Emerging versus Developing Markets; Equities versus Bonds

Given the fragile state of the global economy the resilience of risky assets is remarkable.
Year to date, the MSCI World index is up 8.0%, bonds are up 11.7%, high yield has gained 8.3%, emerging markets bonds 12.3% , emerging markets equities a paltry 3.2% and crude 7.9%.

Volatility and risk in developed markets has risen relative to emerging markets. A rational strategy therefore is to buy straddles on developed markets' businesses while selling straddles on emerging markets' businesses. Here we refer not to equities but to the underlying assets and cash flows of the businesses. Thus, buying a straddle would involve buying both a call and a put option on a company's assets. This is equivalent to buying the equity stock and selling short its corresponding bond. Put together the whole trade broadly looks like: long (or overweight) developed market equities and short (or underweight) emerging market equity; long (or overweight) emerging market bonds and short (or underweight) developed market bonds.

Apart from the real options theory basis for the trade there is a more intuitive justification. Emerging markets growth rates continue to outpace develop markets (despite the current synchronized slowdown). Yet corporate governance and rule of law remain underdeveloped in emerging markets, at a protectionist and mercantilist time in global economics. It is safer to access emerging market growth through developed market companies deriving revenues from emerging markets, or through foreign listings. As Europe slumps and the US remains under very muted growth, the export heavy listed markets of the developing world are more likely to suffer. If one feels compelled to buy emerging market companies for whatever reason, the seniority of claim of bonds is a safer trade expression.