



Key themes in emerging market corporate credit

An uncertain policy dynamic and a period of recovery in distressed EM credit are adding to an already ripe opportunity set for the EM long-short investor

Market backdrop

The global macroeconomic backdrop for emerging market (EM) credit is changing. The US economy is showing signs of strength and as a result we can expect to see a more hawkish stance from the US Federal Reserve and thus higher US rates. In addition, with the election of Trump and the uncertainty surrounding his policy agenda, we anticipate the increased risk of a trade war/import tariffs with EM countries, an intensification of populism, and rising geopolitical manoeuvring between regional powers.

These risks are somewhat counterbalanced by what we see as a positive turn in the credit cycle for EM corporates. Leverage is showing signs of stabilisation and defaults look to have peaked in 2016. There is evidence to suggest that we have reached the balance sheet repair stage of the credit cycle, with companies focused on further deleveraging through asset sales and cost cutting initiatives. As a result, based on our bottom-up analysis, we expect to see a meaningful decline in the projected default rate from 5% in 2016 to 2% in 2017; the largest decline in defaults since the 2008 financial crisis.

Market Insight



**Polina
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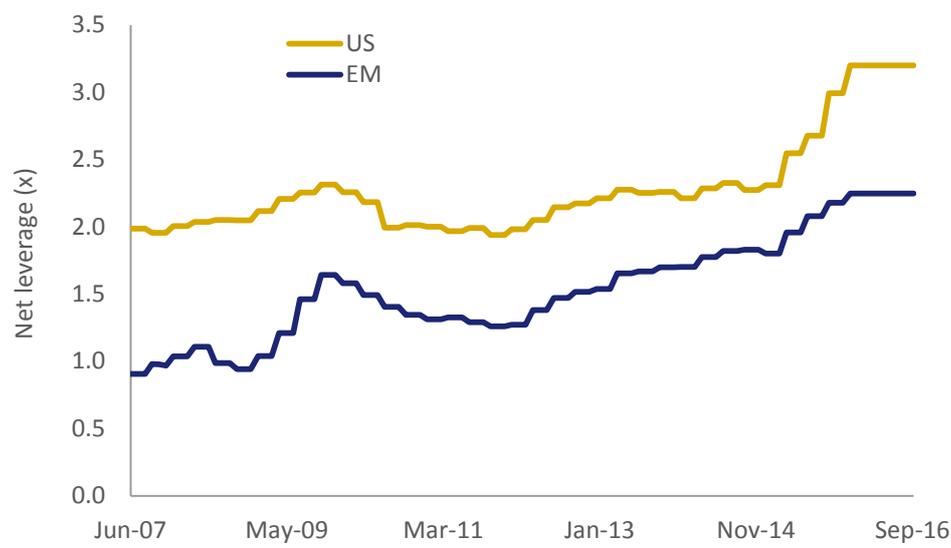


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Emerging market corporates

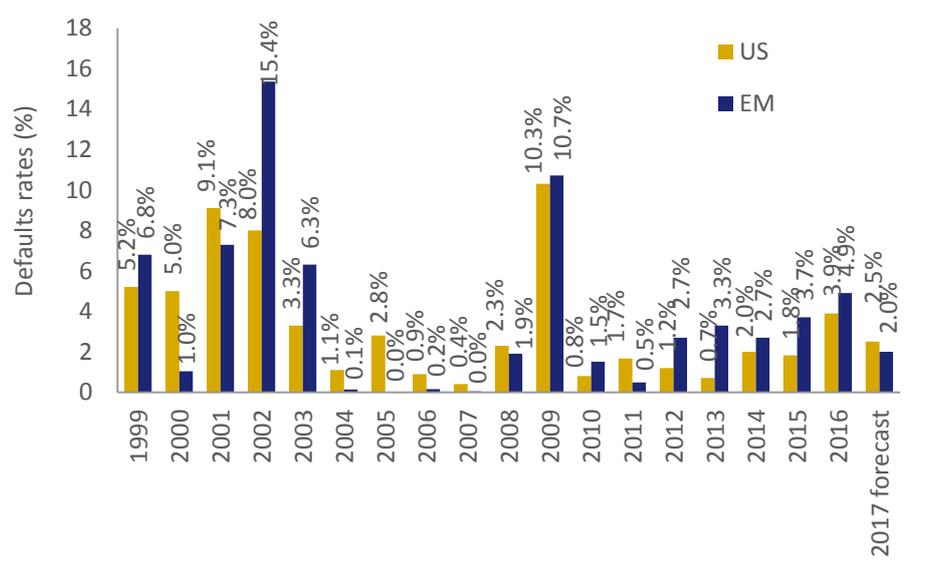
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Fig. 1: Leverage is stabilising



Source: BAML, as at 30 September 2016

Fig. 2: Default rates are declining



Source: JP Morgan, as at 28 November 2016

The opportunity set

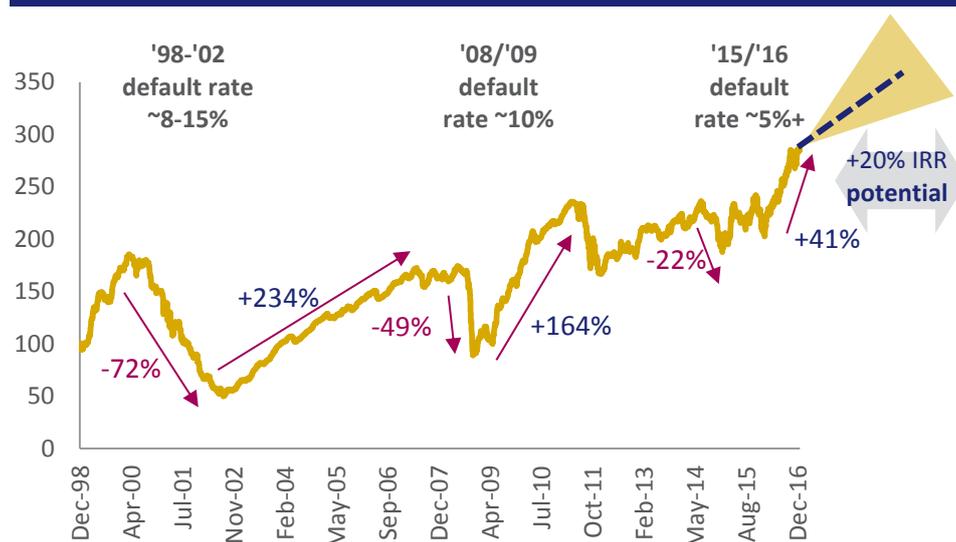
We believe an uncertain policy dynamic and a period of recovery in lower-rated and distressed credit offers two distinct themes and corresponding sets of opportunity in EM corporate credit. These include potential short opportunities in vulnerable sectors likely to be negatively impacted by Trump’s policy agenda and long opportunities in the liquid distressed segment of the market. The opportunity set is further augmented by traditional relative value opportunities, capitalising on dislocations from both the long and short side. Finally, we believe the primary market will continue to offer attractive short-term tactical trades, extracting new issue premiums with often limited downside risk.

Liquid distressed

Giving reference to the performance of the EM Corporate Distressed Index (represented by the universe of EM corporate issues rated CCC and below) over the last two credit cycles, the price recovery at the index level has averaged roughly three times the price decline observed in the period of market stress leading up to peak defaults.

As the market continues to chart a recovery from trough valuations, we believe there is incremental price upside potential in the coming period. Below we aim to outline a few key considerations for investors assessing the opportunity in EM distressed.

Fig. 3: EM corporate distressed index (CCC & below)



Source: BAML as at 30 December 2016

1. Liquid distressed offers significant return potential without sacrificing liquidity or taking undue process risk

Within EM distressed, we believe the liquid distressed segment offers the most attractive risk-adjusted return potential. We define liquid distressed as the universe of EM corporate bonds for which there are multiple flexible trade exits and which trade in spread terms over 1000bps.

While we observe a broad range of short-to-medium-term opportunities in this segment of the market, we have seen a marked increase in the number and quality of shorter-term event plays where the issuer is one to two months away from finalising a restructuring proposal.

In EM distressed, roughly half of the price upside (or return potential) is typically realised in the months immediately following the announcement of a restructuring. We therefore believe that distressed corporates in the advanced stages of a restructuring process offer some of the most compelling risk-adjusted return opportunities, without sacrificing liquidity or taking undue process risk.

2. Bankruptcy reform in select EM jurisdictions should support higher recoveries

Over the last five years, a number of EM countries have implemented changes to the legal framework governing bankruptcy and reinforcement of creditor rights. For example the Brazilian government is proposing to implement a new bankruptcy regime by July 2017, modelled on the US Chapter 11 bankruptcy code. We believe this is a very exciting development for the asset class and should ultimately support higher recoveries.

3. Selecting a manager: navigating the opportunity set requires significant analytic bandwidth and deep EM expertise

Opportunities in liquid distressed are not uniformly attractive. We therefore believe that success in navigating this opportunity set requires a credit-intensive, fundamental approach to asset selection. In our view, an asset manager with significant analytic bandwidth and deep EM jurisdictional expertise will be best-placed to identify fundamentally mis-priced securities within this segment of the market.

The ‘Trump short’

How do EM investors deal with the potential tail risks thrown up by the Trump administration? To date, most of the price action has been observed in currency and rates markets, with a preeminent focus on country-specific risk e.g. Mexico. Even within EM corporate credit markets the focus remains largely on country risk; however, in our view, the focus should shift increasingly on sector risk. Sectors characterised by thin operating margins, high leverage, and/or cyclical weakness have limited cushion to absorb a trade policy shock. The weakest operators within these sectors are vulnerable to a meaningful repricing and could become outright default candidates under more draconian policy outcomes.

When assessing this opportunity set we believe there are two key factors that should be considered:

1. Time horizon

While there is huge uncertainty around Trump’s ultimate trade policies, we anticipate greater visibility over the next 12 months, representing a reasonable time horizon to run short positions in inherently vulnerable names.

2. Entry level

We believe there are a number of credits that remain ‘priced for perfection’ today. As many of these bonds are trading at or above par, risk is definitively skewed to the downside, allowing short positions to benefit meaningfully from any significant negative price action. Moreover, some of the sectors and individual corporates most vulnerable to changes in Trump trade policy (consumer goods, industrials, autos etc.) are trading in spread terms at or near their pre-2008 and 5-year tights, making the cost of implementing shorts the lowest for 9 years.

Fig. 4: Industrial sector historical spreads



Source: JP Morgan, as at 13 February 2017

Compelling return potential

We believe that the two key themes of liquid distressed and the 'Trump short' have the potential to generate what we view as compelling returns for investors over the next 12 months. Moreover, these themes are being played out against a backdrop of elevated dispersion in an asset class which remains largely under-researched with relatively few dedicated managers. As a result, it is our view that the propensity for mis-priced risk is high, adding to an already ripe opportunity set for a specialist EM long-short manager.

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