And the winner is — frontier market bonds

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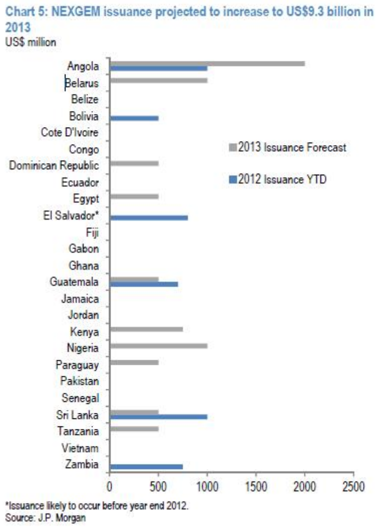
By Sujata Rao

Global Investing has commented [1] before on how strongly the world's riskiest bonds — from the so-called frontier markets such as Mongolia, Nigeria and Guatemala — have performed. NEXGEM, the frontier component of the bond index family run by JP Morgan, is on track to outperform all other fixed income classes this year with returns of over 20 percent., the bank tells clients in a note today. Just to compare, broader emerging dollar bonds on the EMBI Global index have returned some 16 percent year-to-date while local currency emerging debt is up 13 percent.

That appetite for the sector is strong was proven by a September Eurobond from Zambia that was 15 times subscribed. Demand shows no sign of flagging despite a default in frontier peer Belize and shenanigans over the payment of Ivory Coast's missed coupons from last year. Reasons are easy to find. First, the yield. The average yield on the NEXGEM is roughly 6.5 percent compared with just under 5 percent on the EMBIG.



Second, this is where a lot of issuance is happening as big emerging markets such as Brazil and Mexico, once prolific dollar bond issuers, sell less and less on external markets in favour of domestic debt. Frontier markets are filling the gap. JPM says Angola, Guatemala, Mongolia and Zambia joined the NEXGEM in 2012 as they made their debut on global capital markets. Bolivia is also set for inclusion soon, taking the number of NEXGEM members to 23 by end-2012.

NEXGEM's market value also jumped in this period by 36 percent to $33.3 billion. It now represents 5.9 percent of the EMBI Global, up from 5.3 percent a year back, JP says.

The future too looks bright.

JP Morgan predicts NEXGEM credits will return 9-10 percent total next year (it forecasts 7-8 percent for the broader EMBIG). And there will be new entrants. JP Morgan expects new issuance of $9.3 billion next year, more than double 2012 levels. Paraguay and Tanzania could enter the index in 2013 while Nigeria, Angola, Ghana and others are expected to issue more debt.

Investors must recall however that their indiscriminate rush for these high-yield credits is translating into — falling yields. JP Morgan reckons NEXGEM spreads over U.S. Treasuries could fall by 75 to 100 basis points next year. Analysts at the bank write:

This will allow NEXGEM issuers to retain their ability to issue at highly competitive spreads, as was recently illustrated by Bolivia, which despite its interventionist policies in late October, managed to price a debut global bond at under a 5% yield.

Investors will no doubt be weighing up the risk-reward of holding a credit such as Bolivia at that price.

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