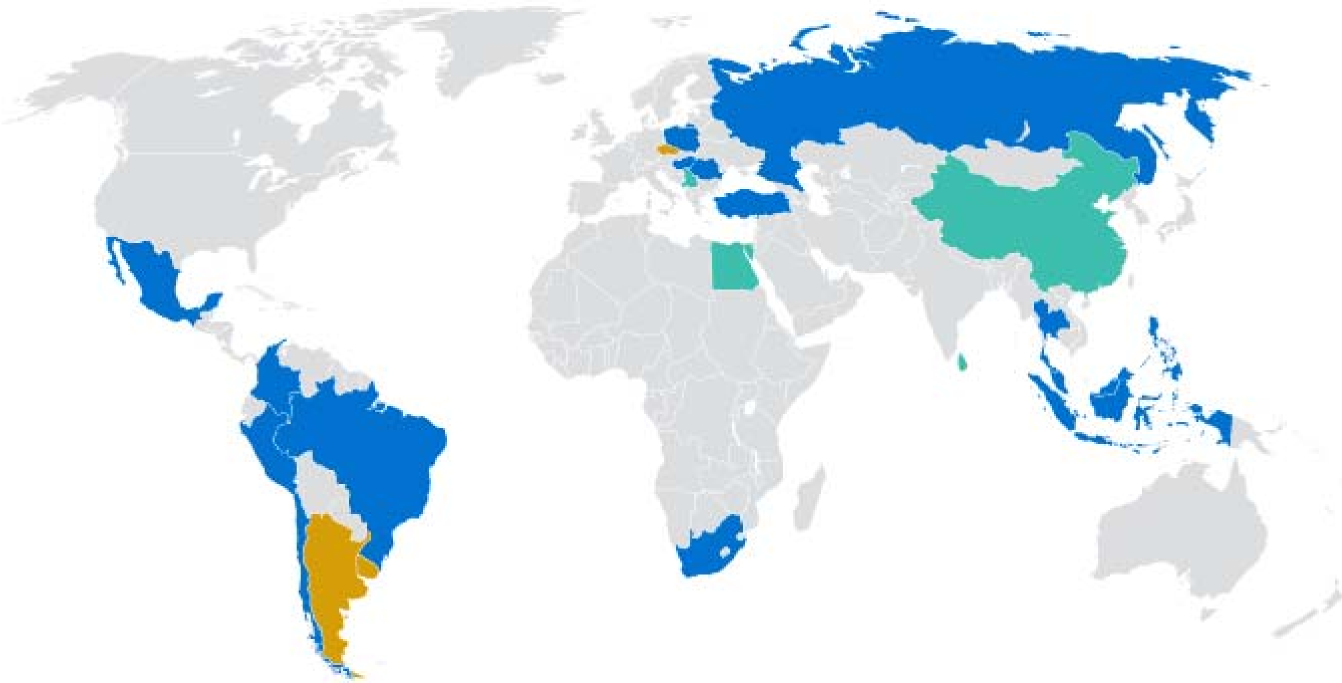

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Emerging Market Local Debt: Growing Depth, Growing Opportunity

The landscape for emerging market (EM) local debt is expanding fast – and looks set to continue.

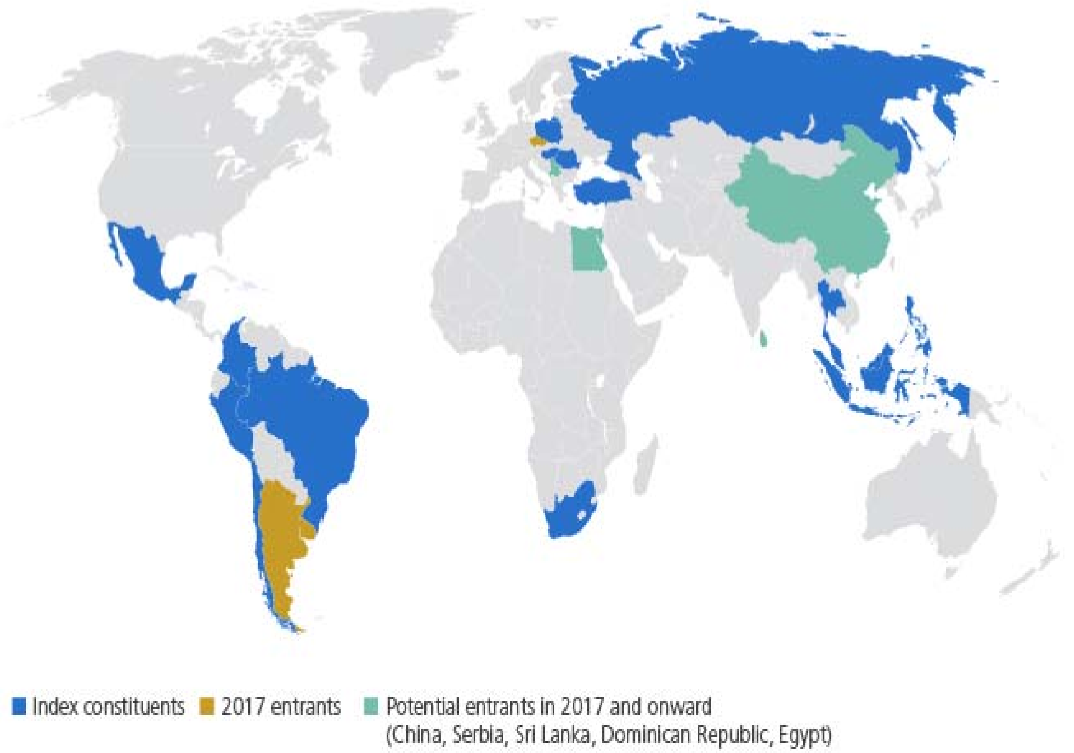
Earlier this year, Argentina, the Czech Republic and Uruguay joined the bellwether benchmark for the asset class, JPMorgan GBI-EM Global Diversified, taking the total to 18 countries. China, Egypt and another three countries may enter the index next year. The inclusions will make the EM local debt asset class much larger, deeper and more liquid. (For more on China, see "China and Emerging Asia: A New Dawn for the Capital Markets.")

Active investors may benefit in two big ways. First, the asset class will become more complex and diversified. This will allow investors to invest in more countries to seek alpha and greater relative-value opportunities. Importantly, the broadening of the index unanchors performance from a small number of index heavyweights. The number of countries whose index weights were capped at 10%, for example, has fallen from six three years ago to two.

Second, index inclusion (or exclusion) will create changing supply and demand forces that, if understood well, could become a significant source of alpha potential in portfolios. Seeking first-mover advantage may require grinding back-office work and taking nonconsensus positions, but the rewards can be handsome.

Offshore investors have shown growing interest in EM local debt, which generally features high nominal and real yields, and undervalued currencies. Peru's launch of $3 billion in local currency bonds in July, for instance, was met with more than $10 billion in demand, according to reports.

More countries are joining the EM local bond index



Source is PIMCO as of 31 July 2017

PIMCO

Seeking balanced currency exposure

The traditional vulnerability for EM countries has been a mismatch on the balance sheet between local currency assets and foreign exchange liabilities. Reducing that risk has long been an important goal of countries seeking to join the club of local index membership.

A good balance between debt issued in external and local currencies can help governments raise assets. Issuing more local currency debt helps establish a local yield curve that can lure both domestic and international players. And it can help countries be more opportunistic, oscillating issuance between the two.

Growing diversification

We envisage the local bond market evolving in a similar, if somewhat slower, fashion as the JPMorgan EMBI Global Index of external debt. It has grown from 15 countries in 1994 to 66 today.

Even with the expansion and growing breadth of EM local market debt, the asset class still plays a small role in global portfolios. We think this will change. The market is bound to grow much larger, deeper and more liquid. Investors, in turn, may benefit from an increasingly more balanced and more diversified portfolio of EM bonds.