Looking for Emerging-Market Opportunities? Go Local.

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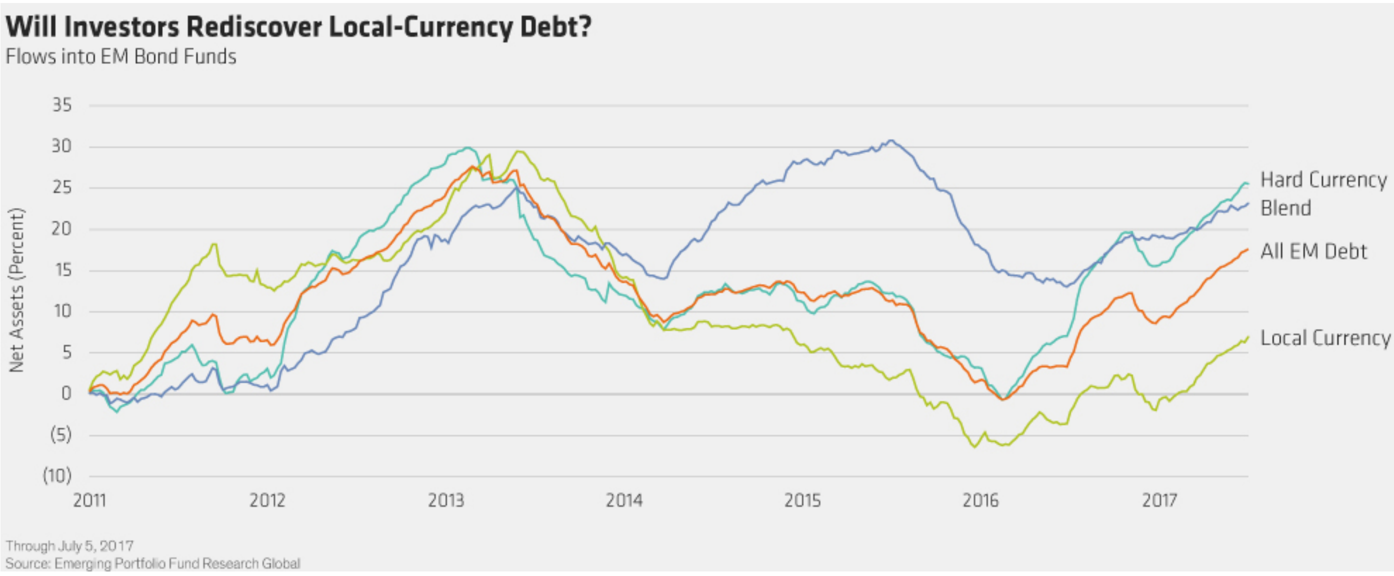
For investors in search of a way to boost income and diversify their bond portfolios, now may be the time to consider what local-currency emerging-market (EM) bonds offer.

Investors have been gravitating to emerging-market bonds over the last year or so—and with good reason. The growth outlook in developing countries is improving, and many governments are embracing economic reform, reducing external vulnerabilities and cracking down on corruption.

But most investors still prefer to buy debt denominated in dollars (*Display*). That's partly because many who turned to local-currency bonds in the years after the global financial crisis got burned when market sentiment soured.



Between 2013 and 2015, high deficits in many EM countries and fear of rising US interest rates provoked a rush for the exit. EM currencies plunged and the J.P. Morgan Government Bond Index-Emerging Markets, which tracks local-currency debt, fell nearly 30%.

There's no doubt that those were tough years for EM assets in general and local-currency debt in particular. But today, these types of EM bonds are the fastest-growing segment of the market—and there's a lot for investors to like. For instance:

•EM currency values are now attractive. Some Asian currencies, for example, are near 10-year lows against the US dollar.

•Governments in São Paulo, New Delhi, Jakarta and beyond are tightening their belts.

•EM inflation is stable or declining, giving central banks room to reduce interest rates.

•Real, or inflation-adjusted, yields are at historical highs relative to those of developed-market bonds.

We don't think investors should fret too much about a gradual rise in US rates, either. Higher US rates mean US economic growth is accelerating, and that should be good for EM countries—commodity producers and export-oriented economies alike.

MORE OPPORTUNITY, MORE DIVERSIFICATION

What's more, the universe of local-currency issuers is likely to grow over time as countries take steps to win back global investors. For example, the ongoing liberalization of China's domestic bond markets should clear the way over the next year or so for renminbi-denominated bonds to enter global market indices. Peso-denominated Argentine bonds won inclusion earlier this year.

We also expect to see more EM companies borrowing in local currency. All this should increase opportunities for investors to benefit from EM countries' strengthening economic fundamentals and to diversify their exposure to the US dollar.

That currency diversification is important. The US dollar's recent rally has left it looking somewhat expensive. And with the Trump administration making trade competitiveness a priority, we would expect US trade policy to favor a weaker dollar.

GO GLOBAL—BUT BE CHOOSY

There are strong local-currency prospects for your bond portfolio across regions. Many Latin American economies stand to benefit from a shift to the political and economic center and away from populism. In Asia, solid growth, a stable banking system and healthy current account balances should underpin the regional economy.

But it still pays to do your research and to be selective about where you take your risk. Country and sector selection matter, of course. But so do other factors, including inflation cycles and yield-curve positioning. The most attractive opportunities may be in intermediate bonds in one country but longer-maturity ones in another.

Another important consideration is the ability to hedge currency exposure. Sometimes a bond and its currency exposure may be attractive. That's the case in many parts of the EM bond world today. At other times, it may make more sense to retain exposure to the bond but to hedge out part or all of the currency exposure. Flexibility is key.

Likewise, the ability to take relative positions in currencies—to be long one and short another—can be another potential source of return.

Investors know the value that exposure to emerging markets can bring. But some of the most exciting EM opportunities aren't denominated in dollars.

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