

# Emerging from the shadows

As the euro crisis escalates, emerging market debt is an asset class which deserves more attention from UK pension funds, says **Helene Williamson**



Both volatility and the correlation between different asset classes are currently very high in global markets as relationships between economic variables are different from what they were historically.

The reason for this is that G7 governments are intervening heavily in markets – the yields on Treasuries and gilts no longer depend on inflation rates or growth rates to the same extent as they used to. Instead, they depend on how many bonds the Bank of England or US Federal Reserve is prepared to buy. In the absence of quantitative easing in the UK or the US, gilt or Treasury yields are unlikely to remain at current levels. This means that economic fundamentals are no longer the most important determinant of market movements in some G7 economies, making economic forecasting hazardous.

At the background of this ‘manipulation’ of markets has been the massive deterioration of the credit quality of the advanced economies since 2007. On a GDP-weighted basis, the debt-to-GDP ratios of advanced economies have risen from around 77% in 2007 to more than 100% in 2011. This restricts the ability of many advanced economies to run expansionary fiscal policies. Instead, non-conventional monetary policy is used to stimulate growth. As investors are focusing on the worsening credit quality in advanced economies, there is a re-appraisal of G7 sovereign debt which used to be perceived as ‘risk-free’. Rating agencies have contributed to this re-appraisal by downgrading the US and several European countries, including a 14-notch downgrade of Greece to ‘CC’.

## Improving credit quality in emerging markets

In contrast to the advanced economies, the average debt-to-GDP ratio for emerging markets is only 34%. Moreover, emerging market countries tend to have younger populations, with unfunded pension liabilities being much less of an issue. This means that the credit quality of these markets is likely to improve further in the future relative to the world’s advanced economies.

Many advanced economies have very substantial pension liabilities which are not included in the debt-to-GDP numbers. Standard & Poor’s has indicated that one of the factors in its decision making process on each credit rating in relation to advanced economies is a government’s willingness to address the pension liabilities issue. Given the political deadlock in the US, the willingness to deal with the entitlement programs is currently very low while some countries in Europe are raising pension ages or increasing employee contributions. In emerging markets, favourable demographics supported by relatively young populations help to keep pension liabilities low relative to the developed world.

We therefore expect to see further downgrades of sovereign debt in the developed world in contrast to the improving quality of emerging markets (EM) debt. In fact, whilst in 1994 the average rating for emerging markets was ‘BB-’, it is now investment grade at ‘BBB-’. With the exception of Japan in 2007, which was upgraded and subsequently downgraded, there have been only downgrades in the developed world since 2004, the US and Italy being the most recent ones with France likely to follow in the coming months.

## Assessing risk in EMs

Traditionally emerging debt markets have been viewed as riskier than those of developed Western democratic countries because they are more heavily influenced by political factors. However, we believe that many emerging markets have achieved better transparency over the years. Also, the quality of economic statistics has improved as the IMF has been setting standards for economic data-gathering. Also, 15 years ago, most emerging market currencies were fixed, which made them sitting ducks for speculators. The Mexican crisis of 1994, the Asia crisis in 1997 and the Argentine crisis in 2001 were all to a large extent due to countries defending fixed exchange rates. Since 2001, there have only been a handful of countries, such as Bulgaria and Ecuador, which did not have floating

exchange rates, so that the risk of currency crises in emerging markets is no longer there.

The majority of UK pension funds are typically underweight EM debt, but are becoming less cautious about investing in this asset class. Schemes have typically used bonds to match their liabilities but in the past did not see EM debt as an asset class that fitted with their perception of risk in that regard. Yet since 1998 there have been only two years when the JPMorgan Emerging Markets Bond Index produced negative returns. Over the period to the end of October 2011, the index posted an annualised return of 10.2% with annualised volatility of 13.8%.

Because our fund is a dollar-denominated vehicle the performance of the instruments it invests in is determined by the risk premium of EM debt over US Treasuries, which currently stands at about 4% and by changes in US Treasury yields. The risk premium is much lower now than it was in Q4 of 2008 as the market has priced in the relative credit strength of emerging market countries. We believe that this risk premium has the potential to reduce further.

In conclusion, EM debt provides good diversification benefits for portfolios largely invested in equities and gilts. Yielding about 6% in dollar terms, the asset class offers a substantial pick-up over current gilt yields. The technical position of emerging economies is also set to remain strong. Emerging markets’ gross financing needs for 2012 stand at 7.7% of GDP, compared to 27.7% for the developed world, which is mainly due to large budget deficits and maturing debt in Europe and the US. We believe that the risk of investing in EM debt is being well-rewarded due to the very positive fundamentals of the underlying economies. ■

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