Ashmore

# Where do broken bonds go?

By Jan Dehn and Gustavo Medeiros

**As investors return to EM local markets on the back of strong performance and a solid outlook they will be forced to inject capital directly into EM economies. This is because most EM local currency bonds now sit with local pension funds and other local institutional investors. The return of global finance to EM economies will reverse the financial tightening of recent years, which in turn will stimulate growth.**

**Based on our expectation of strong performance in local markets, we expect capital inflows into EM countries to beat still very cautious growth projections over the coming years. In turn we expect the stronger economic conditions to justify tighter spreads in Dollar-denominated bonds too.**

## Introduction

Emerging Markets (EM) local currency bonds are the best performing government fixed income asset class in the world over the past 12 months.[1] Foreign investors are heavily underweight following several years of falling EM currencies. Since most of EM's local currency bonds are now in the hands of local pension funds, foreign investors[2] will have to 'go local' in order to pick up securities, thus injecting capital directly into EM's finance-constrained economies. This is a key difference between local and foreign currency denominated bonds: when foreign investors get bullish about EM Dollar bonds, money merely changes hands in the off-shore markets with no money flowing into EM economies.

We expect the financial tightening in EM of recent years to be reversed in the next few years with positive implications for growth. We do not think many investors or forecasters have taken into account the positive liquidity effect. We expect EM growth rates to well exceed consensus expectations. Stronger growth should also justify tighter spreads in EM's Dollar-denominated fixed income markets.

## What makes EM local bonds special in rallies?

The emergence of pension funds and other domestic institutional investors within EM changed the dynamics of EM local bond markets. EM's pension funds are now the *de facto* repositories for bonds during bear markets, so when foreign investors turn bullish and want to build positions they have to go to EM pension funds – possible with a local or international bank as intermediaries – to source securities. In this way financing from overseas ends up flowing directly into EM economies, something which does not happen when bonds trade in off-shore markets.

This special growth externality via an easing of domestic financial conditions is what makes local bond rallies so special.

In practice, the process works as follows. An overseas investor first approaches a local bank, or uses an international investment bank to approach a local bank. The local bank supplies the bonds by sourcing them from a local pension fund. As the bonds get lifted, local bond yields fall. As yields decline local banks and other investors become more inclined to lend to households and businesses. In turn, they begin to spend and invest more. This pushes up the level of economic activity.

## Finance constraints

But why should flows into EM local markets have a growth impact in the first place? Answer: EM economies are severely finance constrained. The table below shows that EM countries now make up about 58% of global GDP (in PPP-adjusted terms), but they only lay claim to about 19% of global bonds and only 26% of total global finance including loans.[3] It is precisely the presence of capital constraints that explain why EM growth rates are impacted when global capital ebbs and flows. Between 2010 and 2015, EM growth rates suffered a great deal when asset purchases by QE central banks distorted bond markets heavily in favour of developed markets and investors off-loaded non-QE exposures, including EM, in order to chase returns in the QE-sponsored markets.

Fig 1: **Bonds and loans: EM vs DM shares**

| | World | DM | | EM | |
|---|---|---|---|---|---|
| | USD trn | USD trn | Share of total | USD trn | Share of total |
| Debt securities | 96.2 | 77.7 | 81% | 18.5 | 19% |
| Loans | 86.8 | 57.8 | 67% | 29.1 | 33% |
| Total | 183.0 | 135.4 | 74% | 47.6 | 26% |
| Share of global (PPP adjusted) | 100% | 42% | – | 58% | – |

Source: BIS, IMF, Ashmore.

[1] As of 12 June 2017 the 12-month return on EM local currency bonds is 8.46% in Dollar terms compared to 8.35% and 7.58% for EM sovereign and corporate Dollar-denominated bonds, respectively. In developed markets, US 5-year bonds, which have the same duration as EM local currency bonds, have returned 0.08% over the past 12 months, while German 5-year bonds have returned 0.1% over this period. The Barclays Aggregate Index, which is a broad global bond index comprising both developed and EM bonds, has returned 3.75% over the past year.

[2] There is no fully comprehensive database of the exact holding structure for all EM local currency bonds. However, date from the Bank of International Settlements shows that the total EM local currency government bond universe is just over USD 7trn. We also know that the market cap of the JP Morgan GBI EM GD index is only 10% of this total. Foreigners tend to be overwhelmingly invested in securities tracked by this index. Foreign ownership of index securities rarely exceeds 50% in the two most popular index names (Indonesia and Mexico) and is typically far lower in the other index names. For example, a recent study from Credit Suisse (*'Share of non-residents in domestic debt increased to 13.6% in April', Brazil Breaking News: Public Debt in April*, Credit Suisse, 24 May 2017) puts foreign ownership of Brazilian bonds at just 13.6% of the index eligible bonds. Hence, it is clear that the vast majority of EM local bonds are held locally.

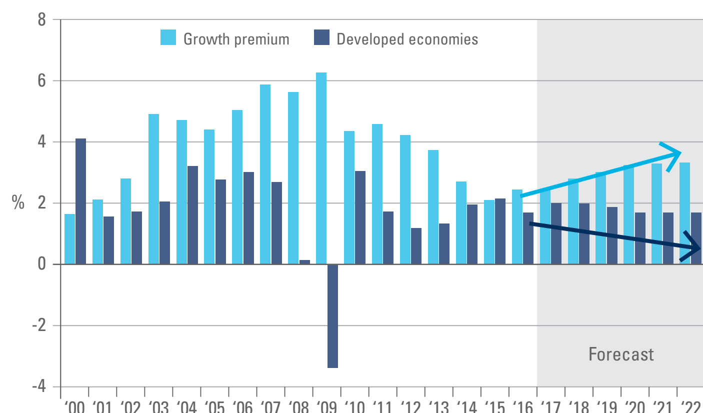
[3] By contrast, developed economies make up 40% of global GDP, but they control more than 80% of global finance. That, in a nutshell, is why EM bonds pay high positive real yields, while bonds in developed markets pay negative real yields.

*Continued overleaf*

## EM growth prospects under-estimated

With EM local markets now performing strongly we expect growth to pick up in response to financial easing. How large will the growth dividend be from capital returning to EM? It is very difficult to quantify, but we do not think the effect should be underestimated. The latest IMF World Economic Outlook forecasts that EM real GDP growth rates will accelerate from a low average of about 4.1% in 2016 to just over 5% by 2022. However, this may be too pessimistic. Prior to the introduction of QE policies in developed economies, EM economies grew on average 6.6% per year in real terms. Granted, some of the growth slowdown was due to lower commodity prices, but the impact of commodities should not be exaggerated, since two thirds of EM countries are net importers of commodities. We do not believe the IMF has yet included the impact of capital returning to EM in its growth projections. These projections – shown in the chart below – already point to much better growth rates in EM than in developed countries, but on balance we see EM growth risks skewed to the upside relative to IMF's projections.

Fig 2: **IMF forecasts for growth out to 2022**




Source: IMF, Ashmore.

## Dollar spreads

The return of capital to EM economies is not just directly beneficial for returns on local currency bonds; easier financial conditions will also stimulate growth. After all, easier financial conditions mean that consumers will be able to get loans and companies will be able to invest. It will also become easier to refinance debt, so corporate default rates should fall. Governments will see their tax revenues improve, which should reduce deficits and hence the need to reduce debt too. All of these factors justify an expectation of tighter EM sovereign and corporate spreads. Sovereign Dollar-denominated bonds currently trade at about 300bps over US Treasuries compared to 220bps over in 2010 and 170bps over in 2007. The number of countries in the index has doubled, so spreads should actually be lower than they are today.[4] Corporate bonds also trade about 100bps wide of previous tights. EM is therefore by no means expensive.

### Even after the recent rally, EM local bond valuations are still attractive and expected to deliver strong returns in Dollar terms

## Outlook for flows

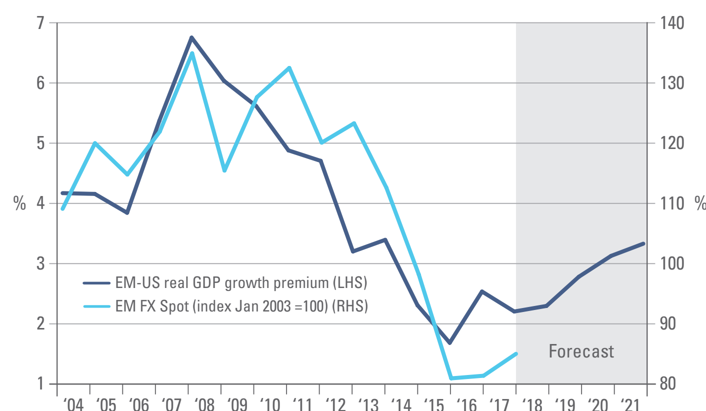
Given that flows are the conduit of capital they are clearly very important to the outlook. Anecdotal evidence suggests that flows to EM have turned positive in the last quarter and we see good reasons to expect foreign flows into EM local markets to pick up further in the coming years, albeit not at a ferocious pace.

The starting point positioning-wise is benign. Positioning is currently skewed strongly in favour of developed markets. Most investors are very heavily overweight developed markets after years of direct central bank sponsorship of those markets. Prospects for returns in developed fixed income markets are deteriorating as inflation gradually rises and governments turn back to fiscal spending, i.e. more supply. On the other hand, scared investors tend only to venture into EM with reluctance. That is why we expect the pace of flows to be sensible. This is not such a bad thing, because sentiment towards EM would benefit considerably if the asset class racks up a few years of solid but stable returns to help investors get over their deep-seated prejudices about the asset class.

Past performance will also slowly start to impact flows in a positive way. Many investors are backwards looking. They will be drawn to an asset class, which has delivered about 18% in Dollars in the past fifteen months, beating all other government bonds markets in the world.

Finally, the value proposition remains strong. EM local bond yields are high (about 6.5% in nominal terms and 250bps in real terms for about 4.5 years of duration). EM inflation averages about 4% today, a multi-year low, and many EM countries operate with a lot of spare capacity, so it will be some time before wage pressures start to push inflation rates meaningfully higher. EM FX bottomed out at 13 year lows in real terms just last year. Growth rates are rising and the correlation between EM growth rates and FX performance is very strong (chart below).

Fig 3: **EM FX and EM growth premium**




Source: Ashmore, IMF, JP Morgan, Bloomberg.

In conclusion, these factors put together suggest that EM local bond markets could return about 50% in Dollar terms over the next five years, i.e. about 10% in Dollar terms per year. This should handsomely beat anything on offer in developed economies over the same period. Local bonds should also beat returns on offer in EM's Dollar-denominated sovereign and corporate bonds, although these sub-asset classes should still perform better than developed market bonds.[5]

[4] See *'Free Money: Arbitrage opportunities in EM external debt'*, Market Commentary, 14 June 2016.
[5] We expect sovereign bonds to return about 30% and corporate bonds to return about 25% in Dollars. For more details see *'Outlook for EM and global backdrop'*, The Emerging View, 11 May 2017.

*Continued overleaf*

## The fear of FX

Undoubtedly the single most off-putting aspect of investing in EM local currency bonds for Dollar-based investors is that they have to take currency risk.[6] Are they justified in fearing EM currencies as much as they do? We see three reasons why fears are exaggerated.

First, FX risk, even in EM, is a two-way risk. EM currencies may have declined 43% between 2011 and the end of 2015, but they are now rising. It is worth remembering that between 2003 and 2009 EM currencies rallied 45% against the Greenback. We are not quite that bullish now: we estimate that there is some 20% upside in EM FX without compromising past ranges for EM real exchange rates.

Second, EM local currency returns can be augmented with duration. EM bonds pay a decent yield, which, depending on the state of each individual country's specific business cycle may be very attractive indeed. For example, more than half of the 60% return (in Dollar-terms) on Brazilian local currency government bonds in 2016 was due to a rally in local rates.

Thirdly, EM inflation is low. Inflation has historically tended to rise with EM currencies due to impact of capital inflows on economic activity. Hence, inflation risks in EM are clearly skewed to the upside in the next few years.[7] However, EM countries today operate with a lot of spare capacity, so inflation risks do not present a major present danger. There is room for inflation to rise towards 5% over the next five years without in any way bringing real yields even close to negative territory.

Fig 4: **EM FX versus USD**

Source: JP Morgan, Ashmore.

Fig 5: **FX pass-through myth**

Source: Ashmore, Bloomberg, JP Morgan.

## Conclusion

When the late US songstress Whitney Houston penned the words to one of her greatest hits she must surely have had EM local currency bonds in mind:

*"Where do broken bonds go*
*Can they find their way home*
*Back to the open arms*
*Of a love that's waiting there"*

Whitney Houston (loosely interpreted)[8]

EM local currency bonds no longer default when foreigners sell them. They go home, meaning they end up in safekeeping with local pension funds and other domestic institutional investors. When sentiment turns positive among foreign investors, ownership of the bonds changes from locals to foreign players and cash moves the opposite way and financial conditions ease in EM's finance-constrained economies. The resulting positive growth externality is unique to local currency bond rallies, whereas off-shore bond rallies are only felt overseas.

EM local bonds have rallied strongly in the past 15 months, but we think positioning is still very light and valuations are still attractive enough to deliver some 50% return in Dollars over the current five year period.

As foreigners begin to build positions they have to 'go local' to get the securities. This will inject finance directly into EM economies. Faster growth means spreads on Dollar bonds can narrow further.

[6] Other differences between EM Dollar-denominated bonds and local currency bonds include clearing, custody, legal framework, index coverage, etc.
[7] The country level data is more ambiguous due to country-specific conditions that can influence the relationship between FX and inflation. For more detail, see *'The Myth of EM FX pass-through'*, The Emerging View, 14 March 2017.
[8] In her original 1987 lyrics Whitney Houston wrote about broken hearts, not broken bonds, but we put this down to artistic licence.

*Continued overleaf*

Ashmore

## Contact

**Head office**

**Ashmore Investment Management Limited**
61 Aldwych, London
WC2B 4AE

T: +44 (0)20 3077 6000

@AshmoreEM

www.ashmoregroup.com

**Bogota**
T: +57 1 347 0649

**Dubai**
T: +971 440 195 86

**Jakarta**
T: +6221 2953 9000

**Mumbai**
T: +91 22 6608 0000

**New York**
T: +1 212 661 0061

**Riyadh**
T: +966 11 483 9100

**Singapore**
T: +65 6580 8288

**Tokyo**
T: +81 03 6860 3777

**Other locations**
**Lima**
**Shanghai**

**Bloomberg page**
Ashmore <GO>

**Fund prices**
www.ashmoregroup.com
Bloomberg
FT.com
Reuters
S&P
Lipper

No part of this article may be reproduced in any form, or referred to in any other publication, without the written permission of Ashmore Investment Management Limited © 2017.

**Important information:** This document is issued by Ashmore Investment Management Limited ('Ashmore') which is authorised and regulated by the UK Financial Conduct Authority and which is also, registered under the U.S. Investment Advisors Act. The information and any opinions contained in this document have been compiled in good faith, but no representation or warranty, express or implied, is made as to their accuracy, completeness or correctness. Save to the extent (if any) that exclusion of liability is prohibited by any applicable law or regulation, Ashmore and its respective officers, employees, representatives and agents expressly advise that they shall not be liable in any respect whatsoever for any loss or damage, whether direct, indirect, consequential or otherwise however arising (whether in negligence or otherwise) out of or in connection with the contents of or any omissions from this document. This document does not constitute an offer to sell, purchase, subscribe for or otherwise invest in units or shares of any Fund referred to in this document. The value of any investment in any such Fund may fall as well as rise and investors may not get back the amount originally invested. Past performance is not a reliable indicator of future results. All prospective investors must obtain a copy of the final Scheme Particulars or (if applicable) other offering document relating to the relevant Fund prior to making any decision to invest in any such Fund. This document does not constitute and may not be relied upon as constituting any form of investment advice and prospective investors are advised to ensure that they obtain appropriate independent professional advice before making any investment in any such Fund. Funds are distributed in the United States by Ashmore Investment Management (US) Corporation, a registered broker-dealer and member of FINRA and SIPC.