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The Major bond letter

#24. EM reaps rewards

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Global

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Who would have thought that Brazil and Mexico would be at the top of the USD performance charts whilst investments in the UK languish at the bottom, having lost about a third of their value?

Part of the explanation lies in a trend nobody wants to go against: dollar strength combined with higher yields, the dominant narrative so far this year. Elevated inflation required the Fed to move rates into restrictive territory. We all know the story.

At some stage, there is likely to be an alternative narrative. Tighter policy could clash with weaker global growth and disinflationary headwinds from longer-run structural drivers. Dollar strength and bond yields could part company.

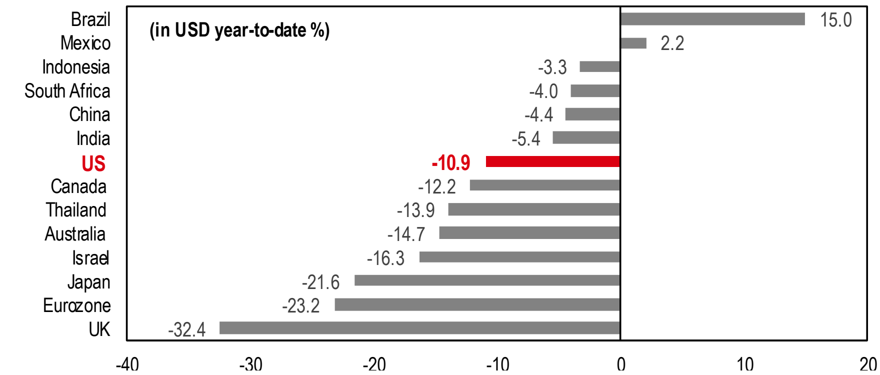
We may not have to wait long before the debate becomes more two-sided because it is already clear that the global economy faces significant growth risks. Markets are so dominated by the powerful trend in the dollar versus bond yields that the near-term view is basically an extrapolation.

We take this opportunity to review the bond market's performance this year, in the context of the dollar rally, and discuss what we think we have learnt.

The dollar is up about 13% (USDX), but the bond sell-off means a domestic US investor holding US bonds experienced a negative total return of about 11% (Figure 1). Euro government bonds lost a bit more in local currency, although in USD terms their losses were more than twice those of the US bond index. These numbers are a reminder that, in a year when most bond markets have generated negative total returns, international investors received some solace from exposure to the dollar.

Interest parity theory posits that it won't matter whether we invest in our home currency or convert that money to invest overseas in a similar risk-free asset. In the end, the total returns will be the same either way. Government bonds are, in theory at least, "risk-free" assets, so there should be no difference in the total returns between domestic and international investments. No free lunch.

Figure 1. Government bond market total returns* from a USD perspective



*Total return measures price appreciation, coupon accrual and payments, and USD versus local currency valuation
Note: Bloomberg Global Treasuries (DM) and EM local currency indices used
Source: Bloomberg, HSBC

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In practice, we need to consider risks, and the outcomes are likely to be different, especially when hedging is taken into account. The point is that diversification makes sense in practice, and our chart illustrates this in light of the huge moves this year.

We show bond returns from the perspective of USD-based investors. In other words, what their returns would be in USD terms if they had bought into these 14 markets without hedging any of the currency risk. It is admittedly a hypothetical exercise because investors use asset managers to build portfolios for them, and this may mean that some or all of the currency risk is hedged. We nonetheless found this a useful exercise.

Staying at home means that US investors would hypothetically be down about 11% this year. Moving into the countries above the US in the table – India, China, South Africa, Indonesia, Mexico, and Brazil – would result in an improvement from a US investor's perspective. Of course, the results for investors who hedged currency risk would differ; a topic for another time.

Taking risk can be good for you. Diversifying into some of the so-called emerging markets, even though they are supposed to carry more risk, would have been a good strategy. These markets beat staying at home or investing in alternatives like Canada or Australia.

Countries below the red US horizontal column might be described as traditionally having lower risk. They certainly offered less yield at the start of the year, with Europe and Japan down at the bottom. The euro and yen have depreciated by 11% and 19%, contributing to negative total returns for unhedged Eurozone and Japanese bonds of 23% and 22%, respectively. Explaining the large Eurozone underperformance is the ECB's rapid shift away from negative rates in response to higher inflation. Our chart shows that investments in the UK bond markets would have fared even worse than the Eurozone and Japan.

When we look at this from a non-US investor's perspective, we see how unhedged diversification can sometimes work well – and sometimes not so well. A Japanese investor holding US bonds unhedged would be up about 11% (22-11%) this year whilst the Mexican investor would be down about 9% (11-2%).

Over the past year, our colleagues in currency research have argued that the USD benefits from a circle of trust, as it has risen along with US yields, heightened risk aversion, and weak global growth. They have been right to stick with the strong dollar view, and we can see how the path of least resistance is more of the same, at least in the near term.

Following a sustained period when the dollar and yields moved upwards together, we are reminded of the benefits of diversification to bond investors.

What did we learn from this? Developed markets offered very little safety in times of heightened uncertainty, including changes in government and threats of regime shift. Emerging markets have proved to be a better safe asset.

When our instincts might be to do the opposite, it was better to be buying more into EM and doing the opposite in DM markets, where risks appeared to be low. Hindsight is a wonderful thing, but we can see that EM investing has reaped rewards.

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