markit

4th floor Ropemaker Place 25 Ropemaker Street London EC2Y 9LY United Kingdom

Markit Commentary

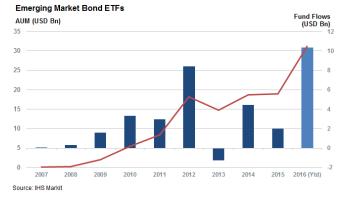
August 3rd 2016

EM bond investors choose liquidity over yield

Emerging market bond ETFs are seeing their strongest inflows on record but investors are steering towards lower yielding and more liquid dollar denominated funds.

- Hard currency EM bond ETFs gathered 70% of the record setting \$10bn by EM bond ETFs
- Hard currency bonds much more liquid than their locally listed peers according to Markit EVB
- Liquidity seen in hard currency bonds also evidenced in tighter bid ask spreads for their ETFs

Emerging market bonds ETFs are the high conviction trade of the year so far. Not even a coup from one of the most active issuers has dented investor appetite for these relatively high yielding bonds as emerging market bond ETFs saw their best inflow month ever in July, pushing the ytd inflows past \$10bn mark for the first time ever.



In the ever evolving trade-off between yield and liquidity however, it seems that investors riding the emerging market bond ETF wave have chosen the latter. This preference for the liquidity is evidenced by the fact that products that investing relatively lower yielding hard currency denominated bonds, such as US dollars, but which carry much less currency risk and liquidity constraints, have seen a 70% share of the record \$10.3bn that has been invested into the asset class.

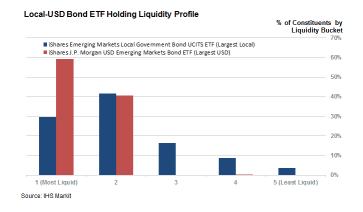
	% of AUM	YTD Inflows
Local Currency	27	3,000,162,571
Hard Currency	73	7,336,743,942

Local currency funds have also proved popular. However, the fact that over two thirds of investors are willing to pass up on the 1.43% of extra yield currently offered by the asset class, as gauged by the current difference in weighted average yield to maturity between the iShares J.P. Morgan USD Emerging Markets Bond ETF (EMB) and the VanEck Vectors J.P. Morgan EM Local Currency Bond ETF (EMLC), the largest US listed hard and local currency funds respectively, shows that yield isn't everything.

Hard currency bonds much more liquid

On top of the obvious currency risk carried by locally denominated emerging market bonds the cautious appetite for the asset class could also be the fact that bonds issued in local currencies tend to be much less liquid than their hard currency peers. The components of the iShares Emerging Markets Local Government Bond UCITS ETF (IEML), the largest locally listed fund, have seen an average of 3.1 quotes in over the last 10 trading days according to Markit Evaluated Bond data, which is a quarter of the 13 average quotes seen in the components of its EMB peer.

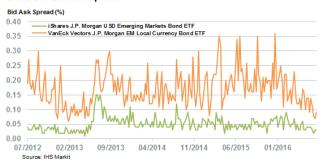
markit



This liquidity profile is also evidenced in the EVB liquidity scores. Whereas all but one of the components of the EMB earn the two most liquid EVB liquidity scores, the components of the IEML have over a quarter of their components in the three least liquid liquidity categories.

Liquidity reflected in lower bid ask spreads

The weaker liquidity profile of locally listed bonds is also evidenced in the cost investors have to incur when trading in and out of the asset class. The bid ask spread of the EMLC is nine bps, which is three times higher than its dollar denominated EMB peer. Bond ETF Bid Ask Spread



Perhaps most worrying for investors is the fact that the bid ask spread of the EMLC has surged ahead in times of market stress, such as the recent commodities rout, while the EMB's bid ask spread has been much less volatile.

Simon Colvin

Analyst Markit Tel: 207 260 7614 Email: simon.colvin@markit.com

The intellectual property rights to this report provided herein is owned by Markit Group limited. Any unauthorised use, including but not limited to copying, distributing, transmitting or otherwise of any data appearing is not permitted without Markit's prior consent. Markit shall not have any liability, duty or obligation for or relating to the content or information ("data") contained herein, any errors, inaccuracies, omission or delays in the data, or for any actions taken in reliance thereon. In no event shall Markit be liable for any special, incidental, consequential damages, arising out of the use of the data. Markit is a trademark owned by the Markit group.

This report does not constitute nor shall it be construed as an offer by Markit to buy or sell any particular security, financial instrument or financial service. The analysis provided in this report is of a general and impersonal nature. This report shall not be construed as providing investment advice that is adapted to or appropriate for any particular investment strategy or portfolio. This report does not and shall not be construed as providing any recommendations as to whether it is appropriate for any person or entity to "buy", "sell" or "hold" a particular investment.