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Ashmore

Risk-reward favours EM over developed market bonds

By Jan Dehn

Risk-reward favours Emerging Markets (EM) bonds over developed market bonds at current yields and volatility. Developed market government bonds are extremely risky relative to their carry with capital losses likely to absorb years of carry. EM bonds offer a far better risk-reward proposition. Central bankers and other investors whose preferences are predominantly for government bonds should pay particular attention.

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	10.4	–	1.28%
MSCI EM Small Cap	10.8	–	1.06%
MSCI Frontier	8.9	–	0.44%
MSCI Asia	10.9	–	0.78%
Shanghai Composite	10.8	–	-2.22%
Hong Kong Hang Seng	6.3	–	0.04%
MSCI EMEA	8.7	–	2.04%
MSCI Latam	12.2	–	2.03%
GBI-EM-GD	6.59%	–	1.93%
ELMI+	3.71%	–	1.04%
EM FX spot	–	–	1.22%
EMBI GD	6.08%	408 bps	0.41%
EMBI GD IG	4.58%	251 bps	0.33%
EMBI GD HY	8.13%	624 bps	0.51%
CEMBI BD	6.05%	421 bps	0.51%
CEMBI BD IG	4.62%	279 bps	0.22%
CEMBI BD Non-IG	8.52%	666 bps	0.99%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P500	15.0	–	1.19%
1-3yr UST	0.96%	–	-0.18%
3-5yr UST	1.49%	–	-0.42%
7-10yr UST	1.98%	–	-0.76%
10yr+ UST	2.75%	–	-1.09%
10yr+ Germany	0.26%	–	-0.31%
10yr+ Japan	-0.04%	–	-1.25%
US HY	8.88%	739 bps	1.14%
European HY	5.68%	575 bps	1.80%
Barclays Ag	–	229 bps	0.52%
VIX Index*	16.50	–	-0.36%
DXY Index*	96.44	–	-0.63%
EURUSD	1.1109	–	0.86%
USDJPY	113.64	–	0.16%
CRY Index*	173.53	–	4.98%
Brent	39.7	–	-2.89%
Gold spot	1255	–	-0.96%

Note: Additional benchmark performance data is provided at the end of this document. *See last page for index definitions.

Emerging Markets

It is becoming more widely recognised that monetary policy – near-sole driver of the developed market fixed income rally since the Developed Market Crisis (DMC) of 2008/2009 – is running into serious diminishing or even negative returns. Experiments with negative interest rates in Europe and Japan have not been successful. ECB President Mario Draghi last week turned to credit easing with a warning that he would not cut rates any more. The move was not met with wild exultation in the markets. Other policy makers are once more talking about fiscal policy as a means of supporting growth. This discussion, too, borders on the surreal, because of the purposeful denial of the existence of debt, which, in case anyone needs a reminder, is the sum of past fiscal deficits. Additional fiscal stimulus would only exacerbate already substantial debt overhangs that already strangle investment and growth. Who seriously believes that building up ever more debt and inflating asset prices fixes debt problems and addresses declining productivity?

Fixed income investors should be seriously concerned. If monetary easing is becoming ineffective then short dated yields are near the bottom of their range and if additional government bonds issuance is on its way then the long end also looks more vulnerable, given already large debt stocks.[1]

Indeed, there have been some important warnings recently. Last week saw extraordinary volatility in the long end of the Japanese curve, where a sharp reversal in the 30 year bond was large enough to wipe out the equivalent of more than eight years of carry at current yields. An even larger move took place in German 30 year bonds last year, where the capital loss was equivalent to 19 years of carry at current yields.

Unlike a few years ago, there is now neither yield nor capital gains to compensate investors for potential volatility in the curve at a time when volatility may actually now be on the rise.

The risks facing bond holders in developed markets today can be illustrated by thinking about how many years of carry an investor would give up if yields rose by given amount. Intuitively, the higher the yield to maturity the shorter the time required to compensate for the rise in yield.

[1] Not to mention currencies, which are likely ultimately to resolve the debt issue.

Continued overleaf

Emerging Markets

Fig 1: **Years of lost carry for a given change in yields – at current yields**

	50bps			100bps			150bps		
	5yr	10yr	30yr	5yr	10yr	30yr	5yr	10yr	30yr
US	2	2	4	3	5	7	5	7	9
UK	3	3	4	5	6	7	8	8	10
Germany	7	20	10	14	40	19	21	58	27
Japan	–	–	17	–	–	32	–	–	44

Source: Ashmore, Bloomberg.

This is illustrated in the table above, which shows the years of lost carry for 50bps, 100bps and 150bps instantaneous jumps in yields at different maturities for the four main developed economies. A mere 50bps move in the 5 year US treasury curve wipes out 2 full years of carry. A similar move in the long end of the Japanese curve wipes out 17 years of carry. The equivalent losses for a 150bps move in the yield curves – which, by the way, would still not be enough to normalise curves to pre-DMC levels – would wipe out between 5 and 44 years of carry at current yields.[2]

Many will argue that this analysis overstates the risks in developed market bonds – they say that yields will not rise, because there is no inflation. This line of reasoning obviously flies in the face of both economic theory and long-run empirical evidence, which show clearly that money printing leads to inflation, but, supposing, just for argument's sake that the argument of no inflation is taken at face then developed market bonds still make for a lousy bet at current yields. The reason is simple: They *already* are far too volatile for comfort at current low yields.

To see this, consider the *actual* change in yields over the last 12 months. This can be taken as a simple indicator of the volatility. Then ask, "How many years would I have to hold the bond in order to completely offset the *actual* loss I incurred due to the *realised* change in yield in the bond over the last twelve months period?" We calculated the change in the yield as the difference between the lowest and highest actual realised yield over the period. The answer is shown in the table below. For 10 year bonds, investors would have to hold the bonds for 4 and 5 years in the US and the UK, but for 37 years in Germany to be compensated for the actual change in yield over the period. In Japan, there is no limit to the holding period that can compensate for the change in yield, because yields are negative.[3] It turns out that yield swings are already quite wide and therefore painful given how low yields are.

Fig 2: **Years of carry required to make up for the actual change in yield in the last 12 months**

	50bps		
	5yr	10yr	30yr
US	2	4	6
UK	5	5	5
Germany	9	37	26
Japan	–	–	37

Source: Ashmore, Bloomberg.

One way to get out of the developed market bond trap is to consider EM bonds. It is well known that EM bonds can be volatile, but they also pay a substantially higher yield. Indeed, EM bond markets entered 2016 with yields in excess of the levels that prevailed before the DMC when Fed still had rates at 5.375%.[4]

But does this higher yield compensate investors sufficiently for the greater volatility in current markets? Figure 3, overleaf, replicates the analysis for developed markets bonds for the three main EM debt asset classes – corporate USD denominated debt (CEMBI BD), sovereign USD denominated government bonds (EMBI GD) and local currency bonds (GBI EM GD). Note that the duration in these EM debt asset classes is between 4.5 years and 7 years, so the relevant columns in the previous tables for purposes of comparison are the 5 year and 10 year columns.

Two results stand out from the EM analysis. First, for equivalent moves in EM bond yields the holding period required to fully recover from the associated capital losses are dramatically lower. The longest recovery required in any EM debt asset class is 1.6 years, which corresponds to the length of time investors would have to hold a bond until the loss of a 150bps move in yields has been fully offset. In most cases, however, EM yields are high enough to compensate for capital losses in a much shorter time. On average, EM bonds make up for capital losses between six and eight times faster than developed market bonds.

[2] The table excludes 5 year and 10 year bonds in Japan, because they have negative yield. This means that not even carry for infinity would be enough to compensate for capital losses. If, at negative yields, Japanese bonds suffer capital losses carry will only add to the losses.
[3] On average across the four markets actual yields changed by an absolute amount of 0.8% for 10 year bonds (0.8% for the US, 0.9% for the UK, 0.9% for Germany and 0.6% for Japan). The average change was 0.7% for 5 year bonds and 0.9% for 30 year bonds.
[4] See *"Fixed Income Outlook 2016"*, Annual outlook 2016, January 2016.

Continued overleaf

Emerging Markets

Secondly, the higher yield on offer in EM also means that investors need to hold the bonds for a shorter period of time in order to neutralise the volatility in EM bonds. Based on the actual ranges within which yields in EM have traded in the past 12 months, which is 1.4% on average (1.5% at the median) investors only need to hold on to the bonds for little over a half a year to neutralise the volatility (less than half a year for corporate bonds).

Fig 3: **EM – an alternative to developed market bonds**

	Years of carry to compensate for change in yield			Years of carry to neutralise 12 month volume
	50 bps	100 bps	150 bps	
CEMBI BD	0.4	0.8	1.2	0.5
EMBI GD	0.5	1.1	1.6	0.7
GBI EM GD	0.4	0.7	1.0	0.7

Source: Ashmore, JP Morgan Bloomberg.

At the current low yields on offer in developed markets government bonds are extremely risky with very little offsetting carry. A capital loss will absorb years of carry. By contrast, EM bonds now offer yields that are so much higher that even controlling for EM's greater volatility EM bonds are unambiguously a far better risk-rewards proposition. This conclusion is particularly relevant for central banks and other institutions with a particularly strong predilection for government bonds.

- Venezuela: Never a dull moment in EM's most high beta credit. The government has revamped the FX system once again. There are now two rates, one rate ('Dipro') at VEF 10 per USD for 'essentials' and a freely floating rate ('DICOM') for everything else. PDVSA, the state oil company, will be able to sell oil at DICOM, though the precise volume of sales remains to be seen. What is happening here is that Venezuela is devaluing its currency by stealth, disguising exchange rate changes through a series of 'system' changes. Despite the messiness and lack of transparency, this is good news for bond holders. Investors should also draw some comfort from President Maduro's announcement last week that the government has reached agreement with China about a multi-year financing arrangement (details not yet disclosed). Meanwhile, the opposition members of parliament stated that they will attempt to stage a recall referendum to oust President Nicolas Maduro. The opposition has launched a website, where opponents of the president can sign up for his recall from office (for those curious to see what such a website looks like, check out https://revocalo.com/). The main challenge they face is that Maduro controls the Supreme Court, which, like the army, is likely to remain loyal to Maduro until or unless public protests against him warrant a tactical switch of allegiance towards the opposition.

- Brazil: Large protests in Brazilian cities over the weekend are likely to increase the pressure on the government of President Dilma Rousseff. PMDB, a key coalition partner of Dilma's PT party, also issued a threat to leave the coalition at its annual conference. Meanwhile, lower house speaker Eduardo Cunha says he will restart impeachment proceedings against President Dilma Rousseff on 17 March and the Sao Paulo state prosecutor presented charges against former President Lula that he illegally hid assets. These developments are positive, in our view, as they increase the odds that the current lame duck administration is replaced. The former chairman of Odebrecht, a major construction company, was sentenced to 19 years in jail for corruption. The stiff sentence sends a very strong signal to those caught up in the so-called 'Carwash' scandal to opt for a plea bargain arrangement with Prosecutor Sergio Moro. It is also positive that inflation declined in February. Year on year headline inflation in the IPCA, Brazil's main CPI index, declined from 10.71% in January to 10.36% in February. Core inflation was 8.6% yoy. Finally, retail sales contracted by less than expected in January (-1.6% mom versus -1.7% mom expected). For more detail see *"The biggest risks in Brazil are now to the upside"*, Weekly Investor Research, 7 March 2016. Brazil's new 10-year USD denominated sovereign bond issued last week was five times oversubscribed and tightened from preliminary price talk of 6.5% yield to 6.125% at issue (price 99).

- China: CPI inflation rose to 2.3% yoy in February due to transitory factors (weather impacting vegetable supply). Core inflation actually declined to 1.0% yoy from 1.2% yoy. Exports slowed sharply in February, while imports were stronger than expected, which suggests stronger domestic demand and weaker global demand. However, the trade numbers are heavily impacted by powerful base year effects and possibly some blowback from a very strong trade balance in January. Net net, the trade numbers should pick up in March, but longer-term China is destined to become a trade deficit economy with less investment and more consumption. This is why China is rotating from export and investment-led growth to consumption-led growth. Retail sales were marginally softer than expected in January and February, but still expanded at a pace of 10.2% yoy. Fixed asset investment was stronger than expected, which may reflect the commencement of a fiscal effort to support growth. Housing was also strong. The PBOC also announced last week that mortgage rules will be further eased, while commercial banks will be allowed to swap non-performing loans of their clients to equity stakes.

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- **Peru:** With one month to go before Peru's presidential election, polls are predicting Keiko Fukimori to become Peru's next president. A GfK Peru poll said that Keiko's share of voting intentions had risen to 35% in February from 33% in January. The runner-up, Julio Guzman, has been ruled ineligible to run for failing to properly register his political party, while the third-placed candidate, Pedro Pablo Kuczynski aka PPK, has 6.9% of voting intentions. The election is likely to usher in economic reforms; because all candidates are market friendly and the odds are rising that Keiko will obtain a workable majority in parliament. Sitting President Ollanta Humala is not eligible to run again. The central bank left rates unchanged at 4.25%.

- **Philippines:** The Supreme Court voted in favour of allowing Senator Grace Poe, full name May Grace Natividad Sonora Poe Llamanzares, to run for president after she was initially ruled ineligible for office on the grounds that she has spent too much time outside the Philippines. The Supreme Court's decision is positive for the institutional reputation of the Philippines. The leading candidates for the presidential election scheduled for May 2016 are all market-friendly, Poe included. The electoral platforms are dominated by promises on poverty alleviation, stronger growth via social and infrastructure investment as well as more transparent government. In other news, exports were lower than expected in January (-3.9% yoy versus +0.4% yoy expected), but FX reserves rose to USD 81.3bn, up nearly 1% in a month.

Snippets:

- **Chile:** The trade surplus rose to USD 597m in February, which was higher than both the consensus (USD 533m) and last year's surplus (USD 590m). Part of the reason may be domestic demand is weak. IMACEC, a monthly indicator of growth, rose by 0.3% in January, which was higher than expected (0.2%), but still the softest print since March 2010.
- **Colombia:** The government said that it intends to issue in global markets within the next five months. In a positive development, consumer prices rose by less than expected in February. Inflation was 1.28% mom versus 1.43% mom anticipated. The economy expanded by 3.3% in Q4 2015, which took the growth rate for 2015 as a whole to 3.1%. This was better than expected (3.0%).
- **Guatemala:** The trade deficit narrowed sharply in January. At USD 409m, the deficit was 14% narrower than at the same time in 2015.
- **India:** Industrial production declined at a yoy pace of 1.5% in January, which was weaker than expected (-0.5% yoy).
- **Malaysia:** Bank Negara left policy rates unchanged at 3.25% as industrial production accelerated in January (+3.2% yoy) versus December (2.7% yoy).
- **Mexico:** Bi-weekly inflation was negative in the second half of February (-0.05%), which was below expectations (+0.07%). Industrial production was stronger than expected (+1.2% mom versus 0.2% mom expected). The government announced that it is preparing to support PEMEX, the state oil company. This underlines the sovereign backstop that exists for most EM state owned energy companies. See *"Switch to EM corporates from US corporates"*, The Emerging View, and February 2016.
- **Mozambique:** Empresa Mocambicana de Atum SA, a government owned fishing company, is restructuring its USD 700m bond, according to media reports. This bond was Mozambique's first entry into the global financial markets. The proposal is to exchange Atum's bond into a pure long-term sovereign bond. The market is currently focused on whether the exchange will trigger ratings action.
- **Nigeria:** Real GDP growth slowed to just 2.1% in Q4 2015 from 2.8% yoy in Q3 2015. Nigeria's government remains in denial about the fall in oil prices, so we expect the economic pain to worsen further.
- **Panama:** The economy expanded by 5.8% in 2015, a modest deceleration from 2014 when the economy expanded by 6.1%.
- **Poland:** The central bank left rates unchanged at 1.5%.
- **Romania:** GDP expanded at a rate of 3.7% yoy in Q4 2015, up from 3.6% yoy in Q3 2015. Inflation declined to -2.7% yoy in February from -2.1% yoy in January, while the trade deficit narrowed sharply from EUR 1.12bn to EUR 383m.
- **South Africa:** Moody's, the ratings agency, placed South Africa's sovereign rating on negative outlook, but did not downgrade the credit.
- **South Korea:** The Bank of Korea left rates unchanged at 1.5%.
- **Sri Lanka:** The government has put forward a proposal to reduce the fiscal deficit from 5.9% of GDP to 5.4% of GDP by raising VAT and increasing coverage plus cancelling planned corporate tax cuts. Fiscal mismanagement is historically the biggest source of macroeconomic instability in Sri Lanka, so these budget adjustments are positive, if approved.
- **Turkey:** The current account deficit narrowed more than expected in January (to USD 2.2bn versus USD 2.4bn expected), but attention is likely to focus instead of the rising tide of violence following the weekend's explosion in Ankara.

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Global backdrop

Ahead of meetings this week by three of the four QE central banks – BOJ, BOE and the FOMC – it is no overstatement to say that global markets have started to develop a healthy scepticism about the value of additional monetary stimulus. This scepticism was on vivid display in the immediately aftermath of ECB President Mario Draghi's latest 'bazooka'.[5] Despite doing more than expected, the EUR rallied, stocks fell and yields rose, though later stocks caught a bid, but this was probably more due to higher oil prices than anything the ECB did. A few years ago a package of this magnitude would have cheered the markets for months on end. No so anymore.

The diminishing returns to monetary easing are very painfully on display. Multiple doses of past monetary stimulus has already pushed developed market asset prices to bubble levels – the scope for capital gain in developed market fixed income simply does not justify the additional risk at current yield levels. In the face of diminishing returns to easy money, policy makers must now come up with something new, or, better still, focus on the ailments that are afflicting the economy and preventing monetary easing from having the usual effect. What other options exist? Fiscal policy? If so, expect way more supply, more debt. Reforms? No way. Currency manipulation? Probably.

In fairness, central bankers are just playing with the cards they were dealt. They do not have powers to fix structural and debt problems. By contrast, politicians do have such powers, but politicians are reluctant to take on productivity and debt challenges, so their powers lay fallow. Meanwhile, voters are getting frustrated and the current impotent bunch of politicians is rapidly being replaced by a new generation of leaders with nothing to offer than populism.

The disturbing shift towards populism in developed economies is partly an unintended consequence of excessive use of unconventional monetary policies. QE has pushed up asset prices, which has made rich people richer and therefore exacerbated already severe income inequality in developed countries. This, along with the broader economic stagnation resulting from lack of attention to the debt and productivity problems are root causes of the collapsing quality of politicians across the developed world.

The rise of populism will not just impact minorities, such as immigrants and refugees – as the state elections in Germany this weekend richly illustrated – but is likely ultimately backfire on the central bankers. Central banks failed to prevent the Developed Market Crisis of 2008/2009, but then redeemed themselves with QE, but now it is only a question of time before the central bankers once again become the scapegoats. After the debacle last week, Draghi is already looking vulnerable. In fact, the entire current crop of QE central bankers – Draghi, Yellen, Carney and Kuroda – looks fated to preside over the biggest slump in central bank credibility since the 1930s.

Benchmark performance

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	8.22%	1.02%	-12.68%	-6.43%	-3.60%
MSCI EM Small Cap	6.29%	-2.44%	-9.22%	-3.90%	-2.25%
MSCI Frontier	2.37%	-1.30%	-13.63%	1.56%	1.14%
MSCI Asia	6.71%	-2.38%	-12.15%	-1.70%	0.42%
Shanghai Composite	4.55%	-20.59%	-13.24%	9.58%	1.61%
Hong Kong Hang Seng	8.15%	-11.36%	-22.69%	-5.69%	-4.28%
MSCI EMEA	8.77%	6.29%	-12.85%	-10.72%	-7.25%
MSCI Latam	15.40%	14.27%	-10.85%	-16.44%	-11.09%
GBI EM GD	5.47%	7.37%	-2.80%	-7.88%	-2.20%
ELMI+	3.35%	2.75%	-1.01%	-4.80%	-2.82%
EM FX Spot	3.83%	3.19%	-8.27%	-12.01%	-9.02%
EMBI GD	1.55%	3.30%	4.00%	2.71%	5.94%
EMBI GD IG	1.30%	3.89%	2.32%	2.27%	5.18%
EMBI GD HY	1.84%	2.45%	6.17%	3.27%	7.07%
CEMBI BD	1.56%	2.24%	1.88%	2.31%	4.68%
CEMBI BD IG	0.79%	1.70%	1.43%	2.79%	5.15%
CEMBI BD Non-IG	2.91%	3.19%	2.53%	1.21%	3.86%

[5] The 'bazooka' included cutting deposit rates to -0.4% (-10bps), lowering the main refi rate to 0% (-5bps), extending refinancing operations to four year maturities and upping QE asset purchases from EUR 60bn per month to EUR 80bn per month while increasing to the list of eligible securities to also include investment grade corporate bonds.

Continued overleaf

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Benchmark performance

Global Backdrop	Month to date	Year to date	1 year	3 years	5 years
S&P500	4.77%	-0.56%	1.29%	11.43%	11.51%
1-3yr UST	-0.40%	0.57%	0.85%	0.50%	0.66%
3-5yr UST	-1.04%	1.12%	2.15%	1.57%	2.03%
7-10yr UST	-1.89%	2.72%	3.79%	2.88%	5.44%
10yr+ UST	-2.60%	5.54%	2.94%	6.52%	10.22%
10yr+ Germany	-2.56%	7.23%	-2.57%	9.54%	11.10%
10yr+ Japan	0.31%	7.17%	12.60%	7.39%	6.84%
US HY	3.57%	2.12%	-5.10%	1.55%	5.00%
European HY	3.16%	1.85%	-0.36%	6.30%	8.94%
Barclays Ag	0.49%	1.51%	-0.12%	3.03%	4.70%
VIX Index*	-19.71%	-9.39%	3.13%	46.02%	-21.91%
DXY Index*	-1.80%	-2.22%	-3.87%	16.75%	26.32%
CRY Index*	6.32%	-1.49%	-17.64%	-41.43%	-50.51%
EURUSD	2.17%	2.27%	5.12%	-14.58%	-20.60%
USDJPY	0.84%	-5.47%	-6.35%	18.24%	39.21%
Brent	10.26%	6.38%	-27.46%	-63.75%	-65.11%
Gold spot	1.34%	18.29%	8.69%	-21.06%	-12.00%

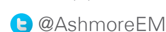
*VIX Index = Chicago Board Options Exchange SPX Volatility Index. *DXY Index = The Dollar Index. *CRY Index = Thomson Reuters / CoreCommodity CRM Commodity Index.
Source: Bloomberg, JP Morgan, Barclays, Merrill Lynch, Chicago Board Options Exchange, Thomson Reuters, MSCI, total returns.
Figures for more than one year are annualised other than in the case of currencies, commodities and the VIX, DXY and CRY which are shown as percentage change.

Contact

Head office

Ashmore Investment Management Limited
61 Aldwych, London
WC2B 4AE

T: +44 (0)20 3077 6000

 @AshmoreEM

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T: +57 1 347 0649

Dubai
T: +971 440 195 86

Jakarta
T: +6221 2953 9000

Istanbul
T: +90 212 349 40 00

Mumbai
T: +91 22 6608 0000

New York
T: +1 212 661 0061

Riyadh
T: +966 11 483 9100

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T: +65 6580 8288

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