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Emerging markets: the case for bonds over equities

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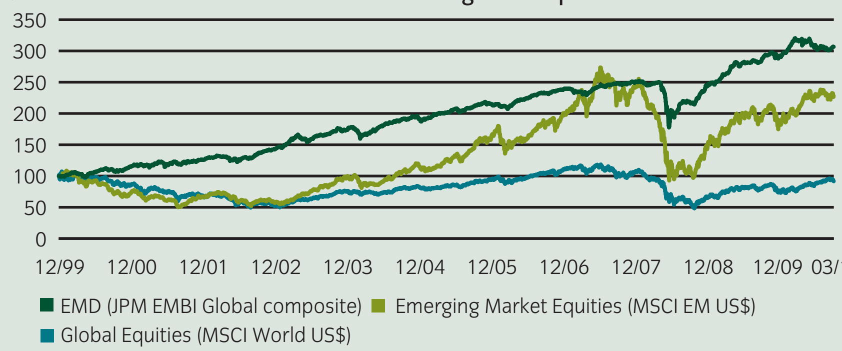
In a world where high levels of debt are leading to a material reduction in long-run growth expectations for western nations, the strong growth rates of emerging economies are becoming increasingly attractive. While investors' first instinct may be to buy emerging market equities to profit from this global power shift, we would argue that investors should actually look to the debt of the emerging world for the best risk-adjusted returns.

While acknowledging the strong underlying fundamentals of the developing world, some professional investors believe that the emerging story is already too widely known and therefore assume that this is reflected in current asset prices. While it is true that emerging markets are a far bigger feature in the press and general investment discussion than they were ten years ago, only a very small proportion of UK pension funds is actually invested in emerging markets. Global fund managers still use indices such as the JPM Global Bond index and the MSCI World index as their benchmarks, which have no allocation to emerging market countries, despite the fact that emerging markets account for almost 40% of global GDP and over 85% of the global population. A gradual change towards truly global benchmarks which include the emerging markets could be a catalyst for fund mangers to increase allocations to developing countries. Furthermore, there are a number of factors which could make emerging market debt (EMD) a more compelling long-term investment prospect than emerging market equities.

Volatility

Emerging market bond curves exhibit much lower volatility than equities of both the emerging and developed world. One reason for this is that the EMD asset class is predominantly in local bonds and is dominated by regional institutional investors. By contrast, emerging market equities are heavily influenced by international money flows, especially from the US, and domestic retail money. This means that returns may not be a true reflection of the underlying investment potential in the short and medium term, with retail investors tending to invest for shorter time periods than institutional investors. Whilst strong international capital flows have the potential to create periods where emerging market equities produce stellar returns, it can also make the market susceptible to bubbles as a result of artificially low interest rates in the western world, which can result in greater market volatility. The past three years have been an excellent example of how volatile emerging market equities can be. In 2007 emerging market equities were up over 50%, in 2008 they fell by over 50%, in 2009 they were back up over 50% and in 2010 they returned ca. 25%. EMD also produced strongly

Chart 1: Performance of EMD vs. EM and global equities since 2000



Source: Datastream.

Past performance is not a guide to future performance.

positive returns in 2007, 2009 and 2010 but in contrast to equities only suffered moderate losses on aggregate in 2008, with local market debt actually gaining over the year. Over the past ten years as a whole the composite EMD index has outperformed global and emerging equities, whilst exhibiting much lower volatility, as Chart 1 shows.

Low correlation is key

When equity prices in the emerging markets soared in 2006 and 2007, it was widely reported that the emerging market stocks had effectively de-coupled from the western world and that high valuations could be sustained even in the event of a recession in the US. The ensuing credit crisis served as a timely reminder that EM equities do indeed remain highly correlated with those in more developed countries. Although the emerging market consumer is growing in power, this is a long-term process, meaning that companies are likely to remain positively correlated with western demand for EM exports for many years to come. By contrast, correlations between emerging market bonds and developed market bonds have been very low historically. According to data supplied by JP Morgan, US treasuries have demonstrated a correlation of 0.18 with the external debt of emerging countries and 0.5 with EM local debt, which compares to a significantly higher correlation between EM equities and global equities of 0.78, where a figure of 1 implies a perfect positive correlation and a figure of 0 implies no correlation at all. This means that there are significant diversification benefits from having an allocation to EMD within a global bond portfolio. As the historical data shows, emerging market equities tend to be more correlated with global equities than EMD does with global bonds, and they therefore provide less diversification as part of a balanced portfolio.

A diversified universe

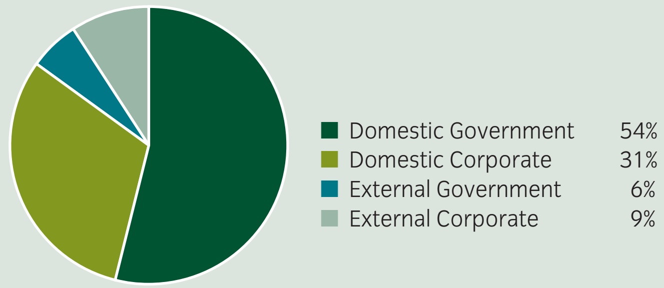
The EMD universe is inherently more diversified than that of EM equities, as it contains both corporate and government debt markets, both of which are denominated in a mix of local and international currencies across 72 countries. Chart 2 shows how the EM universe is broken down. Investors in an emerging market equity fund may not be fully aware of how concentrated portfolios in the asset class tend to be from a geographic perspective. The MSCI Emerging Markets index, which most emerging market equity funds have as their benchmark, has almost 75% allocated to just six countries – China (17.5%), Brazil (16.5%) Korea (12.5%), Taiwan (11%), Russia (7%) and South Africa (7%). Furthermore, the markets of China, Korea and Taiwan are highly correlated, given their reliance on exports to the US, as are the markets of Brazil, South Africa and Russia, given their reliance on natural resources, reducing the index's internal diversification further. Regional indices are often heavily concentrated into a few companies. Brazil's market index, for example, has a 40% weighting in just two companies, Vale and Petrobras. By contrast, the emerging market universe contains the full spectrum of developing world markets, from lowly developed countries such as Sri Lanka, to emerging global heavyweights such as Brazil.

An overlooked asset class

Despite being a $9.2 trillion market, EMD is often overlooked as an asset class in the UK. In contrast to emerging market equities, there are only a few EMD funds accessible to UK investors, with most company pension schemes not having an option to invest in the asset class at all. This means the area is less well researched than emerging market equities, which could lead to better opportunities for analysts and fund mangers that do invest in the asset class. EMD also looks more compelling than EM equities from a valuation perspective, with valuations in developing equity markets now trading at a small premium to global equities, when they have historically tended to trade at a discount.
By comparison, yields on EMD are far higher than most western bonds, despite the fact that it is actually emerging market countries which have the most robust balance sheets and therefore are arguably far less vulnerable to default risk. While there is a strong case for both EM equities and EMD trading at a premium to their developed world counterparts, it is EMD which has a greater valuation cushion against potential future market volatility.

The outlook for the emerging markets looks very bright.

Chart 2: How the EM universe is divided



Source: BofA Merrill Lynch.

Emerging fundamentals seem likely to follow on the opposite trajectory to those of the developed world, with strong fiscal profiles, falling debt levels, strong growth and favourable demographics. Data from the IMF supports this argument, showing the EM countries grew by 2.1% in 2009, a year when developed countries contracted by 3.2%. In 2010, EM growth continued to outperform.This should create good opportunities for investment in both emerging bonds and equities in the coming years ahead, with both asset classes looking well placed to outperform their corresponding asset classes in the west. Yet it is the combined factors of low volatility, low correlations to other asset classes, excellent diversification and being poorly researched which make a compelling argument for emerging market debt being the more attractive long-term investment proposition.

Please note the value of investments and any income from them will fluctuate (this may partly be due to exchange rate changes) and investors may not get back the amount invested.

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