RBC Global Asset Management

Emerging market funds should flex for FX

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Emerging markets (EM) are renowned for their downside currency risk, but FX is a two-way street. An effective EM bond fund must have maximum flexibility to minimise volatility and capture upsides – in both directions.

The history of EM is littered with examples of runaway inflation and currency collapses so many investors only see the downside risks in local currency volatility. But behind the headline events and index charts lies a more complex reality.

Investing in EM bonds can be carried out through hard currency instruments, whereby the value in US dollars is locked in; or in local currency instruments, where the value may vary with the dollar FX rate. But this should not be a binary choice and a sophisticated investment strategy should be unconstrained in its approach to FX.

Most EM indices are overconcentrated in a handful of currencies. In the JP Morgan GBI EM Global Diversified Index for example, 60% of the value is denominated in just six currencies, out of approximately 18 investible EM currencies. Widening a fund's investment universe across more currencies is the first step to reducing volatility and capturing the rise in local currency values when they occur.

The second and equally important aspect is allowing managers the freedom to flex allocations between local and hard currencies. The BlueBay Emerging Market Unconstrained Bond Strategy allows maximum flexibility in this regard and is permitted to hold 100% in EM local currency sovereign assets or, conversely, to allocate 100% to hard currency instruments.

The value of this flexibility is becoming ever clearer as EM economies are maturing and becoming more diverse.

There are still EM economies where inflation, and therefore currency risk, remains significant. On the other hand, during the 2022-23 inflationary spike, many EM central banks enacted strongly orthodox anti-inflationary policies and, in some cases, have been ahead of the curve compared to some developed economies. This reflects a maturation of some EM, which are keen to raise more debt in their own currency and reduce their own exposure to FX risk. In pursuit of this aim, they have also issued greater amounts of inflation-linked bonds.

Meanwhile, with interest rate cuts expected from the Federal Reserve in the coming months, the dollar may drift lower against some currencies, including those of some EM.

The point of raising these factors is not to promote a particular FX strategy, and certainly not to suggest that a single strategy would be appropriate across all EM. The important lesson is that there is potential and risk in both directions for EM currencies that will vary between markets.

At times, it will be appropriate to be short local currencies and at others to be long, smoothing volatility while capturing FX return opportunities wherever they arise. It is rare for a 'one size fits all' strategy to work in EM, and a rigid adherence to hard or local currencies is no exception. The key to managing EM FX is to flex.

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