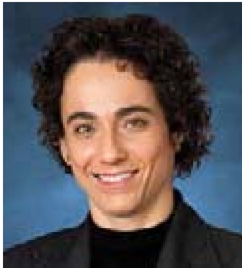
Investment Insights

Invesco Broad Fixed Income



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Why Emerging Markets Debt is an Attractive Asset Class

Although Emerging Markets ('EM') debt in September posted its largest monthly loss since 2008, we believe EM debt remains an attractive investment proposition. EM debt should be viewed by investors and advisors as a strategic opportunity, rather than a tactical play.

Fundamental reasons

- **Stable credit metrics, in contrast with a deterioration in the developed world**
  The creditworthiness of EM continues to converge with developed markets ('DM'). Unlike DM, EM is much less leveraged. At the government level, EM debt ratios are 36.97% vs. 101.42% for DM. This implies that there is less need for tighter fiscal policies as debt-to-GDP levels have been stable for most part. In absence of a fiscal contraction, the negative impact of high debt ratios on economic growth is reduced. While EM will not be immune in a slow global growth environment, the magnitude of the downward revision in growth is smaller than in DM. The International Monetary Fund recently reduced growth in the EM market by 0.2 for 2011 to 6.4% and 0.3 to 6.1% for 2012, whereas the DM growth was reduced by a magnitude twice as large, as 2011 was reduced by 0.6 to 1.6% and 2012 was reduced by 0.7 to 1.9%.

  At the consumer level, personal debt is also relatively lower, as many countries' personal credit only started growing in recent years and from a low base. Finally, the banking sector in EM remains, for most part, well regulated, well capitalized and credit growth remains positive, which has helped to smooth the last economic downturn. A few countries that had current account deficits in 2008 have since shifted into surplus (for example, Hungary -7.4% in 2008 vs. 2.0% for 2011 as of September 2011 IMF World Outlook), which reduces their vulnerabilities and dependence on international financing.
- **Policy flexibility**
  Unlike in DM, where central banks have little or no room to reduce policy rates and/or are in need to engage in unconventional monetary easing, several EM countries have tightened rates earlier in the year in response to rising inflation. With growth likely to slow into 2012 and with some declines in commodity prices, there is scope for additional rate cuts if necessary, should growth and/or inflation surprise on the downside.
- Additionally, most EMs have a higher amount of international reserves now than in 2008 (according to IMF data international reserves grew by 44% since the end of 2008), which gives them room for interventions should their currencies come under pressure.

Data as of Sept. 30, 2011, unless otherwise stated

Technical reasons

- According to JP Morgan, prior to the global credit crisis, leveraged investors such as banks and hedge funds represented nearly 50% of the EM, held larger positions, and employed more leverage than they do today. Since the credit crisis there has been a decrease in risk taking and use of leverage as hedge fund representation has fallen to 20-25% of market share.

  External debt valuations are still compelling despite the recent recovery. The J.P. Morgan Emerging Markets Bond Index - Global Diversified spread over Treasurys is currently at 441bps compared to 275 bps at the end of 2010 and 331 bps in 2008 prior to Lehman's collapse.
- Investors still appear to be underinvested in EM. In the U.S. alone, allocations to EM funds represents less than 1% of all assets and only 2% of taxable fixed income investments.[1] The relatively supportive fundamentals, particularly in light of the deterioration in DM, should continue to attract attention to the asset class for its standalone merits and also diversification benefits.

Still, despite its steady growth over the years, the asset class is relatively less liquid than the core global bond markets and can be subject to short term bouts of volatility should a large number of investors rush to exit at the same time, which is what happened in August-September 2011. We view these periods as a buying opportunity, particularly for investors that are not yet invested or are underinvested in the asset class as we think the medium and long term prospects remain solid.

We believe that the structural improvements that the emerging markets debt asset class has seen over the last 10 years has led to an asset class that weathered the global credit crisis better than developed markets and brought the global economy out of the most recent recession. The structural improvements have also contributed to all three major JP Morgan EM debt indices being rated investment-grade by one or more of the independent rating agencies as of Oct. 31, 2011.

Emerging markets countries on average have better balance sheets and more fiscal and monetary flexibility to engage in countercyclical policies, if needed, than developed markets. It's an asset class investors should consider as a part of a well-diversified portfolio.

1 Source: SimFund as of Sept. 30, 2011.

About risk

Developing Markets Securities Risk. Securities issued by foreign companies and governments located in developing countries may be affected more negatively by inflation, devaluation of their currencies, higher transaction costs, delays in settlement, adverse political developments, the introduction of capital controls, withholding taxes, nationalization of private assets, expropriation, social unrest, war or lack of timely information than those in developed countries. **Foreign Securities Risk.** Foreign investments may be affected by changes in a foreign country's exchange rates; political and social instability; changes in economic or taxation policies; difficulties when enforcing obligations; decreased liquidity; and increased volatility. Foreign companies may be subject to less regulation resulting in less publicly available information about the companies. **High Yield Bond (Junk Bond) Risk.** Junk bonds involve a greater risk of default or price changes due to changes in the credit quality of the issuer. The values of junk bonds fluctuate more than those of high-quality bonds in response to company, political, regulatory or economic developments. Values of junk bonds can decline significantly over short periods of time. **Interest Rate Risk.** Interest rate risk refers to the risk that bond prices generally fall as interest rates rise; conversely, bond prices generally rise as interest rates fall. Specific bonds differ in their sensitivity to changes in interest rates depending on their individual characteristics, including duration.

All data as of 9/30/11, unless otherwise noted. Sources: JP Morgan, SimFund, and International Monetary Fund. A spread is the difference in yields between two fixed-income securities.

The J.P. Morgan Emerging Markets Bond Index - Global Diversified are U.S. dollar-denominated Brady bonds, Eurobonds, and traded loans issued by sovereign and quasi-sovereign entities.

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