Ashmore

The Emerging Markets fixed income universe

By Jan Dehn

The long-term case for investing in Emerging Markets (EM) is strong and rests on the arguments that these economies will grow faster than developed markets over the cycle due to economic convergence and that their financial markets in the emerging world will expand very rapidly.

In this month's Emerging View, we draw on new data to update previous work on the outlook for the Emerging Markets Fixed Income asset class.[1, 2] The outlook for the asset class is relevant both for managers looking at allocating to Emerging Markets for the first time, and for existing investors reviewing their allocations to EM Fixed Income.

We deem the following observations to be particularly relevant:

- The Emerging Markets fixed income universe expanded 10.6% in 2012, broadly in line with historical trends over the recent years
- Emerging Markets fixed income is now larger than each of the US treasury markets, US High Grade, US High Yield, and securitised/collateralised markets in developed economies
- The Emerging Markets fixed income universe in our view is on track to reach USD 52 trillion by 2020
- Our projections for growth of the asset class are in line with long-term historical trends of financial deepening
- The fastest growing segments in Emerging Markets fixed income in our view will continue to be local currency and corporate bond markets, and especially local currency corporate bond markets
- Rapid diversification is sharply improving the attractiveness of external debt
- Benchmark indices continue to lag developments in the asset class

We conclude with a brief discussion of why capital market deepening is so credit enhancing in Emerging Markets.

The Emerging Markets fixed income universe expanded 10.6% in 2012

As Table 1 shows, the total Emerging Markets fixed income universe expanded to USD 14.0trn in 2012 from USD 12.7trn in 2011, a 10.6% yoy expansion compared to 6.4% yoy growth in 2011. Whilst the external debt asset class expanded at a faster rate than the local debt universe in 2012, we think local debt markets will expand faster over time.[3] The corporate external debt market expanded 13.6%, while sovereign debt increased 13.3%. The larger local currency universe increased by 10.2% yoy with local currency sovereign bonds increasing by 10.7% yoy and the local currency corporate bond market increasing by 9.8% yoy. Asia's share of the market increased by 0.6% to 57.9%, while Latin America's share declined by 0.9% to 26.4%. The African and Middle Eastern share was unchanged at 6.15%, while the Eastern European market share rose by 0.6% to 9.6%.

EM fixed income is now larger than each of the US treasury markets; US High Grade, US High Yield, and securitised/collateralised markets in developed economies.

Table 1: **The Emerging Markets fixed income universe (2011-2012)**

	2012 (% yoy)	USD billion	2011 (% yoy)
External Sovereign	13.3%	730	7.8%
External Corporate	13.5%	941	18.7%
Local currency sovereign	10.7%	6,529	3.1%
Local currency corporate	9.8%	5,815	8.4%
Total	**10.6%**	**14,016**	**6.4%**

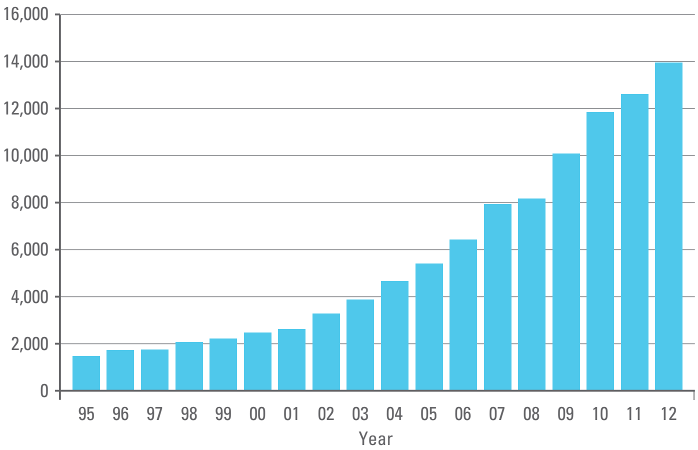
Source: BAML

1 *"Size and structure of Global Emerging Markets debt"*, GEMs FI Strategy Viewpoint, Bank of America Merrill Lynch.
2 *"The Ugly Duckling Grows Up"*, Ashmore Emerging View, February 2012.
3 External debt refers to debt issued in non-local currencies.

2012 was not radically different from the longer-term trends

The growth rate of Emerging Markets fixed income in 2012 was marginally slower than the historical average annual growth rate of 14.2% per year. Our earliest data goes back to 1995, when the Emerging Markets fixed income asset class was a mere USD 1.4trn, or ten times smaller than today (see Chart 1).

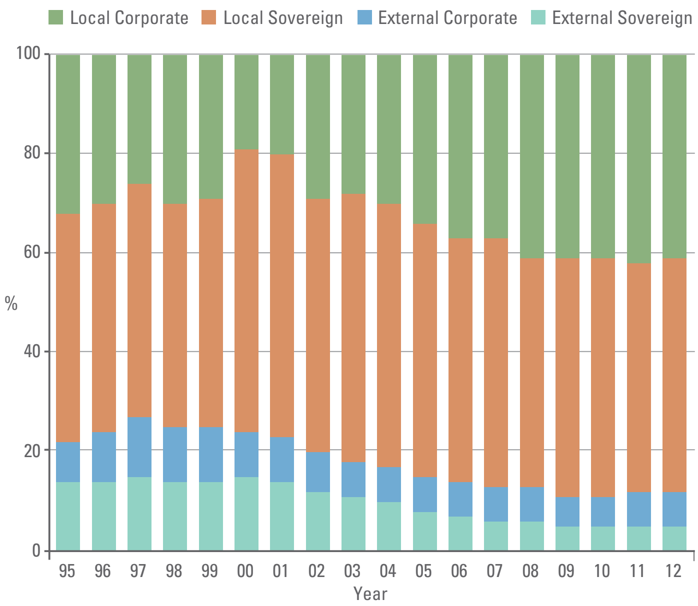
Chart 1: **Total Emerging Markets fixed income (USDbn)**



Source: JP Morgan.

The major change in composition since 1995 has been the increase in the share of local currency bonds, which now comprise 88% of total outstanding fixed income compared to 78% in 1995. Local currency government debt has sustained its share of the total fixed income market at 46-47% over the period, while local currency corporates now account for 41% of the total Emerging Markets fixed income market compared to 32% in 1995. External sovereign debt's share has shrunk to 5% today from 14% in 1995. Corporate Dollar debt is broadly unchanged at 7% of outstanding fixed income (Chart 2).

Chart 2: **The Emerging Markets fixed income universe (by theme)**

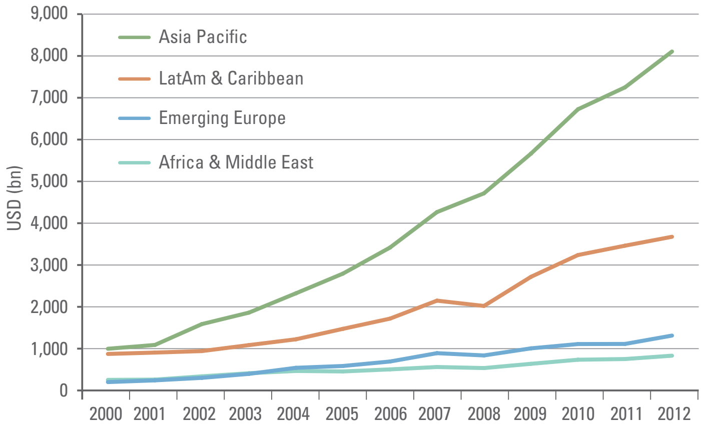


Source: BAML, Ashmore.

The most important fundamental reason for the growth of EM fixed income is the improvement in the political environment after the end of the Cold War.

Over the period from 1995-2012, Asian markets grew fastest. On average, Asian local currency markets have grown 20% per annum since 2000, taking the total volume of outstanding fixed income to a staggering USD 6.7trn (compared to a far more modest increase of USD 392bn in Asian external debt). Latin America's local markets expanded by a more modest USD2.6trn and their external markets by USD211bn. Eastern Europe's markets expanded by less than a third of the pace in Latin America, while African and the Middle Eastern local and external markets increased by USD368bn and USD209bn, respectively. Overall, Asia's share of total Emerging Markets fixed income increased from 42% in 2000 to 58% in 2012, while Eastern Europe's share remained flat at 10%. Latin America and Africa's shares declined from 37% to 26% and 12% to 6%, respectively (Chart 3).

Chart 3: **The Emerging Markets fixed income universe (by region)**



Source: BAML.

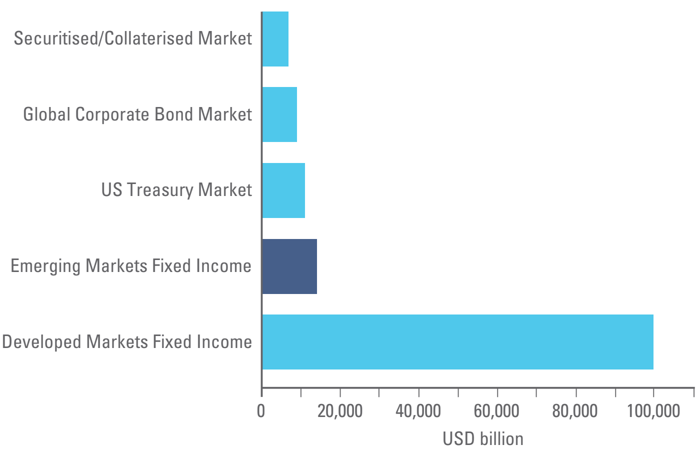
The most important fundamental reason for the growth of fixed income in Emerging Markets is the improvement in the political environment that took place in the aftermath of the end of the Cold War. Local political accountability led to far better economic policies, including widespread adoption of inflation targeting, reserve accumulation, better fiscal policy, debt reduction, and the establishment of domestic yield curves. The first defined contribution pension system in the world was established in Chile in 1982 and, apart from South Africa, nearly all pension systems in Emerging Markets today are defined contribution. Growth in pension assets is fuelled by young populations, formalising labour markets, and rising incomes (demand for financial assets increases as incomes rise beyond subsistence). Domestic pension fund assets have risen at a compounded average annual growth rate of 25% over the past 10 years. Insurance companies have grown at a pace of 15% annualised.[4] Mutual fund assets tend to rise with income too. Global central banks are increasingly allocating to local bond markets. By contrast, hedge funds and other fast money that were previously attracted to the volatility in erstwhile fragile emerging economies, today play a much smaller part. The bulk of investors in Emerging Markets today are dedicated long-term real money.

[4] *"Local Markets Compendium 2013"*, Standard Chartered Bank.
[5] *"World Bond Market Growth Trends"*, Bond Index Almanac, Bank of America Merrill Lynch, 14 January 2013.

Emerging Markets are already larger than the US treasury market, US High Grade, US High Yield, and securitised markets in developed economies

At USD 14trn, the Emerging Markets fixed income universe now comprises 12% of global fixed income (USD 114trn), up from 6% in 2000. Chart 4 shows that the Emerging Markets fixed income universe is nearly twice the size of the combined index-eligible markets for High Grade and High Yield corporate debt (USD 8.0trn) and more than twice the size of the index-eligible market for securitised/collateralised credit in developed economies (USD 6.7trn).[5] Total Emerging Markets fixed income was 28% larger than the tradable US Treasury Market as at the end of 2012 (USD 10.9trn).

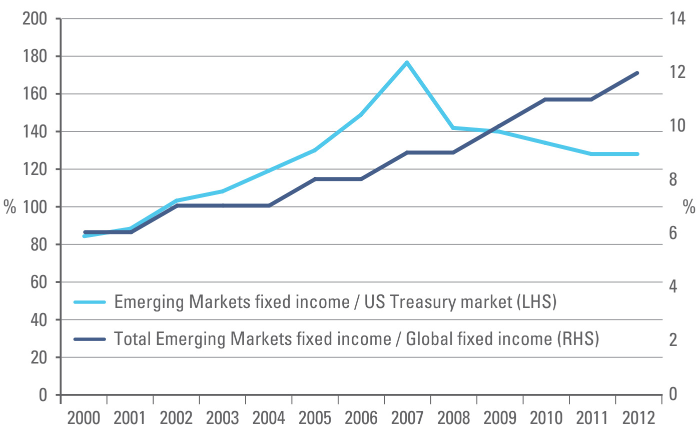
Chart 4: **Emerging Markets fixed income in comparison with other credit markets**



Source: BAML, Ashmore. Data as at end 2012.

Underlining the massive volume of issuance of US treasury debt in the past few years due to Quantative Easing (QE) and large fiscal deficits, Emerging Markets fixed income has continued to grow as a share of global fixed income, except against outstanding US treasury debt which has ballooned since 2007 (Chart 5).

Chart 5: **Growth of Emerging Markets fixed income universe has only been exceeded by the growth of the US treasury market**

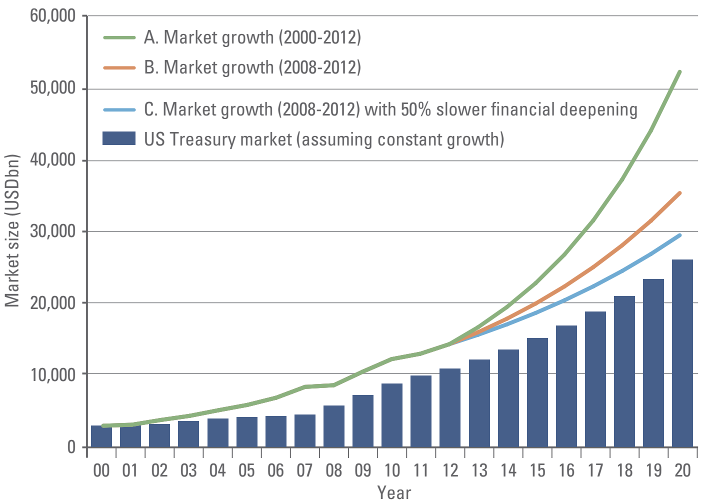


Source: BAML, SIFMA, Ashmore.

Emerging Markets fixed income could reach USD 52trn by 2020

We expect the Emerging Markets fixed income universe to increase significantly this decade. For example, if the market continues to grow at the rates sustained over the past 12 years the EM fixed income universe will reach USD 52trn by 2020, making it twice the size of the US treasury market (assuming that the US treasury market also continues to expand at the same 12% annualised pace which it has sustained over the past 12 years).

Chart 6: **The Emerging Markets fixed income universe is set to expand rapidly in most scenarios**



Source: BAML.

There are different determinants of how fast the asset class grows, including the speed of capital deepening and nominal growth rates. The global outlook remains uncertain. For example Emerging Markets nominal GDP growth has been slower in the 2008/2012 period than in the pre-crisis period, but financial deepening has accelerated. How sensitive are our projections for the size of the market to changes in growth and the pace of financial deepening? Chart 6 shows two alternative scenarios to our base case (A). Scenario B assumes that financial deepening and nominal GDP growth expand at the pace of the 2008-2012 period (14.3% compared to 15.5% during 2000-2012). Scenario C assumes that the pace of financial deepening halves, reflecting perhaps tighter global financial conditions. Table 2 summarises the underlying assumptions behind the three scenarios.

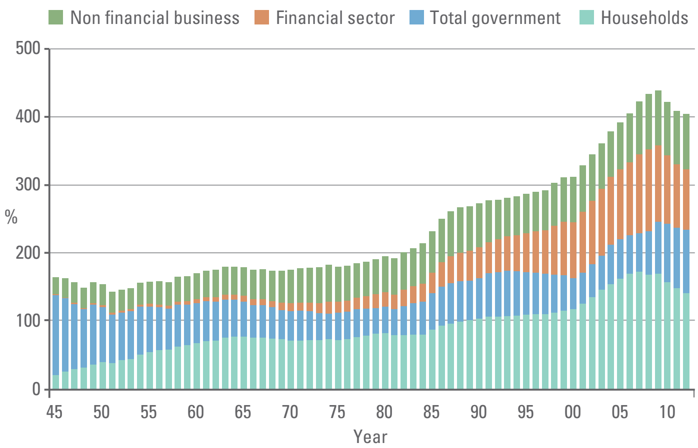
Table 2: **Scenarios for expansion of the Emerging Markets fixed income universe**

Scenarios	Nominal GDP	Financial deepening	Total market growth	Estimated market size 2020 (USDbn)
A. Market Growth (2000-2012)	12.6%	2.9%	15.5%	52,594
B. Market Growth (2008-2012)	9.1%	5.1%	14.3%	35,430
C. Market Growth (2008-2012) with 50% slower financial deepening	9.1%	2.6%	11.7%	29,455

Source: BAML, Ashmore calculations

The scenarios above require one important caveat. We have estimated the market size in US Dollars, assuming constant nominal exchange rates. However, given that the total US debt stock now exceeds 405% of GDP it is likely that, at some point in the next few years, the US will seek to inflate and/or financially repress its way to a smaller stock of debt (Chart 7). This is likely to prove negative for the US dollar. Hence, given the dominance of local currency debt in total Emerging Markets fixed income our projections may significantly understate the growth of the Emerging Markets debt universe in nominal US Dollar terms. Strategic asset allocators in particular need to factor in any future Dollar weakness, because it adversely impacts the purchasing power of Dollar denominated assets and positively impacts the purchasing power of local assets.

Chart 7: **US total (public and private) debt as a share of GDP**

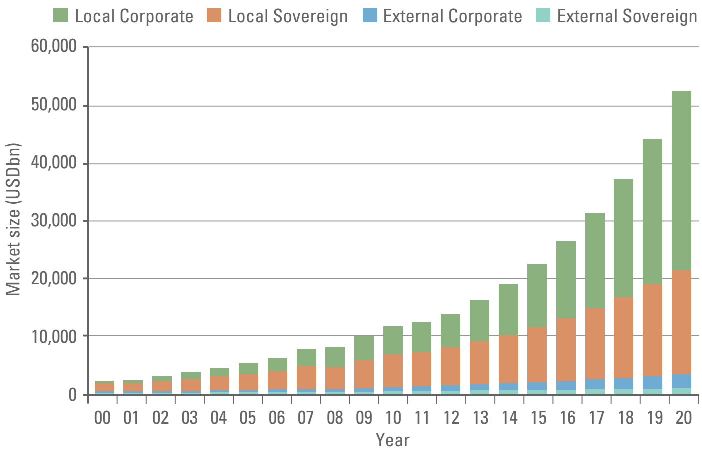


Source: BAML, Ashmore.

By 2020, we believe that local currency sovereign bonds will comprise 94% of all outstanding sovereign debt in Emerging Markets.

In terms of the composition of Emerging Markets fixed income, we estimate that the share of local currency debt in the total outstanding Emerging Markets fixed income universe will rise from 88% today to 93% by 2020. In absolute terms, this means a local currency market of USD 49.0trn compared to USD 3.6trn in outstanding external debt. The corporate bond market's share of total fixed income should increase from 48% today to 63% by 2020, in our view. The volume of outstanding corporate bonds should overtake outstanding sovereign debt as early as this year. We expect the corporate debt universe to reach USD33.3trn by 2020, up from USD6.7trn today. Sovereign issuance will continue to be dominated by local currency bonds. We see the external sovereign debt universe expanding at a rate of 6% per year to reach USD 1.7trn by 2020, while local currency sovereign bonds should grow at a pace of 14% per annum to reach USD 18.2trn by 2020. By 2020, we believe that local currency sovereign bonds will comprise 94% of all outstanding sovereign debt in Emerging Markets (see Chart 8).

Chart 8: **Growth of Emerging Markets fixed income universe (by theme)**

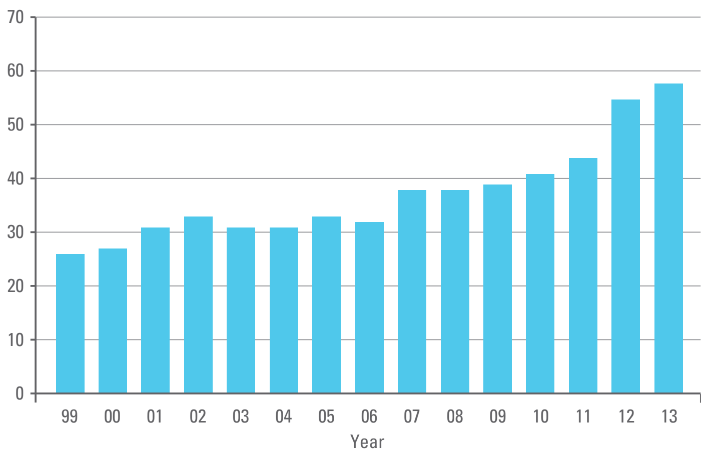


Source: BAML, Ashmore.

Increasing diversification is a major driver of the external debt asset class

The External Debt asset class is flourishing through rapid diversification, despite a slower rate of growth. We believe existing issuers of Dollar bonds will maintain their external yield curves. The yield curves provide a practical and internationally comparable yard stick of sovereign risk even though external debt is becoming relatively less important as a means of financing for established issuers. The external sovereign debt universe, is making up for slower growth by the rapid entry of new issuers from Frontier Markets. This trend is already established. The total number of sovereign issuers was a mere 26 countries in 1999. This has now grown to 58 countries in 2013 (Chart 9). The curtailment of aid flows and low US treasury yields have been strong incentives for Frontier Markets to lock in cheap term financing. Once in, they will rarely leave.

Chart 9: **Number of countries in the JP Morgan EMBI Global Diversified**



Source: JP Morgan, Ashmore.

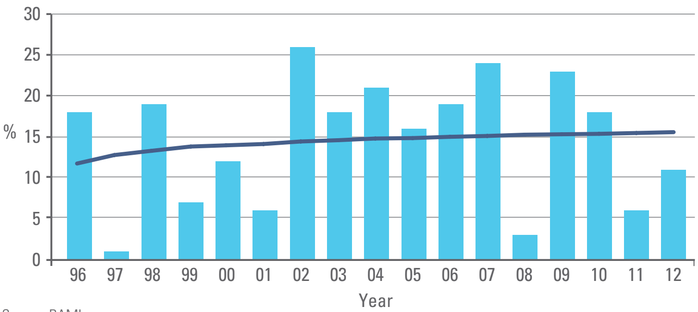
Another reassuring observation is that the stock of Emerging Markets fixed income has remained broadly steady compared to the size of Emerging Market economies.

[6] Emerging Markets fixed income increased only 6% and 3% in the years of the dotcom and subprime crises, respectively. By contrast, the rate of expansion was above 20% in 2001, 2003, 2006, and 2008.

We see no sign of an irresponsible issuance spree in Emerging Markets

Taking into account the growth of the asset class in 2012, the EM fixed income universe expanded at an annualised pace of 14.2% since 1995 and 15.5% since 2000. There is considerable variation in the annual rate from one year to the next with sharp declines in growth rates centered around developed market crises,[6] typically followed by a large pick up in growth rates in the following years. Over the full period, there is little evidence of an explosion in outstanding debt, which should be reassuring to those who fear that Emerging Markets embarked on an issuance spree during the last few years. Indeed, Chart 10 below shows that the rate of growth of the asset class has been significantly below trend in the last two years.

Chart 10: **Annual rate of growth of Emerging Markets fixed income (1995-2012)**



Source: BAML.

During 2000-2012, Emerging Markets nominal GDP expanded at an annualised pace of 12.6%, while fixed income markets expanded 15.5% per year. This implies that capital markets deepened at an annualised rate of 2.9% per year (15.5% market growth less 12.6% nominal GDP growth). This pace of financial deepening is in line with other measures of financial deepening observed in low, middle, and high income countries over the past 20 years (Table 3).

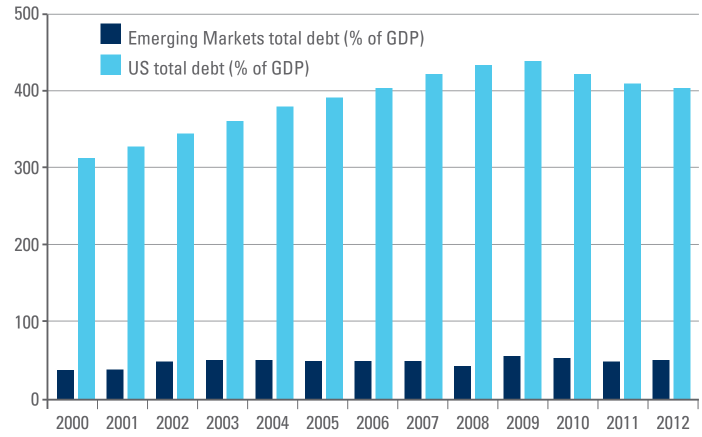
Table 3: **Stylised facts of financial deepening 1990-2009**

Private credit/GDP	1990	2009	% pa
Low income countries	14	23	3%
Middle income countries	22	37	3%
High income countries	41	98	5%
Stock markets capitalisation/GDP	**1990**	**2009**	**% pa**
Low income countries	5	16	7%
Middle income countries	20	40	4%
High income countries	20	40	4%

Source: *"Too Cold, Too Hot, Or Just Right? Assessing Financial Sector Development Across the Globe"*, Adolfo Barajas, Thorsten Beck, Era Dabla-Norris, and Seyed, IMF working paper 13/81, March 2013.

Another reassuring observation is that the stock of Emerging Markets fixed income has remained broadly steady compared to the size of Emerging Market economies. IMF data shows that public debt to GDP ratios in Emerging Markets have remained broadly stable at around 33% over the past 5 years.[7] Total debt ratios – which also include private sector obligations – have been stable too, averaging 38.9% of GDP over the period and 48.5% if financial instruments with less than one year to maturity are included (Chart 11).

Chart 11: **Public sector debt to GDP in the United States and Emerging Markets**



Source: IMF, Ashmore.

Index development continues to lag the development of the asset class

One of the challenges of conveying the full scale of the opportunity set in EM fixed income is that the asset class is poorly represented by the industry's preferred benchmark indices. Moreover, the indices are becoming less representative each year as global investment banks – historically the providers of indices – reduce their presence in Emerging Markets due to regulatory pressures.

Table 4 summarises the relationship between the market capitalisation of the standard indices and the asset class. The market's preferred benchmark indices for external debt, corporate debt, and local currency debt are JP Morgan's EMBI Global Diversified, CEMBI Broad Diversified, and GBI-EM-Global Diversified respectively. Unfortunately, between them these three indices only represent 11% (as at end 2012) of total Emerging Markets fixed income, a further deterioration from the year before. The silver-lining is that the EMBI Global Diversified Index became more representative last year, and now covers 44% of outstanding securities. However, the fact that no index exists for the

Table 4: **Indices remain extremely deficient as proxies for the Emerging Markets fixed income universe**

Asset class	**Asset class** Market cap (USD bn)	**The market's preferred indices** Market cap (USD bn)	**% representation by the market's preferred indices**	**'Theoretical indices'** Market cap (USD bn)	**% representation by 'Theoretical indices'**
External Sovereign	730	319	44%	552	76%
External Corporate	941	268	28%	874	93%
Local Sovereign	6,529	926	14%	3,514	54%
Local Corporate	5,815		0%		0%
Total	**14,016**	**1,513**	**11%**	**4,941**	**35%**

Source: Ashmore, JP Morgan, BAML

[7] *IMF WEO data.*

USD 5.8trn local currency corporate bond universe is a major deficiency. The implication is clear: passive investing in Emerging Markets fixed income is highly inefficient.

Fortunately, the rise of local market makers in Emerging Markets, however, means that the tradable universe is now far wider than what global investment banks trade and what securities are represented in the main benchmark indices.

Why should we care about deeper markets?

Financial market deepening (and broadening) is credit-enhancing, especially when countries are capital constrained. Emerging Markets are still in the early stages of financial sector development. Of the world's approximately 160 potential issuers in Emerging Markets only 58 countries have so far entered JP Morgan's benchmark EMBI Global Diversified index and only about 16 countries feature in the main local currency benchmark (GBI-EM-Global Diversified).

To see why financial market deepening is so important, one only has to consider how the development of local pensions has allowed credit worthiness. The emergence of local pension funds allowed FX and rate volatility to be divorced from one another, helping Emerging Markets economies insulate themselves from the adverse economic and fiscal effects of currency volatility. Today local pension funds dominate local rate markets, rarely exiting the local market. Real money has in turn come to dominate foreign investors from the adverse economic and fiscal consequences of currency volatility. Episodes of currency depreciation now have far smaller consequences for sovereign balance sheets because government liabilities are primarily denominated in local currency.

Until very recently only sovereigns were able to tap global capital markets. The development of corporate debt markets has been as important as the development of sovereign yield curves. The key to realising the long-term growth potential in Emerging Markets is increasing the rate of private sector investment, particularly large ticket long-term projects. Until the development of corporate bonds markets such investment opportunities could not be financed, because corporates only had access to short-term bank credit lines. The economic context here matters: Economic convergence is driven by the private sector and the private sector grows through investment, especially term investment. The term investment in turn requires bond financing.

Emerging Markets are largely unconstrained in terms of investment opportunities, but still constrained in terms of the availability of financing. Emerging Markets are 49% of global GDP in a PPP adjusted basis and set to reach 55% by 2018, according to IMF projections. Emerging Markets still only attract less than 5% of global pension funds, insurance company pools of capital, central bank reserves, sovereign wealth fund assets and other sources of long-term institutional money. Global investors are still learning about this asset class, perhaps because it is still so young. It is worth remembering that the last Emerging Markets contagion only took place in 1998. JP Morgan didn't launch the GBI-EM family of local currency government bonds indices until 2001. Brazil barely had fixed rate domestic bond market ten years ago. The first corporate high yield index was only introduced in 2007. The world has yet to see the first local currency corporate bond index.

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