



Colchester®
GLOBAL INVESTORS

The Case for Local Currency EM Debt

May 2025





Emerging Market (EM) local currency bonds performed strongly in 2024. The benchmark, as measured by the JP Morgan GBI-EM Global Diversified Index, returned 7.6% in Australian dollar unhedged terms. Although the first four months of 2025 has seen a deluge of geopolitical, and economic news, performance has continued to be strong, with the index up 4.2% in Australian dollar unhedged terms, exceeding both Australian government bonds and the equity market¹. Despite these strong returns, the asset class continues to offer attractive real yield potential, and EM currencies remain undervalued against both the Australian and US dollars, all underpinned by robust EM fundamentals. These positive factors are likely to deliver favourable returns going forward.

Performance Year to Date

After such a good year in 2024, it is perhaps surprising that year to date benchmark returns at +4.2% have been as strong (Table 1) given the recent turmoil in financial markets. A number of favourable factors drove returns in 2024. Early and assertive measures by EM central banks in 2021 and 2022 in response to the inflation shock increased their credibility with investors and put them in a position to begin the easing cycle ahead of Developed Markets (DM), see Chart 1. As the disinflation process became more visible and entrenched in EM markets this gave room for EM central banks to begin lowering interest rates in 2023 and 2024, propelling positive bond market returns. A strengthening in their currencies on the back of high short term real interest rates and a rebound from deeply undervalued territory also added to returns in 2024. The positive returns to date in 2025 have again been driven by sustained gains on the bond side and further incremental currency gains against the Australian dollar.

Table 1: Year-to-date Returns to end April 2025

	Currency	2024	2025 YTD Return
JP Morgan GBI-EM Global Diversified (unhedged)	AUD	7.58%	4.21%
FTSE World Government Bond Index (hedged)	AUD	1.23%	2.02%
Bloomberg AusBond Composite	AUD	2.93%	3.01%

Source: Bloomberg and FTSE. Year to date return from 31 December 2024 to 30 April 2025.

The Potential Return Outlook

In considering the outlook for the asset class it is useful to break expected future returns into the return one may receive on the underlying asset, i.e. EM bonds in this instance, and the return associated with the likely direction of the currencies in which those assets are denominated, i.e. the basket of EM currencies associated with those bonds. Both elements contribute to the potential total return. We consider each in turn from the perspective of an Australian dollar-based investor.

Potential Emerging Market Bond Returns:

Inflation and Real Yields in Emerging Markets

In Colchester's investment framework, the prospective real yield is a key indicator of value. Historically, bond markets in those countries with higher relative real yields have generated better returns than those with lower real yields. Accordingly, after adjusting for the robustness, or otherwise, of a country's balance sheet, and the strength and quality of governance and

¹ The local AUD returns of the Australian Government bond component of the FTSE-WGBI returned +3.3% and the S&P ASX returned -0.4% over the same period to end April 2025.

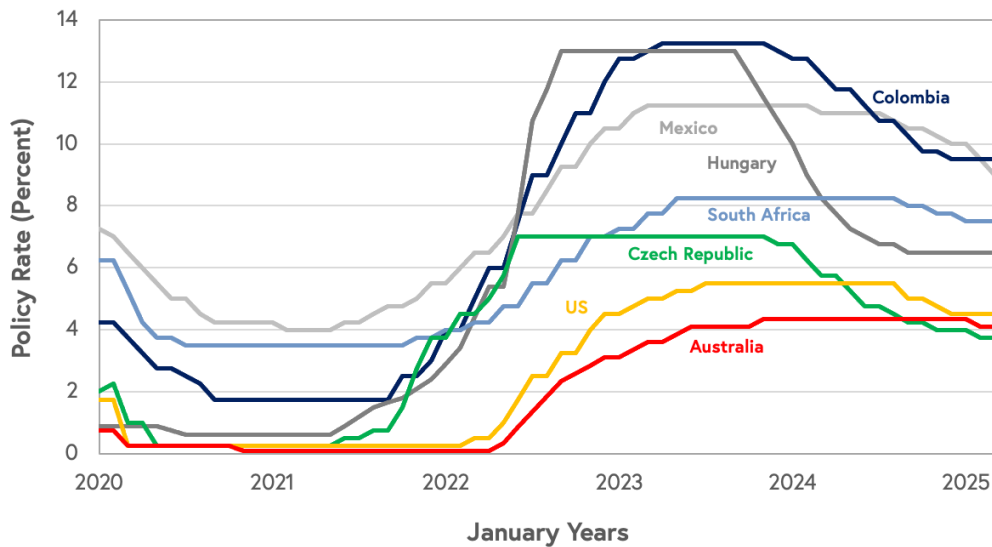


other ESG factors, we are drawn to countries with higher (adjusted) real yields. As the future ex-post real yield is unknown, we focus on the outlook for inflation to determine our estimates of ex-ante or prospective real yields on offer.

Towards this end, inflation in the emerging world was buffeted over the last 3 to 4 years by the same supply and demand shocks that the developed world was exposed to. Like elsewhere, there was a surge in inflation in response to the post-pandemic supply chain disruptions, the subsequent demand shock driven by aggressive stimulus, and elevated food and energy prices. Latin America and Central Europe were particularly hard hit, while the experience in Asia was more mixed². As global inflation pressures have receded, inflation has declined in a number of emerging markets at a similar, if not faster pace, than that seen in some developed markets. Most notably this decline has been seen in Latin America, in economies such as Mexico and Chile, where inflation has been on a clear downward trajectory after peaking in 2022.

The disinflationary process underway in many of the major Emerging Markets is hardly surprising given the pace and scale of the monetary policy tightening that was undertaken. Not only were many EM Central Banks more conservative than their DM counterparts in response to the Covid shock, as noted earlier they also were much more aggressive in tightening policy in the face of the deteriorating inflation outlook. In Mexico and Colombia for example, the respective central banks commenced rate increases some 12 months before the US Federal Reserve (see Chart 1). This put them in a stronger position to begin easing sooner as inflation declined.

Chart 1: The Evolution of Central Bank Policy Rates



Source: Respective Central Bank sources, Bloomberg, Colchester Global Investors. Data from January 2020 to end March 2025.

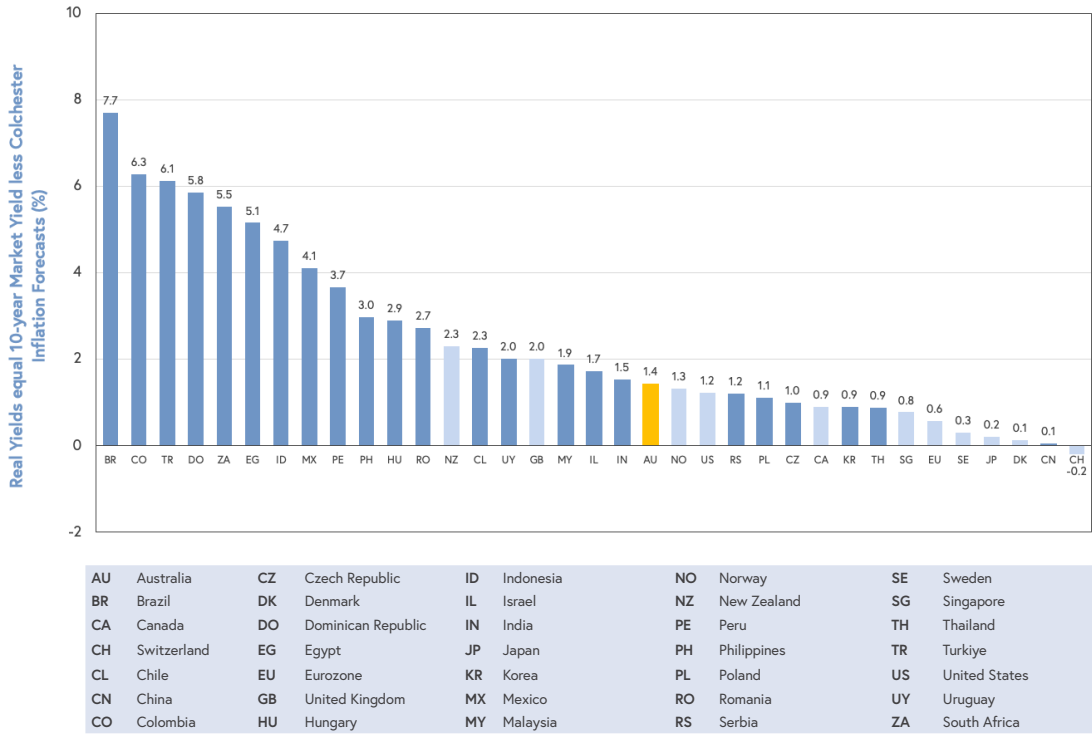
However, both emerging and developed market economies now face considerable uncertainty as the global economy adjusts to the US Administration's new tariff and trade policy. There is considerable uncertainty about the size, duration and coverage of the proposed tariffs, and therefore the potential impact on global growth and inflation. Nonetheless the first-round impact is likely to be inflationary, akin to a supply shock. The US is likely to see the largest move up in inflation as the tariffs on imported goods into the US will be passed through (to various degrees) to the end consumer. The direct impact outside the US is less clear, as in the absence of new or retaliatory tariffs on US exports there is no immediate impact on price levels in those countries.

² Inflation topped 25% in Hungary and rose to around 18% in Poland and the Czech Republic. The likes of Colombia, Brazil and Chile fared a little better, peaking somewhere between 12% and 14%, while Mexican inflation peaked in line with the US at around 9%. In contrast, Indian inflation hardly deviated from its norms, Chinese inflation peaked at 3% and Indonesian and South Korean inflation peaked around 6%. In comparison, Australian and Canadian inflation peaked around 8%, Swedish around 12%, the UK 11%, the Eurozone 10%, Norway and New Zealand 7%, and Japan 4%.



Given the current environment we are confronted by greater complexity than normal when considering the outlook for inflation. Nonetheless, we believe that the inflation outlook has deteriorated more in the US relative to the rest of the world. We also see some upward pressure across Latin America and in other countries that are more exposed to the US economy. Nonetheless, our forecasted inflation in the likes of Mexico, Brazil and Colombia, is contained relative to previous shocks that have negatively impacted on the Latin American continent. In contrast, we see this as a disinflationary shock for China. Those countries across Asia and elsewhere more integrated with China are also likely to see little to no additional inflation pressure.

Chart 2: Prospective Real Yields on Offer in the Emerging and Developed World as at April 2025



Notes: 1. The prospective real yield for the 10 year sector is shown here for representational purposes. Colchester values up the 2, 5, 10 and 20 year sectors of the yield curve when valuing a country. The final portfolio reflects the value on offer in these individual yield curve points. 2. The expected real yield for Euroland is calculated based on the 10 year German Bund yield and the Colchester forecast for inflation in the Eurozone. 3. Source: Colchester Global Investors, individual Central Bank CPI and PPI data, and Bloomberg.

Notwithstanding this evolving inflationary picture, real interest rates remain high in a number of EM countries compared to those in the developed world. This makes those markets attractive not only in absolute terms, but also relative to their developed world counterparties, including the Australian bond market. This can be seen in Chart 2 showing Colchester's prospective real yield estimates as at the end of April, which incorporates our initial assessment of the inflationary impacts of the US tariffs. It is evident that the real yields on offer within a diversified basket of the emerging countries on the lefthand side of the chart are significantly more attractive than those on offer in most DM countries. All else being the same this suggests EM bonds have greater potential to generate higher returns going forward than those in the DM universe, including Australia. This should make EM bonds attractive to an Australian investor.

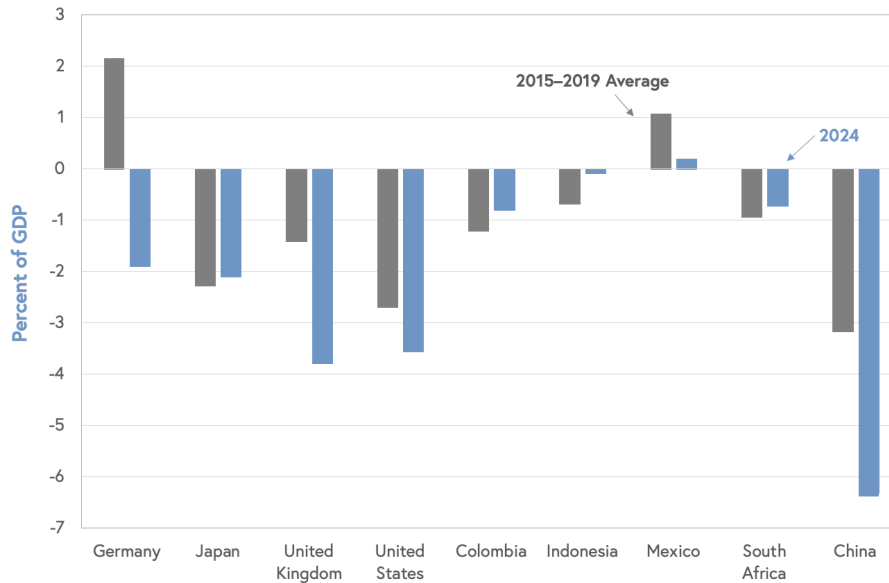
Emerging Market Favourable Fundamentals

Some might argue that those higher real yields are justified given a perception that EM countries have weaker balance sheets, poorer governance and worse ESG factors than the DM world, and the higher real yields simply reflect a higher risk premium. In simple terms, countries with stronger balance sheets, better governance, greater respect for property rights, better educated



healthier workforces and higher social and environment standards etc. typically generate better economic outcomes and are more likely to pay their debt. We at Colchester agree that all these factors matter and explicitly integrate them into our investment valuation framework. Where we would disagree with the view that the higher real yields are justified, is in the interpretation or analysis of the current state of balance sheets, governance and other ESG factors in the emerging world today. EM balance sheets in particular are more robust than many perceive.

Chart 3: Pre and Post Covid Primary Fiscal Balance in a Selection of Countries in the Developed and Emerging World



Source: Colchester, IMF World Economic Outlook Database April 2025.

Note: The government primary fiscal balance is defined as the overall fiscal balance excluding net interest payments.

Over the past three decades or so there has been a 'silent' structural shift in the fundamental creditworthiness and balance sheet strength of many countries still defined as "emerging economies". Many of those countries that once pursued unorthodox policies and lived with the subsequent economic disruption and capital market dislocation that followed, reformed their ways some two or more decades ago, and instead have become paragons of economic virtue in comparison. This is no more apparent than in the credit rating of the emerging market opportunity set that comprises the local market EM debt universe. The index is now solidly investment grade with only around 15% falling below the minimum investment grade credit rating.

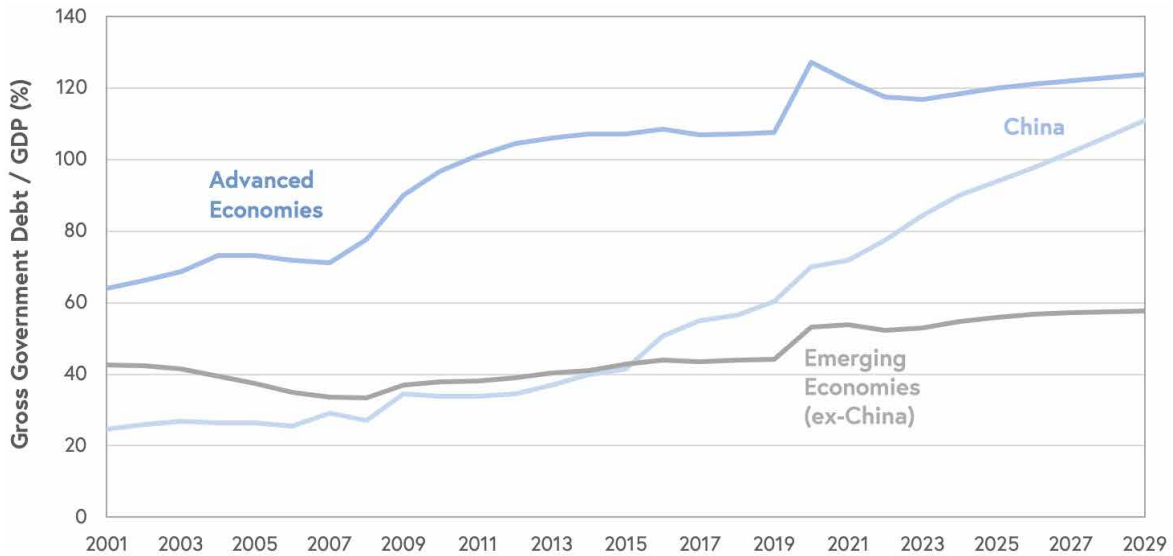
In part, there has been a bit of a role reversal as a number of advanced economies today are struggling with weak balance sheets and poor policy discipline. This was brought into sharp focus by the contrasting policy approaches taken in response to the Covid pandemic shock, and many would argue, more recently by the seemingly erratic policy making in the US in early 2025. Many emerging markets not only demonstrated proactive and assertive monetary policy action throughout the Covid pandemic and subsequent inflation shock, they also pursued more orthodox and prudent macroeconomic management than that seen in much of the DM world. This heightened the increasingly divergent fiscal and government debt paths that the developed and emerging world had been travelling along over the last couple of decades. More recently this can be seen on Chart 3 which contrasts the average primary deficit position between 2015 and 2019 (pre-Covid) with the levels in 2024 for a range of economies.

While emergency fiscal spending was widely used to cushion the Covid shock and sustain activity, many countries surprisingly have, to various degrees, maintained emergency spending levels in its aftermath. The persistence of meaningful fiscal support has been more pronounced across the developed world. Traditional economic analysis would suggest that the size and persistence of the ongoing fiscal deficits in the developed world have been inconsistent with the resilience and level of



economic activity in those countries. Such pro-cyclical fiscal policy has led to a further build-up of debt in those countries, ironically at a time when their central banks were trying to cool the economy. In contrast, as is plainly evident in Chart 3, many emerging markets were more prudent in response to the pandemic shock and quickly returned to more balanced fiscal policies in its aftermath. Relative debt levels have responded accordingly.

Chart 4: Emerging and Advanced Economy Government Debt, Percent of GDP

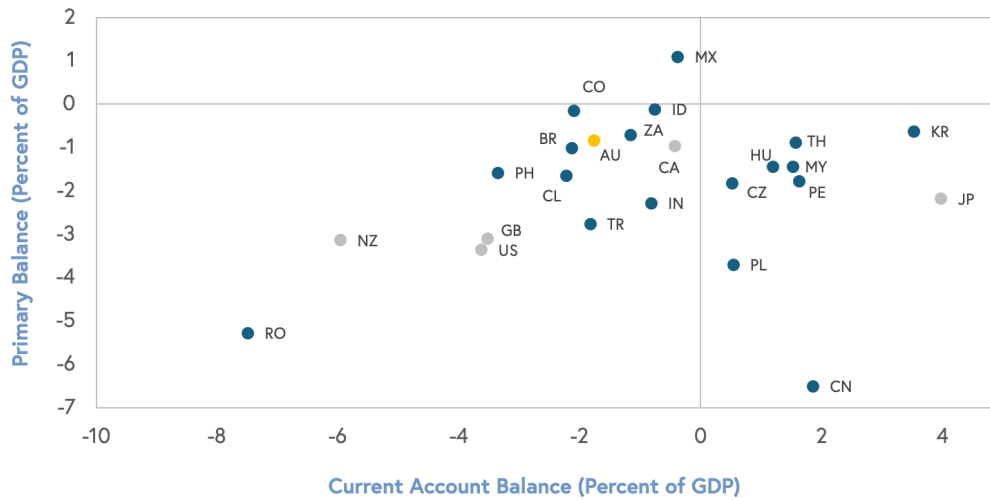


Source: IMF Fiscal Monitor. Latest available as of 2024, later are forecasts.

This paradox can also be seen in the evolution of government debt levels in each group since 2000. This is visibly apparent on Chart 4 which shows the average debt levels for advanced economies, China, and emerging economies ex-China. It may surprise some that the emerging markets as a group (excluding China) have been much more effective than their DM counterparts at controlling debt levels over the last two to three decades. It can clearly be seen that not only do emerging economies have much lower debt levels overall, the increase in debt has also been much more controlled. In contrast to its emerging market peers, China has seen a rapid expansion of debt over this period. Since the GFC, government debt has more than doubled in the country and this upward trend has continued in the post-Covid period.

Such relative balance sheet strength runs counter to many investors' perception that emerging market exposure is associated with economically volatile and vulnerable economies. The term itself, "emerging markets" has its genesis in the 1980s and 1990s and is associated with the creation of the so called "Brady Bonds," the "Mexican Tequila Crisis," and the "Asian Bond Crisis". However, some 30 to 40 years later, many of the countries at the epicentre of those events: Mexico, Thailand, and Indonesia etc., have transformed into solid investment grade countries. They have addressed their vulnerabilities and built a track record of pursuing orthodox macroeconomic policy. Today, all have credible independent central banks, maintain flexible currency regimes, have built a domestic savings industry, and fund themselves domestically in local currency. The "Frontier Markets" of today – the likes of Sri Lanka, Egypt, Kenya, etc. – have characteristics more akin to the emerging markets of the 1980s and 1990s, and in many respects, they may be thought of as the emerging markets of yester-year. In our opinion, the term itself "emerging markets" is a misnomer given the structural shift that has occurred over the past three decades. The countries still commonly referred to as "emerging markets" today may be better thought of as investment grade local currency markets.

Chart 5: Fiscal and Current Account



AU	Australia	CZ	Czech Republic	ID	Indonesia	NO	Norway	SE	Sweden
BR	Brazil	DK	Denmark	IL	Israel	NZ	New Zealand	SG	Singapore
CA	Canada	DO	Dominican Republic	IN	India	PE	Peru	TH	Thailand
CH	Switzerland	EG	Egypt	JP	Japan	PH	Philippines	TR	Turkiye
CL	Chile	EU	Eurozone	KR	Korea	PL	Poland	US	United States
CN	China	GB	United Kingdom	MX	Mexico	RO	Romania	UY	Uruguay
CO	Colombia	HU	Hungary	MY	Malaysia	RS	Serbia	ZA	South Africa

Source: IMF World Economic Outlook, April 2025. Data uses average of 2023, 2024 and IMF forecast for 2025.

Note: DM in grey, EM in blue.

At Colchester, we always assess countries' balance sheet strength to give an insight into how they can withstand external shocks (in this instance sustained US tariffs and a broader dislocation in economic activity). We anticipate countries with stronger balance sheets will fare better in this environment. Specifically, those with strong external positions, with current account surpluses, and positive or near balanced net international investment positions (NIIP) are likely to withstand the shock better. Similarly, those with greater fiscal room may have the ability to support negatively impacted sectors and promote a reallocation of resources and labour. Rather than retaliating directly with reciprocal tariffs, countries that can afford to do so may be more inclined to respond with increased fiscal spending, supporting and promoting affected sectors. Chart 5, providing an overview of both the fiscal and external balances for a selection of EM and DM countries, suggests a number of EM countries have stronger relative balance sheets and therefore potentially have greater capacity to absorb an external shock. Furthermore, when we consider how open EM countries are to trade, and what proportion of their trade is with the US, we see little difference in the landscape to that when we survey the DM world. It is varied in both, with little meaningful difference between the two. For example, Germany's and Sweden's total exports at around 50% of GDP are only marginally lower than the average of 60% seen in Thailand and Poland. Similarly, the direct export exposure of Mexico to the US is like that of Canada at some 80% of total exports.

This underappreciated absolute and relative balance sheet strength and changed structural characteristics underpinning the countries deemed to be included in the EM opportunity set suggests that the immediate assumption that EM exposure equates to higher risk is no longer valid. Rather the picture is more nuanced, and the higher relative and absolute real yields on offer in the local currency debt space are more likely to be an opportunity, rather than a reflection of heightened risk. Undoubtedly higher nominal interest rates make debt servicing costs higher in a number of EM countries compared with their DM counterparts, and there may be heightened volatility in the some 15% of the index that is below investment grade – namely Brazil, South Africa, Dominican Republic and Turkey – nonetheless investors in the local currency debt asset class should take some comfort that the vulnerability in the likes of Poland, Indonesia, and even Mexico where gross government debt sits around 55% of GDP for example, is significantly less. Accordingly, the higher real yields on offer in those markets



is likely to be a structural tailwind for emerging market local currency bond returns over the medium term, enhancing the attractiveness of the asset class.

Potential Emerging Market Currency Returns

The second potential driver of returns is the currency element. In simple terms, if the basket of currencies associated with the foreign assets held (in this case EM currencies) is expected to appreciate against the domestic currency (i.e. the Australian dollar) then this provides a further structural tailwind for returns in the emerging market bond asset class³. The converse also holds true.

When thinking about the potential return, volatility and correlation characteristics in the emerging market space, asset allocators often focus on the return profile in unhedged US dollar terms. In part this is a quirk of history as both EM bond and equity returns have traditionally been reported in US dollar terms. Whilst that may be relevant for a US dollar-based investor, it is not the case for other investors "denominated" in their base currencies. What's relevant for an Australian dollar-based investor for example, is the return profile, volatility and correlation characteristics of the asset class in Australian dollars.

Furthermore, the potential impact of US dollar strength on the highly rated emerging markets that comprise the standard local currency bond opportunity set has diminished. To the extent that US dollar strength often coincides with a tightening of global financial conditions that puts pressure on those emerging and frontier economies with weaker balance sheets, running sustained current account deficits, or dependent upon foreign capital, then the cycle in the US dollar is relevant. The corollary of US dollar strength is counterparty currency weakness that potentially places upward pressure on inflation and prompts a deterioration in credit quality in those countries. Whilst this mechanism plays out to various degrees across developed, emerging and frontier markets alike, it primarily impacts those countries with weak balance sheets, dependent on foreign capital, or funding themselves in US dollars.

Whilst clearly a continuum, the structural changes discussed above suggest that the emerging market local currency bond opportunity set is not as vulnerable to swings in the US dollar as it once was, particularly as their dependency on US dollar funding has reduced dramatically. Today, on average approximately 85% of government debt in the EM opportunity set is funded in domestic currency and of that, some 80% is held by local investors domiciled in those markets. The risk of capital flight is significantly reduced in these circumstances. Furthermore, the deepening of domestic savings industries in these countries has produced natural buyers of domestic debt that view their own government bond market as the risk-free asset. Gone are days when those investors would view US Treasuries as their risk-free asset. Today, for example, the risk-free asset for a Chilean or Thai pension fund is a Chilean or Thai government bond denominated in Chilean peso or Thai baht.

Similarly, the transmission of US dollar strength into domestic inflation is partly a function of income levels and the percentage of food, energy and other necessities in each country's consumer price baskets. Countries at the lower end of the emerging spectrum and those in the frontier markets tend to have lower incomes and greater exposure to these essential goods prices, thereby exposing them to greater imported inflation volatility. While still exposed to the potential pass-through of currency depreciation into inflation, the declining proportion of "essentials" in the consumer baskets and rising incomes has reduced the vulnerability of many of the countries in the EM opportunity set. This declining sensitivity can be seen in the rising income level within the EM debt space. In the approximate 20 years since inception of the local currency debt index in 2003, the percent of Low and Lower Middle-Income countries in the index has dropped from 35% to 2%, and the proportion of High-Income countries has increased from zero to 23%⁴. This is consistent with the improving balance sheet and creditworthiness trend discussed above.

³ If all foreign assets are hedged back into the domestic currency, then the potential for positive or negative currency returns is negated.

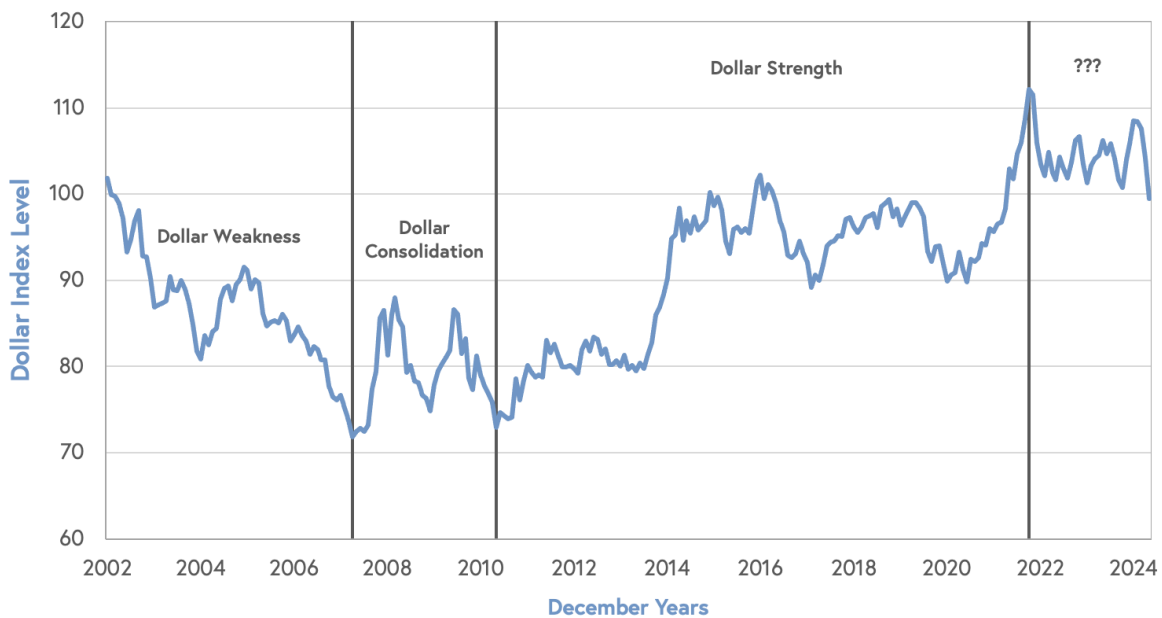
⁴ Source World Bank Income definitions. The comparison uses December 2002 and July 2024 data.



To the extent that the direction of the US dollar still matters for some currencies in the EM debt opportunity set, it is useful to consider where it currently is in the valuation cycle. If it is overvalued and expected to decline over the medium term, then the potential balance sheet and inflation pressures discussed above are likely to be less pressing. Since the inception of the EM local currency debt index, there have been three distinct episodes in the US dollar, (1) the depreciation in the first seven to eight years of this century, (2) the major appreciation that took place from 2011 to 2022 (even though this extended upward trend in the Dollar did see periods of weakness in 2017 and 2020) followed by a further post-covid lift, and (3) a period of consolidation over 2008-2011, (See Chart 6).

To determine the current valuation of the US dollar we turn to an assessment of the real exchange rate. Historically this has proved to be a useful metric with which to assess the relative value of currencies over the medium term and underpins our currency valuation framework at Colchester. Our current assessment of the real value of the US dollar suggests that it may have peaked towards the end of 2022 and may now be at the beginning of another cycle of US dollar depreciation, similar to that seen in the early 2000s. Colchester estimates that the US dollar reached an overvaluation in real terms of close to 30% against an equally weighted basket of five major developed world currencies⁵ in late 2022. Whilst the US dollar has weakened a little since then, it has remained at extremely overvalued levels throughout 2024 and into early 2025, according to our real exchange rate analysis. Assuming, as the weight of historical evidence suggests, this super-cycle in the US dollar is likely drawing to a close, and the probability of a retracement back towards fair value is increasing, then the inflationary and balance sheet pressures that may have been a structural headwind for some emerging markets are likely to ease, if not reverse. In these circumstances, the risk of further US dollar strength negatively impacting on emerging currency returns is reduced, leaving fundamental valuations to drive currency returns going forward.

Chart 6: Cycles in US Dollar Exchange Rate



Source: Dollar Index from Bloomberg, Colchester Global Investors. Data from December 2002 to end April 2025.

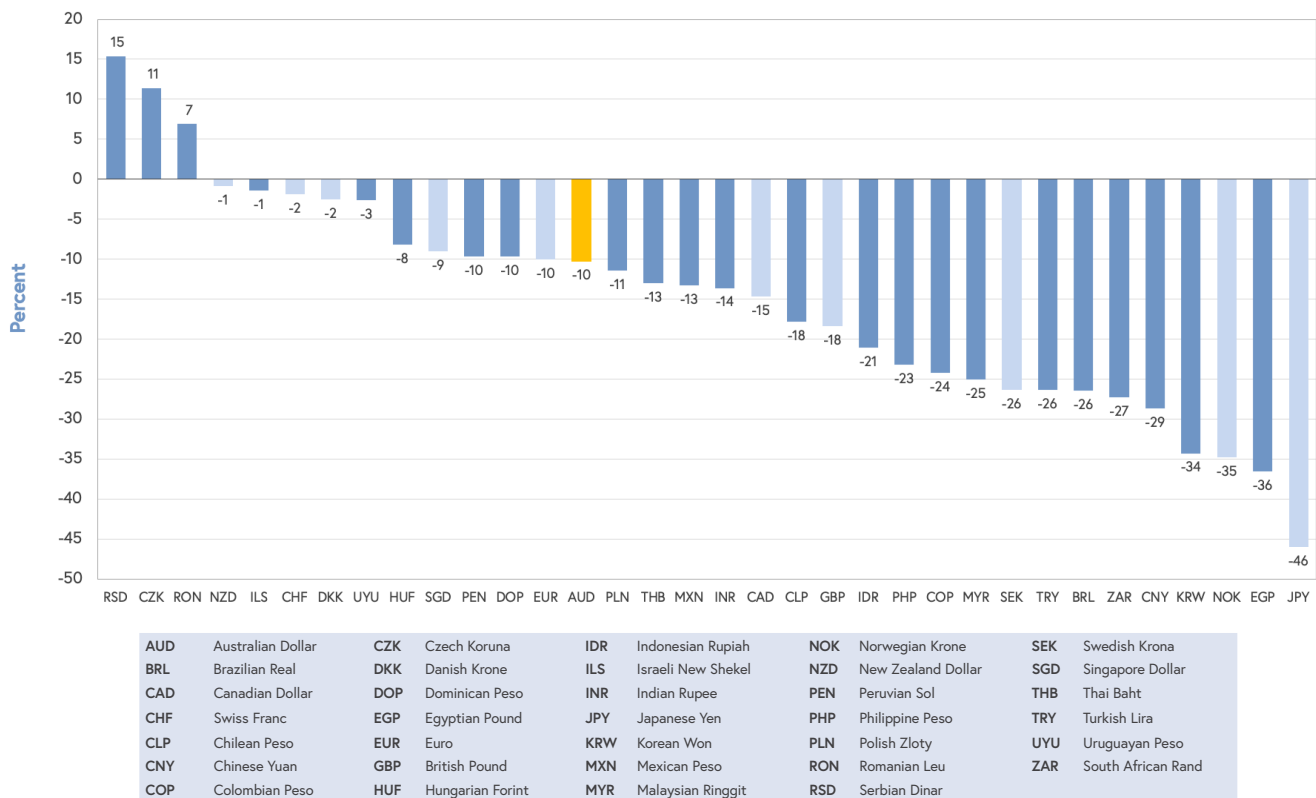
⁵ The Euro, British pound, Japanese yen, Canadian dollar, and Norwegian krone.



Notwithstanding the point that the current over-valuation of the US dollar reduces the likelihood of further appreciation increasing vulnerabilities in the emerging currency space, the current valuation of these currencies against the Australian dollar is more relevant for an Australian dollar-based investor. Should EM currencies be undervalued against the Australian dollar, it would suggest the potential for positive future currency returns as those currencies appreciate towards fair value against the Australian dollar.

Chart 7 shows real exchange rate estimates for both developed and emerging world currencies as at the end of April 2025. Whilst the Australian dollar was undervalued on this metric against the US dollar, it is overvalued against a range of DM and EM currencies to its right on the chart. An equally weighted basket of EM currencies is undervalued relative to the Australian dollar by some 10% in real terms. This suggests EM currencies are more likely than not to appreciate against the Australian dollar over the medium term, providing a potential return tailwind for unhedged EM denominated assets. At the very least it suggests that any positive bond returns, being delivered by the higher real and nominal yields on the bond side of the EM local currency debt asset class, are unlikely to be eroded by EM currency weakness over the medium term. Additional gains also may be sourced by exposure to a range of emerging currencies that are more undervalued versus the Australian dollar than the average.

Chart 7: Real Exchange Estimates Versus US Dollar as at end April 2025



Source: Colchester Global Investors, individual Central Bank CPI and PPI data, Bloomberg and WMR.



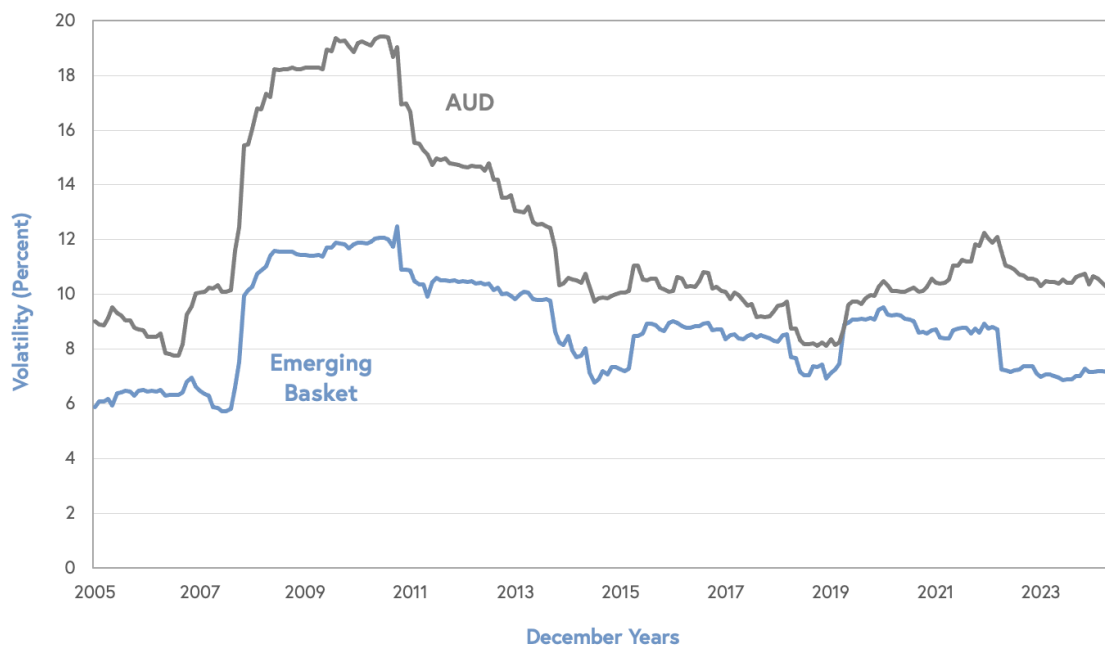
Comparing Apples and Oranges in the Asset Allocation Decision

In the same way that investors need to assess potential EM currency returns against their own domestic currency, they also need to consider the volatility and correlation characteristics of the asset class relative to their own currency. Whilst instinctively investors tend to think of EM currencies as being highly volatile, that assessment needs to be considered relative to the volatility of the investor's home currency. Here too, things may not be as many perceive.

The Australian dollar itself is highly volatile given the perception that it is underpinned by the country's commodity base. As such it is exposed to some of the same commodity price fluctuations that impact upon the likes of the Colombian peso, South African rand and Brazilian real. Notwithstanding those commodity-based currencies such as these that are within the EM opportunity set, there are a number of countries like Poland, Thailand and others, that have little to no commodities. This produces an interesting result when comparing the volatilities of the Australian dollar and EM opportunity set versus the US dollar. As shown in Chart 8, the varied economic characteristics of the countries in the full EM opportunity set, results in it being less volatile than the Australian dollar over time. It may surprise some that this measure suggests the Australian dollar is riskier than a diversified basket of EM currencies⁶.

The lower volatility observed in the second half of the period most likely reflects the more benign environment that prevailed in the aftermath of the Global Financial Crisis and through the "Covid shock" – a period characterised by abnormally low interest rates, pro-active policy intervention and rising asset prices. Nonetheless the Australian dollar still exhibited higher volatility through the earlier, more "normal" period associated with more orthodox policies and greater cyclical economic variation. Given the increasing divergence in economic growth and inflation, potential trade dislocation and varying monetary and fiscal policy paths observed around the world we are likely to be entering a period of higher volatility going forward. An environment more like the early 2000s and the 1990s.

Chart 8: Rolling 3 Year Volatility of EM Currency Index and Australian dollar versus the US dollar



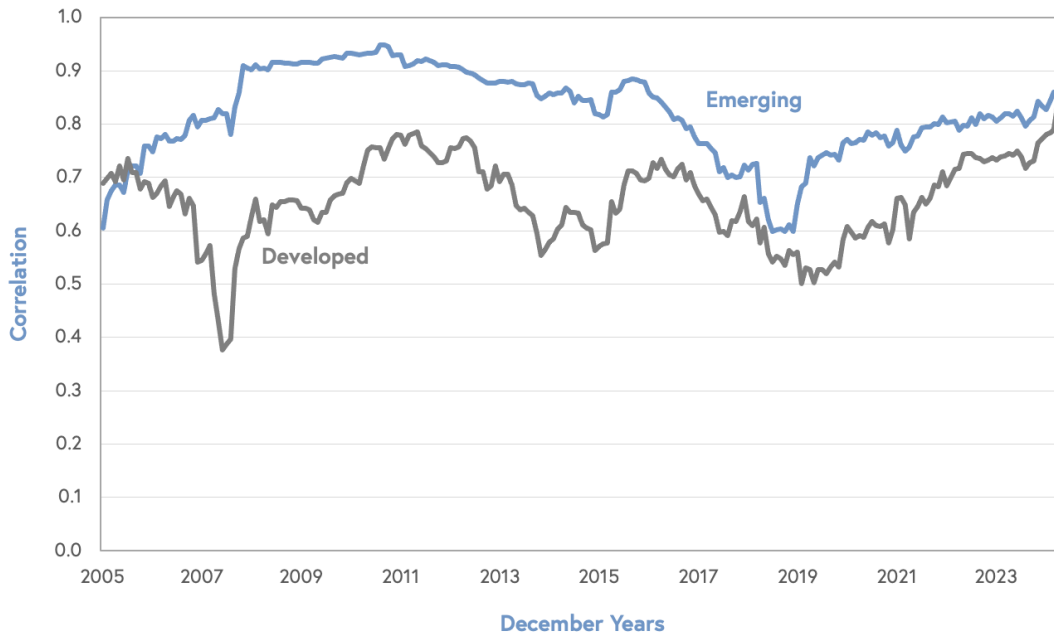
Source: JP Morgan, Bloomberg, Colchester. Data from December 2005 to end April 2025.

⁶ If looked at the other way round, from an Australian dollar investor's point of view, the EM basket is less volatile than the US dollar.



Notwithstanding the diversification inherent in the EM index, given the Australian dollar's correlation with some of the more volatile "commodity currencies", it should not be surprising that it is also highly correlated with the aggregate EM currency basket (see Chart 9)⁷. Notably the Australian dollar is more correlated with the EM currencies in the EM local currency bond index than those currencies in the Developed World global bond index, although the historical difference has diminished.

Chart 9: Australian Dollar Correlation with the Currencies comprising the EM and DM Bond Benchmarks



Source: FTSE, JP Morgan, Bloomberg, Colchester. Data from December 2005 to end April 2025.

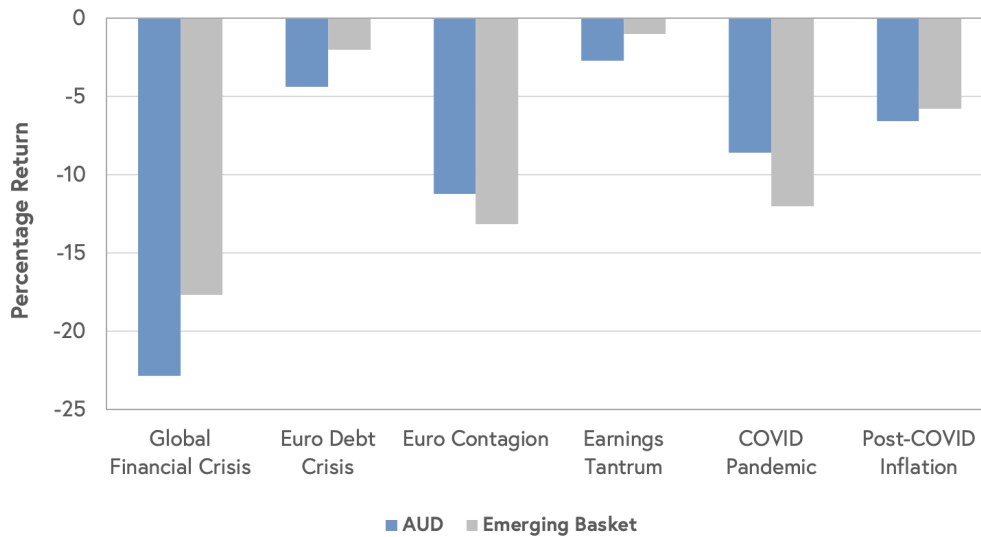
Producing Some Counter Intuitive Outcomes

As the Australian dollar is a more volatile currency compared with its developed market peers, and is more highly correlated with EM currencies, this has resulted in unhedged Australian dollar EM debt historically performing better at times of Australian dollar weakness and market stress. Since the inception of the JP Morgan GBI-EM Global Diversified Index in 2003, the Australian dollar has fallen over a calendar year against the US dollar by more than 1% on ten occasions, averaging a -9.1% decline. Only in three years did unhedged EM local market bond returns fall in Australian dollar terms, declining on average of -3.6% on those occasions. The other seven times EM bonds delivered an average positive return of +9.1%. Many may be surprised to learn that EM local currency debt has produced notable positive returns, in Australian dollar terms, when the Australian dollar has been under pressure. To the extent that Australian dollar weakness may be associated with broader "risk-off" or other country specific or global shocks, perhaps paradoxically, EM bonds have historically been a useful diversifier of risk and delivered positive returns for Australian investors at that time.

⁷ In both instances some specific EM currency volatilities and correlations with the Australian dollar are higher or lower. For example, the 3-year volatility of the Australian dollar versus the US dollar at the end of April 2025 at 10.0% compared with the South African rand at 12.1%, the Thai Baht at 11.0% and the Malaysian ringgit at 9.6%.



Chart 10: Movement in the Australian dollar and EM Index Currencies Against the US dollar at Points of Stress



Source: Bloomberg, JP Morgan, Colchester. Shock dates: Global Financial Crisis Jun-07 to Feb-09, Euro Debt Crisis May-10 to Aug-10, Euro Contagion May-11 to Sep-11, Earnings Tantrum Oct-18 to Dec-18, COVID Pandemic Feb-20 to Mar-20, Post-Covid Inflation Mar-22 to Dec-22. The Post-Covid Inflation Mar-22 to Dec-22, is not a true financial shock and covers only a 2-month period but is included as a reference point.

The interplay between the Australian dollar and EM currencies can also be seen in Chart 10. Here we assess the movement in the Australian dollar and index weighted EM currencies against the US dollar at times of stress. Over the period since the inception of the EM local currency bond index, we can identify six shocks that roiled financial markets to early 2025. Four times the basket of EM currencies fell less than the Australian dollar against the US dollar over the "stressed" period, outperforming the Australian dollar on average by +2.6%. The historical data suggests that more often than not, an Australian dollar-based investor would have done better at these times of stress by holding a diversified basket of EM currencies rather than the Australian dollar⁸.

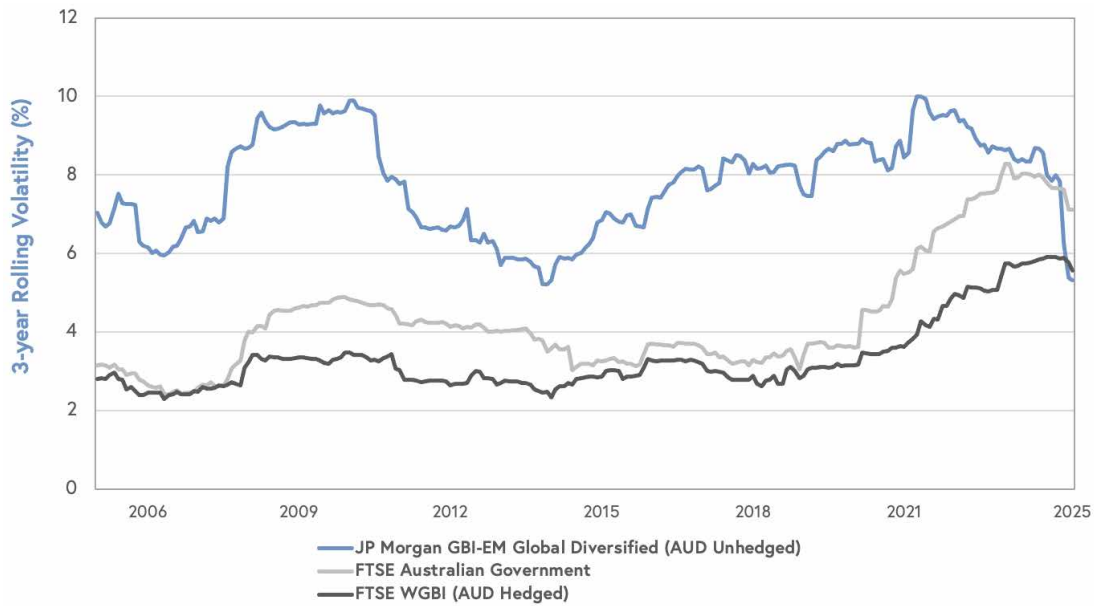
The Aggregate Diversification Characteristics of the LMD Asset Class

Combining both the varied nature of the underlying bond markets and the currencies that comprise the standard emerging market index may provide Australian dollar-based asset allocators with a potentially interesting return and diversification opportunity. The unhedged currency element suggests on average volatility should be higher than traditional defensive sovereign bond allocations such as those to Australian or hedged Global government bonds. Broadly speaking this has been the case, as seen in Chart 11 showing 3-year rolling volatility of all three bond benchmarks since the mid-2000s. The volatility of local currency EM debt has averaged around 8% in Australian dollar terms over this period. This compares with an average of some 3% to 4% for the two alternative traditional defensive bond allocations in the "abnormal years" that characterised the post-GFC and run up to COVID. Volatility has unsurprisingly risen post-Covid in response to the re-setting of interest rates and return to orthodox policy approaches and more normal economic cycles. Somewhat surprisingly this adjustment has had a greater impact on DM world debt as seen in the rise in the Australian government bond market volatility to a similar level as that of EM debt, at around 8%. Similarly hedged global government bond volatility has also risen, albeit to lower levels around 6%. These levels of volatility contrast with the some 13% to 14% average volatility seen in the Australian equity market over the past two decades.

⁸ The hedged AUD return on the JP Morgan Global Diversified Index (i.e. the bond return) averaged +2.5% on the four occasions the EM currencies fell less than the Australian dollar against the US dollar and averaged a +0.9% return on the occasions that they fell more.



Chart 11: Three Year Rolling Monthly Return Volatility of Australian, Global and Local Currency EM Bonds in AUD terms



Source: JP Morgan, FTSE, Colchester, as of April 2025.

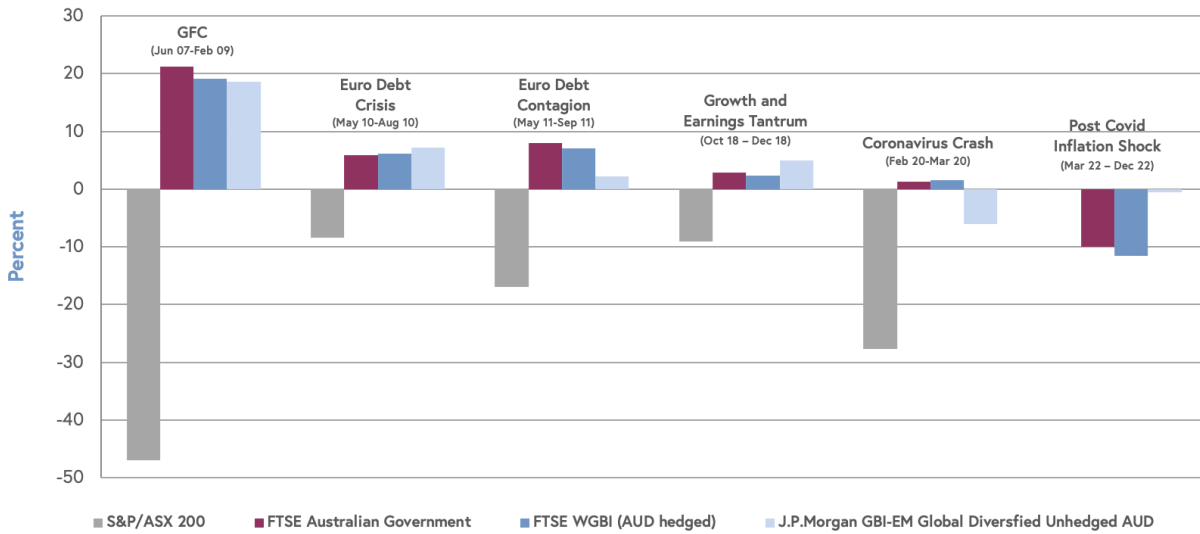
On average one would expect the volatility of the local currency EM debt asset class to be slightly higher than that of traditional defensive DM bond asset allocations. However, the historical evidence suggests that the difference may not be as large as many assume given the sovereign investment grade nature of the local currency debt space. This is also evident when one looks at how the asset class performed at times of stress. Chart 12 shows the returns of the respective debt benchmarks in response to the same six shocks identified in Chart 10 above. What is apparent is the asset class generally held its own, delivering positive returns on 4 occasions, falling in one (albeit over the 2-month Covid period), and effectively remaining flat in the other. Equally as important, it broadly shows a similar return profile to the two traditional defensive assets (Australian and hedged global bonds), and indeed outperformed both half of the time on 3 occasions.

This perhaps surprising observed return outcome at historical times of stress, combined with the convergence in volatility seen over the recent period suggests the inclusion of some EM local currency debt within a diversified portfolio may not be as large a shift in risk as many perceive. While local currency EM debt is unlikely to exhibit the same defensive characteristics as the traditional bond diversifiers, the ex-post historical evidence suggests any substitution may not undermine the defensive role as much as many believe. Accepting some dilution in this defensive characteristic opens up the possibility of accessing the potentially higher returns on offer in the local currency EM debt space.

What does all this mean for an Australian dollar-based investor?

History suggests the Australian dollar is as volatile as many of the so-called emerging currencies that investors sometimes fear. It is more volatile than the diversified basket of EM currencies that make up the index, and historically it has fallen more times than that basket against the US dollar at times of stress or financial market dislocation. Similarly, the EM local currency bond index has delivered positive returns in Australian dollars more times than not when the Australian dollar has fallen against the US dollar and at times of stress. Taken together this suggests that the risk premium for taking on EM local currency bond risk is not as large as many perceive, and perhaps counter-intuitively unhedged EM bonds may provide positive return and diversification benefits at the aggregate total portfolio level.

Chart 12: Returns through crisis periods



Source: Bloomberg, FTSE, JP Morgan, Colchester. The Coronavirus Crash (Feb 20 – Mar 20) is not a traditional financial shock and is only a 2-month period, but it is included as a reference point.

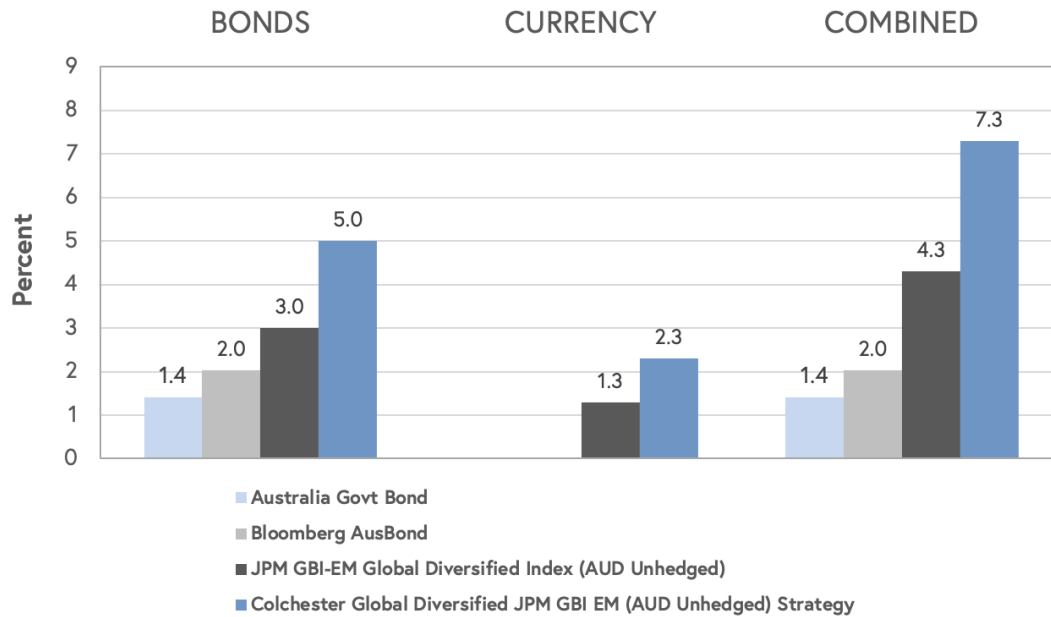
What is the Current Valuation Opportunity in EM Local Debt for an Australian Dollar Investor?

Notwithstanding the potential diversification benefits of owning EM local currency debt discussed above, a primary driver of whether to invest in the EM local currency asset class within a diversified portfolio depends on the valuation on offer. We believe that our prospective real yield and real exchange rate framework provides a useful valuation metric within which to assess potential medium-term returns. Both the benchmark and Colchester portfolio bond and currency exposures can be converted into a potential real return by multiplying their respective weights by the prospective real yield and real exchange rate on offer in each market. This provides us with an indicator of value.

Chart 13 shows Colchester's estimates of the potential "value" on offer in both the JP Morgan GBI-EM Global Diversified Index and in the Colchester Emerging Markets Bond Strategy in Australian dollar unhedged terms as at the end of April 2025. The attractive prospective real yields on offer in the opportunity set, combined with the undervaluation of emerging market currencies versus the Australian dollar, make a compelling valuation case. Notwithstanding recent global financial market volatility across a range of asset classes, the underlying trend improvement in the inflation outlook in a number of emerging market countries in conjunction with the high nominal yields on offer in those markets, suggests a prospective real yield bond return of around 3% on the benchmark, and something around 5% on the Colchester program. This contrasts with the 1.4% real return we anticipate on offer in an equivalent Australian government bond and the some 2% real return we estimate on offer in Australian credit.

As noted, our real exchange rate valuations point to the Australian dollar being somewhat overvalued relative to other currencies within the EM opportunity set. Therefore, given the real exchange rate undervaluation of EM currencies versus the Australian dollar, it suggests another 2% to 3% of intrinsic value from holding the benchmark currencies and the Colchester program respectively on the currency side. Combining both bond and currency returns suggests a potential real return of around 4% on the benchmark and closer to 7% on the Colchester program. This contrasts with the expected real return of around 1% in the Australian bond market.

Chart 13: Potential Real Value on Offer



Source: Colchester. Data as at end April 2025. Currency real value is a function of the real exchange rate and real yield differential. Currency is translated into an equivalent real yield by dividing portfolio aggregate real exchange rate undervaluation (versus the AUD) by 5. This assumes a 5-year reversion to fair value. This enables bonds and currency to be added to produce a prospective real yield for the combined portfolio. Note numbers may not add due to rounding.

Conclusion

For those investors who appreciate the significantly changed structural characteristics of the emerging markets that comprise the local currency bond space there is attractive value on offer. The name "Emerging Markets" and the biases associated with it are no longer relevant for much of this opportunity set. Many have "emerged" into solid investment grade countries. The moniker no longer fits, it is better suited to the Frontier Markets which may be thought of as "the emerging markets of yester-year". The diversity on offer across the opportunity set provides interesting diversification, correlation and return characteristics for an Australian dollar-based investor. The historical evidence directly challenges the perception that emerging markets are highly volatile, overly risky, and are likely to fall more at a time of stress.

Compelling prospective real yields, prudent monetary policy, improved macroeconomic stability across much of the EM local currency debt space, and meaningful real currency undervaluation all provide a positive backdrop for the asset class going forward. Local currency EM debt should potentially perform well in this environment, particularly if the US dollar remains stable or declines. Moreover, Colchester's assessment of the potential real return on offer in the local currency debt space is currently attractive for an Australian dollar-based investor.



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