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US late cycle dynamics and EM bonds

By Jan Dehn

The recent volatility in US stocks may be a warning that the US business cycle expansion is moving into its late stages. How would Emerging Markets (EM) bonds perform if US stocks were to begin to underperform and how should EM investors respond?

Based on the empirical data, there is no consistent relationship between EM fixed income performance and US stocks. Instead, there appears to be a strong relationship between US policy stimulus on the one hand and the performance of US stocks relative to EM bonds on the other. Specifically, US stocks tend to outperform EM fixed income during periods of strong US policy stimulus. Outside such periods, EM bonds tend to perform in line with, or better than, US stocks.

This should be good news for investors considering an allocation to EM bonds. After all, the Fed is tightening policy both qualitatively and quantitatively and the room for additional fiscal stimulus is shrinking fast.

The large correction US stock in September/October may simply be a wobble, but it could also be an early indicator of late business cycle blues. If so, what does that mean for EM?

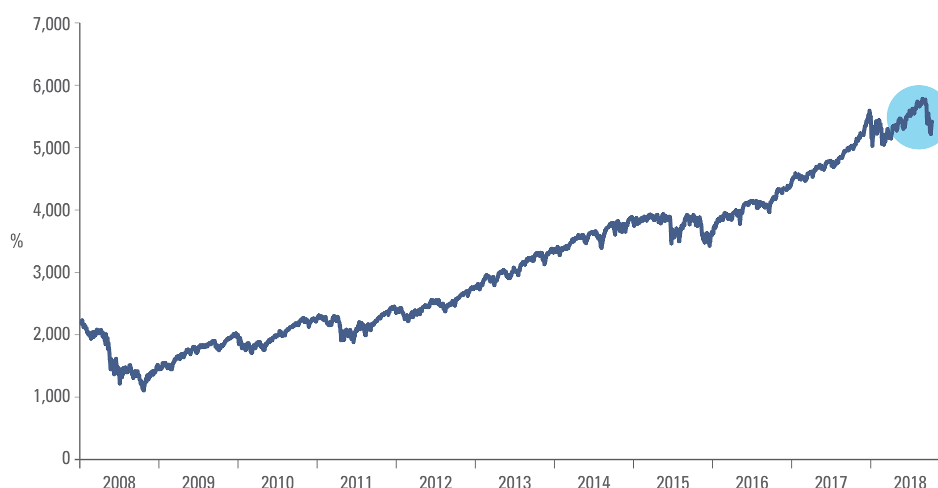
Late cycle blues

The US equity market has displayed a great deal of volatility of late, including a 10% correction in September/October (Figure 1). This may simply be a wobble, but after a nine-year rally, it is entirely rational to begin to expect some late cycle blues.

The Fed is hiking rates, unemployment is at the lowest level since 1969, the Dollar is very expensive in real and nominal terms, the yield curve has flattened most of the year, the stock market is rising on just a handful of equities and housing is softening. Most importantly, company costs have started to eat into earnings in some segments of the US economy. Cost-related problems are difficult to fix and the current US policy mix is, if anything, contributing to rising costs. In this context, US stocks may perform less consistently going forward, perhaps worse.

How will EM bonds perform if US stocks begin to underperform and how should EM investors respond if US equity wobbles become more frequent?

Fig 1: **S&P 500 total return**



Source: Ashmore, Bloomberg. Data as at 31 October 2018.

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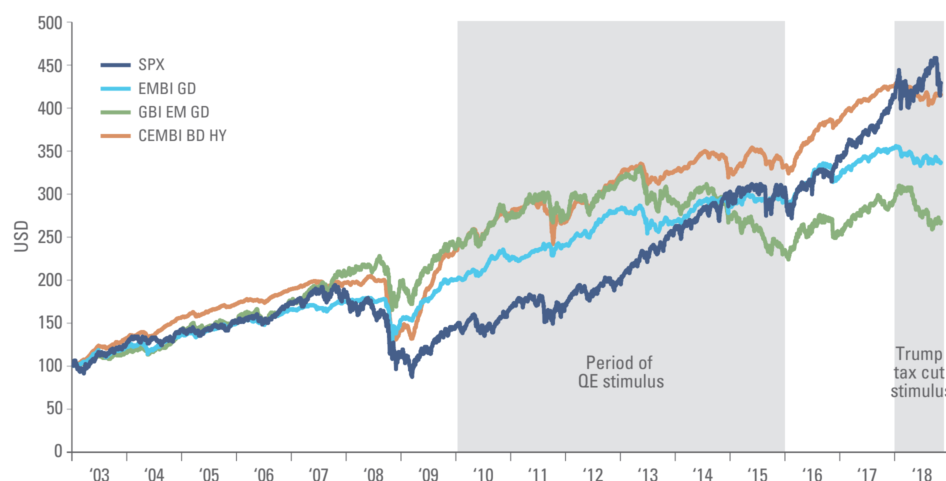
No consistent relationship

There is a widespread perception in many quarters that EM bonds, especially of the local currency variety, cannot possibly perform if US stocks go down. As usual, reality is somewhat more nuanced. Figure 2 shows total return for the S&P 500 index as well as JP Morgan's three EM bond total return indices: the local currency bond index (GBI EM GD), the sovereign Dollar bond index (EMBI GD) and the corporate high yield bond index (CEMBI BD HY). Returns are in US dollars.

Fig 2: **Index total return (USD returns – December 2002 = 100)**



Source: Ashmore, Bloomberg, JP Morgan. Data as at 31 October 2018.

There is no consistent relationship between EM performance and the US stock market. All permutations have taken place in the past

Apart from the impressive fact that some EM corporate bonds have performed as well as US equities over the period in question, the following observations are worth highlighting as far as the relationship between US stocks and EM bonds is concerned:

1. **EM bonds performed *in line* with US stocks** during the US stock market rally from 2002 to 2007.
2. **EM bonds *outperformed* US equities** during the 2008/2009 US stock market rout.
3. **EM bonds displayed *mixed performance* versus US equities** during the 2010-2015 period with **EM corporate high yield bonds performing *in line* with US stocks** and **EM local currency bonds significantly *underperforming* US stocks. Sovereign bonds *underperformed* US stocks, but delivered *steady positive returns***.
4. **All EM bonds *rallied* with US equities** during 2016 and 2017, but not as fast.
5. **All EM bonds *declined*** in 2018, when the US stock market went up and then corrected sharply.

The only conclusion one can draw from the conflicting information is that there is *no consistent relationship* between the performance of EM bonds and the US equity market. EM corporate high yield bonds have matched returns of US stocks over the full period with marginally less volatility. EM sovereign bonds (in Dollars) performed in line with US stocks right up until the end of 2016, but with far less volatility. EM local bonds have outperformed US stocks in some periods and seriously underperformed US stocks over other periods. In general, all EM bonds have smaller drawdowns than US stocks during bouts of US equity volatility, but there does not appear to be any hard and fast rule describing how EM bonds perform during shocks to US stocks.

The importance of US government policy

Whereas the direct relationship between EM fixed income and US stocks is inconsistent, the relationship between US stocks and EM local currency bonds looks very consistent when one takes account of US government policy. Specifically, periods of extra-ordinary government policy support, such as the Quantitative Easing (QE) period (2010-2015) and the recent fiscal splurge (shaded areas in Figure 2) are associated with clear underperformance in EM local bond markets relative to US stocks. The underperformance is also evident in sovereign bonds and EM corporate high yield bonds, only less so. On the other hand, outside periods with intense US government policy support,

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EM local bonds generally do well and in some cases better than US stocks. This is also largely true for sovereign and corporate (Dollar) bonds. In other words, the relationship between US stocks and EM bonds seems stable and predictable only when it is conditional upon policy stimulus.

Reasons to be cheerful, part one

The fact that EM local bond performance versus US stocks depends so heavily on policy stimulus should work in favour of EM bonds as US policy becomes less accommodating in the next few years. The Fed looks set to hike again in December and, for now, maintains that it will hike another four times next year. Meanwhile, it is shrinking its balance sheet at a faster pace over the next couple of years.

Major US fiscal and monetary stimulus is consistently associated with US outperformance versus EM local markets. With stimulus on the wane this should be positive for EM

The Treasury is running out of fiscal room after an eye-watering stimulus over the last few years, not least because the US government's debt stock has increased from 65% of GDP ten years ago to more than 105% of GDP today.[1]

Reasons to be cheerful, part two

What if the US economy falters? Policy stimulus would obviously return, which ought to be negative for EM bonds based on experience. However, the impact may turn out to be less than in the past due to already heavy positioning in both US stocks and the Dollar. Rallies of 430% and 35% for the S&P 500 and the Dollar respective since the 2008/2009 crisis, these trades have not only been the largest recovery trades, but also the most resilient.

The key insight is that investors piled into stocks and Dollars on a bullish view of the US recovery. Hence, if equity returns now face challenges and growth slows due to late cycle factors then this money is in the wrong place and could leave; investors need to sit up and pay attention. This argument is strengthened by the observation that the Fed does not have enough room to cut rates to extract the economy from recession. A return to QE, when investors do not have the same optimistic view of recovery, will probably not receive the same welcome as the last time.

Yield shields against volatility

Of course, there will inevitably be a short period of potentially strong volatility if the US stock market suddenly buckles. The best way to approach bouts of volatility in a high-yielding plain vanilla asset class like EM bonds is to think long-term. EM bond yields are so high that performance over time tends to be quite smooth regardless of what happens in the short-term. This is illustrated in Figure 3, which shows the rolling 3-year annualised returns (in USD) for EM bonds and US stocks.

The best way to approach volatility in high yielding bonds is to take a long-term view; high yields smooth out performance over time

The volatility in returns for US stocks over three years is even higher than for EM local bonds. EM Dollar denominated bonds almost never have negative returns on a 3-year rolling return basis, regardless of the level of volatility in the short term. Note, in passing, the gradual recovery in local bonds since the first Fed hike in December 2015.

Fig 3: **3-year rolling returns (in USD)**

Source: Ashmore, Bloomberg, JP Morgan. Data as at 31 October 2018.

[1] Based on IMF's forecasts in the *World Economic Outlook* from October 2018.

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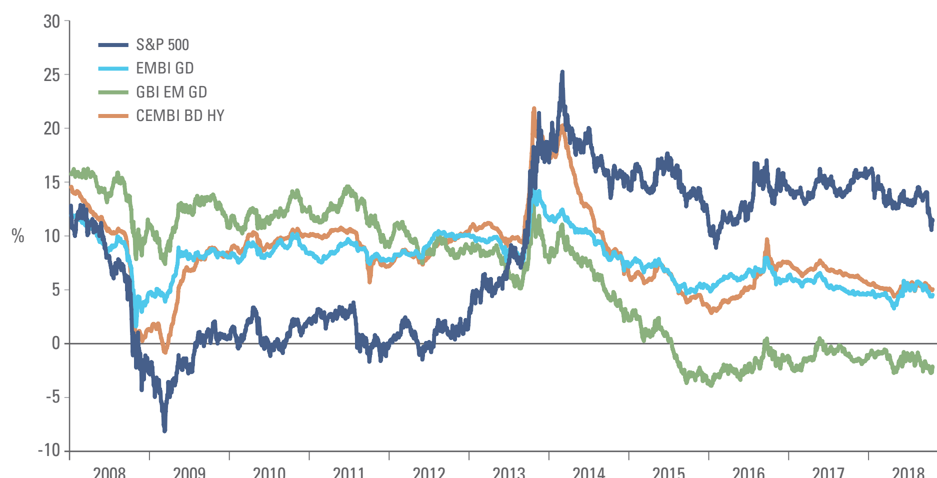
When evaluated over five years, these features become even more pronounced (Figure 4). Returns to EM corporate and sovereign (Dollar) bonds are now extremely stable, while US equity returns and EM local currency bond returns almost look like mirror images of one another. This underlines the close relationship between the bullish US equity trade over the past few years and the bullish Dollar trade, both of which depend heavily on stimulatory policies. When policy stops, the US stock market stops and the Dollar stops and EM local bonds then start to shine.

Fig 4: **5-year rolling returns (in USD)**



Source: Ashmore, Bloomberg, JP Morgan. Data as at 31 October 2018.

Learn to love volatility

Rather than fear volatility, investors should instead embrace it as a signal for when to put money to work

Many investors struggle to see beyond the short-term EM volatility, which typically accompanies US equity market sell-offs. This fear of volatility (as opposed to actual risk, i.e. large permanent losses) leads many investors to buy and sell bonds at precisely the wrong times. Typically, investors end up selling near the bottom during outbreaks of risk aversion and only get in after the market has already rallied substantially, i.e. near the top.

Rather than fear bouts of volatility, investors should instead embrace volatility as a signal for when to put money to work. Volatility has great value as a timing mechanism. For one, bouts of volatility are extremely visible, because every financial journalist and investment banker will be screaming themselves hoarse trying to 'sell' stories of contagion, balance of payments crises, Dollar-shortages, China hard landings and other Doomsday forecasts. Secondly, empirical evidence shows that buying consistently during sell-offs is great for returns. Of course, ideally one buys near the turning points, which is difficult, so it is generally desirable to enter the market in several bites.[2]

Figure 5 illustrates why buying dips works. It shows 1-year and 3-year returns (in USD terms) for the three main EM fixed income asset classes following spikes in yields to levels of 6%, 7% and 8%. The fact that returns are always higher than yields shows that markets tend to overreact to risk-off events. In other words, risk off raises yield, does not lead to permanent impairment and rewards dip-buyers with capital gains (ratio of returns to starting yields is always greater than 1).

Fig 5: **1-year and 3-year subsequent returns at yield thresholds**

Performance	Asset class	YTM > 6%		YTM > 7%		YTM > 8%	
		1yr	3yr	1yr	3yr	1yr	3yr
Returns	EMBI GD	10.6%	8.0%	14.9%	8.6%	18.1%	9.2%
	GBI EM GD	8.6%	12.1%	13.2%	6.9%	21.6%	10.3%
	CEMBI BD HY	10.1%	8.4%	11.1%	8.5%	15.2%	8.9%
Ratio of returns to starting yield	EMBI GD	1.8	1.3	2.1	1.2	2.3	1.2
	GBI EM GD	1.4	2.0	1.9	1.0	2.7	1.3
	CEMBI BD HY	1.7	1.4	1.6	1.2	1.9	1.1

Source: Ashmore, Bloomberg, JP Morgan. Data as at 31 October 2018.

[2] See *'Gee Vix!'*, Weekly investor reserach, 30 May 2017.

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Do not lose sight of the bigger picture

The US equity trade was one of four enormous 'QE trades', which also included going long the Dollar, long European bonds and short most things EM. If, or rather, when stocks soften and growth begins to decline, then rates will also come down in the US. The combination of lower stocks, a lower Dollar and lower yields should be supportive for EM local currency bonds, even if there is short-term volatility. Investors began to unwind long Dollar positions and short EM trades in early 2016 and the Dollar fell against EM currencies in both 2016 and 2017, when EM local bonds made 25%. Granted, these trades reversed course in 2018, but the setbacks are entirely due to temporary factors around the US mid-term election.

The EM local rally is likely to resume in 2019. It is intriguing that 2019 could also see the US equity 'QE trade' begin to unwind. This should not in itself cause problems for EM bonds, absent, that is, massive new fiscal and monetary stimulus in the US.

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

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