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MARKET COMMENTARY

Ashmore

Putting the world into global bond funds

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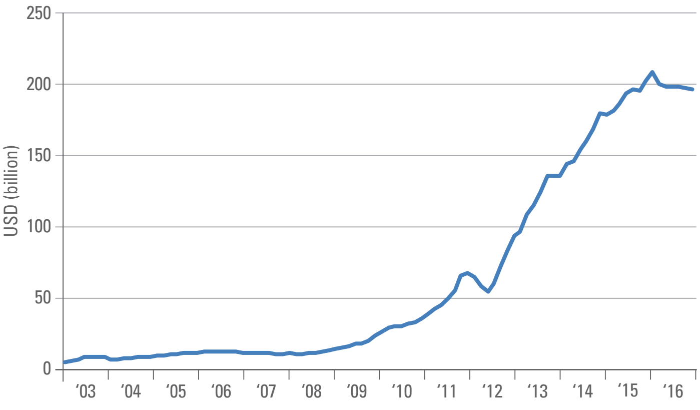
Global bond funds have seen a dramatic rise in assets over the past 10 years, reflecting the desire of investors to be exposed to a broader, more diverse set of assets away from their home markets. However, global bond funds still mainly give investors exposure to the largest developed markets, i.e. the G7 plus a few others. This is because most global bond funds benchmark against the Citi WGBI and the Bloomberg Barclays Global Aggregate indices, which assign only a 2-3% weight to Emerging Markets (EM). In other words, the indices are very poorly matched to the real world both in terms of GDP, where EM countries now comprise nearly 60%, and in terms of market cap, where EM fixed income is now close to 20% of the total global fixed income market.

The good news for investors seeking a better index representation is that a new and more representative index is now available to global bond investors. The JP Morgan GBI-AGG Diversified index, launched last year, offers a far better reflection of the growing importance of EM on the world stage by assigning a 20% weight to EM, which brings it into line with EM's true share of global fixed income markets. For the first time, investors will gain access to a truly global investment universe. We will show that the new index offers higher total returns for the same volatility compared to conventional global bond indices, higher current income and better diversification than pure G7 rates exposure.

The rise of global bond funds

The global bond funds universe has grown substantially over the last 10 years from less than USD 50bn to more than USD 200bn in the past decade, according to Morningstar (see Fig 1).

Fig 1: **Growth of World Bond Fund universe**



Source: Morningstar.

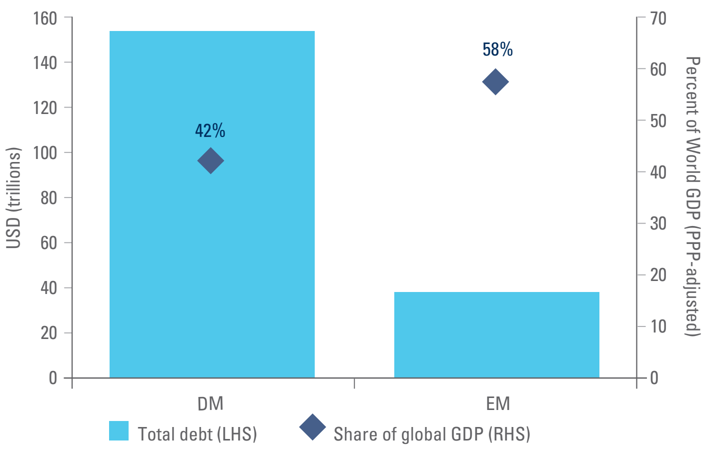
The rise in global bond funds reflects a desire to diversify fixed income investments beyond domestic markets. To this end, the bulk of global bond funds have benchmarked against the Bloomberg Barclays Global Aggregate (formerly known as the Lehman Global Aggregate) as well as Citi's World Government Bond Index (see also inset). These indices are used as benchmarks for more than 90% of the funds in Morningstar's World Bond Fund category.

Existing global bond indices have historically been biased towards developed market economies despite the growth of EM

Outdated global bond indices

Unfortunately, the WGBI and Barclays Agg indices do not offer a good reflection of world GDP nor of global fixed income markets. In particular, the indices only assign a 2-3% weight to EM fixed income assets. This compares to EM's 58% share of global GDP (in PPP adjusted terms) and EM's roughly 20% share of global fixed income markets (see Fig 2).

Fig 2: **Developed economies have three times more debt but less than half of the world's GDP**



Source: Ashmore, Bank of AmericaML, IMF 2016.

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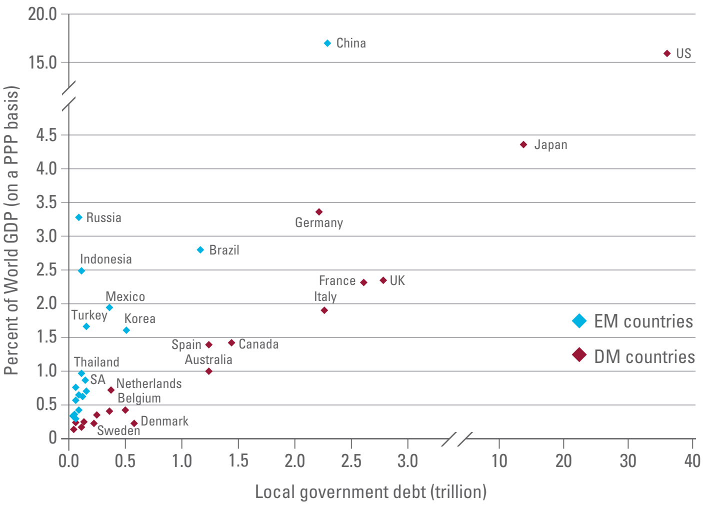
EM local bond markets have grown significantly since the late 1990s owing to the fact that EM countries have made great strides forward in developing their social security systems, adopting inflation targeting regimes, reducing debt levels and accumulating foreign exchange reserves. Most established EM countries now have large liquid and accessible domestic bond markets with well-developed yield curves with a broad range of maturities. Hence, the historical bias of existing indices towards developed market economies now makes these indices appear obsolete. This can be seen in the chart below, which shows the 30 largest issuers in the world in GDP/debt space. Notice how EM countries generally have larger GDP shares and lower debt levels than developed countries. This feature makes them attractive, particularly since their bonds also generally offer higher yields than developed market bonds.

Fig 3: **EM / DM indebtedness and share of global GDP**



Source: BIS, WEO.

Adding EM to global bond indices increases the yield and reduces correlation with global rates, while not meaningfully increasing the volatility – an overall powerful value proposition

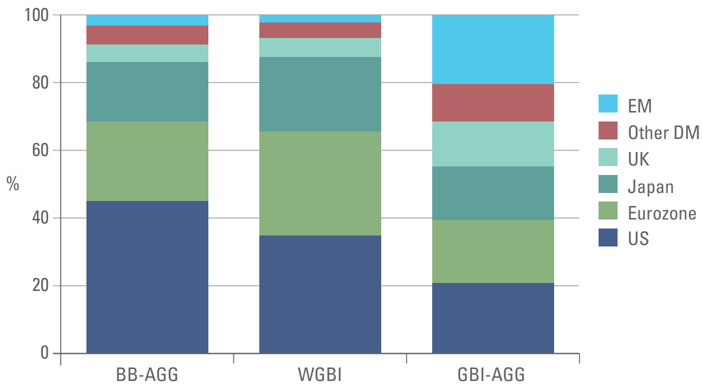
A new global bond index

The new JPMorgan GBI-AGG Diversified index rectifies the imbalance

JP Morgan recently introduced a new index called the Global-AGG Diversified benchmark (hereafter: GBI-AGG Div). This index gives investors the benefit of a far more representative global fixed income index with an appropriate share assigned to EM. The index also happens to perform better than the global government bond index market leader.

The GBI-AGG Div index uses a currency-weighted approach which scales country weights with respect to debt stock outstanding, thus capping highly indebted issuers, such as most developed economies. Developed markets still dominate the index on account of their far larger debt loads, but the index significantly reduces the skew towards the most heavily indebted issues relative to the conventional global fixed income benchmarks. The result is that the new index allocates approximately 20% weight to EM local government bonds (see Fig 4):

Fig 4: **Composition of world bond indices by currency**



Source: JPMorgan, Citibank, Bloomberg.

The other main feature of the index is that it constrains weights based on accessibility of local markets, such as the existence of capital controls, constraints on holdings, tradability or FX convertibility. The index thus omits both China and India for now. On the other hand, JPMorgan does not constrain currencies/countries based on credit ratings. The index only includes fixed-rate and zero coupon instruments with a current face amount outstanding of USD 1bn equivalent (onshore) and USD 500m (offshore).

The prevailing global bond indices and JPMorgan's new index

	World Global Bond Index (Citi WGBI)	Bloomberg Barclays Global Aggregate Index	JP Morgan GBI-AGG Diversified
Covered Asset Classes	The World Government Bond Index (WGBI) measures the performance of fixed-rate, local currency, investment grade sovereign bonds. The WGBI provides a broad benchmark for the global sovereign fixed income market.	Barclays Global Aggregate is a multi-currency IG benchmark which includes Treasury, government-related, corporate and securitised fixed rate bonds from both DM and EM issuers.	The JPM GBI-AGG/Div. provides investors with a comprehensive investable benchmark that spans across all liquid and local currency government markets in both developed and EM countries covering both IG and HY issuers.
Eligible Currencies / Countries	15, of which **5 EM**	24, of which **14 EM**	38, of which **20 EM**
Inception / Launch Date	Dec 1984	Jan 1990 / Jul 2000	Dec 2001 / Oct 2016
Minimum Credit Quality	Entry: A- by S&P and A3 by Moody's, for all new markets; Exit: Below BBB- by S&P and below Baa3 by Moody's	Securities must be rated IG using the middle rating of Moody's, S&P and Fitch.	None

Source: Citi, Bloomberg, JPMorgan – June 2017.

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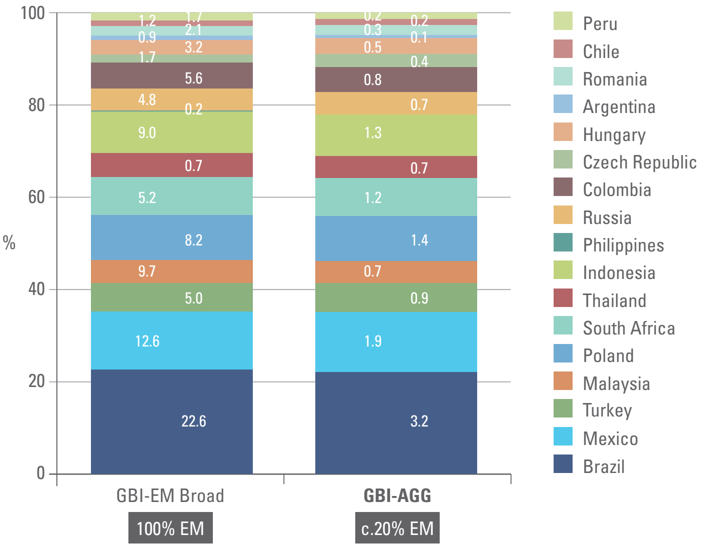
The EM allocation of the GBI-AGG Div Index mirrors the composition of the pre-existing EM-only indices, such as the JP Morgan GBI EM Broad index. The GBI-EM Broad index has a market cap of close to USD 1trn across 16 countries, which between them have issued a total of USD 2.8trn in local debt outstanding. The total EM local currency bond universe is about USD 7.0trn with more than half readily accessible.

Fig 5: **EM portion is a mirror image in JPMorgan's GBI-EM Broad and GBI-AGG Div indices**



Source: Ashmore, JPMorgan.

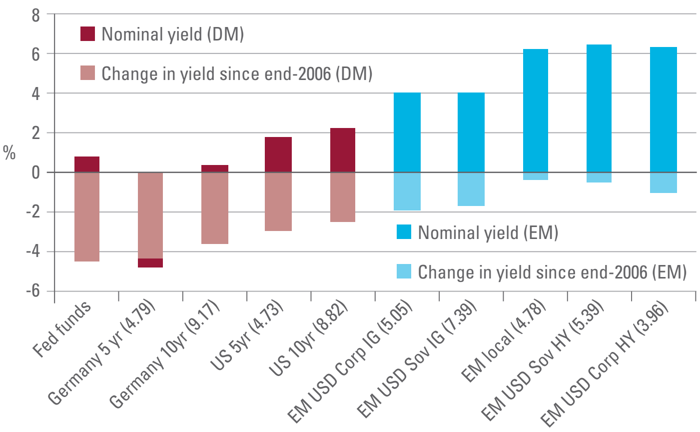
Adding EM to a global benchmark has a host of benefits

The addition of more EM exposure to conventional global benchmarks has a number of benefits including: (a) higher yield; (b) lower volatility to and (c) lower correlation with developed market rates. We demonstrate these effects in the following sections.

a) Adding EM increases the yield

Years of quantitative easing (QE) by developed world central banks have driven yields in the US, UK, Japan and the Eurozone to all-time lows. A good portion of government debt in these markets now trades with negative yields in real terms. By contrast, EM countries have not engaged in QE and yields are significantly higher as a result, this is shown in Fig 6 below.

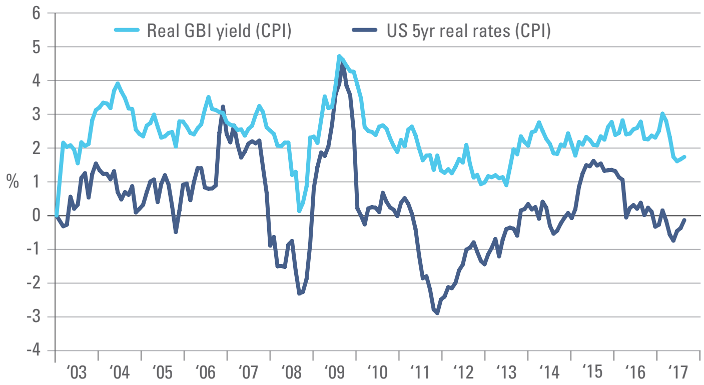
Fig 6: **EM yields more attractive than DM yields**
Nominal bond yields (%), duration in parentheses



Source: Bloomberg, JP Morgan, Ashmore. Data as of 31 May 2017.

Even factoring in higher inflation in EM countries, EM bond yields are substantially higher in real terms (see Fig 7).

Fig 7: **EM real yields are much more attractive than US real yields**
5-year bonds deflated by CPI



Source: Bloomberg, JP Morgan, Ashmore. Data as of 31 May 2017.

Given these yield differentials, the immediate benefit of a greater EM allocation is to raise the overall level of yield in the index. The JPMorgan GBI-AGG Diversified delivered a favourable yield differential of approximately 50 basis points over the last three years as shown in the table below.

Fig 8: **Current index yield comparison for World bond indices**

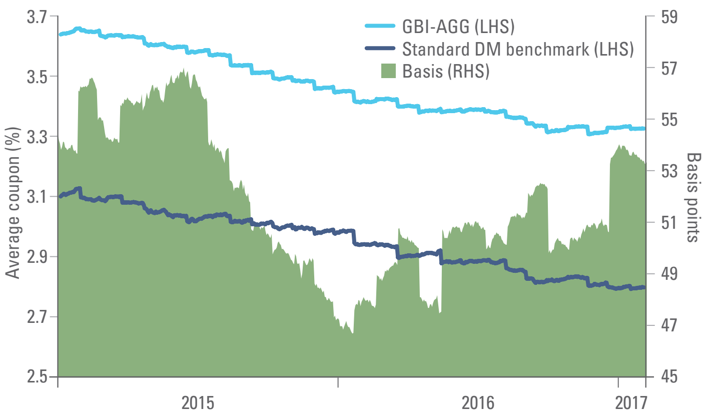
	World Global Bond Index (Citi WGBI)	Bloomberg Barclays Global Aggregate Index	JP Morgan GBI-AGG Diversified
Percentage with negative yields	23%	18%	15%
Yield	1.1%	1.2%	1.9%

Source: Citi, Bloomberg, JPMorgan – June 2017.

JP Morgan's new GBI-AGG Diversified index more accurately reflects the composition of the global fixed income universe

The higher yield in turn leads to a sizeable income differential over time as illustrated in Figures 9 and 10 below. The higher income stream also provides a buffer against volatility as drawdowns can be recouped more quickly.

Fig 9: **GBI-AGG average coupon**



Source: Ashmore, JPMorgan.

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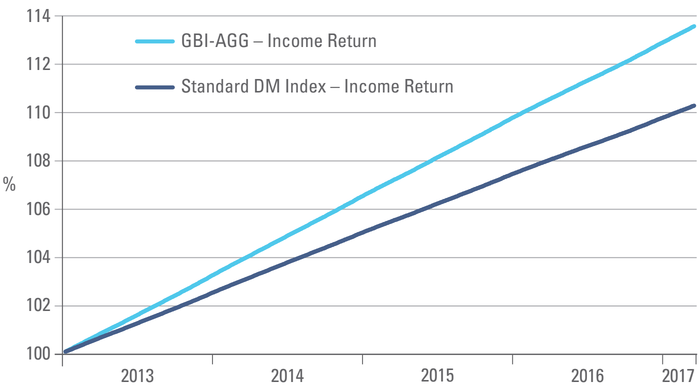
Fig 10: **GBI-AGG income differential**

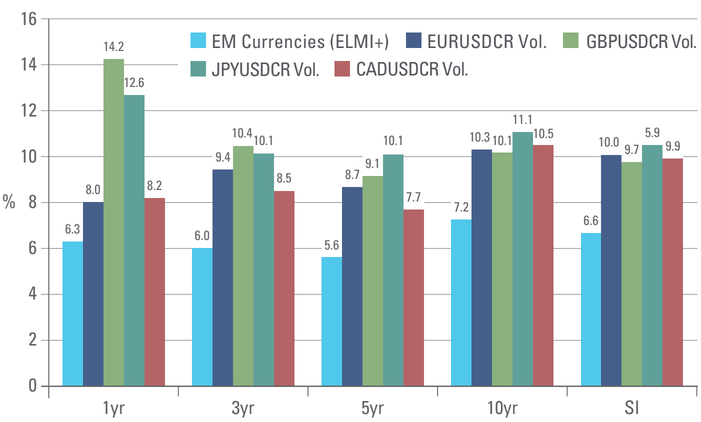


Source: Ashmore, JPMorgan.

b) Adding EM doesn't increase the volatility

Interestingly, increasing the allocation to EM currencies does not change the volatility of the index significantly over time. This is because as a group EM currencies have been less volatile than some of the major G7 currencies with similar drawdowns. Figure 11 compares the volatility of a selection of developed markets currencies versus that of a basket of EM currencies (including carry[1]). It shows that, since 2003, EM currencies have displayed a lower annualised volatility (6.64%) than the other currencies (all close to 10%).

Fig 11: **EM currencies as a group have been less volatile than some USD-DM pairs (return series including carry)**



Source: Ashmore, JP Morgan, Bloomberg.

In terms of drawdowns, the maximum 1-month drawdown since 2003 has been similar in a basket of EM currencies and in the EUR and GBP (around 15% maximum one-month drawdown). This places EM currencies roughly between JPY (-10%) and CAD (-20%) in terms of drawdowns (see Fig 12 below).

Fig 12: **Drawdown comparison**
Maximum drawdown (1 month) percent, since April 2003

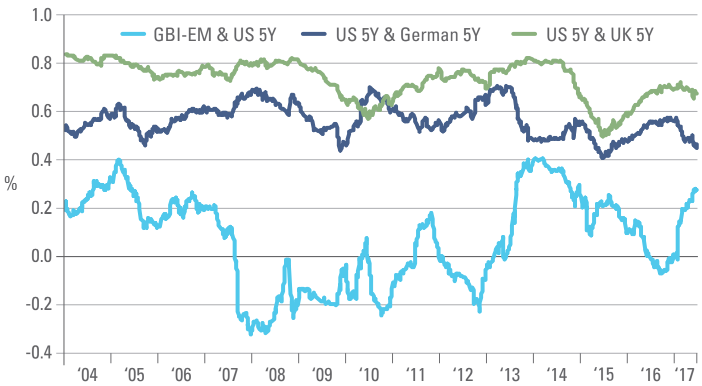
Series	Drawdown
EM currencies	-14.9%
EUR	-14.5%
GBP	-15.7%
JPY	-10.1%
CAD	-20.3%

Source: Ashmore, JPMorgan, Bloomberg.

c) Adding EM reduces correlation with global rates

EM rates are less correlated to US rates than German and UK rates. This is largely because most EM fixed income markets are poorly represented in global benchmarks. The correlations between the German and UK market with the US markets has been roughly 40% over the past 10 years. They have been consistently above 0.4, whereas EM correlations have averaged roughly 0 with fluctuations between +0.4 and -0.4 (see Fig 13).

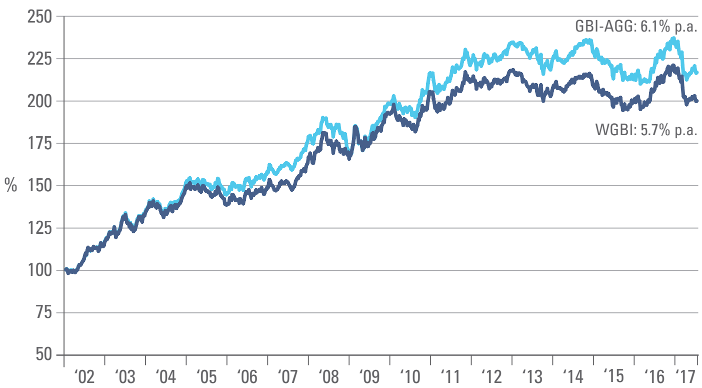
Fig 13: **EM rates are less correlated to G7 rates**
12-month Correlation of Interest Rates returns (local terms)



Source: Ashmore, JPMorgan.

Combining these three advantages (higher yield, lower volatility of EM as a basket against the USD and lower correlations to US rates) in the GBI-AGG Div has delivered a higher overall return over time versus Citi WGBI (see Fig 14 below).

Fig 14: **Returns over time – JPMorgan GBI-AGG Div vs. Citi WGBI**



Source: Ashmore, Bloomberg.

Past actual and simulated performance is not a reliable indicator of future returns.

GBI-AGG Div also delivers a superior Sharpe ratio based on back tested data to 2002 (see Fig 15 below).

Fig 15: **Comparison of JPMorgan GBI-AGG Div vs. Citi WGBI**

Since 2002	JPMorgan GBI-AGG Diversified	World Global Bond Index (Citi WGBI)
Cummulative return	139.2%	123.9%
Annualised return	6.1%	5.7%
Annualised volatility	6.9%	6.8%
Sharpe ratio	**0.65**	**0.60**

Source: Ashmore, JPMorgan.

[1] Our reference is JPMorgan's ELMI+ benchmark of major EM currencies vs. the most relevant USD crosses such as EURUSD, JPYUSD and GBPUSD.

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EM today offers a powerful value proposition

The distortions in global fixed income markets caused by QE in the last few years has now created a powerful value proposition in EM fixed income, which began to translate into positive returns in 2016. The outperformance of EM versus developed markets is likely to be sustained for a number of years, in our view (cf. most recently Ashmore Emerging View, May 2017).

We see the key drivers of returns as the following:

- At 6.3% yield local EM government bonds now offer real yields of about 250bps against a positive backdrop of GBI index-weighted inflation of just 4% for 4.5 years duration government bonds – this is a very high real yield, particularly in the context of waning fundamental stresses.
- EM growth has been accelerating since 2015, but there is a lot more upside given the starting point of the large slowdown in growth between 2010 and 2015. EM's recovery has so far been led by improving external balances on the back of real exchange rates at 13-year lows, but foreign flows back into EM should ease domestic financial conditions and further stimulate growth in the coming years (cf. Ashmore Emerging View, June 2017).
- Unlike their DM counterparts, many EM countries have undertaken deep structural reforms in recent years, including Colombia, Brazil, Argentina, India, Indonesia, Mexico, Russia and others. Reforms remove obstacles to growth and allow countries to grow faster before running into inflationary constraints.
- Positioning remains light and most foreign investors are heavily underweight. This is reflected in benign price action in response to bad news, which no longer induces large sell-offs. There are simply very few sellers left. As a matter of fact, recent weeks and months have seen positive inflows into the asset class, providing a strong technical bid.

Conclusion

EM bonds should occupy a large and growing share of global bond funds. Tactically, EM offers better value than developed markets and adding EM increases income, lowers volatility and reduces exposure to sell-off in the US treasury market. JP Morgan's new GBI-AGG Diversified index provides a new and welcome addition to the universe of global fixed income indices. The index more accurately reflects the composition of the global fixed income universe.

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