Emerging market debt: the next 10 years

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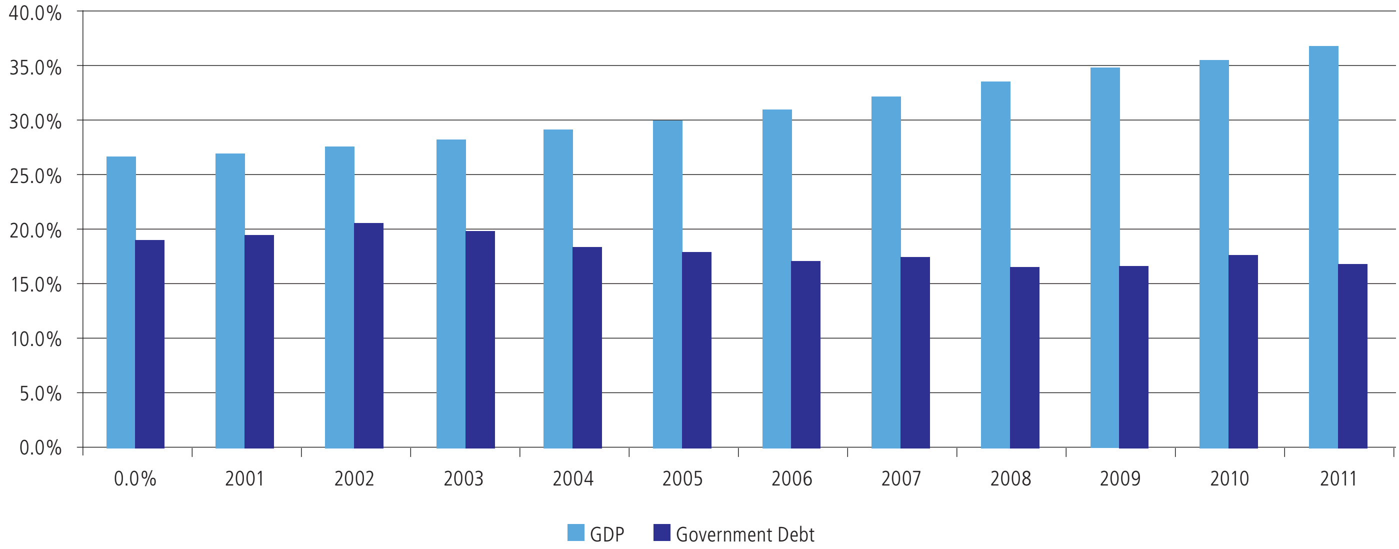
As is now widely publicised, emerging market growth is expected to substantially outstrip that of developed markets such that, within the next ten to fifteen years, emerging economies are likely to account for at least half of total global GDP. Already they account for approximately 37% of global GDP. But will we see the same trend in their level of government debt? Certainly over the past ten years this has not been the case, with emerging market sovereign debt falling as a proportion of total global debt, as highlighted in Figure 1.

Over the next ten years, we expect these debt dynamics to reverse as developed markets undergo an extensive period of de-leveraging while relatively strong emerging market growth continues. Our estimates show that by 2022 the global stock of government debt will grow to almost US$70 trillion – a 21.5% real increase from 2012 levels, representing an average of US$1.2 trillion in new debt per year. While the stock of debt may appear large, the increase is in fact very modest relative to the previous ten years' growth.

From 2002 to 2012 we estimate that emerging market debt grew by 26.4%, while developed market debt grew by a staggering 70.9%. Clearly the last four years have been exceptional, but even before the 2008 financial crisis, developed markets increased their stock of debt by over US$1 trillion per year.

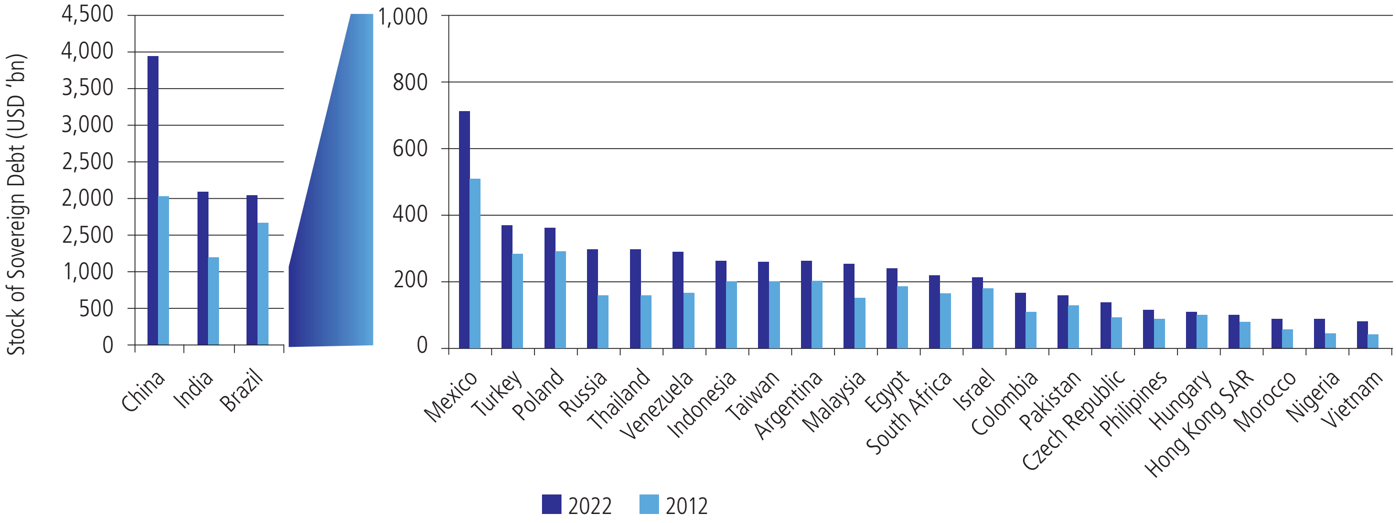
As regards individual issuers, we expect – unsurprisingly given the size of their economies – that China, India and Brazil will account for more than 50% of the debt of what is currently classified as emerging markets in 2022. However, this increase in debt will not be delivered by an increase in leverage – on the contrary our assumptions are that both emerging and developed markets decrease their levels of debt-to-GDP. Instead this increase is founded upon strong economic growth.

Figure 1: Emerging markets' share of global GDP and global government debt



Source: IMF, Investec Asset Management calculations May 2012

Figure 2: Forecast emerging market government debt levels, 2012 and 2022



Source: IMF, Investec Asset Management calculations May 2012

We forecast that China will double its stock of government debt to over US$4 trillion over the next ten years. The noticeable change will be a relatively large expected increase in debt by India; driven by India's strong economic growth compounded by a high, but falling, level of debt-to-GDP.

Russia, which is expected to experience lower growth, has the most scope amongst the BRICs to increase its levels of debt relative to GDP and, as such, it moves up the rankings.

Outside of the traditional BRICs, the countries with the largest capacity to issue debt over the next ten years will be Mexico (US$200 billion), Thailand (US$136 billion), Malaysia (US$101 billion) and Turkey (US$89 billion). For investors wanting to capture the growth in frontier markets however, it is worth considering those economies which, although small, have significant capacity to grow their debt issuance: Morocco, Nigeria, Vietnam, Tunisia, Kenya, The Dominican Republic and Ghana all have the capacity, we forecast, to increase their stock of debt by at least 60% over the next ten years with issuance ranging between US$12 billion and US$40 billion[1].

Future structure of EMD

The exact structure of a given bond market is greatly influenced by the economic history and current macro policies of its host economy. Past debt and financial crises, in particular, leave their mark on the willingness of lenders to take certain risks. For several Latin American countries (Brazil 1988-1990 and 1992-1994, Mexico 1990, Peru 1989) with painful experiences of hyper-inflation, local investors have traditionally been unwilling to take on inflation and interest rate risk and consequently these governments have issued relatively more inflation-linked and floating rate bonds.

However, as a country builds a track record of macro stability, investors become more comfortable to take on these risks and the proportion of non-'vanilla' fixed interest rate bonds decreases. This development is further supported by increasing participation of offshore investors, who typically make their entrance into new markets via fixed interest bonds.

As evidenced by the credit crisis of 2008/09 – when the issuance of corporate bonds in the developed world all but dried up and aggressive fiscal stimulus meant very large issuance of sovereign bonds – the structure of mature bond markets is not static. Financial innovation and unique developmental paths also make forecasting future emerging market bond market structures, particularly at an aggregate level, very challenging.

We discuss each of these characteristics below with reference to the prospects for this trend to occur in key emerging markets over the next 10 years:

1. Sovereign/corporate bond mix
Increasing issuance of private bonds vis-à-vis public bonds – visible

especially in countries, such as Brazil and South Africa, which have already come some way in establishing private bond markets. It is foreseeable that in these markets the private bond markets could be of at least equal size to sovereign markets within the next ten years

2. Bond maturity
Continuing extension of the yield curve within and across emerging markets. On average we see emerging markets adding another four years to their yield curves

3. Local/hard currency bond mix
Local currency bond issuance and share of total outstanding debt to dominate that of hard currency in an increasing number of emerging markets

4. Fixed interest/inflation-linked mix
Increasing issuance of plain-vanilla fixed interest bonds. We see emerging markets on aggregate moving towards the current developed market structure – 80% fixed, 10% floating, 5% inflation-linked and 5% exchange rate linked

5. Local/foreign ownership mix
We see the current trend of increasing foreign participation in emerging bond markets continuing at a steady pace – although not quite reaching developed market levels over the next ten years

At the same time as the changes detailed above, issuance of corporate debt should increase dramatically as the private sector will be able to price their debt off local currency sovereign yield curves.

The development of these markets will be matched by appropriate changes to the traditional emerging market debt benchmarks. By 2022 we believe that JP Morgan's local currency benchmark will grow from 14 countries to 22 while the bank's hard currency benchmark will increase from 48 to 55 issuers (including the potential exits of seven countries).

Demand for emerging market debt

The ability for global funds to absorb future emerging market debt issuance is of critical importance in assessing the potential impact on prices.

The total size of conventional (i.e. pension, insurance and investment) funds was estimated at US$77 trillion at the end of 2010. In addition to this, there is an estimated US$6 trillion in sovereign wealth funds and central banks' foreign exchange reserves. Clearly from the size of these funds even a small shift in allocation towards emerging market debt would result in a large flow of capital: for each 1% change in allocation we could expect as much as US$800 billion in emerging market bond flows (bearing in mind we forecast emerging market sovereign debt issuance of US$500 billion p.a. for the next ten years).

We believe there is significant scope for international investors to increase their exposure to emerging market debt over the next ten years. Currently, according to data sources, the average allocation to emerging markets debt amongst US, UK and European pension funds stands at only 2.2%.

Conclusion

Over the past ten years emerging markets have accounted for an increasingly large proportion of global GDP. However, over the same period, their proportion of global sovereign debt has fallen. We expect these debt dynamics to reverse over the next ten years as developed markets undergo an extensive period of deleveraging while relatively strong emerging market growth continues. We forecast the total global stock of government debt to increase, in real terms, by 21.5% to almost US$70 trillion. Emerging markets will account for 20.4% of this debt, from 16.2% presently as they issue almost US$500 billion per year. While at first the stock of debt may appear large, the increase is in fact modest relative to the previous ten years' growth: from 2002 to 2012 we estimate that emerging market debt grew by 26.4%, while developed market debt grew by a staggering 70.9%.

We believe that emerging markets have substantial capacity to issue debt over the next ten years while still maintaining sustainable levels of leverage. As developed markets experience a difficult period of deleveraging we believe that global sovereign debt markets will undergo a significant re-ordering over the next ten years. In line with their sustainable growth dynamics we foresee emerging markets continuing to offer attractive debt investment opportunities.

[1] For full details on country issuance and assumptions please see our white paper: Emerging Markets Debt: The next 10 years, Paper VII, May 2012