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MARKET COMMENTARY

Ashmore

EM IG sovereign bonds (for the risk averse)

By Jan Dehn

The 2020 Triple Shock of coronavirus, crashing commodity prices, and spread widening reminded many investors that segments of Emerging Markets (EM) fixed income can be extremely volatile during bouts of risk aversion.

Fortunately, there exists a panacea in the shape of EM investment grade (IG) sovereign debt for those investors, who do not have the stomach for the ups and downs associated with the broader EM fixed income asset class.

EM IG sovereign debt has superior Sharpe Ratio compared to both US Treasuries and US high yield (HY). The investment opportunity makes up more than half of the total EM sovereign debt universe, including 38 IG rated sovereigns and total outstanding securities of nearly USD 750bn. In addition to becoming more diversified and liquid every year, the issuers in the EM IG universe also have significantly better ESG scores than the rest of EM and stronger macroeconomic fundamentals than both developed economies and the rest of EM.

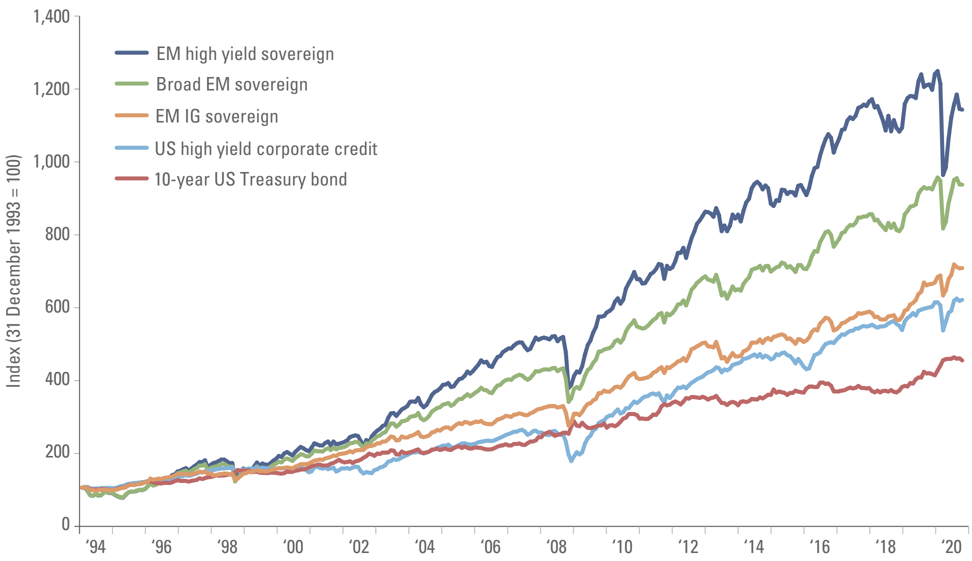
This backdrop of far stronger macroeconomic fundamentals and constantly improving trading characteristics makes for a particularly attractive investment proposition, particularly when one takes into account that at current valuations EM IG sovereign bonds should deliver at least three times more return than US government bonds of similar duration over the next five years.

Performance

EM IG sovereign debt has outperformed both US Treasury bonds and US HY since 1993, which was when JP Morgan launched its index, the EMBI GD IG. Over this period, EM IG sovereign bonds have delivered an average annual return of 7.5% in Dollar terms compared to 7.0% for US HY and 5.8% for the US 10-year Treasury bond. Only broad EM sovereign debt and EM HY sovereign debt have performed better than EM IG sovereign bonds with annualised returns of 8.7% and 9.5%, respectively (Figure 1).

EM IG sovereign debt has outperformed both US Treasury bonds and US HY since 1993

Fig 1: **Total return (December 1993 – October 2020)**

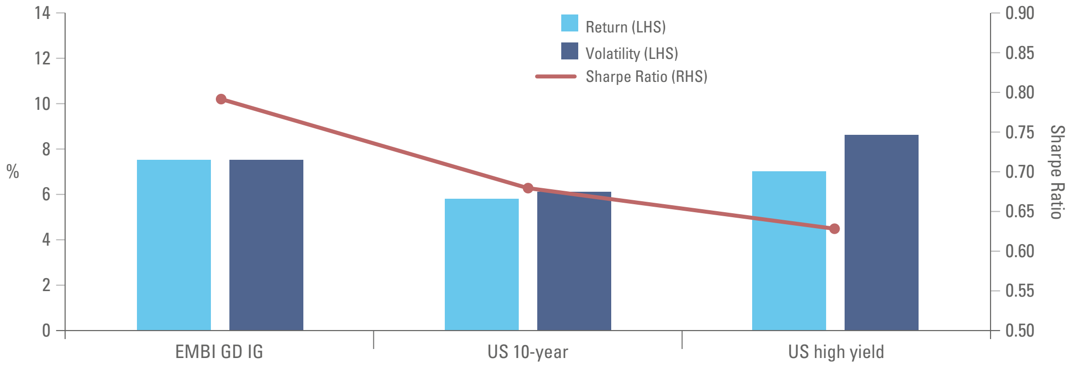


Source: EM performance based on JP Morgan's suite of indices known as Emerging Markets Bond Index Global Diversified (EMBI GD), Ashmore, Bloomberg. Data as at 31 October 2020.

However, unlike broad and HY EM sovereign debt EM IG sovereign debt has delivered its returns with far lower volatility and no defaults. EM IG sovereign debt is also far less volatile than US HY. While the asset class is marginally more volatile than US treasuries, investors are more than compensated for the additional volatility with higher returns as evidenced by a clearly superior Sharpe Ratio (Figure 2). As such, EM IG sovereign debt makes an attractive asset class for investors who are either risk averse or looking for a Dollar-denominated alternative to US sovereign or corporate credit.

EM IG sovereign bonds have a superior Sharpe Ratio compared to both US Treasury bond and US high yield

Fig 2: **Returns, volatility, and Sharpe Ratios (December 1993 – October 2020)**



Source: Ashmore, Bloomberg. Data as at 31 October 2020.

Composition of the asset class

As of November 2020, there are thirty-eight EM countries with at least one IG rating. The three main global rating agencies – Standard & Poor's, Moody's, and Fitch Ratings – are broadly consistent in terms of how they rate EM countries, although two EM countries only have two IG ratings, while another three EM countries only have one IG rating (Figure 3). For a full list of the thirty-eight IG rated countries and which ratings agencies have rated them IG see the Appendix.

Fig 3: **Number of IG rated EM countries**

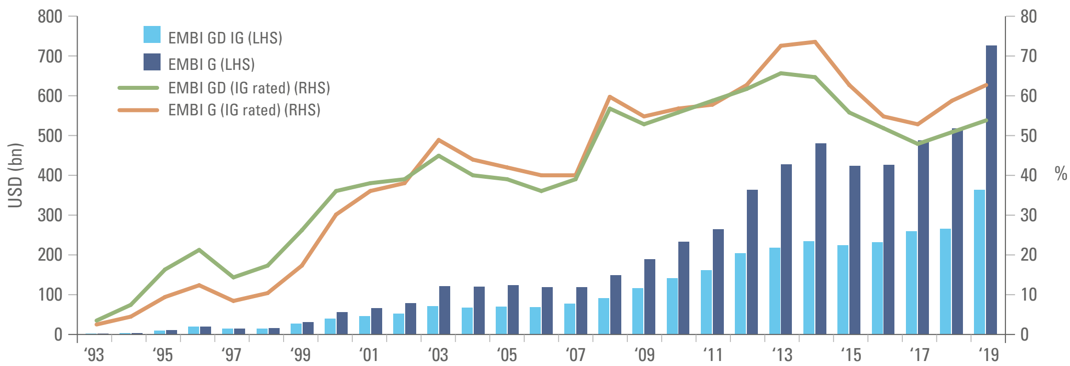
EM investment grade universe	
3 IG ratings	33
2 IG ratings	2
1 IG rating	3
Total number of EM IG countries	38

Source: Ashmore, Bloomberg.

The EM IG sovereign bond market has ballooned from less than USD 2bn in 1993 to more than USD 725bn today

In addition to offering considerable diversification across countries, the size of the EM IG sovereign bond market continues to expand and liquidity is therefore steadily improving too. In 1993, market capitalisation for JP Morgan's EM IG sovereign index was a mere USD 1.9bn. By the end of 2019, this has increased to USD 364bn for the diversified version of the index and USD 727bn for the non-diversified index (Figure 4).[1]

Fig 4: **Index market capitalisation**



Source: Ashmore, JP Morgan.

[1] Diversified indices cap the country weight at a maximum of 10% in order to enable smaller countries to be represented in the index. Total market cap for the EMBI GD was USD 679bn as of end-2019 compared to USD 1,153bn for the non-diversified version of the index (EMBI G).

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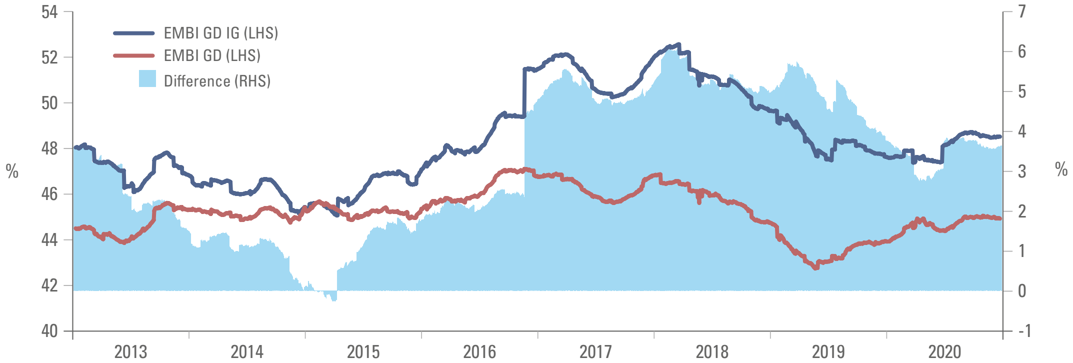
In addition to becoming larger and more liquid, the share of IG rated securities within the overall EM sovereign bond market is also growing as shown in Figure 4. The various global business cycle dynamics mean that the proportion of EM bonds that are rated IG meanders up and down, but the trend is clearly upwards: in 1993 fewer than 5% of outstanding bonds had IG status. Today, the percentages of EM sovereign bonds with IG rating on the EM fixed income universe are 54% and 63% for the diversified or non-diversified versions of the EMBI index, respectively.

ESG

Investors in EM IG sovereigns enjoy superior ESG scores relative to broader EM bond strategies. Figure 5 shows the composite ESG scores for JP Morgan's EMBI GD and EMBI GD IG, respectively. In addition to achieving a better composite score, EM IG countries have also seen faster improvement in their ESG scores than the rest of EM, partly as a consequence of higher per capita GDP.

The ESG scores of EM IG sovereign issues are better than for EM sovereign issuers more broadly

Fig 5: **ESG scores for JP Morgan's EMBI GD index (broad and IG only)**



Source: Ashmore, JP Morgan.

Fundamentals

Aside from ESG criteria, EM's IG-rated sovereigns also generally have far stronger macroeconomic fundamentals than both developed economies and the EM sovereign debt universe as a whole. Figure 6 illustrates this point with reference to the debt, growth, and inflation characteristics of EM IG issuers, all EM issuers, and developed economies. The table covers four time periods in order to illustrate how the broader trends have evolved in the face of shocks: the five years prior to the coronavirus shock (2015-2019), the coronavirus shock in 2020, the recovery from coronavirus in 2021 as well as the post-coronavirus period (2021-2025). All the numbers are from the International Monetary Fund's October 2020 version of the *World Economic Outlook*.

EM's IG-rated sovereigns generally have far stronger macroeconomic fundamentals than developed economies and EM sovereigns as a whole

Fig 6: **Key macroeconomic fundamental indicators**

Key macroeconomic indicators	Gross debt to GDP	Real GDP growth	Inflation
		2015-2019	
IG rated EM countries	42%	3.2%	2.3%
All EM countries	48%	4.3%	4.9%
Developed countries	104%	2.1%	1.4%
		2020	
IG rated EM countries	53%	-6.1%	1.7%
All EM countries	61%	-3.3%	4.3%
Developed countries	124%	-5.8%	0.9%
		2021	
IG rated EM countries	54%	4.8%	2.3%
All EM countries	64%	6.0%	4.6%
Developed countries	124%	3.9%	1.5%
		2021-2025	
IG rated EM countries	55%	3.9%	2.3%
All EM countries	67%	5.1%	4.2%
Developed countries	124%	2.5%	1.7%

Source: Ashmore, IMF (World Economic Outlook, October 2020).

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The indebtedness of EM IG-rated countries is low and likely to remain well within limits of sustainability for the foreseeable future

Low and stable, inflation in EM IG countries is unlikely to pose an issue from a credit quality perspective

The key insights from Figure 5 provide a very positive picture of EM IG sovereign fundamentals, which can be summarised as follows:

- **Debt:** The level of indebtedness of EM IG-rated countries is low and likely to remain well within limits of sustainability for the foreseeable future. EM IG-rated sovereigns were indebted to the tune of 42% of GDP in the pre-coronavirus period. This is expected to rise to 55% of GDP in the post-coronavirus period. In comparison, broad EM indebtedness is expected to rise from 48% of GDP to 67% of GDP. EM IG is particularly impressive compared to developed economies, whose indebtedness is expected to rise by a full 20% of GDP to a whopping 124% in the post-coronavirus period. This means that developed economies will be more than twice as indebted as EM IG sovereigns. There have been no defaults in the EM IG-rated asset class.[2]

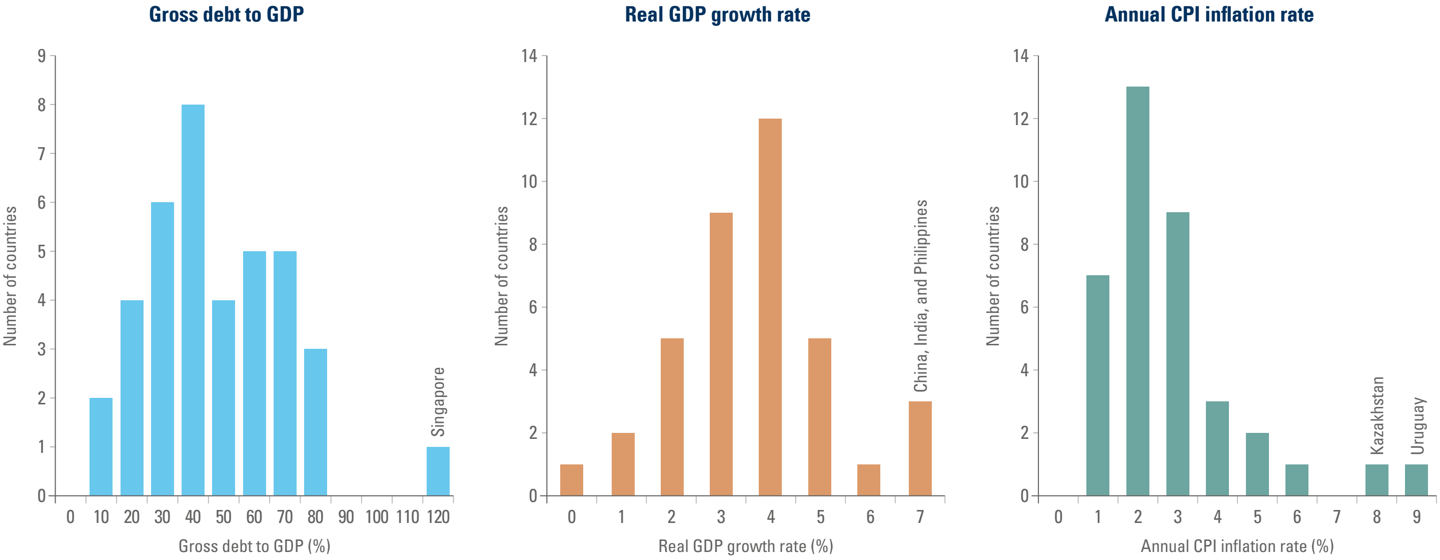
- **Growth:** EM IG sovereigns generally have superior growth rates to developed countries, but inferior growth rates compared to broad EM. This is entirely consistent with the basic predictions of convergence in standard economic growth theory. Prior to 2020, EM IG countries grew 50% faster than developed economies. In 2020, they recorded marginally weaker growth than in developed economies, but this was due to two outliers, namely Mauritius (hurt by a collapse in tourism) and Peru (one of the worst afflicted countries in the coronavirus pandemic). Excluding these two outliers, the remaining thirty-six EM IG countries on average contracted less than developed economies (5.7% versus 5.8%). Looking forward, EM IG countries are expected to grow more than 20% faster than developed countries in 2021 and the growth outperformance relative to developed economies is expected to rise to more than 50% in the post-coronavirus period.

- **Inflation:** Inflation in EM IG countries is higher than in developed economies and lower than in EM as a whole. This is true for all periods. However, inflation is low and stable in EM IG, so it is unlikely to pose an issue from a credit quality perspective. This is particularly the case since debt levels are low and growth rates solid. Rather, the main risk to the inflation outlook is likely to be in developed economies, where risks are clearly binary: attempts in coming years to reduce debt overhangs by means of fiscal adjustment could easily push developed economies into deflation. On the other hand, if they attempt to inflate their way out of debt then clearly inflation could rise sharply. Fortunately, EM IG sovereign credits do not face this unpleasant dilemma.

Fundamental dispersion within the EM IG universe

The variation across EM IG sovereigns in terms of their key macroeconomic variables is generally low with most countries clustered fairly tightly around the mean with only a few outliers. This is illustrated in Figure 7. Singapore, as a global financial centre, has more debt than other EM IG countries, while China, India, and Philippines have generally grown faster. Uruguay and Kazakhstan stand out in terms of their higher inflation rates, but the median inflation rate for EM IG sovereigns at 1.9% sits well below the average of 2.3%, illustrating the genuinely benign inflation picture in these countries.

Fig 7: **Dispersion of key macroeconomic variables for EM IG sovereigns**



Source: Ashmore, IMF (World Economic Outlook October 2020).

[2] The defaulters in EM since 1999 have been Argentina (thrice), Ecuador and Mozambique (twice) as well as Ivory Coast, Belize, Ukraine, Venezuela, and Lebanon (once). None were IG rated at the time of default.

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Valuations

Like all other segments of EM fixed income and equities, it pays to think both tactically and strategically about how to invest in the EM IG asset class. Tactically, investors tend to sell EM assets rather indiscriminately during bouts of risk aversion, including EM IG sovereign bonds. This irrational behaviour creates massive short-term opportunities and nowhere more so than in EM IG asset classes, where default rates are zero. Here, truly, volatility and risk –that is, permanent loss of capital – are not the same thing.

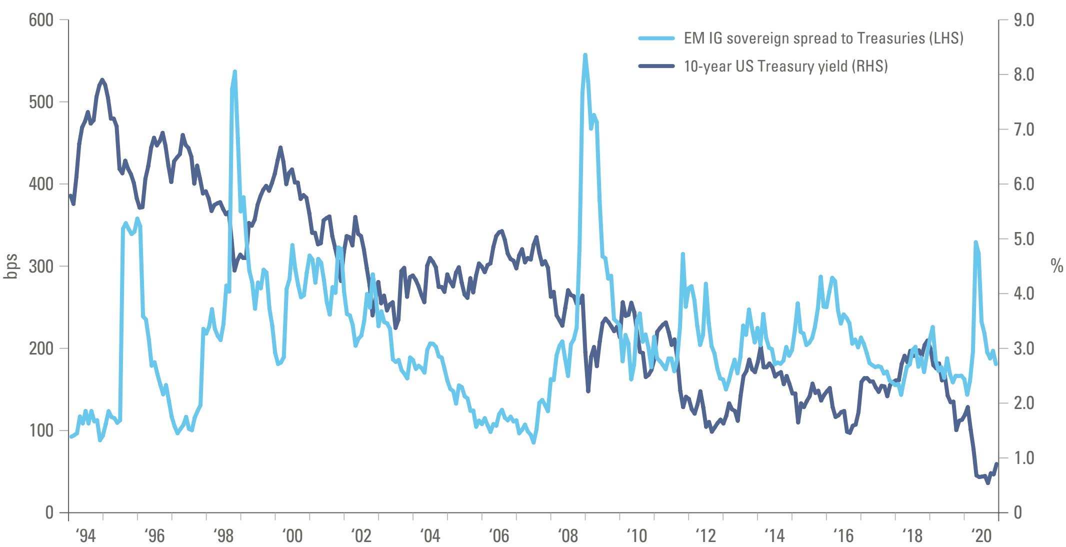
Since index inception, EM IG sovereign bonds rewarded investors with 270bps of average annual alpha when they added exposure during bouts of risk aversion

Consistent with past risk-off episodes, this year the EM IG sovereign spread briefly blew out to more than 400bps over Treasuries from a low point of 142bps in late 2019. Today, markets have largely normalised with spreads sitting around 160bps over Treasuries. It is worth noting that since the inception of the asset class in 1993 investors in EM IG sovereign bonds would have made an average annual alpha of 270bps purely from timing their entry to coincide with spikes in the VIX index of more than 10 points in a month.[3] The implication is clear: it pays to buy when assets are cheap.

Strategically, as pointed out at the start of this report, EM IG sovereign bonds have beaten both US HY and US government bonds over time. The current spread for EM IG sovereign bonds is well wide of previous lows. For example, in 2006, EM IG sovereign debt asset class, which has a duration of about 9.5 years, traded as tight as 95bps over Treasuries. The average spread over the entire lifespan of the asset class is 210bps, so a bit wider than today, but much of this period was characterised by much higher US yields as shown in Figure 8. In other words, EM IG sovereign debt has retained a relatively generous spread despite the global backdrop of a steadily declining cost of international capital (in USD terms).

EM IG sovereign debt retain a generous spread despite the backdrop of declining US bond yields

Fig 8: **EM IG sovereign spread and 10-year US Treasury bond yield**



Source: Ashmore, Bloomberg, JP Morgan. Data as at 31 October 2020.

In terms of future returns, on the conservative assumption that the world economy remains as uncertain in the next five years as it is today one can surmise that demand for US Treasuries holds up, while demand for EM bonds remains tepid (both due to elevated levels of risk aversion). In other words, suppose that yields do not change.

In this simple scenario, the large yield differential between EM IG sovereign bonds and the 10-year US Treasury bond implies that US government bonds will pay investors just 4.4% in compounded terms over the next five years, while EM IG sovereign bonds will pay investors 14.7%, or 3.3 times more. If US yields rise, EM IG bonds will outperform US Treasuries as spread cushions absorb part of the rise in Treasury yields. Historically, about half of the rise in US yields has been absorbed in spreads.

3 For a discussion of how to trade risk-off episodes in EM. See: *'It is here again – the VIX spike!'*, Market Commentary, 28 February 2020.

Conclusion

Investors in EM IG sovereign bonds can expect to make at least three times more than investors in US government bonds over the next five years if the current conditions of elevated uncertainty and therefore yields do not change.

Does the additional return relative to developed market bonds justify the perceived extra risk of investing in EM IG? Based on the analysis presented here the answer is clearly yes.

EM IG bonds have better Sharpe Ratios than both US government bonds and US HY bonds and they do not default. EM countries with IG ratings have better growth prospects, moderate inflation, and far superior debt metrics. They also have better ESG scores than EM as a whole. Moreover, the assets class already comprises thirty-eight countries and continues to grow in size, diversification, and liquidity.

Appendix

Country	Moody's	Fitch	S&P	Number of IG ratings
United Arab Emirates	1	1	1	3
Bulgaria	1	1	1	3
Botswana	1	0	1	2
Chile	1	1	1	3
China	1	1	1	3
Colombia	1	1	1	3
Czech Republic	1	1	1	3
Estonia	1	1	1	3
Hong Kong SAR	1	1	1	3
Croatia	0	1	1	2
Hungary	1	1	1	3
Indonesia	1	1	1	3
Israel	1	1	1	3
India	1	1	1	3
Korea	1	1	1	3
Kuwait	1	1	1	3
Kazakhstan	1	1	1	3
Lithuania	1	1	1	3
Latvia	1	1	1	3
Morocco	0	0	1	1
Mauritius	1	0	0	1
Mexico	1	1	1	3
Malaysia	1	1	1	3
Panama	1	1	1	3
Peru	1	1	1	3
Philippines	1	1	1	3
Poland	1	1	1	3
Qatar	1	1	1	3
Romania	1	1	1	3
Russia	1	1	1	3
Saudi Arabia	1	1	1	3
Singapore	1	1	1	3
Slovenia	1	1	1	3
Slovak Republic	1	1	1	3
Thailand	1	1	1	3
Trinidad and Tobago	0	0	1	1
Taiwan Province of China	1	1	1	3
Uruguay	1	1	1	3
Total	**35**	**34**	**37**	**106**

Source: Ashmore, Bloomberg.

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