



# Emerging Markets - Hard or Local Currency?

INSIGHT

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## Will looser US monetary policy benefit hard or local currency denominated emerging market corporate bonds?



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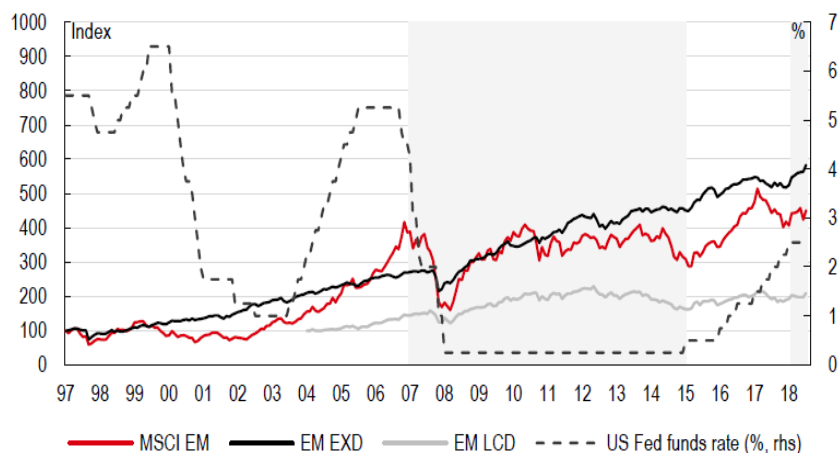
Prior to joining Muzinich in 2013, Warren was with Schroders, where he was a Global Portfolio Manager and later, the Senior Portfolio Manager for Global Emerging Markets. In the latter role, he managed about \$2 billion and helped to develop the firm's emerging markets corporate capabilities. Previously, Warren was the Head of European Money Markets at UniCredito Italiano. Warren earned a BSc in Mathematics for Business from the Middlesex University London and an MSc in Shipping Trade and Finance from the CASS Business School. He holds the Chartered Financial Analyst designation.

In my experience, one of the most commonly asked questions for emerging market investors is whether they should choose a hard or local currency allocation.

HSBC has produced a timely research piece on this subject (Fig.1). Their conclusion being you should buy hard currency when the US Federal Reserve (Fed) is cutting rates and local currency (equities or bonds) when the Fed is hiking rates (see HSBC Global Research Compounding Coupons report, 7 July 2019).

Why is this?

Fig. 1 Performance of EM Assets versus Fed Funds Rate



Source: HSBC, MSCI, Refinitiv Datastream. (EM LCD Index is available only from the end of 2002). HSBC Global Research Compounding Coupons report, July 2019. Past performance is not indicative of future results. Grey area denotes period when Federal reserve is cutting rates and when they're on hold.

Firstly, a large majority of the return from local currency bonds comes from the FX component, meaning the main driver of total return in local currency comes from FX moves.<sup>1</sup> The key drivers of currency movements are interest rate differentials, terms of trade and sentiment.

Therefore, we believe the ideal environment for emerging market currencies would be when the US economy is expanding. As the world's largest consumer pulls the rest of the world along, and as emerging market economies are at an earlier stage of their economic development, we have observed emerging market economies start to grow faster than the US. We believe this in turn pushes the global economy above potential growth, which sends commodity prices higher and sentiment hits new highs - a perfect storm; interest rate differentials move in favour of emerging markets, terms of trade are positive, and sentiment is risk seeking.

As Fig. 1 shows, in the period 2002 -2007, local currency was the ideal asset class.

However, today emerging markets are cutting rates faster than the US and the global economy is also growing below potential, yet sentiment currently remains strong.<sup>2</sup>

When looking at what drives hard currency performance, total return is driven by US rates and credit spreads. As the Fed cuts rates, this tends to benefit hard currency bonds and, as policy loosens, it supports growth, sentiment and profit, pushing credit spreads tighter.

This current environment, in our view, justifies an allocation into emerging market hard currency bonds.

1. Source: Refinitive Datastream and HSBC, HSCB Global Research, Compounding Coupons report 7 July 2019

2.  
[https://bank.gov.ua/control/en/publish/article?art\\_id=99447265&cat\\_id=76291](https://bank.gov.ua/control/en/publish/article?art_id=99447265&cat_id=76291);  
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<https://www.resbank.co.za/Research/Rates/Pages/Rates-Home.aspx>.  
<https://www.worldbank.org/en/news/press-release/2019/06/04/global-growth-to-weaken-to-26-in-2019-substantial-risks-seen>.  
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### Index Descriptions

MSCI EM - Morgan Stanley Capital International Emerging Markets Index - Captures large and mid cap representation across 26 Emerging Markets (EM) countries. With 1,194 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country.

EM EXD - Bloomberg Barclays Emerging Markets USD Aggregate Total Return Index Value Unhedged - A flagship hard currency Emerging Markets debt benchmark that includes USD-denominated debt from sovereign, quasi-sovereign, and corporate EM issuers.

EM LCD - Bloomberg Barclays Emerging Markets Local Currency Government TR Index Unhedged USD. A flagship index that measures the performance of local currency Emerging Markets (EM) debt. Classification as an EM is rules-based and reviewed annually using World Bank income group, International Monetary Fund (IMF) country classification and additional considerations such as market size and investability.