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Bond Funds Turn to Emerging Markets

Shift reflects pinch from low or negative yields in developed world

Big asset managers such as BlackRock have increased their positions in emerging-market debt. *PHOTO: SHANNON STAPLETON/REUTERS*

By **CAROLYN CUI** and **MIKE BIRD**
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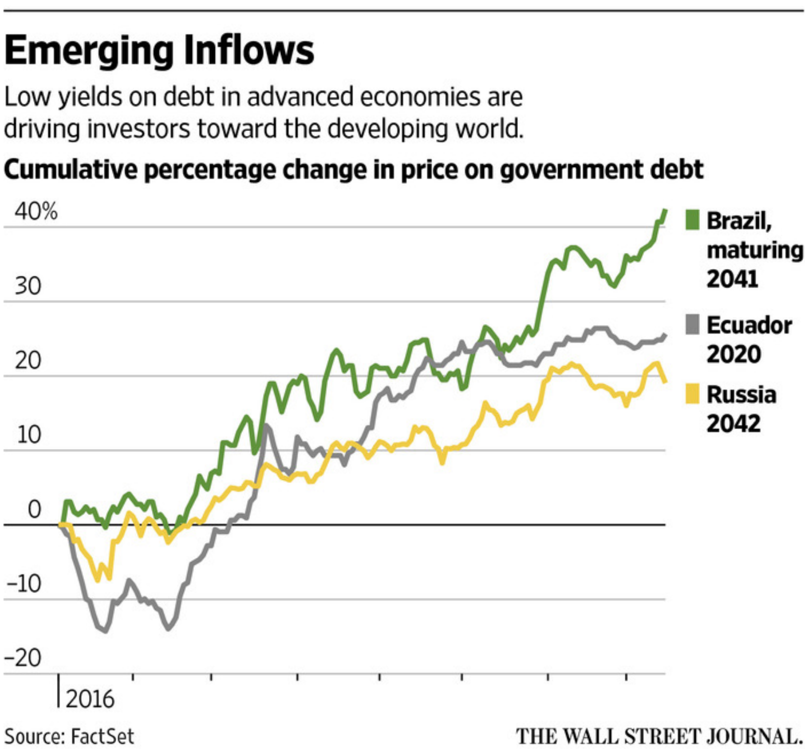
Bond investment funds that usually have little appetite for riskier debt are boosting their exposure to the developing world, a move that is helping drive this year's emerging-markets rally.

International bond funds run by BlackRock Inc., Legg Mason Inc. and OppenheimerFunds are among the big money managers that have been increasing their positions in emerging-market debt in recent months. That shift reflects how global bond funds are feeling the pinch from low U.S. interest rates and negative rates in Japan and much of Europe.

Government bonds with negative yields have grown to $11.4 trillion, mostly in developed markets, according to Fitch Ratings.

Many global bond managers are also turning to emerging markets because a number of their institutional clients, including some pension funds and insurance companies, have restrictions on how much of their money can be invested in debt with negative yields. These investors need cash to meet ongoing liabilities and want income-producing investments.

Global bond funds raised their emerging-market allocations in the first week of August to 10.6% from 9.8% in February. That is the highest level in about a year, according to the Institute of International Finance. The recent high was a 14% allocation to emerging markets in 2013.



While the uptick isn't a big percentage move, because global fund managers oversee about $1 trillion in debt—according to figures from data tracker EPFR Global—even a modest increase in their allocation to emerging markets can bring tens of billions of dollars.

The big bond funds' growing interest—along with record inflows of $14.3 billion into dedicated emerging-market funds in July—has helped power gains in the developing world, analysts say.

Emerging-market bonds denominated in dollars returned 12.3% through July, according to J.P. Morgan Chase & Co. The Citi World Government Bond Index, a broad benchmark for global bonds, was up 7.5% over the same period.

The average bond yield on Bank of America's developed-market index is 0.56%, compared with 4.44% for emerging-market sovereign bonds. Emerging markets now constitute nearly half the yield income of these two indexes combined. In 2008, they made up around 20% of the total yield.

Rick Rieder, global chief investment officer of fixed income at BlackRock, the world's largest asset manager, said the BlackRock Strategic Global Bond Fund has increased its holdings in Brazil, India, Indonesia and Argentina. As of June, the $160 million fund had 37.3% of its assets in emerging markets, according to regulatory filings, up from 25% by the end of 2015. He said the fund recently reduced "a good deal of exposure" in negative-yielding bonds, especially in Japan.

"The only reason that you buy a negative-rate bond is that you think it will go more negative," he said.

But by scaling back their exposure to negative rates, many global bond managers are taking on other risks in volatile emerging-market debt.

Some of the same investors got burned last year when emerging-market bonds in local currencies lost 15% in response to slowing Chinese economic growth, slumping commodities prices and fears of tighter U.S. monetary policy.

"The inflows have been surprising," said Zsolt Papp, a portfolio manager for J.P. Morgan Asset Management. The backdrop for emerging markets, he added, still looks "very clearly more negative than positive."

Political instability has made many investors wary of big bond issuers such as Brazil, Turkey and Venezuela, despite their debt's recent gains.

Credit quality is also deteriorating. Nineteen corporate issuers have defaulted in emerging countries this year, up from 15 at the same time last year, according to S&P Global Ratings. Nearly one third of all emerging-market issuers are at the risk of being downgraded.

Yet even bonds from governments that have defaulted in the past are attracting global money. Ecuador paid off $650 million in bonds last year, the first time in more than 180 years it repaid its foreign debt on time. Ecuador issued new debt in January that matures in 2020 and yielded more than 22%. The rush of foreign money into Ecuador helped drop that yield to 10.4%. Bond yields and prices move in the opposite direction.

Hemant Baijal, who runs the $6.2-billion Oppenheimer International Bond fund, began to raise exposure to emerging markets in the fourth quarter of last year, betting the dollar rally would slow, which would boost emerging-market debt. Emerging-market debt accounts for 47% of the funds' assets, up from 30% at the end of September.

With much of the developed-market debt falling into negative territory, "we are obviously looking at other investments," he said.

Jack McIntyre, a portfolio manager of the $3.2-billion Legg Mason BW Global Opportunities Bond Fund, raised his emerging-market allocation to 43% after it slashed U.S. Treasurys from 20% to 5%.

"Which is riskier, buying a double-digit yielding sovereign bond or buying a negative-yielding government bond?" he asked.

"I'll take the yield any day, knowing that there'll be some volatility but knowing that over time you're going to make a lot of money."

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