EM is now the world's most diverse bond market

By Jan Dehn

On current trends, EM fixed income benchmark indices will cover more than 380 individual bond markets by the middle of this century. There are already more than 150 individual markets included in the four main EM fixed income benchmark indices. This compared to a maximum of 144 individual markets in developed economies. In other words, EM is already the most diverse fixed income asset class in the world. Diversification is only going to increase further in the future.

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	10.3	–	-1.72%
MSCI EM Small Cap	10.1	–	-1.34%
MSCI Frontier	8.4	–	-0.40%
MSCI Asia	10.9	–	-1.43%
Shanghai Composite	9.3	–	-3.72%
Hong Kong Hang Seng	7.4	–	-1.84%
MSCI EMEA	8.5	–	-0.51%
MSCI Latam	11.2	–	-4.01%
GBI-EM-GD	6.58%	–	0.03%
ELMI+	5.22%	–	-0.05%
EM FX spot	–	–	-0.34%
EMBI GD	7.04%	398 bps	-0.70%
EMBI GD IG	5.24%	217 bps	-0.23%
EMBI GD HY	9.12%	609 bps	-1.18%
CEMBI BD	6.43%	345 bps	-0.26%
CEMBI BD IG	5.22%	225 bps	-0.14%
CEMBI BD Non-IG	8.08%	510 bps	-0.42%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	14.8	–	-3.55%
1-3yr UST	2.83%	–	0.16%
3-5yr UST	2.89%	–	0.31%
7-10yr UST	3.06%	–	0.53%
10yr+ UST	3.31%	–	1.04%
10yr+ Germany	0.36%	–	0.65%
10yr+ Japan	0.09%	–	0.36%
US HY	7.32%	426 bps	-0.46%
European HY	4.56%	524 bps	-0.50%
Barclays Ag	2.21%	-85 bps	-0.06%
VIX Index*	20.51	–	2.37%
DXY Index*	96.75	–	0.28%
EURUSD	1.1377	–	-0.66%
USDJPY	113.26	–	0.62%
CRY Index*	179.60	–	-5.94%
Brent	60.2	–	-9.85%
Gold spot	1227	–	0.23%

Note: Additional benchmark performance data is provided at the end of this document. *See last page for index definitions.

Emerging Markets

It is common practice to define the level of development using per capita GDP, with developing countries occupying the lower end of the per capita GDP spectrum. The moment developing countries begin to issue bonds, we classify them as 'Emerging Markets' (EM). When per capita GDP reaches a high enough level and when capital markets are deep enough, we reclassify them again as 'developed countries' with 'developed markets'. The Theory of Economic Convergence explains how 'developing' countries become 'developed countries' and somewhere along the path of convergence developing countries typically join international capital markets due to the importance to the development process of having access to finance (this is why finance is sometimes called the 'handmaiden of growth').

Also, somewhere along the development path, a smaller number of developing countries have bestowed upon them the privilege of joining one or more of the EM fixed income benchmark indices. Index inclusion is very significant, because almost all the world's large institutional investors allocate to markets only if they are included in benchmark indices. In other words, benchmark inclusion is critical to access to stable long-term funding.

As proprietors and managers of EM fixed income benchmark indices, the big investment banks act as *de facto* gatekeepers for EM countries' access to finance. Godlike, they decide which countries can and cannot access the holy grail of stable term financing. The big banks guard this power zealously; so far, they have only allowed 9% of the bonds in EM to enter their precious indices (EMBI GD, CEMBI BD, GBI EM GD and LOCL).[1] However, index representation is not just about the share of the EM fixed income universe, which is included in the indices. After all, some issuers are far larger than other issuers, which means that the percentage of bonds in indices does not reveal very much about index diversification.

The good news for investors is that, despite the fact that a very small percentage of all bonds are included in the benchmark indices, at least there is a high level of diversification of issuers across the four main benchmark indices.

To see how many EM issuers have gained some representation in EM fixed income indices, let us start by determining the maximum number of markets, which can possibly gain index representation. There are 206

[1] For more on the index problem see '*Passive is active: the EM index problem*', The Emerging View, July 2017.

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countries in the world of which developing countries make up a just over 80%, or 170 countries.[2] Each country can potentially issue bonds in four markets: onshore corporate and government bond markets and offshore versions of these markets.[3] Hence, if all countries issue bonds in all their four markets then the total number of indexed bond markets in the world will be 824 (4x206). EM will account for 680 markets (4x170) and developed countries will account for the balance of 144 (4x36). Of course, this is just a snapshot. Over time EM countries will 'catch up' with developed countries, so the number of 'emerging' markets will decline and the number of 'developed' markets will increase. Presumably, at some point in the future, EM will cease to exist altogether as the last developing country graduates to developed market status. However, this will take some time, as we shall argue below.

In fact, so far only 68 developing countries have managed to get their bonds represented in the main benchmark index for sovereign Dollar-denominated bonds (EMBI GD). Additionally, companies from 50 developing countries now have bonds in the main index for Dollar-denominated corporate bonds (CEMBI BD). Some 19 developing countries have even managed to gain inclusion for their local currency government bonds in the GBI EM GD index, and, starting in 2015, EM companies were able to get their local currency-denominated bonds included in a benchmark index (the 'LOCL'), although, so far, only Euroclearable, offshore corporate bonds are eligible for inclusion.

Despite the enormous challenges facing EM issuers in developing capital markets and joining benchmark indices, diversification of the EM fixed income universe as measured by the benchmarks has increased dramatically. As recently as 2000, there were only 26 individual fixed income markets formally represented in EM fixed income indices. Today, the EM fixed income universe benchmarks comprise 153 individual markets (Figure 1). This number is greater than the theoretical maximum for the number of developed bond markets. In other words, EM fixed income is already the most diverse bond market in the world.

Fig 1: **EM markets represented in benchmark indices**

Market	Number of countries represented in benchmarks					
	2000	2005	2010	2015	2019 (f)	2050 (f)
Local currency government bonds	3	11	14	15	20	–
Local currency corporate bonds	0	0	0	13	19	–
Sovereign Dollar bonds	23	32	43	65	73	–
Corporate Dollar bonds	0	27	35	52	51	–
Total	26	70	92	145	163	382

Source: Ashmore, JP Morgan, ICE.

Going forward, the EM fixed income markets will only become more diverse still. So far, only one fifth of the total possible number of markets has made it into a benchmark index. The speed of index inclusion has averaged 7.5% per year since 2000 and this pace is probably a good guide to the future.[4] If so, EM fixed income indices will cover some 380 individual EM bond markets by the year 2050. Index inclusion will not be linear, of course. The rate of inclusion of new markets tends to vary from year to year, usually speeding up in years with EM bull markets. As for this year, we expect EM will end 2018 with 155 markets represented in benchmark indices. In 2019, the number should rise to 163 as five Middle Eastern countries and possibly China join the EMBI GD and GBI EM GD, respectively.

- China: China indicated last week that interest income on onshore bonds will be exempt from corporate and value added tax. China is placing the management of state-owned enterprises onto the principle of so-called 'competitive neutrality', which means that SOEs will no longer be given competitive advantages by virtue of being government owned. This is consistent with China's broader reform objective of giving a much greater role for markets in resource allocation. The reforms will undermine the rationale for many of the criticisms aimed at China by lobby groups in the West.

- Venezuela: Crystallex, a gold mining company, has settled a dispute with the Venezuelan government. The settlement appears to remove the threat of attachment of Citgo shares, which has been hanging over the PDVSA 2020 bonds for some time (backed by collateral of Citgo shares, the PDVSA 2020 bonds are not in default. Citgo is a US-based chain of petrol stations owned by Venezuela). Following the newly resumed discussions between IMF and the Venezuelan government, central bank sources in Caracas have indicated that the Venezuelan economy contracted 16.6% in real terms in 2017. In other news, Venezuelan ambassador to Cuba Ali Rodriguez has died. During the 1960s and early 1970s, Rodriguez was active in the Marxist guerrilla movement as an explosives expert. In 2003, Rodriguez fired all the workers at the national oil company, PDVSA, in order to concentrate more power into the hands of his boss, then President Hugo Chavez. This was one of the

[2] There is no clear definition of what constitutes a country.
[3] In reality, there will also be bond-like markets such as CDS.
[4] This rate excludes launch years for EM fixed income benchmark indices, because launch years are one-off outlier events. The corporate index (CEMBI BD) launched in 2001. The local currency corporate index (LOCL) launched in 2015.

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most disastrous corporate decisions ever taken in modern Venezuelan history and oil production in Venezuela has fallen ever since. Finally, we note that the US government is considering adding Venezuela to a list of terrorism sponsors, according to the Washington Post. This suggest that oil sanctions are not in cards.

- Mexico: The government is due to announce the results of a public consultation on its investment program today. Unlike the recently concluded public consultation on the Mexico City airport project, which resulted in cancellation of the project, the investment projects under consideration in this latest public consultation have not yet begun, so there will be no cancellation of existing projects. Still, while public consultation on specific projects is clearly democratic (and provides political cover for those in power), it is not necessarily the most economically efficient way to select projects. In other economic news, Mexican real GDP expanded 0.8% during Q3 2018, which means real GDP growth moderated slightly in Q3 2018 to 2.5% yoy from 2.6% yoy in Q2 2018. Mexico's current account deficit in Q3 2018 was USD 5bn. This implies a deficit of about USD 17bn ytd (similar size to the deficit at the same time last year). Meanwhile, inflation in the first half of November was 0.61% mom versus 0.67% mom expected.

- Taiwan: Voters rebuked the ruling Democratic Progressive Party (DPP) heavily in local elections at the weekend. The anti-China KMT party gained at DPP's expense. The election issues were mainly domestic in nature, however. The next presidential election is scheduled for January 2020. Meanwhile, industrial production was 1.0% higher in October than in September or +8.3% on a yoy basis versus 1.6% yoy in September. Export orders were up 5.1% on yoy basis in October.

- Argentina: Economic activity contracted at a yoy rate of 5.8% in September versus a medium expectation of -4.6% yoy. As demand contracts due to tighter policies, however, the trade balance is moving into surplus. The trade surplus in October of USD 300m was the second consecutive monthly trade surplus.

Snippets:

- Brazil: Mid-month inflation slowed from 4.56% yoy in October to 4.39% yoy in November. The Bolsonaro Administration is seeking to pass a bill granting full independence to the central bank.
- Chile: Real GDP was 2.8% higher on a yoy basis in Q3 2018. Growth in Q2 2018 was revised up to 5.4% yoy from 5.3% yoy.
- Colombia: The government is considering replacing a planned hike in VAT with taxes in high-income earners as well as spending cuts in order to obtain support in the congress for a required fiscal adjustment. We believe that VAT is a more efficient tax.
- Costa Rica: The Supreme Court has ruled that the fiscal reform bill may be passed by congress with a simple majority rather than a two-thirds majority. This increases the odds that the reform passes this side of New Year.
- Ecuador: President Lenin Moreno has requested that all members of his Cabinet resign as part of a process of evaluating the performance of his ministers. This the second time Moreno has done this.
- Ghana: The 2019 Budget envisages a return to fiscal expansion following two years of fiscal consolidation.
- Hungary: The National Bank of Hungary left the policy rate unchanged at 0.9% in line with expectations.
- India: The Reserve Bank of India and the government have decided to set up a committee to study whether the RBI should transfer capital gains from revaluation of FX and gold reserves to the government.
- Malaysia: Core inflation slowed to 0.1% yoy in October from 0.3% yoy in September. Headline inflation was in line with expectations at 0.6% yoy.
- Mongolia: IMF and the government have reached staff-level agreement following the sixth review of Mongolia's standby agreement.
- Nigeria: The Central Bank of Nigeria left the policy rate unchanged at 14%.
- Pakistan: IMF and the government still have outstanding issues, which the two sides aim to resolve in January, according to government spokesperson Noor Ahmed.
- Peru: Real GDP growth in Q3 2018 was 2.3%, down from 5.5% yoy in Q2 2018.
- Poland: The government says it will absorb a rise in wholesale energy prices scheduled for implementation in January next year. This should reduce inflation relative to expectations.
- Singapore: Headline inflation was steady at 0.7% yoy in October, while core inflation edged up to 1.9% yoy from 1.8% yoy in September. Industrial production expanded at a yoy rate of 4.3% in October, which was far stronger than expected (2.6% yoy).
- South Africa: The South African Reserve Bank hiked the key monetary policy interest rate by 25bps to 6.75%.
- Sri Lanka: Moody's downgraded the sovereign credit rating to B2 (stable).
- South Korea: Exports in the first 20-days of November were 5.7% higher than at the time last year.
- Thailand: Tourist arrivals declined at a yoy rate of 0.5% in October following a drop in arrivals from the Middle East. However, overall exports were stronger than expected in October (8.7% yoy versus 4.0% yoy expected).
- Ukraine: Tensions between Russia and Ukraine ramped higher over the weekend following an altercation between warships near Crimea.

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Global backdrop

The fable of the boiling frog says that a frog will jump out if suddenly immersed in boiling water, but stays put if the water is brought to a boil very slowly. How will investors in developed markets behave as the waters get progressively hotter and hotter? In addition to poor performance in markets this year, investors in developed economies are also beginning to feel the heat from both politics and economies.

On the political side, the governments of all the major Western economies, including UK, Germany, France and the US are weakening rapidly. The Trump Administration has become a lame duck, Merkel is leaving and Macron's approval ratings are rock bottom. The most pressing political problems are faced by UK Prime Minister Theresa May, who has to get her Brexit deal with EU through parliament. The crucial vote is scheduled for 12 December 2018. Meanwhile, in Italy the dispute with the EU over fiscal policy escalated further as the European Commission launched the Excessive Deficit Procedure (a formal process intended to punish EU member states, which fail to conform to EU fiscal rules). On global level, markets will focus sharply on the G-20 Summit in Buenos Aires this week. US and China will try to put into motion a process, which could ultimately end US President Donald Trump's ill-advised trade war, which is now hurting both economies.

On the economic front, developed countries are displaying worrying signs of super-low resilience to the gradual tightening of US monetary policies. Yet, the US policy rate is still negative in real terms. In Europe, German growth has softened in recent months and last week European PMIs disappointed as well (-0.7 points to 52.4 in October). This is already leading to speculation that ECB may launch a third generation of so-called Targeted Longer-Term Refinancing Operations (TLTROs) as soon as December or early next year. TLTROs term loans from ECB directly to European banks, which were never recapitalised following 2008/2009. Meanwhile, in the US the data is also softer, including PMIs (55.4 versus 55.7 expected), existing home sales (down 5.1% on yoy basis) as well as declining durable good spending and weaker housing.

In other global developments, it was a Black Friday for oil. Big technical unwinds of long positions in low liquidity holiday-shortened markets pushed oil prices down sharply last week. Oil is now sitting at levels, which are now close to those assumed in the budgets of many EM oil-producing countries. In other words, there is cause for concern only to the extent that prices fall further from here and if the decline is sustained. Barring a sharper lurch toward US recession, this should not happen, in our view.

Benchmark performance

Emerging Markets	Month to date	Quarter to date	Year to date	1 year	3 years	5 years
MSCI EM	1.43%	-7.39%	-14.30%	-13.55%	7.73%	1.93%
MSCI EM Small Cap	2.88%	-7.96%	-19.14%	-16.53%	3.04%	1.11%
MSCI Frontier	1.07%	-2.50%	-14.82%	-11.57%	3.84%	1.56%
MSCI Asia	2.33%	-8.77%	-14.35%	-14.42%	7.90%	4.38%
Shanghai Composite	-0.88%	-8.55%	-20.10%	-21.17%	-8.64%	5.63%
Hong Kong Hang Seng	2.46%	-5.69%	-7.65%	-7.87%	4.67%	1.94%
MSCI EMEA	3.58%	-3.40%	-15.01%	-8.84%	4.14%	-2.88%
MSCI Latam	-3.80%	-0.47%	-7.12%	-6.36%	10.50%	-2.23%
GBI EM GD	2.60%	0.59%	-7.61%	-5.33%	4.06%	-1.51%
ELMI+	1.38%	0.22%	-4.27%	-3.31%	2.85%	-1.08%
EM FX Spot	1.14%	-0.77%	-9.07%	-8.13%	-2.05%	-7.33%
EMBI GD	-0.92%	-3.06%	-6.01%	-5.26%	3.94%	4.49%
EMBI GD IG	-0.43%	-2.70%	-4.43%	-4.07%	3.24%	3.90%
EMBI GD HY	-1.43%	-3.43%	-7.70%	-6.61%	4.66%	5.00%
CEMBI BD	-0.16%	-0.76%	-2.35%	-2.00%	4.41%	4.27%
CEMBI BD IG	-0.13%	-0.83%	-1.81%	-1.59%	3.13%	3.71%
CEMBI BD Non-IG	-0.21%	-0.67%	-2.97%	-2.44%	6.50%	5.00%

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Benchmark performance

Global Backdrop	Month to date	Quarter to date	Year to date	1 year	3 years	5 years
S&P 500	-2.74%	-9.39%	0.18%	3.33%	10.27%	10.06%
1-3yr UST	0.29%	0.44%	0.68%	0.67%	0.63%	0.61%
3-5yr UST	0.55%	0.65%	-0.26%	-0.41%	0.62%	0.97%
7-10yr UST	0.95%	0.58%	-2.18%	-2.33%	0.36%	1.87%
10yr+ UST	1.80%	-1.30%	-7.02%	-6.50%	0.73%	4.37%
10yr+ Germany	0.58%	1.69%	4.51%	3.34%	2.96%	6.89%
10yr+ Japan	0.67%	0.90%	0.20%	0.28%	3.50%	3.96%
US HY	-1.29%	-2.87%	-0.37%	0.34%	6.97%	4.38%
European HY	-1.72%	-2.87%	-2.82%	-2.80%	3.38%	4.31%
Barclays Ag	0.34%	-0.79%	-3.14%	-2.88%	2.21%	0.60%
VIX Index*	-3.39%	69.22%	85.78%	112.10%	35.02%	60.11%
DXY Index*	-0.39%	1.70%	5.02%	4.27%	-3.05%	20.02%
CRY Index*	-5.95%	-7.97%	-7.36%	-6.56%	-3.28%	-34.64%
EURUSD	0.57%	-1.96%	-5.23%	-4.38%	7.23%	-16.17%
USDJPY	0.28%	-0.39%	0.51%	1.95%	-7.59%	11.82%
Brent	-20.22%	-27.21%	-9.96%	-5.72%	32.45%	-45.70%
Gold spot	1.00%	2.89%	-5.84%	-5.23%	14.43%	-1.28%

*VIX Index = Chicago Board Options Exchange SPX Volatility Index. *DXY Index = The Dollar Index. *CRY Index = Thomson Reuters / CoreCommodity CRM Commodity Index.
Source: Bloomberg, JP Morgan, Barclays, Merrill Lynch, Chicago Board Options Exchange, Thomson Reuters, MSCI, total returns.
Figures for more than one year are annualised other than in the case of currencies, commodities and the VIX, DXY and CRY which are shown as percentage change.

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