HEALTH WEALTH CAREER

TO HEDGE OR NOT TO HEDGE?

EMERGING MARKET DEBT FROM AN AUSTRALIAN PERSPECTIVE

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INTRODUCTION

Emerging market debt (EMD) has been an increasingly popular asset class for investors, typically providing higher yields and arguably the potential to participate in emerging economy growth through currency appreciation. There is a large body of research arguing the case for emerging markets, including superior economic growth and demographics[1]. Often the research is written from a United States dollar (USD) perspective.

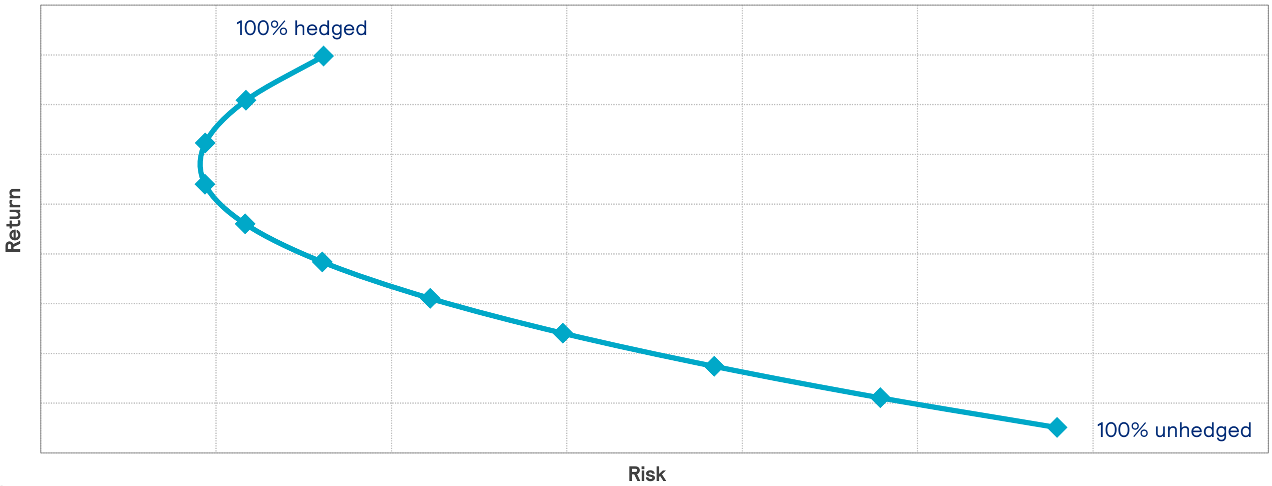
However, Australian investors who usually invest through AUD feeder funds into USD products, face quite different dynamics. With deep ties to emerging economies and the higher reliance on commodity production, there is a strong correlation between the Australian dollar (AUD) and an emerging market currency basket (EMFX) based on the JP Morgan GBI-EM index. This correlation results in a different return profile for Australian investors in unhedged EMD compared to USD denominated investors. In this paper, we explore the impact of this currency exposure and the implications for Australian investors and whether the one-size-fits-all approach provided by managers is appropriate.

WHY DO INVESTORS HEDGE DEVELOPED MARKET DEBT?

For Australian investors, the most common treatment of fixed income investments, especially those in Developed Markets, is to hedge the currency exposures. There are a number of reasons for this, such as reducing the level of "risk" from fixed income investments by removing currency volatility, and in addition, benefitting from the hedge pickup, especially from lower yielding regions like Europe and Japan. Figure 1 below shows a stylised representation of the first point.

Figure 1. For developed market bonds, hedging the currency risk currently improves return and reduces risk

Currency hedging of fixed income holdings | Stylised risk-return deviation chart



Source: Mercer

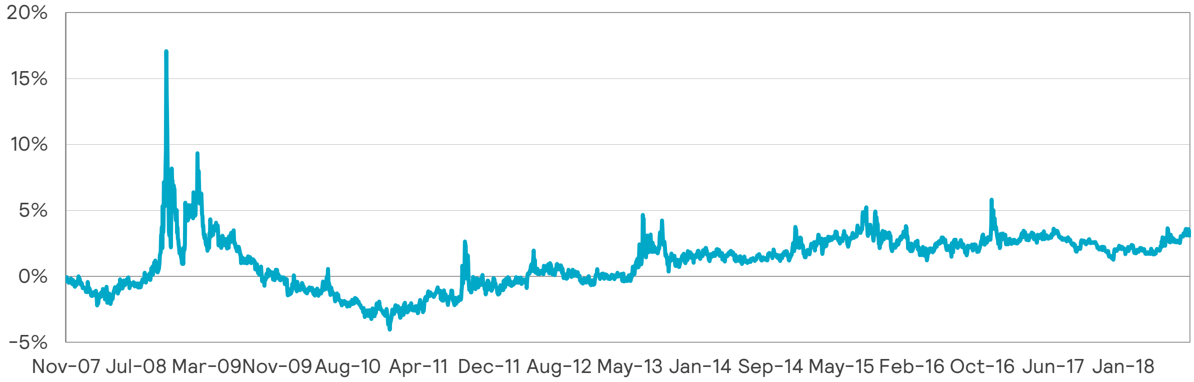
1 Refer for example: *Investing in Emerging Market Debt, Mercer, July 2018* for the fundamental characteristics of this asset class, albeit from a USD perspective.

WHY DO AUSTRALIAN INVESTORS TYPICALLY NOT HEDGE EMERGING MARKET DEBT?

Investors typically access local currency EMD investments on an unhedged basis. There are a few arguments as to why this is the case:

1. **The level of carry paid for hedging is costly**, given that EM interest rates are often higher than Australia's rates, as shown in figure 2, and liquid hedging instruments are not always available.

Figure 2. Cost of hedging an EM FX basket will set you back around 3% per annum
JPM GBI-EM Global Diversified Index | Cost of Carry: Interest rate differential to AUD

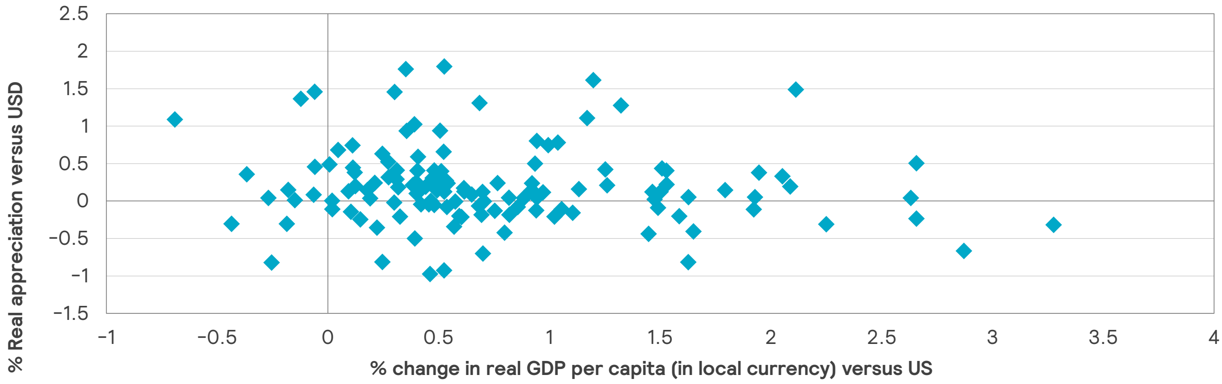


Source: Mercer

2. **The potential for gains through (real) currency appreciation of EMFX** in light of the Balassa-Samuelson effect, which suggests higher productivity countries should in the long run have appreciating currencies in real terms. Whilst this theory provides a framework for considering currency movements over time, the evidence in practice is mixed. Figure 3 shows the real change in EMFX (versus the USD) against the real change in GDP per capita (as a proxy for productivity) from 1990 to 2017 based on IMF data.

   There may be impediments to the hypothesis holding in practice, such as tariffs on free trade resulting in no one global price for tradeable goods, the difficulty and/or lags associated with changes to production and capital controls, and the lack of freely traded exchange rates.

Figure 3. The Balassa-Samuelson effect in practice
Real appreciation against USD versus real GDP per capita growth versus US | 1990 to 2017

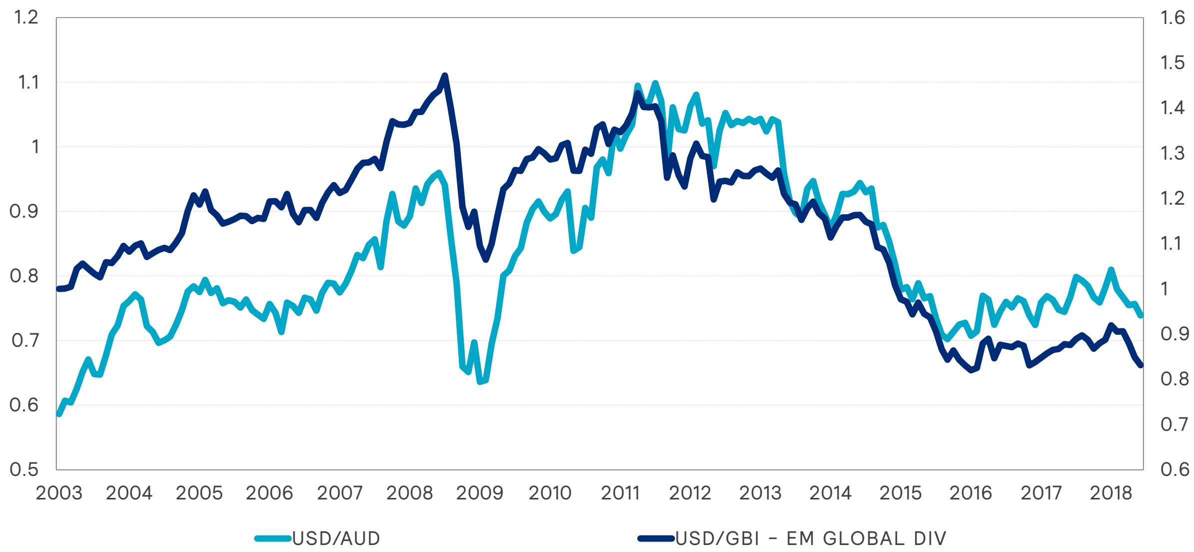


Source: IMF, Mercer

3. **Downside protection**. Australian investors face an additional consideration when considering an investment in local currency EMD: the correlation of EMFX to AUD. Figure 4 below shows the USD/AUD spot exchange rate versus a basket of currencies in the JP Morgan GBI-EM Global Diversified Index.

Figure 4. The correlation between EMFX and the USD/AUD is strong

USD/AUD spot (LHS) vs GBI-EM Currency Basket Index (RHS)

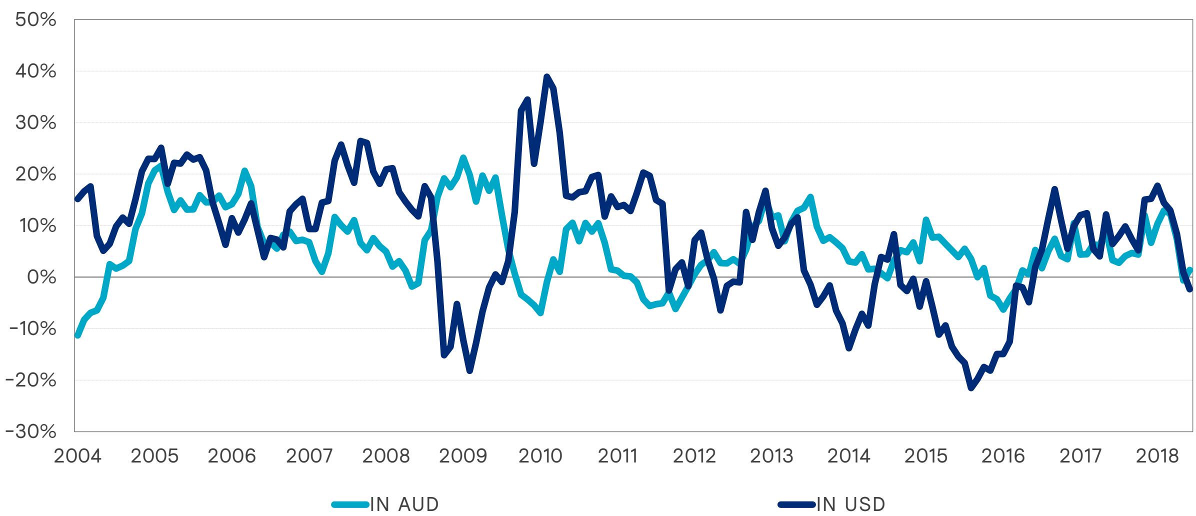


Source: Bloomberg, JPMorgan, Mercer

Figure 5 illustrates the experience from local currency EMD investment has therefore been quite different for a US investor compared to an Australian investor. For example, during the Global Financial Crisis (GFC), local currency EMD unhedged in USD produced negative returns, whilst from an unhedged AUD perspective, it produced positive returns.

Figure 5. The EMD LC UH experience for USD and AUD investors is quite different!

12 month rolling return of JPM GBI-EM Global Diversified | Unhedged in AUD vs USD

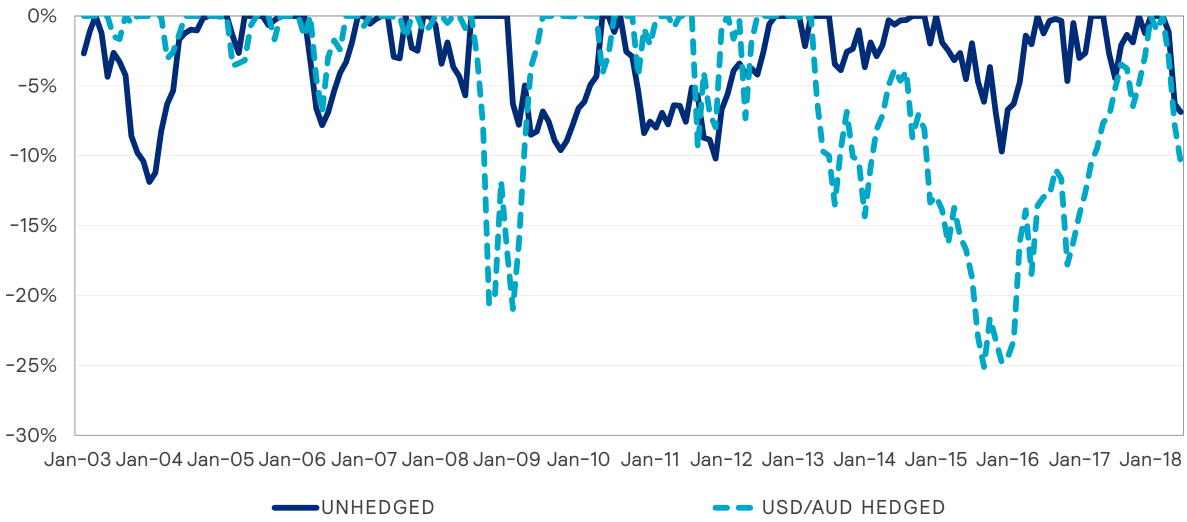


Source: JPMorgan, Mercer

Thus, hedging emerging markets would not only mean the EMFX basket would need to appreciate by 3% a year to make up for the cost of carry, but also would potentially increase the downside risk, as both EMFX and the AUD are “risk off” currencies, and during situations like the GFC the fall in the AUD would offset the decline in local currency bond values. This is shown in Figure 6.

Figure 6. The AUD investor experience versus a 100% USD perspective

JPM GBI-EM Global Div Index Drawdowns | Unhedged vs USD/AUD hedged



Source: JPMorgan, Mercer

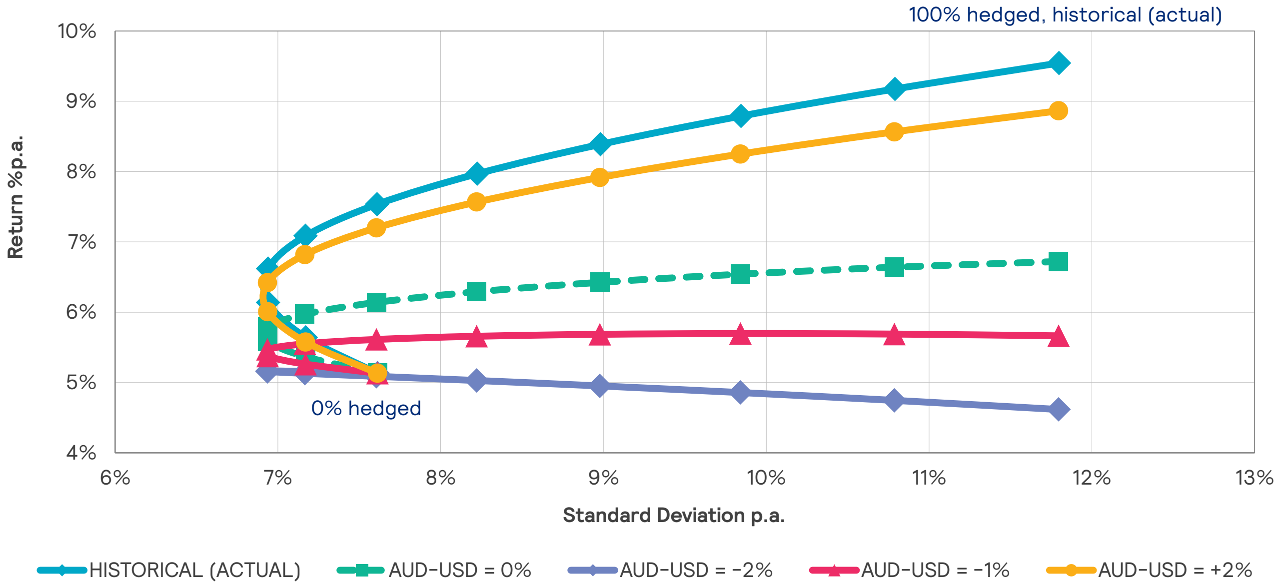
WHAT OTHER FX APPROACHES CAN BE ADOPTED BY AUSTRALIAN INVESTORS?

An intuitive outcome of the above, if hedging the EMFX to AUD is too costly, is to introduce a USD/AUD hedge (short USD and long AUD through FX forwards) instead. This brings the investment closer to that of a USD investor and hence arguably the way the manager manages the portfolio. Indeed, this would be further supported by the fact that Australian interest rates have in the past typically been higher than US interest rates and one would have been paid to hedge.

However, if the AUD is correlated to EMFX and therefore translated back offsets the EM currency risk, then installing an USD/AUD hedge is basically taking an active currency position on the USD, and thus increases risk. Figure 7 shows historic evidence. Note, at 30% hedged, returns have historically increased with risk slightly lower/ stable. The current condition however is that US interest rates are higher than Australian interest rates, and consequently the addition of a USD/AUD hedge results in the negative carry (shown in the 0%, -1% and -2% carry environments in Figure 7), if the Fed continues raising and the RBA stays on hold.

Figure 7. The AUD investor EMD experience – past and future(?) environments

JPM GBI-EM Global Div return versus Standard deviation (annualised) (Jan-03 to Jun-18) | Different AUD-USD cash rate differentials



Source: Bloomberg, JPMorgan, Mercer

CONCLUSIONS

In this paper, we have sought to address the different issues faced by AUD investors compared to USD investors in investing in EMD. Specifically, we have sought to address the issue of the one-size-fits-all approach or EMD given the correlation in currency between EMFX and AUD and the different implications it has for Australian investors.

In a "typical" environment where Australian interest rates are higher than US interest rates (as we have higher inflation targets), hedging the USD/AUD would be intuitive as this could increase the level of expected return, although at an increase in risk. Historical experience suggests a 30% hedging point could reduce risk and increase return. In the current environment however, the carry between Australia and the US is negative and consequently adding a USD/AUD hedge to a local currency EMD investment reduces the expected return and potentially increases risk.

Consequently, our findings suggest that leaving EMD investments unhedged for Australian investors is preferred at this point in time. However, in an environment whereby AUD rates are substantially higher than USD rates again, a (partially) hedged allocation could potentially become beneficial.

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