The Emerging Markets fixed income and equity universes – an update[1]

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Introduction

We update our forecasts for the Emerging Markets (EM) asset class in both fixed income and equities. We conclude that by 2020:

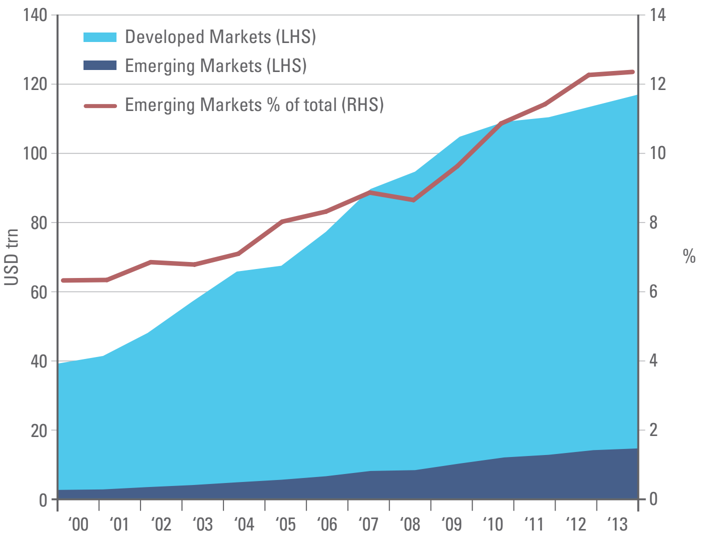
- EM fixed income will triple in size in Dollar terms to USD 45trn with the share of local currency rising to 90% of total outstanding, while corporates will account for more than 60% of total outstanding. Local currency corporate bonds will be the single largest EM fixed income asset class with 55% of total outstanding.
- We expect EM equity market cap to rise to nearly USD 40trn, more than twice its present size. This presents major problems for index providers, who still confuse EM and Frontier Markets, while excluding a myriad of opportunities across the EM space.

The purpose of this report is to help those looking at EM for the first time to receive a comprehensive overview of the asset class and also to enable existing investors to keep up with changes in the asset class.

The size of the EM fixed income universe

The EM universe expanded 3.2% in US dollar terms in 2013 to reach a size of USD 14.5trn. Over the same period, developed fixed income markets expanded by USD 2.8trn to USD 102.7trn. EM countries now account for 50% of global GDP but only 12.4% of total outstanding debt, while developed economies – the other half of global GDP – account for the remaining 87.6% of total debt. It is clear that EM's indebtedness is orders of magnitude lower than that of developed countries.

Fig 1: **Global fixed income – as at end December 2013**



Source: BAML, Ashmore.

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Composition of EM fixed income

Local currency debt is the backbone of EM fixed income. No less than 86% of all outstanding EM fixed income is in local currency with the balance made up of debt issued in non-EM currencies, mainly Dollars. Local currency government debt is 45.8% of total EM fixed income, local currency corporate debt 40.2%, Dollar denominated government debt 5.4%, and Dollar corporate debt 8.6%. The regional breakdown has not changed materially from last year: Some 59% of EM debt is issued in Asia, 25% in Latin America, 10% in Eastern Europe and 6% in the Middle East and Africa.

Currency effects

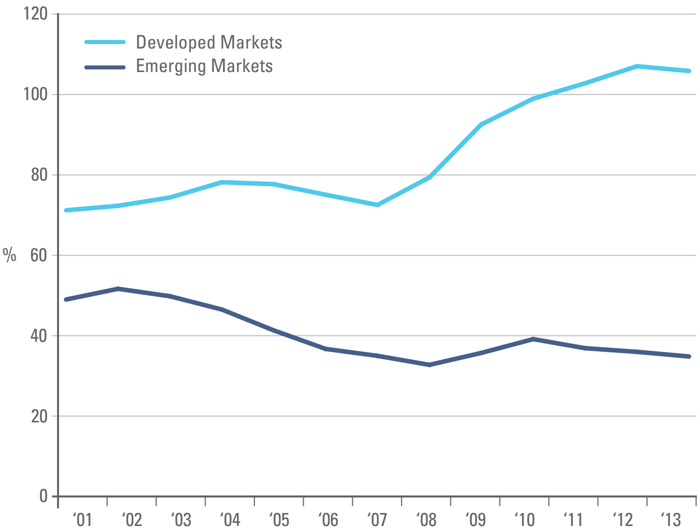
In 2013, the universe of EM Dollar denominated fixed income expanded by 15.9% to USD 2.0trn, while the local universe (in Dollar terms) expanded by 1.4% to USD 12.5trn. The slower growth rate of local currency was due to the 8.7% drop in EM FX last year caused by the 'Taper Tantrum'. In nominal local currency terms, the EM local currency universe grew faster. We estimate that in nominal local currency terms the actual outstanding expanded about 10% in 2013, reaching a size of about USD 13.6trn (in constant 2012 Dollar terms). As such, the total EM fixed income universe is now closer to USD 15.6trn in constant 2012 Dollar terms; or about 11% larger than in 2012.

[1] *The Emerging Market fixed income universe,* The Emerging View, August 2013.

Debt dynamics

What does this rate of expansion of EM's fixed income markets mean for debt sustainability in EM? Answer: Debt dynamics remain extremely comfortable. In 2013, EM real GDP increased by 4.7%, according to the IMF. The IMF also reports that EM inflation averaged 5.8% in 2013. With EM nominal GDP thus expanding roughly at the same rate as outstanding fixed income it is unsurprising that the IMF reported in April 2014 that EM gross government debt as a percentage of GDP declined marginally from 35.6% in 2012 to 34.5% of GDP in 2013 (bear in mind that outstanding corporate debt increased a bit faster than government debt). The modest pace of expansion of EM fixed income markets is also consistent with Ashmore proprietary research, which shows that EM has experienced financial shallowing in absolute and relative terms compared to developed economies since QE policies began.[2] Indeed, the contrast with developed countries is dramatic – gross debt to GDP in developed countries rose from 103.2% to 107.5% last year.

Fig 2: **Debt to GDP**



Source: IMF, Ashmore.

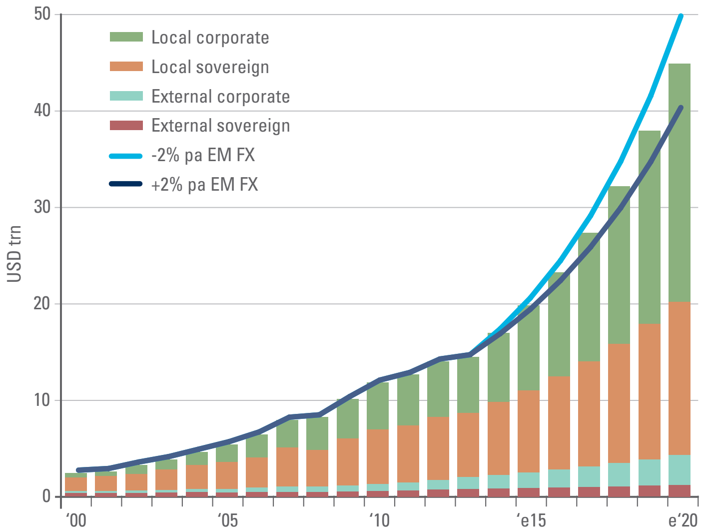
Growth of EM fixed income markets going forward

EM fixed income markets continue to expand at an orderly pace closely related to the size of the underlying expansion of nominal GDP in EM. That is, the drivers of fixed income markets are largely structural rather than cyclical, despite very low global interest rates. It is therefore sensible to work with the assumption that each EM fixed income asset class will continue to expand at roughly the same average annual growth rate as in the past. Using the average annual growth rates of each fixed income asset class since 2000 – a period that covers the Dotcom Bubble, the US Sub-prime Crisis, and the European debt crisis – we estimate that the EM fixed income universe will reach a size of USD 45trn by 2020. By that year, local currency bonds will constitute 90% of the EM fixed income universe. Corporate bonds will be 62% of the total outstanding. Local currency corporate bonds will be the single largest asset class, accounting for 55% of total outstanding bonds (compared to 40% today).

We estimate that the EM fixed income universe will reach a size of USD 45trn by 2020

External sovereign debt will be a USD 1.2trn asset class compared to USD 788bn today, but external sovereign debt will only be 3% of total EM fixed income (compared to 5% today).

Fig 3: **Projections for growth of EM fixed income**



Source: BAML, Ashmore.

Alternative projections

What might cause the size of the asset class to differ from our basic projection? One possibility is that EM debt issuance turns out to be slower in the coming years. Indeed, EM countries have issued debt more slowly since 2008 than, say, in the 2003-2007 period. We estimate that if EM fixed income grows at the pace we have seen since 2008 (instead of since 2000) then the asset class will grow to about USD 30trn by 2020, which is still more than double the size of today. Alternatively, if the asset class as a whole grows simply in line with EM nominal growth (roughly 10% pa) plus a modest 2% of financial deepening each year then the EM fixed income universe will reach some USD 32trn by 2020.

As 2013 showed, an important determinant of size of the universe in Dollar terms is obviously currencies. After all, in an investment universe where 86% of the securities are denominated in local currencies it matters a great deal what happens to the exchange rate. While the size of the Dollar denominated universe is not directly affected by changes in EM FX rates versus the Dollar[3] a decline in EM currencies of 2% per annum versus the US dollar each year until 2020 would reduce the Dollar value of total the EM fixed income from USD 45trn to approximately USD 40trn. By contrast, if EM currencies appreciate 2% per annum versus the Dollar the EM universe (in Dollar terms) increases to USD 50trn by 2020. This is roughly five times the size of the tradable US treasury market today.

[2] See *"Financial Divergence: How ready are Emerging Markets for global financial tightening?"* The Emerging View, May 2014. .
[3] But note that exchange rate changes could cause issues to switch from one currency to another. Such effects are not considered here.

Index representation

Index representation was unchanged in 2013 and remains woeful. Some 11% of EM fixed income is represented in the main indices, unchanged from last year. Index representation of external sovereign debt, external corporate debt, and local currency debt all declined, but a bright spot was the arrival of the first ever index purporting to cover the local currency corporate debt market. Last year BAML broke JP Morgan's near-monopoly on fixed income indices in EM by launching the USD 122bn LOCL index. While this is a clear step in the right direction, the index so far only covers Euroclearable bonds, which comprise only 2% of the USD 5.8trn total outstanding of local currency corporate bonds in EM.

Fig 4: **The asset class and index representation**

Index name	Provider	2012 USD bn	2012 % of asset class	2013 USD bn	2013 % of asset class
EMBI GD	JP Morgan	332	45%	330	42%
CEMBI Broad Diversified	JP Morgan	265	26%	275	22%
GBI EM Global Diversified	JP Morgan	965	15%	930	14%
Local EM non-sovereign (LOCL)	BAML	–	–	122	2%
Total	–	**1,562**	**11%**	**1,657**	**11%**

Source: Ashmore, BAML, JP Morgan.

Fortunately, the number of EM issuers represented in indices continues to increase. We expect the JP Morgan EMBI index to have 62 sovereign issuers by August or September once Kenya is included, up from 60 last year (and just 26 countries a decade ago). This puts the sovereign indices on track to have about 80 issuers by the end of the decade – a truly remarkably diversified index. Meanwhile, in the corporate space we estimate that between various JP Morgan and Bank of America Merrill Lynch corporate indices there were 1,333 corporate index names as of June 2014.

Local indices continue to be far less representative than Dollar indices, not just in terms of the percentage of the universe covered, but also in terms of the number of countries represented. For example, JP Morgan's GBI EM GD index of local currency government bond issuers still only includes 16 issuers, despite the fact that the local universe is ten times larger than the Dollar universe and despite the fact that the majority of EM's 165 countries have local government bond markets in some shape or size. While some countries are legitimately excluded due to capital controls, the main reason why local markets are so poorly represented is that the index providers only tend to include bonds in which they make markets, and the truth is that few international investment banks have market making operations in more than a dozen or two EM local markets.[4]

Of course, the lack of index representation does not mean that these markets are inaccessible or illiquid. Liquidity is largely a function of geography and manager capabilities – just as in developed countries the best liquidity in any EM market is always found within the EM country itself. No one would dream of looking for liquid markets in, say, Australian bonds in Peru or Ghana or even London. The same is true for EM – the best liquidity for local Ghanaian bonds is unambiguously in Ghana, not in London and New York. This means that the future of EM local currency trading is firmly within each individual EM country. The challenge for index providers to remain relevant is truly enormous.

The EM equity universe expanded by 8% in 2013 to reach USD 15.1trn

The size of the EM equity universe

The EM equity universe expanded by 8% in 2013 to reach USD 15.1trn, according to Bloomberg's World Market Cap series. We define EM equity markets as all markets not identified by MSCI as 'developed'; this means that our definition also includes markets that would be classified as 'frontier' – or simply are not included in any formal classifications. Developed markets expanded by 22% over the same period. As of the end of the year, EM equities represented 24% of total market cap, down from the previous year at 27%.

Asian markets continue to account for the largest share of the total EM market cap with over 60% market share. The largest market by far is China, with a total market cap of more than USD 5trn as of the end of December 2013 – this of course includes the China A-share market, which alone is valued at approximately USD 4trn – this of course includes the total size of the A-share market, which was valued at approximately USD 4trn alone. It is important not to underestimate the sheer size and scale of this market. The Chinese government has taken significant steps to gradually open this market to foreign investment, first by granting RQFII licenses to foreign asset managers outside of Singapore and Hong Kong, and then opening up dual listings of local shares between Shanghai and Hong Kong exchanges.

Fig 5: **Top 10 EM equity markets as at end December 2013**

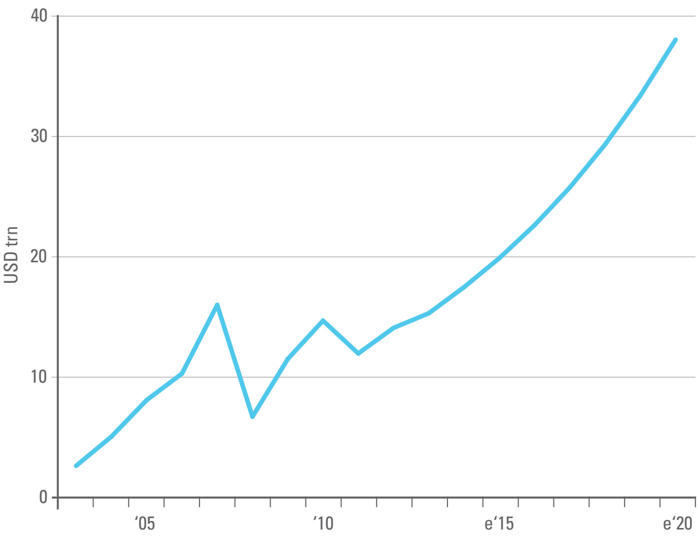
Market	Size (total market cap USD bn)
China	5,100
India	1,200
S. Korea	1,200
Brazil	1,000
Taiwan	1,000
Russia	760
Malaysia	500
Mexico	500
South Africa	480
Saudi Arabia	470

Source: Bloomberg, as at July 2014, except China which also sourced HSBC data.

[4] See *"Are Emerging Markets bond indices public goods?"*, Market Commentary, 21 May 2014.

We expect EM equity market cap to reach nearly USD 40trn by 2020 on the view that EM growth and market expansion are largely structural in nature. Our projection is based on EM's long-term earnings growth rate at 14% per annum. One of the most significant developments we have seen since the end of December has been the announcement that Saudi Arabia will be opening its equity markets to direct foreign investment.[5] As shown in the table above, Saudi Arabia's equity market is among the 10 largest in EM. It trades over USD 2bn per day. As investors flow into these markets we expect them to continue to grow.

Fig 6: **Total market cap EM and Frontier Markets equities**



Source: Ashmore, MSCI and HSBC.

Equity Returns, Volatility, Correlation

The key issue facing investors is how to allocate capital to EM equities. Clearly over the years EM equity markets have broadened and deepened. Investors are now able to make a discreet allocation to subsectors of EM equities, either by region or by market cap. Last year, EM equity markets behaved differently compared with their longer history due to significant index changes. The result was a significant decrease in the correlations of some index returns:

Fig 7: **Correlation of monthly market returns December 2002 – December 2013**

	MSCI FM	MSCI ACWI	MSCI US	MSCI EAFE	MSCI EM	MSCI EM SC
MSCI FM	1.0	–	–	–	–	–
MSCI ACWI	0.64	1.0	–	–	–	–
MSCI US	0.59	0.96	1.0	–	–	–
MSCI EAFE	0.64	0.98	0.90	1.0	–	–
MSCI EM	0.60	0.91	0.80	0.89	1.0	–
MSCI EM SC	0.61	0.88	0.77	0.87	0.96	1.0

Source: Ashmore, Bloomberg, MSCI.

EM equity markets have broadened and deepened. Investors can now make discreet allocations to subsectors either by region or by market cap

In particular, correlations have significantly moved with respect to Frontier Markets with the rest of the world:

Fig 8: **Correlation of Frontier Markets monthly market returns over 1 year and 3 years (to December 2013)**

MSCI FM vs:	1 year	3 year
MSCI EM	0.38	0.50
MSCI US	0.19	0.32
MSCI EAFE	0.40	0.49
MSCI WORLD	0.33	0.44

Source: Ashmore, Bloomberg, MSCI.

Frontier markets are famously unsynchronised with the broader EM and DM investment universes, but this has been accentuated over the past year. The African and Middle Eastern regions are linked into the global commodity and oil markets, but unlike the larger EM countries such as China, India, and Korea depend far less on demand for discretionary goods and services from the developed world. During 2013 the GCC markets which are dominated by Saudi Arabia enjoyed a growing property and consumer-driven economic upswing that propelled their markets to sharp recoveries while the EM markets in aggregate were stagnant. Investor flows into frontier Africa over the past year reached a near fever pitch as consumer stocks, in particular, were bid up by anxious investors looking to capitalise on the region's strong secular growth story. By contract, the larger stories of DM export demand and market responses to the latest macroeconomic data that drive short-term returns in developed market indexes had less direct impact on Frontier market shares.

Index representation

As mentioned at the outset, index representation remains a key problem for investors. According to MSCI, as of the end of December 2013, the MSCI Emerging Markets index included 824 companies across 21 markets. Many markets remain outside the index, yet it is still the main measure by which investors gauge returns and investment opportunities. The total market cap of the index was approximately USD 7.5trn, according to Bloomberg, which is roughly half the total size of the EM and Frontier Markets universe. Frontier Markets, according to MSCI, included 127 companies in 27 markets, worth approximately USD 530bn. Markets such as Saudi Arabia (160 stocks), worth USD 470bn, are not included. Other markets such as Ghana, Zambia and Zimbabwe are also missing. Smaller markets, particularly Cambodia, Georgia and Palestine, only have one company represented in their respective country index.

[5] See *'Saudi Arabia: A USD 560bn opportunity'* – Occasional View, 5 August 2014.

Ashmore

Last year, MSCI amended a reclassification of certain markets in its investment universe, which had significant impact on market returns:

Fig 9: **Index reclassification**

Market	MSCI Old classification	MSCI New classification
Greece	Developed	Emerging
Morocco	Emerging	Frontier
Qatar	Frontier	Emerging
UAE	Frontier	Emerging

The smallest market in EM equities as of the end of December (2013) was Egypt, representing just 0.20% weight, with the largest being China at nearly 20%. Such disparities across a benchmark can risk creating an impression that the smaller markets are perhaps not worth investing in. Egypt returns for 2013 were about 7.8%, compared to -2.3% for the MSCI EM index. The Egyptian market remains diverse due to a large number of stocks with a total market cap size of nearly USD 70bn.

With the new country classification, Frontier Markets are now even less representative than before. Following the promotion of Qatar and UAE to EM status, the MSCI Frontier Markets index now has nearly 45% of its weight in only two markets: Kuwait and Nigeria. Its smallest market, Lithuania, will be only 0.15%!

We expect EM equity market cap to reach nearly USD 40trn by 2020

But the confusion doesn't stop there. Last year, saw one of the largest EM Equity ETF providers switch benchmarks from MSCI to FTSE, resulting in a significant sale out of South Korea as the former index deems South Korea to be 'Emerging' while the latter deems it to be 'Developed'.

Small caps also continue to be left off the table. As of December 2013 there were over 2,000 companies with a market cap size of USD 2bn or less that are not part of the standard EM equity universe,[6] yet represent some of the most significant growth opportunities in EM, in our view. For many investors, an allocation to EM small caps, like Frontier Markets, remains largely an 'off-benchmark' bet. As with fixed income, lack of inclusion does not necessarily mean lack of access or liquidity: Saudi Arabia is a very liquid market and some companies in the Small Cap space trade more than companies included in the standard benchmark.

For these and other reasons, we firmly believe there are many opportunities for active management in the EM equity space. Lack of analyst coverage, lower correlations and a significantly broader universe of companies create rich opportunities for active stock pickers.

[6] Source: Ashmore.

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