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Are developed bond markets dying?

By Jan Dehn

Developed bond markets are in danger of dying. The end of a 35-year rally in developed market fixed income may be more than just the death of positive returns as inflation risks push up bond yields. There is also a material risk that markets themselves may eventually be relieved of their traditional roles of determining term yields. The reason is that no developed market country is likely to handle the bear market steepening that would occur if markets were free to price bonds as inflation returns. Inflation and currency depreciation would decimate developed market bonds. Meanwhile, the conditions that could usher in the death of developed bond markets simply do not exist in Emerging Markets (EM). This means that EM fixed income markets could soon be the only freely tradable government bond markets in the world. In the global backdrop section we discuss the recent Dollar rally, which has been far more pronounced against EUR and JPY than against EM. In sharp contrast with the current market consensus we do not see great upside for the USD versus EM currencies, because real effective exchange rates strongly point to major upside potential for EM currencies, while inflation could hurt rather than help the Greenback.

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	11.5	–	-0.52%
MSCI EM Small Cap	11.8	–	-1.00%
MSCI Frontier	10.4	–	-0.46%
MSCI Asia	12.2	–	-1.20%
Shanghai Composite	13.4	–	-0.10%
Hong Kong Hang Seng	7.8	–	-0.89%
MSCI EMEA	9.3	–	0.60%
MSCI Latam	13.6	–	2.82%
GBI-EM-GD	6.89%	–	-1.15%
ELMI+	4.65%	–	-1.64%
EM FX spot	–	–	-0.74%
EMBI GD	5.88%	354 bps	-1.81%
EMBI GD IG	4.58%	219 bps	-2.16%
EMBI GD HY	7.54%	528 bps	-1.44%
CEMBI BD	5.51%	332 bps	-1.17%
CEMBI BD IG	4.43%	225 bps	-1.36%
CEMBI BD Non-IG	7.22%	504 bps	-0.87%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	16.4	–	0.89%
1-3yr UST	1.06%	–	-0.28%
3-5yr UST	1.77%	–	-0.83%
7-10yr UST	2.32%	–	-1.66%
10yr+ UST	2.99%	–	-1.72%
10yr+ Germany	0.28%	–	0.60%
10yr+ Japan	0.03%	–	-1.18%
US HY	6.74%	474 bps	-0.32%
European HY	4.23%	466 bps	-0.75%
Barclays Ag	–	237 bps	-0.95%
VIX Index*	13.18	–	-1.30%
DXY Index*	100.82	–	0.71%
EURUSD	1.0640	–	-0.90%
USDJPY	110.74	–	-2.10%
CRY Index*	185.15	–	4.89%
Brent	48.1	–	8.26%
Gold spot	1214	–	-0.59%

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

Emerging Markets

The risk is increasing that the markets role in pricing government bonds in developed economies could be seriously curtailed or eliminated over the next few years. The reason is not that markets do not work, though in many cases that would be a valid criticism. Rather, the reason is that developed countries are likely to cope very badly with the yield curve bear steepening that would occur naturally if markets were free to price in future inflation, given high debt levels and low trend growth rates. Growth rates are simply too low, productivity rates too low, debt levels too high and asset prices too elevated for developed economies to handle the required steepening. Inflation is therefore not just a threat to returns, but could lead to measures that end trading altogether.

To those that think that this sounds alarmist, the elimination of bond markets in the developed world is already well underway. Japan's recent decision to stabilise the 10-year government bond yield at zero – a policy euphemistically dubbed yield curve targeting – is indicative of things to come in other developed bond markets. Western economies are also a lot closer to killing off their bond markets than many appreciate. The European Central Bank (ECB) has almost run out of room to buy bonds and the US Fed is already the single largest owner of US Treasuries and mortgages. Pension funds and insurance companies own huge chunks of government debt too, but they are severely restricted in their ability to off-load their holdings due to regulation. Basel II and III and Solvency II regulation forced enormous volumes of bonds onto those institutions.

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Emerging Markets

Japan's yield curve targeting policy is revolutionary, because it overturns a very, very long tradition in capitalist societies of tasking markets with determining long yields, a policy that has traditionally relegated solely the very shortest end of the curve to government control. This division of labour between markets and policy makers along duration lines already began to blur with the start of Quantitative Easing (QE). By shifting its *de facto* policy rate to the 10 year point on the government curve, the Bank of Japan has truly gone the extra mile by effectively eliminating the role of the market in setting term yields.

Looking ahead, it is easy to imagine that Japan's approach – or an equivalent policy – could gain popularity in the rest of the developed world, because it confers considerable short term advantages upon governments. In comparison to US long bonds, Japanese long bonds have already proven to be more stable in the face of volatility than in the past, which is a quality that surely must seem desirable in countries with large debt stocks. One imagines, for example, that Japan's policy has caused some European governments and ECB policy makers to sit up and listen as a means of defending against another European periphery debt crisis.

Nearly every developed market government is also gearing up for more fiscal spending, having exhausted the scope for monetary stimulus. The certainty that the central bank will buy any bond in order to keep yields at zero gives *carte blanche* to the Japanese Treasury to increase fiscal spending in the knowledge that yields are stable.

In addition, the Japanese policy has longer-term benefits that become evident after inflation returns in earnest. Each uptick in inflation will erode the real debt stock, but for the most part without any need to fear bond market vigilantes. Of course, bond holders will take losses, but the underlying investors in pension funds will not know they are being lulled into a false sense of security until they retire many years from now. Currencies also go down as inflation rises against the backdrop of frozen nominal bond yields, but this actually helps to solve the debt problem and benefit exporters. The losses from currency depreciation will accrue to foreign holders of debt. They, like future generations, do not vote in home elections. Hence, this policy works politically.

Governments have ways of controlling term yields other than the Japanese way. Central banks can engage in direct purchases of bonds in primary auctions to hold down yields, so-called Helicopter Money, and they can swap the existing bonds on their balance sheets into longer-dated securities at the same yield.

Whatever the method used the implication is the same: bonds will cease to be freely traded in markets and their real value will be steadily eroded over time. In our view investors who do not want to sit on such loss-making securities should exit early and shift into assets, where they still have a degree of latitude to price assets. They should be aware, however, that markets without bonds can be volatile as China's experience has shown. One of the reasons why the A-share market has been volatile is precisely that Chinese retail investors generally do not have recourse to bonds, which is the natural bear market instrument of choice. Hence, to trade negative sentiment they need to short stocks instead, which explains why A-shares are so volatile. A similar fate could befall developed market stocks if and when the bonds markets are destroyed.

The destruction of developed market bonds makes EM bonds more attractive as the only truly tradeable fixed income markets left in the world. At USD 18.5trn in size and extremely diversified, EM bonds are already attractively priced with bond yields sitting just 40bps below the yield they had in late 2006 when the Fed had rates at 5.25%.

More importantly, the conditions that are leading to the death of bond markets in rich countries are simply not in existence in EM. No EM country has anywhere near the combination of low growth rates and high debt levels that characterise developed countries. No EM country has done QE. No EM country is ever granted the luxury of low or even negative yields. No EM country can rely on currency appreciation when they have a crisis. No EM countries can avoid reforms when the economy starts to fail. In other words, EM countries are always forced to deal with their problems head-on, which is why things never get as disastrous as they are in developed economies these days. Above all, most EM countries are in the process of developing their markets, not killing them. This bodes well for depth and breadth and diversification of the asset class over time.

Global backdrop

For a central banker Fed Chairwoman Janet Yellen was remarkably explicit last week when she stated that the Federal Open Market Committee (FOMC) would raise rates by 25bps on 14 December. The hike is already fully priced in, so her statement did not move markets at all.

Instead, what moved markets was her forthright statement about her career plans; specifically that she intends to serve out her full term as Chairwoman. Her term expires in 2018. The market had begun to speculate lately that maybe she would leave her post early after being publicly criticised by President-elect Donald Trump during the election campaign.

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Global backdrop

Yellen's insistence on completing her term was welcomed by the US stock market. In the minds of many she is equated with dovishness. Her statement that she will stay therefore stoked inflation fears further causing bond investors to flee out of bonds and into stocks, sending US equity indices to new post-election highs. By contrast, bonds crashed. The 30-year bond yield rose above 3.04%, which is also a post-election high.

The bloodbath in the US bond market so far this year has wiped out all the positive returns for the year. In fact, 30 year bonds futures are now down to a +2.7% ytd. Or to put it another way, the US 30-year bond has now lost more than 16% since mid-year, while the US 10-year bonds is also close to flat for the year following the 'last QE trade' earlier this year.[1]

By contrast, EM bonds have performed much better as indeed one would expect of shorter duration bonds with higher yields/spreads issued by less indebted countries and corporates at a time of rising US Treasury yields.

The USD also had a good week as the broad Dollar index, DXY, hit a new high above 101. Money is sucked into the US from abroad when the US stock market rallies. The USD thus rallied against EM currencies, although the real fireworks were against JPY and EUR. As far as EM currencies are concerned they are now flat versus the Dollar YTD, a resilience which may surprise many given the number and the seriousness of developed market shocks this year, notably Brexit and Trump's election.

As far as JPY is concerned, the rise in USD was aided by Bank of Japan's confirmation last week that its policy of yield curve targeting – as discussed earlier – will be implemented as planned. This makes JPY the world's favourite funding currency, albeit with the added little twist that the funding is now 10-year duration funding.

As for the EUR, analysts seem to be building a bearish EUR narrative around the upcoming Italian referendum, the shrinking universe of bonds for ECB to buy, and political risks in 2017 such as the upcoming Dutch, French and German elections.

The rally in the USD may, however, be short-lived. If the underlying reason for the sell-off in US bonds is that investors are fleeing from inflation why should the Dollar go higher? This smacks of serious money illusion, because rising inflation in the context of a dovish Fed, which is unable to reach neutral monetary policy for several years, suggests a period of lower rather than higher real rates. And lower real rates ought to be negative for the Dollar.

US growth optimism may also be fuelling the Greenback, but here too hopes may be somewhat overstated. Sure, fiscal stimulus will add to aggregate demand, but as long as the outlook for aggregate supply remains tepid the fiscal stimulus may end up creating more inflation and overheating rather than elevating the trend growth rate.

The existing macroeconomic backdrop is important here. The threat of inflation already looks real enough:

- First, core CPI inflation is already above the Fed's target, even after moderating marginally to 2.1% yoy in November.
- Second, households have deleveraged, negative equity is back to frictional levels and the economy is close to full employment, so consumers look set to spend.
- Thirdly, never before has the Fed allowed the US economy to reach full employment with only one hike on the books.
- Fourth, the likelihood that the Fed can 'catch up' by executing the eight or so hikes it would take just to get back to neutral, as well as soaking up all the outstanding QE liquidity, is poor.

In addition, the failure to reform means that growth is quite simply too low, productivity is negative, debt levels are too high and asset prices so high (after years of hyper monetary easing) that sharply rising real rates could crash not only markets, but the wider economy.

Hence, the rotation out of bonds and into stocks may make sense within the context of US markets, but not from a global investment perspective. Rising inflation will undermine the purchasing power of all assets denominated in Dollars, including stocks, so investors can do better being in non-Dollar assets.

Quite aside from this macroeconomic argument there is also a valuation problem for the Dollar. The overwhelming consensus among global investors has been – for several years now – that the US economy is just about to have exit velocity and that the Fed is just about to raise rates materially. This so far over-optimistic view has been priced into the Dollar as enormous amounts of liquidity, amplified by QE, have piled into the US, driving up both stocks and the Dollar itself. As the chart overleaf shows, the US REER is sitting at the highs (apart from the overshoot around the DotCom Bubble). By contrast, EM REERs are back to levels last seen at the very start of the big local currency bond rally in 2003. These contrasting REERs point strongly to better growth potential in EM and growth challenges in the US.

[1] *"The last QE trade"*, Weekly Investor Research, 31 October 2016.

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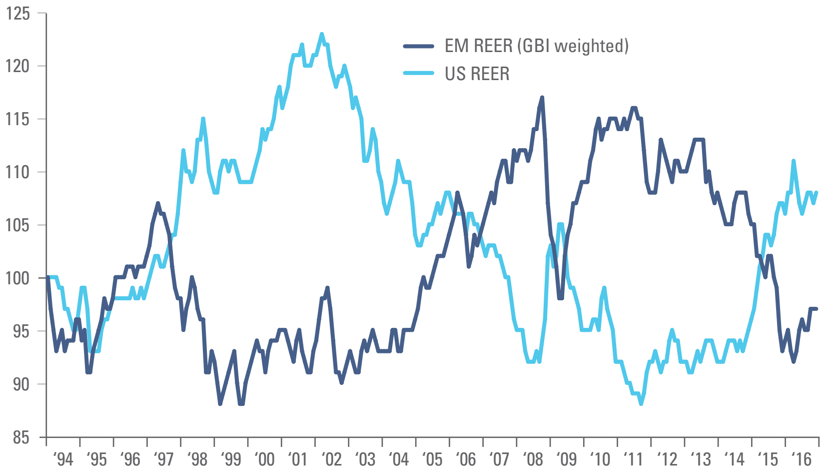
Global backdrop

Fig 1: **Real Effective Exchange Rates: US and EM**



Sources: Ashmore, BIS, Bloomberg.

Finally, we note that the primary cause of the post-US election adjustment in EM FX is the outbreak of uncertainty caused by Trump's ascent to the US presidency. EM FX always responds quite chirpily to global events, so this should not really surprise anyone too much. Going forward, however, the uncertainty surrounding Trump will decline as more information becomes available about his appointments, his policies and his ability – or otherwise – to work with Congress.

Benchmark performance

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	-6.65%	8.83%	5.44%	-3.68%	0.77%
MSCI EM Small Cap	-5.55%	1.63%	2.37%	-1.35%	2.61%
MSCI Frontier	-0.75%	1.06%	-1.97%	-1.57%	3.99%
MSCI Asia	-4.94%	5.54%	5.24%	0.14%	4.85%
Shanghai Composite	2.98%	-7.93%	-8.68%	15.88%	8.39%
Hong Kong Hang Seng	-2.19%	0.95%	-3.01%	-2.50%	2.68%
MSCI EMEA	-6.38%	10.63%	-0.66%	-9.72%	-3.05%
MSCI Latam	-13.07%	26.61%	15.49%	-10.04%	-6.51%
GBI EM GD	-7.59%	7.27%	4.28%	-5.55%	-2.12%
ELMI+	-3.61%	2.71%	1.62%	-4.30%	-1.79%
EM FX Spot	-5.34%	-0.62%	-2.78%	-11.25%	-8.16%
EMBI GD	-4.06%	8.74%	7.35%	5.78%	5.78%
EMBI GD IG	-4.59%	6.12%	4.85%	4.65%	4.25%
EMBI GD HY	-3.48%	11.61%	10.07%	6.87%	7.83%
CEMBI BD	-2.23%	8.63%	7.08%	5.00%	5.70%
CEMBI BD IG	-2.47%	5.50%	4.81%	4.62%	5.02%
CEMBI BD Non-IG	-1.87%	13.97%	10.86%	5.33%	7.06%

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Ashmore

Benchmark performance

Global Backdrop	Month to date	Year to date	1 year	3 years	5 years
S&P 500	2.83%	8.87%	7.05%	9.06%	14.83%
1-3yr UST	-0.47%	0.99%	0.92%	0.55%	0.55%
3-5yr UST	-1.65%	1.43%	1.45%	1.40%	1.23%
7-10yr UST	-3.99%	1.34%	1.55%	3.18%	2.29%
10yr+ UST	-7.53%	1.67%	2.74%	7.53%	3.12%
10yr+ Germany	-1.79%	9.64%	7.60%	10.92%	8.00%
10yr+ Japan	-1.57%	9.34%	11.32%	6.88%	6.03%
US HY	-1.25%	14.11%	10.62%	4.10%	7.25%
European HY	-1.04%	7.31%	4.98%	5.46%	10.66%
Barclays Ag	-2.17%	5.32%	4.98%	4.09%	4.84%
VIX Index*	-22.74%	-27.62%	-14.80%	4.11%	-59.95%
DXY Index*	2.41%	2.22%	1.26%	24.36%	28.76%
CRY Index*	-0.61%	5.11%	0.77%	-32.81%	-40.04%
EURUSD	-3.11%	-2.04%	0.04%	-21.08%	-21.12%
USDJPY	-5.35%	8.56%	10.93%	-8.65%	-30.57%
Brent	-0.41%	29.02%	7.70%	-56.30%	-55.00%
Gold spot	-4.94%	14.42%	13.56%	-2.31%	-27.62%

*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.

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