Pity the others

The case for EM fixed income should always be couched within a discussion of the outlook for developed market fixed income – after all, developed market fixed income is the opportunity cost of investing in EM.

Quite aside from the basic valuation argument – the fact that EM fixed income pays high positive yields while developed market fixed income pays very low or even negative real yields – there is now also clear evidence that developed market bonds are becoming more risky than EM bonds.

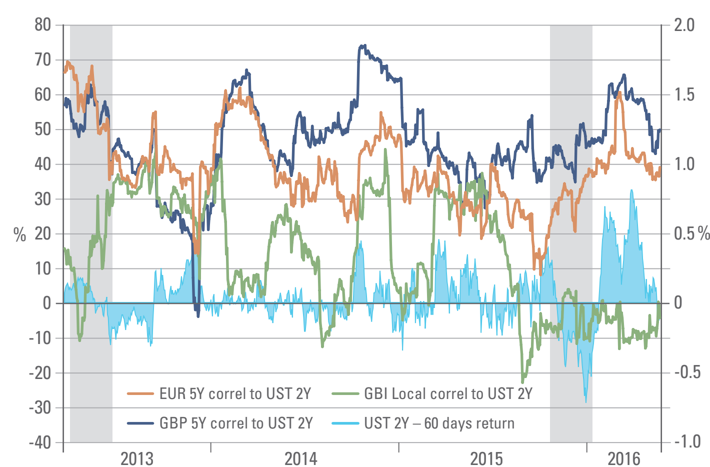
Figure 4 shows correlations between movements in the short end of the US curve – a proxy for Fed expectations – and returns in European and the UK bond markets. Just like in EM, correlations have flipped, albeit the other way around. European and British bond correlations with 2-year US Treasuries declined during in 2013, but by 2015 European and UK bond market correlations began to increase.

As an aside, the overall correlations between 2-year Treasury bonds and five-year bonds – in the US, Japan, Europe and in the UK – are all higher in absolute terms than correlations between 2-year Treasuries and EM bonds. Moreover, in the case of the US and Japanese five year bonds the correlations are actually rising over time (see appendix 2).

Developed market bonds tend to be highly correlated with each other, because the bonds tend to sit in the same portfolios. Hence, if US bond yields rise so will other developed market bonds as investors take profits in the better performing markets. Inflation is likely to arrive in the US before Europe and Japan, so it can be expected that central banks in the latter will have to expand bond purchase programs if only to keep real yields from rising in response to rising nominal yields in the US.

Correlations have also flipped in developed markets, but the other way around. Declining in 2013, correlations with 2-year US Treasuries has been on the rise since 2015

Fig 4: **60 days correlations between UST 2-year returns and 5-year bonds in Europe, Britain and EM local bond markets, compared to 2-year US Treasury 60 days rolling returns**



Source: Ashmore, Bloomberg, JP Morgan.

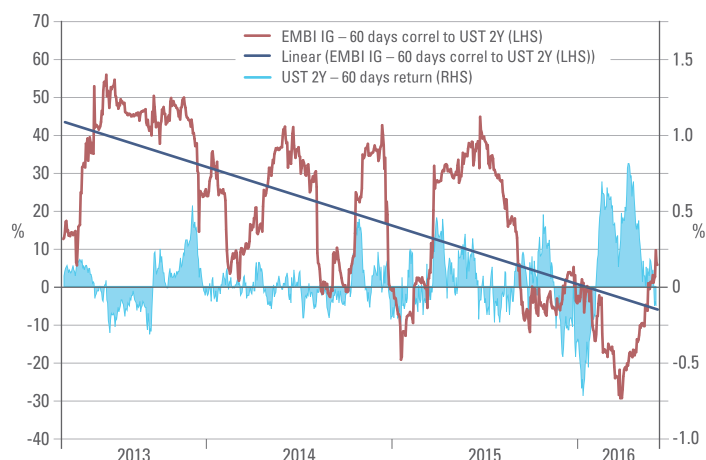
Conclusion

- EM bonds are becoming less sensitive to Fed events.
- Pullbacks ahead of events are smaller and recoveries are stronger.
- EM yields are higher and EM currencies have adjusted significantly, which now imparts upon EM countries greater resilience to Fed tightening.
- Bonds in developed markets have largely lost this protection. This has important implications for fixed income investors as the Fed continues on its path towards normalisation of interest rates.
- EM investors should no longer be afraid of such events. Instead, they should actively buy into the market in event of temporary weakness, because the odds strongly favour positive net returns around Fed events. The opposite is the case for developed market bonds.

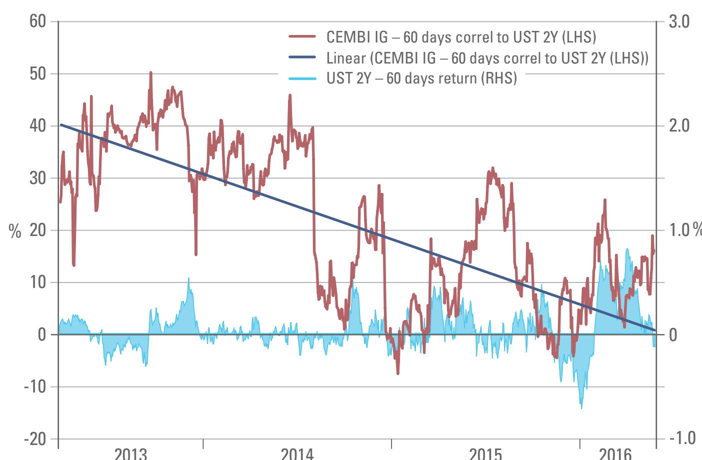
Continued overleaf

Appendix 1:

60 days correlations between returns in 2-year US Treasuries and IG version of EMBI and CEMBI, compared to 2-year US Treasury 60 days rolling returns



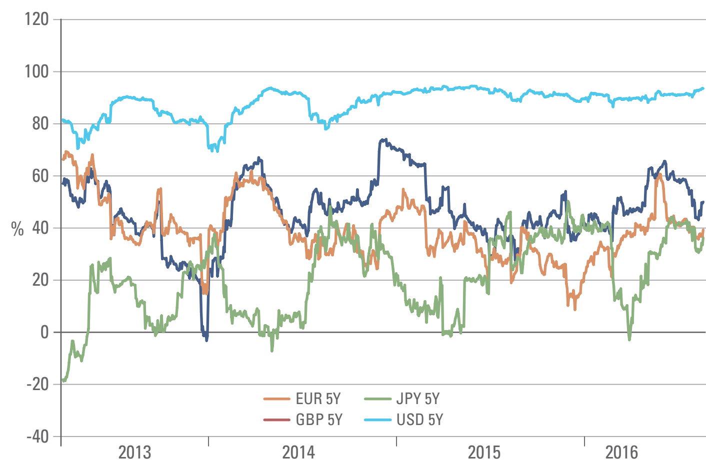
Source: Ashmore, Bloomberg, JP Morgan.



Source: Ashmore, Bloomberg, JP Morgan.

Appendix 2:

High and in some cases rising correlations between performance of 2-year US Treasury and performance of 5-year bonds in the US, Japan, UK, and Europe



Source: Ashmore, Bloomberg, JP Morgan.

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