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Emerging market local currency bonds: investing in frontier markets

For many investors, frontier markets remain relatively unexplored. They offer an additional opportunity set to informed investors, but investing in these smaller, less efficient markets also involves a number of unique challenges and risks. In this paper, we discuss how to define frontier local currency markets, why they could make an attractive investment and how best to invest in them.

Defining frontier markets

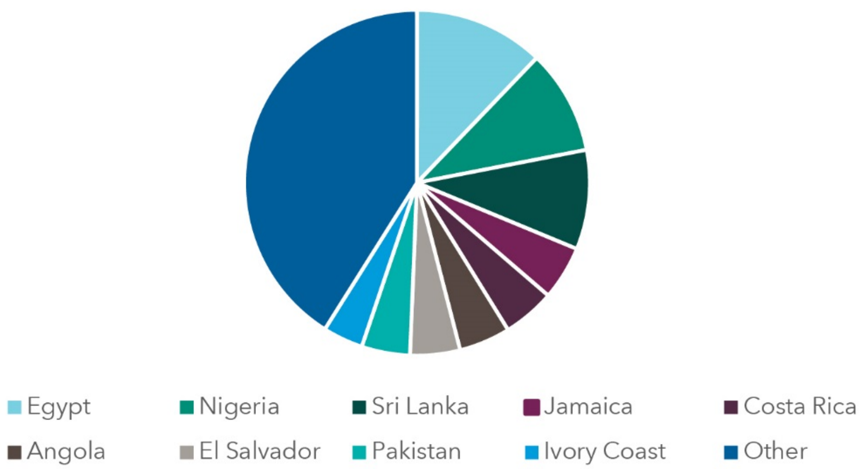
Frontier markets are generally emerging market (EM) economies that are at the lower end of the development spectrum (as measured in per capita income) and have sub-investment-grade credit ratings. They generally have weaker infrastructure and score low in various social metrics such as life expectancy and literacy. These countries are yet to embark on a sustainable reform process to strengthen institutions and help drive economic growth further. Some are 'fallen angels' – markets that were part of the main EM universe, but have lost their core EM status because of economic crises, typically resulting from short-term or populist economic policies.

Emerging markets are volatile and may suffer from liquidity issues.

There is no frontier markets index within local currency EM debt (EMD). The JPMorgan Next Generation Markets Index (NEXGEM) is often used to define the frontier market group within the hard currency space. The 33 countries classified as 'Next Generation' are non-investment grade, relatively infrequent issuers and less liquid markets. The following rules determine index eligibility:

- The country must have possessed a weight of less than 2% of the JPMorgan EMBI Global Diversified Index for the past 12 consecutive months.
- It cannot be a European Union member or be engaged in the process of seeking EU membership.
- The country must be rated Ba1/BB+ or lower by both Moody's and S&P. A country will no longer be eligible if it is rated investment grade by either S&P or Moody's.

JPMorgan NEXGEM country weights (%)



As at 31 January 2019. Source: JPMorgan

For the purpose of this paper, we define frontier local currency markets as the NEXGEM countries, with the addition of India. India displays many characteristics of frontier markets and there are not any local currency bonds in the JPMorgan GBI-EM Global Diversified Index.

Why invest in frontier markets?

Potential growth/higher returns

Many traditional EM countries, such as Mexico, Russia and South Africa, are now much more developed than they used to be, with more stable institutions and infrastructure. As such, it will be difficult for these countries to grow at the same rate as they did in previous decades. Meanwhile, financial markets have deepened, communication from authorities has improved and risk premiums have declined, reducing expected returns from investing in EM. In contrast, many frontier markets, such as Egypt, Ghana and India, are at the early stage of development (economic, political, and financial) and display many of the same characteristics that traditional EM countries had years ago.

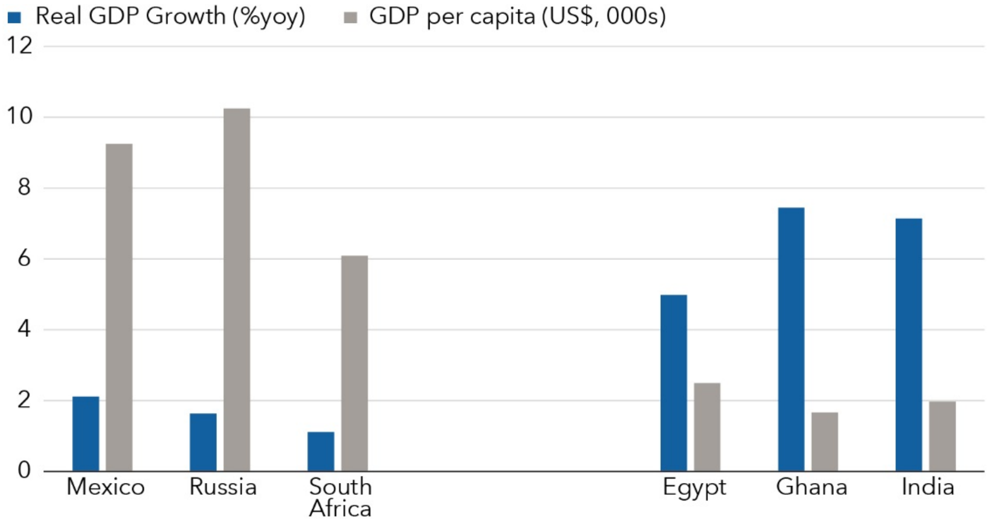
Past results are not a guarantee of future results.

Demographic dividend: A key characteristic of the frontier markets that has resulted in even faster economic growth is a young, growing population. Many frontier markets are currently benefiting from a 'demographic dividend', which means that the labour force is temporarily growing more rapidly than the population that is dependent on it, freeing up resources for investment in economic development and welfare. This can help improve per capita income, domestic consumer spending and the sustainability of economic growth.

Improvement in macroeconomic framework and governance: An effective and accountable government can lay foundations and provide a stable macroeconomic framework. This in turn enables more sustainable growth (rather than a boom/bust cycle) and could increase potential returns. While still clearly an issue, governance and accountability are improving in many frontier market countries. Part of this happens naturally as the electorate becomes more knowledgeable and leaders understand the importance of good governance to allow the natural laws of the economy to function properly. The International Monetary Fund (IMF) has also helped some frontier markets develop. IMF loan programmes carry conditionality requirements, requiring frontier countries to improve accountability and provide a stable macroeconomic framework in exchange for funding. Egypt is an example of a country that has made progress in macroeconomic stabilisation, growth, inflation and the budget deficit in conjunction with an IMF programme.

Attractive for foreign direct investment: The above factors, as well as abundant natural resources in many of the countries, make frontier markets attractive destinations for foreign direct investment (FDI) and new manufacturing hubs. China has been a major recipient of FDI in the past, but growing labour costs in recent years have led many companies to relocate their manufacturing facilities to frontier countries. China, meanwhile, has been investing in many African countries, particularly in commodity- and infrastructure-related sectors.

Example emerging markets and frontier markets: real GDP growth forecast 2017-19 and GDP per capita in 2017



Forecasts shown for illustrative purposes only.

As at October 2018. Source: IMF, World Economic Outlook

GDP: gross domestic product. GDP per capita is in thousands of dollars, based on 2007 data.

Diversification

Historically, frontier markets have had low correlation with developed and emerging markets, as well as with other frontier markets. This is partly because they are mostly owned by domestic investors (rather than global investors), they are generally not held passively, and also because they have lower debt levels (so are less correlated with global currency and interest rate movements) and are generally less involved in global trade.

There also tends to be wide variation among, and different investment opportunities offered by, frontier market economies. As a result, investments in frontier markets tend to be impacted more by the domestic political or economic situation than by global events. For example, a change in the political regime in Egypt is unlikely to have any impact on the prospects for Argentina.

Value opportunities

Frontier markets are generally under-owned and under-researched, which can create excess risk premiums and opportunities to generate alpha.
We see attractive opportunities within a number of local currency frontier markets. Within Africa, Egyptian bonds became attractive after the country had a large devaluation and allowed its currency to float towards the end of 2016. Egypt is now on a positive track, with inflation moving into single digits and the country's external position improving. Ghana continues to offer attractive yields, with inflation relatively contained and slowing, although the currency is a concern. In Nigeria, both the country's monetary and fiscal policy look unsustainable longer term, but the short-term bills continue to look attractive with yields at over 17%.

Meanwhile, dollarization in Argentina has eased somewhat, and median 12-month inflation expectations have finally dropped, allowing interest rates to come down, and supporting the local currency bonds.

Valuation opportunities within frontier markets

Argentina: High local bond yields, Macri reform story, IMF support.

Nigeria: Post devaluation, reform story.

India: Longer term disinflation and structural reform.

Kenya: Diversified African economy with decent long-term prospects.

Ghana: Growth slowing to comfortable levels, inflation should remain contained.

Egypt: High local bond yields following devaluation.

Past results are not a guarantee of future results. For illustrative purposes only.
As at February 2019. Macri: President Mauricio Macri. Source: Capital Group

Another market with frontier-like characteristics is India, which has been a high-conviction investment in Capital Group Emerging Markets Local Currency Debt Fund (LUX), based on a long-term disinflation and structural reform story. Yields have come down since the current government came into power in May 2014. The central bank has been focused on inflation targeting, which has been positive with regard to the country's debt. Longer term, we would expect the entire yield curve to be lowered as structural reform is implemented.

Investing in frontier markets through an active research-based approach

The rationale for potentially having a strategic allocation to frontier local currency EMD is therefore strong; we now look at how best to manage that exposure.

A passive strategy

The JPMorgan GBI-EM Global Diversified Index is the benchmark most commonly used by passive investors of EM local currency debt and includes a couple of frontier countries, including Argentina and Uruguay. However, a large proportion of the investable universe and most frontier markets are excluded because of difficulties in investing in them. Many countries require foreigners to complete lengthy registration processes before they are allowed to trade in local bonds, while some frontier markets impose taxes on foreign investors. An active manager with experience in EM can navigate these restrictions and assess whether the additional burden still makes the investments worthwhile.

A dedicated frontier market local currency bond strategy

Another option is to invest in local currency frontier markets through a dedicated frontier market strategy. However, this may be too restrictive given the relatively small number of frontier markets that are able to issue in local currency. A wider investment universe would ensure that investments are not 'forced' into less appealing countries for lack of opportunities elsewhere.

In general, a broad universe including both core and frontier local market currency debt could be beneficial to portfolio construction, allowing managers to use the core markets (e.g. Mexico and South Africa) as the base of the portfolio, and adding frontier markets (e.g. Egypt and Ghana) to improve diversification and potentially enhance returns.

An active broad EM local currency strategy

While all investments involve some level of risk, investors in frontier markets face additional risks, given the lack of domestic pension funds, capital markets infrastructure and regulatory safeguards, all of which cushion shocks in more developed markets including more established emerging markets. In particular, frontier markets typically have higher levels of risk around politics and governance (corruption, social unrest, etc.), and macroeconomic cyclicality.

These kinds of risks warrant a research-based active approach to investment, based on bottom-up, fundamental research. Managers need to frequently visit smaller markets in order to understand changes in their macroeconomic environments and policies, and assess longer term debt opportunities, ideally with equity colleagues to share investment insights. This is more important for frontier markets than more developed EM countries. Kirstie Spence, one of Capital Group's EMD portfolio managers, has talked about how analysing newer African credits today brings back memories of Central and Eastern Europe when the region was less developed in the mid-1990s, and how it is beneficial to spend a lot of time on the ground. "I was part of a team of Capital analysts and portfolio managers that visited Nigeria a few years back," she says. "The experience was instrumental to my gaining greater confidence in the country's outlook. We met with policymakers, corporate management, bank executives and even local pension plan managers. To hear people talk about how they are responding to current reforms, or the real cost of capital in the economy, was extremely instructive."

Frontier markets also tend to be less liquid than more developed EM economies. The lower liquidity of frontier markets can have both a positive and negative impact – they can suffer from sharp declines based on selling by a small group of investors, but they can also hold up better during wider market downturns as the more liquid assets are often sold first. A well-connected, experienced trading desk is important to monitor sentiment and flows, and to be able to transact in small or large sizes as needed.

Given difficulties in access to foreign investors, frontier market investing would also benefit from active managers that have teams that investigate all aspects of investing in new markets, including custody, clearance, repatriation, domestic market regulation and local brokerage services. This allows managers to invest with ease as and when investment opportunities arise.

How to assess investment opportunities within frontier markets

Within an active strategy, portfolio managers can assess frontier markets broadly through three approaches: data, screening and active engagement.

Data: Managers can look at macroeconomic and financial data to better understand frontier markets. Data on the composition and growth of GDP, inflation, debt, balance of payments, etc. can give an indication of how an economy is progressing and how resilient it may be to shocks. However, the availability and reliability of data, particularly in frontier markets, can be challenging. Another issue with data, even if it is accurate, is that it has to be understood within the wider context of what is going on in an economy. So for example, quantitative easing and the search for yield allowed many African countries to start issuing debt on the international capital markets. This could either turn out to be a problem for these countries (if dollar debt can't be paid back, it could cause an economic crisis), or it may turn out to be the best thing to happen to the region if access to finance facilitates infrastructure investment that leads to structural growth. Rather than looking at the numbers alone, it is important to consider the composition of growth and the flow of funds to help determine the sustainability of credit growth.

Screening: Managers can screen countries for various metrics such as levels of corruption, human rights, etc. However, there are multiple screening categories for sovereigns, these are harder to define than for corporates, and a blind reliance on screening with dramatically narrow the opportunity set. As the table below shows, most countries in Sub-Saharan Africa would be ruled out if we needed positive indicators on all the metrics mentioned. Systematically excluding countries with poorer metrics makes it difficult to capture the transition from frontier to emerging to developed market.

Moreover, positive and negative screening can tell different stories. For example, in Rwanda, the representation of women in parliament is high, but the freedom of its press is relatively low.

Screening within frontier markets

	Corruption	Resource Economy	Human Rights	Political Stability	Democracy
South Africa					
Ghana					
Nigeria	X	X			
Kenya	X				X
Ivory Coast				X	
Zambia		X			
Angola	X		X		
Gabon		X	X		X
Rwanda			X		X
Ethiopia			X		X

For illustrative purposes only.
Based on Capital Group assumptions as at 28 February 2019.

Active engagement: Engagement is not just for equity investors – long-term relationships with policy makers create potential to impact the development path. The complexity of frontier markets makes local engagement a necessity – spending time on the ground and with equity colleagues can help managers see arising risks. Incorporating data and governance/economic indicators alongside active engagement can help complete the picture.

The power of global integrated research: a long-term, comprehensive approach is critical to understanding the viability of frontier market investment opportunities

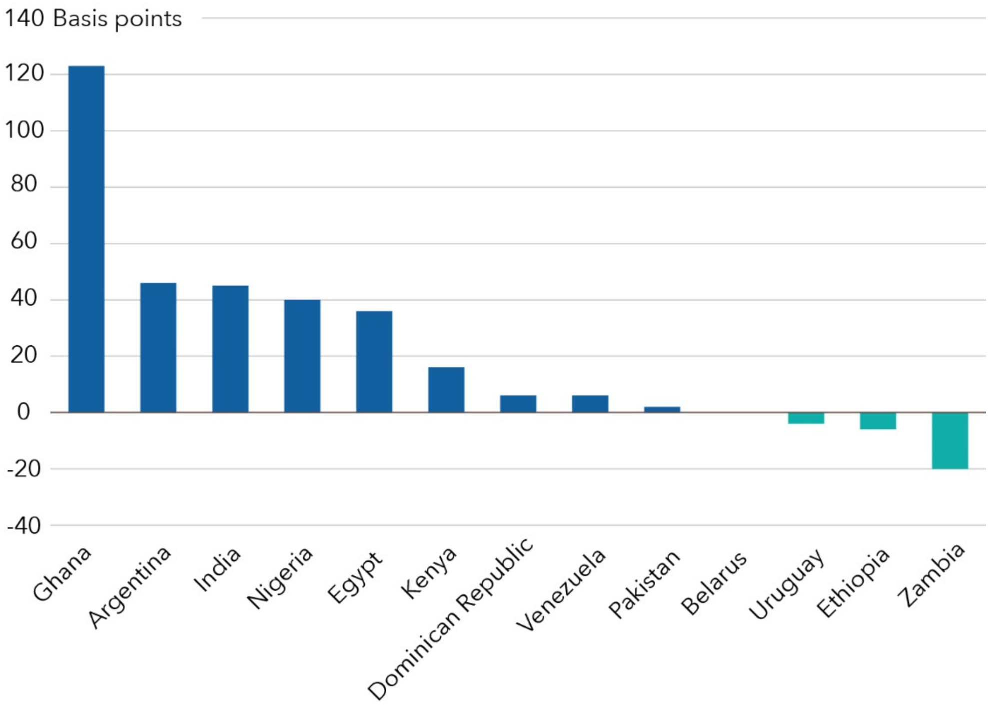
Capital Group has been investing in emerging markets since 1986, when many EM countries displayed similar characteristics to frontier markets today. Our long history of investing within EM means we have the experience to be able to identify early signals of changes in political regimes, and how this could impact a country's bonds.

Capital's experience in frontier markets is evident from our results. Within our EM local currency fund, our country selection in frontier markets added 284 basis points to relative returns during the past five years.[1] These relative gains have come predominantly from off-benchmark local currency frontier investments, including in Ghana, India, Nigeria and Egypt and overweight positions in Argentina.

We started investing in Ghana in 2014, soon after the central bank had imposed a number of foreign exchange controls to halt the depreciation of the currency. While this may have put many foreign investors off the market, our expertise in frontier markets helped us to navigate the difficult liquidity conditions and as a result, our allocation to Ghana has been the top contributor to relative returns on a country allocation basis over the past five years.

Past results are not a guarantee of future results.
[1]Over the period 1 January 2014 to 31 December 2018. Returns for Capital Group Emerging Markets Local Currency Debt Fund (LUX) are relative to the benchmark JPMorgan GBI-EM Global Diversified Index. Returns are cumulative over the five-year period in US dollar terms, shown before fees and expenses with income reinvested. For illustration purposes only, the Z share class has a maximum Total Expense Ratio of 90bps. The impact of fees on returns may vary depending on the investor and share class. Please visit capitalgroup.com/europe for further details. Sources: Capital Group, JPMorgan

Capital Group Emerging Markets Local Currency Debt Fund (LUX): frontier market contributions to relative returns in 2014-18[1]



Past results are not a guarantee of future results.

While the Indian government removed some of the constraints on foreign investment in 2013, the market for local currency sovereign bonds remains restricted. Foreign investors have to buy the rights to access sovereign bonds through an auction when holdings exceed 90% of the investment limits, while other rules require that foreigners invest in notes with a minimum residual maturity of three years. Despite these constraints, Capital Group was one of the earliest foreign investors in the local currency bonds, helped by our team of associates that are focused on gaining access to new markets.

We starting building a position in Argentine local currency bonds in 2016, before the inclusion of the bonds in the index. Despite the fact that we expected the currency to depreciate to restore competitiveness, our analysis suggested that high local currency bond yields in a declining inflation environment would more than offset any currency losses, providing a strong positive overall return.

Conclusion

Whether investing in local currency frontier bonds through a broad local currency bond portfolio or through a dedicated frontier mandate, the potential alpha, growth and development, along with diversification benefits offered by the asset class, is significant for long-term investors. Given the additional risks that come with investing in frontier markets, lack of research in the asset class and lower levels of liquidity, we believe that an active, research-based approach is the most effective way to navigate the dynamic market conditions.

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