August 2019

InFocus

Aberdeen Standard Investments

Aberdeen Standard Emerging Market Local Currency Debt Fund

High Potential Returns (absolute and risk adjusted)	Diversification Benefits (lack of credit risk)	High Correlation of AUD/EMFX (benefits Australian investors)

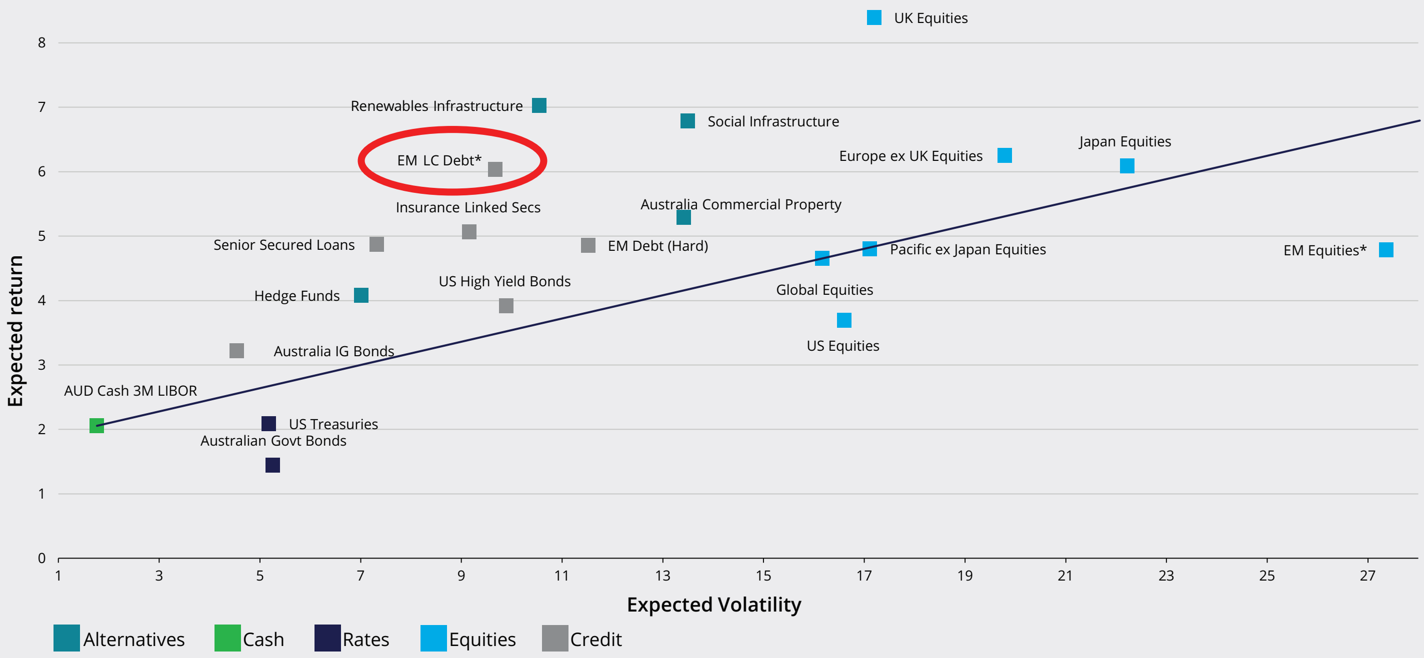
The collapse of Australian bond yields in 2019 and the high quality of domestic credit markets mean that finding reliable sources of income has become much more challenging for Australian investors. Historically, when venturing overseas they have focused on the large and liquid US credit markets, hedging the FX risk back to Australian dollar.

The best time to take credit risk is when volatility is falling, because credit risk is all about selling optionality. That strategy has worked very well until now, as global central banks have contained any spikes in volatility indices, such as the VIX. What is new now is that political risk is on the rise; volatility may have bottomed and central banks have little ammunition left. Against this background it's time for Australian investors to look at new sources of income, yield and risk. Emerging Market Local Currency Debt (EMLCD) is one such opportunity.

I. High potential returns

EMLCDs offer an attractive risk return profile for the next 5 years

Chart 01. Risk & Return, Aberdeen Standard Investments forecasts (5yrs AUD hedged, % pa)



*AUD Unhedged

Source: Aberdeen Standard Investments

Note: Returns are over five years (AUD hedged, except EM LC Debt and EM Equities) on a per annum basis.

Return projections are estimates and provide no guarantee of future results or take into account any associated investment costs.

At Aberdeen Standard Investments we make five-year risk and return forecasts across a range of asset classes for Australian investors. We like to focus on opportunities in the top left quadrant of Chart 1, where expected returns are high and expected volatility is relatively low. Emerging Market Local Currency Debt (EMLCD) offers a compelling opportunity. In our local multi asset fund portfolios we currently have a near 20% allocation to EMD of which 10% is in EMLCDs. There are five main reasons for our optimism.

1. High yield pick-up to Commonwealth bonds.

At the time of writing, the yield to maturity (YTM) on the benchmark 10-year Commonwealth bond is below 1%. By comparison, the YTM of the index for EMLCDs (JPM GBI EM GB) is 5.5% and our fund is just over 6%. The compounding effect of this pick-up over time will be very powerful. This is all in nominal terms. When one looks at real yields, most developed market yields are at zero or negative, whilst in emerging markets real yields are positive. There is value in EMLCDs in nominal, real and relative terms.

2. Structural improvements to most emerging economies and bond markets.

Investors with long memories will recall the Latin American sovereign debt crisis of the 1980s and the Asian crisis of the late 1990s. During these periods, investors faced the risk of sovereign default and dramatic currency devaluations; and contagion was rife. The good news is that governments in most of the main EM economies have learned the lessons from these crises and developed liquid domestic bond markets of their own. There are always exceptions such as Turkey or Argentina today, but the contagion effect has gone.

A crisis in one country no longer means a crisis for the entire asset class. Investors have learned to differentiate. These structural improvements give us confidence, as long as we do our homework and allocate selectively.

3. Relatively inexpensive currencies.

Aberdeen Standard Investments modelling suggests many emerging market currencies are now at or below fair value. Therefore we are able to forecast some currency appreciation.

4. US Federal Reserve in rate-cutting mode.

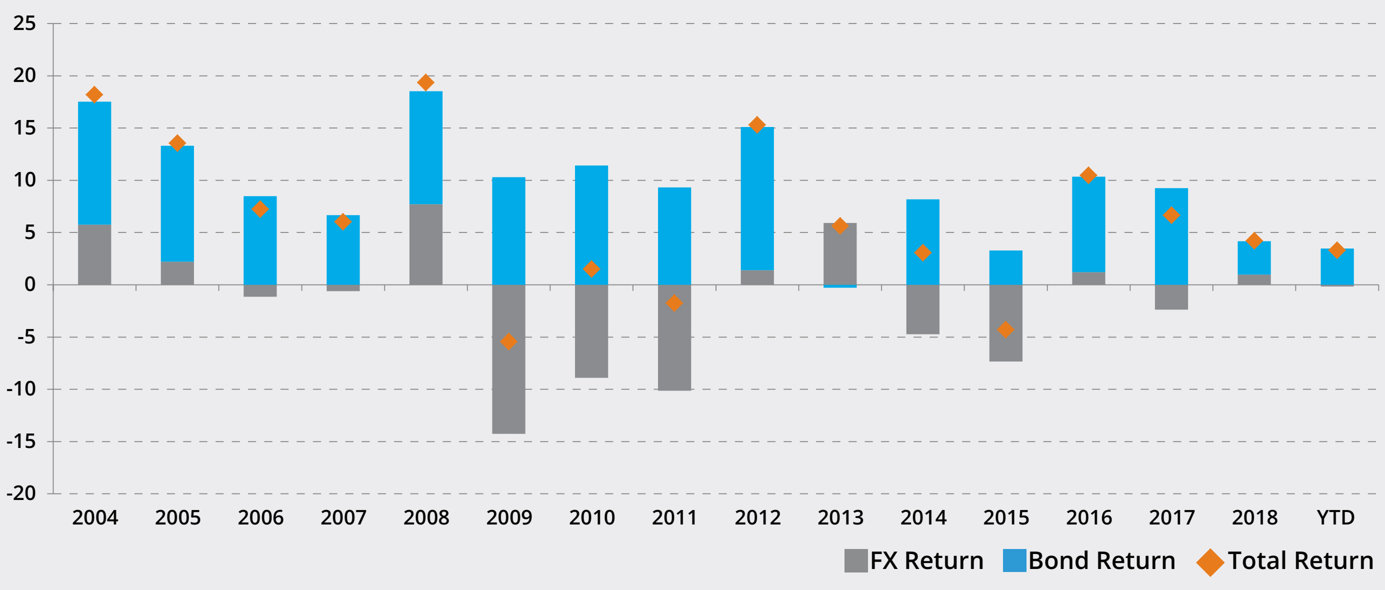
When US Federal Reserve (Fed) is raising rates it tends to suck capital out of emerging market assets and back to the US, and vice-versa. In 2018 the markets priced in as many as four hikes in the Fed Funds rate. This paper is being written after the Fed cut rates by 25bp – its first cut in more than a decade. While this was predicted, it comes at a time when other major developed market central banks seem intent on further easing their already easy monetary stances. This positive global backdrop is already giving central banks in emerging markets the room to cut rates and we expect more. This is very positive for EMLCDs.

5. Sub-par expected returns from competing asset classes.

With developed market bond yields so low, the expected returns are also extremely low. As we look ahead over the next five years, we conclude that returns from EMLCDs are going to be high absolutely, relative to other opportunities and on a risk-adjusted basis.

II. Diversification benefits and high historical returns

Chart 02. Emerging Market Local Currency Debts has produced positive returns in 12 of the last 15 years (in AUD terms)



Source: Bloomberg, 28 May 19.
Past performance is not a reliable indicator of future results.

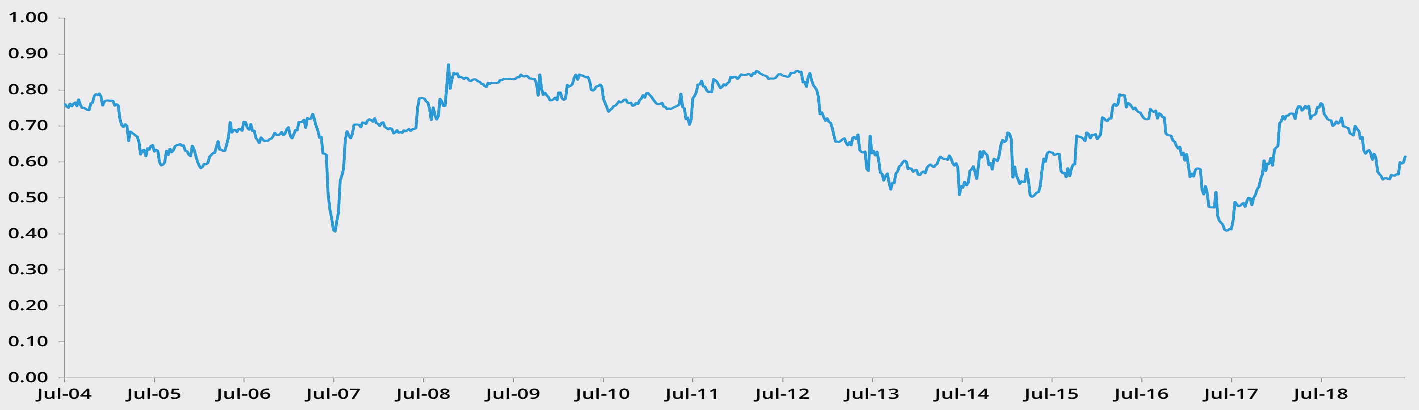
Chart 2 surprises many who see it for the first time. What are the key drivers of EMLCDs' positive returns in 12 of the last 15 years? One is that there is very little credit risk in the asset class. The risks that investors take when investing in EMLCDs are local currency duration risk and EM Currency risk versus the Australian dollar. There is almost no credit risk because virtually all the bonds are issued by governments, government agencies and quasi-sovereigns. This lack of credit exposure in EMLCDs is a key reason for Australian investors – who may already have exposure to credit risk and who are worried about a repeat of 2008 – to consider allocating to EMLCDs. Another factor driving returns is that carry has more than compensated for the negative impact of currency in all but three of the last 15 years. Currency returns were negative in eight of them, yet this led to negative total returns only in 2009, 2011 and 2015. Even then, the negative return in 2009 came after a stellar year in 2008.

3. High correlation of AUD and EMFX

Chart 3 shows the 12-month rolling correlation of the Australian dollar and the currencies component of the JPM GBI EM GD index. It is rather high as you can see.

The correlation of Australian dollar and the currencies component of JM GBI Em GD is high

Chart 03



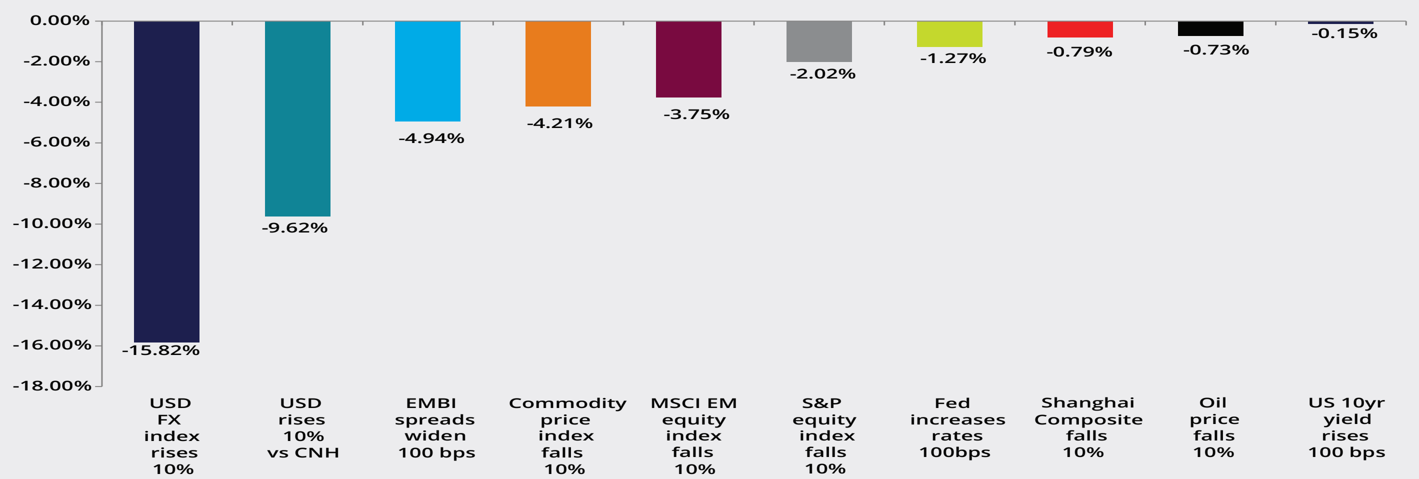
Source: Bloomberg.
Past performance is not a reliable indicator of future results.

What it means is that the riskiness of EMLCDs for Australian dollar investors is much lower than for US dollar investors. If you look at the asset class through a US dollar lens, it tends to be in the upper right quartile of a risk and return chart such as Chart 1 (if it were in US dollar terms rather than Australian dollar terms). The yield may be high, but so are the levels of volatility because emerging market currencies are very volatile against the US dollar. However, the Australian dollar is also a volatile currency versus the US dollar. There are some factors which drive both the Australian dollar and EM currencies versus the US dollar. Both are seen as an option on global growth and both have exposure to commodity prices. The good news for Australian investors is that you can clip those high coupons in EMLCDs with only limited levels of FX volatility, because of this high correlation of Australian dollar and EM currencies. Australians are in a far better position than their American counterparts.

What about the risks?

This asset class is NOT risk free and risk is something that is part of Aberdeen Standard Investment's DNA, especially our emerging market debt team. Chart 4 below shows the types of risk factors we look at and their impact on the asset class.

Chart 04: GMB EM GD (local currency sovereign) risk factors



Source: Aberdeen Standard Investments, 30 June 2019
Past performance is not a reliable indicator of future results.

From a US dollar perspective the biggest risk to the asset class is when the US dollar is rising, a risk that is mitigated somewhat for Australian dollar-based investors. Currency aside, other factors that can negatively impact the asset class are a malaise in emerging markets, such as EM-US dollar bond spreads (as measured by the EMBI index) widening by 100bp; or if EM equities fall 10%. Falling commodity prices and a falling oil price can also hurt the asset class, although the impact of falling oil prices is muted as the EMLCD asset class contains a mix of both energy producers and importers. The asset class can also be vulnerable in a situation where the world goes risk-off, for example if the S&P falls by 10%. Sensitivity to the US Fed was noted above, although the impact from rising US bond yields is more limited. It should be stressed this list of risk factors is not complete; investors must also factor in idiosyncratic country risks in particular and political risk in general. The good news on the political front is that most of the main elections happened in 2019, with just Argentina to come. All these risk factors need to be considered before investing in the asset class.

Conclusion

In this paper, we have talked about the reasons why Aberdeen Standard Investments believes that EMLCDs are such an interesting opportunity for Australian investors. Expected returns over the next five years are high, absolutely and risk adjusted. There are appealing diversification benefits, particularly for those who already have high exposure to credit risk. Finally the fact that the Australian dollar and emerging market currencies are highly correlated means that , almost uniquely, Australian investors can clip those high coupons in EMLCDs with only limited levels of FX volatility. Aberdeen Standard Investments is making substantial allocations to this asset class for our Australian clients.

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