Don’t try this at home:
Avoiding the pitfalls of local emerging market debt investing

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April 2015

Summary

- The emerging market debt universe comprises a myriad of individual market complexities and nuances
- The 2013 'taper tantrum' highlighted why some EM countries impose restrictions to deter excessive inflows
- Currency restrictions necessitating a local third-party custodian can introduce FX conversion timing issues for bond trades
- Overnight currency balance restrictions apply in markets such as Thailand
- Pre-registration is required by foreign investors in India, Korea, Taiwan and China
- Tax: a minefield of specifics
- Avoiding all of these takes knowledge, skill and experience

Introduction

In a seemingly commoditised world, the potential pitfalls that are still to be found trading emerging market local debt may come as a surprise. Rules, taxes, regulations and market convention vary wildly from country to country. What might be perfectly acceptable in one country can land you in hot water in another. Fortunately the emerging market debt team at GAM has many years’ experience trading these local markets. This article sheds some light on the obstacles one faces when navigating around local markets and why it can be beneficial to task a professional with the job.

Historic context

Many of the difficulties posed when trading and accessing local markets stem from capital account convertibility – many emerging market countries understandably have been reluctant to entertain the risks that an increased number of cross-border transactions might bring. Foreign participation, while potentially a valuable source of capital, can also export global shocks to local markets. For example, in 2010 / 2011 cash flowed into EM countries as investors searched for yields given the ultra-low interest rates on offer in the advanced economies. Many EM governments became worried this could precipitate a boom / bust scenario that might create problems for the banking system, corporate borrowers and for external financing if there was a sudden withdrawal of these inflows (Brazil’s 6% tax on bond inflows introduced in March 2011 was one of the most high-profile measures taken by any EM country in response at that time). And indeed, in May 2013, when then Fed Chairman Bernanke raised the possibility of scaling back monetary expansion, we saw a sharp sell-off in emerging markets, the so-called ‘taper tantrum’.

FX restrictions

As a starting point, any country that has a developed non-deliverable forward (NDF) FX market (a cash-settled, short-term forward contract market) should immediately alert the investor that there could be restrictions associated with trading that domestic market. This, after all, is why the non-deliverable market has developed – as a result of foreign investors being restricted in their ability to transact domestically with local counterparties. With a non-deliverable forward, only the profit / loss is exchanged between the counterparties. There is no exchange of notional value. Moreover, this adjustment is in US dollars, as the counterparties cannot settle in the local currency.

Commonly traded NDF markets

Asia-Pacific	EMEA	Latin America
CNY: Chinese renminbi	EGP: Egyptian pound	BRL: Brazilian real
IDR: Indonesian rupiah	NGN: Nigerian naira	ARS: Argentine peso
KRW: South Korean won	KZT: Kazakhstani tenge	CLP: Chilean peso
MYR: Malaysian ringgit	KES: Kenyan shilling	COP: Colombian peso
PHP: Philippine peso	GHS: Ghanaian cedi	PEN: Peruvian nuevo sol
INR: Indian rupee		UYU: Uruguayan peso
TWD: Taiwan dollar		
VND: Vietnamese dong		

Source: Bloomberg, March 2015

Under these circumstances, when buying and selling bonds where US dollars are exchanged for local currency and vice-versa, the restrictions on foreigners transacting in the local currency can be bypassed by having a locally registered bank act as sub-custodian to buy and sell on your behalf. But even this route brings its own difficulties as it separates the timing of the bond trade and the FX transaction.

One problematic country recently has been Nigeria, where a sharp currency sell-off amid speculation of an imminent devaluation could leave the investor with a much worse rate than at the time of trading the bond, as it usually takes two days for the bond sale proceeds to be converted into US dollars by the sub-custodian. Even then, given the current difficult market conditions in Nigeria, the sub-custodian may not be able to commit to specific conversion time frames.

Chart 1: Sharply weakening Nigerian naira makes local bond trading more difficult

Source: Bloomberg, as at 13/03/15

In Thailand, as a prevention measure against currency speculation, there is no scope for foreign investors to hold Thai baht balances domestically overnight above THB 300 million (approximately USD 9.2 million, a relatively small trading size). As such, extending duration for example, by swapping from one bond to another with differing settlement dates that will leave the owner with cash overnight pending settlement of the new bond purchase, while arguably a conservative approach in many markets, could see you forced to sell the excess baht at an exchange rate imposed by the Bank of Thailand.

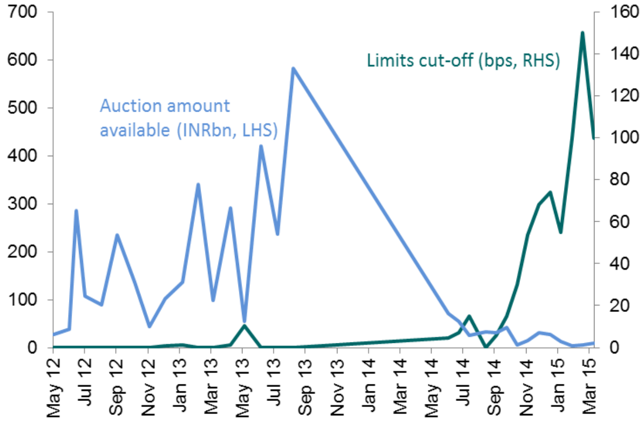
India – a league of its own

A number of markets require pre-registration by foreign investors, including Korea, Taiwan, India and China. This often requires the submission of a plethora of documents and financial statements. Even after the initial administration effort, it is not necessarily then straightforward to trade.

One of the most difficult local bond markets to trade is India. After registration with the Indian regulator, foreign investors must then bid for 'limits' to purchase government bonds. The cost of these limits, as a percentage of the notional amount of bonds one wants to bid for, has risen dramatically since the beginning of 2014. The amount of limits on offer has also fallen (see Chart 2)

These limits have recently cost as much as 100–150 bps. For a trade the equivalent of USD 10 million, at 100 bps this would cost the investor USD 100,000, before they have begun the bond purchase. Cost-to-purchase limits have risen drastically as the amount of bonds on offer has become restricted.

Chart 2: Indian bond limit cost-to-purchase dynamic

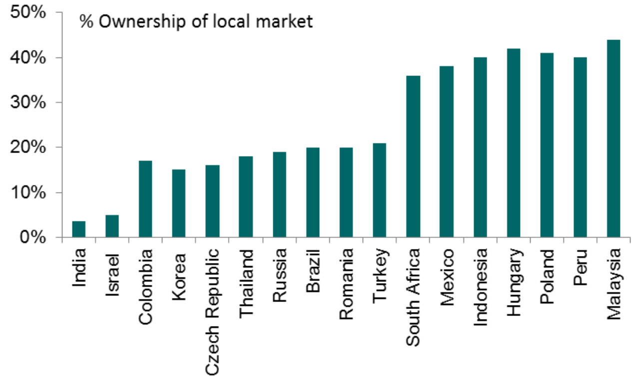


Source: Edelweiss Securities, as at 13/03/15

The Reserve Bank of India recently announced an easing of the cut-off times that restricted when trading instructions could be submitted. These have historically made the market more challenging to trade from European time zones.

Failure to pre-match the details by the cut-off – which could be due to very simple problems, such as as the timestamp on the trade or a delayed instruction – would cause the trade to fail. A failed trade not only involves reputational risk and potential claims from leaving the counterparty stranded with bonds on their hands, but in India the counterparties must also write a letter jointly to the local exchange notifying it of the failed trade. Part of the reason the foreign ownership of Indian debt stock is so low is due to the access difficulties.

Chart 3: Foreign holders of the domestic bond market



Source: JPMorgan, Reserve Bank of India, as at 13/03/15

Tax minefields

Many local emerging bonds are taxed. Trading a bond market without having first acquired a tax ID, despite having done the groundwork to set up a local account, is a common client pitfall reported by counterparties. How much tax is charged can depend on whether there is a double taxation agreement between the investment country, and a fund's domicile location. Countries for which withholding tax on coupon interest is payable include India, Indonesia, Philippines, Korea and Colombia. A fund manager needs to be aware of how the taxes are collected across countries; otherwise it can be difficult to determine the net amount available for repatriation or reinvestment. Some countries, India for example, require the appointment of a local tax agent, such are the complexities involved. In Indonesia, withholding tax and capital gains tax are paid by the bond seller at settlement. In Colombia, withholding tax owing is calculated by the sub-custodian on a monthly basis on accrued interest.

Conclusion

It is vital to have clarity on all of these potential pitfalls before trading local currency EM debt to avoid the risk of incurring costly financial penalties, not to mention reputational damage. The GAM team’s experience of more than fifteen years in this area is beneficial when navigating what is still a relatively tricky asset class to trade.