

Positioning for a Weaker Dollar: The Case for Local Currency Emerging Markets Debt



The U.S. dollar faces downward pressure due to a combination of macro and technical factors, and investors in sovereign emerging markets debt (EMD) that is denominated in local currencies could benefit.

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The unprecedented scale of the COVID-19 pandemic has created turmoil in economies and markets. While fiscal and monetary stimulus has propped up asset prices from first quarter 2020 lows, investors still face a high degree of uncertainty in the medium term.

This will likely have profound implications for asset-allocation decisions. In particular, we expect the U.S. dollar to face downward pressure this year and next due to a combination of macro and technical factors.

“We believe a key beneficiary of downward pressure on the U.S. dollar trend will be investors in sovereign EMD that is denominated in local currencies.”

We believe a key beneficiary of this trend will be investors in sovereign EMD that is denominated in local currencies, where several factors—a rising growth advantage, light market positioning, and attractive valuations in both bonds and foreign exchange (FX)—underpin our favorable outlook relative to other fixed-income asset classes.

In the pages that follow, Lewis Jones, CFA, FRM, and Daniel Wood, local currency portfolio managers on our team, provide insights that I hope offer a useful guide to investing in local currency EMD.



Marcelo Assalin, CFA

HEAD OF WILLIAM BLAIR'S EMERGING MARKETS DEBT TEAM

Headwinds Fading

Performance of local currency sovereign bonds has been mixed since the Global Financial Crisis (GFC). The past few years have been no exception, as shown in exhibit 1.

Bonds have generally performed well, in line with the nearly constant downward pressure on developed-market yield curves, driven by ample global liquidity, weaker-than-trend growth, low inflation, and fiscal consolidation among emerging markets issuers (until recently, at least).

However, this was solid performance offset by weaker currencies. Investors have been wary of exposure to the higher volatility present in emerging markets FX, and the cost of hedging back to U.S. dollars or euros has fallen as central banks have cut rates.

Looking out over the second half of 2020 and beyond, however, we believe many of the headwinds holding back emerging markets currencies should fade as several factors drive a weaker U.S. dollar in the near term.

A shallower and more prolonged recovery in U.S. economic growth

According to the latest International Monetary Fund (IMF) projections, advanced economies will not

recover to 2019 levels of economic output until 2022 to 2023. Emerging markets, however, are expected to fully recover by early 2021.

Extreme monetary stimulus pushing U.S. real yields into deeply negative territory

Even as the recovery progresses, we expect the U.S. Federal Reserve (Fed) to hold course for some time. This could also lead to a steepening of the Treasury curve, particularly in the 10-year and beyond.

Improving market risk sentiment

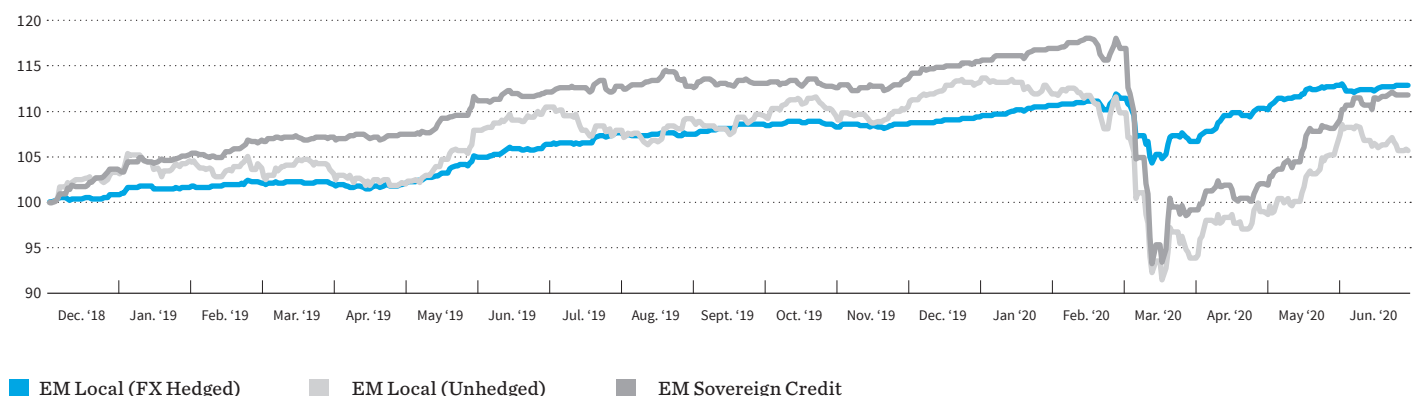
As pandemic-triggered lockdown measures ease and economic activity picks up, investors could become more willing to take on risk.

Spot appreciation, combined with relatively attractive real interest rates, could deliver strong results for investors willing to hold local assets on an unhedged basis.

More broadly, in the context of a wider range of asset classes and investment opportunities encompassing both emerging and developed markets, emerging markets FX stands out for being attractively valued relative to fundamentals.

EXHIBIT 1

Performance of Local Currency vs. Dollar-Denominated EMD



Sources: J.P. Morgan and Bloomberg, as of June 30, 2020. EM local refers to the J.P. Morgan Government Bond Index-Emerging Markets (GBI-EM) Global Diversified (Hedged and Unhedged). EM sovereign credit refers to the J.P. Morgan Emerging Markets Bond Index Global Diversified (EMBIGD). Past performance is not indicative of future returns. A direct investment in an unmanaged index is not possible.

Improving Macro Fundamentals

In terms of our outlook for emerging economies, we have been encouraged by several tentatively positive macro trends that should continue through the coming year.

First and most importantly, aggregate GDP in emerging markets is forecast to recover quickly over the next 18 months from the deep contraction in the first half, as shown in exhibit 2.

At the same time, developed markets should face a flatter and more prolonged recovery curve, and will likely take two or more years to get back to 2019 output levels.

Widening growth differentials historically have been an important driver of capital flows and currency valuations, and we do not expect this relationship to change in the near term. Indeed, one of the strongest drivers of U.S. dollar strengthening since 2014 has been the country's above-potential GDP growth amid a period of greater global uncertainty.

Consensus forecasts have been further supported by surprises versus expectations in data. After a strong third quarter in 2019, developed markets trended downward—even before the COVID-19 crisis—and have been in negative territory since October 2019. Emerging markets, on the other hand, have been more or less neutral over the same period, spiking back into the green this year.

Importantly, we do not expect faster growth to lead to a significant deterioration in most macro variables, at least at the aggregate emerging markets level. Higher imports should put some pressure on external balances, but the basket should remain in surplus. Meanwhile, Consumer Price Indices (CPI) should remain fairly stable. While central banks in emerging markets have cut rates heavily, negative output gaps and FX appreciation should keep inflation upside relatively limited this year and into next.

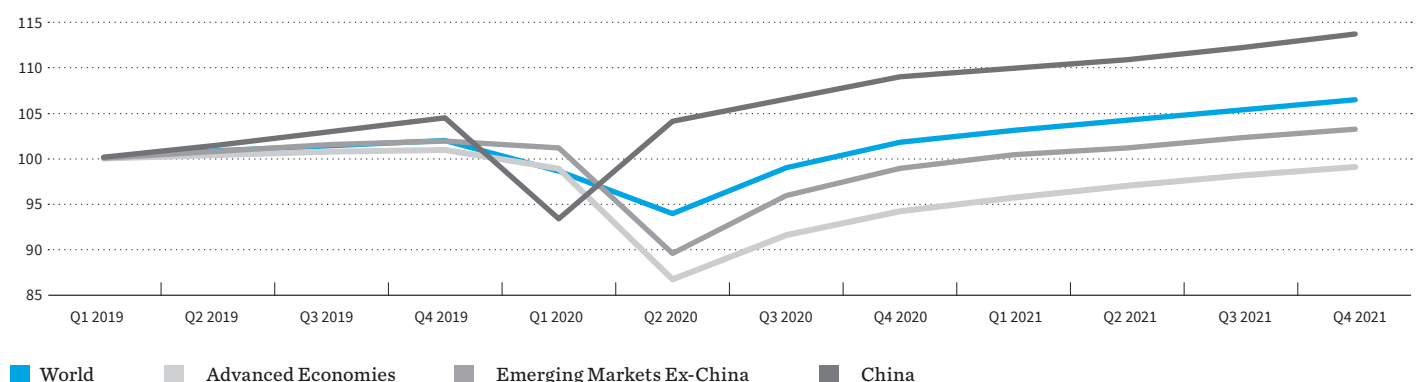
The main area of concern for emerging markets on the macro side has been fiscal deterioration and challenging debt dynamics. Somewhat unexpectedly, however, we have seen only a modest change in the overall level of external debt as a percentage of emerging markets GDP as local markets have absorbed the bulk of new issuance. With little sign that appetite for sovereign bonds is slowing among domestic emerging markets investors, the risk of a lack of liquidity or solvency triggering a crisis among the larger local currency debt markets remains low.

“The risk of a lack of liquidity or solvency triggering a crisis among the larger local currency debt markets remains low.”

Daniel Wood

EXHIBIT 2

Faster Recovery Expected in Emerging Markets (Quarterly GDP Growth)



Source: IMF World Economic Outlook, June 2020 Update. Quarterly GDP is rebased to 100 in Q1 2019.

Solid Technicals and Capital Flow Dynamics

We expect this combination of positive real rates, attractive valuations, and stable-to-improving fundamentals to drive portfolio flows into local markets in the coming year.

From what we have seen so far in reported fund data, investors have been hesitant to allocate new money to the asset class, but the flows trend has been steadily improving at the margin. Exhibit 3 illustrates.

Additionally, we have seen much improvement in investor risk appetite, with cash holdings falling and average fund betas rising back to normal ranges.

“The flows trend has been steadily improving at the margin.”

Lewis Jones, CFA, FRM

We are still early in the rebalancing process and far from stretched levels in both dedicated positioning and global investor allocations to local emerging markets debt, so the trend still has legs, in our view.

EXHIBIT 3

Fund Flows (In Millions)

Fund Flows (US \$MN)	June 2020	First-Half 2020	First-Half 2020 vs. First-Half 2019
Currency Breakdown			
Hard Currency	\$2,403	-\$8,869	-\$34,656
ETF	\$1,447	\$1,035	-\$3,102
Non-ETF	\$956	-\$9,903	-\$31,554
Local Currency	-\$2,530	-\$26,236	-\$27,382
ETF	-\$709	-\$5,525	-\$9,052
Non-ETF	-\$1,821	-\$20,712	-\$18,330
Blended Currency	\$274	-\$3,629	-\$5,724
Regional Breakdown			
Global	-\$315	-\$28,171	-\$54,001
Regional/Country	\$464	-\$10,504	-\$13,713
Asia ex-Japan	\$393	-\$9,153	-\$11,875
Latin America	\$211	-\$1,445	-\$1,745
CEEMEA	-\$139	\$95	-\$93
Total	\$147	-\$38,735	-\$67,761

Sources: Morgan Stanley and EPFR, as of July 3, 2020. CEEMEA refers to Central and Eastern Europe and the Middle East. Total is the total of each of the two categories: (1) local currency plus hard currency plus blended currency, and (2) global plus regional/country. Total may not add up exactly due to rounding.

Positive FX and Bond Valuations

Lastly, in terms of valuations for emerging markets FX and local bonds, the picture is somewhat mixed when considering emerging markets alone. However, it is considerably more positive on a relative basis, when comparing emerging markets with developed markets, as exhibit 4 illustrates.

First, we estimate that for the countries comprising the main local debt benchmark—the J.P. Morgan Government Bond Index-Emerging Markets (GBI-EM) Global Diversified—currencies are at least 3% to 5% cheaper than fair value, averaging across a number of longer-term valuation methodologies (including purchasing power parity, real effect exchange rate, and fundamental effective exchange rate). Combined with an average real five-year bond yield of about 1.3%, this makes a compelling case for holding local assets unhedged, whether in bonds or equities.

On the bond side, however, term premium has all but disappeared from the curves of many of the lower-yielding,

investment-grade names. High yield curves have also flattened, but this is also reflective of much lower current inflationary pressures and expectations over the next few years as well as increased issuance.

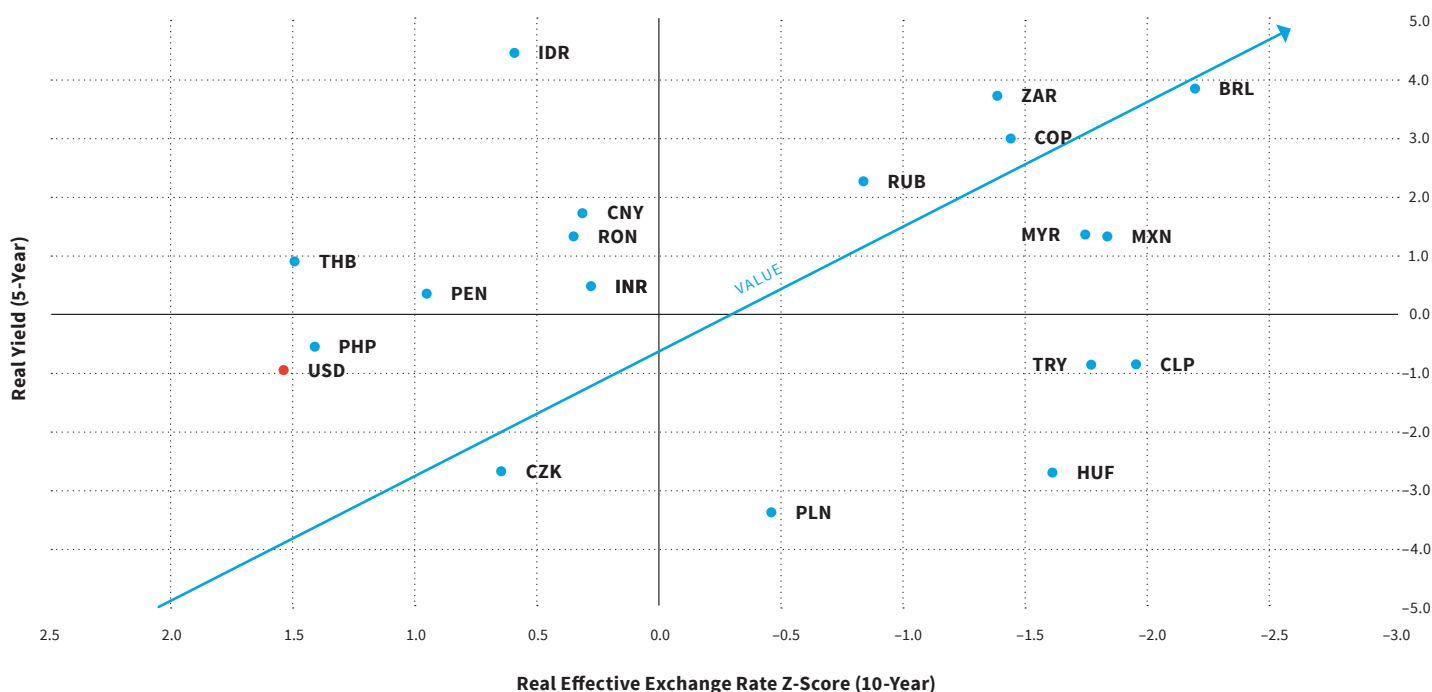
Ultimately though, the huge amount of negative-yielding debt globally will likely continue to encourage investors to increase allocations to emerging markets. While we do not anticipate a repeat of 2019's strong bond performance, we believe curves will remain well supported.

“The huge amount of negative-yielding debt globally will likely continue to encourage investors to increase allocations to emerging markets.”

Daniel Wood

EXHIBIT 4

FX Valuations and Real Rates



Sources: J.P. Morgan, Bloomberg, and William Blair estimates, as of June 30, 2020.

Why William Blair EMD

“Successfully navigating emerging markets requires the focus and specialist skills of a dedicated investment team.”

Lewis Jones, CFA, FRM

Successfully navigating emerging markets—which are complex and rapidly changing—requires the focus and specialist skills of a dedicated investment team.

We believe EM sovereign bond markets tend to have long-term, structural performance drivers with strong linkages to credit markets, and our decision-making process reflects this.

Our unique investment process combines bottom-up fundamental analysis of EM sovereign and corporate issuers and currencies with top-down analysis of global and regional market conditions. This comprehensive approach across the broader EMD universe deepens our understanding of performance drivers and helps improve decision-making quality—which ultimately benefits the potential long-term risk and return characteristics of our investments.

Whether top-down or bottom-up, our qualitative analysis is focused on fundamentals, technicals, and valuations via a risk-scoring framework. Top-down scores are set monthly in a joint effort by the wider EMD team, while bottom-up scores are determined by individual portfolio managers for each sub-strategy. The resulting positive, negative, or neutral scores represent the sum total of the portfolio managers’ assessment of each asset class, issuer, or security. This translates directly into under- or overweight exposures and overall risk at the portfolio level.

Our local currency strategy separates FX and rates decisions, where possible. This allows us to adopt a more tactical approach in FX, where periods of excess volatility and larger drawdowns are more frequent.

William Blair’s Emerging Markets Debt Team

The William Blair emerging markets debt team is a dedicated group of emerging markets fixed-income professionals focused on delivering strong results for our clients.

We have a global presence (in Chicago, New York, London, and The Hague) in both research and trading, giving us 24-hour access to markets.

Our portfolio managers have dual functions, both evaluating and selecting securities and participating in trade execution. The team maintains constant contact with the market, responding quickly to new developments.

Our unique investment approach combines the deep fundamental expertise and experience

of our team members with cutting-edge quantitative tools to generate investment ideas and contextualize the large quantity of available data.

Our research incorporates a broad combination of macroeconomic, ESG, and market data, covering an extended universe of more than 80 emerging markets.

We believe diversification of alpha sources is the best way to meet our strategy objectives through the full market cycle and under a range of market conditions. Our diversification discipline effectively means constructing portfolios by deploying a relatively large number of small active positions, which we believe leads to the potential for superior risk-adjusted returns over the medium and long term.

About William Blair

William Blair is committed to building enduring relationships with our clients and providing expertise and solutions to meet their evolving needs. We work closely with most sophisticated investors globally across institutional and intermediary channels. We are 100% active-employee-owned with broad-based ownership. Our investment teams are solely focused on active management and employ disciplined, analytical research processes across a wide range of strategies. As of June 30, 2020, we manage \$56.8 billion in assets. We are based in Chicago with resources in New York, London, Zurich, Sydney, Stockholm, and The Hague, and dedicated coverage for Canada.

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The **J.P. Morgan Government Bond Index-Emerging Markets (GBI-EM) Global Diversified** tracks local currency bonds issued by emerging markets governments. The **J.P. Morgan Emerging Market Bond Index Global Diversified (EMBIGD)** tracks the total return of U.S.-dollar-denominated debt instruments issued by sovereign and quasi-sovereign entities. (Index information has been obtained from sources believed to be reliable but J.P. Morgan does not warrant its completeness or accuracy. The indices are used with permission. The indices may not be copied, used, or distributed without J.P. Morgan's prior written approval. Copyright 2020, JPMorgan Chase & Co. All rights reserved.)

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