Insights
**Fixed Income**

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# Time to Hedge USD in EM Local Currency Bond Exposure

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- Given that currency can contribute significantly to the risk of emerging market local currency bonds, investors need to consider whether or not to hedge their currency exposure.
- It is possible to accept the exposure to undervalued emerging market currencies while removing the exposure to US dollar.

## Currency Considerations for Investors in Emerging Market Local Currency Bonds

Currency represents a substantial amount of the risk in emerging market local currency bonds. For instance, since 2010, the historical volatility of the Barclays Bloomberg EM Local Currency Liquid Index has been 10.4%. The volatility of the currency component alone is 7.6%, so over 70% of the risk can be due to currency.[1] This means that accepting or removing the currency exposure can be an important decision when investing in emerging markets.

The currency risk can be split into two parts:

- **The risk of emerging market currencies:** arguably, currency provides part of the risk premium investors are seeking when investing in emerging markets. These currencies can also be expensive to hedge.
- **US dollar (USD) risk:** most emerging market currencies are measured against the USD — indeed, many emerging market monetary authorities and governments explicitly manage their currencies against the USD.

Therefore, if an investor's base currency is something other than USD, an investment in emerging market local fixed income can create exposure to both the emerging market currencies and USD. It is not necessarily the case that both emerging market currencies and USD are appealing at the same time.

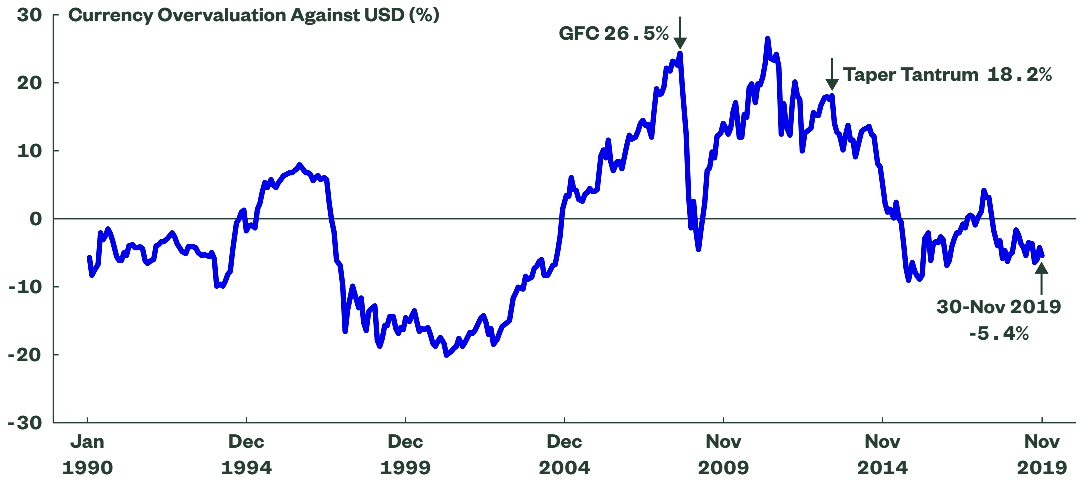
SPDR Bloomberg Barclays Emerging Markets Local Bond USD Base CCY Hdg to EUR UCITS ETF[1] employs a "base currency hedging" methodology, where only the base currency of the portfolio is hedged. Thus it enables investors to accept the emerging market currency risk without also being burdened by USD risk. This differs from the majority of currency hedging methodologies, which employ "portfolio hedging," where underlying portfolio currencies are hedged (for further information on methodologies, please see the table on page 4).

## Are Emerging Market Currencies Currently Good Value?

In USD terms, according to estimates from State Street Global Advisors, the currencies in the Barclays Bloomberg EM Local Currency Liquid Government Index are undervalued by -5.4% (as at 30 November 2019). That does not mean that they cannot fall further (they became -20.0% undervalued in March 2001).

However, as Figure 1 shows, the same emerging market currency basket is a long way from the peak of 26.5% before the Global Financial Crisis or 18.2% before the Taper Tantrum in 2013. On that basis, we believe emerging market local bonds look relatively attractive on a long-term basis, especially when combined with the enhanced yield on the index (4.47% yield to worst as at 30 November 2019, according to Bloomberg).

Figure 1
**Valuation of Emerging Market Currencies Against USD**

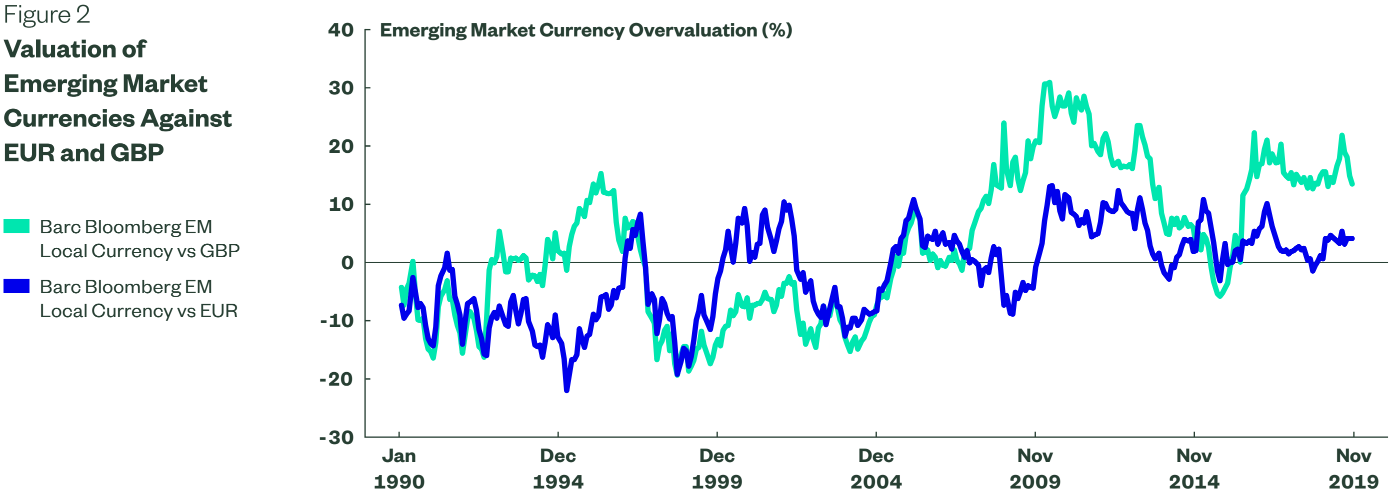



Source: Bloomberg Finance L.P., State Street Global Advisors, as of 30 November 2019.

Most emerging markets are considered relative to USD and many of the currencies are managed relative to USD. However, as discussed above, if an investor has a different currency base, then the value of USD also matters. Is it possible to make a similar valuation case in EUR or GBP? As Figure 2 shows, a similar pattern can be observed and emerging market currencies are cheaper than in 2008 or 2013. Nevertheless, according to our measure they are overvalued — in the case of GBP by a considerable amount.

So here is the challenge: emerging market currencies are cheap relative to USD but expensive for GBP and EUR investors. To express this another way, USD is expensive relative to not only emerging market currencies, but also EUR and GBP.

Figure 2
**Valuation of Emerging Market Currencies Against EUR and GBP**




Source: Bloomberg Finance L.P., State Street Global Advisors, as of 30 November 2019.

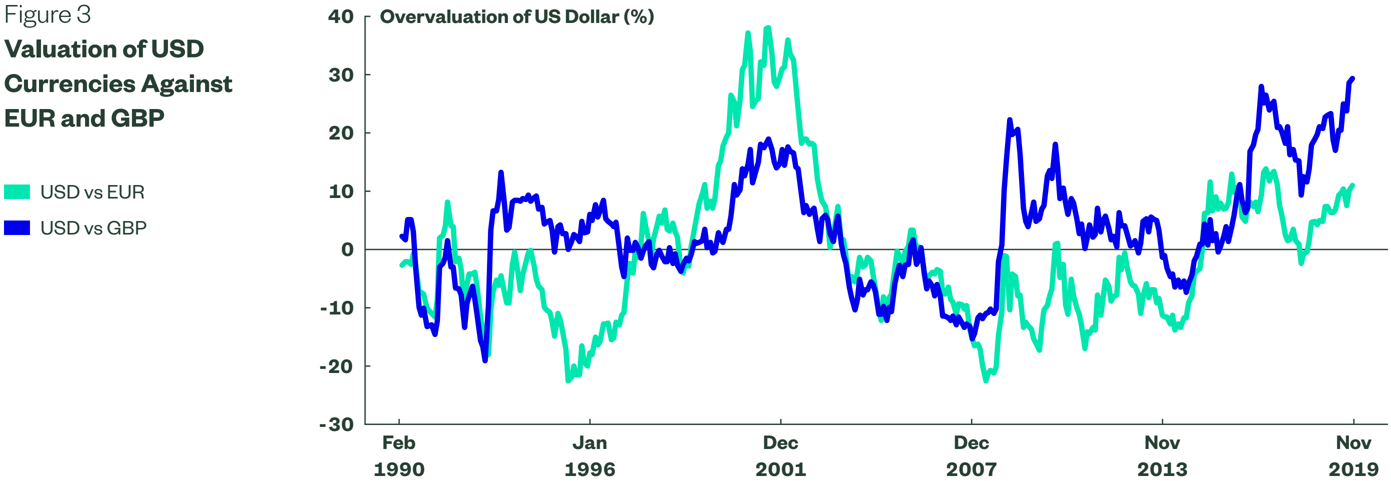
SPDR Bloomberg Barclays Emerging Markets Local Bond USD Base CCY Hdg to EUR UCITS ETF tries to make sense of these valuation differences by obtaining exposure to the undervalued emerging market currencies without being exposed to the overvalued USD.

Looking at Figure 3, which shows the value of USD relative to EUR and GBP (i.e. excluding any emerging market impact), it is possible to see that currency valuations rise and fall according to estimates from State Street Global Advisors. But ultimately, historically they have not only returned to fair value, but also overshot on the other side (i.e. the figures cross over the 0% line on many occasions).

Common sense seems to imply that investors might be better off not accepting the USD risk when it is towards the top end of valuations (conversely, one might want to switch into the unhedged version of the ETF when the dollar is undervalued). It is worth noting the timescale on the figure — currency valuations can take time to revert, but from a long-term perspective, reversion to the mean has always occurred.

What is clear from the figures is that the USD would currently appear overvalued against EUR and especially against GBP. Now may be an opportune time to hedge USD exposure using a base currency hedged ETF.

Figure 3
**Valuation of USD Currencies Against EUR and GBP**




Source: Bloomberg Finance L.P., State Street Global Advisors, as of 30 November 2019.

Figure 4
**Base Currency Hedging vs. Portfolio Hedging**

| Hedging Methodology | Base Currency Hedging | Portfolio Hedging |
|---|---|---|
| Also known as | "NAV hedging" or "share class hedging" | "Full-look-through hedging" |
| Description | Base currency hedged share classes simply hedge the currency risk of the share class relative to the fund's base currency. Consequently, the value of the fund in its share class currency is protected from currency fluctuations between the share class and the fund's base currency but not from any other underlying currency exposure.<br><br>For these hedged share classes, currencies in the portfolio are not hedged into the share class currency, leaving exposures to the underlying currencies unhedged.<br><br>This approach involves selling a one-month FX forward contract of the fund's base currency in exchange for the currency of the share class. | Portfolio hedging means that any currency exposures other than the base (share class) currency are hedged. In this way, the value of the fund in its share class currency is protected from currency fluctuations.<br><br>For these hedged shares classes, typically most currencies in the portfolio are hedged into the share class currency, minimising unhedged currency exposures.<br><br>This approach involves entering into several one-month FX forward contracts to sell each currency in the portfolio in exchange for receipt of the share class currency.<br><br>The majority of hedged classes offered by SPDR ETFs implement portfolio hedging. |
| Example SPDR ETF | SPDR Bloomberg Barclays Emerging Markets Local Bond USD Base CCY Hdg to EUR UCITS ETF[2] | SPDR Bloomberg Barclays Global Aggregate Bond EUR Hdg UCITS ETF[3]<br><br>SPDR Thomson Reuters Global Convertible Bond EUR Hdg UCITS ETF[4] |

Source: State Street Global Advisors, as of 30 November 2019.

## Endnotes

1 Source: Bloomberg Finance L.P., State Street Global Advisors, as of 30 November 2019.

2 GBP and CHF hedged classes also available.

3 USD, GBP, CHF and SGD hedged share classes also available.

4 USD, GBP and CHF hedged share classes also available.also available.

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