Pay or be paid?

By Jan Dehn and Gustavo Medeiros

Developed Markets bonds offer negative yields, suffer from poor long-term macroeconomic policies and have exposure to debt levels that pose major risks for bond holders in the future, in our view. By contrast, Emerging Markets (EM) fixed income is not only relatively cheap, but also backed by much stronger economic dynamics and far less debt. We quantify the yield differentials in the market right now.

Emerging Markets	Index level/ yield	Spread over UST	1 week change
MSCI EM	981	–	-0.30%
MSCI EM Small Cap	1,016	–	0.12%
MSCI FM	604	–	2.20%
GBI EM GD	6.17%	–	-0.59%
EM FX spot	–	–	-0.53%
ELMI+	4.93%	–	-0.15%
EMBI GD	5.65%	352 bps	-0.25%
EMBI GD IG	4.35%	218 bps	-0.01%
EMBI GD HY	8.52%	649 bps	-0.70%
CEMBI BD	5.46%	348 bps	0.24%
CEMBI BD HG	4.34%	235 bps	0.12%
CEMBI BD HY	8.01%	605 bps	0.49%

Global backdrop	Index level/yield/ FX rate/price	5 business day change
S&P 500	2110	0.68%
VIX Index	14.30	-2.65%
5 year UST	1.60%	6 bps
7 year UST	1.93%	7 bps
10 year UST	2.12%	7 bps
US HY	6.61%	0.44%
European HY	4.77%	0.47%
EURUSD	1.1324	-0.29%
USDJPY	119.23	0.71%
Brent	59.88	-1.52%
Copper	259.05	-1.45%
Gold	1193.76	-3.12%

Additional benchmark performance data is provided at the end of this document.

Emerging Markets

Two year and five year government yields in developed economies are now negative on average. To argue that these markets are not in a bubble is becoming less and less credible. Investors in developed market bonds are literally *paying* for the privilege of lending money to over-indebted, money-printing, reform-shunning developed market governments. These governments are the most heavily indebted in the world with debt ratios of 138.5% of GDP, according to 2014 IMF data. Some USD 105 trillion of the world's USD 120 trillion of bonds – 87.5% of the total – have been issued by developed economies despite that fact that developed economies only make up 44% of global GDP.[1] To make matters worse, these economies are also pursuing policies that are likely to lead to losses for fixed income investors. In the seven years since the Subprime Crisis, developed economies have undertaken virtually no reforms at all. Nor have they achieved any meaningful aggregate deleveraging – in fact issuers and investors alike appear to completely ignore the debt problem, perhaps because debt is easy to ignore when interest rates are zero. Instead, they have printed a staggering amount of money. In a nutshell, these countries are all desperately trying to convert their debt problem into an inflation problem. They will eventually succeed, so the outlook for returns in these markets is ultimately dismal, because it hinges on continuing to inflate a bubble. The fact that a huge chunk of the world's savings are parked in these fixed income markets means that the outlook for future generations is bleak.

The table below illustrates the problem. It shows nominal and real yields for the largest and most developed economies based on index weighted GBI indices from JP Morgan. For comparison, we also show nominal and real yields for EM countries as well as US dollar bond yields for the same EM countries (to enable a comparison on a currency neutral basis).

Fig 1: **Real and nominal yields in EM and DM**

	Real 2 year LC yield	Real 5 year LC yield	Nominal 2 year LC yield	Nominal 5 year LC yield	US Dollar bond yields	Government debt to GDP (%)
13 GBI DM countries*	-0.52%	-0.04%	0.33%	0.81%	–	134%
16 GBI EM countries#	1.96%	2.26%	5.75%	6.08%	##3.13%	44%
Yield pick-up in EM	2.48%	2.30%	5.42%	5.28%	2.32%	–

Source: Ashmore, JP Morgan, Bloomberg, Data as at 20-Feb-15

* 13 DM countries are Australia, Belgium, Canada, Denmark, France, Germany, Italy, Japan, Netherlands, Spain, Sweden, United Kingdom and United States.

16 EM countries are Brazil, Chile, Colombia, Hungary, Indonesia, Mexico, Malaysia, Nigeria, Peru, Philippines, Poland, Romania, Russia, Thailand, Turkey and South Africa.

Same as above excluding Malaysia and Thailand.

[1] Sources: IMF and BAML.

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Emerging Markets

The contrast with EM countries is startling: Not only are EM yields high and positive in nominal terms they are also positive in real terms by between 248bps (2yr) and 230bps (5yr) higher than in developed economies. 5yr Dollar bonds in the same EM countries today pay a yield in Dollars of 3.13%, which is a staggering 232bps over the nominal index yield in developed economies (0.81%).

Hence, from a relative value perspective the case for investing in EM fixed income as an alternative to developed market bonds is now very strong. But the case is also strong from a fundamental perspective. Firstly, EM has just been through three major shocks – a 25% fall in commodity prices, a 25% fall in their currencies and the loss of half of US and European mutual fund flows. Yet EM has come through these shocks largely unscathed (no defaults, no balance of payments crises, etc. across the 62-country EM universe - aside from the usual small number of idiosyncratic problem countries). Secondly, EM countries are generally pursuing much better policies. They tend to reform regularly, and they are generally also quick and decisive in making fundamental macroeconomic adjustments when they get off course, not least because they never get the benefit of the doubt in the markets. This helps to keep them healthy. Finally, they do not print money and they have only issued USD 15 trillion of fixed income – 12.5% of the total – despite now making up 56% of global GDP. The average government debt to GDP ratio is only 44%.

We do not expect the world to become rational enough to price EM fairly despite the fact that EM's better debt dynamics and better policies justify that debt in EM countries should trade tighter than debt in most developed economies. But at least investors should think of EM bonds as insurance. When developed economies ultimately succeed in generating inflation the best way to preserve purchasing power of assets will be to keep the assets issued by countries with less debt, faster growth, more reserves and less money printing.

- Venezuela: Antonio Ledezma, a veteran opposition mayor in Caracas, has been arrested in connection with the unrest that marked the one-year anniversary of the arrest of another opposition leader, Leopoldo Lopez. President Nicholas Maduro's approval rating is tumbling amidst an economic downturn caused by lower oil prices. On the positive side, Venezuelan FX reserves jumped by USD 2bn to USD 23.4bn and likely funding raised by CITGO, a Venezuelan owned chain of petrol stations mainly in Eastern US.

- Nigeria: The approaching election and unrest caused by Boko Haram, has continued to put pressure on the Naira. A weaker Naira is a necessary part of the macroeconomic adjustment to lower oil prices. Liquidity is the main challenge the Central Bank is facing to let the market determine the FX rate as the monetary authority continues to occupy a large role in the market and it could take some time before the market picks up the slack.

- Russia-Ukraine: The situation on the ground in Eastern Ukraine is still 'catching up' with the newly minted Minsk peace agreement. The parties to the agreement – France, Germany, Russia and Ukraine – have so far been reluctant to give up on the settlement, but the situation on the ground in Ukraine also needs to reach a more stable equilibrium. This equilibrium is likely to be closer following the Ukrainian army withdrawal from the strategic railway hub of Debaltseve over the past week.

- Russia: Moody's, the ratings agency, downgraded Russian sovereign foreign currency bonds to Ba1. Another rating agency, S&P, also rates Russia below investment grade. The second downgrade will require some investors with minimum investment grade rating restrictions to sell their positions, creating a short-term technical imbalance in the market that may turn out to be a buying opportunity for those investors without such restrictions. According to JP Morgan, the provider of the EMBI GD sovereign bond index, the selling resulting from the downgrade could amount to about USD 4.7bn. Russia's local currency government bond ratings have not been affected. The US and Europe stepped up their threats of sanctions over Russia's alleged support for rebels in Eastern Ukraine.

- South Africa: Inflation continues to fall across many EM countries. In South Africa, the yoy rate of inflation in January declined to 4.4% from 5.3% in December. The main reason is of course oil prices. Core inflation was broadly unchanged at 5.8% yoy (5.7% in December). The fact that core inflation is relatively unaffected by falling headline inflation testifies to the high credibility of the central bank.

- Colombia: Retail sales rose strongly in December despite the negative terms of trade shocks sustained by Colombia on account of the fall in oil prices. Consumption was up 9.6% yoy in December and retail sales ex-fuel was up even more (10.6% yoy).

- Malaysia: Another oil sensitive EM credit, saw inflation decline to just 1% yoy from 2.7% yoy in December due to falling fuel prices. Lower inflation across EM has enabled local bond yields to decline from 7.2% in Q1 2014 to 6.15% now. This decline in yields has benefitted mainly local investors, because foreigners fled EM local markets in 2013 on the view that slower money printing by the United States (the Taper Tantrum) would derail EM fundamentals. Obviously, EM fundamentals were not impacted by this policy, but the headless flight of mutual fund investors out of the asset class did produce a 200bps re pricing of bonds, creating value which is now being captured by locals.

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Ashmore

Emerging Markets

- **Indonesia:** The central bank cut rates by 25bps to 7.5%. The decision was unexpected, following a December 25bps hike, justified by the recent decline in oil prices on the local market. Inflation is 6.96%, but expected to decline during the year towards the lower end of the 3-5% target range supported by benign core inflation, lower oil prices and improvement in the food security.

Snippets:

- **Singapore:** Real GDP expanded 2.1% yoy in Q4 versus 1.5% yoy expected. In January, exports rose strongly (4.3% yoy vs 2.0% yoy expected)

Global backdrop

Tensions between Greece and Europe receded as Athens agreed to extend the existing loan agreement for four months without any change in terms. The Greek government will this week submit details about its specific reform intentions, which will then be approved by the EU (barring any last minute shenanigans). Problems will soon return, however, once the extension expires. We expect Europe and Greece to struggle to find a formula that will allow Greece to stay in the currency union, while at the same time satisfying the populist demands of the Tsipras-led government in Athens, particularly since Greece's debt profile is fundamentally unsustainable.

Europe's periphery is turning towards left-wing populist governments, while northern Europe is increasingly turning towards right-wing populists. As these tendencies deepen the political divisions within the Eurozone centrist consensus in favour of maintaining cohesion across these disparate countries will increasingly be challenged politically, not just economically as has been the case hitherto. Strong pro-European leadership will be needed in the face of such developments. After all, the disastrous consequences of the actions of such populist movements were the very rationale that motivated the establishment of the European Union in the first place. In a mirror image of what is happening in Europe' southern periphery, speculative positions are being mounted in favour of the Danish Krone. Denmark's currency is pegged to the Euro and investors are buying the currency and investing in Danish fixed income on the view that the Danish central bank will maintain the peg with a QE inflated EUR, wherefore it must continue to cut rates. If the peg is abandoned, the Krone will rally hard, as did the Swiss Franc only recently.

Meanwhile, the FOMC minutes were more dovish than expected. This follows a series of weaker economic data releases over the last few weeks. According to the Citibank economic surprise index, which measures data surprises (actual release versus Bloomberg survey median) the US has had the most negative surprises relative to expectations of all countries in the three months to 18 February 2015.

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	2.5%	3.1%	6.5%	0.2%	3.9%
MSCI EM Small Cap	0.9%	2.4%	3.7%	2.6%	4.6%
MSCI FM	2.8%	-1.4%	1.7%	12.0%	6.6%
S&P 500	6.00%	2.82%	17.07%	18.17%	16.13%
GBI EM GD	-1.24%	-0.91%	-4.56%	-3.36%	2.33%
ELMI+	0.94%	-1.86%	-7.78%	-3.06%	-0.57%
EM spot FX	-0.20%	-3.19%	-13.72%	NA	NA
EMBI GD	-0.03%	0.90%	7.70%	5.44%	7.67%
EMBI GD IG	-0.39%	1.40%	9.33%	4.97%	7.04%
EMBI GD HY	0.63%	-0.03%	5.07%	6.18%	8.55%
5 year UST	-1.97%	0.47%	2.57%	1.12%	3.44%
7 year UST	-2.92%	0.57%	5.11%	1.87%	5.24%
10 year UST	-4.01%	0.60%	9.38%	3.24%	6.84%
CEMBI BD	0.76%	1.44%	4.93%	5.54%	6.73%
CEMBI BD HG	0.14%	1.60%	6.88%	5.78%	6.88%
CEMBI BD HY	2.13%	1.09%	0.92%	5.30%	6.63%
US HY	1.71%	2.17%	2.24%	7.79%	9.61%
European HY	1.20%	2.37%	6.30%	13.13%	12.20%
Barclays Agg	-0.93%	-1.09%	-2.14%	-0.01%	2.64%

Source: Bloomberg, total returns. Figures for more than one year are annualised.

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