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The Emerging View
The Great Flight From Liabilities

Jan Dehn

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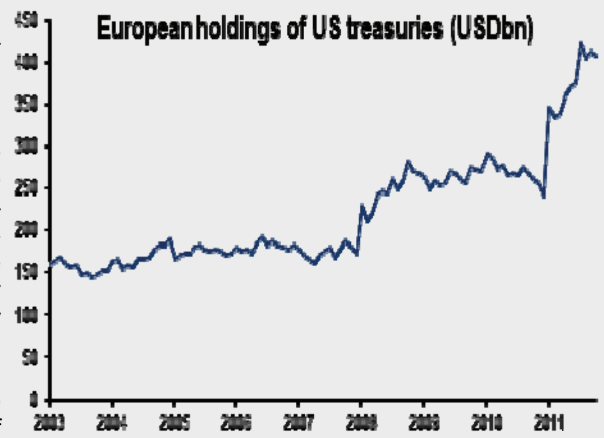
We argued previously that purchases of US treasuries and US dollars constitute a flight to liabilities, not a flight to safety. But this can also reverse. We now develop this line of reasoning by arguing that the greatest risk facing fixed income investors today may not be the European periphery, but how to manage the coming rise in US treasury yields. We estimate that anyone holding a 10yr Treasury bond when yields return to their historical average stands to lose more than 30% of their money. How should investors manage the coming Flight From Liabilities?

The Greatest Risk

The 10yr US Treasury yield is today trading below 1.8%. German 10 year Bunds trade at a yield below 1.45%. Bonds in Heavily Indebted Developed Countries (HIDCs) will not continue to trade at these low yields. At a minimum, we expect yields in HIDC bonds to return to their long-term averages, with risks for yields to the upside. The average yield on the 10yr US Treasury bond over the past 50 years was 6%, or closer to 7% if you include the 1980-1985 period when yields briefly spiked to 15.8%. A simple calculation shows that if you own a 10 year treasury when yields rise to 6.5% from the current level you stand to lose 34%. This risk is potentially many times costlier than a Greek default. It is a risk which investors should not ignore.

Why are HIDC yields vulnerable? Policy rates have been pushed to their all-time lows. The Fed, ECB, BOE, and BOJ have engaged in unprecedented money printing via Quantitative Easing (QE). The combination of zero interest rates policy and QE has pushed government bond term yields to historical lows.

But US consumers are gradually deleveraging. Europe's policy makers are turning away from austerity and towards more growth. Central Bankers are already becoming more reluctant to support the market with additional stimulus, wary not just of the dangers of stimulus addiction, but also of the ever-increasing risk that a significant inflation premium creeps into long-term bond yields.



There is no precedent for reversing QE of the magnitude currently in place. At best, when the time comes for reversing the current set of policies, the market will therefore price in a material risk of policy mistakes. Not only may yields rise, they will also become more volatile. Rate volatility in turn will end the phoney war in currencies; FX markets will become extremely unstable too. FX weakness and higher rates will both work against holders of HIDC bonds.

Investor exposure to HIDC bonds is likely to increase and become more concentrated. The effect of the debt crisis in peripheral Europe and the direction of regulation is to encourage investors to add to already heavy exposures in US treasuries. For example, data from Barclays Bank shows that European holdings of US treasuries expanded 67% since May 2011. This should concern everyone. Liquidity depends on the existence of both buyers and sellers. If HIDC bond yields unhinge much more paper has to exit via a smaller door.

Emerging Market Local Currency Bond Markets as a Hedge

The obvious defences against rising yields are to hedge interest rates directly, for example by shorting treasury futures or receiving floating legs of swaps contracts, shortening duration, or buying equities. But these options are not available to all investors. Long-only fixed income investors must try to find less rate sensitive assets, such as perhaps counter-intuitively higher spread bonds, or bonds with entirely different yield drivers. Typically, this means markets with materially different bases of investors. On both these premises, Emerging Market local currency government bonds look attractive.

First, local yields respond to local inflation dynamics, local monetary policy, and local credit worthiness. Unlike HIDC central banks, Emerging Market central banks have not printed unprecedented levels of cash, and have no reason to do so in the near future, which is the case in HIDCs. The inflation risk premium is therefore likely to remain low, particularly since policy makers in Emerging Markets are extremely sensitive to inflation.

Second, Emerging Market local currency government bonds are owned by local pension funds, which are usually prohibited from investing in non-domestic securities. It is a different and largely independent investor base. According to Deutsche Bank and JP Morgan data, as of end 2011 some 77% of all domestic debt issued by Emerging Market governments was in the hands of local pension funds and other domestic investors.

By contrast, all HIDC bonds are largely held by the same investors. A rise in yields in one HIDC market will therefore likely induce profit-taking in other markets, thus spreading the rise in yields in one market to the next with great speed.

The data shows that US and German bond yields are nearly 8 times more correlated than US and...cont.

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Emerging Market local currency bond yields, based on data from April 2003 to May 2012 (see table below). The correlations do not change materially whether you look at daily, monthly or quarterly data, and the result also carries over to correlations in changes in yields.

Correlation coefficients	JP Morgan GBI-EM Global Diversified vs. US Treasury 5yr Bond	JP Morgan GBI-EM Global Diversified vs. German 5yr Obl	US Treasury 5yr Bond vs. German 5yr Obl
Daily	11.3	41.0	82.2
Monthly	12.5	36.5	82.1
Quarterly	2.1	15.5	64.7

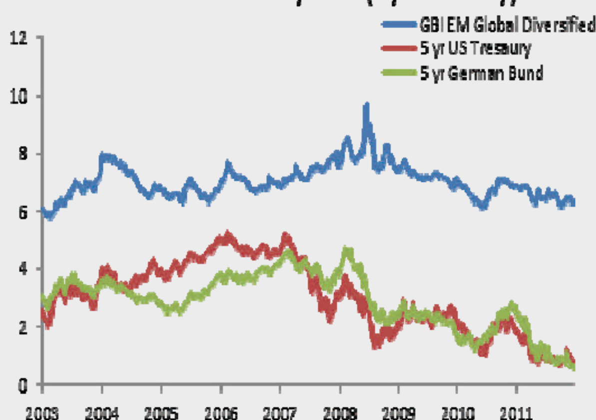
Emerging Market local currency government bond yields are also less volatile than HIDC bond yields, and they pay more. Over the 2003-2012 period the annualized standard deviation of Emerging Market local currency government bond yields was 8.9% compared to 19.3% and 15.1% for US and German bonds, respectively. The yield on Emerging Market local currency government bonds was, on average, more than twice as high as US and German bonds over the period. This against much stronger fundamentals – see section later in this piece.

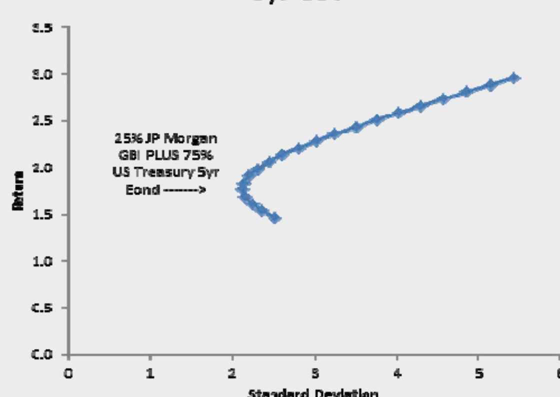
Yields (2003-2012)	JP Morgan GBI-EM Global Diversified	US Treasury 5yr Bond	German 5 yr Obl
Annualized Standard Deviation	8.9%	19.3%	15.1%
Mean	7.0	3.0	2.9
Mean - 2 standard deviations	*5.8*	*1.9*	*2.0*
Mean + 2 standard deviations	*8.3*	*4.2*	*3.8*

We also calculated volatility and returns on Emerging Market local currency bonds and US 5 year bonds over the same period and put the numbers into a simple efficient frontier analysis. The result shows that 25% would be a volatility-minimizing allocation to Emerging Market local currency government bonds. All else even, a greater tolerance for volatility would justify an even greater allocation. We believe that efficient frontier analysis of this kind actually understates the optimal allocation to Emerging Market local currency bonds for two reasons:

First, it does not distinguish between volatility and risk. There is a major difference between volatility and risk in both Emerging Markets and HIDC bond markets. In Emerging Markets, volatility tends to overstate risk due to the behaviour of cross-over investors and banks, many of whom trade Emerging Markets as souped-up bets on HIDC stock markets. By contrast, HIDC bond markets tend to understate risks relative to volatility, because many investors still buy into the concept of 'risk free'. There is, obviously, no such thing as a risk free investment — use of the term signals risk is un-priced.

Second, efficient frontier analysis does not take account of the massive disequilibrium in HIDC rates. Current HIDC yields are the lowest in at least 50 years. They will rise over time, inflicting losses on holders. By contrast, Emerging Market local currency bond markets are trading within a very stable 6% to 8% range. This difference is illustrated in the chart below. The directional risk in HIDC bonds is far, far greater than in Emerging Market bonds, particularly for strategic investors.





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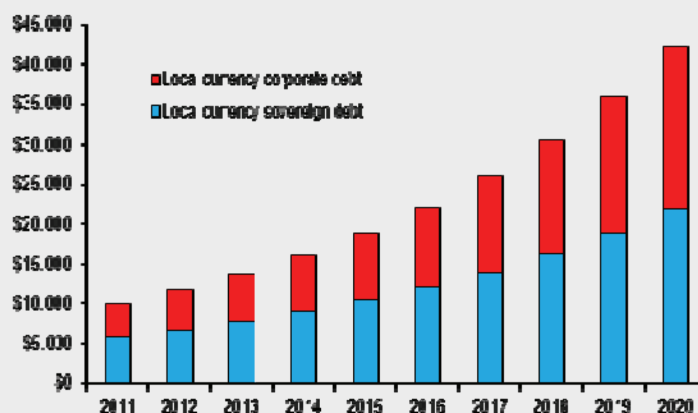
Does Size Matter?

Is the Emerging Market local currency bond universe large enough to accommodate potentially very large flows out of G10 bond markets when the Great Flight from Liabilities begins?

US treasury yields will not go to 6% overnight. We expect 10yr US treasury yields to end this year at 2.25% with yields only creeping higher gradually. But towards the end of 2013 and into 2014 the market is already beginning to price in the start of the hiking cycle as the risk of an inflation risk premium increases with time.

Our central projection is that the Emerging Market asset class will reach USD47trn by 2020, nearly 5 times the size of the US treasury market. The main driver is a combination of an expanding middle class, young populations, and formalization of labour markets, which ensure rapid accumulation of savings. Our projection assumes constant fiscal deficits and stable exchange rates between Emerging Market currencies and the USD. A decline in the dollar versus Emerging Market currencies would increase the dollar equivalent value of the Emerging Market fixed income universe further. Even in the absence of capital deepening and broadening the asset class is expected to reach USD30trn by 2020, three times larger than today.



By 2020, the vast majority of the asset class will be local currency. We estimate that the local currency government bond market will be USD21trn and local currency corporates another USD20trn. This compares to less than USD10trn. By 2020, local currency bonds should comprise 89% of the Emerging Market fixed income universe, thus offering a very meaningfully sized destination for those seeking to escape rising US treasury yields.

Emerging Markets used to be so risky, so what happened?

It is still possible to hear the view that Emerging Market strength is temporary and will soon give way to the populism of old. We think this view betrays a profound misunderstanding of the deep changes that have taken place in the global economy over the past two and half decades. Let us therefore briefly recap why we think Emerging Market fundamentals will continue to be strong for the foreseeable future.

Cast your mind back to the Cold War. In the second half of the 20th Century the vast majority of Emerging Market governments were de facto puppet regimes in the service of Superpowers. Countries were run not for the people, or by the people, but to preserve spheres of influence in the great ideological battle between Communism and Capitalism. Politicians of the period answered to their chosen Superpower in exchange for guarantees of power, almost regardless of how they managed their countries. Unsurprisingly, many ruled with impunity. Dictatorship became the norm, from Statist pro-Soviet satellites in the Eastern Block to the plethora of right-wing dictators in South America. In Africa, the Cold War often turned distinctly hot, locking the continent into decades of economic and political disasters.

The politics of impunity were an unmitigated economic disaster: Balance of payments crises; inflation; fiscal mismanagement; defaults; abuse of property rights; deepening poverty; desperate populations; political repression; human rights abuses; instability; coups; civil wars; famines. These were not conditions conducive to the development of an asset class. As late as the mid 1990s, Emerging Markets were still a tiny asset class of just USD2trn, less than 1/5 of the size of the US treasury market, consisting of a few loans, a few hard currency bonds, virtually no local curves. Investors tended to be fast money chasing speculative FX profits in thinly disguised bets on the US business cycle or commodities. No institutional investors in sight.

The end of the Cold War in 1989 cast Emerging Economies adrift in a sorry state. Their reputations were in tatters, they were bereft of institutions, they had little or no experience in democracy, and they were saddled with mountains of debt, which many could simply never hope to repay. A decade of adjustment and occasion crises ensued, a difficult period which included lowlights such as the Tesobono Crisis, the Asia Crisis, the Russia Crisis, and numerous sovereign defaults, especially in Latin America.

But behind the scenes Emerging Markets began to restructure their economies, repay or renegotiate their debts, and then set out to develop their own institutions. They found new overwhelmingly democratic political equilibria. Despots were replaced by elected leaders, heeding strong demands for stability and growth from poor populations. Most Emerging Market governments have now held 4 or even 5 elections since the Cold War ended 23 years ago; democracy is becoming institutionalized. The main exceptions are confined to idiosyncratic cases and oil producing states.

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The new political dynamics in Emerging Markets will only change if the Cold War returns or when voters in Emerging Markets get rich. Neither is imminent, though the latter seems more likely, in our view.

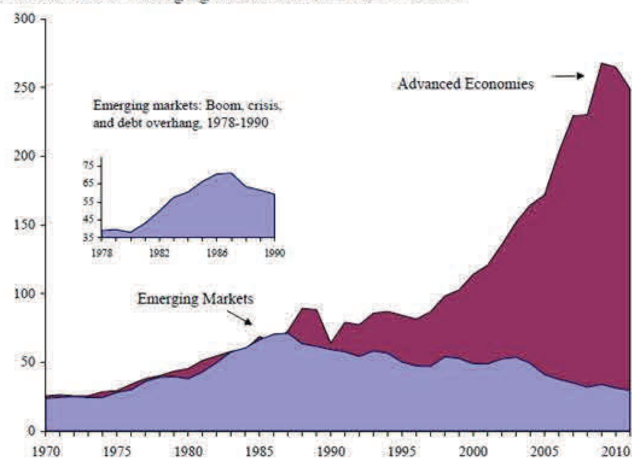
Fundamentals, fundamentals, fundamentals

What is less well understood is that the political changes after the end of the Cold War also ushered in much better economic policies. The reason is simple: voters in Emerging Markets are generally poor and vulnerable to shocks. They have no inflation hedges, no unemployment benefit, and no social security. They experience each and every bump of the business cycle. They are also better informed. Information technology means that people even in the deepest rural areas now know what is going on. Political leaders wishing to stay in office power must deliver stability and growth.

The result was dramatically better policies: Tighter fiscal policy, lower debt levels, foreign exchange reserve accumulation, privatization, and pension reforms. Today approximately 63% of the issuers in JP Morgan's EMBI Index are investment grade. This year Emerging Economies are expected to grow 5 times faster than the OECD average. Emerging Markets control nearly 70% of the world's foreign exchange reserves and they are far more structurally stable due to the rise of the middle class.

The combination of pension reforms and young populations rapidly generated inflows to sustain the development of local yield curves, which in turn facilitated the decoupling of rate and FX volatility. The asset class expanded rapidly from a low base – 16% annualized in the past 10 years – and now comprises a respectable USD12trn.

Emerging Markets now look very different from HIDCs. The chart below is taken from a recent paper by Rogoff, Reinhart and Reinhart. It shows that total private and public sector debt as a share of GDP in Emerging Markets has declined by more than 50% to just 25% of GDP since the 1990s, while debt in HIDCs has quintupled to 250% of GDP over the same period. Back in the late 1990s, both regions had about 60% debt to GDP.



Perception and reality

Good reputations take decades to establish. Prejudices take just as long to dislodge. Core-periphery disease is resistant to evidence and logic. Investors still sell, say, Philippines bonds when Greece has a problem. Institutional investors remain massively underinvested in the asset class. Sovereign ratings still do not reflect the relative safety of Emerging Market bonds. Regulators in HIDCs actively engage in efforts to force savers to allocate even more to over-indebted HIDC governments (financial repression). Market infrastructure still lags behind the development of the asset class. The EMBI GD index, which is still viewed by many as the most important benchmark index in the asset class, represents a mere 2% of the Emerging Market fixed income universe.

Ironically, some of the most virulently anti-Emerging Market sentiments are found within Emerging Markets, particularly among central bankers. Emerging Market central banks still allocate the bulk of foreign exchange reserves to HIDC bonds on the argument that HIDC bonds are more liquid. But what happens to liquidity when everyone sells at the same time? What happens when the Great Flight from Liabilities gets underway? Ultimately, the coming rise in US treasury yields is a problem for all fixed income investors, Emerging Market central banks included. It may be too late to get out of Treasuries once it starts.

Sources for charts and tables: Bloomberg, Barclays Capital, Deutsche Bank, Bank of America Merrill Lynch, and Reinhart, Carmen M., Reinhart, Vincent R., and Rogoff, Kenneth S. (2012) "Debt Overhangs: Past and Present, NBER Working Paper, #18015, April 2012 . All analysis of raw data undertaken by Ashmore Investment Management, Ltd.

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