Emerging Markets Bonds THEN and NOW: From Weakness to Resilience

Eric Fine; Portfolio Manager, Global Fixed Income
Natalia Gurushina; Economist, Global Fixed Income

INTRODUCTION

Aside from their well-debated strength and growth potential, the emerging markets have proven to be resilient.

As a result of various reforms, emerging markets have lowered their external debt and improved their fiscal profiles. This has created a chain of positive events, starting with higher economic growth, flexible exchange rates, and a greater ability to conserve reserves. Maintaining higher reserves diminishes default risk and keeps a ceiling on hard currency-denominated bonds' credit spreads.

In the past, due to high hard currency debt levels, emerging markets reserves were vulnerable to adverse market events. Many countries saw their reserves quickly depleted during a crisis, as they were used to defend fixed exchange rates. This created a chain of negative events that led to self-fulfilling crises, starting with lower reserves, eventual currency weakening that could not be controlled by raising interest rates, and, ultimately, defaults on external debt.

This is no longer the case. Van Eck believes that emerging markets have proven to be resilient and are now more established. Fund managers, with the ability to access both local and hard currency-denominated debt markets, are now able to effectively maintain their exposure through market cycles.

THE ORIGINAL SIN – TOO MUCH EXTERNAL DEBT – LED TO MANY EMERGING MARKETS CRISES

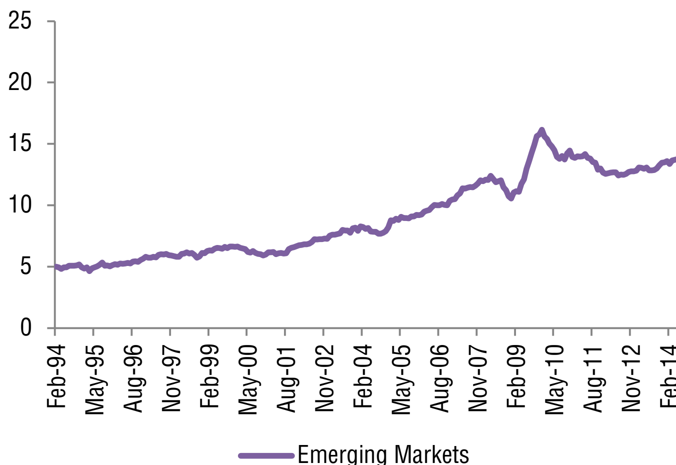
There are many similarities between the earlier emerging markets crises: the LATAM crisis in the 1980s, the Mexican crisis in 1994, the Asia crisis in 1997, and the Russian crisis in 1998. Investor flows surged prior to each crisis as countries could borrow in international markets on favorable terms. External debt constituted a large portion of emerging markets countries' public debt. This meant that any weakening in an emerging markets currency led to a self-fulfilling crisis of deteriorating ability to repay that hard currency debt, thereby further weakening the country's currency, and often spreading to other countries in the region. As a result, the eventual exchange rate adjustment, usually large and abrupt, would, typically, initiate a chain of macroeconomic, social, and political disruptions that spread to the rest of the region and caused defaults and multiyear loss of market access.

How exactly did it happen? High external debt in USD left emerging markets countries exposed to currency weakening, which in turn led to capital flight, even more decline in currency, depletion of reserves to defend the pegged currency, and, ultimately, default!

ECONOMIC AND FINANCIAL POLICY REFORMS – THE WASHINGTON CONSENSUS

The "Washington Consensus" solution. In response to these crises, a "Washington Consensus" evolved. It included greater exchange rate flexibility, central bank independence, sustainable fiscal policy, and structural reform. The implementation of these policies led to stronger sovereign balance sheets across emerging markets, an overall reduction in emerging markets countries' external debt (through a combination of defaults and repayments, and a substitution of external with domestic debt, the overall level of debt as a percentage of GDP actually remained stable), and a significant increase in international reserves.

Exhibit 1: Countries' Reserves-to-Import Ratio (months)

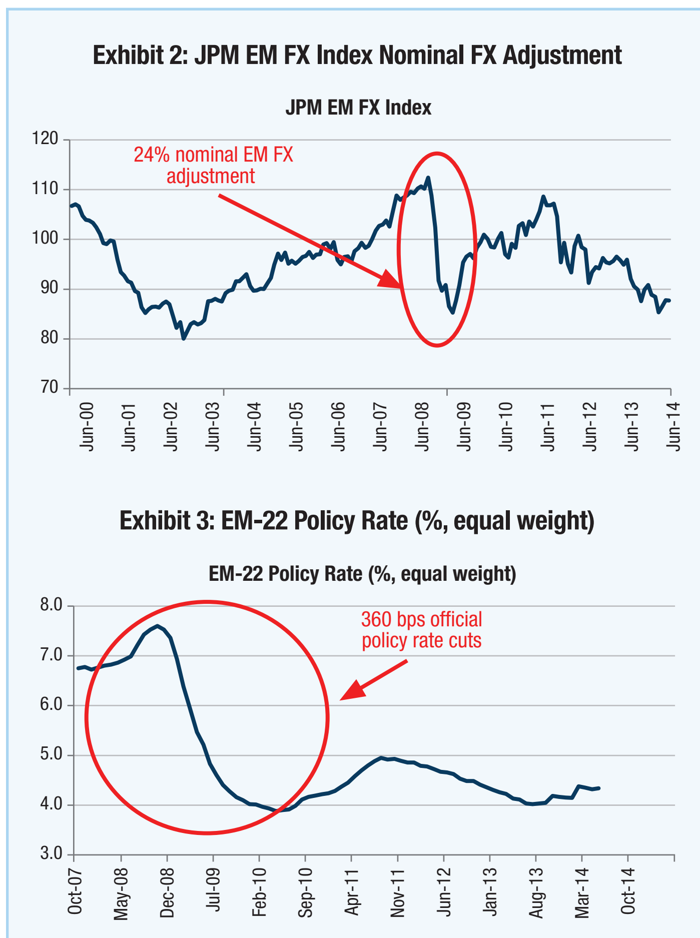


Source: Bloomberg. Data as of 6/30/14.

Please note that the information herein represents the opinion of Van Eck Global and these opinions may change at any time and from time to time.

GLOBAL FINANCIAL CRISIS, EUROPEAN DEBT CRISIS, AND TAPER TANTRUM

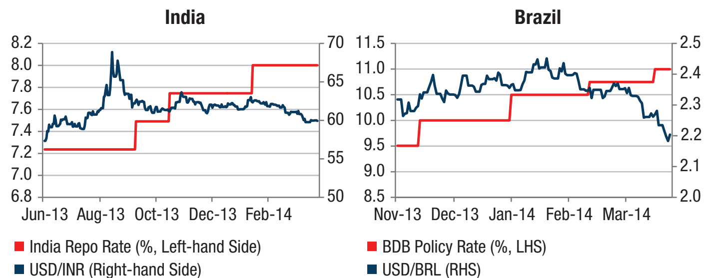
The first global test of the new model occurred during the 2008/2009 U.S. financial crisis. Global trade collapsed and financial markets froze for several months. Emerging markets debt suffered volatility along with all asset prices, but lower external debt ratios allowed their central banks to more actively use exchange rates as shock absorbers by allowing them to weaken. Even though some loss of reserves was inevitable, they were able to recover quickly, and the post-crisis reserves-to-import ratio – by and large – have not dropped to the dangerous levels seen during the crises of the 1990s. This allowed countries with healthier fiscal balances, especially in Asia, to use counter-cyclical policies to support growth. Moreover, emerging markets central banks were able to support growth by aggressively easing their monetary policy stances as EM-22 policy rates dropped by 360 basis points between the end of 2008 and the beginning of 2010. Those growth-stimulating policy moves were not an option during the earlier emerging markets crises.



Source: Bloomberg. Data as of 6/30/14.

Another test of the new policymaking paradigm for emerging markets economies was the "taper tantrum" in reaction to the Fed's indications that it would unwind its quantitative easing program; the "tantrum" started around May 2013, and ended around October 2013. In October 2013, we declared that emerging markets had, once again, acquitted themselves of the charge that when developed markets sneeze, they get the flu. This time it was barely a cold, with a rapid recovery. Markets in the emerging countries did drop sharply after the U.S. Fed declared that it would start ending its quantitative easing policies, particularly their local currency markets. However, these countries recovered in the following months and reserves regained stability quickly. Many central banks allowed currencies to weaken, and many were quick to raise interest rates. As a result, reserves stabilized and, importantly, have not been met with runaway inflation expectations.

Exhibit 4: Countries' Policy Rate and Commodity Weakness Around "Taper Tantrum"



Source: Bloomberg. Data as of 4/10/14.

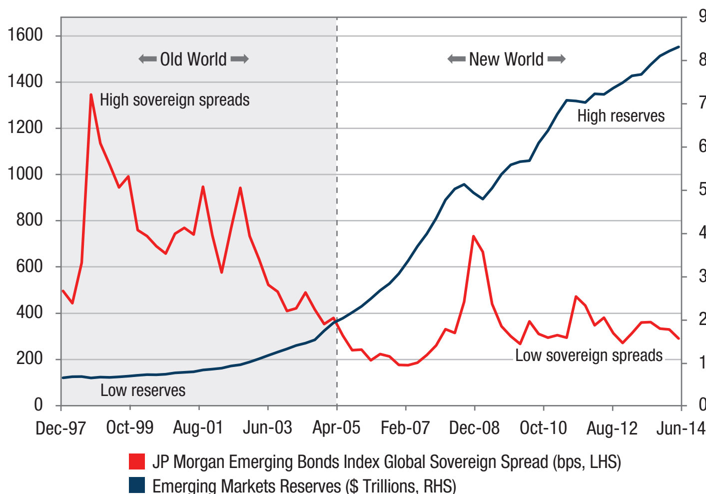
Please note that the information herein represents the opinion of Van Eck Global and these opinions may change at any time and from time to time.

FEWER REASONS FOR SELF-FULFILLING CRISES – WHAT CHANGED?

The good news is that such policy reactions have helped prevent emerging markets from sliding into self-fulfilling crises. The policy reactions have protected international reserves as a buffer, and have led to big, secular reductions in credit spreads. Moreover, growth in emerging economies has been higher since these policies have been implemented, increasing the denominator from which all debt (hard currency and local currency) is essentially paid.

High reserves matter, at least in terms of anchoring hard currency spreads. The important consequence of emerging markets getting their act together after a series of devastating crises in the 1990s is the improved outlook for emerging markets hard currency debt. Hard currency debt is now differentiated from local currency, especially in those emerging markets "graduates" that stop wasting (or having to waste) international reserves to defend their currencies. The historical, long-term link between international reserves and sovereign spreads in emerging markets – and the difference between the "old world" and the "new world" regimes for those countries that went through major internal crises – can be clearly seen in Exhibit 5.

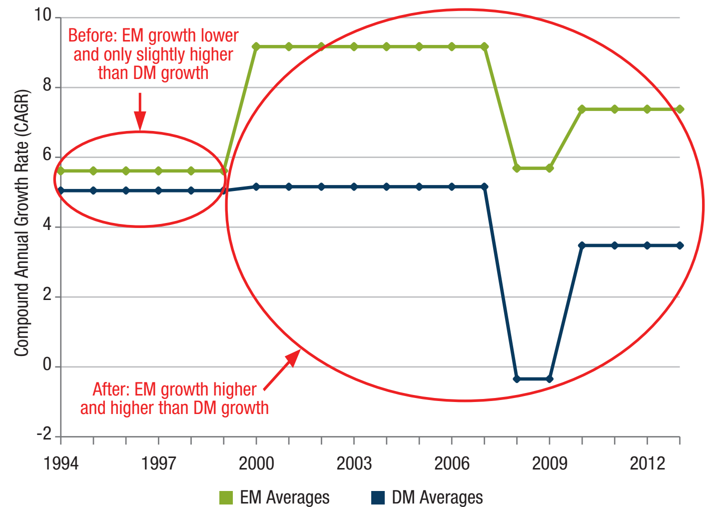
Exhibit 5: Emerging Markets Reserves and Spreads



Source: Bloomberg, IMF, Van Eck Global. Data as of 6/30/14.

These policies also appear to have increased emerging markets growth rates. Exhibit 6 shows the higher growth rates of emerging markets economies following their new policy paradigm. This has been a key reason behind rating agencies' steady upgrades of emerging economies over the past decade. Interestingly, developed market (DM) growth rates have declined even further during this time period. At some point (not necessarily now), we would not be surprised if emerging markets local currency bond markets are compared increasingly to the major DM bond markets (e.g., Treasuries and Bunds).

Exhibit 6: Emerging Markets Growth Remained Higher Than 1990s, After U.S. Crisis



Source: Bloomberg, IMF, Van Eck Global. Data as of 12/31/13.

FINALLY

To conclude, emerging markets countries have learned from their crises, and this learning directly benefits emerging markets bond markets. Most importantly, emerging markets policymakers understand the importance of high, or stable, hard currency reserves. This initially required a big reduction in dollar-denominated debt, but it has also required continuing vigilance in the form of a willingness to tolerate currency weakness and higher interest rates. In our view, the vigilance we have seen in a range of global crises (e.g., the 2008/2009 U.S. financial crisis and the 2013 "taper tantrum"), underlines the durability of their commitment to stabilizing reserves. Keep in mind that such policies involve pain – higher interest rates are a headwind to growth and currency weakness risks inflation – but despite this pain, the emerging markets seem to be reacting consistently when it comes to defending reserves.

This new focus on reserves, moreover, is, over time, likely to have positive spill-over to other emerging markets bond markets. In particular, local currency bond markets could benefit in the long run. First, having less external debt reduces the chance of self-fulfilling crises, as we noted in the "Original Sin" discussion on Page 1. Second, maintaining market access reduces liquidity risks – at least they can borrow while they are addressing any particular crisis that arise. Third, these policies boost confidence, which should put downward pressure on *local* currency bond yields in the long run. And, this would mean that borrowing costs in local currency would be lower and even more sustainable. However, that is a topic for another white paper.

Please note that the information herein represents the opinion of Van Eck Global and these opinions may change at any time and from time to time.

Emerging Markets Hard Currency Bonds refers to bonds denominated in currencies that are generally widely accepted around the world (such as the U.S. dollar, euro, or yen). **Emerging Markets Local Currency Bonds** are bonds denominated in the local currency of the issuer. **Emerging Markets Sovereign Bonds** are bonds issued by national governments of emerging countries in order to finance a country's growth. **Emerging Markets Quasi-Sovereign Bonds** are bonds issued by corporations domiciled in emerging countries that are either 100% government owned or whose debts are 100% government guaranteed. **Emerging Markets Corporate Bonds** are bonds issued by non-government owned corporations that are domiciled in emerging countries.

Any indices listed are unmanaged indices and include the reinvestment of all dividends, but do not reflect the payment of transaction costs, advisory fees, or expenses. Indices are not securities in which investments can be made. The **J.P. Morgan Government Bond Index-Emerging Markets Global Diversified (GBI-EM)** tracks local currency denominated bonds issued by emerging markets governments. The index spans over 15 countries. The **J.P. Morgan Emerging Markets Bond Index Global Diversified (EMBI) Index** tracks returns for actively traded external debt instruments in emerging markets, and is also J.P. Morgan's most liquid U.S-dollar emerging markets debt benchmark. The **J.P. Morgan Emerging Markets Currency Index** is a tradable benchmark for emerging markets currency markets. The index is comprised of 10 liquid currencies across three equally weighted regions, Latin America, Asia and Central and Eastern Europe, Middle East and Africa (CEEMA), versus the U.S. dollar. "Emerging Markets Reserves," as represented by the **IMF Emerging and Developing Economic International Reserves Index**, reports the value of all emerging and developing market international reserves as compiled and tracked by the International Monetary Fund. Reserves are reflected in millions of special drawing rights (SDRs), a supplemental currency developed by the IMF representing a "basket of national currencies" and used primarily for internal accounting purposes.

Non-Van Eck Global proprietary information contained herein has been obtained from sources believed to be reliable, but not guaranteed. No part of this material may be reproduced in any form, or referred to in any other publication, without express written permission of Van Eck Global. This material contains the opinions of the author, but not necessarily those of Van Eck Global, and such opinions are subject to change without notice. This material has been distributed for informational purposes only. Any projections, market outlooks, or estimates in this material are forward-looking statements and are based upon certain assumptions that are solely the opinion of the author. Any projections, outlooks, or assumptions should not be construed to be indicative of the actual events that will occur.

Forecasts, estimates, and certain information contained herein are based upon proprietary research, and the information contained in this material is not intended to be, nor should it be construed or used as, investment, tax, or legal advice, any recommendation, or an offer to sell, or a solicitation of any offer to buy, an interest in any security, strategy, or investment product. References to specific securities and their issuers or sectors are for illustrative purposes only and are not intended, and should not be interpreted, as recommendations to purchase or sell such securities or gain exposure to such sectors.

Fixed income securities are subject to credit risk and interest rate risk. High yield bonds may be subject to greater risk of loss of income and principal and are likely to be more sensitive to adverse economic changes than higher rated securities. Bonds and bond funds will decrease in value as interest rates rise. International investing involves additional risks, which include greater market volatility, the availability of less reliable financial information, higher transactional and custody costs, taxation by foreign governments, decreased market liquidity, and political instability. Changes in currency exchange rates may negatively impact an investment's return. Investments in emerging markets securities are subject to elevated risks, which include, among others, expropriation, confiscatory taxation, issues with repatriation of investment income, limitations of foreign ownership, political instability, armed conflict, and social instability.

© 2015 Van Eck Global. All Rights Reserved.

Van Eck Securities Corporation, Distributor | 335 Madison Avenue | New York, NY 10017