

Local Currency Bond Returns in Emerging Economies and the Role of Foreign Investors

Inhwan So

International Department, The Bank of Korea

Giorgio Valente

Hong Kong Institute for Monetary Research

Hong Kong Monetary Authority

Jason Wu

Hong Kong Monetary Authority

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Summary

Foreign investors play a key role in EME sovereign bond markets, in part because their portfolio flows are sensitive to bond returns and are therefore pro-cyclical in nature. This note discusses the implications of the framework proposed by So et al. (2019) which incorporates the risk that arises from the portfolio performance and flows of actively managed bond funds. When the framework is applied to the data, using local currency sovereign bonds of 16 EMEs, preliminary calculations show that local currency sovereign bonds that positively covary with the returns of active funds receive risk premia as compensations for active fund risk. Furthermore, and in line with theory, the price of this risk increases when bond funds experience outflows and the exposure to active funds risk increases with the heightened price of risk. This double effect helps explain why spikes in returns of some EME local currency bonds can be especially large. These results demonstrate how the portfolio performance and flows of actively managed funds help transmit shocks across EMEs.