Ashmore

Price and Prejudice

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This month's Emerging View provides an overview of Emerging Markets sovereign dollar debt, including a brief history of the asset class, recent developments in external debt, current valuations and an assessment of the quality of issuers. We conclude with a brief discussion of some of the unresolved issues relating to the asset class.

The process of credit improvement in Emerging Markets is continuing apace, reflected in the sharply rising number of Emerging Markets countries entering global capital markets for the first time. Many do this via external sovereign debt issuance. The number of issuers of external sovereign debt has more than doubled in the past decade. This means that external debt now offers significantly more alpha potential from country selection. External debt will also continue to play an important part in blended portfolios even after global interest rates begin to normalise, a process which we believe will be gradual and characterised by considerable volatility. Furthermore, the recent spread widening in external debt is offering a good entry point in the context of a benign nearer term outlook for US Treasuries.

A brief history of external debt

The market for Emerging Markets sovereign debt was 'born' in the 1970s, when European banks began to extend loans to so-called Less Developed Countries (LDC) on the back of the first oil shock. When commodity prices collapsed in the 1980s, many of these loans went bad. Banks began to trade the loans, though the bulk remained on the banks' books, marked far above their fair value. The 'LDC loans' came to pose a threat to the global banking system.

In a bid to resolve the problem, in 1989 US Treasury Secretary Nicholas Brady consolidated the disparate loans into larger tradable 'Brady bonds'. These were long-dated securities backed by US Treasury collateral in a bid to both reassure investors and incentivise Emerging Markets governments to pay.

Emerging Markets governments soon began to swap Brady bonds into Global bonds in order to release the collateral. Global bonds thus became the mainstay of today's external debt universe. Today, external debt is a $700bn asset class, more than three times larger than in 1995 ($204bn). The sub-set of index-eligible external debt has grown from $133bn in 1999 (market value of $106bn) to $280bn (with a market value approaching $332bn). Based on the average growth rate of the asset class over the past decade of 6%, we estimate that external debt will grow to $1.1trn by 2020.

Despite the lack of collateral backing the Globals performed extremely well, outperforming other Emerging Markets fixed income asset classes in 3 out of 4 years and returning on average more than 14% per year between 2002 and 2005. Investors were gradually beginning to understand the secular credit improvement underway in Emerging Markets since the end of the Cold War.

By the mid-2000s the next big phase in capital market development in Emerging Markets was already underway. Eyeing the high savings rates of young work forces rapidly entering the formal labour markets, the more advanced Emerging Markets undertook deep pension reforms and began to build local currency yield curves, something they were able to do because they had credibly tamed inflation. By the mid-2000s, local currency debt markets had become the dominant fixed income asset class and local currency outperformed external debt each year during the 2006-2008 period. However, external debt also continued to perform, returning more than 8% to investors during 2006 and 2007. From 2009-2012, average returns on external debt rose to an impressive 16.7% per year, thus more than compensating each individual post-crisis year for the 12% loss sustained during 2008 (a temporary episode of serious mispricing of Emerging Markets risk). In 2011 and 2012, external debt was once again the strongest performing asset class in Emerging Markets as global sentiment was held hostage to bouts of risk aversion due to a plethora of problems in the HIDCs (Heavily Indebted Developed Countries), including the ratings downgrade of US Treasuries, fiscal cliff and debt ceiling issues, Greek defaults, Spanish banking sector problems, etc.

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Fig 1: **Emerging Markets fixed income returns by asset class (2002-2012)**

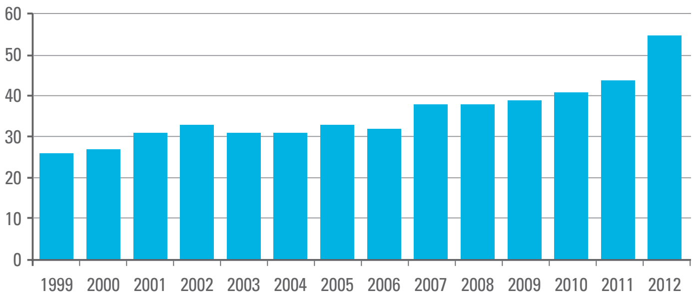
2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
External Debt 13.7%	External Debt 22.2%	Local Bonds 23.0%	External Debt 10.2%	Local Bonds 15.2%	Local Bonds 18.1%	Local FX -3.8%	Corporate Debt 34.9%	Local Bonds 15.7%	External Debt 7.35%	External Debt 17.44%
Local FX 11.4%	Local Bonds 16.9%	Local FX 14.8%	Local Bonds 6.3%	Local FX 12.3%	Local FX 16.0%	Local Bonds -5.2%	External Debt 29.8%	Corporate Debt 13.1%	Corporate Debt 2.31%	Local Bonds 16.87%
Corporate Debt 10.9%	Corporate Debt 16.2%	External Debt 11.6%	Corporate Debt 6.1%	External Debt 9.9%	External Debt 6.2%	External Debt -12.0%	Local Bonds 22.0%	External Debt 12.2%	Local Bonds -1.75%	Corporate Debt 15.44%
	Local FX 15.8%	Corporate Debt 10.3%	Local FX 3.2%	Corporate Debt 6.5%	Corporate Debt 3.9%	Corporate Debt -15.9%	Local FX 11.7%	Local FX 5.7%	Local FX -5.19%	Local FX 7.57%

Source: Bloomberg. JP Morgan.

The external debt renaissance

In 1993 there were only 14 index eligible Emerging Markets countries. By 1999 the number had risen to 26. In 2012 alone, 11 countries entered the index taking the total number of index eligible sovereigns to 55 and the number of index eligible issuers to 93 (including quasi-sovereigns). This year the number of index eligible issuers may reach 60 countries or more,[1] and we believe that the universe of external debt issuers could reach 80 countries by the end of the decade. The term 'external debt renaissance' seems appropriate.[2]

Fig 2: **Number of index-eligible countries in the JP Morgan EMBI GD Index**



Source: JP Morgan.

Frontier Markets are a particularly strong growth area in external debt. Formerly aid-dependent economies are graduating from donor financing.[3] For investors this ought to be good news. A myriad of fresh credit stories, not unlike the original wave of sovereign issuers in the 1990s, is breathing life into an asset class which for a time appeared threatened with extinction. For the Frontier Markets issuers themselves the ability to issue is also a blessing. Sovereign yield curves are a key piece of financial infrastructure, which not only introduces market accountability to governments but also helps corporates to price bonds. For Frontier Markets issuers with shallow local markets, long-dated external debt is attractive because it reduces interest rate volatility (since foreign portfolio investors, who measure returns in dollar terms, do not flip dollar bonds purely on movements in the country's currency) and it generates predictable refinancing requirements year by year.

Price…

External debt performed exceptionally well in 2012 because the asset class was severely mispriced at the end of 2011. In late 2011, external debt traded nearly 400bps over US Treasuries. This was not due to any fundamental weakness in Emerging Markets. It was due to risk aversion arising from the situation in Greece and fears of contagion within the Eurozone. No matter what happened to Greece however, there would almost certainly have been no impact on Emerging Markets, which in most cases have no ties with Greece whatsoever. The sell-off in late 2011 was the largest buying opportunity in Emerging Markets since 2008/2009, and returns in 2012 rewarded those who recognised the opportunity.

The outlook for external debt in 2013 is positive, albeit less spectacular than in 2012 due to the absence of extreme mispricing. The outlook for external debt is positive for three reasons:

First, the outlook for US Treasury yields is supportive. We believe the US economy will struggle to achieve 2% growth this year as fiscal drags more than offset the positive effect on GDP from stronger housing. Labour markets only improve modestly and inflation will remain tame. The Fed therefore stays dovish throughout this year and into 2014.

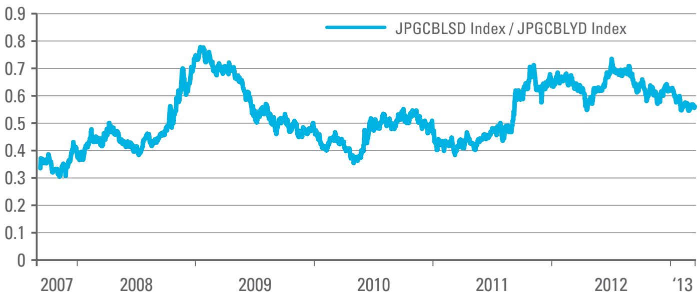
Second, fundamentals in Emerging Markets are picking up. The global manufacturing cycle is improving after a deep inventory correction in 2012 following the slowdown in Europe. Domestic demand will also receive a boost from rate cuts implemented last year across a range of countries. We believe that some of the bigger Emerging Markets countries such as Brazil and China will perform stronger this year than last.

Finally, technicals are good; we expect only about $15bn of net new issuance this year of which much will come from new issuers.

[1] Current prospects at the time of writing include Honduras, Bangladesh, Papua New Guinea, and Kenya.
[2] As a result of the many new entrants, the average weight of each country in the main indices has fallen. For example, the average country weight in the JP Morgan EMBI GD Index has fallen from 3.85% in 1999 to just 1.89% in 2012 and will likely fall further going forward. The number of bonds in the index has also grown and now stands at 330.
[3] http://blogs.ft.com/beyond-brics/2010/08/09/guest-post-why-africa-needs-a-bond-market/

The recent profit taking in the asset class following its extraordinarily strong performance in 2012 offers an attractive entry point for external debt. External debt spreads have pushed out to around 280bps over US treasuries, which means that the ratio of spread to yield – a key metric in the context of low treasury yields – is now wide by historical standards. External debt spreads are also wide by historical standards, trading 110bps and 60bps wide of the pre- and post-Lehman tights, respectively. External debt is extremely attractive compared to HIDC bond yields. At current spreads, Emerging Markets debt has cheapened versus US treasuries in the pre-crisis period, something quite remarkable considering what has been revealed about relative fundamentals in Emerging Markets and in the HIDCs in the intervening period (we return to this subject in our discussion of fundamentals later). Active specialist managers can expect to do better as credit selection is becoming far more important as a source of alpha generation due to the rapid growth of the asset class.

Fig 3: **Spread to yield ratio in Emerging Markets external debt**



Source: Bloomberg.

Returns in external debt will certainly not be a straight line, they never are. Treasury volatility is not going away. Every year for the past five years there have been one or more global panics triggered by problems in the HIDCs. However, each time a US Treasury rally has coincided with spread widening in external debt the event has proven to be an excellent buying opportunity, leading to new highs as credit improvement continues apace in Emerging Markets. Similarly, US Treasury sell-offs have subsequently given way to narrower spreads in Emerging Markets debt after a relatively short time lag.

Looking further ahead to the eventual and inevitable rise in US Treasury yields, we expect the Fed to lean against rising yields in order to generate an orderly unwind of unconventional and conventional easing measures. This ensures a smoother path for US Treasury yields than would be the case in the absence of Fed support, but it also transfers the adjustment into the currency space in the shape of a weaker and more volatile US Dollar. The main challenge facing the Fed is to avoid a 1994 style bond crash, while a weakening of the dollar would actually be helpful to the US recovery. In an environment of active Fed management of US Treasury yields, external debt will continue to play an important part in blended debt portfolios.

…And Prejudice

Prior to the 2008/2009 crisis, the Greenspan Fed was credited with fixing the age-old problem of business cycles. The debate over the state versus the market had been resolved firmly in favour of the latter. Declining US equity market volatility together with a flat and sometimes inverted US Treasury curve was 'proof' of policy-making success. The resulting rise in US mortgage debt was the economic fruit to be harvested and enjoyed. Warning signs such as the ever-widening US current account deficit were conjured into insignificance with quasi-religious constructs, such as 'dark matter'.[4] Needless to say, HIDC government bonds were 'risk free'.

By contrast, Emerging Markets were still regarded as a 'derivative' asset class, meaning an asset class without intrinsic value, which only performs if commodity prices are high and the US business cycle is on the up. Strip away these positive external factors and all you are left with is risk. Emerging Markets were seen as fundamentally peripheral to the global economy and absolutely not an asset class. Exposures were consigned to 'alternative' buckets rather than 'fixed income' or 'equity' buckets.

The crisis has revealed these views to be mere prejudices. Emerging Markets are manifestly not a 'derivative' asset class. They grew on average 5.5% per year from 2009 to 2012, despite 8% lower commodity prices and average growth rates of just 0.6%, -0.1%, and -0.2% per year in the US, Japan, and Europe, respectively. Emerging Markets are able to grow without strong external support because their expansion is driven by domestic demand. Domestic demand is strong because economic policies are better, which is a direct result of better domestic politics. Better politics in Emerging Markets has its origin in the end of the Cold War a quarter of a century ago.

Today, Emerging Markets are far safer investment destinations than the HIDCs. Emerging Markets central banks control 80% of the world's foreign exchange reserves, or about $8.7trn, which means that they can cope if global capital markets shut down. Emerging Markets issuers – sovereign and corporate – meet 85% of their financing needs in local currency markets, where yields are very uncorrelated with US Treasury yields.

Emerging Markets have ten times less external debt than the HIDCs (corporate and sovereign).[5] Even general government debt, which includes local currency debt, has fallen from 48% of GDP in 2000 to 42% of GDP in 2012, while general government debt has risen from 72% of GDP to 110% of GDP in the HIDCs over the same period. The average rating of Emerging Markets issuers rose to investment grade (Baa3/BBB-) in 2012 from two notches below investment grade (Ba2/BB) in 1999.[6] HIDCs have moved in the opposite direction. On a purchasing power parity basis, GDP per capita in Emerging Markets increased by 50% from $8,400 to $12,616 between 2000 and 2012. The average ratio of investment to GDP rose to a new high of 24% in 2012. Inflation has declined steadily from more than 10% in 2000 to 6% in 2012. The International Monetary Fund projects these improvements to continue. Inflation and general government debt to GDP will decline to 5% and 40% by 2017, respectively, while investment rates and GDP per capita will rise to 25% and $16,000, respectively.[7]

[4] Ricardo Hausmann and Federico Sturzenegger (2006) *"The Implications of Dark Matter for Assessing the US External Imbalance"*, CID Working Paper No. 137, November 2006.
[5] Carmen Reinhart, Vincent Reinhart, and Kenneth Rogoff (2012) *"Debt Overhangs: Past and Present"*, NBER working paper 18015, National Bureau of Economic Research.
[6] Moody's and Standard & Poor's.
[7] http://www.imf.org/external/pubs/ft/weo/2013/update/01/index.htm

Unresolved issues pertaining to external debt

The future role of New York Law

The outcome of the Argentina case before the Appeals Court in New York may have implications for the choice of legal jurisdiction for future dollar bond issuance by Emerging Markets governments. English Law is not an ideal alternative due to a recent adverse ruling pertaining to debt in former HIPCs (Heavily Indebted Poor Countries). Eventually, we expect Emerging Markets to move towards issuing under local law, even when they issue in dollars.

Market infrastructure

The development of Emerging Markets fixed income benchmark indices has begun to significantly lag the development of the asset class since the 2008/2009 crisis. The index-eligible share of the external debt universe has declined from 44% of outstanding external debt securities to 37% over the past decade. Local currency corporate bonds – a $3trn asset class – have no index at all. However, the weaknesses of the indices should not deter investors from entering the asset class. It is risky to hug benchmarks, because there is no such thing as a risk free investment.

Financial Repression

The Basel 2/3 and Solvency II regulatory regimes, are, in our view, thinly disguised mechanisms for financing bloated fiscal deficits in the HIDCs. They make traditional investment banks less competitive, so more and more trading of Emerging Markets fixed income is moving to local market-makers within the Emerging Markets themselves. This shift in liquidity to banks, brokers, and other institutions within Emerging Markets is a welcome development, though it may create barriers to entry for some managers.

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