LATIN AMERICA: Local bond markets prove resilient

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Abstract

Foreign investment in local government bond markets.

In stark contrast to the sharp declines in emerging market (EM) equity markets, down by 9.3% in dollar terms this year, the domestic government bond markets of developing economies remain relatively resilient, despite the dramatic falls in EM currencies. Latin America's main local debt markets have attracted the largest inflows of foreign investment among the main EM regions, with non-resident investors even increasing their holdings of Brazilian and Colombian domestic bonds this year in the face of declines of 46% and 23% in their respective currencies.

Full text

SUBJECT:Foreign investment in local government bond markets.

SIGNIFICANCE:In stark contrast to the sharp declines in emerging market (EM) equity markets, down by 9.3% in dollar terms this year, the domestic government bond markets of developing economies remain relatively resilient, despite the dramatic falls in EM currencies. Latin America's main local debt markets have attracted the largest inflows of foreign investment among the main EM regions, with non-resident investors even increasing their holdings of Brazilian and Colombian domestic bonds this year in the face of declines of 46% and 23% in their respective currencies.

ANALYSIS: Impacts.

China's latest interest rate cut on October 23 will put more pressure on many commodity-dependent EM economies.

EM local government bond markets are underpinned by domestic institutional investors, such as pension funds and insurance companies.

EM dollar-denominated government debt will prove more resilient than local currency bonds.

However, companies with large external debts are vulnerable because of sharp falls in local currencies.

The recent improvement in investor sentiment towards EMs is fragile given the persistent strain on commodity markets -- oil prices have dropped by 10.5% since October 8 -- and the plethora of country-specific vulnerabilities across the asset class.

Nevertheless, sentiment towards EMs has recently improved markedly, mainly because of the perception among investors that a further delay in the expected tightening in US monetary policy is beneficial for EM asset prices.

Following three months of large outflows from EM equity funds, foreign investors are once again pouring money into the stock markets of developing economies, with 850 million dollars of inflows into EM equity funds over the past two weeks, according to JP Morgan. EM shares, moreover, rose by 9.5% in dollar terms in October, trimming their losses over the past three months to just 3.7%.

EM currencies, meanwhile, have strengthened significantly against the dollar, with the Brazilian real and the Malaysian ringgit, two of the most vulnerable currencies, rising by 3.2% and 3.8% respectively.

The improvement in sentiment, however, is fragile given the persistent strain on commodity markets, China's severe economic problems and the plethora of country-specific vulnerabilities weighing on the EM asset class.

Resilient bond markets?.

EM local government bond markets, however, are proving relatively resilient, with returns on JP Morgan's benchmark EM local government bond index (GBI-EM) in the first nine of months of this year in positive territory despite the steep declines in currencies.

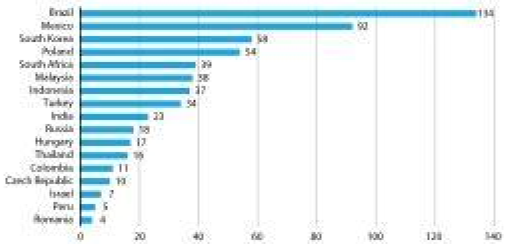
More surprisingly, foreign holdings of EM local debt have not fallen significantly, mostly because of continued support from institutional investors (such as central banks and sovereign wealth funds), which are less swayed by sudden shifts in sentiment, unlike speculative retail investors (such as European and US mutual funds), which are more likely to sell if sentiment deteriorates.

Latin American bond market inflows.

The Latin America region -- the largest recipient of foreign investment into EM local bond markets since 2007, owing to inflows of more than 300 billion dollars into Brazilian and Mexican domestic debt -- has enjoyed the greatest increase in non-resident holdings of EM local bonds since the end of last year.

According to Bank of America Merrill Lynch (BAML), the four most-liquid Latin American domestic bond markets -- Brazil, Mexico, Colombia and Peru -- have attracted inflows of more than 31 billion dollars since the end of last year, representing a 13% increase in foreign holdings of the four countries' local bonds. This compares with a 3% reduction in non-resident holdings in the emerging Europe region and a 3% increase in emerging Asia.

Brazil and Mexico.



Stock of foreign holdings of EM local government bonds (billion dollars, notional)
Source: JP Morgan; official sources

The significant rise in foreign holdings of Latin American local debt stems almost entirely from the increase in non-resident participation in the domestic bond markets of Brazil and Mexico, with inflows of 20.0 billion and 9.5 billion dollars, respectively, since the end of 2014.

Favourable Mexican fundamentals.

Indeed, Mexico is still attracting sizeable foreign inflows -- more than 3 billion dollars in August and September, the largest increase among the 23 EMs covered by BAML -- despite the deterioration in sentiment towards EMs caused mainly by concerns about China's economy and policy regime, and specific worries relating to the fiscal deficit and low oil prices (see MEXICO: Fiscal consolidation steady despite oil price - June 19, 2015).

However, Mexico also has one of the largest shares of foreign holdings of EM local debt, with non-residents accounting for 60% of Mexican domestic bonds, compared with foreign shares of 47%, 17% and 19% for Peru, Colombia and Brazil respectively.

Greater foreign participation in EM local debt markets is perceived as a source of vulnerability during periods of financial turmoil. According to JP Morgan, Mexico is at risk because of the less secure structure of foreign holdings of the country's local bonds, with a large portion (45%) of non-dedicated -- or so-called 'residual' -- investors, who are likely to include speculative hedge funds and private banks.

Mexico's relatively strong fundamentals, however, reduce the scope for selling pressure (see MEXICO: Fiscal package for 2016 is realistic - September 18, 2015).

Brazilian market risks.

Brazil's local bond market, on the other hand, has been suffering outflows over the past several months -- more than 5 billion dollars in June and July alone -- because of the severity of the country's economic and political woes (see BRAZIL: Recession will be long and recovery tepid - August 5, 2015).

The yield on Brazil's ten-year local bonds, moreover, has surged by 350 basis points since the end of July to nearly 16.0% (compared with 7.7% in Colombia and 5.8% in Mexico), partly as a result of Standard & Poor's September 9 decision to downgrade Brazil's credit rating to junk status and fears that a second downgrade could follow (see BRAZIL: Governance will become more challenging - September 17, 2015).

Brazil, which has the largest stock of foreign holdings of EM local bonds (nearly 135 billion dollars), is also vulnerable because of the large share of residual holdings which, according to JP Morgan, "are of a more speculative nature rather than foreign central banks or institutional investors".

However, even in the case of Brazil, the share of foreign participation in the local bond market has declined only marginally since the beginning of this year and, at nearly 19%, is now higher than in May 2013, when the US Federal Reserve triggered a sharp sell-off in EMs by announcing plans to wind down its programme of quantitative easing.

CONCLUSION: While Latin America's main local debt markets will remain more resilient than the region's equity and currency markets, mainly because of strong support from institutional investors and countries' stronger creditworthiness, Brazil's highly liquid domestic debt market is likely to continue to suffer outflows given the severity of the country's economic and political problems and the large share of speculative (as opposed to institutional) investors in the composition of foreign holdings of Brazilian local bonds.

Details

Subject	Economic conditions; Bonds; Debt; Derivatives; Stocks; Foreign exchange rates; Fiscal policy; Mining industry; Monetary policy; Petroleum industry; Public policy; Prices; Commodities
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