The Emerging View
The Ugly Duckling Grows Up

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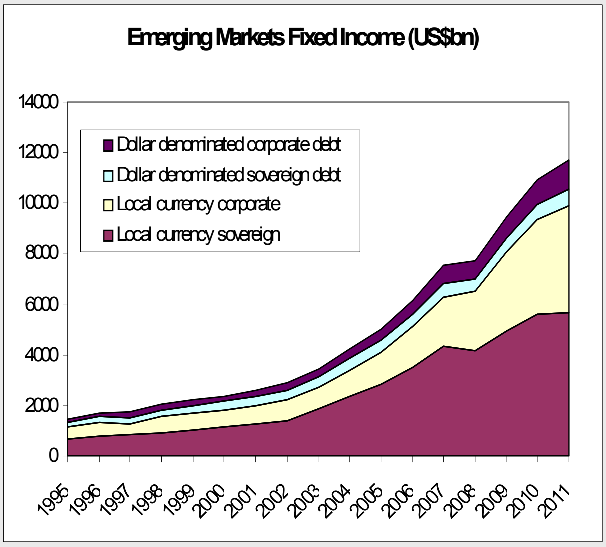
February 2012 Issue No. 89

Ignore Emerging Market Fixed Income at your peril!

In the mid 1990s, Emerging Market Fixed Income was still just a niche asset class, which was mainly traded by appointment. Today, it is a $12trn asset class, larger than the US treasury market. The Emerging Markets asset class has sustained average annual growth rates of 16% over the past decade. We expect this rate of growth to continue or accelerate going forward due to the still very low level of financial assets relative to GDP. Indeed, issuance has merely paused during crisis years before rebounding briskly on the back of powerful structural drivers.

We estimate that the Emerging Markets Fixed Income universe is likely to triple or even quadruple in size by the end of the current decade. We expect all Emerging Markets Fixed Income asset classes to expand in absolute terms, but local currency in particular to be become hugely dominant, while local currency corporate bonds will be well on the way to occupying the very top spot by the time we hit 2020.



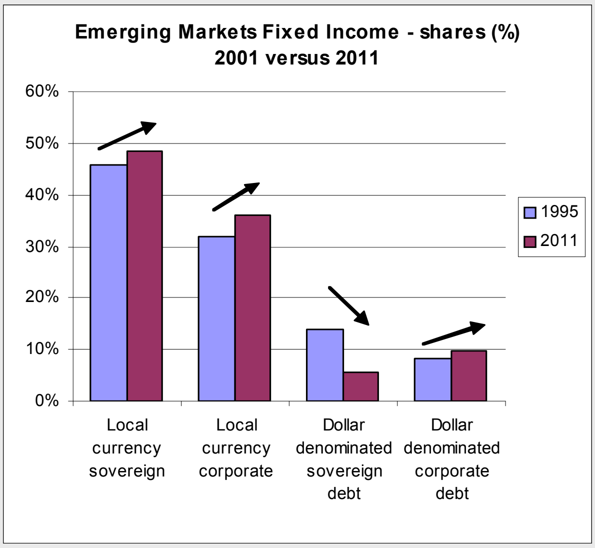
The growth of the asset class is a virtuous circle: financial deepening and broadening and a shift in capital from the public to the private sector will improve liquidity conditions as well as raise trend growth rates in parts of the world, where the private sector until recently was—and still in many cases remains—entirely capital constrained.

We believe investors underestimate what an Emerging Markets Fixed Income asset class of $47trn by 2020 means for their asset allocation, whether they are based in G10 or manage money for Emerging Market central banks or sovereign wealth funds.

The Emerging Markets Fixed Income universe today...

The Emerging Markets Fixed Income universe continues to expand rapidly. In conformity with the long-run stylised facts of economic development, Emerging Markets Fixed Income has expanded at a faster clip than nominal GDP growth. The chart on the right shows the growth of Emerging Markets Fixed Income since 1995, when our data began. Note that the asset class has shown positive growth every single year, including the years of the Asian crisis and the credit crunch. The universe of Emerging Markets Fixed Income is now $11.7trn, larger than the US treasury market and eight times larger than in 1995. The average annual rate of growth of the asset class since 1996 has been 15%.

The asset class is expanding mainly for structural reasons. Two developments in particular have been key. First, Emerging Market governments began in the 1990s to prioritise the development of pension systems, which, in economies with young populations strongly supports the rapid growth of domestic government bond markets. The share of local currency debt in total Emerging Markets fixed income rose from a low of 72% in 1997 to 85% by 2011, mainly due to this development. The other driver is corporate issuance, which began to take off more recently. From a share of just 33% of total Emerging Markets Fixed Income in 2004, corporate bonds now account for nearly half (46%) of all fixed income in Emerging Markets. Local currency corporate issuance is particularly rapid and there is now nearly three times more local currency corporate paper outstanding than G10 denominated corporate paper. The ability of corporates to tap both domestic and global capital markets stems from the vast improvements in economic and political governance, which followed the end of the Cold War in 1989.



One corollary of the rise in local currency and corporate issuance is that the asset class' conventional benchmark, that is, dollar denominated sovereign bonds, has become a much smaller part of the total Emerging Markets Fixed Income universe. In 1995, these bonds constituted 14% of total outstanding. Today, the share has fallen to just 6% as the chart on the right shows, despite average annual growth of 6% over the past 10 years. Still, we expect a raft of new sovereign issuers to enter the theme from Frontier Economies over the next decade, and we also believe existing issuers of hard currency debt will want to maintain their curves, so as to enable corporates to price bonds. Even so, the more rapid growth will happen within the themes of local and corporate issuance, in our view.

...and in the near future

Where is the Emerging Markets Fixed Income universe heading? We expect that the asset class is going to grow at a solid, but steady pace over the next decade and more. The combination of on the one hand elastic supply from corporates and local currency denominated sovereigns, and on the other hand behaviourally constrained gradual demand growth from institutional investors, creates precisely this type of steady growth, the very opposite of bubble dynamics. Most institutional investors probably underestimate just how large the Emerging Markets Fixed Income asset class will get by the end of this decade.

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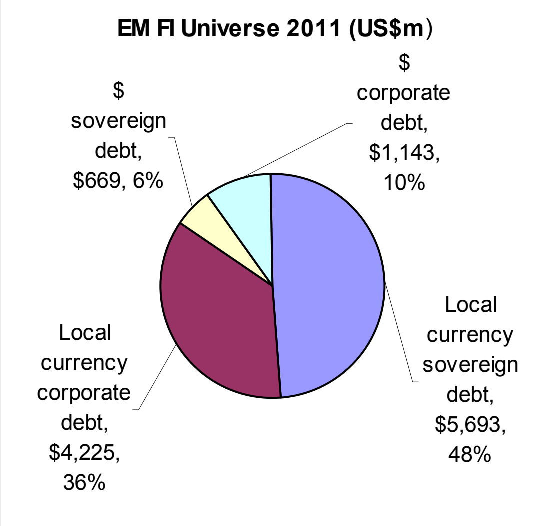
To see why, consider a few scenarios for how the asset class may grow from its current size of $12trn between now and 2020:

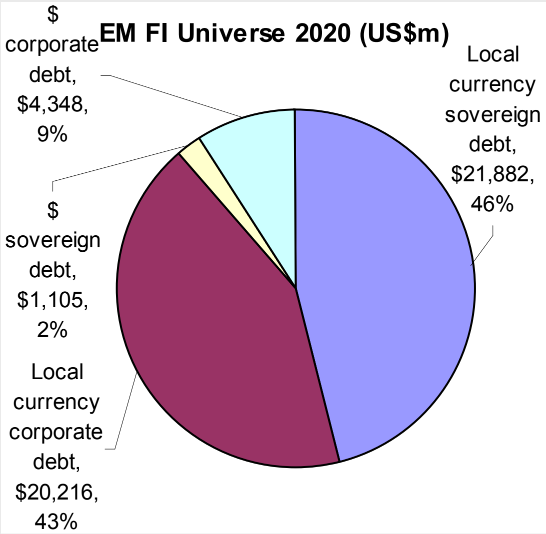
(1) 5% per annum real growth: This growth rate is equivalent to the growth rate of Emerging Markets economies at the current depressed levels of global growth, i.e. 5% real GDP growth. Even at this growth rate, the Emerging Markets Fixed Income asset class triples to $30trn by 2020.

(2) 7% per annum real growth: This is how fast Emerging Market economies grew in real terms over the 2005-2011 period. At this growth rate, the Emerging Markets Fixed Income universe would expand to $36trn by 2020, roughly four times the current size of the US treasury market. Note that 7% real GDP growth is a conservative assumption, when it comes to financial sector development, because it implies constant fiscal deficits as a share of GDP and zero capital deepening in the corporate sector. In our view, it is more realistic to expect the Emerging Markets Fixed Income asset class to grow faster than this, for the structural reasons outlined above.

(3) 11% per annum real growth: This is the pace at which Emerging Markets Fixed Income has grown over the past decade in real terms, including the Dotcom and Sub-prime crisis periods. If this rate of growth is replicated between now and the end of the decade then the Emerging Markets Fixed Income universe will grow to $48trn by 2020. The scaled pie charts to the right provide a visual impression of how the different rates of growth of individual asset themes plays out over this time period. Thus, by 2020, dollar denominated sovereign debt is a US$1trn asset class, while dollar denominated corporate debt is four times larger at US$4trn. The real expansion, of course, is felt in local currency space. Local currency sovereign becomes an enormous asset class of its own right at US$22trn, while local currency corporate debt, an asset class, which does not even have a benchmark index yet, will have risen to a staggering US$20trn.

(4) 16% per annum real growth: This scenario assumes that financial sector development occurs at a pace, which is 5% faster than the real economy. This is entirely possible if capital markets continue to move to Emerging Markets, if the habit of institutional investors in Emerging Markets to invest only in Developed Markets changes, and if Emerging Market economies get the structural changes associated with the unwind of global imbalances right. In this scenario, the Emerging Markets Fixed Income asset class could reach $63trn of which some $56trn is in local currency.





Implications for investors

Emerging Markets are still significantly under-represented in the Global Fixed Income universe. The table below shows Emerging Markets Fixed Income as a percentage of Global Fixed Income. These figures are significantly below Emerging Markets' share of Global GDP, which is now close to 36%, according to the IMF - and 36% is conservative: one should also consider that the share is already over 50% using purchasing parity power, and that given growth rates and likely near term currency appreciation could be over 50% in market terms within a decade

We expect that Emerging Markets Fixed Income will multiply by factors of anywhere between 3 or 6 over the next 8 years with the majority of new paper absorbed by local pension funds and traded within Emerging Markets themselves. The resulting financial deepening will significantly enhance liquidity and further stabilise local fixed income markets. We also believe corporate debt will overtake sovereign debt as the single biggest asset class in Emerging Markets as early as 2017, partly due to benign fiscal developments in Emerging economies. By 2020, corporate debt should account for 52% of total Emerging Markets Fixed Income compared to 45% today. Local currency corporate debt will, alongside local currency sovereign debt, be the dominant theme in the asset class with $20trn in outstanding paper (roughly four times the size of the dollar denominated corporate debt universe). The growth of local corporate paper poses a major challenge to investors and index providers alike; this asset class still has no index and we believe Ashmore is still one of the only managers out there to have launched a fund in this theme: That the private sector in Emerging Markets can now access term capital is a game changer, in our view.

Dollar denominated sovereign debt, once the backbone of the whole Emerging Markets asset class, will grow at a slower pace, reducing its share (but not absolute value) from the current 6% to about 2% by 2020. But there is upside risk to this projection: issuance from a large number of Frontier Economies over the next decade. As many as 50 low to low-middle income countries could yet come to market with index-eligible dollar denominated sovereign bonds over the coming years, increasing both the diversity and the spread of the asset class as more established emerging issuers trade ever closer to and, in many cases, likely through US treasuries.

Emerging Markets Fixed Income class	% of Global Fixed Income universe
Local currency corporate	15%
Local currency sovereign	14%
$ corporate debt	5%
$ sovereign debt	28%

(Table and chart data from "Size and structure of Global Emerging Markets Debt", 7 February 2012, Bank of America Merrill Lynch, and International Monetary Fund)

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