INSIGHT

VIEWPOINT

Opportunities in Local Currency Debt

JAE LEE & ANISHA A. GOODLY | JUNE 21, 2017

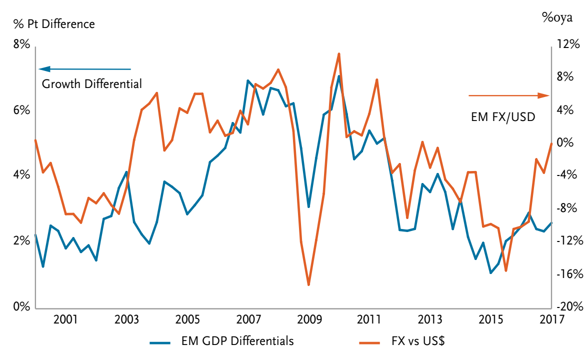
In our last white paper on Emerging Markets (EM) local currency debt (September 2016), we argued that we saw the asset class as an attractive long-term opportunity. EM local currency debt is up 10% year-to-date, and has retraced post U.S.-election losses.

We continue to see EM local currency debt as one of the more attractive asset classes in global fixed income. Our thesis remains intact: improved EM growth, combined with attractive carry and stable currencies, provides the backdrop for a sustained recovery in the asset class. In our base case, we see potential for 8-12% annual returns for local currency debt – an investment grade rated asset class – over the near to medium term. This reflects local market carry in the 6-6¼% range (with the opportunity to capture higher carry in select markets) and the potential for currency gains in the 10-20% range over the next several years. Our view is based on the following:

Improving Growth Rates in EM Economies

For the first time in five years, the spread between EM and developed market (DM) growth is widening, which historically has been positive for both EM currencies and flows. This pickup in growth has been driven by important structural reforms over the last few years, including initiatives in India, Indonesia, Argentina and Brazil. Additionally global growth is improving, which is supportive of global trade, and thus, emerging market economies.

EM U.S. Growth Differential & EMFX vs. USD



Source: JP Morgan; Data as of March 31, 2017

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Attractive Yield Advantage Relative to Developed Markets

EM local currency debt yields over 6% on average. This is around 100 basis points (bps) higher than the level immediately before the taper tantrum. Nearly 80% of the EM debt index is rated investment grade.

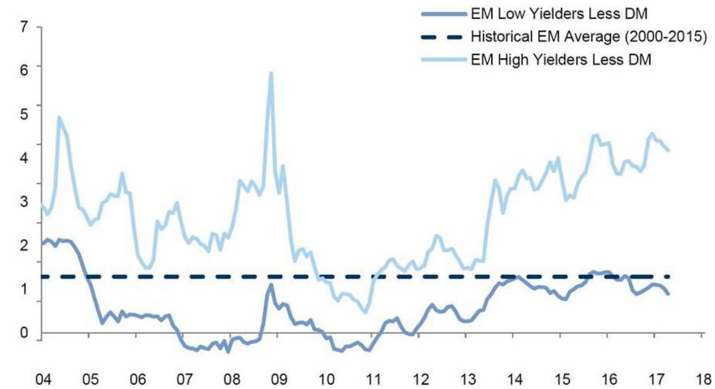
In addition, the differential between real EM and DM rates is at the wider end of the dispersion range of the last five years. Real rates in EM are also over 200 (bps) higher than they were before the taper tantrum – and at that time, EM fundamentals were deteriorating. Today, they're on the upswing, which gives EM central banks room to cut rates if needed and provides cushion against higher U.S. rates, particularly as the inflation backdrop is improving.

Potential for Significant Catch-up in EMFX as Dollar Rally Slows

Historically, carry has represented the bulk of the return for local currency debt, with FX a moderate drag. We see the improved growth dynamics, along with important structural reforms, driving a long-term retracement in EMFX. To put this in context, while EM currencies have appreciated this year, they are still down over 25% on average since the taper tantrum. And, they are down close to 35% from their peak versus the dollar in 2011. Even a moderate catch-up of 10% would serve as a powerful 'kicker' on top of high carry.

Attractive Carry Profile in EM Relative to DM

1-year Swap Rates Deflated by Consensus Inflation



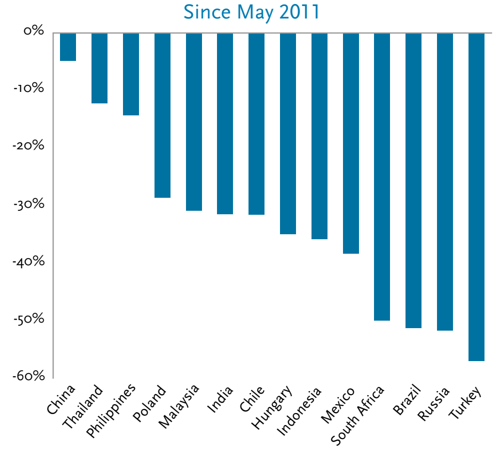
Source: Consensus Economics, Goldman Sachs Global Investment Research

EM Low Yielders: CLP, CNY, CZK, HKD, HUF, ILS, KRW, MYR, PEN, PHP, PLN, RON, SGD, TWD, THB

EM High Yielders: BRL, COP, INR, IDR, MXN, TRY, RUB, ZAR

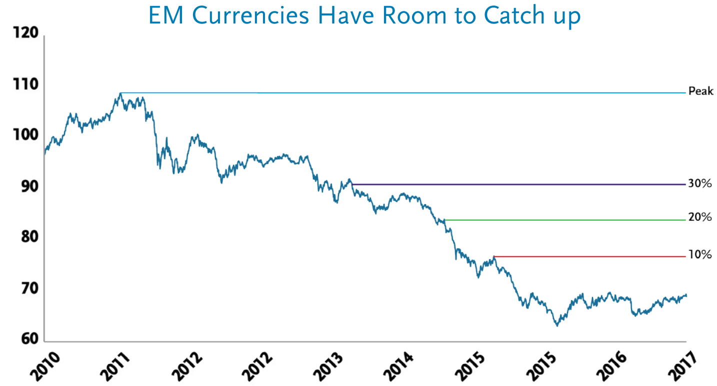
EM Currencies Have Repriced on Average 34%

Since May 2011



Source: Bloomberg; Data as of May 31, 2017

EM Currencies Have Room to Catch up



Source: JP Morgan; Data as of June 15, 2017

EMFX Cheap to Developed Markets Relative to Long-Term History

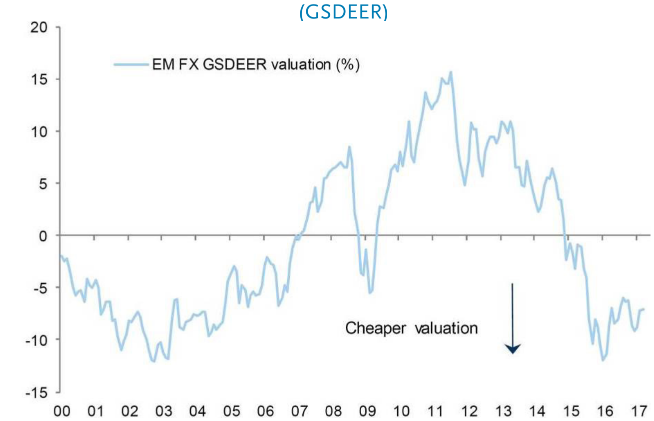
Not only do EM currencies look cheap relative to their 2011 peak, but also from the perspective of longer-term economic fundamentals. Based upon valuation models that take into account inflation, terms of trade and productivity, EMFX looks cheap versus developed market currencies.

Healthy Technicals, as Inflows Remain Below Peak Levels

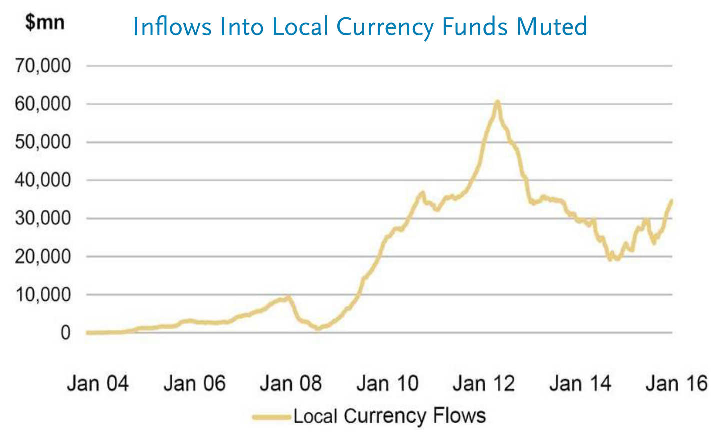
Flows into local currency debt have lagged hard currency debt, and the bounceback post the U.S. election suggests that investors remain underweight the asset class but are inclined to add on sell-offs.

Inflows into EM local markets further augment growth prospects going forward, as they help reverse some of the financial tightening of the past few years, while improving public finances.

Goldman Sachs Dynamic Equilibrium Exchange Rate (GSDEER)

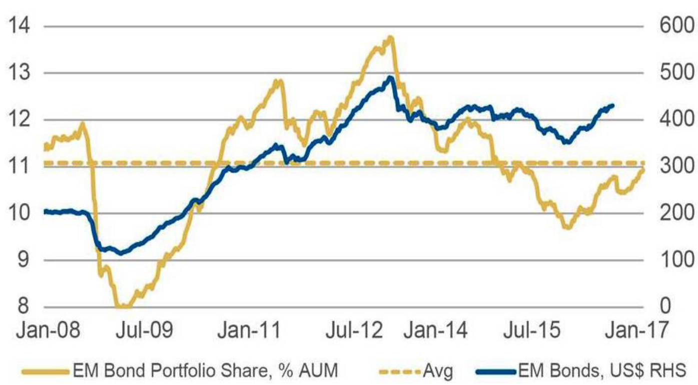


Source: Consensus Economics, Goldman Sachs
Simple Average of 16 EM Currencies Relative to USD (CE3 verses the EUR)



Source: EPFR Global, Country Allocation Database, Morgan Stanley Research

EM Bonds in Global Portfolio



Source: IMF Coordinated Portfolio Investment Survey, Morgan Stanley Research

Benign Monetary Policy Backdrop

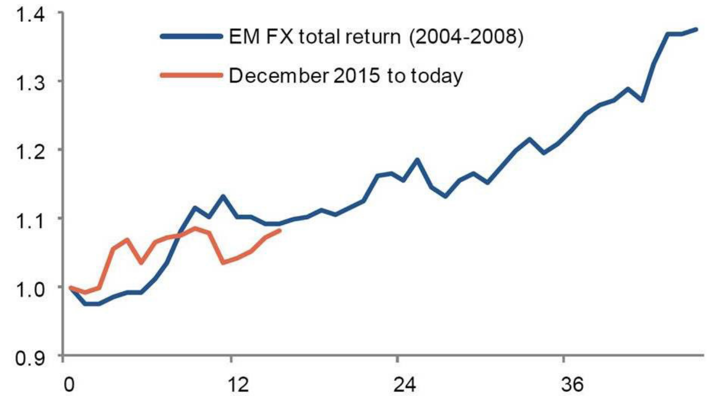
Rising U.S. rates are less of a concern in the context of a synchronous global growth environment, given the gradual and well-communicated path of Fed policy. We believe that the European Central Bank remains very deliberate with its exit strategy, and also believe that the Bank of Japan will continue with yield curve targeting.

Bottom Line

We believe local currency debt allows investors to capitalize on improving growth, attractive carry, and the potential for a catch-up trade in EMFX. Investors currently remain underweight the asset class, which provides a healthy technical backdrop. In our base case, we see potential for 8-12% per annum returns for local currency debt, driven by both carry and possible EMFX appreciation over the near to medium term.

Certainly there are risks to our view. However, we see them as more idiosyncratic than systemic. We could see periods of support for the U.S. dollar if the U.S. were to implement more growth-supportive fiscal and/or protectionist measures. However, we believe that these policies are farther down the road than originally anticipated and, if implemented, will not be as aggressive as originally advertised. In addition, we believe that these measures will likely be more supportive of the U.S. dollar versus other developed market currencies, whereas the risks against EMFX are more balanced. Accordingly, we would look to take advantage of any sell-offs to begin to build or add to local currency holdings.

EM FX Following the Script from 2004 to 2007



Source: SG Cross Asset Research/EM

Blue line: 2004-2007 cycle measured from the start of Fed tightening in May 2004. Orange line: measured from start of Fed tightening in Dec 2015.

Jae H. Lee
Managing Director
Currency Strategy and Trading

Mr. Lee is responsible for emerging markets currency strategy and trading. Prior to joining TCW, Mr. Lee was a Director at Standard Chartered Bank in New York, where he oversaw Asian foreign exchange trading. Before Standard Chartered, he was Head of Local Markets Trading in Asia for Commerzbank. Jae started his career at Bank of America Merrill Lynch where he held FX and Rates trading positions in New York, Hong Kong and Singapore. Mr. Lee is a graduate of Georgetown University, where he received a bachelor's degree in finance, as well as a master's degree in international relations.

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Managing Director
Emerging Markets Portfolio Specialist

Ms. Goodly is the Portfolio Specialist for the TCW Emerging Markets group, which includes the Emerging Markets Fixed Income, Emerging Markets Local Currency Income, and Worldwide Opportunities strategies. In this role, she serves as the primary liaison between TCW's Emerging Markets investment team and TCW's client relations and marketing professionals. Prior to joining TCW in 2013, Ms. Goodly spent eleven years at Morgan Stanley, most recently as one of the firm's top-producing EM Fixed Income salespersons. At Morgan Stanley, she also served as the Asia Credit Product Manager, marketing Asian credit products globally to the firm's largest institutional clients. In addition, she spent several years working as part of Morgan Stanley's Institutional Investor-ranked U.S. Credit Strategy research team. Ms. Goodly currently serves on the board of Consano. Ms. Goodly graduated with a BA in Economics from Stanford University.

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