DWS

Chart of the week

For the first time since the financial crisis, hard-currency-denominated bonds are trading at higher yields compared to their local-currency counterparts

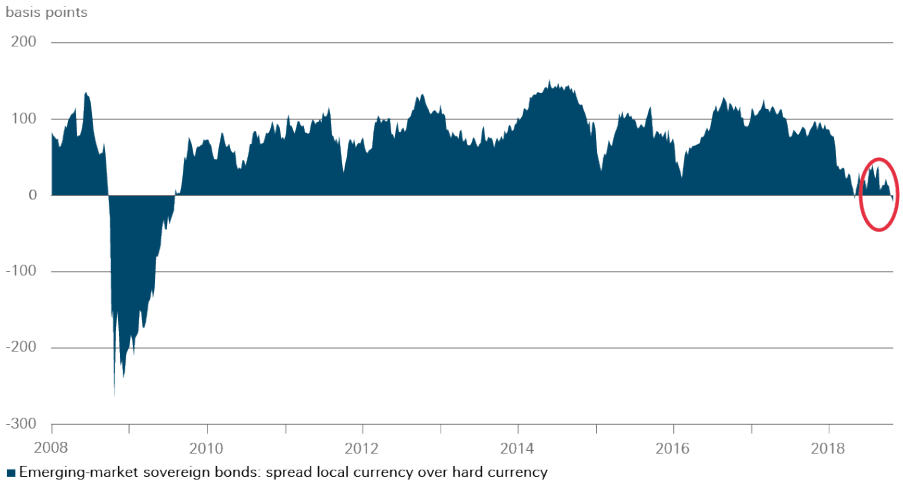
The significance of the U.S. midterm elections for financial markets is hard to overstate. This is evident from the strong short-term boost we have already seen in U.S. equities, despite some rather less benign longer-term implications. For now, though, there has been plenty of relief in capital markets after the election results came in. Emerging markets provide an interesting example for the reasons why. In recent months, investors in emerging markets have become increasingly concerned about a stronger U.S. dollar or stronger increases in U.S. interest rates. Such concerns were somewhat alleviated, now that Donald Trump will no longer easily be able to put together large, deficit-financed economic-stimulus packages without seeking bipartisan compromises first. (see CIO Flash - The midterm verdict is in) Such political bargaining takes time, at the very least. This should reduce U.S. debt issuance and perhaps ease pressures on the U.S. Federal Reserve in quickly raising interest rates.

All this makes it worthwhile to take a closer look at emerging-market bonds. Investments in emerging-market fixed-income securities come in various forms. On the one hand, there is the choice of issuer. Besides sovereign bonds, there are securities issued by private-sector entities, usually from emerging-market corporates. On the other hand, there is the choice of currency: Often, the same issuers issue bonds in both domestic and foreign currencies. So, this offers the choice between bonds denominated in external currency, typically the likes of the dollar or euro (often also referred to as "hard" currency); alternatively, there are bonds issued in local currency, like the Indonesian rupiah or Turkish lira.

Usually, bonds in local currency offer higher yields. This partly reflects inflation rates, which tend to be higher in emerging economies. So, all else equal, a local-currency bond needs to offer a higher nominal yield simply to retain the purchasing power of the money invested. Looking at data from the International Monetary Fund, consumer-price inflation currently runs at about 5%, on average, in emerging-market countries. By contrast, it is expected to come in at slightly below 2% in advanced economies this year. In addition, higher yields in local currency should compensate investors for the exchange-rate risk. Historical return volatility is significantly higher for local-currency bond indices than for external-debt indices. Developments in 2018, such as the sharp swings in the value of the Turkish lira, have plenty of reminders of exchange-rate risks. On top of that, it's often more difficult to gain access to local markets, while buying a bond denominated in dollars on a regulated market in one of the world's financial centers. Technically, it is as easy as to buy an emerging-market hard-currency bond as it is to buy, say, a European corporate bond.

All these factors explain why there's usually a yield pickup in local-currency bonds.

Currently, however, this relationship has changed. For the first time since the financial crisis, hard-currency-denominated bonds are trading at higher yields than their local-currency counterparts, as our "Chart of the Week" shows. One reason for such a reversed relationship can be investors questioning a country's ability to service its external debt, while local debt can always be repaid since necessary money can simply be printed. Nicolas Schlotthauer, head of EM sovereign bonds at DWS, adds: "Over the course of 2018, investors have attached an ever increasing risk premium to external debt. In various cases, this does not match our constructive economic outlook for a number of EM sovereign issuers."



Sources: Bloomberg Finance L.P., DWS Investment GmbH as of 11/7/18

Glossary

Consumer price index (CPI)

The **consumer price index (CPI)** measures the price inflation as a percentage, year over year, of a basket of products and services that is based on the typical consumption of a private household.

Emerging markets (EM)

Emerging markets (EM) are economies not yet fully developed in terms of, amongst others, market efficiency and liquidity.

Euro (EUR)

The **euro (EUR)** is the common currency of states participating in the Economic and Monetary Union and is the second most held reserve currency in the world after the dollar.

Indonesian rupiah

Indonesian rupiah (IDR) is the official currency of Indonesia.

Inflation

Inflation is the rate at which the general level of prices for goods and services is rising and, subsequently, purchasing power is falling.

International Monetary Fund (IMF)

The **International Monetary Fund (IMF)**, created in 1945 and headquartered in Washington, D.C., is an organization of 188 countries, working to foster global monetary cooperation, secure financial stability, facilitate international trade, promote high employment and sustainable economic growth, and reduce poverty around the world.

Nominal

In economics, a **nominal** value is not adjusted for inflation; a real value is.

Turkish lira

The currency of Turkey

U.S. Federal Reserve Board (the Fed)

The **U.S. Federal Reserve Board**, often referred to as "**the Fed**", is the central bank of the United States.

Volatility

Volatility is the degree of variation of a trading-price series over time. It can be used as a measure of an asset's risk.

Risk warning

Investments are subject to investment risk, including market fluctuations, regulatory change, possible delays in repayment and loss of income and principal invested. The value of investments can fall as well as rise and you might not get back the amount originally invested at any point in time.

Investments in Foreign Countries – Such investments may be in countries that prove to be politically or economically unstable. Furthermore, in the case of investments in foreign securities or other assets, any fluctuations in currency exchange rates will affect the value of the investments and any restrictions imposed to prevent capital flight may make it difficult or impossible to exchange or repatriate foreign currency.

Foreign Exchange/Currency – Such transactions involve multiple risks, including currency risk and settlement risk. Economic or financial instability, lack of timely or reliable financial information or unfavorable political or legal developments may substantially and permanently alter the conditions, terms, marketability or price of a foreign currency. Profits and losses in transactions in foreign exchange will also be affected by fluctuations in currency where there is a need to convert the product's denomination(s) to another currency. Time zone differences may cause several hours to elapse between a payment being made in one currency and an offsetting payment in another currency. Relevant movements in currencies during the settlement period may seriously erode potential profits or significantly increase any losses.

High Yield Fixed Income Securities – Investing in high yield bonds, which tend to be more volatile than investment grade fixed income securities, is speculative. These bonds are affected by interest rate changes and the creditworthiness of the issuers, and investing in high yield bonds poses additional credit risk, as well as greater risk of default.

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