A Star is born

By Jan Dehn

One of the reasons to invest in Emerging Markets (EM) is the possibility of capturing the upside from rapid structural change. This past week saw the birth of local currency corporate bonds as an EM asset class. We believe local currency corporate bonds will become a star in the EM fixed income sky. Of course, the USD 5.8trn market has been around for much longer, but it was only last week that Bank of America Merrill Lynch (BAML) formally launched the world's first index for this asset class. Whilst the BAML index is imperfect – it only represents 5% of the universe of local currency corporate debt – its existence enables investors to tap into what could eventually become a USD 30trn asset class. Meanwhile, Europe produced the lowest inflation print in Eurostat's history; we discuss why inflation is so low in Europe and what this means for the Euro over the medium term.

Emerging Markets	Index level/ yield	Spread over UST	1 week change
MSCI EM	1,028		-0.58%
MSCI FM	573		0.81%
GBI-GD	6.47%		-2.94%
ELMI+	3.92%		-1.07%
EMBI GD	5.61%	297 bps	-0.60%
EMBI GD IG	4.72%	206 bps	-0.68%
EMBI GD HY	8.97%	654 bps	-0.43%
CEMBI BD	5.49%	329 bps	-0.14%
CEMBI BD HG	4.67%	246 bps	-0.20%
CEMBI BD HY	7.40%	524 bps	0.24%

Global backdrop	Index level/yield/ FX rate/price	1 week change
S&P 500	1,762	0.00%
VIX Index	13.28	-0.23%
5 year UST	1.36%	7 bps
10 year UST	2.61%	9 bps
10 year Bund	1.68%	-6 bps
EURUSD	1.3510	-2.04%
USDJPY	98.67	1.00%
Brent	$106	-3.32%
Copper	$335	1.49%
Gold	$1315	-2.87%

Emerging Markets

One fundamental attraction of Emerging Markets is that both economies and asset classes evolve so rapidly. Ten years ago Brazil barely had a fixed coupon local currency sovereign bond market, today it is one of the largest and most liquid local markets in the EM universe. Five years ago African countries largely depended on donor financing with few accessing the markets; now 20% of the 60 countries in JP Morgan EMBI GD index are African.

Last week Bank of America Merrill Lynch (BAML) launched the world's first Emerging Markets local currency corporate bond index.

Index development is important: the vast majority of the world's institutional investors only recognise asset classes if they have indices. Indices are used as a basis for comparing the relative performance of managers, measuring risk, etc. Excessive reliance on benchmarks for such purposes can be dangerous due to the inefficiency of the EM asset class and the vast ocean of off-benchmark opportunities. But we firmly believe that indices are desirable, because they constitute a key part of any market's infrastructure.

Local currency corporate bond indices have been long in coming. Indices are public goods, whose benefits tend to accrue far more widely than the index provider itself. The inability of the index provider to capture all the benefits means that indices tend to be under-provided. The economic crisis, regulatory pressures, and bank specific issues have exacerbated this market failure. While the EM fixed income universe has continued to expand, indices have progressively become less and less representative of this universe.

BAML's new family of local currency corporate bond indices breaks this trend. It is the first major development in the world of EM fixed income indices for a long time, and breaks open a whole new asset class. BAML's initiative should therefore be applauded.

However, despite their enormous symbolic significance, BAML's indices are still severely limited in scope. Their most important limitation is that they only cover Euroclearable securities, which probably reflects the difficulty of the provider to cover the costs of collecting data. The exclusion of non-Euroclearable securities whittles the universe of index-eligible bonds down to just USD 264bn, or 5% of the total universe of EM local currency corporate debt USD 5.8trn.

BAML produces four different versions of the index: with / without issuer caps and with / without Sukuk bonds. There are also bond size restrictions, which further reduces the size of index eligible securities. The broad version that excludes bonds below USD 75m produces a universe of USD 168bn, and if stricter size limitations are applied (excluding bonds below USD 150m in size) the universe is reduced to USD 142bn. Exclude Sukuks and the universe shrinks to just USD 118bn.

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Emerging Markets

Russia will move to Euroclearable local currency corporate bonds in early 2014. We believe other countries are likely to follow suit.

The BAML local currency corporate bond indices offer a brand new type of risk to investors. They are fundamentally different from Dollar corporate indices. More than half the names in the BAML indices are companies that do not feature in BAML's external corporate bond indices, and only a quarter of the companies in the external indices feature in the local indices. The indices include non-rated securities, yet at BBB (for rated bonds) the average rating is high (similar to Dollar denominated corporate bond indices).

Global backdrop

Europe is beset on all sides by the inequities of ignorance and myth. Europe's politicians are regarded as irrational, divided, and ineffective. But they are not. Europe's economy is now widely believed to be in recovery. We believe it not to be. Over the next 12 months, the focus in Europe will be on banking sector recapitalisation with the expectation that Europe will be able to fix its zombie banks. We believe it will not.

Just because something is complex, opaque and slow it does not mean that it is irrational. Eurozone politicians have been remarkably effective in the past few years, taking into account the complexities of the environment in which they operate. They had no roadmap for handling the European debt crisis. They did not even have any institutions. Additionally, they each owe more loyalty to their highly tribalistic populations strewn across seventeen fully formed countries, complete with their own languages, cultures, hundreds of years of history, old affiliations and animosities than they do to the European Union. Getting a gang like that to agree on anything is like herding cats. Just think about the recent challenges in reaching agreement over the US budget and debt ceiling in the infinitely less complicated US Congress.

Europe has achieved much in a relatively short time. Markets have continuously underestimated the commitment on the part of European politicians to compromise in order to keep the Eurozone together. Quasi-fiscal institutions such as the ESM were erected where none existed before. LTROs (long Term Refinancing Operations) were launched to support banks. OMT (Outright Monetary Transactions) was introduced to support sovereigns. The periphery has reformed aggressively. Germany has bailed out Greece. A break-up of the Eurozone – a consensus trade worth at least 18% to the US dollar and 50bps in the US Treasury market – was avoided. The US took 137 years to achieve Federal status; at the current pace we believe Europe is set to beat this by some distance.

Turning to Europe's economy, the Euro has appreciated 15% against the US dollar in the past year. This is a remarkable turnaround for the Euro, due in part to the ECB's OMT programme and in part to a return to growth in Q2 2013.

Even so, Europe is unlikely to return to trend growth because of two problems. Firstly, Europe's average public debt level recently crossed the 90% of GDP threshold. Countries within the Eurozone such as Ireland and Spain have huge real estate legacy issues. Private debt levels are high. So-called 'core' economies are heavily indebted. Europe's demographics are horrendous. The weak growth picture and high levels of debt render Europe's economy particularly prone to higher global interest rates. It was no coincidence that the ECB rushed into forward guidance when the Fed began to talk about tapering. A normalisation of US interest rates would easily push Europe's periphery into a second debt crisis.

Secondly, Europe's banks are insolvent. No one in the private sector knows exactly how bad the problem is. Even the IMF gets its information about European bank balance sheets from national banking regulators, who in the past have shown that they will lie to conceal weaknesses in national banks. But even using official data, there are big capital requirements. Spain's banks need 10% of GDP, Portugal's banks 12% of GDP, and Italy's banks 8% of GDP.[1] The true figure is likely to be much higher, and the problems are not just confined to the periphery, in our view. On a Europe wide level, how big is the problem? 5% of GDP? 10% of GDP? Who knows?

No politician in Europe can go to the electorate and ask for that kind of money to give to the banks. It would be political suicide. Economies with zombie banking systems do not financially intermediate very well, and hence do not grow very fast. Sure, manufacturing cycles ebb and flow, and GDP prints ebb and flow, but in our view, the underlying trend growth rate in Europe will remain weak. Slow growth in turn means low inflation. This is the backdrop against which Eurozone core CPI inflation for the month of October came at just 0.8% versus 1.0% expected, the lowest ever print in the history of the series.

But things are not completely stagnant. The next big leap forward in Europe's march towards a federal state is the adoption of the Single Resolution Mechanism, Eurospeak for a common banking regulator under centralised ECB supervision.

[1] *"Banking Union – The Year Ahead: Part 1"*, European Economics, Credit Suisse, 16 October 2013.

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Global backdrop

ECB and the European Commission (EC) are already fighting over who should pay for the cost of recapitalising Europe's insolvent banks. The EC wants haircuts for bond holders in order to spare tax payers and thus preserve the popularity of the European Union. The ECB wants a fiscal solution in preference to haircuts, because it fears the market reaction and knows its own credibility will be challenged if it ends up holding the baby. As always, the final decision will end up with France and Germany, who are likely to form a compromise, which involves postponing a resolution. Long live Zombie Europe.

With Europe thus on track for 'Japanisation' the region is likely to continue to experience low inflation. Low inflation should support the EUR over the medium term despite Europe's weaker growth, for the same reason that the Japanese Yen strengthened versus the US dollar throughout the deflation period. Germany will need a strong currency to keep inflation under control, while the ECB will have to keep rates low and monetary policy easy in order to help the periphery recover, especially if US rates begin to rise. The main driver of currencies over the medium term is likely to be inflation – and inflation will arrive in the US long before it gets to Europe.

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