Ashmore

The EM fixed income universe version 7.0

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This is the 7th annual review of the Emerging Markets (EM) fixed income asset class. The EM bond market now measures USD 24trn and accounts for 22% of global fixed income. Almost 90% of EM bonds are denominated in local currency and Asian markets continue to dominate the EM fixed income space. The corporate bond market is bigger than the government bond market.

From the perspective of index representation, external debt remains the most diversified segment of the EM bond market, but EM fixed income as a whole remains extremely under-represented in the main fixed income benchmark indices. Case in point: the single largest EM bond market is China, which accounts for 48% of all EM bonds yet still does not feature in the main EM local currency benchmark index.

The main growth drivers for the asset class are structural and on conservative projections, the asset class should grow to nearly USD 40trn in size over the next five years.

The global bond market

As of the end of 2017, the global bond market reached a size of USD 109.6trn, which is equivalent to 137% of global GDP (Figure 1). The global bond market comprises roughly USD 53trn of government bonds and USD 56trn of corporate bonds. The latter consists of USD 41trn of bonds issued by financial sector corporates and USD 15trn issued by non-financial corporates.

Within this global bond universe, EM bonds make up USD 24.3trn, or 22% of the total. The EM fixed income universe includes USD 11trn of government bonds (47%) and USD 13trn of corporate bonds (53%). The EM corporate bonds universe is divided into USD 8trn of bonds issued by financial corporates and USD 5trn issued by non-financial corporates. Hence, the structure of the EM bond market is broadly similar to that of Developed Markets (DM), where 49% of bonds are government bonds and 51% corporate bonds.

The Emerging Markets (EM) fixed income universe now measures USD 24trn, which is equivalent to 22% of global fixed income. Corporate bonds account for more than half of all the outstanding EM bonds

The most distinguishing feature of the EM bond universe compared to that of DM fixed income is its size relative to GDP. The EM fixed income universe measures 77% of EM GDP compared to 177% in DM, i.e. less than half. The EM government bond market is 36% of GDP on average compared to 87% on average in DM. The corporate bond market is 41% of GDP on average in EM compared to 90% of GDP on average in DM. This illustrates just how seriously finance constrained EM continues to be, relative to DM.

Fig 1: **The global fixed income universe**

Asset class	USD trn	% of global bond universe	% of GDP (global, EM, DM)
Global bond market	**109.6**	**100%**	**137%**
Governments	53.2	49%	67%
Corporate	56.4	51%	71%
Non-financial corporates	14.9	14%	19%
Financial corporates	41.5	38%	52%
Emerging Markets	**24.3**	**22%**	**77%**
Governments	11.5	10%	36%
Corporates	12.9	12%	41%
Non-financial corporates	5.1	5%	16%
Financial corporates	7.8	7%	25%
Developed markets	**85.3**	**78%**	**177%**
Governments	41.8	38%	87%
Corporates	43.5	40%	90%
Non-financial corporates	9.9	9%	20%
Financial corporates	33.6	31%	70%

Source: Ashmore, BIS, IMF, data as at end-2017.

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At more than USD 21trn, local currency bonds now make up 87% of the total EM bond universe. Local currency is made up of USD 10.9trn of corporate bonds and USD 10.3trn of government bonds

Local versus external markets

The local currency bond market in EM now measures USD 21.1trn, or 87% of the total EM fixed income universe (see Figure 2). This means that local currency is now larger than the *entire* EM fixed income universe as of the end of 2016 (when the EM fixed income universe measured USD 20.1trn). This growth in the local currency bond market is not just due to the natural growth of markets through issuance, but also due to BIS's practice of measuring the size of local currency markets in Dollar terms. The weakness of the Dollar in 2017 versus EM currencies thus contributed to the growth in the size of the asset class in Dollar terms. Some of this growth will reverse over the course of 2018, when EM currencies have so far pulled back versus the Dollar.

Within the local currency universe, USD 10.3trn is government debt, while USD 10.9trn is corporate debt. The latter, which is the single largest segment of the EM fixed income universe, comprises USD 4.3trn and USD 6.6trn of non-financial sector and financial sector bonds, respectively.

By contrast, the EM external debt universe is far smaller. In total, there is only USD 3.2trn of external debt, or 13% of the total EM fixed income universe, comprising 63% corporate bonds (USD 2trn) which in turn breaks down into 62% financial sector bonds (USD 1.2trn) and 38% non-financial sector bonds. The EM sovereign external debt universe is USD 1.2trn.

Fig 2: **Size and composition of EM fixed income**

	2017		2012		2007		2002	
Asset class	**USD trn**	**Share (%)**	**USD trn**	**Share (%)**	**USD trn**	**Share (%)**	**USD trn**	**Share (%)**
Total Emerging Markets	**24.3**	**100%**	**14.3**	**100%**	**7.4**	**100%**	**2.6**	**100%**
Local currency	**21.1**	**87%**	**12.3**	**86%**	**6.1**	**83%**	**1.8**	**71%**
Local currency government	10.3	42%	6.2	43%	3.3	44%	1.0	38%
Corporates	10.9	45%	6.2	43%	2.9	39%	0.8	32%
Local currency corporate	*4.3*	*18%*	*2.5*	*18%*	*0.7*	*10%*	*0.4*	*14%*
Local currency financial	*6.6*	*27%*	*3.7*	*26%*	*2.1*	*29%*	*0.5*	*18%*
External	**3.2**	**13%**	**1.9**	**14%**	**1.3**	**17%**	**0.8**	**29%**
External government	1.2	5%	0.8	5%	0.5	7%	0.4	15%
Corporates	2.0	8%	1.2	8%	0.7	10%	0.4	14%
External corporate	*0.8*	*3%*	*0.5*	*3%*	*0.2*	*3%*	*0.1*	*5%*
External financial	*1.2*	*5%*	*0.7*	*5%*	*0.5*	*7%*	*0.2*	*9%*

Source: Ashmore, BIS, data as at end-2017.

Regional distribution

There are large regional differences across EM in terms of size and composition of bond markets. Asia dominates the EM fixed income world having issued seven of every ten outstanding bonds in EM, or USD 17trn (Figure 3). Some 18% of outstanding EM bonds (USD 4.6trn) are from issuers in Latin America and the Caribbean, while the balance of 12% of bonds (about USD 3trn) come from issuers in Eastern Europe, the former Soviet Union, Africa and the Middle East.

In terms of the government/corporate bond markets split, Asia's corporates command a larger share of total financing than corporates in other regions. Asian corporates account for 59% of all outstanding Asian bonds compared to 42% in Latin America, 38% in Eastern Europe and just 30% in Middle East and Africa. The low percentage of corporate penetration in Africa is particularly worrisome. Years of foreign aid in Africa has clearly done very little to encourage the development of the financial sector and domestic savings institutions.

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Asia continues to dominate the EM bond universe with approximately 70% of all outstanding bonds. Corporate bond issuance is also a larger share of the total bond market in Asia than in other regions

Fig 3: **Regional distribution of EM bonds (as of December 2017)**

EM region	Local Currency				External				Total	
	Government		Corporate		Government		Corporate			
	USD trn	Share (%)	USD trn	Share (%)	USD trn	Share (%)	USD trn	Share (%)	USD trn	Share (%)
Asia and Pacific	6.8	28%	9.3	38%	0.2	1%	0.7	3%	16.9	70%
o/w China	*4.3*	*18%*	*2.8*	*12%*	*0.0*	*0%*	*0.2*	*1%*	*7.3*	*30%*
Asia ex-China	*2.5*	*10%*	*6.4*	*26%*	*0.1*	*1%*	*0.6*	*2%*	*9.6*	*39%*
Latin America and Caribbean	2.3	9%	1.0	4%	0.4	2%	0.9	4%	4.6	19%
Eastern Europe and former Soviet Union	0.6	2%	0.4	2%	0.3	1%	0.1	1%	1.4	6%
Middle East and Africa	0.7	3%	0.2	1%	0.4	1%	0.3	1%	1.5	6%
All EM	10.3	42%	10.9	45%	1.2	5%	2.0	8%	24.3	100%

Source: Ashmore, BIS, data as at end-2017.

In terms of the local/external split, Asia is now almost entirely self-sufficient in terms of financing. Some 95% of total outstanding Asian fixed income securities are domestic market bonds. Much of this is due to China. The percentage share of local markets drops to 73% in Latin America and Caribbean, 71% in Eastern Europe and the former Soviet Union and 60% in Middle East/Africa. Hence, domestic markets now dominate in all regions of EM, which is one of the main reasons why pullbacks in global investor sentiment towards EM no longer inflict massive damage in EM in terms of tightening of financial conditions.

The local/external split is particularly pronounced within the corporate bond markets. Eastern European corporates obtain 73% of funding at home, while Latin American corporates only get 54% of their funding at home. In Asia, the percentage is extremely high at 93%, but in Middle East and Africa it is only 40%.

It is generally preferable for a country to be able to obtain finance within its own domestic market rather than overseas, but the greater reliance on external funding among corporates in the Middle East/Africa as well as Latin America is not necessarily a cause for concern.

- First, many corporates are commodity exporters with incomes in Dollars, so they are right to issue in Dollars to eliminate balance sheet FX mismatches.
- Second, some currencies in these regions are pegged to the Dollar for the long term, so it makes sense to issue in the more liquid Dollar markets. Having said that, the low level of domestic corporate finance in Africa reflects the fact that domestic pension systems are not as advanced as in other countries. This is a source of vulnerability.

The biggest markets

Though still excluded from the main global fixed income benchmark indices, China stands out as the largest fixed income market in EM by some margin (Figure 4). China accounts for a whopping 48% of all EM fixed income, or USD 11.6trn. The market is almost entirely domestic and broadly balanced between sovereign and corporate bonds.

At USD 2.3trn, Brazil is the second largest market in EM, followed by South Korea and India (USD 1.9trn and USD 0.9trn, respectively). Mexico is the next in line, followed by Hong Kong. Russia and Poland are the only two Eastern European markets in the top 15 and Turkey is the only Middle East/Africa to make the list (South Africa is 16th).

All the biggest markets in EM have very large domestic markets relative to their external markets. This is because external bond markets tend to be more important in earlier stages of development and then decline in importance over time as the domestic pension systems evolve.

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Fig 4: **The 15 biggest markets in EM**

Rank	Country	Region	Size		Structure of market			
			USD trn	% of total EM	Local	External	Govt	Corp
1	**China**	Asia and Pacific	11.6	48%	11.4	0.2	4.3	7.3
2	**Brazil**	Latin America and Caribbean	2.3	9%	2.2	0.1	1.6	0.7
3	**South Korea**	Asia and Pacific	1.9	8%	1.7	0.2	0.6	1.2
4	**India**	Asia and Pacific	0.9	4%	0.9	0.0	0.9	0.0
5	**Mexico**	Latin America and Caribbean	0.8	3%	0.5	0.3	0.4	0.4
6	**Hong Kong**	Asia and Pacific	0.5	2%	0.4	0.0	0.1	0.3
7	**Russia**	Eastern Europe	0.4	2%	0.3	0.1	0.2	0.3
8	**Singapore**	Asia and Pacific	0.4	2%	0.3	0.1	0.1	0.3
9	**Taiwan**	Asia and Pacific	0.4	2%	0.4	0.0	0.2	0.2
10	**Malaysia**	Asia and Pacific	0.4	2%	0.3	0.0	0.2	0.2
11	**Thailand**	Asia and Pacific	0.4	2%	0.4	0.0	0.1	0.2
12	**Poland**	Eastern Europe	0.3	1%	0.3	0.1	0.3	0.1
13	**Indonesia**	Asia and Pacific	0.3	1%	0.2	0.1	0.2	0.1
14	**Turkey**	Middle East and Africa	0.3	1%	0.2	0.1	0.2	0.1
15	**Argentina**	Latin America and Caribbean	0.3	1%	0.2	0.1	0.2	0.1

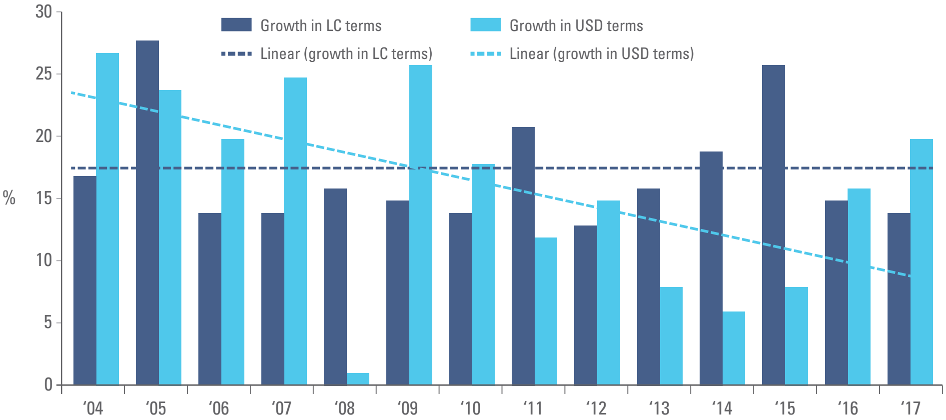
Source: Ashmore, BIS, data as at end-2017.

Three recent trends

EM fixed income is an extremely dynamic asset class. The market is sixteen times larger today than at the turn of the century and the number of countries in the main fixed income benchmark index has more than doubled since the global financial crisis in 2008/2009. Some of the prominent recent trends in the asset class include:

a) Growth: The asset class has expanded sharply in USD terms in the past two years (Figure 5). The average annual growth rate of EM fixed income in USD terms was 18% on average in 2016 and 2017 compared to 7% in 2013-2015. The volatility in growth rates is partly due to changes in exchange rates (BIS measures market size in Dollar terms). Thus, the strengthening of EM currencies versus the Dollar in 2016 and 2017 explains part of the increase. In local currency terms, growth rates have moderated in the past two years. In general, the average growth rate year by year is volatile, but around a flat trend, which can be seen as a rough proxy for the sustainable pace of growth of the asset class. In general, EM countries and corporates are severely constrained financially. This means that supply tends to move in line with demand. Marginal demand comes from expanding local savings institutions and foreign investors. The former, which dominates over time, is structural, while the latter is fickle and cyclical and becomes progressively less important over time.

Fig 5: **Growth rates of EM fixed income (% change yoy, 2004-2017)**



Source: Ashmore, BIS, data as at end-2017.

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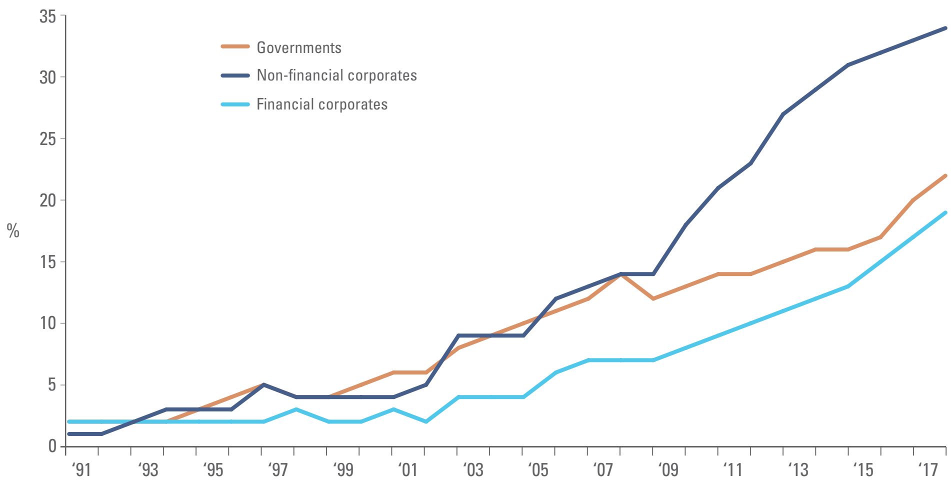
b) **Share of global fixed income:** Due to the importance of structural growth drivers, the EM fixed income asset class continues to grow steadily as a share of global fixed income. The shares of all three segments of EM fixed income – financials, corporates and government bonds – in global bond markets continue to rise on a secular basis as shown in Figure 6. This growth means that EM fixed income now accounts for 22% of the global bond market compared to 20% last year. EM is about 50% of global GDP, so EM are rising from a low base of underfinancing. As such, the increase in EM share of global fixed income is healthy rather than an expression of irresponsible borrowing. EM non-financial corporates have made the greatest inroads into the global market place, where they now account for 34% of outstanding bonds. By contrast, EM financial corporates only account for 19% of global financial corporate bonds, which reflects the still dominant role of Western banks on the global stage. EM governments' share of global government debt is 22%.

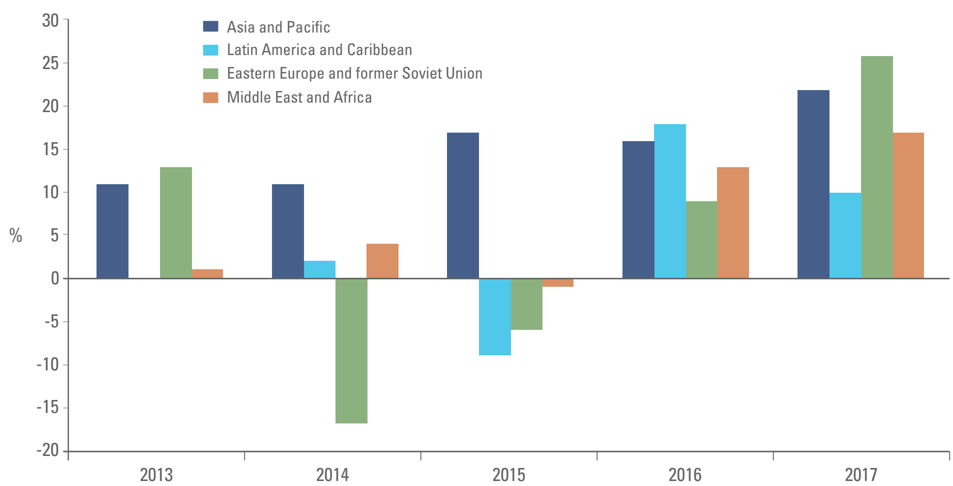
Fig 6: **EM share of global fixed income (% by fixed income segment)**



Source: Ashmore, BIS.

c) **Regional variation:** The EM fixed income universe expands at very different trajectories across the main EM regions (Figure 7). The growth rates of the asset class have tended to be very stable in Asia and extremely volatile in Eastern Europe and former Soviet states. The latter is probably due to the combination of flexible exchange rates and oil dependence among some of the larger issuers.[1] Middle Eastern and African issuance did not grow much until recently, but supply has now expanded sharply as several prominent Middle Eastern countries turned to debt financed fiscal expansion after the fall in oil prices in 2014. Growth of the asset class in Latin America and Caribbean, regions with low savings rates, have tended to move in close correlation with overall appetite for EM.

Fig 7: **Regional growth rates (EM fixed income in USD terms)**



Source: Ashmore, BIS.

[1] Sanctions on Russia will have reduced external issuance, but local bond issuance will have gone up in its place. Russia will have become less Dollar dependent as a result.

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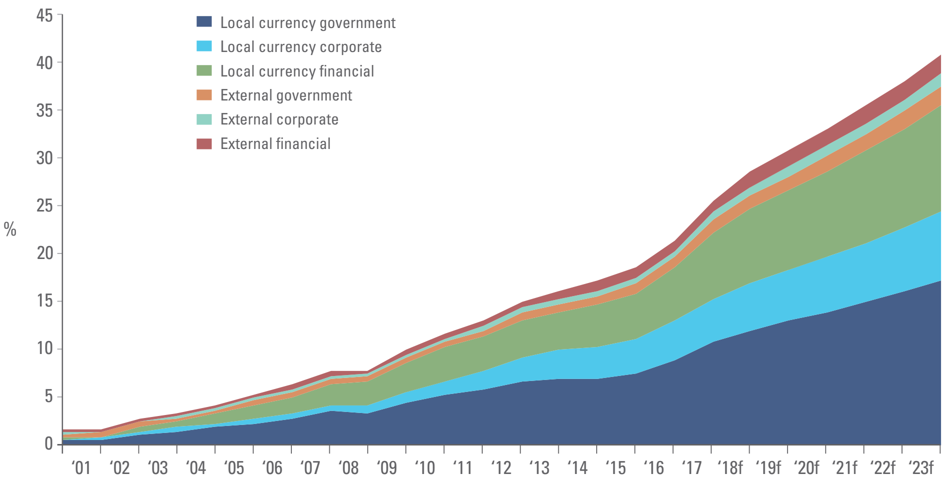
Future growth

The EM fixed income asset class will easily reach USD 39trn by 2023 at which point its share of the global bond market will reach 24%. This assumes that the market expands in line with the IMF's projections for EM GDP growth (in current USD terms) over the next five years. In reality, the EM bond market will likely grow faster, since issuance has historically grown faster than GDP for the simple reason that bond markets broaden and deepen as part of the development process. More countries are also entering the asset class for the first time. The share of local currency is likely to continue to expand at a faster pace than external debt at the margin.

Fig 8: **Future growth (USD trn)**



Source: Ashmore, BIS, data as at end-2017, forecasts ('F') are Ashmore's own projections.

Index representation

Despite the obvious structural drivers of the asset class, there continues to be no material improvement in EM fixed income index representation. As Figure 9 shows, only 9% of EM fixed income is represented in the most commonly used benchmark indices. The main benchmark providers continue to include only those countries, where they make markets, which is not necessarily those countries, where there are markets. The inadequate provision of index coverage results in distortions in global asset allocation on a truly monumental scale. Since most investors hug benchmark indices to some various degrees, the poor index coverage means that too much money gets funnelled into too few countries and not enough money is funnelled into the rest. Global regulators are to blame for not recognising this market failure and not fixing it.

Fig 9: **EM fixed income benchmark representation (as of end 2017)**

Asset class	Index name	Index acronym	Index provider	No. of countries	No. of issuers	No. 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	67	152	643	541	1,185	46%
External corporate debt	CEMBI Broad Diversified	CEMBI BD	JP Morgan	52	609	1,331	454	2,011	23%
Local currency government debt	GBI EM Global Diversified	GBI EM GD	JP Morgan	18	18	214	893	10,289	9%
Local currency corporate debt	Local EM non-sovereign	LOCL	ICE	16	147	298	199	10,859	2%
All EM fixed income							**2,087**	**24,343**	**9%**

Source: Ashmore, BIS, JP Morgan, ICE, data as at end-2017.

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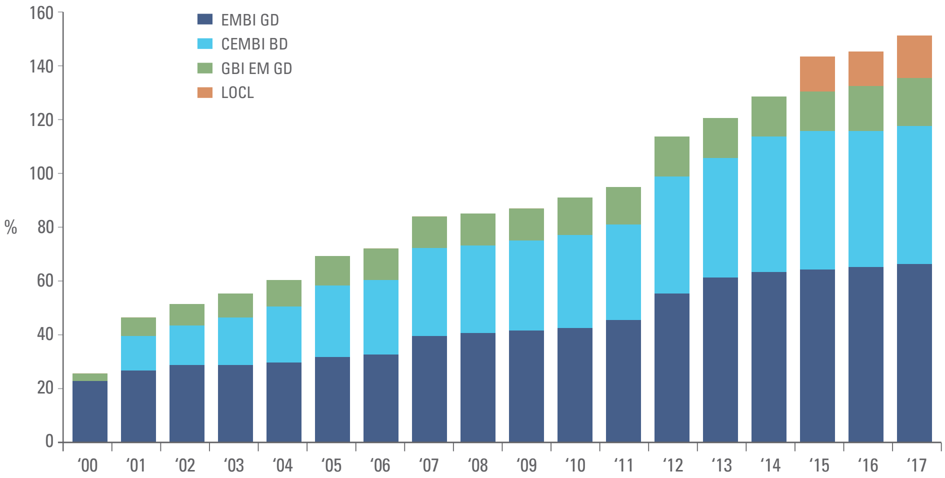
Diversification against the odds

Despite poor index representation, the number of markets in the main benchmark indices nevertheless continues to increase every single year. Adding up the individual markets represented within the four major EM fixed income indices, the number of 'indexed' bond markets in EM has now reached 153. This is up from 147 last year and just 26 at the turn of the century (Figure 10). The majority of 'indexed' markets continues to be in the Dollar bond space and the lowest number in the local currency space. Again, this is because the big global banks provide benchmark services in markets where they have local market-making operations.[2]

Fig 10: **Number of individual EM fixed income markets with index representation**



Source: Ashmore, JP Morgan, ICE, data as at end-2017.

[2] This gives them access to free daily pricing data.

Sources and methodology

The primary source of data on securities is the Bank of International Settlements (BIS). Economic data comes from IMF's World Economic Outlook database. Index data is from ICE and JP Morgan. BIS distinguishes between domestic and international markets based on where the securities are issued. Hence, the size of the debt market in any one country is the sum of debt securities issued by residents at home ('domestic debt securities' in BIS terminology) and debt securities issued by non-residents within the country. It is possible that size of a country's bond market does not equate to liabilities of issuers in that country, say, if some countries attract high primary issuance volumes for tax reasons. Such securities have been re-assigned to the issuer's home market, in order to obtain a more correct estimate of the size of the home market. Issuers include governments, financial corporations and non-financial corporations. BIS obtains data from central banks, other public sources and commercial sources.

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