking cycle amid low inflationary pressures that doesn't overturn both the economic and financial apple carts. However, if the Federal Reserve is far more aggressive than market expectations (including our own) due to fears over financial stability or rising inflation, we believe the risk of a Phase Two repeat rises materially. The result would likely be a U.S. and global growth slowdown where G-3 currencies appreciate against EM currencies. The other evident macro risks are in the geopolitical arena relating to North Korea and U.S. trade policy towards Asia and its North American neighbors.

While our outlook on the local currency asset class is constructive due to attractive valuations amid lower risks both on the macro and micro level, not all countries have aligned their economic structures considering the three new harsh realities detailed in Section One. Whether driven by political unwillingness to engage in structural reforms or political interference with central bank policy, this lack of action by these EM countries presents both opportunities and risks for the active investor.

SECTION 3: RELATIVE-VALUE OPPORTUNITIES RULE THE DAY

Local currency issuance continues to grow and maturities are extending beyond the duration requirements of committed local banks, mutual funds, and pension schemes. And as EM local bond curves deepen, it enhances the appeal of these large, liquid local curves as attractive alternatives to developed market bonds.

A reasonable place to start an evaluation of the opportunities in EM local bonds and currencies is the JPMorgan GBI local bond index. With a diverse mix of local government securities rebalanced monthly, the index currently offers a weighted-average ex-ante real yield of 2.1%, (based on JPMorgan Q4 2017 headline inflation forecasts), which is more than 2 and 3.5 percentage points higher than U.S. and German equivalents, respectively.

While the index is composed of liquid local bonds issued by the larger EM constituents throughout Asia, LatAm, and CEEMEA, securities issued by Brazil, Colombia, Indonesia, Mexico, Poland, Russia, South Africa, Thailand, and Turkey make up approximately 75% of the index capitalization, which highlights the broad range of credit-rating options available to an active manager.

The opportunity set within local EM markets can be expanded when active investors leverage regional knowledge and consider bond and currency analysis in each country *independently* to optimize intra-country bond versus currency exposures. Figure 7 indicates the large-country FX and hedged bond monthly correlations between September 2010 and November 2017, colored blue to red (0 to 1) according to the correlation coefficient. The sea of blue highlights the diverse range of lowly correlated developed market alternatives that an asset class comprised of highly nuanced local markets offers to active investors.

FIGURE 7: MONTHLY FX AND HEDGED BOND CORRELATIONS

		LATAM				ASIA				CEEMEA						DEVELOPED		
		BRL	Brazil	MXN	Mexico	MYR	Malaysia	IDR	Indonesia	PLN	Poland	TRY	Turkey	ZAR	S. Africa	USD	JPY	EUR
LATAM	BRL (FX)	1.0																
	Brazil	0.5	1.0															
	MXN	0.6	0.3	1.0														
	Mexico	0.4	0.5	0.5	1.0													
ASIA	MYR	0.7	0.5	0.6	0.4	1.0												
	Malaysia	0.3	0.4	0.2	0.4	0.5	1.0											
	IDR	0.5	0.4	0.4	0.3	0.6	0.4	1.0										
	Indonesia	0.4	0.5	0.3	0.6	0.5	0.5	0.6	1.0									
CEEMEA	PLN	0.6	0.2	0.7	0.3	0.6	0.2	0.3	0.2	1.0								
	Poland	0.2	0.4	0.4	0.6	0.3	0.4	0.3	0.6	0.3	1.0							
	TRY	0.6	0.4	0.7	0.5	0.6	0.3	0.5	0.5	0.5	0.5	1.0						
	Turkey	0.4	0.5	0.3	0.6	0.4	0.5	0.5	0.6	0.2	0.6	0.6	1.0					
	ZAR	0.7	0.4	0.6	0.3	0.6	0.2	0.5	0.4	0.6	0.3	0.5	0.4	1.0				
	S. Africa	0.4	0.6	0.3	0.7	0.4	0.5	0.3	0.6	0.3	0.6	0.4	0.6	0.6	1.0			
DEVELOPED	USD	0.6	0.2	0.6	0.3	0.6	0.1	0.3	0.2	0.9	0.2	0.5	0.1	0.5	0.2	1.0		
	JPY	0.2	0.3	0.1	0.3	0.2	0.3	0.3	0.2	0.2	0.0	0.1	0.1	0.2	0.2	0.3	1.0	
	EUR	0.6	0.2	0.5	0.3	0.5	0.0	0.3	0.1	0.9	0.1	0.5	0.1	0.5	0.2	1.0	0.1	1.0

Source: PGIM Fixed Income and Bloomberg. Correlation data is monthly, beginning in September 2010 through November 2017

We can see from the table of currency-unhedged GBI returns in Figure 8 that the range of returns from investments in different countries has been significant over time. The wide range of country returns and the disparity in the directionality of country returns is seen in both positive and negative total return years for the GBI index as a whole. For example, in 2016, when the index returned nearly 10%, the top performer—Brazil—outperformed the bottom performer—Mexico—by a staggering 70 percentage points. Similarly, in 2014, the index returned -5.7%, and the top performer—Indonesia—outperformed the bottom performer—Russia—by almost 70 percentage points as well.

FIGURE 8: UNHEDGED GBI RETURNS

	GBI-EM	Brazil	Chile	Colombia	Hungary	Indonesia	Malaysia	Mexico	Peru	Philippines	Poland	Romania	Russia	S. Africa	Thailand	Turkey
Sep-17	14.3%	18.9%	9.9%	10.6%	16.2%	14.2%	11.0%	23.5%	17.3%	6.5%	18.8%	11.9%	16.3%	9.2%	12.4%	6.8%
2016	9.9%	57.8%	13.7%	21.9%	6.1%	16.7%	-1.6%	-16.8%	16.4%	-1.9%	-5.2%	-0.1%	37.5%	30.8%	2.0%	-9.2%
2015	-14.9%	-30.7%	-11.9%	-25.3%	-6.3%	-8.4%	-14.7%	-11.1%	-16.2%	-3.3%	-8.6%	-7.7%	8.3%	-28.2%	-4.5%	-21.0%
2014	-5.7%	-0.7%	-5.6%	-14.9%	-7.4%	12.5%	-2.7%	-2.0%	2.9%	5.8%	-6.8%	-3.6%	-54.4%	-0.3%	8.2%	8.3%
2013	-9.0%	-13.6%	-12.9%	-8.1%	12.7%	-31.2%	-6.1%	0.1%	-17.2%	-10.6%	4.5%	14.9%	-3.2%	-18.5%	-4.3%	-20.7%
2012	16.8%	7.2%	23.5%	25.6%	33.9%	6.2%	7.9%	21.4%	28.8%	29.2%	26.3%	n/a	19.5%	10.2%	6.4%	27.1%
2011	-1.8%	3.0%	-3.6%	6.2%	-12.7%	22.0%	2.1%	-3.3%	11.7%	6.2%	-8.8%	n/a	0.5%	-11.0%	0.4%	-15.8%
2010	15.7%	19.0%	n/a	19.4%	-3.4%	28.5%	16.4%	18.6%	6.1%	n/a	3.5%	n/a	9.7%	27.5%	17.4%	11.5%

Source: JPMorgan as of September 30, 2017

As developed market currency dominance ends with QE, the GBI index as a whole surely has the potential to supply returns to a DM-focused global bond portfolio. However, we believe the real appeal is the diversity found within the index. As global fixed income volatility remains relatively low, an index made up of liquid government bonds and currencies with the potential for significant relative-value alpha puts the sector in a class by itself.

Indeed, we believe a portfolio consisting of investments in Brazil, Indonesia, and Mexico that are barbelled with positions in local rates from higher-rated countries, such as Poland, Malaysia, and Thailand, will likely yield attractive results going forward. We feel that this combination—which represents an optimal mix of countries with inexpensive currencies, local bonds with high real yields, and strengthening economies—could continue to outperform its global fixed income peers going forward.

Conclusion

The emerging market local bond and currency markets certainly faced their fair share of headwinds over the past several years. However, after a significant shift in the market landscape forced many EM countries to undertake economic reforms, certain risks have begun to abate while value remains. With many of the factors that had previously disrupted the asset class now seemingly in the rearview, EM local debt and FX offers the opportunity to achieve attractive relative-value returns—particularly when combined with an in-depth, active investment process.

NOTICE: IMPORTANT INFORMATION

Source(s) of data (unless otherwise noted): PGIM Fixed Income as of February 2018.

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