

# Switch from Eurozone IG bonds to EM IG EUR-denominated bonds

By Jan Dehn and Romain Bocket

Years of selective buying of Eurozone bonds by central banks and institutional investors has created a strong relative value proposition in favour of Emerging Markets (EM) EUR-denominated bonds.

Investment grade (IG) EUR-denominated sovereign bonds now offer sharply better expected returns and lower volatility than Eurozone sovereign bonds. We recommend that investors rotate out of the latter into the former.

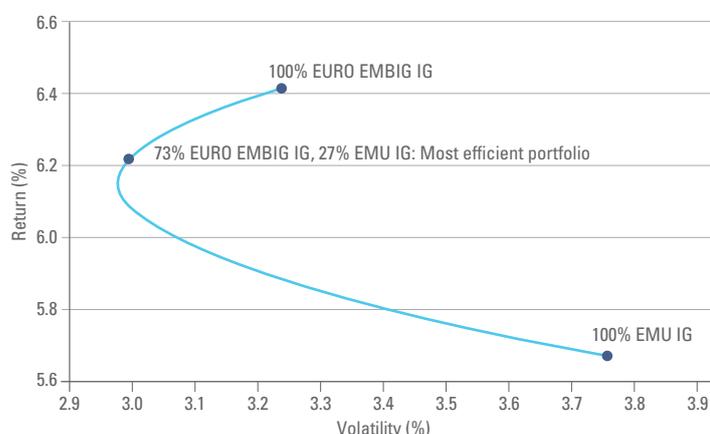
EM IG EUR-denominated sovereign bonds offer better returns and lower volatility than Eurozone IG sovereign bonds. We explain our data sources and methodology and present our results, which, albeit extreme, show that EM bonds are extremely mispriced relative to developed markets fixed income. This is consistent with other recently published analysis, which points to mispricing in US denominated bonds as well. We believe the distortion in valuations is due to Quantitative Easing (QE) policies and that investors should take advantage of the current mispricing by rotating into EM as the risk-return profile deteriorates in the Eurozone.

## Methodology

We calculate the most efficient allocation in a portfolio of IG bonds that can invest in both EM EUR-denominated bonds and Eurozone government bonds.

We calculate returns and volatility using the JP Morgan's Euro-denominated Emerging Markets (EM) investment grade index (EURO EMBIG IG) and JP Morgan's Economic and Monetary Union investment grade index (EMU IG). We use the longest available time series – the EM data goes back to the inception of the EURO EMBIG IG index on 29 February 2000.

Fig 1: Efficient allocation to EM EUR IG bonds (based on historical data)

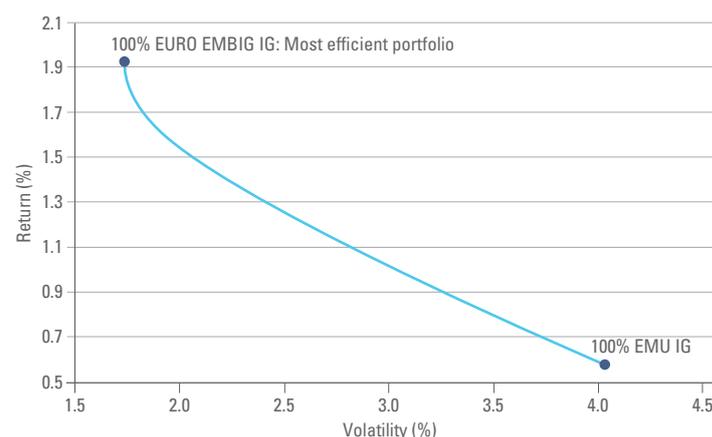


Source: Ashmore, JP Morgan, Bloomberg.

## The scope for further performance in Eurozone bonds is now becoming exhausted as more and more bond yields turn negative. We encourage investors to rotate out of Eurozone government bonds towards EM EUR-denominated IG government bonds

In order to determine the most efficient allocation from a forward-looking perspective we also compare current yield-to-maturity (YTM) for both indices against their respective 1-year volatilities. This forward-looking analysis shows that the best portfolio at current valuations is obtained by allocating 100% to EM (figure 2).

Fig 2: Efficient allocation based on 1-year volatility and current yield-to-maturity



Source: Ashmore, JP Morgan, Bloomberg.

At first sight these results appear extreme, but they are entirely consistent with other recently published research, which shows that EM bonds are also extremely mispriced, in general as well as relative to US fixed income.<sup>1</sup> We believe this mispricing is mainly due to QE policies. As for the EUR-denominated segment of the market, we think the scope for further performance in Eurozone bonds is now becoming exhausted as more and more bond yields turn negative. For this reason, we strongly encourage investors to rotate out of Eurozone government bonds towards EM EUR-denominated IG government bonds.

<sup>1</sup> See "Superior returns and lower risk in EM IG corporate bonds", The Emerging View, July 2016, "Free Money: Arbitrage opportunities in EM external debt", Market Commentary, June 2014 and "EM and the Fed: Smaller pullbacks and greater recoveries", The Emerging View, June 2016.

## Descriptive statistics

As of the 30 June 2016, the YTM of EM Euro-denominated IG bonds were more than three times higher than the YTM of Eurozone bonds, at 1.92% versus 0.58%, respectively. Yet, over the past twelve months (to 30 June 2016) the annualised volatility of daily returns for EM bonds has been less than half the volatility of the Eurozone index, at 1.74% versus 4.02%. In fact, EM EUR-denominated bonds have had better risk-return ratios than Eurozone bonds over other time periods, including 1yr, 3yrs, 5yrs, 10yrs, and since inception of the EM index.

EM bonds also offer diversification benefits for EUR bond investors. The historical correlation between EM and Eurozone Euro-denominated IG bonds as of 30 June has been just 49% since inception and as figure 3 shows this correlation has declined to 41% in the last year. This means that EM EUR-denominated sovereign IG bonds offer a good diversifier for a Eurozone sovereign IG bond portfolio. Note also that correlations between EM and Eurozone bonds have tended to decline during periods of Eurozone troubles, thus shielding the portfolio somewhat from Eurozone-specific risks.

Fig 3: 1-year rolling correlations – EUR EMBIG IG vs EMU IG



Source: Ashmore, JP Morgan, Bloomberg.

## Characteristics of the EM EUR-denominated bond market

EM issuance of EUR-denominated bonds has increased significantly in recent years. The EM index has more issuers from many different parts of the globe, which means that the index of EUR-denominated EM IG bonds is more diversified than the EMU IG index. The diversified version of the index (EURO EMBIG Diversified IG) is particularly interesting, because it avoids high country concentrations while keeping almost identical characteristics in terms of return to volatility and outperformance compared to the EMU IG index.

The table below summarises the main features of the EM's EUR-denominated IG government bonds universe and provides a comparison with the Eurozone IG government bonds universe.

Fig 4: Characteristics of the EM EUR-denominated IG government bonds universe versus the Eurozone IG government bond universe

As at 30.06.16	EMU IG		Statistics	
Country	Face OS (m)	Mkt Cap %	Yield	Duration
France	1,151,791	24.75	0.34	8.20
Italy	1,135,678	23.60	1.35	7.15
Germany	865,501	18.38	-0.08	7.94
Spain	639,996	13.44	1.26	7.10
Belgium	286,587	6.43	0.41	9.26
Netherlands	274,273	5.89	0.08	8.35
Austria	183,365	3.94	0.28	8.15
Ireland	98,446	2.03	0.45	6.22
Finland	77,506	1.54	0.05	7.17
<b>Total</b>	<b>4,713,143</b>	<b>100.00</b>	<b>0.58</b>	<b>7.78</b>

As at 30.06.16	Euro EMBIG IG		Statistics	
Country	Face OS (m)	Mkt Cap %	Yield	Duration
Poland	28,675	29.44	0.95	5.87
Mexico	17,900	16.24	3.15	8.50
Romania	12,000	11.86	2.20	6.30
China	9,200	8.38	0.88	3.97
Bulgaria	6,637	6.05	2.53	7.69
Turkey	5,500	5.50	2.15	3.99
Indonesia	5,250	4.84	2.95	7.14
Chile	3,990	3.74	1.31	9.08
Latvia	3,700	3.66	0.58	7.84
Lithuania	2,900	2.97	0.40	5.24
Peru	2,100	2.04	2.48	9.46
Morocco	2,000	1.95	2.48	5.29
Colombia	1,350	1.31	2.96	8.03
Slovakia	1,000	1.08	-0.25	4.41
Estonia	500	0.47	1.89	6.49
South Africa	500	0.47	3.56	8.02
<b>Total</b>	<b>103,202</b>	<b>100.00</b>	<b>1.92</b>	<b>6.54</b>

As at 30.06.16	Euro EMBIG Diversified IG		Statistics	
Country	Face OS (m)	Mkt Cap %	Yield	Duration
Poland	7,075	12.33	0.95	5.87
Mexico	7,923	12.21	3.15	8.50
Romania	6,635	11.14	2.20	6.30
China	6,024	9.32	0.88	3.97
Turkey	5,217	8.85	2.15	3.99
Indonesia	5,162	8.09	2.95	7.14
Bulgaria	5,183	8.03	2.53	7.69
Chile	3,990	6.36	1.31	9.08
Latvia	3,700	6.22	0.58	7.84
Lithuania	2,900	5.04	0.40	5.24
Peru	2,100	3.47	2.48	9.46
Morocco	2,000	3.31	2.48	5.29
Colombia	1,350	2.22	2.96	8.03
Slovakia	1,000	1.83	-0.25	4.41
Estonia	500	0.79	1.89	6.49
South Africa	500	0.79	3.56	8.02
<b>Total</b>	<b>61,261</b>	<b>100.00</b>	<b>1.99</b>	<b>6.62</b>

Source: Ashmore, JP Morgan, Bloomberg.

## Conclusion

Eurozone government bonds offer a deteriorating risk-return profile as a result of negative yields and rising risks due to a looming banking crisis and threats from populist political movements. EM EUR-denominated IG bonds offer an attractive source of relative safety and higher returns. The EM bond universe is growing in depth and diversity and IG EM issuers have healthier fundamentals.

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