Frontier-currency fixed income: a developing asset class

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- **TCX, a frontier-market currency-risk hedge provider, needed to sell risk to fuel its growth**
- **This created a market for frontier-currency risk, partly resolving a global development challenge**
- **Investors receive unique risk-return characteristics and diversification benefits, whilst creating a positive impact**

Currency mismatches are detrimental to hard-currency borrowers in frontier markets, as sudden and steep depreciations of their local currencies are overly common, resulting in ballooning debt in local-currency terms. This dynamic is reflected in today's frontier-market debt crisis that is to a large extent the result of a stronger US dollar and rising interest rates. Exchange-rate risk hedging solutions are needed to protect borrowers and lenders, but these are absent for frontier markets.

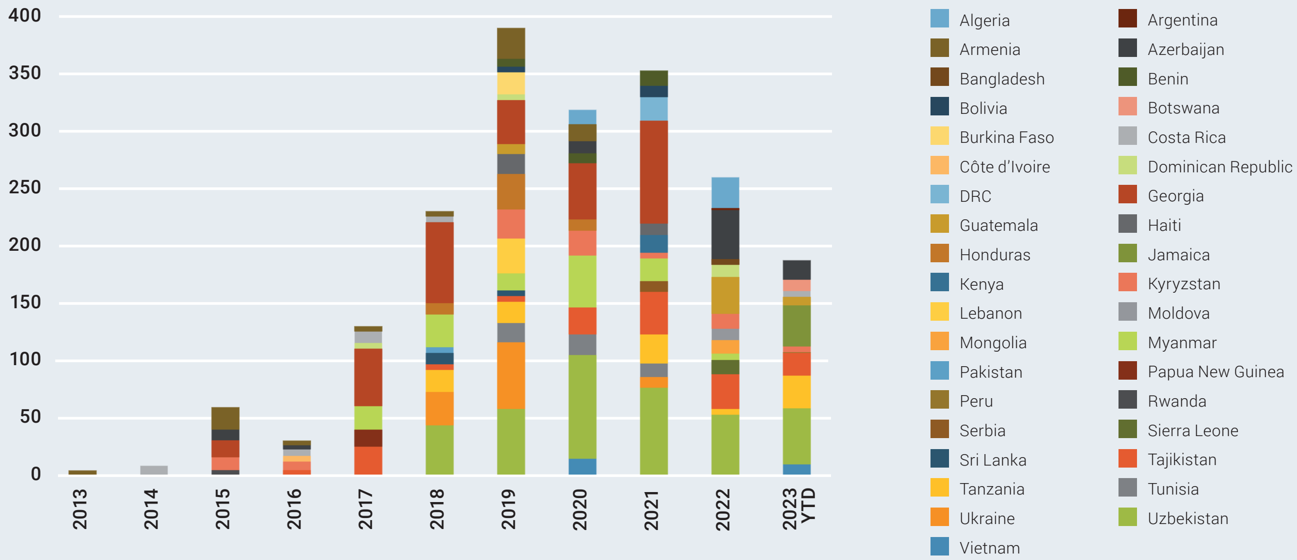
Here we arrive at the raison d'être of The Currency Exchange Fund ('TCX', 'the Fund'): offering cross-currency swaps and forwards in currencies and maturities that are not covered by the market. Established in 2007, the fund has seen a continuously increasing demand for its unique product. To cater for this growth, it started to sell currency exposure to investors, creating a market that transformed a global development challenge into a business opportunity.

The increased interest in frontier-market currency risk and return can be seen as a consequence of more than a decade of low yields in developed markets, pushing investors to search for yields elsewhere. TCX notices however, that this market continues to grow, even in the risk-off environment following the Covid crisis and the invasion of Ukraine.

The Fund has a frontier-currency market-development mandate. Selling exposure in the form of frontier-currency-linked notes and bonds is an important tool in this regard. It creates a market and in doing so, makes local-currency pricing and return information publicly available. Pricing transparency serves as a catalyst for other players in these markets, fostering follow-up bond issuances, bringing supply and demand in local currency together, and, ultimately, leading to deeper, more mature capital markets in local currency. By bringing down currency mismatches, economic resilience improves.

From TCX's perspective, this is a clear win-win situation, as rechanneling part of its frontier-currency exposure to international investors lowers the open exposure in its book, creates room for more hedges and leads to a more efficient use of capital.

Frontier-currency bond hedges
(USD million)



From the perspective of investors, these bonds offer an opportunity to combine the lowest credit risk with real frontier-market currency risk and return. Issues include the Sierra Leonean leone, Guatemalan quetzal, Kyrgyzstani som and Vietnamese dong. The diversification this offers is quite unique, as correlation with developed-market assets is often very moderate. The credit risk is low as the bonds are issued by TCX's AAA-rated shareholders such as AFD, AFDB, EBRD, EIB, FMO and IFC, and subsequently hedged by the Fund. As settlement is offshore, capital controls, convertibility and transfer risks are avoided.

This brings us to some concrete numbers: in the last 5 years alone, TCX's shareholders have issued over 150 frontier-currency bonds where TCX acted as the hedging counterparty. The total notional amount of these bonds was over USD 1.5 billion, spread over 35 different currencies.

Georgia and Uzbekistan are examples of the development impact of this activity. Both governments are issuing local-currency bonds offshore, after a series of issuances by TCX's shareholders raised awareness and offered crucial pricing insights. Being able to issue in local currency offshore decreases currency mismatches, increases debt-management flexibility and allows these governments to tap into hitherto uncharted investor markets.

To make this trend even more visible and to provide information on the performance and risk metrics of these frontier-currency bonds, TCX launched an informative index: the TCX Frontier Index, which tracks just these bonds (Bloomberg: 'TCX FI'). The purpose is not to generate financial return, but to support market creation. Still, so far, the TCX FI compares favorably to both emerging-market and developed-market bond indices, showing higher annualized returns and lower volatility, even in the turbulent recent years. From this perspective, the growing popularity of frontier-currency fixed income as an asset class is no surprise at all.

Performance over time

TCX FI vs JPM GBI-EM and FTSE G7 Govt USD