EM Fixed Income universe grows bigger and stronger

By Jan Dehn

The Emerging Markets (EM) fixed income universe increased by 3% in 2013 to reach USD 14.5trn. This compares to USD 103trn for developed economies. EM is now more than 50% of global GDP, so EM's credit fundamentals improved further relative to developed economies last year. This means that investors have a safer alternative to developed market fixed income as the world slowly heads towards global monetary policy normalisation. Seen in this light it is unsurprising that developed market central banks continue to err on the side of dovishness.

Emerging Markets	Index level/ yield	Spread over UST	1 week change
MSCI EM	1,061	–	-0.13%
MSCI EM Small Cap	1,094	–	-0.31%
MSCI FM	708	–	1.75%
GBI EM GD	6.54%	–	0.40%
ELMI+	3.35%	–	0.15%
EMBI GD	5.07%	253 bps	0.56%
EMBI GD IG	4.39%	180 bps	0.38%
EMBI GD HY	6.64%	435 bps	0.90%
CEMBI BD	5.03%	280 bps	0.27%
CEMBI BD HG	4.26%	202 bps	0.33%
CEMBI BD HY	6.67%	447 bps	0.17%

Global backdrop	Index level/yield/ FX rate/price	5 business day change
S&P 500	1968	-0.46%
VIX Index	12.08	6.62%
5 year UST	1.65%	-8 bps
10 year UST	2.53%	-9 bps
US HY	5.32%	-0.17%
European HY	4.53%	-0.37%
EURUSD	1.3627	0.16%
USDJPY	101.48	-0.37%
Brent	106.25	-2.47%
Copper	330.43	-0.67%
Gold	1318.42	-0.12%

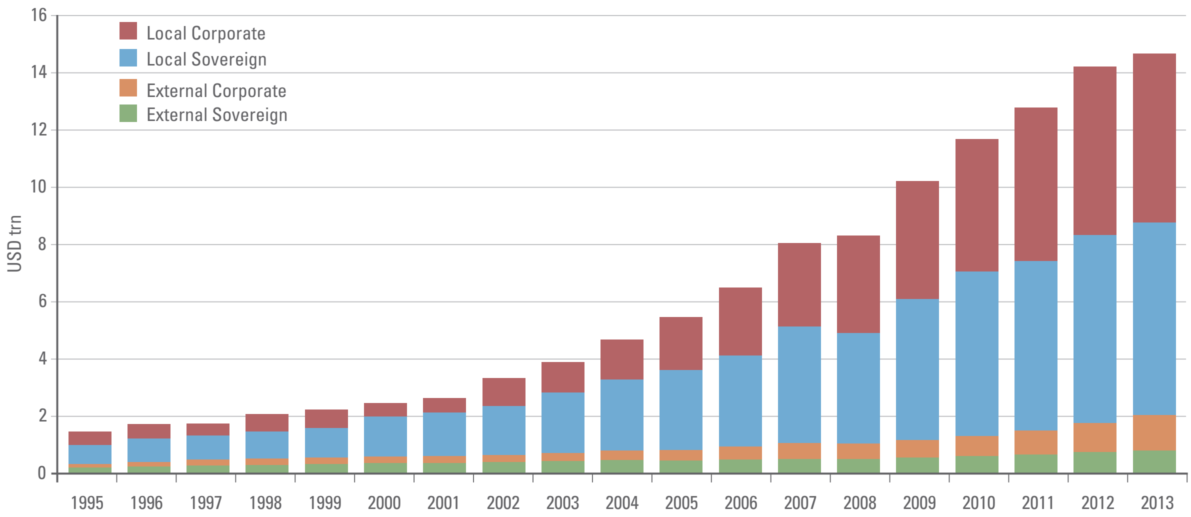
Additional benchmark performance data is provided at the end of this document.

Emerging Markets

Update on the EM Fixed Income universe

The already vastly stronger credit fundamentals in EM compared to developed economies improved further in 2013. According to newly published data on the stock of total outstanding debt from Bank of America Merrill Lynch (BAML), the EM fixed income universe increased by 3% in dollar terms in 2013 to USD 14.5trn. EM issuers now account for 12.4% of total global fixed income (USD 117.3trn). This means that the average debt burden in EM is 39% of GDP, unchanged from 2012. By contrast, the debt burden in developed countries increased by 5% of GDP to 280% of GDP. The seven times greater indebtedness in GDP terms of developed economies means that EM is relatively better positioned fundamentally to manage a rise in global interest rates.

Fig 1: **Outstanding EM fixed income (end of 2013, USD trn, market value)**



Source: BAML, Ashmore.

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Emerging Markets

Local currency bond markets now constitute 86% of total EM fixed income, up from 78% in 1995. Only 15% of EM's local currency government debt is represented in the JP Morgan GBI EM GD index. Most foreign investors hug the narrow sleeve of benchmarked securities, but EM economies are resilient to sell-offs, because the bulk of local bonds are held locally.

The corporate debt share has risen from 40% to 49% since 1995. This reflects the ability of corporates to price bonds following the establishment sovereign curves plus recent disintermediation of banks in favour of bond markets. It is very positive that EM corporates can now access term finance.

The fastest growing element within EM fixed income is local currency corporate debt, which has grown on average 17% per year since 1995 compared to 14% for local currency sovereign and dollar corporate debt and 8% for external sovereign debt. However, 2013 was different. Total outstanding corporate dollar debt was up 22% and sovereign dollar debt was up 8% in 2013, more than their local currency equivalents. This was largely in part due to the 'taper tantrum' of 2013, which disproportionately impacted local currency markets.

EM fixed income benchmarks continue to represent the asset class extremely poorly and it's not just in local currency markets. Only 46% of external debt is represented in the most commonly used dollar sovereign index, while index representation is even lower for corporate dollar debt and local currency corporate debt at 24% and 2%, respectively.

- India: India's Finance Minister, Arun Jaitley, published the much awaited budget, which delivered an ambitious fiscal deficit target of 4.1% and a target for FY17 of 3.0% of GDP. This is extremely positive. Excessive fiscal spending has been the main source of macroeconomic imbalance in India in recent years. Tighter fiscal policy will reduce inflationary pressures and give room to the central bank to ease rates. We note that the government took another step towards opening its domestic bond markets – Indian bonds will now be allowed to be cleared internationally. This should help to remove one of the two major obstacles to index inclusion for Indian bonds, namely cumbersome settlement. India still has quotas limiting foreign access to local bond markets.

- Indonesia: The election in Indonesia failed to produce a clear winner and attention now turns to 21-22 July, when the election commission is set to publish its findings. Exit polls suggest that Joko Widodo (Jokowi), the market's favourite, will win. Golkar, the main opposition party, has already signalled that it does not intend to be in opposition. Jokowi is widely expected to be more reform friendly than his main rival, Prabowo Subianto. However, the market is likely to overstate the differences between the two candidates, in our view. We think the first order effect of the change of government is that fresh momentum will be injected into the reform process, regardless of who wins. Bank Indonesia left its FASBI deposit rate and reference interest rates unchanged last week at 5.75% and 7.50% respectively.

- Mexico: More evidence emerged of the start of a cyclical upturn in Mexico when gross fixed investment rose strongly in April. Investment increased by 1.3% mom seasonally adjusted (sa), which follows an upwards revised reading in March and another strong print in February (1.4% mom sa). Mexico's economy should be able to grow significantly before encountering inflationary pressure due to recent substantial reforms. On that note, the Lower House last week passed secondary legislation for recent telecommunications reforms and will now consider legislation associated with a critical reform of the energy sector. Last week CPI inflation was 3.75% yoy versus 3.8% expected. Seasonal factors are likely to lift headline inflation in H2, but we expect core inflation to remain entirely contained.

- Russia: The European Union adopted new (and largely ineffective) sanctions against a handful of individuals in Russia and Ukraine, while the US postponed a decision to impose more significant sanctions pending European support for even tougher sanctions (which we think will not materialise). The Western threat of sanctions against Russia prevents the West appearing impotent in the face of Russia's annexation of Crimea. However, European dependence on Russian energy means that meaningful sanctions are not credible. The second leg of the West's strategy is to pour resources into Ukraine to turn what remains of the country into a strong European ally. This means that, despite the simmering tensions in Eastern Ukraine, we believe neither Russia nor Ukraine are facing any immediate threats to their ability and willingness to service debt. Russia released strong data last week. The Q2 trade balance surplus improved sharply to USD 54.5bn compared to USD 42.8bn in Q2 2013, while capital account outflows slowed to a trickle.

- Malaysia: Industrial output rose 6.1% yoy in May. The strong print was driven mainly by strong domestic demand. Malaysia has quietly been reforming its economy and been able to replace weak external demand with greater domestic demand without major inflationary consequences. The Malaysian central bank last week hiked 25bps to 3.25%, but without a strong hawkish bias.

- China: The pace of China's exports and imports both picked up in June, but fell short of expectations. Exports were up 7.2% yoy in June from 7% in May, while imports rose 5.5% yoy compared to -1.6% yoy in May. The trade surplus narrowed slight to USD 32bn in June from USD 36bn in May. Domestic demand in China is now stronger at the margin than external demand for Chinese exports. Despite this, inflation remains extremely well contained. In June inflation was 2.3% yoy, lower than the 2.5% yoy recorded for May.

Policy actions:

- Peru cut rates by 25bps to 3.75%
- Malaysia hikes 25bps to 3.25%

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Global backdrop

Europe served up a reminder of its fundamental vulnerability last week when financial difficulties in the parent company of a Portuguese bank raised questions about the stability of the bank itself. We think this episode is likely to be contained, but it serves as a reminder that whole swathes of the European credit and sovereign debt markets remain entirely dependent on ECB backing. We believe there is a very strong determination on the part of European leaders and the ECB to avoid another European debt crisis. European industrial production declined more than expected in May, but other indicators suggest strength.

The ripples from Hafez Al-Assad's victory in Syria and the reconciliation of Hamas and Fatah in Palestine continue to be felt in the wider Middle East (see Weekly 28 April 2014). In addition to destabilising Iraq, tensions have now spread to Israel, Gaza and Lebanon, but so far oil prices have remained within the broader ranges that have prevailed since 2011.

Having ruled out using interest rates to stamp out bubbles last week, the US Fed this week took another dovish step by clarifying its position regarding the sequencing of monetary policy tightening (the so-called 'exit strategy'). The FOMC also indicated that QE will end in October, as previously indicated. FOMC minutes showed that the bulk of members favoured rate hikes prior to soaking up the outstanding liquidity created by QE. This is dovish because the marginal effect of a rate hike from current levels is largely innocuous, while the process of reducing the outstanding volume of liquidity will directly withdraw the fuel behind the rally in inflated financial markets in developed economies in addition to increasing the supply of securities in the market. We believe the market is underestimating both the Fed's willingness to tolerate inflation and its limitations in terms of reversing the extreme easing of recent years due to the economy's large outstanding debt burden.

In Japan, machinery orders collapsed in May. Orders fell 19.5% mom versus an expected rise of 0.7%. Orders were also down 9.1% in April. Following enormous monetary and fiscal stimuli last year, Prime Minister Shinzo Abe has so far under-delivered on his so-called "third arrow" of structural reforms in Japan. The public sector remains heavily indebted and the country has very poor demographics. This means that USDJPY is likely to fall back towards the lower levels that prevailed prior to the start of Abenomics, in our view.

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	1.4%	7.2%	15.3%	0.3%	10.5%
MSCI EM Small Cap	1.0%	9.4%	15.1%	0.8%	12.2%
MSCI FM	2.2%	22.2%	35.1%	13.1%	12.1%
S&P 500	0.45%	7.61%	19.92%	16.74%	19.96%
GBI EM GD	0.34%	6.36%	4.57%	1.43%	7.60%
ELMI+	0.07%	2.38%	2.54%	-0.60%	2.88%
EMBI GD	0.53%	9.24%	12.09%	7.52%	10.38%
EMBI GD IG	0.15%	8.21%	9.81%	5.91%	8.49%
EMBI GD HY	1.26%	11.25%	16.80%	10.46%	13.29%
5 year UST	-0.04%	2.12%	2.06%	1.89%	3.39%
7 year UST	0.03%	4.21%	3.33%	3.26%	4.73%
10 year UST	0.17%	7.25%	5.38%	5.44%	5.46%
CEMBI BD	0.31%	6.67%	9.87%	6.28%	9.48%
CEMBI BD HG	0.24%	6.52%	9.15%	6.30%	8.49%
CEMBI BD HY	0.44%	6.92%	11.38%	6.56%	12.57%
US HY	-0.06%	5.66%	11.21%	9.95%	14.62%
European HY	-0.27%	5.74%	13.79%	13.55%	17.19%
Barclays Ag	-0.15%	4.78%	6.82%	2.67%	4.30%

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