

Q4 2018

Emerging Market Bond Traders Embrace E-Trading



CONTENTS

- 2 Executive Summary
- 3 Introduction
- 5 Emerging Markets:
Fixed Income 101
- 8 Liquidity Provision
- 10 E-Trading Emerging Markets
- 11 Looking Forward



Managing Director
Kevin McPartland is
the Head of Research
for Market Structure
and Technology at
the Firm.

**ELECTRONIC TRADING OF
EMERGING-MARKET BONDS
WILL CONTINUE TO GROW,
AS INVESTORS LOOK TO
IMPROVE TRANSPARENCY,
GAIN ACCESS TO A WIDER
POOL OF LIQUIDITY AND
COMPLY WITH NEW
REPORTING REQUIREMENTS**

70% OF U.S.
INVESTORS ARE TRADING
EMERGING-MARKET
FIXED-INCOME PRODUCTS
ELECTRONICALLY

Executive Summary

Emerging-market economies—those that are newly industrialized but have not yet fully developed—have proven themselves attractive to global fixed-income investors over the past decade. The perpetual search for yield has driven investment dollars from low-interest-rate developed markets into more risky emerging markets in hopes of improved returns.

While the search for yield is nothing new, accessing emerging-market fixed income has been a non-trivial pursuit for foreign investors. Global investment banks provided institutional investors access, but at a high cost. Banks local to those markets could help, but often stayed focused on local customers. And even if market access had deep, accurate and trusted pricing, data was often elusive.

But as electronic trading has increased access to both data and markets in the developed world, the same is happening in emerging markets. Technology is increasing the flow of information, removing the language hurdle and connecting disparate brokers and investors from all over the world, allowing trades to consummate that only a few years ago would have been too expensive if not impossible to get done.

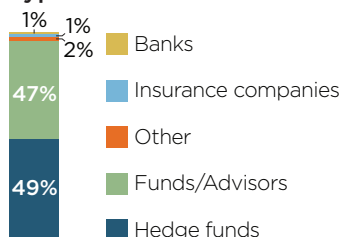
Nevertheless, e-trading in emerging-market fixed income is, well, emerging. To understand where we are now and where we are likely headed, it is critical to fully grasp the diversity that is emerging-market fixed income. These markets are as diverse as the cultures of the countries and corporations that issue the debt, and electronic platform providers and their users need to recognize those nuances to ensure that progress continues.

METHODOLOGY

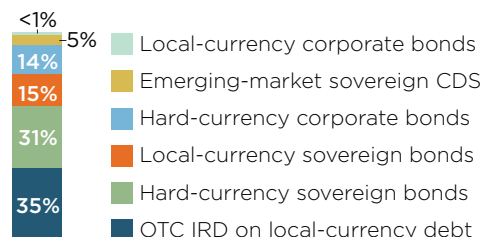
Between February and April 2018, Greenwich Associates interviewed 62 U.S.-based emerging-market fixed-income investors, primarily from hedge funds and investment managers. Interview topics included trade and research activities, product and dealer use, as well as electronic trading behavior.

TOTAL TRADING VOLUME DISTRIBUTION

Type of Investor



Product

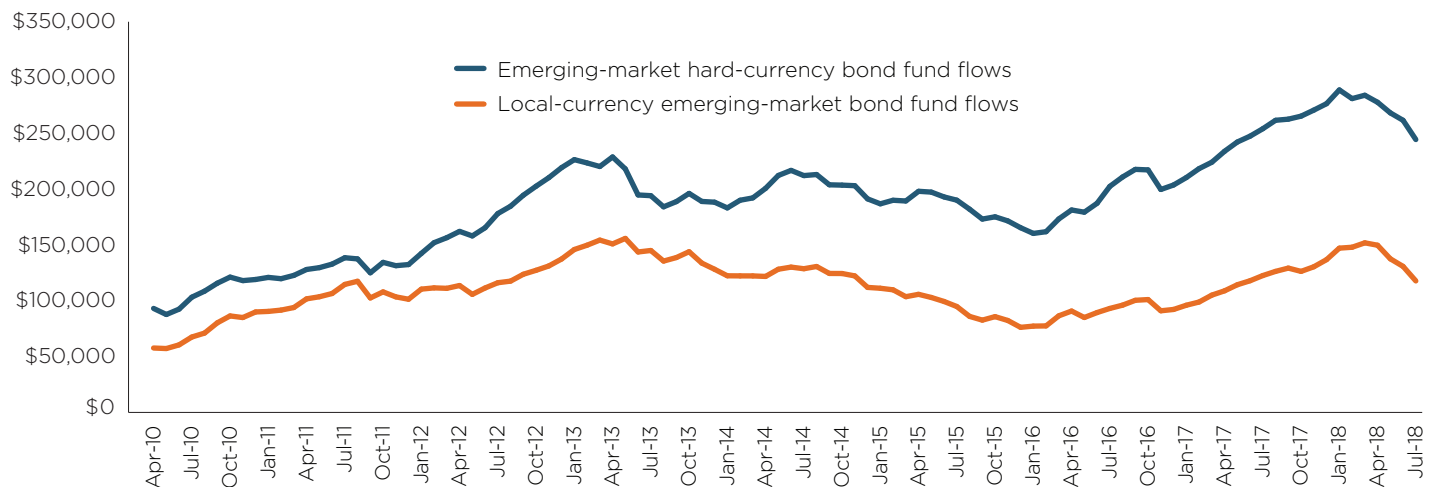


Note: May not total 100% due to rounding. Based on 62 respondents.
Source: Greenwich Associates 2018 North American Fixed-Income Study

Introduction

Fixed-income investors like emerging markets. Total assets in hard-currency emerging-market bonds have increased roughly 200% between April 2010 and April 2018. With interest rates in the developed world hovering at or below zero for the better part of the last decade, the search for yield by institutional investors has often ended in previously untrodden lands.

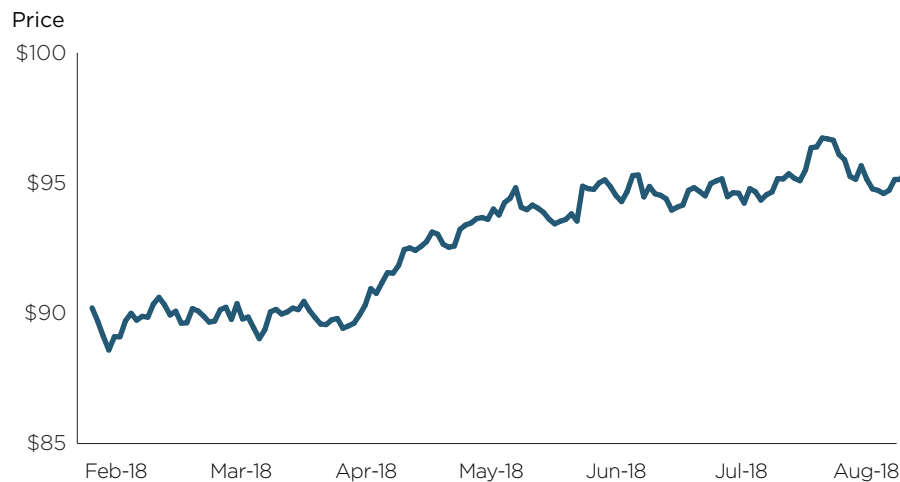
EMERGING-MARKET BOND FUND FLOWS



Source: Thomson Reuters

But recent fiscal tightening in the U.S. along with U.S.-dollar-moving trade policies have made emerging-market bonds less attractive. Assets in hard-currency emerging-market bond funds declined by 14% between April and July of 2018, while the value of the U.S. dollar increased simultaneously. Local-currency bond funds fared even worse, losing 22% of their assets. Issuance has also stalled after 10 years of continuous growth, now averaging around \$2 trillion annually.

DXY—U.S. DOLLAR CURRENCY INDEX

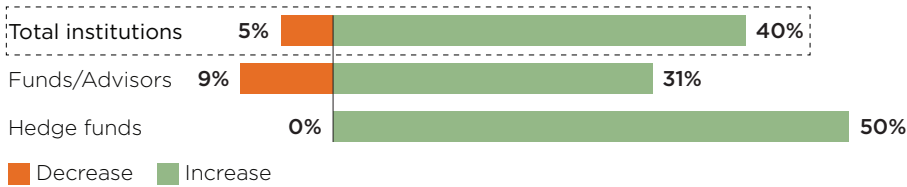


Source: Bloomberg

There is a silver lining, however—at least for some. As portfolio managers reposition for the current economic and geopolitical climate we’ve entered, trading volume increases. In fact, nearly one-third of the U.S. asset managers and half of the U.S. hedge funds we interviewed expect their volumes to increase in the coming year. This is in stark contrast to the previous year, where buy-and-hold had become the norm for corporate bond markets globally.

TRADING VOLUME MOMENTUM

Percentage of clients expecting to increase or decrease their trading volume in the coming year



Note: Based on 55 respondents.
Source: Greenwich Associates 2018 North American Fixed-Income Study

As such, the upticks in turnover, limited new issuance supply and price volatility driven by macroeconomic changes create opportunities for those who profit in a market that moves. The importance of bond dealers and their balance sheets only grows as portfolio turnover and volatility increases. Electronic trading of both hard- and local-currency emerging-market bonds will also continue to grow, with investors looking to improve their transparency into the market, gain access to a wider pool of liquidity and comply with new reporting requirements brought on by MiFID II.

SIGN OF MARKET VOLATILITY

iShares J.P. Morgan USD Emerging Markets Bond ETF



Source: Bloomberg

Emerging Markets: Fixed Income 101

Before we examine the path forward for emerging market debt, it is important to clearly define this segment. The J.P. Morgan Emerging Market Bond Index (EMBI) is the most widely tracked measure and provides good insight into what is considered an emerging market. Currently, the index tracks the bond markets of 67 emerging economies from Angola to Zambia. Unsurprisingly, the largest of those economies see the vast majority of trading volume. That said, major economic and/or geopolitical events—such as those in Turkey and Venezuela—can also trigger increased market participation.

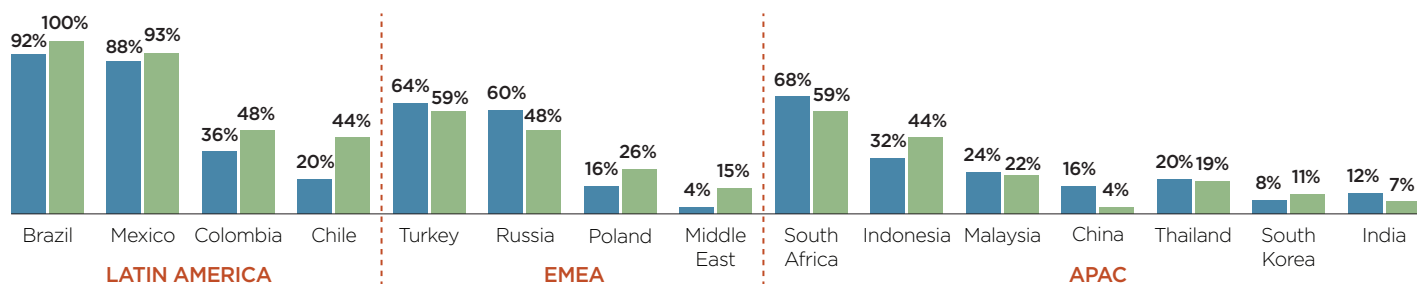
COUNTRIES IN THE J.P. MORGAN EMERGING MARKET BOND INDEX (EMBI)					
LATAM		CEEMEA		ASIA	
Argentina	Paraguay	Angola	Lebanon	China	
Belize	Peru	Armenia	Lithuania	India	
Bolivia	Suriname	Azerbaijan	Morocco	Indonesia	
Brazil	Trinidad & Tobago	Belarus	Mozambique	Iraq	
Chile	Uruguay	Cameroon	Namibia	Jordan	
Colombia	Venezuela	Croatia	Nigeria	Kazakhstan	
Costa Rica		Egypt	Poland	Malaysia	
Dominican Republic		Ethiopia	Romania	Mongolia	
Ecuador		Gabon	Senegal	Oman	
El Salvador		Georgia	Serbia	Pakistan	
Guatemala		Ghana	Slovakia	Philippines	
Honduras		Hungary	South Africa	Russia	
Jamaica		Ivory Coast	Tunisia	Sri Lanka	
Mexico		Kenya	Ukraine	Tajikistan	
Panama		Latvia	Zambia	Turkey	
				Vietnam	

Note: As of September 2018.

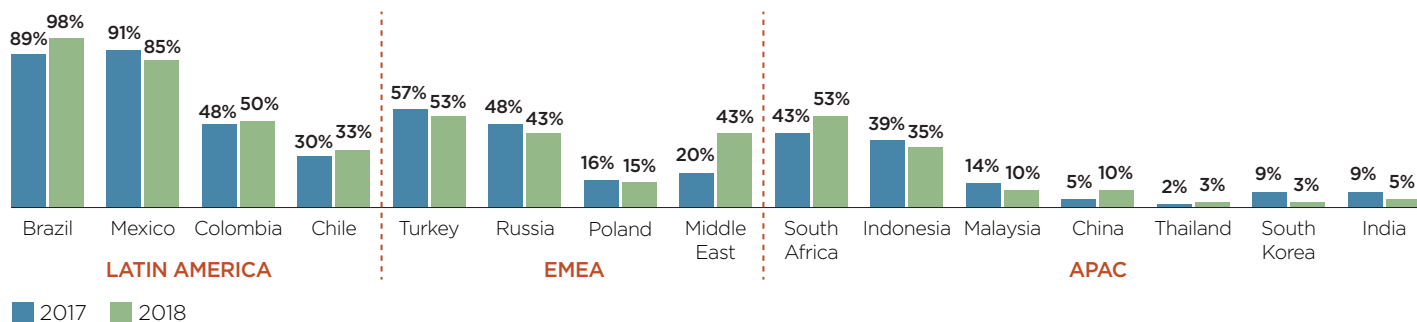
While the BRICS acronym has fallen somewhat out of favor in recent years, its constituents (Brazil, Russia, India, China, and South Africa) still garner considerable attention, fitting the criteria outlined above. For instance, the vast majority of our study participants are actively investing in Brazil and Mexico, two of the largest economies in Latin America. On the other side of the Atlantic, South Africa is popular with investors, as it is the most advanced economy in Africa. Conversely, the market for Turkish debt has been active recently due to concerns over its economy's health. In general, emerging market investors tend to invest in those markets that are in close geographic proximity—U.S. investors in Latin America, European investors in Eastern Europe and Asian investors in developing Asian economies.

USE OF LOCAL- AND HARD-CURRENCY SOVEREIGN PRODUCTS BY COUNTRY

Local Currency¹



Hard Currency²



Note: ¹Based on 25 respondents in 2017 and 27 in 2018. ²Based on 44 respondents in 2017 and 40 in 2018.
Source: Greenwich Associates 2018 North American Fixed-Income Study

Within those regional boundaries, emerging-market debt can then be broken down into rates and credit. Emerging-market rates consist primarily of government bonds issued in the local currency of that government and its related derivatives (i.e., futures, swaps). If the United States were an emerging market, U.S. Treasuries would fit into this bucket. There is nearly \$8 trillion in local-currency sovereign bonds outstanding, accounting for over 40% of the notional value of emerging-market bonds outstanding. Trading in these bonds accounts for between half and three-quarters of volume on any given day.

The remainder of the market falls into the credit category, which contains a much broader set of products. Corporate bonds issued by corporations in emerging-market currencies are the most obvious component. These bonds can be issued in either local or hard currencies, with the former making up the lion's share. U.S.-based emerging-markets investors tend to favor hard-currency bonds, whereas the rest of the world favors local-currency corporates. It is important to note that many major dealers trade local-currency corporate bonds on their emerging-markets interest-rate desk alongside government bonds in those same local currencies.

Chinese bonds make up an increasingly large portion of what is considered local-currency emerging-markets debt. Much of this remains largely unavailable to foreign emerging-market investors, however, with the

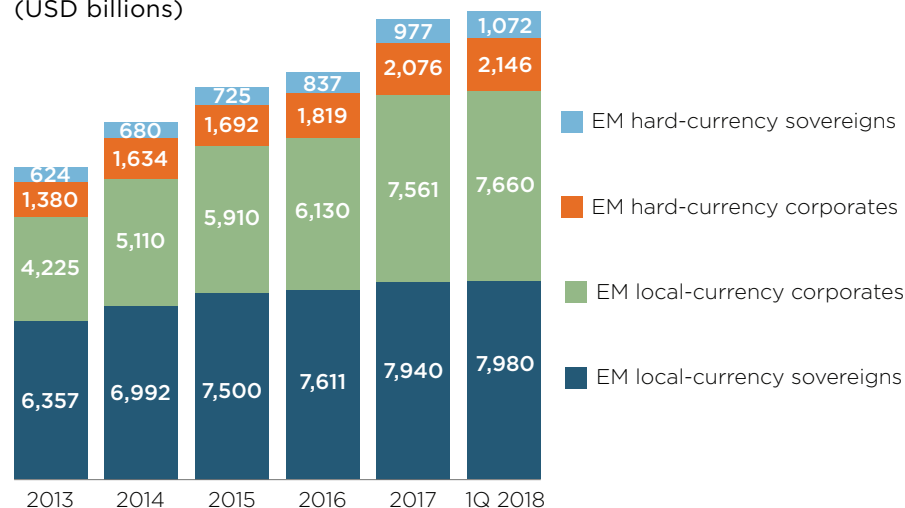
majority of bonds issued in China held by local individuals and firms. This is slowly beginning to change with the Chinese bond market presenting a large potential opportunity for market participants in this space.

EMERGING-MARKET FIXED INCOME

Emerging-Market Rates	Emerging-Market Credit
Local-Currency Sovereign Bonds (e.g., Turkish government bond) issued in Turkish lira)	Hard-Currency Sovereigns Emerging-market government bonds issued primarily in USD
Interest-Rate Derivatives (i.e. swaps, futures)	Hard-Currency Corporates Emerging-market corporations issuing bonds in USD
Local-Currency Corporates Emerging-market corporations issuing bonds in the local currency	Emerging-Markets Sovereign CDS CDS protecting against the default of emerging-market government debt

Source: Greenwich Associates 2018

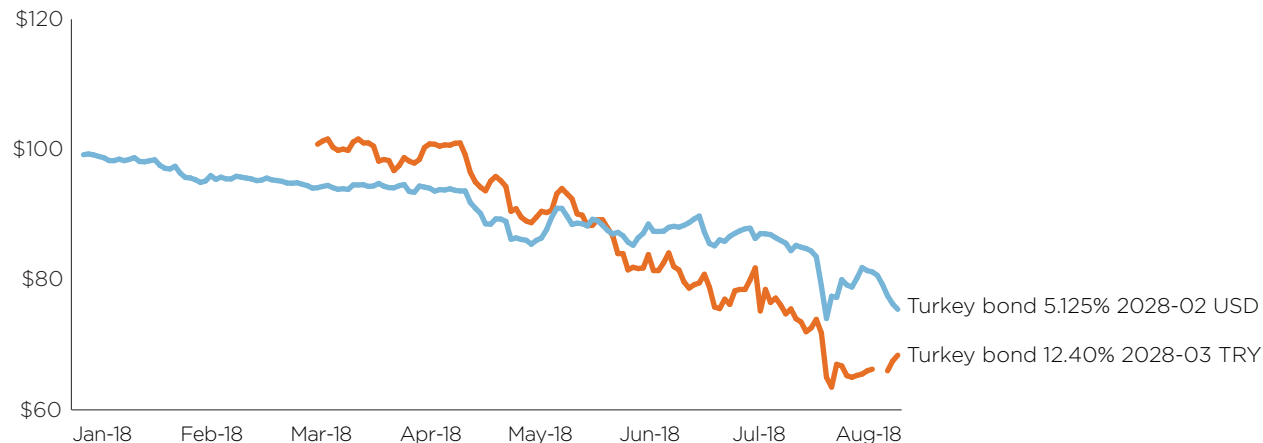
EMERGING-MARKET DEBT OUTSTANDING (USD billions)



Source: J.P. Morgan

The other component of emerging-market credit is hard-currency sovereign bonds. While sovereign bonds are generally considered interest-rate products, trading emerging-market sovereign bonds in USD or EUR all but removes the interest-rate risk, leaving only credit risk for the portfolio manager or trader managing. This can drastically change the value and yield of the bond over time, with Turkish government debt providing a recent extreme example. In that same vein, credit default swaps (CDS) on hard-currency emerging-market sovereign bonds also fit into the credit category.

TURKISH 10-YEAR GOVERNMENT BOND PRICES



Source: Bloomberg

Liquidity Provision

The leading dealers in emerging-market fixed income need to provide coverage as diverse as the market itself. In each of the nearly 70 emerging economies around the world, the top liquidity providers can vary greatly by hard versus local currency, and sovereign versus corporate debt. Providing coverage is no easy task, especially in this post-crisis era, in which even the largest dealers have been forced to pull out of certain regions and products due to the limited return on equity they can generate.

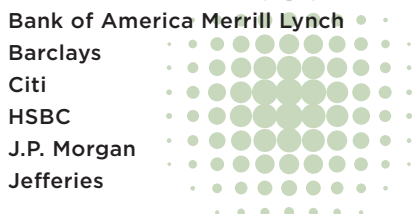
This has created opportunities for banks outside of the top five in developed fixed-income markets to become market leaders in emerging markets. Jefferies is a prime example in the U.S., a top dealer of U.S.-based investors trading emerging-market fixed income. Similarly, Standard Chartered is a top three bank in Asian fixed income, and HSBC is the market-share leader in European emerging-market debt trading.

“[One of our big dealers] lost a lot of local market access that they used to have.”

~Medium-size hedge fund

TOP U.S. FIXED-INCOME DEALERS—EMERGING MARKETS

(listed alphabetically)



Note: Based on 62 respondents.

Source: Greenwich Associates 2018 North American Fixed-Income Study

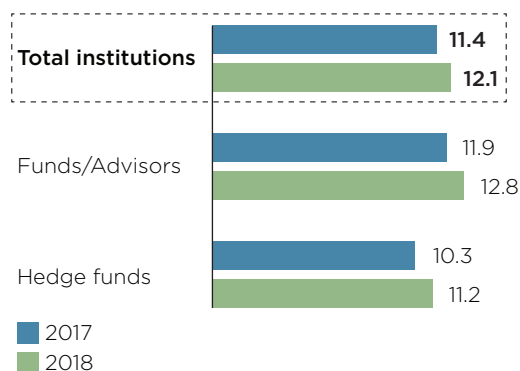
Despite the large role of global bond dealers, each country also has its own top dealers. For example, Banco Galicia, Banco Bradesco and Banco Itau are top 10 players in Latin American emerging-market bond trading, according to Greenwich Associates research. These local dealers are particularly big in local-currency trading, which in many countries is restricted to onshore entities. Even for large global banks, creating an onshore presence can be expensive and time-consuming, a major reason that many have pulled out of various emerging markets around the world. Top local banks have a longer list of local customers as well, whereas global banks operating within each country more often focus on servicing international investors.

This dynamic has caused emerging-markets investors to broaden their access to liquidity providers and direct less of their trading to their top dealers. Hedge funds, for instance, have on average increased their dealer lists from 11 to 12 in the past year, and asset managers from 12 to 13.

This change is also reflected in the market share of the top five dealers. In 2014, the top five handled 65% of U.S. investor trading in emerging-market fixed income. Today the top five handle only 54%, with share lost to dealers 5-10 as well as 11-20. Clearly, the largest global banks, with their balance sheets and global reach, are still crucial partners for emerging-markets investors. However, the local expertise of regional banks is resonating now more than it had in the past.

DEALER RELATIONSHIPS AND CONCENTRATION

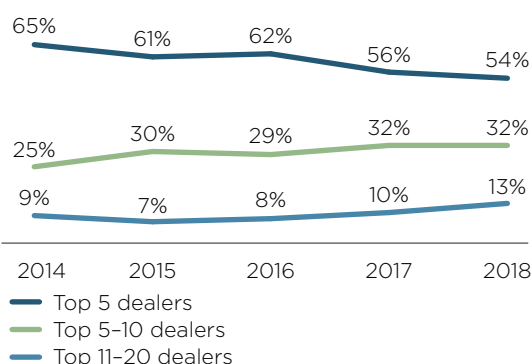
Average # of Meaningful Dealer Relationships—EM Credit



Note: Based on 61 respondents in 2017 and 62 in 2018.

Source: Greenwich Associates 2018 North American Fixed-Income Study

Dealer Concentration—Emerging Markets



Even so, most of the liquidity in this market comes from traditional banks. Emerging-market fixed income is generally not attractive to nonbank liquidity providers. The large number of bonds available to trade around the world makes the U.S. investment-grade market feel small. Even restricting trading to hard-currency bonds, and thereby removing currency conversions from the equation, few instruments exist for hedging the resulting credit risk—a necessity for trading firms that like to keep their market exposure as close to zero as possible.

That said, emerging-market fixed-income ETFs have grown in popularity and assets. The largest, from iShares and tracking the EMBI, has grown to nearly \$14 billion in assets under management. This puts it in the same league as other large, developed-market bond ETFs such as LQD and JNK. When individual ETFs achieve notable asset and trading volume levels, ETF liquidity providers are quick to follow. This is increasingly the case for emerging-markets debt, where these ETF-focused market makers have ramped up trading of the bonds themselves, and their use of emerging-market bond e-trading platforms more specifically.

E-Trading Emerging Markets

Until recent years, electronic trading in emerging-market bonds has been nascent, given the market's diversity of instruments and relative lack of liquidity. But as U.S. investors have migrated one-fifth of their investment-grade bond volume to electronic platforms, they have increasingly looked to these same platforms to trade in emerging markets. Dealers are following suit, especially those local dealers that can leverage electronic platforms to expand beyond their local customer base to large international investors hoping to gain access to the region.

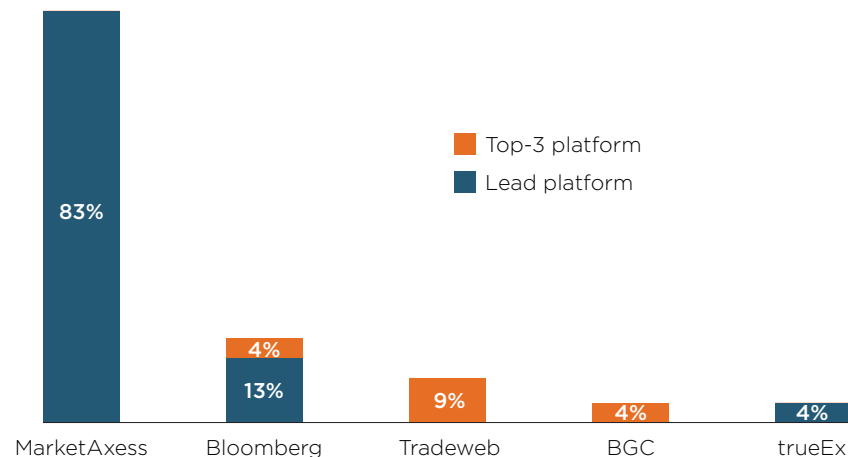
Greenwich Associates research has found that 70% of U.S. investors are trading emerging-market fixed-income products electronically, amounting to 14% of the notional volume traded. The majority of hard currency debt trading on electronic platforms is of smaller-sized orders, following the growth trend of odd lots leading to round lots established by e-trading of developed-market bonds.

U.S. investors favor MarketAxess here, which is not surprising, given they are the market share leader in U.S. investment-grade and high-yield bonds. The top dealers trading on the emerging-market platforms differ little from the top dealers in emerging-market bonds overall, with Barclays, Jefferies and J.P. Morgan the most-used electronic counterparties by the U.S. investors in our study.

“The gaps in liquidity are filled in pretty well when we request stuff electronically.”

~Large hedge fund

MARKET FOOTPRINT AND RELATIONSHIP DEPTH—EMERGING MARKETS— MULTI-DEALER PLATFORMS



Note: Based on 23 U.S.-based emerging market fixed-income investors. Percentages denote proportion of respondents using the platform.

Source: Greenwich Associates 2018 North American Fixed-Income Study

Hard-currency bonds—those denominated in USD or EUR—are more electronic, while those traded in local currencies are less so, given their accompanying FX component. This dynamic creates an opportunity for bond-market platform providers, who have already spent the better part of the last decade working on trading tools and protocols to help facilitate electronic trading.

Auctions, all-to-all trading pools, and pre- and post-trade analytics—much of which was developed to help grow e-trading in developed-market high-yield bonds to the more than 10% of volume it is today—are now being applied to emerging markets in general and to local-currency bonds specifically. In fact, 15% of emerging-market hard-currency bond trading on MarketAxess is done via its Open Trading™ platform. Add in tools to help investors and dealers manage the interest-rate and FX risk, coupled with MiFID II's incentives for moving trading to the screen, and e-trading in local-currency emerging-market bonds has a clear path for growth.

Looking Forward

While the search for yield drove investor interest in emerging-market bonds, now trade wars, a more valuable U.S. dollar and rising interest rates are causing investors to rethink their investment approach. But with uncertainty comes volatility, with volatility volume, and in today's market, healthy volatility drives increased adoption of technology and electronic trading, allowing market participants to more quickly react.

Cover Illustration: © iStockphoto/tigristiara

The data reported in this document reflect solely the views reported to Greenwich Associates by the research participants. Interviewees may be asked about their use of and demand for financial products and services and about investment practices in relevant financial markets. Greenwich Associates compiles the data received, conducts statistical analysis and reviews for presentation purposes in order to produce the final results. Unless otherwise indicated, any opinions or market observations made are strictly our own.

© 2018 Greenwich Associates, LLC. Javelin Strategy & Research is a division of Greenwich Associates. All rights reserved. No portion of these materials may be copied, reproduced, distributed or transmitted, electronically or otherwise, to external parties or publicly without the permission of Greenwich Associates, LLC. Greenwich Associates®, Competitive Challenges®, Greenwich Quality Index®, Greenwich ACCESS™, Greenwich AIM™ and Greenwich Reports® are registered marks of Greenwich Associates, LLC. Greenwich Associates may also have rights in certain other marks used in these materials.

