Ashmore

The EM fixed income universe

By Jan Dehn

This is the 5th annual review of the EM fixed income asset class. The analysis covers all the EM countries whose banks and governments submit data to the Bank of International Settlements (BIS), making this one of the most comprehensive surveys of EM fixed income so far.

We estimate that the EM debt securities universe has reached USD 18.5trn as of the end of 2015 and that total financing in EM is now close to USD 48trn. Still, this means that EM entities only account for about 20% of total global financing at a time when EM economies make up nearly 60% of global GDP. The fact that EM issuers are finance constrained, however, ensures that leverage ratios remain sensible and reduces the risk of bubbles.

Today, EM fixed income offers a vastly superior alternative to negative yielding developed market bonds.

Introduction

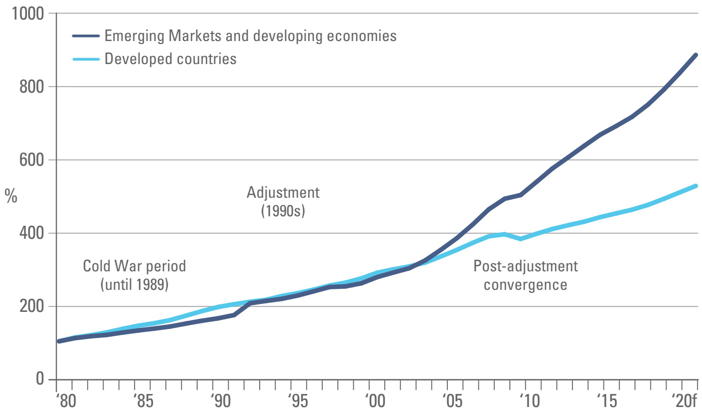
The universe of Emerging Markets (EM) fixed income issuers encapsulates a large and diverse group of countries that collectively find themselves on a journey from lower to higher per capita GDP and towards deeper and broader capital markets. EM fixed income securities now constitute a universe of USD 18.5trn. Even so, EM economies are far less indebted than most developed economies. EM local bond markets are by far the greater part of EM fixed income, while corporate bonds now make up nearly 60% of the total. Index representation of the asset class remains as woeful as ever. The pace of growth of the EM asset class has slowed since the onset of QE, particularly among financials. On the other hand, non-financial corporate bond markets have grown in response to the disintermediation of banks. The number of issuers has also risen; there are now three times as many as in 2000. This growing diversification, together with higher yields, better fundamentals and strong technicals makes EM fixed income an ideal destination for investment at a time when most developed market bonds pay negative yields.

What is EM?

At least 165 countries can be considered EM or EM-like. The classic distinguishing features of this diverse group of countries are that they are on a journey from lower to higher stages of (a) economic development and (b) financial breadth and depth. Low per capita GDP is therefore a key characteristic that defines EM countries and one that also links directly into standard economic growth theory. Countries with lower per capita GDP, according to economic theory, should grow faster than countries with higher per capita, policies permitting ('conditional convergence'). The evidence in favour of economic convergence is very strong in post-Cold War period – as figure 1 illustrates.

The pace of growth of the EM asset class has slowed since the onset of QE, particularly among financials. On the other hand, non-financial corporate bond markets have grown in response to the disintermediation of banks. The number of issuers has also risen; there are now three times as many as in 2000

Fig 1: **Convergence (per capita GDP, index 1980=100)**



Source: Ashmore, IMF.

Growth in per capita GDP tends to be loosely related to financial developments, including the emergence of domestic savings institutions and markets of growing complexity and financial instruments. Even so, financial and economic developments are conceptually distinct. For example, many Middle East countries have high levels of per capita GDP but shallow financial markets that behave in a distinctly 'EM like' manner.[1]

[1] For example, they are often more volatile than what is justified by fundamentals and they have not achieved the same level of penetration among institutional investors as so-called developed markets.

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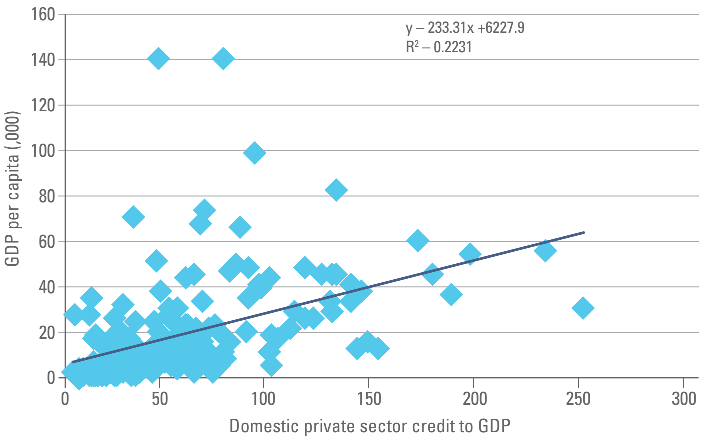
The statistical relationship between per capita income and financial market depth is therefore quite weak as figure 2 shows. The reason is that evolution of the financial system is affected by many factors other than basic economic fundamentals.

Fig 2: **Growth and financial market debt – weak correlation**



Source: Ashmore, Bloomberg, World Bank.

Dynamism

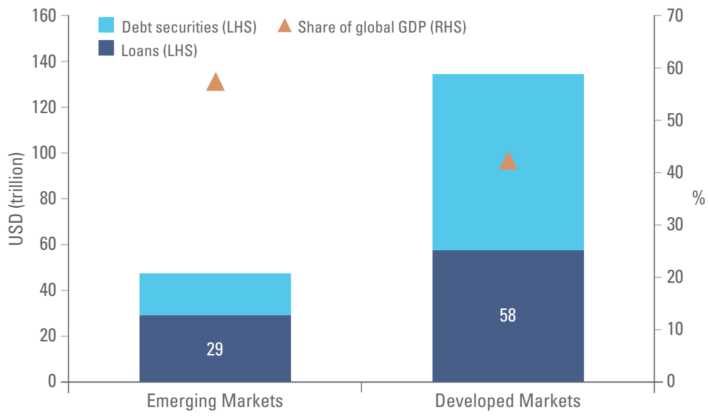
It actually makes more sense to think of EM countries in dynamic terms than in static terms – that is, in terms of their greater potential to grow and to deepen and broaden their markets.

For example, EM countries undergo frequent and often quite significant structural leaps forward. The bulk of such advances are 'natural' occurrences that form part of the broader process of development. There is an abundance of examples. An entrepreneur starts a brand new industry from scratch. A technology is adopted for the first time. A bank launches a brand new savings product. A yield curve appears. A corporate or a sovereign enters global capital markets for the first time. Workers migrate from the informal to the formal sector. Tax systems are introduced. Girls receive education. Women enter the work force. Children are inoculated, etc. So many things happen only once. Sometimes the leaps forward can be huge as EM countries adopt the latest technologies, skipping entire stages of development, fixed line telephony being perhaps the best know example. Quite aside from which many EM countries show a far greater proclivity to engage in conventional reforms, if only because they are rarely given the benefit of the doubt by markets.

Finance constrained

Like their economies, EM's financial markets tend to grow mainly for natural reasons rather than due to speculation, leverage, pushing the boundaries of complexity, etc. EM markets tend to be rudimentary, less liquid, shorter duration, with poorer index representation and less research coverage and weaker ratings agency penetration. Financial sector development in EM has generally lagged GDP growth, so most EM countries find themselves quite severely finance constrained. EM only commands about 20% of global finance even though EM countries make up nearly 60% of global GDP. The opposite characterises developed markets and may help to explain why most bubbles occur in high income economies.

Fig 3: **Financial markets and share of global GDP: DM vs EM**



Source: Ashmore, BAML, IMF.

Size and composition

Fixed income means different things to different people, but for purposes of this report, fixed income is defined as debt securities issued in both local and external markets by governments, non-financial corporates and financial corporates. Based on this definition, the total EM fixed income universe is USD 18.5trn (as of the end of 2015). Figure 4 breaks down the EM fixed income universe into its constituent parts. Corporate bonds make up 58% (USD 10.7trn) of which financial corporates account for USD 6.6trn and non-financial corporates USD 4.1trn. The balance of USD 7.8trn (42%) is issued by governments. We estimate that developed economies have issued USD 78trn of bonds, so EM bonds make up 19% of global debt securities.

Fig 4: **EM debt securities – size and composition of universe**

USD trn	2000	2005	2010	2015	% of total
Total tradable debt	1.7	5.4	12.0	18.5	100%
Local (total)	*0.8*	*4.0*	*9.5*	*15.0*	*81%*
External (total)	*0.8*	*1.4*	*2.5*	*3.5*	*19%*
Government	1.0	2.7	5.5	7.8	42%
Local government	*0.6*	*2.3*	*4.9*	*7.0*	*38%*
External government	*0.4*	*0.5*	*0.6*	*0.8*	*5%*
Corporate	0.7	2.6	6.5	10.7	58%
Local	***0.2***	***1.7***	***4.6***	***8.0***	***43%***
Local financial corporate	*0.1*	*1.2*	*3.2*	*4.6*	*25%*
Local non-financial corporate	*0.1*	*0.5*	*1.5*	*3.4*	*18%*
External	***0.5***	***0.9***	***1.9***	***2.6***	***14%***
External financial corporate	*0.4*	*0.7*	*1.5*	*2.0*	*11%*
External non-financial corporate	*0.1*	*0.2*	*0.3*	*0.6*	*3%*

Source: Ashmore, BIS.

[2] 2015 is the last year with full data. The data is from BIS. The BIS data includes debt securities issued by all the countries whose banks and governments report to BIS as well as debt securities issued by EM entities in offshore destinations such as Cayman Islands, Netherlands, Luxembourg and Ireland. The BIS data set covers governments and banks in 103 EM countries and 29 developed countries.

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Local bond markets dominate the EM fixed income landscape. More than 80% of EM fixed income is local (USD 15trn) and only USD 3.5trn has been issued in overseas markets.[3] Nearly 90% of all government bonds in EM are now issued in local markets (USD 7.0trn), which means that the external sovereign debt universe is only 5% of total EM fixed income (USD 0.8trn). In the corporate space, roughly three quarters of all outstanding debt is in local markets (USD 8.0trn) with the balance of USD 2.6trn issued externally.

Regionally, the EM fixed income markets are dominated by Asian issuers. Asian governments and corporate entities have jointly issued 65% of all EM fixed income. This compares to 20% from Latin American and the Caribbean issuers, 9% from Eastern European & the former Soviet Union issuers and 6% from the Middle East and Africa.

Local issuance is particularly pronounced among Asian issuers (more than 90% of the total outstanding is local). Local issuance nevertheless also makes up sizeable shares in other regions, including 70% of Latin American and Caribbean issuance, 48% in Eastern Europe and the former Soviet Union and 41% in the Middle East and Africa (see box opposite).

In addition to being predominantly local, Asian bond markets are also predominantly corporate. Corporate bonds make up 62% of all Asian debt securities. This compares to 48% in both Latin America and the Caribbean and in Eastern Europe and the former Soviet Union. The corporate debt share is surprisingly high in the Middle East & Africa (58%), but this reflects a large number of state-owned enterprises that issue debt; these securities are best thought of as quasi-sovereign issuers rather than pure private sector companies.

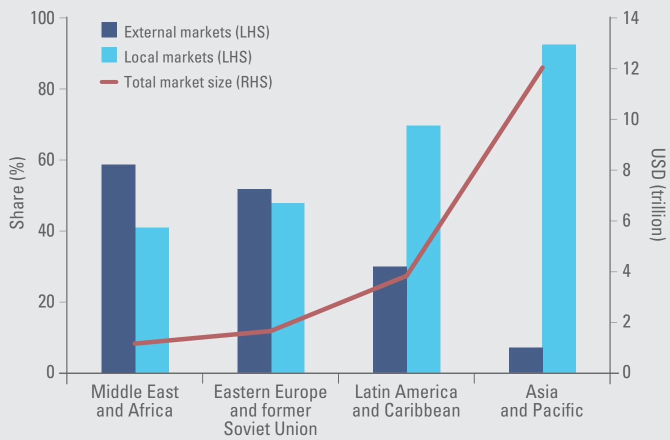
Local currency and market size

The greater importance of local currency in Asia illustrates one of the basic 'laws' of capital market development: the importance of local markets increases roughly in proportion with the level of market development. Figure 5 shows this relationship clearly.

Why do local markets become more important as markets get larger?

The answer is that domestic savings institutions have not yet evolved sufficiently to support local debt markets in EM countries at early stages of financial development. Such countries therefore tend to rely more on external markets. As local savings institutions evolve, however, local markets become progressively more important and external debt markets decline as a share of overall financing. Interestingly, this suggests that external debt becomes progressively safer as local markets expand. After all, the potential gain to any issuer of defaulting on external debt – in terms of overall debt service relief – is smaller the larger the domestic market share.

Fig 5: **Local versus external markets – by region**



Source: Ashmore, BIS.

EM debt securities in broader context

Debt securities are just one part of a broader financing universe, which also includes loans to non-financial corporates and bank credit to households. We estimate that the total global financing universe on this definition reached USD 183trn as of the end of 2015. EM entities account for just one quarter of this total (USD 47.6trn).

The difference in indebtedness becomes particularly meaningful in the context of GDP. The average indebtedness worldwide is 250% of GDP, but the indebtedness of EM economies is meaningfully lower at 165% of GDP compared to developed economies (305% of GDP). Using PPP-adjusted measures of GDP, EM economies are only indebted to the tune of 73% of GDP compared to 281% of GDP for developed economies (figure 7 overleaf). Another difference is that EM countries generally rely less on bond markets than credit and loan markets compared to developed economies. Some 61% of total EM financing comes from loan and credit markets (USD 29.1trn) compared to 43% in developed economies.

We estimate that the total global financing universe on this definition reached USD 183trn as of the end of 2015. EM entities account for just one quarter of this total (USD 47.6trn)

Fig 6: **EM total financing – the global context**

	USD trn	% of GDP	% of PPP adjusted GDP
Global Finance	**183.0**	**250%**	**161%**
Global loans & credit	86.8	119%	76%
Global debt Securities	96.2	131%	85%
Emerging markets	**47.6**	**165%**	**73%**
Loans & credit	29.1	101%	44%
Debt securities	18.5	64%	28%
Government	*7.8*	*27%*	*12%*
Financial	*6.6*	*23%*	*10%*
Corporate	*4.1*	*14%*	*6%*
Developed markets	**135.4**	**305%**	**281%**
Loans & credit	57.8	130%	120%
Debt securities	77.7	175%	161%
Government	*37.5*	*85%*	*78%*
Financial	*31.4*	*71%*	*65%*
Corporate	*8.7*	*20%*	*18%*

Source: Ashmore, BIS.

[3] The vast majority of local markets issuance is in local currency.

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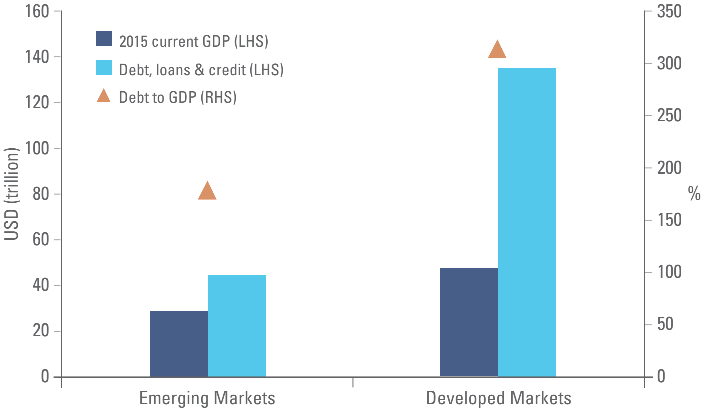
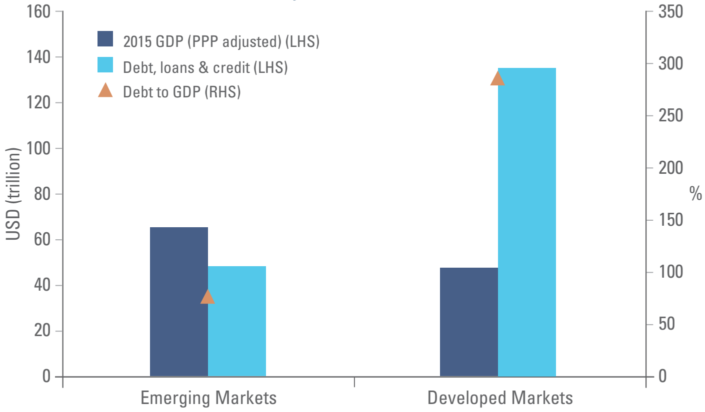
Fig 7: **Indebtedness versus GDP – EM versus DM**



Source: Ashmore, BIS, IMF.



Source: Ashmore, BIS, IMF.

Index representation

It is customary to think that benchmark indices provide a reasonable approximation of market, but this is not the case in EM, where fixed income benchmark indices are generally poor representations of the asset class (see figure 8 below). Only 8% of EM bonds are represented in the most widely used benchmark indices. The most representative indices are those that cover the external debt universe – roughly half of the bonds are captured in the JP Morgan EMBI GD benchmark, for example. Index coverage then declines sharply for corporate debt (14%), while local markets are particularly badly represented (9% and 2% for government and corporate bonds, respectively).

Local markets are so poorly represented in the benchmark indices due to a classic market failure. Index providing banks only have incentives to include the markets in which they actively trade. Based mainly in the US and Europe, they only have major business operations in the largest EM economies, which is why these are the countries in the indices. Of course, the banks also cover EM securities issued under English or New York Law in offshore markets. This is why sovereign Dollar-denominated government bonds are so much better represented in indices than local securities.[4] There exists, in our view, a strong argument for public provision of EM local currency government and corporate bond benchmark indices, for example by one of the international public sector financial institutions.[5]

Fig 8: **EM fixed income benchmark indices**

				As at end 2015					
Asset class	**Index name**	**Index acronym**	**Index provider**	**Number of countries**	**Number of issuers**	**Number of issues**	**Index market cap (USD bn)**	**Asset class (USD bn)**	**Index as % of asset class**
External sovereign debt	EMBI Global Diversified	EMBI GD	JP Morgan	65	133	506	397	835	**48%**
External corporate debt	CEMBI Broad Diversified	CEMBI BD	JP Morgan	51	558	1,190	376	2,627	**14%**
Local currency government debt	GBI EM Global Diversified	GBI EM GD	JP Morgan	15	15	188	599	7,003	**9%**
Local currency corporate debt	Local EM non-sovereign	LOCL	BAML	13	206	406	122	8,043	**2%**
All EM fixed income	–	–	–	–	–	–	**1,494**	18,507	**8%**

Source: Ashmore, BAML, JP Morgan.

Recent trends

The EM fixed income universe is far from stagnant. Two pronounced trends have characterised these markets in the past five years. One is that markets have generally grown more slowly in recent years. As figure 9 (overleaf) shows, the average annual rate of growth of outstanding EM fixed income has almost halved to just 10% per annum between 2011 and 2015 compared to 18% in the preceding five-year period from 2006 to 2010. The second trend is that the biggest slowdowns have taken place among financial issuers. Here, the annual rate of growth has declined from 21% per annum to just 8% per annum over the two periods. This, by the way, means that issuance of bonds by EM financials is now expanding at a slower pace than nominal GDP growth.

In our view, these two trends reflect the onset of QE policies by central banks in developed economies and the effects of regulatory pressures, also in developed economies. QE has acted as a giant magnet that has sucked capital out of EM, while regulation has made it far more expensive for banks in developed economies to lend to EM entities. The silver-lining is that disintermediation of international banks has made room for the corporate bond markets in EM to flourish. In constant Dollar terms, local currency corporate bond markets have actually grown 16% in the latest five year period and in general corporate bond markets have held up far better in growth terms than both government and financial bond markets.

[4] A large section of external debt is nevertheless excluded, including bonds of smaller than minimum-size (usually USD 500m), non-Dollar securities, bonds with greater complexity and bonds with less than one year to maturity.
[5] *"Are Emerging Markets bond indices public goods?"*, The Emerging View, 21 May 2014.

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A few other recent trends are worth highlighting:

- Local market issuance has held up better than external issuance after controlling for currency moves.
  Even so, in constant Dollar terms, local issuance growth has still slowed by 12%.
- Asian bond market growth has been far less impacted by global headwinds than other regions.
  The pace of issuance is only down 13% compared to 79% in Middle East & Africa, 87% in Latin America and 91% in Eastern Europe & the former Soviet Union (the latter has also been impacted by issuance-related sanctions on Russian issuers following the Crimea conflict).
- Sovereign Dollar issuance has gone up.
  Government external debt is the only part of the EM debt universe that has seen an increase in absolute issuance in current Dollar terms in the past five years (+3%).

The number of sovereign debt issuers in EM has grown from 44 to 66 countries in the last five years and since 2000 the number of issuers has tripled

Fig 9: **Recent trends in EM debt securities**

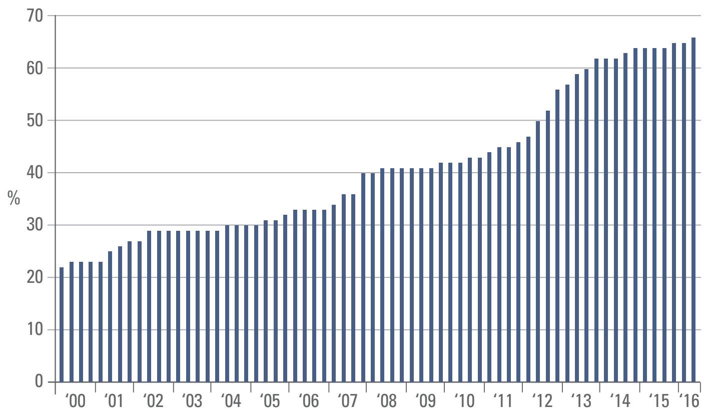
% change, yoy	2001 – 2005	2006 – 2010	2011 – 2015	% change '11 – '15 vs. '06 – '10	% change net of USD
Emerging Markets	**30%**	**18%**	**10%**	**-47%**	–
Government	*30%*	*16%*	*9%*	*-47%*	–
Financial	*35%*	*21%*	*8%*	*-64%*	–
Non-financial corporate	*83%*	*22%*	*18%*	*-18%*	–
Local	**54%**	**20%**	**10%**	**-48%**	**-12%**
Government	*48%*	*18%*	*9%*	*-50%*	*-14%*
Financial corporate	*84%*	*23%*	*8%*	*-63%*	*-27%*
Non-financial corporate	*500%*	*24%*	*19%*	*-20%*	*16%*
External	**10%**	**14%**	**7%**	**-48%**	–
Government	*5%*	*7%*	*7%*	*3%*	–
Financial corporate	*16%*	*18%*	*6%*	*-67%*	–
Non-financial corporate	*6%*	*16%*	*13%*	*-16%*	–
Regions					
Latin America and Caribbean	*68%*	*22%*	*3%*	*-87%*	–
Middle East and Africa	*10%*	*12%*	*3%*	*-79%*	–
Eastern Europe & former Soviet Un.	*128%*	*20%*	*2%*	*-91%*	–
Asia and Pacific	*50%*	*18%*	*16%*	*-13%*	–

Source: Ashmore, BIS.

Diversification

While some EM governments have become more indebted, the growth of EM's fixed income markets is not principally due to greater indebtedness. Instead, the asset class has become dramatically broader. For example, the number of sovereign debt issuers in EM has grown from 44 to 66 countries in the last five years and since 2000 the number of issuers has tripled (see chart below). We expect this trend to continue given that not even half of EM countries have yet entered global capital markets. The resulting greater diversification within the asset class makes indices far more stable, a fact that we do not think has been adequately priced in.[6]

Fig 10: **Sovereign Dollar debt index names**



Source: Ashmore, JP Morgan.

Common misperceptions about EM

- Risky versus risk-free: Financial markets stubbornly cling on to an outdated binary distinction between 'risky' EM countries and 'risk free' developed economies. The EM universe is today too nuanced and changeable to fit into one simple risk bucket and it is plain nonsense to say that developed markets are risk free.
- Acronyms: The endemic (and annoying) use of fancy acronyms in EM, such as 'Fragile Five', BRICs, MINT, and N11 should be avoided. Some acronyms simplify unnecessarily and tend to be motivated by sales, not serious investment considerations.
- Ratings: Investors still often associate low ratings with 'EM-ness'. This is inappropriate, because it confuses credit quality with the state of development. Rich countries can be irresponsible borrowers, while poor countries can be highly prudent.
- Benchmark-based definitions: EM is not defined by its benchmark indices. Most index providers include a raft of subjective eligibility criteria in order to limit membership to countries and corporates with which they wish to trade.
- Regional biases: EM-based investors often exhibit strong regional biases. Asian, Latin American and Middle Eastern investors are typically sanguine about taking exposure in their own regions, but view with horror the prospect of investing in other EM regions.

[6] For more information on the implications of greater index diversification see *"Free Money: Arbitrage opportunities in EM external debt"*, Market Commentary, June 2016.

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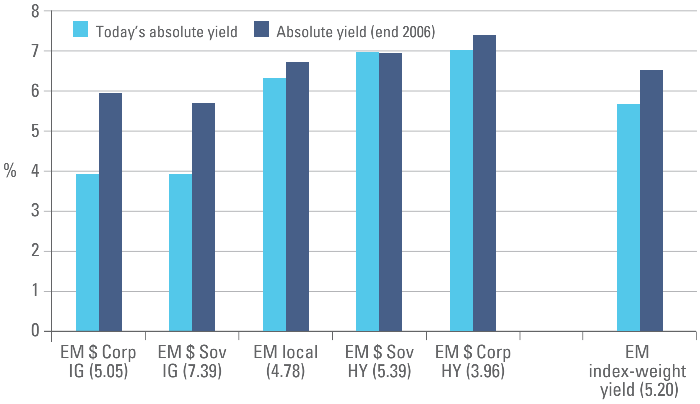
Valuations

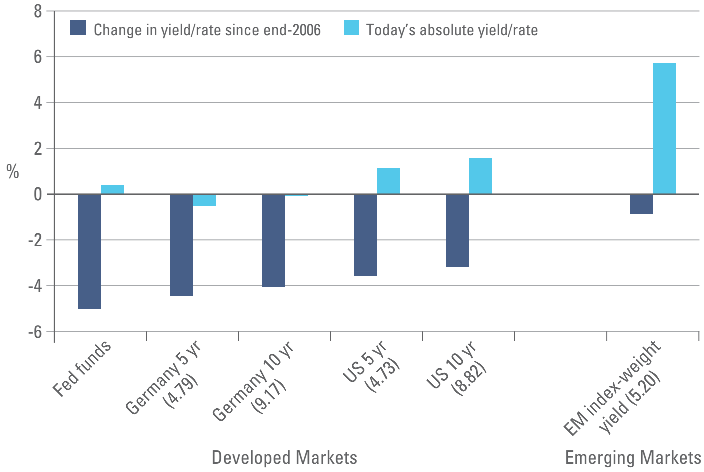
The average index weighted yield on EM fixed income is just a few basis points lower than at the end of 2006, when the US Federal Funds Rate was 5.375%. It is quite remarkable to think that bonds issued by more than half of the world's economies still offer yields at these levels at a time when investors are panicking over negative yields in most developed bond markets. Only in the EM investment grade universe have yields declined materially, but given EM IG's lower volatility and higher yields compared to developed market bonds EM IG bonds are still vastly preferable.[7]

Fig 11: **Absolute EM FI yields, by theme**



Source: Ashmore, JP Morgan.
Numbers in brackets denote duration in years.

Fig 12: **EM vs DM yields (and change vs 2006)**



Source: Ashmore, JP Morgan. Numbers in brackets denote duration in years.

Conclusion

EM fixed income takes exposure to fast growing and evolving economies. As such EM bonds ought to be a large core holding in any long-term investment portfolio. The fact that EM fixed income is still not a large part of such portfolios speaks far more about the incentive problems in global financial markets than about the value proposition posed by EM fixed income.

The EM fixed income investment universe will continue to expand rapidly. If the EM universe of debt securities continues to grow at the same pace as over the past five years we estimate that it will reach just short of USD 30trn by the end of 2020. In other words, it will be 156% larger than today. In addition, the asset class will be far more diversified than today as the number of issuers continues to increase from still low levels.

Structural trends aside, the case for allocating to EM has not been this strong for many years. The EM growth premium is picking up, EM bond yields are far more attractive than yields in developed fixed income markets and technicals are extremely strong after years of QE-motivated selling of EM assets.

[7] See *"Switch from Eurozone IG bonds to EM IG EUR-denominated bonds"*, Market Commentary, July 2016 and *"Superior returns and lower risk in EM IG corporate bonds"*, The Emerging View, July 2016.

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