BlueBay Asset Management

Credit synergies; a holistic approach to EM hard currency debt

Market Insight

Blending corporate and sovereign hard currency debt into a single portfolio can provide investors greater geographical and thematic diversification and help mitigate downside risk

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Over the last decade, the emerging market (EM) hard currency universe has grown and evolved, as has its composition; corporates now outweigh sovereigns in the amount of total debt stock outstanding (Fig. 1).

Whilst sovereigns have historically been the asset class of choice for investors looking to branch into EM, the growth of the corporate sector provides access to a much broader opportunity set. Nevertheless, despite the US$1.8trn size of the corporate asset class, the growth of the international EM corporate dedicated investor base has lagged somewhat.

Here, we argue that an aggregate approach to the EM hard currency universe provides investors the opportunity to take advantage of the complementary features offered by each asset class in one strategy, creating a geographically and thematically diversified portfolio with an improved liquidity, credit quality and volatility profile.

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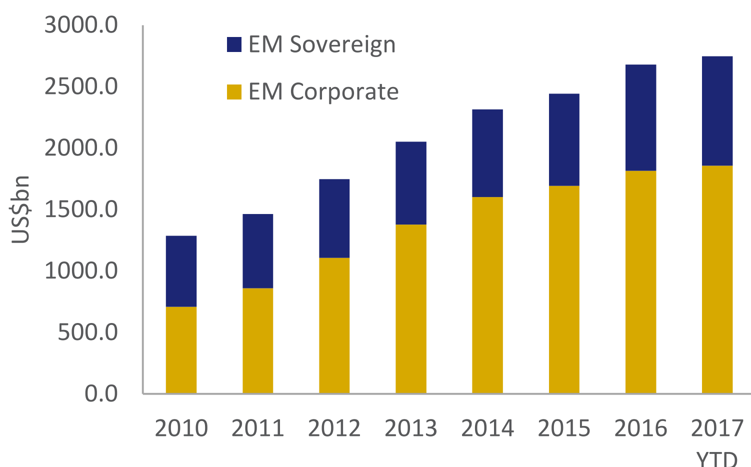
Fig. 1: Total debt stock outstanding



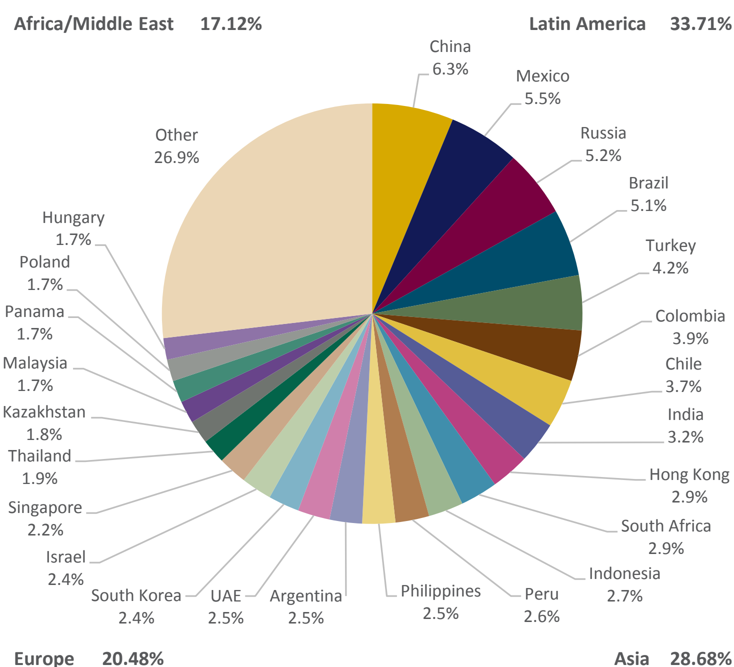
Source: JP Morgan, as at 31 March 2017

Why choose a blended approach?

1. Greater diversification

An aggregate approach gives you much broader geographic and thematic diversification. The sovereign asset class comprises over 60 country constituents but is heavily weighted towards Latin America, with less representation to Asia and the Middle East. The reverse is true in the corporate universe. Aggregating exposure dilutes the extremes of each sub-set and provides a more balanced investment universe.

Fig. 2: Increased diversity and scope of the investible universe



Data source: JP Morgan, as at 30 September 2016

2. More liquidity, less volatility

The corporate universe can be less liquid in some places due to the 'buy-and-hold' mentality of certain domestic buyers, but this also means it can be less volatile. The international market for sovereigns leads to greater liquidity but also higher volatility. An aggregate portfolio smooths out the volatility and enhances the overall liquidity profile of a portfolio.

3. Improved credit quality

Incorporating corporates into a sovereign portfolio raises the overall credit quality of the investment universe. Corporates issuing internationally need to be of a higher credit quality whereas higher-quality sovereigns have a tendency not to issue externally because they have very developed domestic markets. For example, while India's macro story might be compelling, it's inaccessible to sovereign investors as all sovereign issuance is done domestically in local currency. Therefore the only entry for international investors investing in dollar assets into this space is via the corporate market.

4. Lower duration

The impact of rising rates on EM fixed income, as developed market (DM) central banks unwind the extraordinary stimulus of the recent past, no matter how well telegraphed, will have a detrimental impact due to the Treasury component of the asset class. However, in an environment of stronger economic growth, the higher-yielding, more cyclical sectors (oil & gas, metals & mining) in the corporate universe tend to perform better. Furthermore, corporate issuers on aggregate have lower duration than sovereigns, who are able to finance themselves for 30 or even 100 years. Therefore, the higher-yielding shorter duration component of the corporate market, which is less US Treasury sensitive, helps lower the overall duration exposure of the portfolio.

A good entry point

There are a number of reasons why we believe now is a good time for investors to consider increasing their exposure to EM:

The Trump effect appears to have had little impact

Initial fears of President Trump having a negative impact on EM have so far proved unfounded. We have seen little real evidence of him delivering on his aggressive campaign rhetoric and protectionist policies. This has given way to expectations of a more gradual approach to changes in policy and thus a more gradual rise in US Treasury yields, which we believe EM should be able to absorb.

The (geo)political scales have swung in favour of EM

Over the last 12 months we have seen a transferral of political and geopolitical risk from EM into DM with Brexit and the US elections in 2016 and the upcoming European elections in 2017. While political risks in EM remain, such as in South Africa and Turkey, risks of large-scale political turbulence in some of the biggest countries in the EM universe (e.g. Brazil, Argentina etc) appear to have dissipated.

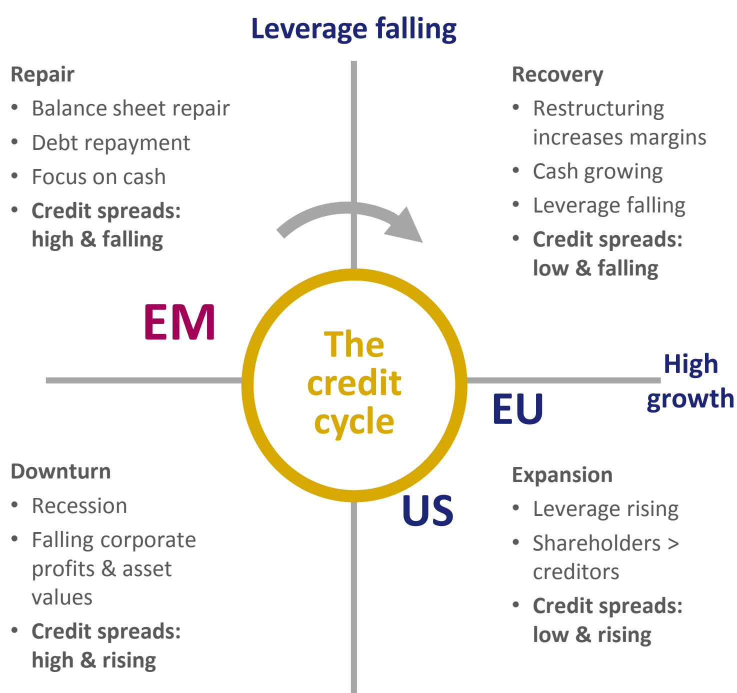
EM valuations remain compelling on a relative basis

While DM risks have increased, valuations remain tight. EM valuations are more attractive on a relative basis than in DM and are thus appealing for investors looking for extra yield pick up and to diversify their DM risk.

Corporate fundamentals are on an improving trend

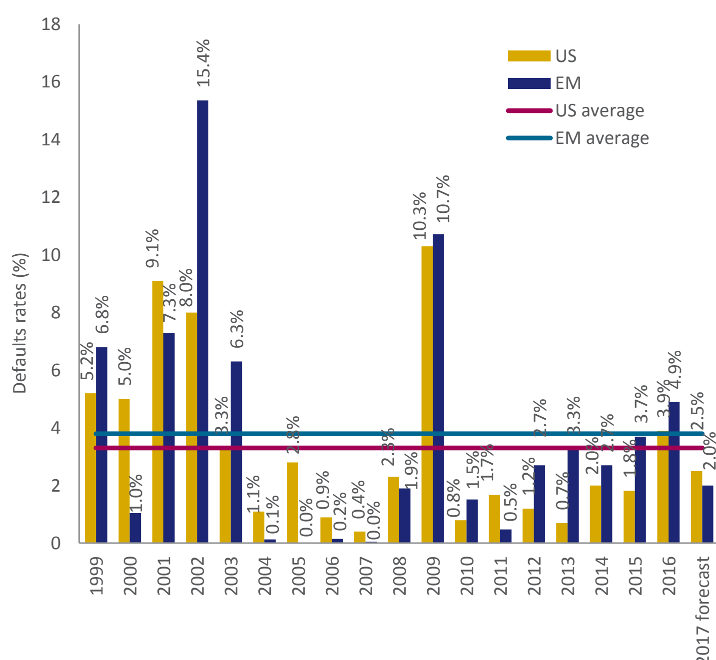
The corporate segment of the market is coming out of a default cycle (in our base case, we expect default rates to reduce from >5% in 2016 to <2% in 2017), balance sheets are correcting and fundamentals are on an improving trend. A falling default rate and a pick up in economic growth is a positive environment for spread assets.

Fig. 3: EM is further into the balance sheet repair phase



Data source: BlueBay Asset Management as at 31 March 2017

Fig. 4: Default rates expected to reduce to 2% in 2017



Data source: JP Morgan, as at December 2016

Chinese risks have diminished

While the risks from China's large credit imbalances remain, given 2017 is the government's transition year, authorities are keen to preserve stability. Capital controls implemented towards the end of 2016 have stabilised outflows and broader sentiment in EM. Finally, last year's extraordinary monetary stimulus has provided a strong growth momentum into the first half of this year and, as the latest data suggest, China appears on track to reach this year's growth target with risks skewed to the upside.

Current opportunities

In our view, there are a number of attractive areas for alpha potential in the market, notably within the higher-yielding part of the investment universe.

Credit	Opportunity
Sovereigns • Idiosyncratic higher-yielders • Under-researched sovereigns • Countries benefiting from accelerating growth	Sub-Saharan Africa (benefiting from IMF support), Middle East (offering attractive rating-adjusted valuations), Latin America (benefiting from a much-improved growth backdrop and reform momentum).
Corporates • Quasi-sovereign oil and gas credits • 'Distressed' credits	Range of 'distressed' credits which are nearing the final phase of their restructuring processes, supported by stable commodity backdrop and attractive recovery rates.

An asset class with broad appeal

As we have discussed, an aggregate approach to EM hard currency debt offers diversity across regions and geographies. It also lowers the overall volatility and duration profile, increases liquidity and provides access to higher-credit-quality assets than investing in just corporates or sovereigns. In addition, with the asset allocation component available via an aggregated portfolio, a manager can swiftly change their exposures to reflect the current most optimal opportunity set at any given time, providing further upside potential. For investors looking to allocate into EM fixed income, we believe an aggregate approach to EM hard currency debt is an appealing option.

Fig.5: Calendar year returns by asset class

2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	YTD 2017
EM Sovereign 10.6%	EM Sovereign 10.3%	EM Sovereign 6.3%	EM Sovereign -11.9%	EM Corporate 38.6%	EM Corporate 13.5%	EM Sovereign 7.4%	EM Sovereign 17.6%	EM Corporate -1.7%	EM Sovereign 8.6%	EM Quasi Sov 1.4%	EM Quasi Sov 11.1%	**EM Sovereign 4.0%**
EM Corporate 6.8%	EM Corporate 6.6%	EM Quasi Sov 4.8%	EM Quasi Sov -12.9%	EM Quasi Sov 31.7%	EM Sovereign 12.3%	EM Quasi Sov 7.3%	EM Corporate 17.0%	EM Quasi Sov -5.1%	EM Corporate 5.7%	EM Corporate 1.2%	EM Corporate 10.4%	**EM Quasi Sov 3.4%**
EM Quasi Sov 5.6%	EM Quasi Sov 4.8%	EM Corporate 3.5%	EM Corporate -15.4%	EM Sovereign 29.5%	EM Quasi Sov 12.1%	EM Corporate 3.2%	EM Quasi Sov 16.9%	EM Sovereign -5.3%	EM Quasi Sov 4.0%	EM Sovereign 1.1%	EM Sovereign 9.9%	EM Corporate 3.1%
Difference between the best and worst performing EM credit sub-asset classes												
5.1%	**5.5%**	**2.9%**	**3.5%**	**9.1%**	**1.4%**	**4.1%**	**0.7%**	**3.6%**	**4.6%**	**0.3%**	**1.2%**	**0.9%**

Data source: BlueBay Asset Management, JP Morgan, as at 31 March 2017

Nevertheless, we would caveat that the combined investible universe is rather large (comprising some 500 issuers across 77 countries); picking the right entry level and focusing on a bottom-up, fundamental approach to investing in each issuer is key to generating attractive, risk-adjusted returns.

We continue to expect ongoing differentiation between the best and worst performing credits in the market place and, looking ahead, we believe this will be a year requiring very particular and careful security selection and country analysis.

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