The ironic world of EM bond indices

By Jan Dehn

It is no small irony that the two main providers of benchmark indices for developed economies either already include or may be about to include Chinese government bonds, while the main provider of index services in Emerging Markets still does not deem Chinese bonds adequately tradable for index inclusion. In other news, Argentina reverts to myopic economic policies, Chinese data beats expectations, Jokowi is re-elected in Indonesia, Imran Khan reshuffles his cabinet in Pakistan, CHP wins the local election in Istanbul, Zelensky is Ukraine's new president and sequential growth in South Korean exports stabilises.

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	11.3	–	0.28%
MSCI EM Small Cap	10.2	–	-0.43%
MSCI Frontier	9.2	–	-0.30%
MSCI Asia	12.2	–	-0.01%
Shanghai Composite	10.9	–	1.17%
Hong Kong Hang Seng	8.3	–	1.30%
MSCI EMEA	8.9	–	1.43%
MSCI Latam	11.3	–	0.63%
GBI-EM-GD	6.16%	–	-0.33%
ELMI+	5.48%	–	-0.25%
EM FX spot	–	–	-0.46%
EMBI GD	6.03%	342 bps	0.10%
EMBI GD IG	4.36%	172 bps	0.14%
EMBI GD HY	7.86%	527 bps	0.06%
CEMBI BD	5.71%	319 bps	0.13%
CEMBI BD IG	4.46%	195 bps	0.14%
CEMBI BD Non-IG	7.41%	489 bps	0.13%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	15.7	–	0.04%
1-3yr UST	2.39%	–	0.07%
3-5yr UST	2.38%	–	0.04%
7-10yr UST	2.58%	–	-0.13%
10yr+ UST	2.99%	–	-0.35%
10yr+ Germany	0.05%	–	-0.62%
10yr+ Japan	-0.03%	–	-0.27%
US HY	6.18%	354 bps	0.03%
European HY	3.99%	410 bps	0.30%
Barclays Ag	1.86%	-72 bps	-0.23%
VIX Index*	12.58	–	0.26%
DXY Index*	97.34	–	0.40%
EURUSD	1.1251	–	-0.27%
USDJPY	111.86	–	-0.13%
CRY Index*	187.92	–	-0.44%
Brent	74.4	–	4.45%
Gold spot	1273	–	-0.31%

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

Emerging Markets

- **Index news:** Irony is when what appears to be the case differs radically from what is actually the case. As such, the world of benchmark indices last week delivered a rather exquisite example of irony. Both the main developed market (DM) fixed income index providers now either include or may be about to include Chinese government bonds, while the main Emerging Markets (EM) index provider has still not done so.

FTSE last week took a very concrete step towards including Chinese local currency bonds in its influential World Government Bond Index (WGBI) by announcing a formal review of Chinese market accessibility. The review will be completed by September 2019. Assuming that FTSE deems market accessibility to be acceptable, Chinese government bonds will presumably enter the WGBI shortly afterwards. FTSE's decision follows the inclusion, starting this month, of Chinese government bonds into Bloomberg's equally influential Global Aggregate Index ('Global Ag').

It is no small irony that the two most influential providers of fixed income benchmark indices for developed economies deem Chinese bonds to be sufficiently accessible for inclusion in their indices, when, by contrast, the main specialist Emerging Market (EM) fixed income benchmark provider, JP Morgan, still does not deem Chinese bonds adequately tradable to be included in its main EM local currency bond market index, the GBI EM GD.

One is left wondering how this is even possible. Does JP Morgan hold EM countries to higher standards than those, which FTSE and Bloomberg apply to their developed market indices? If so, why? Surely, one of the defining characteristics of EM – indeed one of the reasons for investing in such markets – is that they are not yet as deep and broad and liquid as markets in developed economies. One of the important attractions of EM investing is precisely to be invested at the time when such structural advances take place.

Whatever the reason for JP Morgan's lingering reluctance to include Chinese bonds in the GBI EM GD, the general observation remains that bond indices are notoriously unrepresentative of the EM investment universe. Only nineteen EM countries are included in the GBI EM GD index and only 9% of EM local currency government bonds are represented in the index.[1]

[1] Based on 2017 full-year data from Bank of International Settlements. Full-year 2018 data usually made available around mid-year.

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Emerging Markets

The issue of poor index representation in EM is not just an academic one. The vast majority of the world's institutional investors appear to closely hug benchmark indices. Many may not allocate to markets, which are not part of an index. As such, poor index representation amounts to a *systematic bias* in global asset allocation in favour of developed economies and against EM countries.

Private sector index providers, such as JP Morgan, are not to blame for this sorry state of affairs. They rightly act in their own private interest, which is what one would want private companies to do. However, index provision is a public good, which is why it is underprovided. Global asset allocation would be far better served if international financial institutions, such as the World Bank, IFC or even the IMF, recognised the public good element of indices and stepped up to provide proper representative benchmark indices. Sadly, none of the enlightened policy-makers in these institutions have yet found it worthy of their time to pick this obvious low-hanging fruit.

In other index-related news, FTSE also announced that Malaysia has been placed on index review over issues of accessibility to its domestic bond market. If FTSE deems Malaysian bonds to be inadequately accessible, they may be dropped from the WGBI. This will limit the ability of foreign investors to participate in the Malaysian domestic bond market to the extent that they are required to hug indices. However, Malaysia is likely to continue to be able to finance itself by placing bonds in its domestic market.

- Argentina: One way to assess the stage of development of a country is whether its government can keep inflation relatively stable and its public finances in good order. On those metrics, Argentina is one of the least developed economies in the world. Consistent with its long-standing tradition of mismanaging its economy, the Argentine government last week abandoned its most recent attempt at macroeconomic orthodoxy in favour of the kind of heterodox policy measures, which have been to blame for Argentina's long record of dismal economic performance. Specifically, the government cancelled planned hikes in electricity and gas prices and arranged price freezes for up to 60 products. The government also introduced measures to help small and medium sized companies repay past-due taxes. These measures, which followed an inflation print of 4.7% mom in March, may, at best, provide temporary relief from high inflation. However, they are clearly politically motivated, given the proximity of elections scheduled for Q3 2019, and, in isolation, they will not help Argentina to combat inflation.

- China: Q1 real GDP growth was 6.4% yoy. This was better than expected. Industrial production also beat expectations. Over the weekend, the Chinese Politburo expressed confidence in the economy, which suggests that reform efforts may now be stepped up further.

- Indonesia: Although the final result will not be known until May, it seems clear that incumbent President Joko Widodo (aka 'Jokowi') was re-elected as president of Indonesia. Jokowi has delivered stable macroeconomic policies, which should make it possible for him to expand infrastructure spending and broaden the tax base in his next term.

- Pakistan: Prime Minister Imran Khan's reshuffle of his ministerial team last week included a replacement for Finance Minister Asad Umar. This development is likely to usher in some temporary uncertainty about the government's economic reform program, which is widely expected to include devaluation, a freely floating exchange rate and new financing to the tune of USD 6-8bn from the IMF. Prior to the news of the reshuffle, it was announced that IMF plans to visit Pakistan before the end of the month.

- Turkey: Following his victory in a recent local election, Ekrem Imamoglu of the opposition CHP formally accepted the influential position of mayor of Istanbul, offered by the provincial election board for Istanbul. However, the losing side, President Erdogan's AKP, on Saturday lodged a second petition to the Supreme Electoral Council calling for cancellation of the election result and re-run of the election. Meanwhile, the fiscal deficit widened to 2.3% of GDP in March compared to 2.0% of GDP at year-end.

- Ukraine: *"Everything is changing. People are taking their comedians seriously and the politicians as a joke"*. Those are the words of Will Rogers, erstwhile American vaudeville performer. Rogers died in 1935, his words apply perfectly to Ukraine today. At the weekend, Volodymyr Zelensky, a former comedian, was elected President of Ukraine after securing a landslide victory with more than 70% of the votes. Former President Petro Poroshenko has conceded defeat. There is nothing wrong with comedians becoming presidents. Like others, Zelensky will be judged on the merits of his governance and may soon find himself in need of a good sense of humour in the maelstrom of Ukrainian politics. Zelensky's most important task will be to translate his large election victory into seats in the Rada, Ukraine's unruly parliament. Rada elections are due to be held on 27 October, so expect politics to continue to dominate events for several more months. Attention will also shift to Zelensky's policies towards Russia (Zelensky is expected to be pro-Western), corruption (Zelensky has ties to oligarch Igor Kolomoisky) and the economic reform program (the IMF program is key to economic stability).

- South Korea: Exports in the first twenty days of April declined even faster than in March. Exports in the first 20 days of April were 10% lower than a year ago compared to -6.4% yoy in March. However, much of the decline was due to base effects as evidenced by the stability of sequential export growth (only down 0.1% mom). Moreover, exports to China rose sharply (+5% mom). Exports to the US fell sharply (-4.3% mom), while exports to Europe were only down 0.1% mom. The Bank of Korea left the policy rate unchanged at 1.75%.

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Emerging Markets

Snippets:

- **Brazil:** Amidst continuing noise arising from process of passing an important pension reform, the real economy expanded at a modest yoy rate of 2.5% in February versus 2.9% yoy expected. The pension reform is currently in committee stage with a vote likely this week.
- **Croatia:** CPI inflation increased to 0.9% yoy in March from 0.5% yoy in February.
- **Egypt:** Voting began on Saturday for a new constitution, which may extend the rule of strongman President Abdel Fattah el-Sisi until 2030.
- **India:** Exports surged at a yoy rate of 11% in March compared to 2.4% yoy in February. Imports also recovered (1.4% yoy in March versus -4.2% in February). The net effect was to increase the trade deficit to USD 10.9bn from USD 9.6bn in February.
- **Kazakhstan:** The National Bank of Kazakhstan cut the base rate by 25bps to 9.0%. Inflation is in range and oil revenues are rising. Kazakhstan holds a presidential election on 9 June this year.
- **Philippines:** The fiscal deficit narrowed to PHP 58.4bn in March from PHP 76.3bn in February. This means that the fiscal deficit narrowed by more than one third in Q1 2019 relative to Q4 2018, mainly due to slower government spending. The 2019 Budget was approved on 15 April, so spending may well pick up again soon.
- **Peru:** The real GDP growth rate in February was 2.1% yoy, up from 1.6% yoy in January.
- **Poland:** CPI inflation increased to 1.7% yoy in March from 1.2% yoy in February. Industrial production was up 5.6% yoy in March, which was well ahead of expectations (4.4% yoy).
- **Singapore:** Core CPI inflation was 0.6% yoy in March versus 0.7% yoy expected. Core inflation dropped to 1.4% yoy in March from 1.5% yoy in February.
- **Sri Lanka:** A series of terrorist attacks on churches and hotels could have a temporary negative impact on tourism revenues and market sentiment towards Sri Lanka.
- **Thailand:** The trade surplus was USD 2.0bn in March versus USD 1.3bn expected.

Global backdrop

Global markets have been treading water some time now, lacking direction. EM bonds continue to dramatically outperform developed market bonds. For example, EM local currency government bonds are up 4.13% ytd compared to 1.19% for US bonds of similar duration, while EM external debt is up 7.03% ytd compared to 1.70% for US 10 year Treasury bonds. From 2016 through 2018, EM local currency bonds returned 18.80% compared to 3.56% for similar duration US bonds, while EM external debt returned 16.20% compared to 4.13% for US 10 year Treasuries. EM bonds currently price in a terminal Fed funds rate of about 480bps compared to 289bps for US 10 year Treasuries. With the Fed stuck at 250bps and unlikely to hike more than once or twice, it seems to us that EM bonds remain significantly mispriced with significant further upside.

Media reports indicate that the United States will remove sanction waivers for importers of Iranian oil from China, India, Turkey, Japan and South Korea. The removal of the waivers may have two effects. One is to further alienate other countries, including undermining reliance on US-based payment systems and the Dollar. The second effect is to restrict supply of oil from Iran, thus creating an imbalance between global demand and global supply, which may push up oil prices. Higher oil prices in turn increases the cost of doing business in America and other countries.

US data was mixed last week. Housing starts, housing permits, existing home sales, the Philly Fed Index, industrial production, and flash PMIs all disappointed, while retail sales were strong and claims for unemployment benefit continued to decline. The trade deficit narrowed to USD 49.4bn in February versus USD 53.4bn expected. The stronger than expected trade balance will provide some support for Q1 2019 GDP growth. In another positive development, Herman Cain has withdrawn his candidacy for the Federal Reserve Board, acknowledging perhaps that he was simply not "Abel". Finally, we note that the Euro-area composite PMI disappointed by declining 0.3 points to 51.3 in April, although it remains in expansion territory.

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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	3.02%	3.02%	13.22%	-4.19%	11.81%	4.35%
MSCI EM Small Cap	1.93%	1.93%	9.85%	-11.25%	6.30%	2.01%
MSCI Frontier	1.37%	1.37%	8.37%	-11.95%	6.76%	-0.46%
MSCI Asia	2.60%	2.60%	14.29%	-2.81%	12.77%	6.75%
Shanghai Composite	4.04%	4.04%	28.95%	7.24%	5.05%	11.68%
Hong Kong Hang Seng	3.42%	3.42%	16.24%	2.20%	13.49%	7.20%
MSCI EMEA	6.91%	6.91%	12.89%	-3.23%	7.39%	0.19%
MSCI Latam	0.72%	0.72%	8.71%	-5.78%	11.05%	-0.38%
GBI EM GD	1.17%	1.17%	4.13%	-5.37%	3.38%	-0.60%
ELMI+	0.79%	0.79%	2.28%	-2.71%	2.75%	-0.49%
EM FX Spot	0.74%	0.74%	1.00%	-8.91%	-2.50%	-6.85%
EMBI GD	0.07%	0.07%	7.03%	4.93%	5.30%	5.25%
EMBI GD IG	-0.13%	-0.13%	5.83%	6.60%	4.07%	4.58%
EMBI GD HY	0.27%	0.27%	8.30%	3.24%	6.66%	5.73%
CEMBI BD	0.46%	0.46%	5.64%	5.29%	5.32%	4.80%
CEMBI BD IG	0.28%	0.28%	5.06%	6.29%	4.11%	4.22%
CEMBI BD Non-IG	0.71%	0.71%	6.39%	4.10%	7.29%	5.54%

Global Backdrop	Month to date	Quarter to date	Year to date	1 year	3 years	5 years
S&P 500	2.70%	2.70%	16.71%	11.09%	13.89%	11.38%
1-3yr UST	-0.05%	-0.05%	0.94%	2.90%	0.99%	0.95%
3-5yr UST	-0.39%	-0.39%	1.19%	4.20%	0.97%	1.64%
7-10yr UST	-1.14%	-1.14%	1.70%	6.05%	0.73%	2.67%
10yr+ UST	-2.80%	-2.80%	1.73%	6.17%	0.97%	4.52%
10yr+ Germany	-1.57%	-1.57%	3.77%	9.63%	2.24%	6.95%
10yr+ Japan	-0.89%	-0.89%	2.38%	3.40%	0.21%	4.55%
US HY	1.10%	1.10%	8.44%	6.01%	7.85%	4.82%
European HY	1.49%	1.49%	7.21%	2.80%	4.78%	4.39%
Barclays Ag	-0.58%	-0.58%	1.61%	-0.10%	1.34%	0.81%
VIX Index*	-8.24%	-8.24%	-50.51%	-23.01%	-4.84%	-5.20%
DXY Index*	0.06%	0.06%	1.22%	7.03%	2.34%	21.90%
CRY Index*	2.27%	2.27%	10.67%	-6.38%	4.60%	-39.65%
EURUSD	0.29%	0.29%	-1.88%	-7.85%	0.26%	-18.57%
USDJPY	0.90%	0.90%	1.98%	2.90%	0.06%	9.09%
Brent	8.71%	8.71%	38.20%	-0.48%	64.82%	-31.86%
Gold spot	-1.51%	-1.51%	-0.75%	-3.92%	3.23%	-0.86%

*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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