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Ashmore

Institutional investors still allocate too little to EM bonds. Why?

By Jan Dehn

Allocations by institutional investors to EM fixed income are structurally too low. We explain the reasons behind the low allocations and put forward some proposals for fixing the problem. There are good technical, fundamental and valuation arguments for increasing allocations.

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	11.2	–	2.58%
MSCI EM Small Cap	10.3	–	1.83%
MSCI Frontier	8.7	–	0.93%
MSCI Asia	12.2	–	2.42%
Shanghai Composite	10.9	–	8.40%
Hong Kong Hang Seng	8.3	–	3.52%
MSCI EMEA	8.7	–	3.76%
MSCI Latam	11.6	–	3.20%
GBI-EM-GD	6.13%	–	1.22%
ELMI+	5.56%	–	0.60%
EM FX spot	–	–	0.87%
EMBI GD	5.97%	345 bps	0.25%
EMBI GD IG	4.34%	179 bps	-0.15%
EMBI GD HY	7.75%	526 bps	0.64%
CEMBI BD	5.68%	324 bps	0.32%
CEMBI BD IG	4.46%	203 bps	0.07%
CEMBI BD Non-IG	7.34%	490 bps	0.66%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	15.6	–	2.09%
1-3yr UST	2.33%	–	-0.08%
3-5yr UST	2.30%	–	-0.24%
7-10yr UST	2.49%	–	-0.60%
10yr+ UST	2.90%	–	-1.49%
10yr+ Germany	0.00%	–	-0.96%
10yr+ Japan	-0.05%	–	-0.70%
US HY	6.25%	368 bps	0.50%
European HY	4.17%	424 bps	0.71%
Barclays Ag	1.83%	-66 bps	-0.48%
VIX Index*	12.82	–	-0.89%
DXY Index*	97.28	–	0.05%
EURUSD	1.1227	–	0.12%
USDJPY	111.44	–	0.08%
CRY Index*	187.68	–	3.93%
Brent	70.7	–	2.39%
Gold spot	1296	–	0.67%

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

Emerging Markets

The asset class of Emerging Markets (EM) sovereign Dollar-denominated government bonds ('external debt') has just celebrated its twenty-fifth birthday. External debt now comprises more than USD 1.1trn of bonds distributed over 73 sovereign index names, which, on average, are rated investment grade. The spread for EM sovereign bonds is 345bps over US Treasuries, which means that the bonds yield approximately 6% with a duration of about seven years. Since the inception of the asset class, external debt has paid investors a passive return of approximately 9% annualised with a relatively high Sharpe Ratio of 0.53.[1]

EM's other government bond market is the sixteen-year old EM local currency bond market, whose index is JP Morgan's Government Bond Index-Emerging Markets Global Diversified. This market covers nineteen sovereigns, which are also investment grade rated on average. Local bonds have delivered an annualised return since index inception of 7% in Dollar terms with a Sharpe Ratio of 0.32. The yield is currently 6.1% against an average index-weighted inflation rate of about 2.5%.[2] Duration is just over 5 years, so just a smidgen higher than the duration of a US 5-year Treasury bond.

The performance of EM government bonds compares favourably to the S&P 500. As Figure 1 shows, the US stock market has delivered a return about 7% per annum over 25 years, but with a lower Sharpe Ratio (0.31).[3,4] The superior performance of EM bonds relative to US stocks is noteworthy. After all, bonds are supposed to have lower returns than stocks, because they are less volatile. Investors ought to own more EM debt relative to US stocks. Why have greed and the fierce competition between investors not quickly eroded away the arbitrage?

1 Based on JP Morgan's EMBI GD index, which is the most widely used benchmark index for this asset class.
2 Excluding Argentina and Turkey.
3 Based on the S&P 500 index performance excluding dividends.
4 The Sharpe Ratio assumes a risk free rate of 2.9%, which is the 25-year average of the US 3-month LIBOR rate.

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Emerging Markets

Fig 1: **Performance indicators: various markets**

Strategy	Sharpe Ratio	Annual Volume	Annual Return	Years
EM sovereign Dollar bonds	0.53	12%	9%	25
EM local currency government bonds	0.32	12%	7%	16
S&P 500	0.31	14%	7%	25

Source: Ashmore, Bloomberg.

One of the most obvious reason why investors have sustained under-allocations to EM fixed income is home bias. As of end-2018, the twenty-two countries with the largest pension systems in the world had a whopping 71% of their bond exposures in their home markets.[5] Sure, home bias is slowly getting weaker, but it is still very strong. EM pension funds and insurance are now the fastest growing pools of capital in the world, but in terms of their absolute size, they are still far smaller than pensions and insurance in developed economies.

Structurally low allocations to EM are also due to the fact that many large institutional investors still have not begun to allocate to EM fixed income. We estimate that two thirds of US state pension funds still do not own EM bonds in their largest pension portfolios and that only 12 of the largest 30 public plans in the US have dedicated allocations to EM bonds. We also believe that a significant percentage of European pension funds have not yet allocated to EM; indeed, some long-term investors are even removing EM bonds from their benchmark indices.[6] In addition, most of the world's central banks, which jointly manage some USD 11trn of assets, allocate little or nothing to EM debt, which is ironic, because central banks, supposedly the most prudent of all investors, appear to shun the first rule of risk mitigation: diversification.

The widespread practice of index hugging also contributes to underinvestment in EM bonds. Most institutional investors measure performance against benchmark indices with only modest tolerance for so-called benchmark 'risk'.[7] Unfortunately, EM benchmark indices massively underrepresent the EM fixed income universe. For example, JP Morgan, the main index provider for EM bonds, only includes 9% (USD 2.2trn) of EM bonds (USD 24.3trn) within its main benchmark indices. This stands in sharp contrast to developed markets, where almost all bonds are included in indices. Low index inclusion is a *de facto* 'exclusion factor' of 91% for EM bonds relative to developed market bonds as far as index hugging institutional investors are concerned.[8]

Finally, the reality is that many institutional investors, especially in fixed income, still cling to theoretical concepts of risk, which do not make a great deal of sense in very imperfect EM bond markets. Most importantly, institutional investors with seriously long investment horizons tend to focus too much on short-term volatility. The tendency to offload/buy EM in response to short-term bouts of risk-off/risk-on sentiment contributes to raising the level of volatility of the asset class far above the level of actual risk, i.e. realised permanent losses, or defaults.

It is also odd that the very same institutions, which often shun EM bonds due to currency volatility, happily own EM equities, which give exactly the same FX exposure. Why the greater willingness to own EM stocks than EM bonds? One explanation may simply be that institutional investors are aware that *both* EM and developed market stocks are risky assets, meaning that they occasionally deliver permanent losses: think Lehman Brothers, ENRON and Bear Stearns. By contrast, a pleasant fiction still prevails within the world of fixed income that developed market bonds are somehow risk-free, while EM bonds are very risky. In accordance with this fiction, institutional investors do not want to pollute their pristine, virgin developed market bond portfolios with filthy, default-prone EM bonds. To the extent that such perceptions contribute to lower allocations to EM bonds, the best thing one can say is that prejudices are costly! EM bonds have more than compensated investors for default risk as Figure 2 shows. EM external debt has paid investors an average annual *risk-free spread* of 366 bps over Treasuries since 1998. By 'risk-free spread', we mean that the spreads already take full account of default-related losses over the period.[9] In fact, the excess spread on EM external debt, after controlling for defaults, has been so large that the asset class has handsomely beaten the S&P 500 index over the past two decades, with lower volatility.

Fig 2: **EM bond yields net of default versus US bonds**

	Payout to investors (bps)	
	1998-2018	Average per annum
EM 'risk free spread'	7,678	366
EM net of defaults (bps)	15,143	721
US 10yr bond (bps)	7,465	355

Source: Ashmore, Bloomberg, JP Morgan.

5 *Global Pension Asset Study 2019*, Thinking Ahead Institute, Willis Towers Watson, pages 32-33.
6 See – https://www.bloomberg.com/news/articles/2019-04-05/norway-s-1-trillion-fund-told-to-sell-emerging-market-bonds?utm_source=google&utm_medium=bd&cmpld=google
7 'Benchmark risk' is a misnomer. It measures departures of performance of funds from the performance of an index, not risk. Risk is permanent loss, i.e. risk from default. To hug an index does not reduce the risk of default.
8 Goldman Sachs estimates that the largest US pension plans only allocate between 0.2% and 0.7% to dedicated EM bonds ("Much Ado About Everything", Public Pension Viewpoints, Q4 2018, Goldman Sachs Asset Management).
9 Based on JP Morgan's methodology, these losses in the year of default were: Argentina 2001(483bps), Ecuador 2008 (125bps), Ivory Coast 2011 (61bps), Belize 2012 (10bps), Argentina 2014 (92bps), Ukraine 2015 (63bps), Mozambique 2017 (7bps) and Venezuela 2018 (154bps). The actual losses were lower, because in many cases recovery values ended up being higher than the initial market reaction implied. For example, the eventual loss on the Argentina default in 2014 was zero as investors were paid in full.

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Emerging Markets

What can investors do to increase allocations to EM bonds in order to improve the overall performance of their fixed income portfolios? The good news is that it is well within the powers of most institutional asset managers to overcome the obstacles to allocating more as described in the previous paragraphs.

First, they should give their EM managers plenty of room to make off-benchmark allocations rather than hug benchmarks too closely. Going off benchmark increases the opportunity set, diversification and potential return.

Second, they should recognise and seek to overcome their own biases, including home bias. This process is likely to be incremental, but it is better to move forwards slowly than not to move at all.

Thirdly, they should recognise that volatility and risk are patently not the same thing in an inefficient asset class, such as EM. Bouts of volatility are frequent in EM and they are usually excellent times to add to exposure. As for risk, defaults are surprisingly rare in EM and active management is the best means of mitigating such risks.

Finally, investors should maintain large over-weights to EM bonds until the arbitrage of EM bonds versus developed markets stocks is fully exhausted. On current trends, this may take years, even decades.

The appeal of EM debt is further enhanced right now by the fact that distortions caused by asset purchase programmes (Quantitative Easing, or 'QE') undertaken by central banks in developed countries over the last decade are finally unwinding. This strongly favours EM debt. We believe that the normalisation of global asset allocation after QE means that EM bonds can continue to outperform both developed market bonds and stocks for several years. This outperformance has already begun as Figure 3 illustrates.

Fig 3: **Performance of EM bonds since Q1 2016**

Asset class	% return (USD terms) 2016-2018	Q1 2019
Government bonds		
EM local currency bonds	**18.80%**	**2.92%**
3-5yr UST	*3.56%*	*1.59%*
EM external debt (USD)	**16.20%**	**6.95%**
7-10yr UST	*4.13%*	*2.87%*
Corporate credit		
EM corporate debt (USD)	**15.97%**	**6.95%**
EM HY (USD)	**23.74%**	**8.01%**
US HY	*22.23%*	*7.26%*
EU HY	*8.21%*	*5.63%*
Currencies		
EM spot FX	**-2.97%**	**0.26%**
EM FX forwards	**11.77%**	**1.48%**
DXY Index	*-4.79%*	*1.04%*

Source: Ashmore, Bloomberg.

However, based on current positioning, valuations and fundamentals, we believe that EM bonds have far more return potential both in absolute terms and relative to developed market bonds. Specifically:

a. Positioning: We estimate that many institutional investors currently have one third of the allocation to EM bonds that they had before QE. While flows have started to return to EM, it will take years for allocations to get back to normal.

b. Fundamentals: EM countries already contribute three quarters of global growth, but this contribution should rise to 84% by 2023 as developed economies continue to slow.[10] In the coming years, there is a greater risk that the supply of bonds increases faster in developed bonds markets than in EM, as the former return to 'Big Fiscal' policies.[11]

c. Valuations: EM bonds currently price in a Fed funds rate of more than 450 bps. This is clearly excessive. The Fed, which is currently keeping the Fed funds rate at 250 bps, is unlikely to hike a lot and may even cut again soon. If so, EM bond yields could be mispriced to the tune of at least 200 bps. We also believe that EM currencies are about 20% cheap to the Dollar.

If we are right in these views, it follows that EM local currency bonds could deliver some 60% return in Dollar terms over the next five years. External debt should deliver about 40% return, while corporate high yield bonds could return roughly 50%. These return scenarios assume reinvestment of returns, i.e. compounding.

[10] See *'EM versus DM growth (2019-2023): How global is 'global' growth really?'*, The Emerging View, 26 February 2019.
[11] See *'Beware of Big Fiscal'*, The Emerging View, 3 April 2019.

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Emerging Markets

Snippets:

- Algeria: President Abdelaziz Bouteflika resigned, but protests continue as Algerians demand wholesale changes to the system of government. Algeria has struggled for a long time with a binary choice on the political menu: Islamic Fundamentalism or outright dictatorship.
- Argentina: Agricultural export sales are running a bit below previous years despite a likely record harvest. Sales are often timed based on exporters' expectations for the currency, which explains most of the swings in the harvest/sales ratio year to year. IMF completed the third review of Argentina's standby agreement, approving a USD 10.8bn disbursement for release.
- Bahrain: FX reserves were stable at USD 8.1bn in January, equivalent to less than one month of imports.
- Belarus: Russia is lending USD 600m to the government of Belarus.
- Brazil: A heated meeting between Economy Minister Paulo Guedes and far-left members of the Justice Committee charged with processing the pension reform led to more market volatility in the past week. The market over-reacted to the noise, in our view. Industrial production recovered sharply after a weak January print.
- Chile: Real GDP was 1.4% higher yoy in February, which was below expectations (2.0% yoy) due mainly to calendar effects.
- China: Both US and Chinese officials wrapped up trade talks in Washington with positive statements about the state of negotiations. FX reserves reached USD 3.098trn, the highest level since August 2018.
- Colombia: CPI inflation was 0.43% mom in March versus the consensus expectation of 0.32% mom.
- Czech Republic: Industrial production in February was 1.5% higher yoy after declining at a yoy rate of 1.1% in January.
- Hungary: Industrial production was in rude health in February, rising at a rate of 5.9% yoy versus 5.0% yoy last month and 5.1% yoy expected.
- India: The Reserve Bank of India cut the policy rate by 25 bps to 6.0%. The latest yoy inflation print was 2.6%, which continues a trend of decline from the peak of 5.2% in December 2017. Services PMI moderated to 52.0 in March from 52.5 in February. Manufacturing PMI also slowed to 52.6 from 54.3 ahead of India's upcoming general election.
- Malaysia: The trade surplus was USD 2.7bn in February, slightly lower than in February (USD 2.8bn).
- Mexico: The resignation of US Homeland Secretary Kirstjen Nielsen may signal the onset of an even more anti-immigrant policy stance by the US government, which could increase tensions at the Mexican border.
- Peru: CPI inflation rose to 2.25% yoy in March from 2.00% in February. The central bank targets 2% inflation +/- 1%. The trade balance was in surplus to the tune of USD 325m in February, equivalent to 2.8% of GDP on a 12-month rolling basis.
- Philippines: The yoy rate of CPI inflation declined to 3.3% in March from 3.8% in February. The consensus expectation was 3.5% yoy.
- Poland: The National Bank of Poland left the policy rate unchanged at 1.5%.
- Romania: Solid retail sales. They were up at a rate of 9.5% yoy in February from 6.6% yoy in January. The central bank left the policy rate unchanged.
- Russia: The US Senate is considering yet more sanctions against Russia for allegedly meddling in the US election. Sovereign bonds could potentially become a target of these sanctions. Inflation for the week to 1st April slowed to 0.0% from 0.1% the week prior. Full year real GDP growth in 2018 was 2.3%.
- South Africa: At 0.3% of GDP below target, government revenues disappointed in the 2018/2019 fiscal year.
- South Korea: The yoy rate of CPI inflation declined to 0.4% in March from 0.5% yoy in February.
- Slovakia: The government issued EUR 1bn 11-year bond in global markets, meeting a quarter of the government's funding needs.
- Turkey: The yoy rate of inflation increased marginally to 19.7% in March from 19.67% yoy in February, but core inflation moderated to 17.5% yoy (from 18.1% yoy). A dispute over the integrity of the result of the local election in Istanbul has not yet been resolved.
- Venezuela: The Constitutional Convention has stripped opposition leader Juan Guaido of his immunity from prosecution. This may be a precursor for his arrest. The US announced that it will sanction 34 ships owned or operated by PDVSA, the national oil company.

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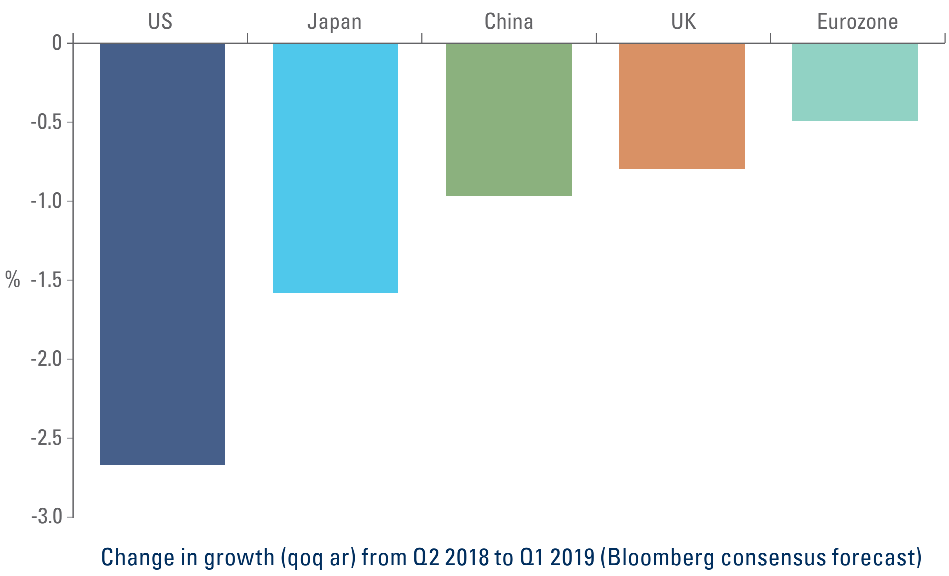
Global backdrop

Figure 4 shows changes in real GDP growth rates (qoq saar) between Q2 2018 and Q1 2019 for four major developed economies plus China.[12] The US economy has slowed 2.7% in the last four quarters, despite the passage in Congress of massive tax cut measuring some 7% of GDP. The second fastest slowing economy over the past four quarters has been Japan (-1.6%) followed by China with a 1% slowdown. The UK is next with a slowdown of 0.8%, although UK growth may slow far more in the coming quarters due to Brexit. The region with the smallest slowdown has been the Eurozone (-0.5%).

Fig 4: **Change in growth rates (qoq saar): Q2 2018 to Q1 2019**



Source: Ashmore, Bloomberg.

Despite its sharp slowdown, the US economy may not enter recession immediately. Last week's payroll number did not deliver the strong bounce-back expected after the very weak print of 20K last month. Besides, the participation rate declined and hourly earnings were softer than anticipated. However, the Fed has been quick to turn more dovish on weaker economic data after its excessive hawkishness in Q2 2018. Besides, the December 2017 tax cut is likely still to impart a bit of stimulus to the economy in the coming year. Hence, the main implication of the payroll number is that it keeps the Fed on the sidelines for now. The bigger risk is that so much faith and money is vested in continuing strength in the US economy that even a modest slowdown can trigger meaningful corrections in valuations and allocations. Last year's crash in US stocks was a perfect example of this kind of risk. In other US news, US President Donald Trump has proposed to put Herman Cain on the Fed. Cain has weak credentials for the job. This is true for another Trump nominee, Stephen Moore. It would seem that the US president is trying stuff the Fed with 'yes men', which does not bode well for the credibility of the world's most influential central bank. On Friday last week, Trump also called for more QE, thus applying pressure upon the Fed.

In the UK, the Labour and Tory parties are trying to put together a solution to the Brexit impasse. Cross-party cooperation of this kind is very difficult under a first-past-the-post electoral system, which, like the Oxford-Cambridge Boat Race, tends to deliver only one winner and one loser. Meanwhile, the UK government has requested a delay to Article 50 to 30th June. EU leaders will respond to this request at a Summit planned for 10th April. Unless it is granted an extension, the UK crashes out of the EU on 12th April.

As for the Eurozone, markets got excited about Germany's weak factory order numbers only to experience relief after a strong industrial production number. German car production is also slowly recovering.

[12] The Q1 2019 forecast is based on the Bloomberg consensus, which can be found at ECFC <go>

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Benchmark performance

Emerging Markets	Month to date	Quarter to date	Year to date	1 year	3 years	5 years
MSCI EM	2.58%	2.58%	12.74%	-4.39%	13.14%	4.42%
MSCI EM Small Cap	1.83%	1.83%	9.74%	-10.98%	7.20%	2.03%
MSCI Frontier	0.93%	0.93%	7.90%	-13.79%	7.48%	0.31%
MSCI Asia	2.42%	2.42%	14.08%	-1.88%	13.97%	6.99%
Shanghai Composite	5.04%	5.04%	30.19%	6.22%	4.79%	12.05%
Hong Kong Hang Seng	2.75%	2.75%	15.49%	2.64%	14.25%	7.01%
MSCI EMEA	3.76%	3.76%	9.57%	-7.13%	8.61%	-0.63%
MSCI Latam	3.20%	3.20%	11.39%	-4.70%	14.42%	0.35%
GBI EM GD	1.22%	1.22%	4.17%	-6.24%	4.15%	-0.59%
ELMI+	0.60%	0.60%	2.08%	-3.76%	3.00%	-0.54%
EM FX Spot	0.87%	0.87%	1.13%	-9.72%	-2.11%	-6.87%
EMBI GD	0.25%	0.25%	7.22%	4.21%	5.89%	5.37%
EMBI GD IG	-0.15%	-0.15%	5.81%	5.64%	4.49%	4.69%
EMBI GD HY	0.64%	0.64%	8.70%	2.73%	7.45%	5.83%
CEMBI BD	0.32%	0.32%	5.49%	4.81%	5.72%	4.84%
CEMBI BD IG	0.07%	0.07%	4.84%	5.70%	4.26%	4.27%
CEMBI BD Non-IG	0.66%	0.66%	6.35%	3.75%	8.10%	5.54%

Global Backdrop	Month to date	Quarter to date	Year to date	1 year	3 years	5 years
S&P 500	2.09%	2.09%	16.02%	10.81%	14.54%	11.42%
1-3yr UST	-0.08%	-0.08%	0.91%	2.70%	0.94%	0.96%
3-5yr UST	-0.24%	-0.24%	1.35%	3.85%	0.83%	1.67%
7-10yr UST	-0.60%	-0.60%	2.25%	5.76%	0.52%	2.81%
10yr+ UST	-1.49%	-1.49%	3.11%	6.44%	0.52%	5.12%
10yr+ Germany	-0.96%	-0.96%	4.42%	10.29%	1.94%	7.31%
10yr+ Japan	-0.70%	-0.70%	2.58%	3.42%	0.68%	4.64%
US HY	0.50%	0.50%	7.79%	6.20%	8.78%	4.73%
European HY	0.71%	0.71%	6.38%	2.67%	5.09%	4.28%
Barclays Ag	-0.48%	-0.48%	1.71%	-0.32%	1.20%	0.97%
VIX Index*	-6.49%	-6.49%	-49.57%	-40.34%	-16.54%	-13.90%
DXY Index*	0.00%	0.00%	1.15%	7.96%	3.23%	21.98%
CRY Index*	2.14%	2.14%	10.53%	-2.38%	9.73%	-39.06%
EURUSD	0.09%	0.09%	-2.11%	-8.88%	-1.47%	-18.63%
USDJPY	0.53%	0.53%	1.59%	4.37%	3.13%	9.46%
Brent	3.32%	3.32%	31.34%	5.29%	68.48%	-34.37%
Gold spot	0.32%	0.32%	1.09%	-2.99%	4.60%	-0.93%

*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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Contact

Head office

Ashmore Investment Management Limited
61 Aldwych, London
WC2B 4AE
T: +44 (0)20 3077 6000
@AshmoreEM
www.ashmoregroup.com

Bogota
T: +57 1 316 2070

Dubai
T: +971 440 195 86

Jakarta
T: +6221 2953 9000

Mumbai
T: +9122 6269 0000

New York
T: +1 212 661 0061

Riyadh
T: +966 11 483 9100

Singapore
T: +65 6580 8288

Tokyo
T: +81 03 6860 3777

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