Stocks and bonds are upside-down – except in EM

By Gustavo Medeiros and Jan Dehn

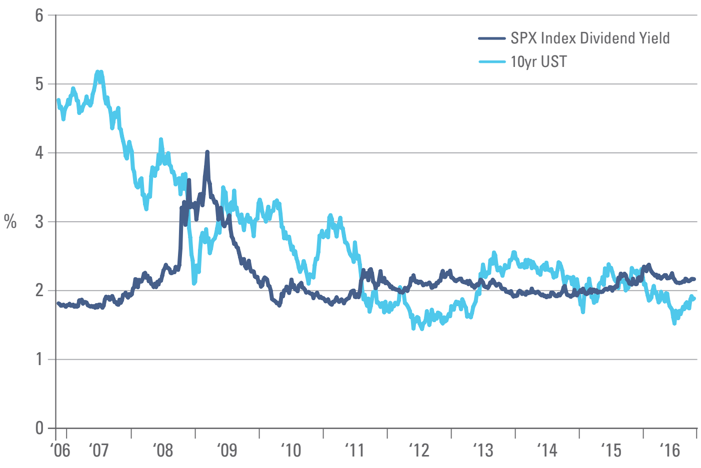
Investors are buying developed market equities for yield and developed market bonds for capital gain. This makes no sense from a risk-reward perspective. The widespread perception that there is no alternative is also wrong. Emerging Markets (EM) bonds pay high yields and EM equities offer opportunities for capital gains. The world of investing is only upside down in developed markets, not in Emerging Markets.

Upside down developed world

In developed markets, equities pay a higher yield (via dividends) than bonds. According to Bloomberg, the dividend yield on the S&P 500 Index is currently 2.15%, while JP Morgan's GBI Global index for the US shows the yield on a US Treasury bond to be at just 1.89%.

That is not to say that developed market equity dividend yields are particularly high, offering a good opportunity. In fact, the current dividend yield is almost in line with its previous 10 year average at 2.14%. The equity dividend yield only looks better in relative terms, due to the fact that bond yields have declined by nearly 3% in the past ten years.

Fig 1: **Bond and dividend yields: United States**



Source: Ashmore, Bloomberg.

Poor risk-reward

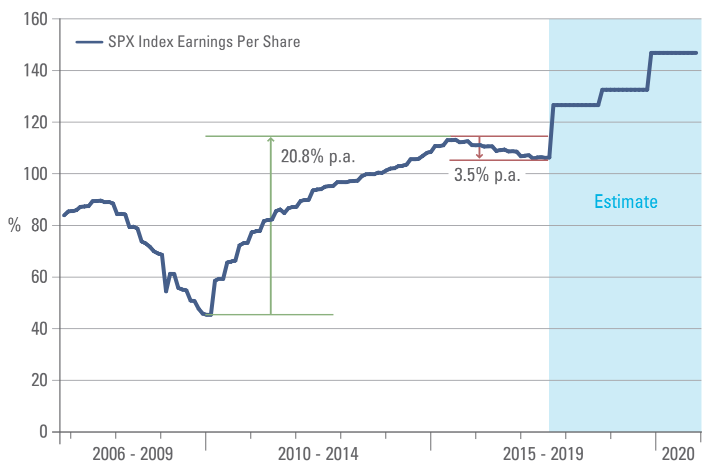
The fundamental problems posed by searching for yield in equities and capital gains in bonds are two-fold: first, equities are far more volatile than bonds, which means that equity investors are not making a sound risk-return decision. For example, the volatility of US equities averages 14% per year compared to just 4.4% per year for US Treasuries. Equities need capital gains to compensate for their greater riskiness – dividend yield is not enough.

> Investing in stocks for yield and bonds for capital gain offers poor risk-adjusted returns

Expensive valuations in DM when earnings are softening

Unfortunately, the likelihood of further capital gains in developed market equities has been weakening of late. US earnings expanded by a significant 153.5% (20.8% per annum) from trough to peak between November 2009 and October 2014, but have since declined by 6.5% (-3.5% per annum) between November 2014 and October 2016. The current earnings growth consensus forecast for the S&P 500 for next few years of north of 20% looks too optimistic alongside mounting evidence that the economy is suffering from late cycle blues. The market may well be over-estimating the ability of companies to expand earnings at the post-recession pace.

Fig 2: **Earnings expectations: S&P 500**



Source: Ashmore, Bloomberg.

Capital appreciation in DM bonds?

Bonds in developed markets have the opposite problem. They benefited tremendously from the QE bid from central banks, but now they offer very little yield, so little, in fact, that investors are buying them on the prospect of capital gains. But capital gains can only come if bond prices continue to appreciate, i.e. if bond yields continue to decline. And the only way bond yields will decline meaningfully from current levels is if a recession strikes in one or more countries in the developed world with sufficient severity to trigger a reversal of planned gradual policy-tightening in the US and more policy easing – by hook or by crook – in Europe and Japan.

Besides, central banks appear to face important limitations with respect to their easing options. Experience in Japan and Europe shows that negative interest rates can damage financial sector balance sheets. Depositors may not accept negative deposit rates, so banks will struggle to pass them onto clients for fear of losing their most important source of funding. Japan has already moved to yield targeting (at zero) at the ten year point of the curve. The ECB is contemplating tapering, not out of a wish to tighten policy, but because it is running out of bonds to buy. Indeed, yield curves flattened considerably this year in both Europe and the US in what increasingly looks like the last expression of the big QE fixed income bonanza unleashed by developed market central banks after the Developed Market Crisis (DMC) of 2008/2009.

Fundamental resolution is possible, but looks unlikely

Continued heavy exposure to bonds and equities in developed economies could yet turn out to be an OK investment provided that developed economies can generate strong, supply-side growth, i.e. growth caused by significant cost reductions and productivity improvements.

However, this is clearly not happening. Eight years after the DMC policy-makers have boosted asset prices; they have entirely failed to reform. If anything, the real economy is even more challenged due to a continuing worsening of the demographic picture, shrinking global trade, rising levels of debt, stagnant productivity, increasing unfunded pension liabilities and a frightening exhaustion of easing options at a time when recession risks are clearly increasing. Recent political developments in Europe, the UK and the US offer little hope of reforms, free trade and other policies that would be supportive of stronger trend growth.

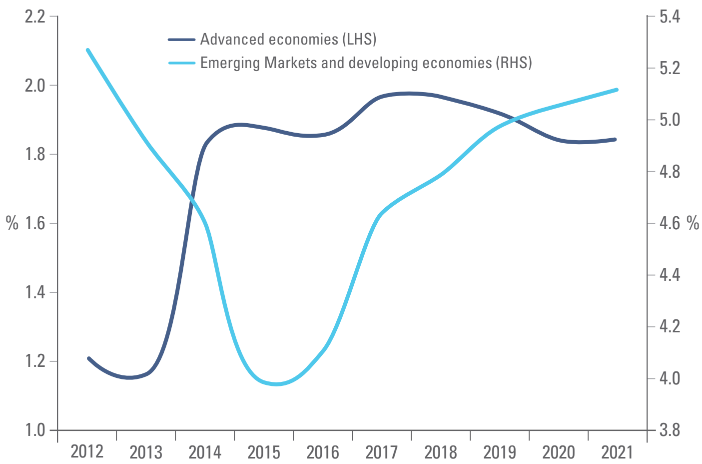
Tech as a structural driver in EM

The notion of 'TINA' – There Is No Alternative – has become prevalent among many investors in developed markets. In reality, there are perfectly viable alternative investments available within EM. A giant portfolio re-allocation into QE markets and out of non-QE markets, including EM, has taken place between 2010 and 2015. This means that EM assets offer very strong value, even after a stellar performance in 2016, which has seen EM bonds and stocks outperform US bonds and stocks by a factor of 5 and 3, respectively. EM bonds pay high positive yields, while equities have clear capital gain potential.

EM stocks offer capital gains, while bonds pay a level of yield which appropriately compensates for the risks in the asset class. Both look attractive compared to developed markets

However the case for EM is not just based on yield and prospective equity capital gains. The tech component of EM equities is now higher than in the S&P 500. Also inflation has fallen in EM, so that real yields have gone up meaningfully in recent years proving that EM central banks have room to ease and thus means of protecting themselves in the event of a slowdown. Meanwhile, the EM growth premium has actually turned positive and EM looks set to deliver strong and sustained growth outperformance versus developed economies in the next five years on the back of the most competitive real effective exchange rates since 2003. Technicals also remain very strong. Investors are therefore being paid well for the risks they take in the EM asset classes.

Fig 3: **IMF real GDP growth forecast: Stagnation in developed markets and acceleration in EM.**



Source: Ashmore, IMF.

EM bonds offer attractive returns from income

Emerging Market fixed income offers a much higher yield than developed economies with sovereign and corporate credit spreads hovering around 330 basis points over US Treasuries. High yield spreads are even wider, above 500 basis points. These spreads translate into 5% USD yields to maturity at the benchmark level compared to non-existent yields in many developed markets.

Despite much higher yields, the volatility of EM bonds over the last 15 years has been a modest 7% to 8%, which is not much higher than the 6% volatility on the Barclays Global Aggregate (one of the largest fixed income benchmarks in the world).Yields on local currency bonds are even higher at 6.3% and real yields are high by historical standards, which means that EM local currency bonds offer both yield and capital appreciation, the latter without the need for a recession.

[1] For more details on the case for EM local currency bonds please see *"Emerging Market Local Currency Bonds – the stars are aligned"*, Market Commentary, 3 August 2016.

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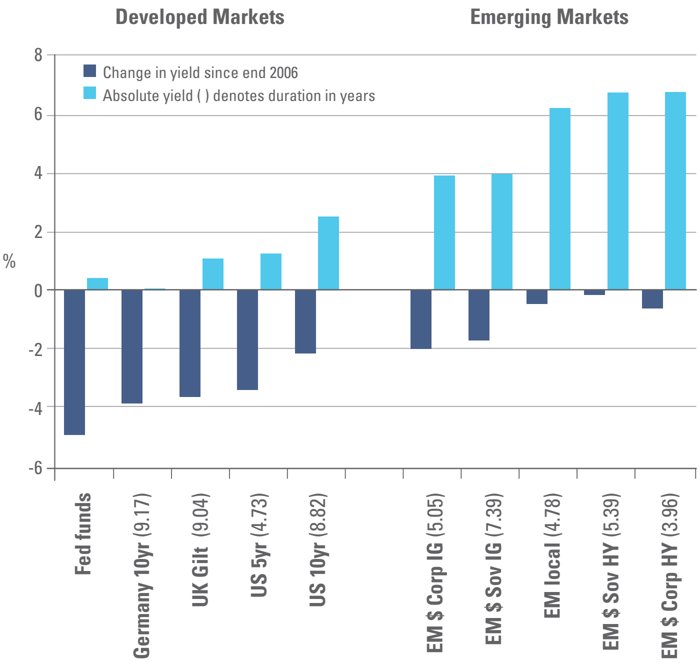
Fig 4: **Yields and change in yields since end-2006: EM versus selected developed markets**



Source: Ashmore, JP Morgan, Bloomberg.

Earnings have now stabilised in EM after a long period of decline. The macroeconomic adjustment that most countries went through since 2013 has created competitive labour prices in international terms, which is now boosting competitiveness. Companies also rationalised, cutting unnecessary capex and costs, which should allow for a sustained rebound in earnings, supported by the more positive growth outlook in emerging markets. MSCI earnings have rebounded since the start of the year, as evidenced by the chart below.

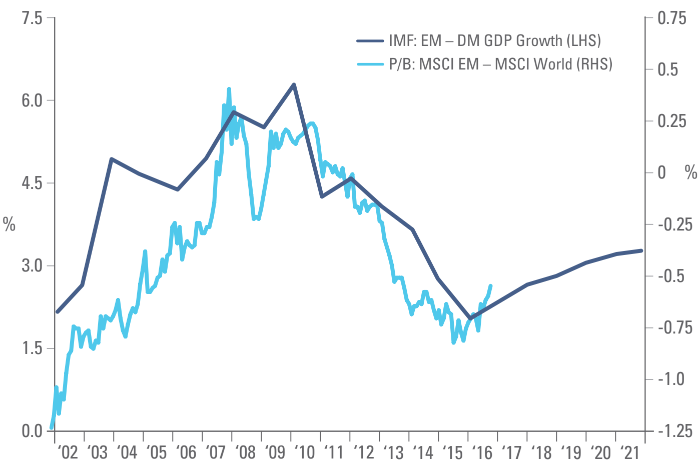
Fig 6: **Earnings per share: MSCI EM**

Source: Bloomberg.

EM equities offer attractive returns from capital appreciation

EM equities are deeply undervalued in comparison to historical valuations. The MSCI Emerging Markets index trades at a price/earnings ratio of 15.3 compared to 21.7x for the MSCI World. The price to book ratio also points to heavy under-valuation, with EM equities trading at 1.55x price to book compared to 2.1x for the MSCI World index. This means that EM stocks have traded at 11.4% discount to their average valuation over the last 15 years whereas MSCI world equities are trading in line with their average over the same period.

Fig 5: **EM vs. DM growth and price to book: MSCI EM vs MSCI World**

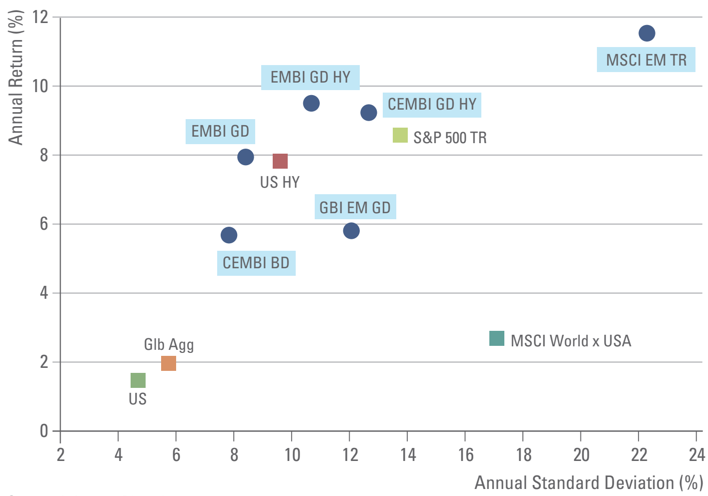


Source: Ashmore, Bloomberg.

Scenario analysis

Investors remain unconvinced of the case for EM, despite evident value in absolute and relative terms, stronger returns, proven fundamental resilience over the last few years and the stronger growth outlook. On any objective empirical measure, EM debt should clearly be a much bigger part of fixed income portfolios. EM debt has been sitting at the efficient frontier of the fixed income universe since the inception of the main benchmarks in 2003 (see chart below) even after the painful external adjustment over the last 3 years.

Fig 7: **Return versus volatility: EM and the rest**



Source: Ashmore, Bloomberg.

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A careful exercise on returns forecasts over the next three years and contrasting these with the volatility of the asset class will deliver superior risk adjusted returns as well.

How resilient is EM to shocks? We examine the robustness of EM returns by means of three scenarios:

1. **The base case**
   In this scenario, we assume US Treasury yields evolve in line with the current forward market as at 28 October. We assume credit spreads tighten in line with the average of the last 10 years and that EM spot FX sells off by 1% per year (in line with the rolling average of 3-year calendar returns since 1995.

2. **Bear case**
   We stress the asset class with a 'Taper Tantrum' – like shock where US Treasury yields rise and credit spreads widen at the same time and by the same magnitude as in 2013.

3. **Bull case**
   We model a benign de-coupling with US Treasury yields undershooting forward expectations by 30-40 basis points, while credit spreads tighten in EM credit and EMFX appreciates.

Based on these scenarios, we estimate that conservatively EM fixed income will deliver annualised returns over the next three years in the following range:

Asset class	Range	Avg. forecast
Sovereign Debt	2.1% – 5.9%	+4.3%
Corporate Debt	3.6% – 5.7%	+4.6%
Local Currency Bonds	-4.3% – 14.0%	+4.9%
7yr US Treasury	-0.6% – 1.1%	+0.4%

The main risks to these scenarios are tilted to the upside. EM has just 'survived' with remarkably low default rates, balance of payments stresses and IMF emergency support programmes, four major external shocks, including capital flight (Taper Tantrum), a 40% Dollar rally, the start of the Fed hiking cycle and a 50% fall in commodity prices. Developed economies, by contrast, face mounting challenges. EM is now no longer just the highest paying segment of the market, but also the least risky destination for capital. Hence, there is a non-trivial risk that investors leave developed markets in favour of EM. Such a re-allocation of capital would increase the returns in EM considerably relative to the conservative estimates listed above.

Conclusion

The world of investment is upside down in developed economies. Buying bonds in expectation of capital gain and equities in pursuit of income offer extremely poor risk-adjusted returns and will not deliver in accordance with the objectives of most institutional investors.

This strange, upside down world has come about as a result of central bank policies, but QE has exclusively targeted developed markets, not EM. The feeling that there is no alternative to investing in developed economies is wrong – it ignores both EM debt and EM equities.

Today, EM debt is a USD 18.5trn asset class – about 20% of total outstanding bonds in the global financial system – which offers plenty of income over the next years with volatility not dissimilar to that prevailing in developed fixed income. Similarly, emerging market equities are trading at relatively cheap levels. In the context of the return of the EM growth premium, capital gains could be considerable in the coming years.

Many investors wonder if the time is right for an EM allocation. The memory of considerable asset price volatility in recent years is causing them to hesitate.

Some investors also wonder if they have already missed the rally. Most importantly of all, many investors are simply afraid, because they are heavily overweight in QE markets and wondering where they are going to get their next 10 per cent return. This is a good question, but the answer is remarkably simple. Investors should take profits in the QE markets and re-allocate to the non-QE markets, including EM. Hence, the only real obstacle they face is their own fear.

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