Ashmore

The EM fixed income universe version 6.0

By Jan Dehn

This is the 6th annual review of global fixed income. The report provides an overview of bond markets in 106 EM countries and 26 developed economies. As of the end of 2016 the EM fixed income universe had grown to just over USD 20trn, or 20% of the global bond market. In addition, EM financial institutions are extending USD 30trn of domestic credit, so the total EM financing universe on the fixed income side now stands at approximately USD 50trn. This is equivalent to 27% of total global bond and loans finance. Yet, since EM countries account for nearly 60% of global GDP EM countries remain severely finance constrained. This simple fact alone suggests that EM fixed income offers a significantly stronger investment proposition than developed market fixed income.

Introduction

Emerging Markets (EM) is a group of countries, which are evolving along paths of rising per capita GDP and ever deeper and broader financial markets. The EM bond universe now measures just over USD 20trn with a further USD 30trn in credit and loans. The majority of EM bonds are denominated in local currency and issued by corporates. Asia dominates the investment universe, but there are now sizeable issuers on all continents as the asset class becomes ever more diversified.

This report provides a detailed overview of the EM fixed income asset class with particular emphasis on bond markets.

Global fixed income universe

The global fixed income finance universe reached a whopping USD 189trn at the end of 2016, which is equivalent to 250% of current world GDP.[1] The universe breaks into USD 89trn of loans and domestic credit and USD 100trn of bonds. Within these broad totals, there are three major differences in the structure of financing in EMs and developed markets (DMs):

1. **EMs account for only a quarter of total financing:** EM issuers account for 27% of total financing (USD 50.3trn) of which domestic credit makes up 58% (USD 30.3trn) and debt securities make up the remaining 42% (USD 20.1trn).
2. **Loans and credit are more important within overall financing in EM than in DM:** EMs account for some 34% of world loans and domestic credit, but only 20% of the total bond universe. The under-representation of EM bonds within total financing may be a reflection of the EM index problem.[2]
3. **EM economic indebtedness is materially lower than in the DMs:** The average EM country is indebted to the tune of 172% of current GDP compared to an average of 300% for DMs. In terms of purchasing-power adjusted GDP EM average indebtedness is just 72% of GDP compared to 275% of GDP for DMs. See Figure 1.

Fig 1: **The global fixed income finance universe**

Asset class	USD trn	% of total finance	% of GDP	% of PPP adjusted GDP
Global Finance	**188.5**	**100%**	**250%**	**157%**
Global loans & credit	89.1	47%	118%	74%
Global debt Securities	99.5	53%	132%	83%
Emerging Markets	**50.3**	**27%**	**172%**	**72%**
Loans & credit	30.3	16%	104%	43%
Debt securities	20.1	11%	69%	29%
Government	*9.3*	*5%*	*32%*	*13%*
Financial	*6.3*	*3%*	*22%*	*9%*
Corporate	*4.4*	*2%*	*15%*	*6%*
Developed Markets	**138.2**	**73%**	**300%**	**275%**
Loans & credit	58.8	31%	128%	117%
Debt securities	79.4	42%	172%	158%
Government	*38.8*	*21%*	*84%*	*77%*
Financial	*31.5*	*17%*	*68%*	*63%*
Corporate	*9.1*	*5%*	*20%*	*18%*

Source: Ashmore, BIS.

[1] For purposes of this report we define the global fixed income finance universe as debt securities and loans issued in both local and external markets by governments, non-financial corporates and financial corporates. This includes domestic credit issued to households and non-financial corporates. 2016 is the last full year with complete data. The main data source is Bank of International Settlements (BIS). The BIS database includes debt securities issued by all countries, whose banks and governments report to the BIS as well as debt securities issued by such institutions in offshore destinations, such as Cayman Islands, Netherlands, Luxembourg and Ireland. We have assigned such debt as financial corporate debt, but this probably overstates the size of the financial corporate debt universe relative to the non-financial corporate debt universe as far as external debt is concerned. The BIS data set covers 106 EM countries and 26 developed countries.

[2] See *'The EM index problem'*, The Emerging View, July 2017.

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Zooming in further Figure 2 shows the constituent parts of the EM fixed income universe. Local currency bonds now make up 86% of total fixed income (USD 17.2trn) of which government debt accounts for little under half (USD 8.3trn versus USD 8.9trn for corporates). The sovereign external debt universe has now reached USD 1trn for the first time, which is equivalent to roughly 5% of the total EM debt market. More than 80% of the USD 10.8trn corporate debt universe is in local currency (USD 8.9trn) with the balance mainly in Dollars (USD 1.8trn). Corporates account for 54% of total outstanding issuance.

Fig 2: **EM fixed income universe – size and composition**

USD trn	2000	2005	2010	2015		2016	
				USD trn	%	USD trn	%
Total tradable debt	**1.4**	**4.9**	**11.0**	**17.4**	**100%**	**20.1**	**100%**
Local currency	0.7	3.9	9.5	14.8	85%	17.2	86%
External	0.7	0.9	1.6	2.6	15%	2.8	14%
Government	**0.9**	**2.6**	**5.4**	**7.7**	**44%**	**9.3**	**46%**
Local currency	0.5	2.1	4.8	6.9	39%	8.3	42%
External	0.4	0.5	0.6	0.8	5%	1.0	5%
Corporate	**0.5**	**2.3**	**5.6**	**9.7**	**56%**	**10.8**	**54%**
Local	**0.2**	**1.8**	**4.7**	**7.9**	**46%**	**8.9**	**44%**
Financials	0.1	1.2	3.2	4.5	26%	5.2	26%
Non-financials	0.1	0.5	1.5	3.4	20%	3.7	19%
External	**0.3**	**0.5**	**1.0**	**1.7**	**10%**	**1.8**	**9%**
Financials	0.2	0.3	0.6	1.1	6%	1.2	6%
Non-financials	0.1	0.2	0.3	0.6	4%	0.7	3%

Source: Ashmore, BIS.

Local currency bonds now make up 86% of the total EM fixed income, while 54% of all bonds have been issued by corporates. External debt has reached USD 1trn for the first time

A regional transect drawn through the EM bond universe shows that Asian & Pacific issuers now account for 69% of all outstanding bonds following by Latin American & Caribbean issuers with a 19% share (Figure 3 below). Eastern Europe & the former Soviet Union and Middle East & Africa account for 7% and 4% of total outstanding bonds, respectively.

Fig 3: **Regional distribution of bonds**

	Local				External				Total	
	Government		Financial & non-financial corporates		Government		Financial & non-financial corporates			
	USD trn	%	USD trn	%	USD trn	%	USD trn	%	USD trn	%
All EM	**8.3**	**42%**	**8.9**	**44%**	**1.0**	**5%**	**1.8**	**9%**	**20.1**	**100%**
Asia and Pacific	5.5	39%	7.5	54%	0.1	1%	0.8	6%	**13.9**	**69%**
Latin America and Caribbean	1.9	49%	1.0	26%	0.3	9%	0.6	15%	**3.9**	**19%**
Eastern Europe & former Soviet Union	0.6	41%	0.3	20%	0.3	21%	0.2	18%	**1.4**	**7%**
Middle East and Africa	0.4	42%	0.1	15%	0.2	22%	0.2	22%	**0.9**	**4%**

Source: Ashmore, BIS.

A number of other regional differences are worth highlighting:

1. **Reliance on external markets:** Middle Eastern & African markets secure nearly half (44%) of their bond financing externally, whereas Asian & Pacific issuers obtain a mere 7% of their financing from external markets. Eastern Europe and the former Soviet Union states plus Latin American & Caribbean issuers fall in between with 24% to 39% of their financing coming from external markets.
2. **Corporate/sovereign balance:** Corporates account for 60% of total outstanding bonds in the Asian & Pacific region. The corporate share in Latin America is 42% and 37% in Eastern Europe & the former Soviet Union. In the Middle East & Africa corporates account for only 36% of total outstanding debt.
3. **Local currency corporate debt:** Asian & Pacific issuers account for 84% of all local currency corporate debt in EM compared to just 11%, 3% and 1% in the other three EM regions. This reflects, in part, the more advanced state of financial markets in Asia plus the enormous domestic bond markets in both China and India (neither of which is included in the main industry fixed income benchmarks).

Biggest issuers

At USD 9.3trn, China's fixed income markets account for 46% of the total EM bond market. This is followed by sizeable markets in Brazil, South Korea, India, Mexico, Russia and Hong Kong. Between them, these countries make up three quarters of all EM bonds. See Figure 4.

Fig 4: **Regional distribution of bonds**

	Size	Share of total EM market	Internal stucture of market (% share)			
Country	**USD trn**	**%**	**Local**	**External**	**Govt**	**Corp**
China	9.31	46%	99%	1%	35%	65%
Brazil	2.26	11%	92%	8%	64%	36%
South Korea	1.60	8%	89%	11%	33%	67%
India	0.80	4%	95%	5%	95%	5%
Mexico	0.70	3%	66%	34%	51%	49%
Russia	0.40	2%	62%	38%	34%	66%
Hong Kong	0.36	2%	37%	63%	38%	62%
Taiwan	0.34	2%	96%	4%	52%	48%
Singapore	0.33	2%	64%	36%	23%	77%
Thailand	0.32	2%	97%	3%	36%	64%
Malaysia	0.32	2%	85%	15%	45%	55%
Rest of EM	3.33	17%	77%	23%	76%	24%

Source: Ashmore, BIS.

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Recent trends

We see three notable recent trends in EM fixed income. The first is that the average annual rate of growth of the EM fixed income universe has declined to 11% in the past five years compared to 18% in the previous 5-year period (see Figure 5). Growth rates have declined in USD terms in all EM regions and in all fixed income segments with the sole exception of external sovereign debt. Much of the slowdown is undoubtedly due to the strong Dollar, since these numbers are all in US dollars. EM investing has also been out of favour with foreign investors, so issuance volumes have declined somewhat.

Fig 5: **Recent trends in EM debt securities**

Average growth rates (% change, qoq annualised in USD terms)	2007-2011	2012-2016
Emerging Markets	**18%**	**11%**
Government	19%	9%
Financial	15%	10%
Non-financial corporate	23%	16%
Local	**19%**	**11%**
Government	21%	10%
Financial corporate	16%	10%
Non-financial corporate	25%	17%
External	**10%**	**10%**
Government	7%	9%
Financial corporate	12%	11%
Non-financial corporate	16%	11%
Regions		
Latin America and Caribbean	22%	4%
Middle East and Africa	10%	6%
Eastern Europe and former Soviet	14%	4%
Asia and Pacific	18%	15%

Source: Ashmore, BIS.

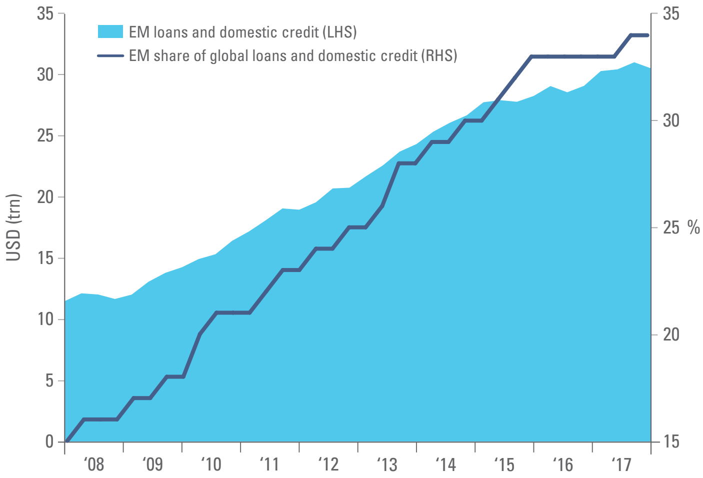
The second recent trend is that EM's share of global loans and domestic credit has more than doubled from 15% in 2008 to 34% at the end of 2016 (Figure 6). This probably reflects three separate developments:

a) Disintermediation of international bond-issuing banks in favour of local credit issuing banks within EM;
b) balance sheet reduction by banks in DMs, and;
c) massive encouragement to issue bonds in DMs due to Quantitative Easing policies.

These trends provide further evidence that QE acted like a giant magnet which sucked capital out of EM at a time when post 2008/2009 regulation also made it more expensive for banks in developed economies to extend credit to EM entities.

Loan and credit markets in EM have gained share at the expense of bonds in recent years as Asia's share in the total EM fixed income market has continued to rise

Fig 6: **Recent trends in EM debt securities**



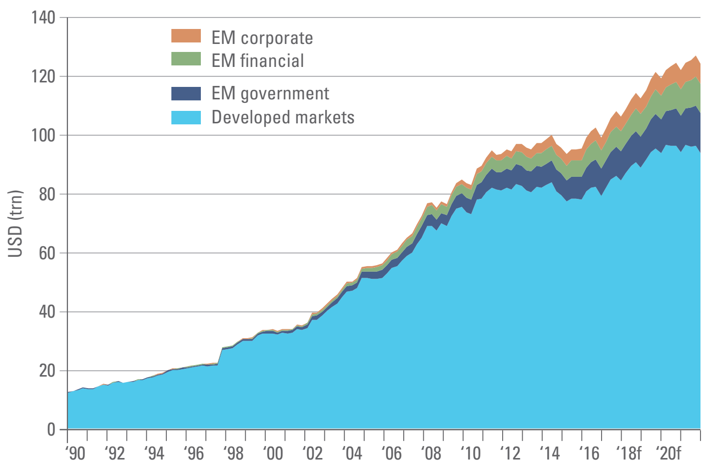
Source: Ashmore, BIS.

The third trend is that Asian bond markets have been far less impacted by global headwinds of the last few years than other regions. This can be seen from the slower decline in the pace of issuance compared to other regions: Asian issuance has declined from 18% annualised to 15% annualised growth in the most recent 5-year period compared to the previous 5-year period, whereas the slowdowns have been much larger in Latin America & Caribbean and Eastern Europe & the former Soviet Union (see Figure 5). The Russia-Ukraine crisis impacted issuance in the latter, while the former was disproportionately hit by capital flight, falling commodity prices and the Dollar rally.

Projections for future growth

We expect the EM fixed income asset class to grow from its current size of USD 20.1trn to roughly USD 30.5trn over the next five years, that is, by Q4 2021. By then, EM bonds should make up about 25% of global fixed income (compared to 20% today). The asset class will likely cover 80 countries and China and maybe India could be dominant benchmark names by then. Government bonds should be roughly USD 13.7trn while the corporate bond universe will measure some USD 16.7trn, in our estimation. Local currency will dominate with an 89% share of total EM fixed income.

Fig 7: **Ashmore's EM fixed income growth projections**



Source: Ashmore, BAML.

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Index representation

The main EM fixed income benchmark indices are roughly as unrepresentative today as a year ago. Across all four segments the main benchmark indices cover less than one in ten bonds (8.3% of bonds to be exact compared to 8.1% last year). The most representative indices are the Dollar-denominated sovereign bonds with 45.6% index coverage, mainly because most are benchmark sized Euroclearable global bonds issued under English or New York law and traded by all the index-providing banks.[3] However, index coverage drops off sharply for corporate Dollar-denominated debt (22.0%) and local currency bond markets are woefully represented with only 8.5% of government bonds and 1.2% of corporate bonds represented in the main indices (see Figure 8).

For more details on why the EM fixed income benchmarks are so poor and what can be done about it see *'Passive is active: the EM index problem'*, The Emerging View, July 2017.

Fig 8: **EM fixed income benchmark indices (as at end-2016)**

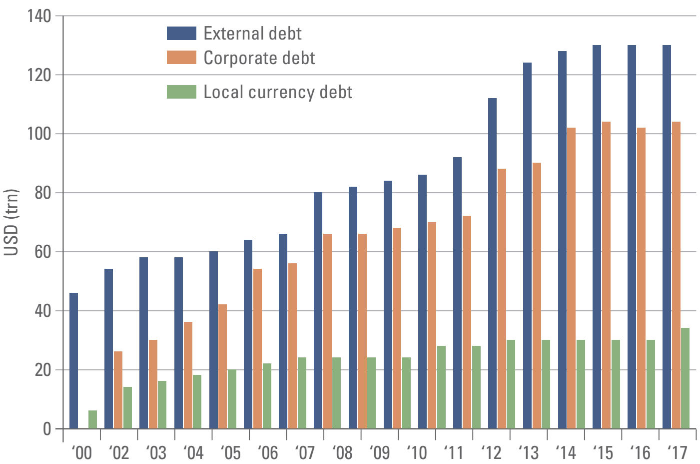
Asset class	Index name	Index acronym	Index provider	Number of countries	Number of issuers	Number of issues	Index market cap (USD bn)	Asset class (USD bn)	Index as % of asset class
External sovereign debt	EMBI Global Diversified	EMBI GD	JP Morgan	65	142	559	445	976	45.6%
External corporate debt	CEMBI Broad Diversified	CEMBI BD	JP Morgan	51	554	1,200	406	1,845	22.0%
Local currency government debt	GBI EM Global Diversified	GBI EM GD	JP Morgan	15	15	201	707	8,341	8.5%
Local currency corporate debt	Local EM non-sovereign	LOCL	BAML	13	185	336	104	8,909	1.2%
All EM fixed income							**1,662**	**20,071**	**8.3%**

Source: Ashmore, BAML, JP Morgan.

In spite of poor overall index coverage the indices are nevertheless becoming more diversified. Figure 9 shows that the number of sovereign issuers has grown from 22 countries to 65 since 2000. We expect this trend to continue, because more than 100 EM countries have yet to issue index-eligible sovereign debt. Greater diversification within the asset class obviously makes indices more stable, a fact that we do not think has been adequately priced in.

We welcome the fact that local currency government bond indices have started to add new countries. For example, the number of issuers in the JP Morgan GBI EM GD index has increased from 15 last year to 17 as of June this year with more countries in the pipeline. One of the big new potential entrants lurking on the horizon is China.

Fig 9: **Number of index names in the main sovereign, corporate and local currency JP Morgan bond indices**

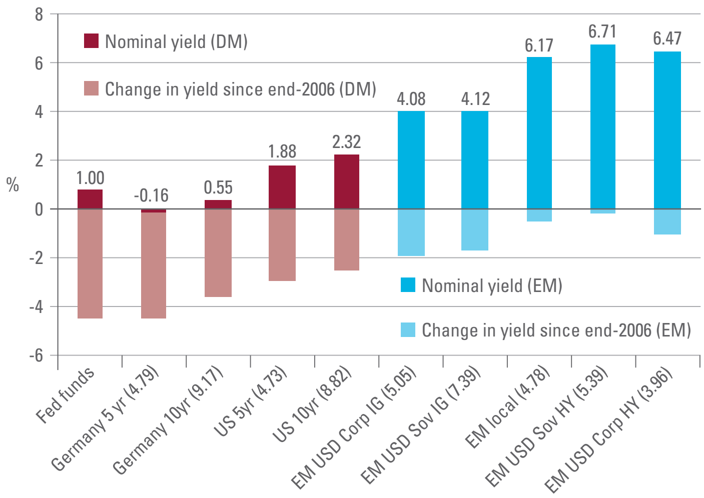


Source: Ashmore, JP Morgan. Data to June 2017.

Valuations

Local and high yield bond yields are roughly the same as before the Developed Markets Crisis of 2008/2009, when the Federal Reserve had Fed funds rates at 5.25% (Figure 10). Investment grade bonds are trading with somewhat lower yields than pre-crisis, but continue to look very attractive relative to the yields on offer in similar duration bonds in developed markets.

Fig 10: **EM yields versus yields in selected developed countries**



Ashmore, JP Morgan, Bloomberg.

Another way to illustrate valuations is to ask how many years investors would need to hold onto bonds before their carry makes up for capital losses associated with given moves in the yield curve. Figure 11 shows this for selected EM and DM bonds. The carry on DM bonds is currently so low that investors would have to hold the bonds between 3 and 100 times longer than EM bonds before break even is achieved for a given shift in the

[3] A large section of external debt is nevertheless excluded, including bonds of smaller than minimum-size (usually USD 500m), non-Dollar securities, bonds with greater complexity and bonds with less than one year to maturity.

[4] For more information on the implications of greater index diversification see *'Free Money: Arbitrage opportunities in EM external debt'*, Market Commentary, June 2016.

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yield curve. This difference arises because yields in EM bonds are so much higher. Of course, this also means that the opportunity cost of remaining invested in DM bonds as the world slowly heads into a hiking cycle is much greater, they lock up capital, which could otherwise be invested elsewhere for a positive return.

Fig 11: **Years of carry required to make up for losses associated with given moves in the yield curve**

	50bps yield shock			Yields return to pre-2008/2009 levels
Maturity	**5yr**	**10yr**	**30yr**	**10yr**
US	1.2	1.8	3.2	9.3
UK	4.1	3.4	5.9	17.4
Germany	Infinite	8.6	7.6	43.3
Japan	Infinite	63.1	12.2	275.2
EM local currency		0.4		2.6
EM USD corporate		0.4		3.8
EM USD sovereign		0.7		2.1

Source: Ashmore, Bloomberg, JP Morgan.

EM fixed income markets grow most rapidly in the early stages of development and local markets become increasingly dominant over time. The share of corporate debt tends to be stable over time

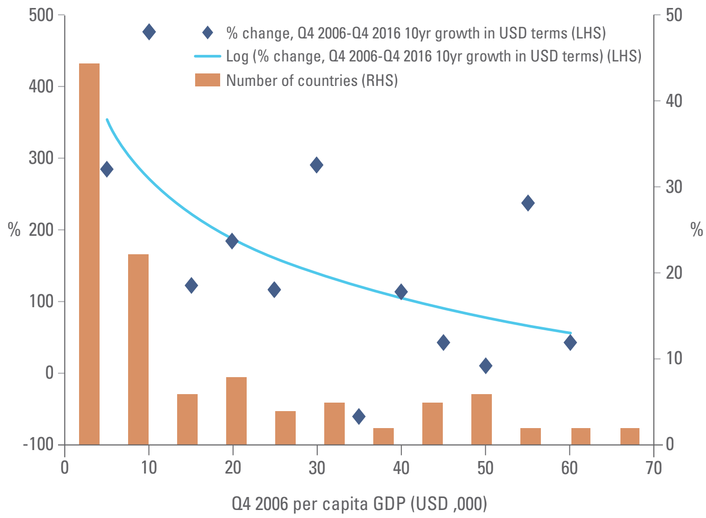
Three stylised facts of capital market development

Modern EM fixed income markets are relatively young. They only began to appear in earnest following significant economic and political adjustments in the decade following the end of the Cold War. Despite their youth, three 'stylised facts' they should be factored into investment planning decisions for the EM fixed income asset class. They are:

- **Stylised Fact 1:** Financial markets grow most rapidly in the early stages of economic development.

This is illustrated in Figure 12, which shows a clear downwards trend in the rate of growth of financial markets with respect to per capita GDP. The analysis is based on a sample of 105 DM and EM countries. The relationship is obviously not extremely precise. There is considerable variation around the trend and a number of the lowest income countries do not even feature in the database at all, mainly because aid donors have completely monopolised financing in those countries to the detriment of private sector financial development. Also, in the very high end of the distribution (per capital income greater than USD 60,000) a few tax havens have seen unusually strong financial sector growth, including Switzerland and Luxembourg. We have excluded such countries from Figure 12.

Fig 12: **Financial sector development is most rapid in early stages of development**

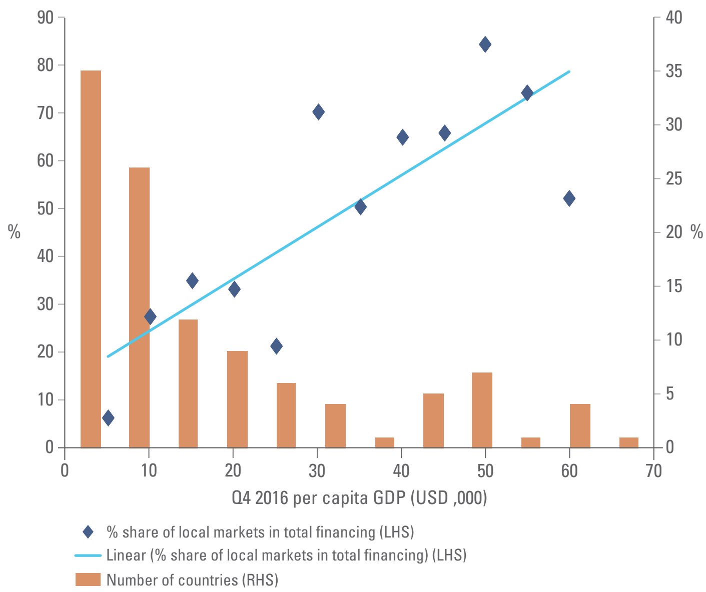


Source: Ashmore, IMF, BIS.

- **Stylised Fact 2:** Local markets become more dominant as a share of total financing as GDP per capita rises.

Figure 13 illustrates this relationship, which is probably rooted in the emergence of local pension funds and other institutional investors. There are big advantages to issuing in local currency compared to issuing in the currency of another country, but being able to issue locally requires domestic institutions, which can act as buyers of last resort. Domestic institutional investors pick up bonds when foreign investors sell thus avoiding a major destabilisation of the economy. The political importance of avoiding destabilising capital flight episodes has been a driving force in the development of local bonds markets across EM in the last two decades. Issuance in foreign currency implies that the FX risk is borne by the issuer, while the FX risk goes to the investor if the security is in local currency.

Fig 13: **Local currency share of total finance**



Source: Ashmore, IMF, BIS.

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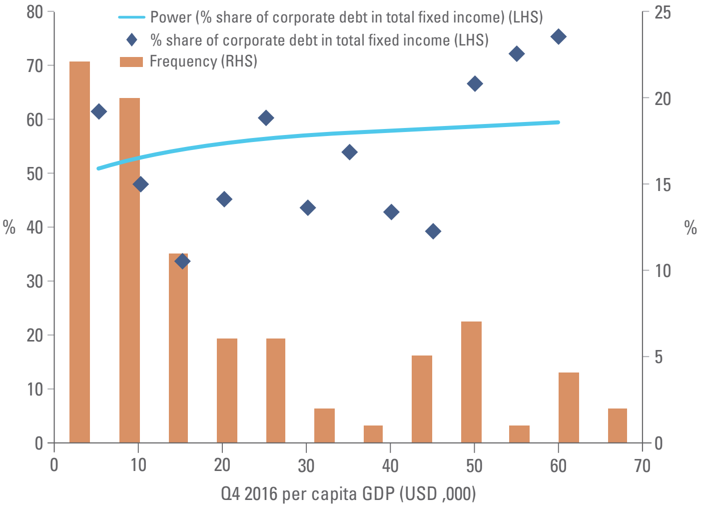
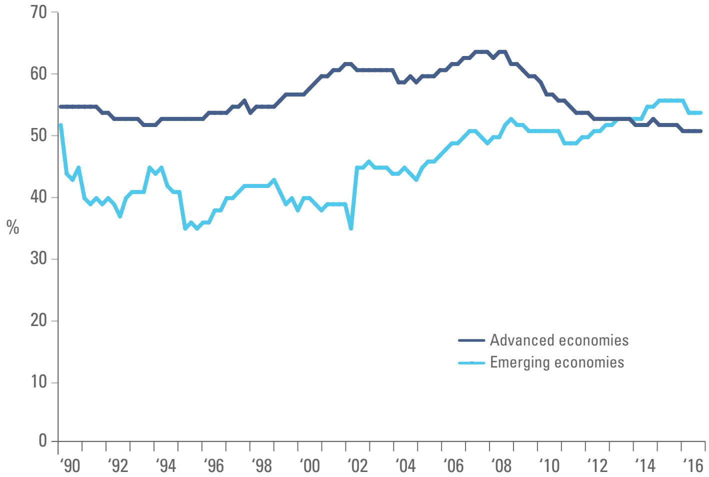
- **Stylised Fact 3:** The corporate debt share of total financing is stable with respect to per capita GDP.

This is the least pronounced stylised fact, which we have illustrated in Figures 14a and 14b. The corporate debt share of total fixed income remains broadly static with or without inclusion of financial sector corporates. The fact that the corporate debt share remains stable likely reflects deliberate efforts on the part of regulators to ensure that government debt maintains its overall share in the market, something which it achieves through regulatory measures, including lower capital buffers, tax free status, etc. Government yield curves also help to price corporate bonds, which trade as spreads over government curves. Hence, growth of government markets constrains corporate bond market development, especially in the early stage of capital market development.

Figs 14a and 14b: **Corporate share of total finance**



Source: Ashmore, IMF, BIS.



Source: Ashmore, IMF, BIS.

Conclusion

EM countries are on a journey through structural changes and their financial markets are deepening and broadening with the occasional mishap. This makes EM fixed income quintessential investment material. The EM fixed income universe is now more than USD 20trn, so EM bonds ought to be a large core holding in the portfolios of all long-term investors.

In reality, EM continues to be under-represented in the portfolios of most institutional investors. However, this speaks more about incentives and regulatory challenges in the global finance industry than the investment case for EM, which has been and remains compelling.

We expect the EM fixed income asset class to grow to more than USD 30trn by 2021 at which point it should account for approximately 25% of global fixed income. The asset class is likely to evolve along the lines of the stylised facts outlined in the main body of this report, namely faster than in rich countries, with faster growth in local markets and with a roughly stable share of corporate debt as a share of total issuance.

The asset class is also likely to become more diversified in the next five year as the number of sovereign issuers rises towards 80 countries with a commensurate increase in the number of corporate issuers.

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