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MARKET COMMENTARY

Ashmore

Is DM bond issuance 'crowding out' EM?

By Jan Dehn

As the twin burdens of coronavirus and late business cycle dynamics increasingly weigh on growth prospects in developed markets (DMs), governments have been quick to spend more. Current Bloomberg consensus forecasts suggest that the United States (US) will rack up a fiscal deficit of nearly 17% of GDP in 2020, while Germany is expected to spend 8% of GDP more than it takes in revenues this year. The fiscal deficits in the rest of Western Europe are also expected to average about 8% of GDP, while the UK is on track for a fiscal deficit of 14% of GDP. In Japan, investors expect a deficit of around 11% of GDP in 2020.

None of the governments in the major DMs are contemplating tax increases in the current economic environment, so the unprecedented fiscal deficits will be financed with debt. The supply of bonds will rise sharply. Will this push up rates in DM and somehow 'crowd out' Emerging Markets (EM) fixed income?

In our view, there is no evidence that increased supply of bonds in DMs has 'crowded out' EM bond markets through the conventional 'interest rate effect', that is, higher DM bond yields. In fact, the massive incremental supply of bonds in DMs has been associated with lower DM bond yields, which, all else being even, ought to have 'crowded in' EM bond markets. Yet, 'crowding in' has not happened either, because institutional investors have generally reduced their exposure to EM fixed income markets in recent years rather than 'reach' for yield.

These seemingly contradictory observations – greater supply of bonds, lower bond yields, flight from rather than search for yield in EM – can easily be reconciled if one thinks of Quantitative Easing (QE) policies for what they are: interest rate subsidies. They have introduced massive distortions in global financial markets and precipitated a massive 'volume effect', whereby capital moved in size from EMs towards DMs.

The rest of this short note explains: (a) why DM bond issuance has not 'crowded out' EM debt in the conventional sense; (b) how EM has been impacted by QE policies in DMs; (c) the impact of QE policies on economic performance in DMs; (d) implications for the Dollar; and, (e) return prospects for investors going forward.

What is 'crowding out'?

'Crowding out' easily arises because DM governments face very few constraints in terms of how much debt they can issue

'Crowding out' refers to the discouragement of investment in the private sector as increased supply of government bonds pushes up benchmark interest rates. 'Crowding out' can easily arise for the simple reason that DM governments face very few constraints in the short term in terms of how much debt they can issue. They typically issue bonds through a system of primary dealers, who have committed to buying whatever is supplied. Regulators also designate most DM government bonds as risk free, wherefore the bonds carry a zero risk rating, which means that pension funds and insurance companies can add exposure without officially incurring any additional risk. In addition, DM government bonds usually benefit from more favourable tax treatment than other types of bonds and DM government bonds tend to be given higher ratings by credit agencies than, say, bonds issued by EM governments, even when the latter have lower debt stocks, smaller fiscal deficits, greater proclivity to reform, faster real GDP growth rates, better demographic profiles, etc.

While usually associated with the corporate sector, 'crowding out' could in principle be applied to any market that happens to price bonds off a given government yield curve, including EM fixed income, since many companies and governments issue bonds that trade as a spread over the US Treasury curve.[1]

[1] Some 73 EM sovereigns issued bonds that trade as a spread over the US Treasury curve, while corporates from more than 50 countries issued Dollar-denominated bonds. There are also 36 EM sovereigns that issue EUR denominated paper.

[2] The US is the most relevant DM country in the context of EM bond issuance, because most foreign currency denominated bonds are in Dollars and trade as a spread over the US curve. Besides, US yields are higher than European yields.

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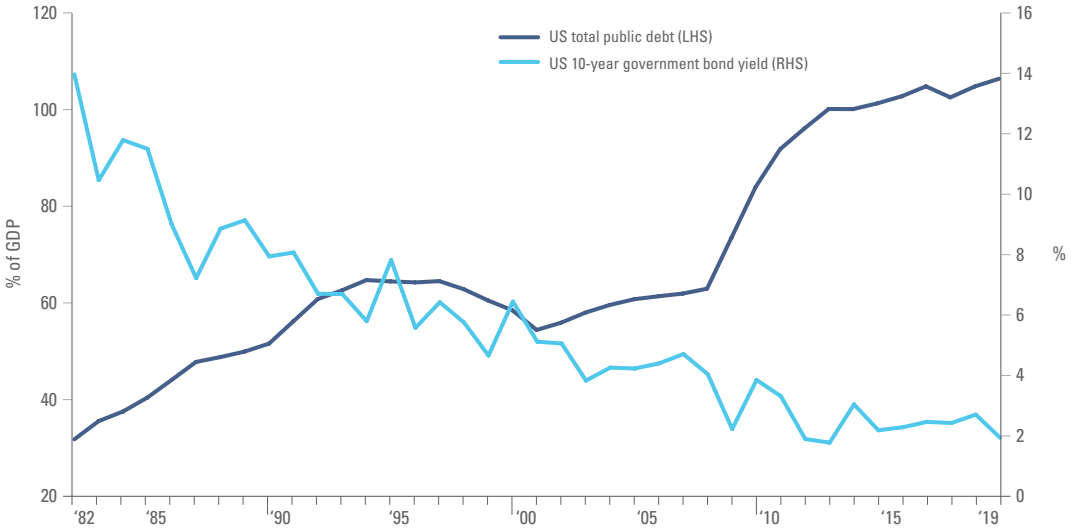
No evidence of 'crowding out' in EM

There is no evidence to suggest that the rapid expansion of issuance in DMs has pushed up yields and thus negatively impacted EM bond markets. This is clear from Figure 1, which shows that the increase in supply of government bonds in DMs in recent years has not pushed up interest rates. To the contrary, increased supply appears to be associated with lower interest rates. Since the early 1980s, the US government's outstanding debt has more than tripled from just over 30% of GDP to about 110% of GDP today, but the 10-year US Treasury yield has declined from 14% in the early 1980s to less than 2% as of the end of 2019. Today, the US 10-year bond is trading at an even lower yield of just 70bps.[2]

The increase in supply of government bonds in DMs in recent years been associated with lower interest rates

Fig 1: **US Federal Government debt and 10-year US Treasury yield (annual data 1981-2019)**



Source: Ashmore, Bloomberg. Annual data as at end-2019.

The other reason why conventional 'crowding out' has not been nor is likely to become a major issue in the future is that EM countries rely more and more on local funding sources, whose yields are not highly correlated with US interest rates. Today, EM countries obtain 82% of their total funding from local markets (Figure 2). Only 11% of all sovereign funding, or USD 1.4trn out of a total of USD 13.0trn, comes from overseas, while EM corporates obtain 75% of their funding from local sources. The correlation between yields in EM local bond markets and 5-year US Treasury bonds is very low at just 0.4 (based on monthly data from 1994 to today).

EM countries rely more and more on local funding sources, whose yields are not highly correlated with US interest rates

Fig 2: **EM fixed income by currency**

Region	USD trn	Share (%)
Total EM fixed income	**29.6**	**100%**
Local currency	*24.2*	*82%*
Foreign currency	*5.5*	*18%*
Sovereign bonds	**13.0**	**100%**
Local currency	*11.6*	*89%*
Foreign currency	*1.4*	*11%*
Corporate bonds	**16.6**	**100%**
Local currency	*12.5*	*75%*
Foreign currency	*4.1*	*25%*

Source: Ashmore, BIS. Data as at end 2019.

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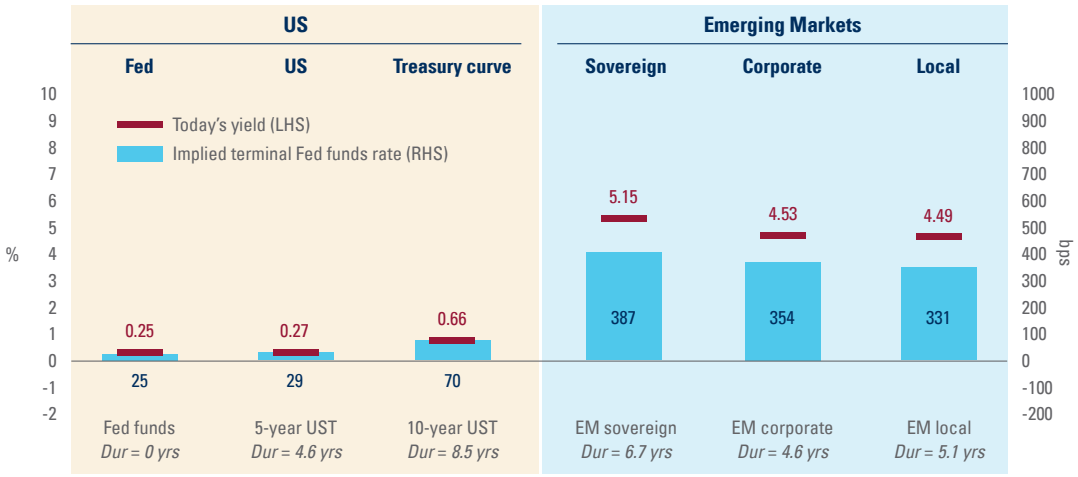
How have DM macroeconomic policies impacted EM?

Macroeconomic policies in DMs have contributed to an extreme divergence in valuations between EM and DM bond markets

Despite the absence of evidence of conventional 'crowding out' via the conventional interest rate channel, there is no disputing the fact that macroeconomic policies in DMs – and notably QE – have had a profound impact on EM. This is most obviously manifested in the extreme divergence, which currently exists in valuations across EM and DM bond markets and Figure 3 illustrates this point. The chart shows yields in the US bond market as well as yields in EM's external sovereign, external corporate, and local currency bond markets. The grey bars show where the Fed funds rate has historically been, given the current level of yields. Hence, while bond yields in DMs appear to be fairly consistent with the Fed's ultra-dovish stance of not raising interest rates until after 2023, EM bonds are trading at yields, which are consistent with a far higher Fed funds rate (well above 300bps for the three categories of EM fixed income).[3] Why are EM bond yields so high, when the cost of international funding is near all-time lows?

Fig 3: **Divergence of yields with respect to Fed funds rate**



Source: Ashmore, Bloomberg. Data as at 24 September 2020.

The great divergence between EM and DM bond yields is the opposite of conventional 'crowding out'. EM yields are higher than they ought to be *in spite of* record low yields in DM. This implies that something has caused investors to off-load EM debt and the reason is clearly not higher interest rates in DMs.

QE policies are a subsidy of interest rates that have guaranteed a steady decline in the cost of funding and created strong incentives for investors to allocate to DMs in preference to EMs

The higher than normal EM bond yields are evidence of a *volume effect*, that is, large redemptions from the asset class in the period between 2011 and 2015 followed by sustained under-allocations to the asset class in the period up to now. For example, we estimate that US pension funds only have 2% exposure to EM fixed income compared to 6% pre-2008/2009.

This volume effect is closely linked to QE policies. QE policies act as a *de facto* subsidy of interest rates in DMs. The subsidies guarantee a steady decline in the cost of capital in DMs, which in turn create strong incentives for institutional investors to allocate to those markets in preference to non-subsidised markets. After all, the steady decline in interest rates under QE gives rise to massive capital gains against which the mere yield available in EM fixed income can simply not compete.

Unfortunately, as always happens when governments interfere in free markets, the result is distortions and inefficiencies. The impact of interest subsidies in DMs has been to grossly misallocate capital on a global scale with profoundly negative consequences for returns, efficiency, economic growth, equality within and between countries, even to the point where economic and financial stability are now at risk.

In EM, capital flight in recent years has worsened what was already a severely skewed distribution of global finance. Outflows have tightening financial conditions in EM further, thus pushing EM growth rates much lower than they were in the pre-2008/2009 era. Lower commodity prices due to slower global growth rates have further contributed to the dearth of finance in EM. Figure 4 shows just how skewed the distribution of global capital is today. Mirroring the rise in income inequality within DMs in recent years, global finance is now overwhelmingly concentrated within DMs, which currently absorbs 3.6 times more finance than their annual GDP. In contrast, EM countries on average control finance equivalent to just 0.9 times their GDP. The worst hit EM countries happen to be poorest; African countries command finance equivalent to just 0.3 times their annual GDP.

[3] Based on the historical relationship between bond yields and the terminal fed funds rate.

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Fig 4: **The skewed distribution of global capital**

Region	Share of global markets		Share of GDP (PPP-adjusted)	Ratio: Financial markets vs GDP
	Stock	Bonds		
Developed Markets	**69%**	**77%**	**40%**	**3.6**
Emerging Markets	**31%**	**23%**	**60%**	**0.9**
of which Africa	*1%*	*1%*	*5%*	*0.3*

Source: Ashmore, SIFMA, BIS, MSCI, Bloomberg, IMF. Data as at end 2019.

The impact of current policies on economic performance in DM

The ongoing re-allocation of capital from EM to DM will not continue, because it is unsustainable

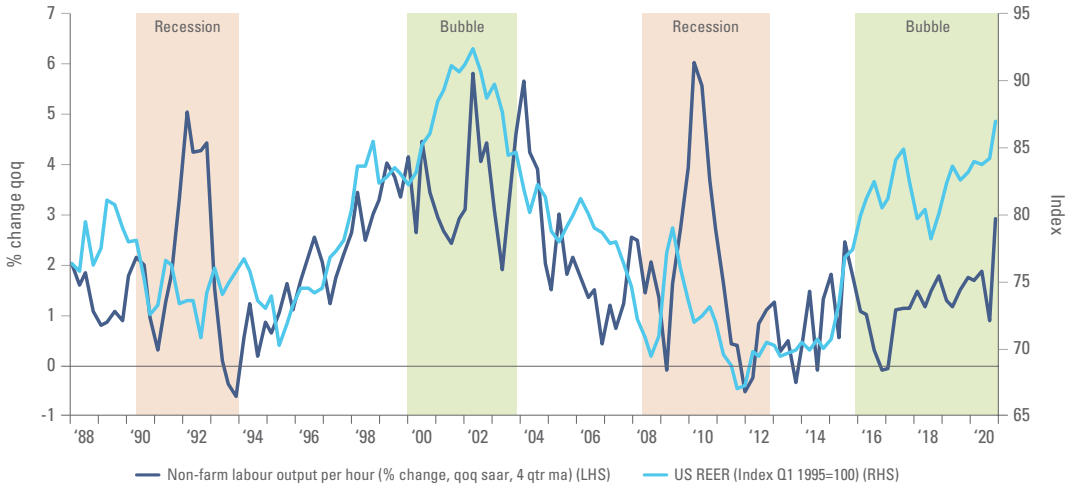
The re-allocation of capital from EM to DM will not continue, because it is unsustainable. As more and more capital flows into DMs, valuations eventually reach a point where the scope for additional capital gain approaches nil, while yields are pushed into non-existence. By contrast, the flight of capital in EMs slowly pushes bond yields above the level justified by actual riskiness and in doing so also raises the potential for capital gain. It is worth remembering that these are just competing markets, so they will turn when the imbalances in positioning and valuations become sufficiently extreme. In fact, global bond markets already turned once after the Fed began to hike rates in December 2015. Prior to December 2015, EM fixed income markets suffered serious losses and massive outflows. Since the start of 2016, however, EM fixed income markets have generally outperformed DM bond markets. There are likely to be further turning points to come, because the largest distortions in global capital markets have not yet gone into reverse. US markets look particularly pregnant from a technical and valuation perspective, in our view.

The trigger for the next turning point in global bond markets looks increasingly likely to be a fundamental event, probably emanating from within the US

The trigger for the next turning point in global bond markets looks increasingly likely to be a fundamental event, probably emanating from within the US. While the Fed is still able to squeeze a bit of juice from its stimulus efforts, this is clearly proving ever more challenging. Meanwhile, drowning in capital, US markets look more and more ridiculous in terms of valuations, especially in the context of weakening economic performance. Inflows no longer help as the marginal unit of capital flowing into US markets has long since lost its ability to boost US growth.

The excessive allocation of capital to the US market is a classic macroeconomic problem. Inflows have pushed the Dollar far higher than justified by US productivity growth as shown in Figure 5. Notice how the current situation is eerily similar to that which prevailed during the last major US financial market bubble, namely the Tech Bubble around the turn of the century. At that time, the Dollar was also pushed far higher than warranted by productivity growth due to foreign investors chasing overvalued dotcom assets within the US. It is quite possible that productivity will rise to provide support for the Dollar, but as Figure 5 also shows only a sustained rise in productivity growth, such as that which occurred in the 1990s, can provide anything other than short-term support for the Dollar. The violent but short-lived productivity spikes that tend to occur around recessions notably do not provide sustained Dollar support. In fact, the Dollar has tended to fall in US recessions for the obvious reason that there are better places in the world to invest at such times.

Fig 5: **US productivity growth and the real Dollar**



Source: Ashmore, Bloomberg. Data as at 24 September 2020.

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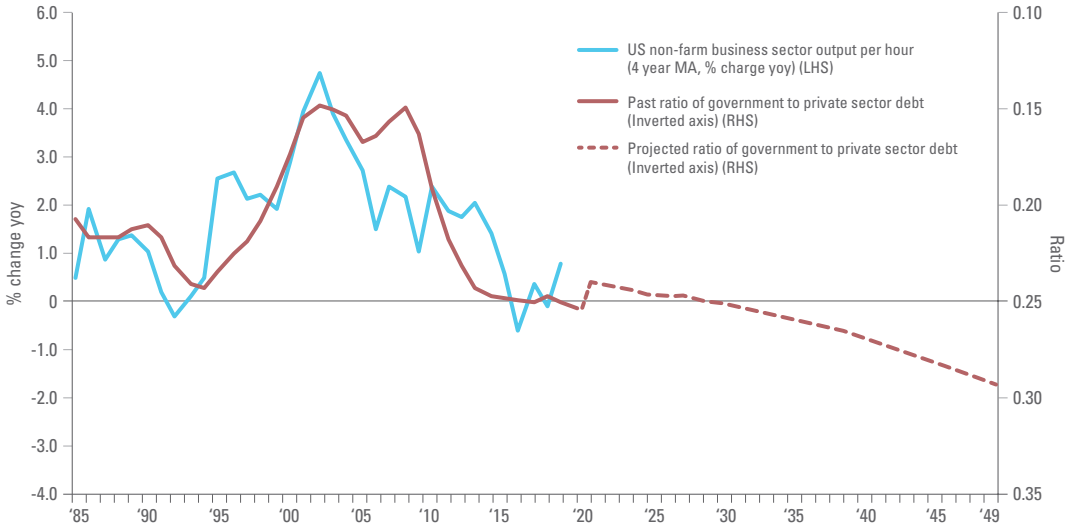
Given the profound impact of the 'volume effect' of QE on global asset allocation, the most important question in global finance today is this: does the Dollar decline to a level consistent with low trend productivity growth, or does the US experience a productivity miracle, which allows the Dollar to keep its value or even rise further? The Dollar will have to fall to restore macroeconomic equilibrium in the US if productivity declines from here, but if productivity growth is high and sustained from here there is no reason why the US could not absorb yet more inflows and see the Dollar rise even further.

A lower Dollar

By far the most likely outcome is that the Dollar will have to fall to restore macroeconomic equilibrium in the US. The reason is fiscal policy. There is a very close relationship between US productivity growth and the size of the government's footprint in debt markets. As Figure 6 shows a rising share of US government debt in total US credit – denoted as a decline in the red line in the chart – is associated with declining productivity growth.

There is a very close relationship between US productivity growth and the size of the government's footprint in debt markets

Fig 6: **The link between US productivity growth and the government 'footprint'**



Source: Ashmore, US Treasury, Bloomberg. Annual data – 2019 is last data point.

It is tempting to attribute this negative relationship between the government footprint and productivity to a conventional 'crowding out' mechanism via higher US government bond yields, but this explanation makes no sense in QE world with record low yields. In reality, the mechanism is far simpler. US government spending is simply far less productive than US private sector spending, so when the government issues more debt and thereby usurps capital that could otherwise be invested more productivity in the private sector, it lowers the average productivity of the US economy as a whole. The reason why the 1990s was associated with a sustained rise in productivity growth was because the US government significantly reduced its financial footprint, thus leaving more capital to be invested in the private sector. The reason why productivity growth has subsequently slumped is that three consecutive US Administrations (George W. Bush, Barack Obama, and Donald Trump) have massively increased the government footprint through debt issuance.

Higher fiscal deficits in the coming years are likely to undermine productivity growth on a sustained basis – and push down the Dollar

What does the relationship between the government footprint and productivity growth imply for productivity growth going forward? The dotted line in Figure 6 shows the Congressional Budget Office's (CBO) forecast for the US government's footprint going forward, based on a regression of the CBO's projections for US government debt on the past relationship between government debt and private sector debt. Higher fiscal deficits in the coming years are likely to undermine productivity growth on a sustained basis. Hence, linking back to Figure 5, it seems very likely indeed that productivity growth will not picked up to stand in the way of a significant lower adjustment in the value of the Dollar in the coming years.

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Implications for investors going forward

EM fixed income may deliver between 8 and 32 times higher return than US government bond markets in the coming five years

What do these macroeconomic considerations imply from an investment perspective? Abstracting for a moment from FX the big yield differentials in EM and DM bond markets as a result of QE 'volume effects' imply sharply contrasting return profiles over time. Suppose, for example, that investors continue to be fearful of coronavirus and economic and political uncertainties in the years ahead. If so, it seems reasonable to assume that EM bond yields will not fall from current levels, nor will DM bond yields rise. Constant yields would mean that investors in EM external debt earn 28% in Dollar terms over the next five years compared to a compounded return of just 3.5% for holders of US 10-year government bonds. If, for the reasons outlined above, one introduces a decline in the Dollar of 20% versus EM currencies then EM local currency bonds should return about 44% in Dollar terms over five years compared to a compounded total nominal return of just 1.4% for US 5-year government bonds. In other words, EM fixed income will deliver between 8 and 32 times higher return than US government bond markets.

Conclusion

There is no evidence that conventional 'crowding out' arising from *rising* US Treasury yields has impacted EM bond markets negatively, despite record high levels of debt issuance in the US and other DM countries. In fact, yields in DMs are near record lows, while EM countries are increasingly dependent on funding in local markets, where yields are not highly correlated with US interest rates.

Rather, something akin to the opposite of 'crowding out' has occurred, since *falling* US interest rates has been associated with outflows from EM bond market. QE policies have interfered with market interest rates and introduced strong incentives to allocate to DMs over EMs. This has resulted in massive distortions in global asset allocation. Far too much money is now invested in DMs, while EM countries have had to adjust to increasing capital scarcity in recent years.

One of the consequences of the distortions in global asset allocation caused by QE interest rate subsidies is that the Dollar has become too strong. Another consequence is that the US government is borrowing too much, which is weighing on US productivity growth. A macroeconomic disequilibrium now exists, which will only be resolved through a productivity miracle, or a much lower Dollar. Given the fiscal outlook in the US, a lower Dollar seems the more likely outcome.

A lower Dollar would help to restore a more rational balance in global asset allocation. While the prospect of reducing exposure to US markets in favour of EM may scare some investors, it will be good for the global economy, returns, and financial stability. Since marginal unit of capital in the US no longer creates any growth, it can leave without causing much damage. On the other hand, the same marginal unit of capital will significantly relieve binding finance constraints if it flows to EM. A more efficient asset allocation will therefore be positive for global growth. Investors will also be rewarded for making the shift, because EM bond markets will, at current relative yields, deliver between 8 and 32 times greater returns than US government bonds over the next five years, in our humble opinion.

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