Ashmore

Consultation exercise could lead to important EM index changes

By Jan Dehn

JP Morgan is seeking investor feedback on proposals to include Gulf Cooperation Council (GCC) and Chinese government bonds into the EMBI Global Diversified (GD) and GBI Emerging Markets (EM) GD indices, respectively. The index provider expects to make a decision on these matters by Q3 2018.

Introduction

JP Morgan is the dominant provider of EM fixed income benchmark indices, so any changes could, given the heavy reliance on indices by institutional investors, have a meaningful impact on asset allocation towards and within EM.

This note sets out the nature of the changes proposed by JP Morgan and Ashmore's perspective. In general, we welcome the proposals, which would confer material diversification benefits to both benchmark indices.

Changes to the index eligibility criteria will be required in order to facilitate the inclusion of GCC countries, which are too rich to qualify for index inclusion under the current rules. The net effect of the new rules will be to raise the hurdle for EM countries to graduate out of the asset class. This should entail greater diversification and higher credit quality within the asset class, all else being even.

Despite the welcome improvements put forward by JP Morgan, the fact remains that EM fixed income indices are still inadequate, because the most commonly used benchmark indices still cover less than 10% of the EM fixed income universe.

JP Morgan launches index consultation

On 22 June 2018, JP Morgan launched a consultation exercise with a view to gauging investor support for two proposed changes to the investment bank's suite of EM fixed income benchmark indices:

- Including GCC countries in EMBI GD
- Including Chinese local currency government bonds in GBI EM GD

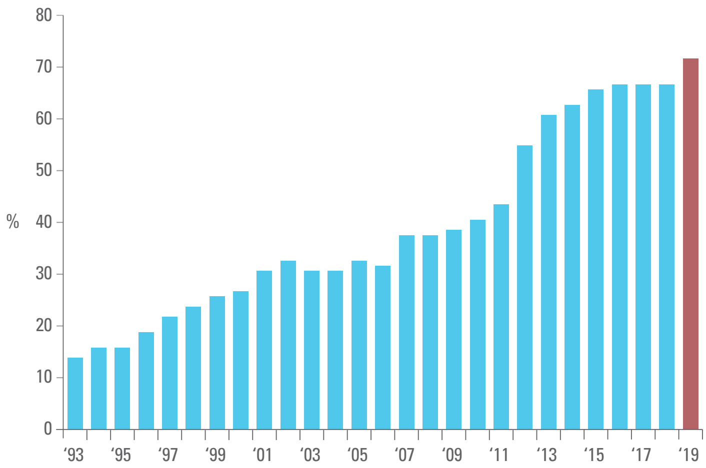
Investors have no direct influence on the final decision. JP Morgan obtains feedback "via solicited and unsolicited client, consultant and other interested party conversations and written communications". The Global Index Research Group Internal Oversights Committee, which exclusively makes all decisions regarding the topics and potential changes, will announce its decision by the middle of Q3 2018, according to the consultation document.

The inclusion of GCC countries in EMBI GD would add some 14% to the index-eligible bond universe and increase the number of index countries to 72

GCC in EMBI GD

Investors should welcome JP Morgan's proposed index change with respect to GCC countries. Their inclusion in the EMBI GD would add roughly 14% to the index-eligible universe of EM Dollar-denominated sovereign debt as well five more countries. The number of sovereigns represented in the EMBI GD would therefore rise to 72 countries compared to just 32 countries in 2006 (Figure 1). Assuming a phase-in period of six months, the weight to GCC would eventually exceed 12% of the index. The resulting sharp increase in diversification of this index will further reduce the index's credit risk and volatility, in our view.[1]

Fig 1: **Number of countries in the JP Morgan EMBI GD**



Source: JP Morgan, Ashmore.

[1] *'Free Money: Arbitrage opportunities in EM external debt'*, Market Commentary, 14 June 2016.

Continued overleaf

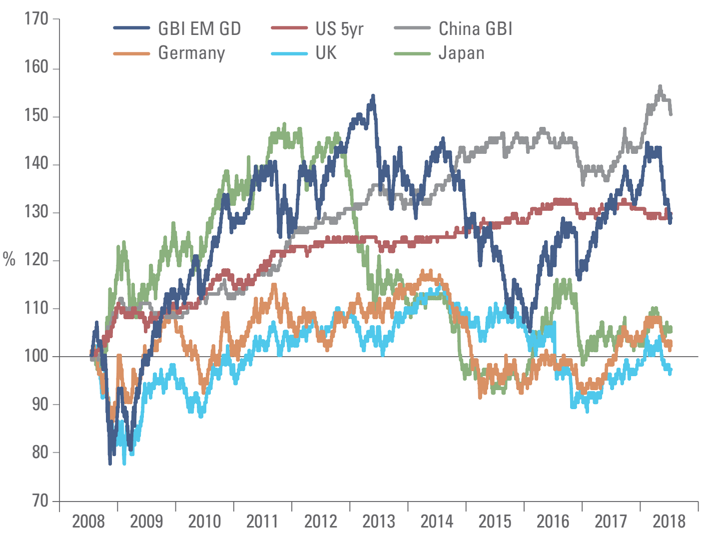
China's inclusion in the GBI EM GD is less certain, but would give EM investors an important hedge during EM bear markets, because Chinese bonds have outperformed US Treasuries in USD-terms during EM risk-off episodes

China in GBI EM GD

The addition of China to the GBI EM GD is less certain due to lingering unresolved issues pertaining to accessibility, but JP Morgan notes that Chinese authorities have made considerable progress in the last couple of years. Besides, Barclays-Bloomberg are forging ahead with index inclusion next year in a business with clear first-mover advantages. Based on on-the-run bonds alone, China's index weight in the GBI EM GD would be 7%, according to JP Morgan, though we would expect this weight to reach the cap of 10% over time ('diversified' indices cap exposure at 10% in order that large markets do not completely dominate the index).

The inclusion of Chinese bonds in the GBI EM GD would confer massive benefits to investors in EM local bond markets, in our view. Chinese government bonds have tended to outperform other EM local bond markets during EM bear markets in particular. In fact, Chinese bonds have even outperformed US Treasuries in USD terms during EM risk-off episodes. Hence, their inclusion in the GBI EM GD could remove the need felt by some investors in EM local markets during pullbacks (especially those without the stomach for temporary bouts of volatility) to redeem from the asset class.[2] This should, in turn, help to stabilise flows into and out of EM local markets as a whole. Chinese bonds have also done well relative to Developed Markets bonds (Figure 2).

Fig 2: **USD returns for various bonds markets (10 years)**



Source: Ashmore, Bloomberg, JP Morgan, Barclays.

Changes to index eligibility rules

The inclusion of wealthy GCC countries in the EMBI GD will require changes to the existing rules governing index eligibility. To fix this problem, JP Morgan is proposing to introduce an additional eligibility criterion, which means that EM countries have to satisfy three criteria before graduating out of the asset class:

- Per capita gross national income must be above USD 18,769 for a minimum three consecutive years (No change)[3]
- The long-term sovereign credit rating must be A-/A3/A- or higher for at least three consecutive years (No change)
- The purchasing power parity (PPP) Ratio must exceed the EM threshold for at least three consecutive years (New)

The PPP Ratio is defined as the ratio of nominal exchange rates to PPP exchange rates. The introduction of this criterion will, in effect, broaden the universe of eligible countries to include high-income countries. EM per capita GDP is higher when measured in PPP terms than with nominal exchange rates, because markets for non-tradable goods and services tend to be larger and cheaper relative to developed countries. JP Morgan's current threshold for the PPP Ratio is 60 for EM countries compared to 96 for developed countries.

Welcome changes to index criteria

Investors should welcome the proposed changes to JP Morgan's index eligibility criteria for three reasons. First, the inclusion of the PPP Ratio criterion means that the indices more closely capture the spirit of economic convergence, which is what 'EM-ness' is all about. Second, inclusion of the GCC countries increases index diversification and broadens the opportunity set. Third, the higher hurdle for graduation from the asset class will raise the average quality of EM credits in the index, all else being even.

There is room for further improvement of indices; in addition to wider coverage the indices should phase out the use of sovereign credit ratings in favour of measures of market depth and breadth

Remaining issues

We strongly welcome the proposed changes to the index graduation rules, but we continue to see room for improvement. In addition to broader coverage, we think the reliance on sovereign credit ratings as an eligibility criterion is inappropriate. Conceptually, ratings measure the quality of government policies, not the level of development. The quality of government policy can be good or bad regardless of the country's level development. In other words, ratings simply do not belong among the criteria for 'EM-ness'. Instead, it would be far more appropriate to employ indicators of the state of development of financial markets, such as the depth and breadth of local bonds markets. JP Morgan is aware of this, but opts to use ratings

[2] See '*How Chinese bonds can enhance your portfolio*', The Emerging View, 16 March 2018.
[3] This threshold is adjusted for inflation every year.

instead, because it has been difficult to find internationally comparable measures of market development. Still, one can hope for progress on this point at some point in the future. For now, the continued use of ratings 'locks' EM countries into 'EM status' for longer, since ratings agencies consistently bias their ratings of EM sovereigns lower than is justified by their fundamentals.

The EM fixed income universe

As of end-2016, the EM fixed income universe was worth over USD 20trn, or roughly 20% of global fixed income (USD 100trn).[4] We estimate that the EM fixed income market expanded about 10% in Dollar terms last year to reach about USD 22trn as of the end of 2017.[5] This total comprises about USD 1trn in sovereign Dollar-denominated debt, USD 2trn in Dollar-denominated corporate bonds and some USD 17trn in local currency denominated securities. The latter roughly divides half-half into government and corporate bonds. Only about 8% of the total EM fixed income universe is currently represented within the main benchmark indices, which are provided by JP Morgan and Bank of America Merrill Lynch.

[4] Based on information compiled from Bank of International Settlements (www.bis.org).

[5] Ashmore aims to publish its annual update of the size and composition of the EM fixed income universe in August 2018. For last year's update, see: *'The EM fixed income universe version 6.0'*, The Emerging View, August 2017.

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