BlueBay
Asset Management

Insights

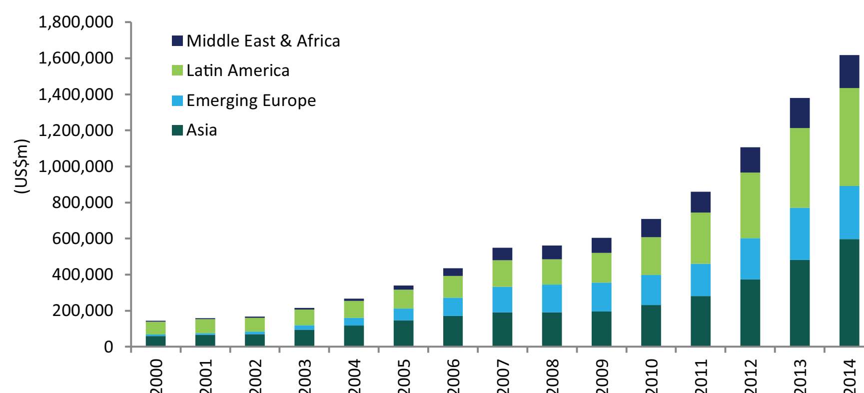
The Top 12 Myths About Emerging Market Corporate Debt Dispelled

January 2015

Myth 1: "The asset class is too small and niche"

Reality: Emerging market (EM) corporate debt has been one of the fastest-growing asset classes over the past decade. Indeed, with a total debt stock of over US$1.6 trillion in EM hard currency corporate debt alone (not to mention another approx. US$4 trillion[1] in local currency-denominated EM corporate debt), the EM corporate debt asset class is now larger than both the US and European high yield markets, as well as the EM sovereign market.

Fig. 1 Total debt stock outstanding

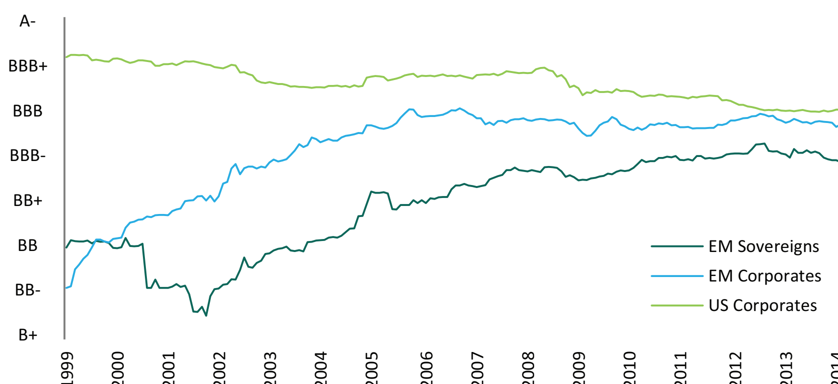


Source: BIS and JP Morgan estimates, as at 31 October 2014
Note: 1 JP Morgan estimate

Myth 2: "These companies are too low quality for me; I don't want to go that far down the credit quality spectrum"

Reality: In parallel with the surge in issuance over the past decade, the asset class has undergone a transformation in terms of its overall credit quality, which has improved significantly over time. As it stands today, the EM corporate market is now approximately 70%[2] investment grade-rated by the agencies, and the JP Morgan Corporate Emerging Market Bond Index (CEMBI) Diversified carries an average rating of BBB. This ranks higher than the EM sovereign market (which has a greater proportion of lower-quality frontier markets) and has converged with developed market (DM) credit.

Fig. 2 Average credit quality



Data source: BAML, JP Morgan as at July 2014
Note: 2 JP Morgan CEMBI Div Index

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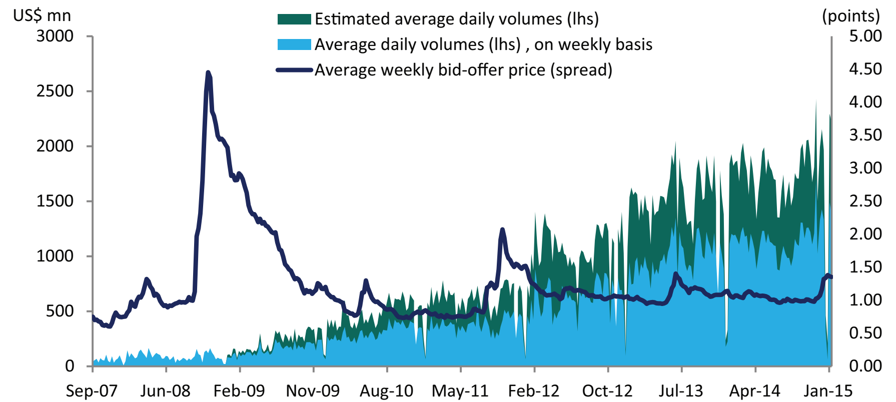
Myth 3: "These credits are far too illiquid relative to sovereign debt and developed markets"

Reality: Liquidity has also increased commensurately with the growth of the asset class; post the global financial crisis of 2007/08, large banks have been under pressure to reduce their balance sheets, resulting in a decline in liquidity. During this time, EM corporate debt has actually experienced increased liquidity owing to i) more market participants and ii) a growing number of local EM banks acting as market-makers. Daily trading volumes in EM corporates have increased significantly since 2007. Bid/ask spreads are also now more in line with developed market credit and EM sovereign levels. That said, in times of extreme market stress, price action can become gappy, in particular in the high yield segment of the market, which means an active management approach is needed.

Fig. 3 Average daily volume per week



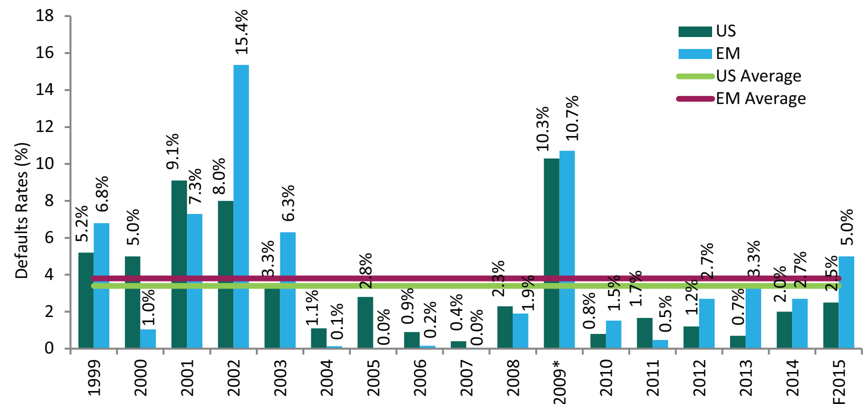
Data source: JP Morgan, as at 16 January 2015

Myth 4: "I cannot stomach such a high level of default rates that EM corporates experience"

Reality: As Fig. 4 shows, the long-run historical default rates in EM corporate debt have been roughly on a par with those of DM high yield. Furthermore, recovery values in EM have been broadly in line with developed markets.

Looking forward, our base case for defaults is in the 3-5% range for 2015, with a lot of these well telegraphed and the market priced accordingly.

Fig. 4 Historical defaults (as a % of HY bonds outstanding)

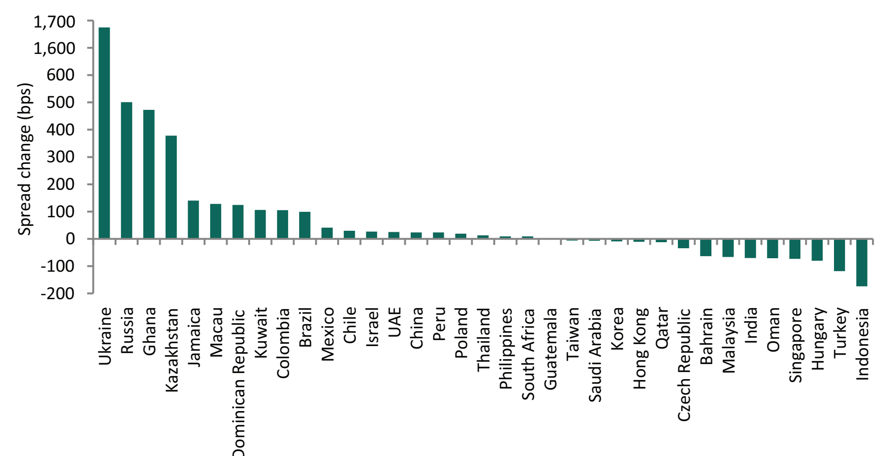


Data source: S&P, JP Morgan, as at 31 December 2014

Myth 5: "This market just trades like risk-on/risk-off; there's no scope for credit differentiation"

Reality: What we witnessed over the course of last year was a significant dispersion of returns, with the market doing a very good job of differentiating between 'good' and 'bad' credits and improving versus deteriorating stories. This lack of contagion is positive for the asset class, particularly as geopolitical and idiosyncratic headline risks have been elevated.

Fig. 5 2014 spread change



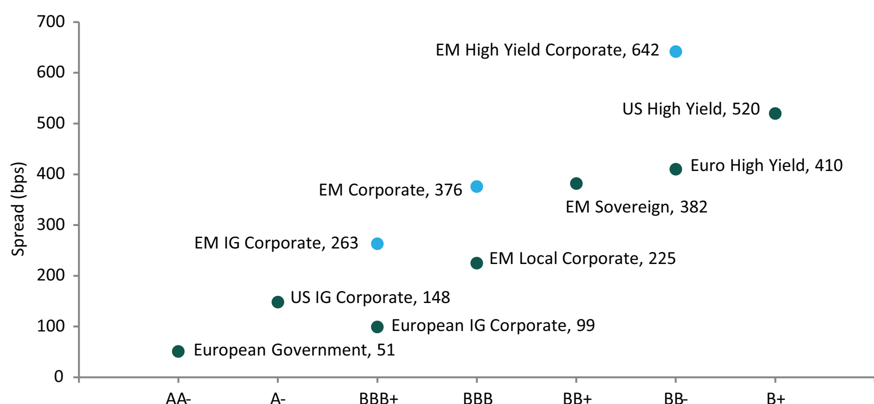
Data source: JP Morgan, as at December 2014

Myth 6: "Valuations are too tight; all the money has been made and the beta is no longer attractive"

Reality: We believe valuations look quite attractive at current levels, in particular after the sell-off we witnessed in the latter part of 2014 (Fig. 7).

As such, relative to other fixed income products on a standalone yield basis, we believe the carry in EM corporate debt is quite compelling with investment grade yielding 4.62% and high yield at 8.04% (as at 31 December 2014). Furthermore, looking at the spread pick-up one receives for investing in EM corporates relative to DM corporates, this ratio is at an all-time wide, and as such in our view the relative value arguments for the asset class are pretty robust.

Fig. 6 EM Spreads vs. other fixed income asset classes



Data source: JP Morgan, BAML as at 9 January 2015

Myth 7: "These securities are far too volatile"

Reality: EM corporate debt actually exhibits comparable levels of volatility to developed market credit; in the investment grade space it is usually lower, whereas in the high yield space, it is typically slightly higher. Furthermore, in times of extreme market stress, e.g. the global financial crisis, this market exhibits 'fixed income-like volatility', not 'equity-like volatility'.

Fig. 7.1 Volatility in EM vs. US IG

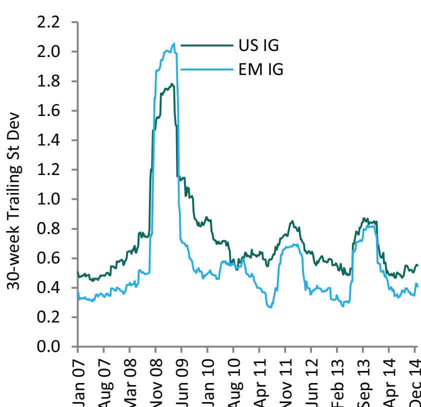
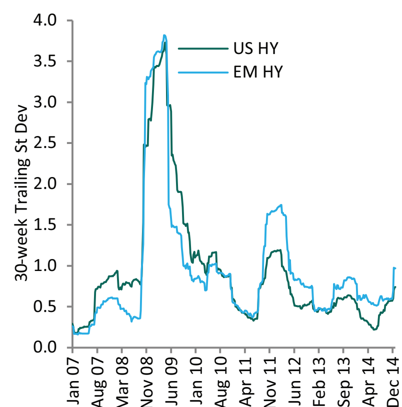


Fig. 7.2 Volatility in EM vs. US HY

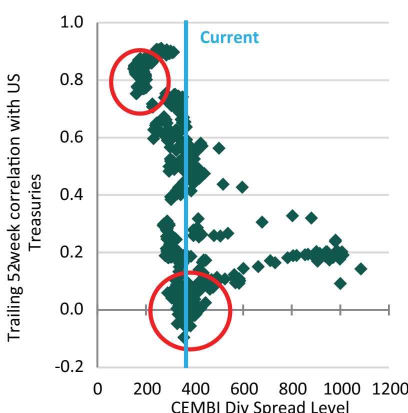


Data source: BAML Global Research, as at 26 December 2014

Myth 8: "These securities are too sensitive to a move in US Treasuries. Once the Federal Reserve hikes rates, EM corporates will be disproportionately affected"

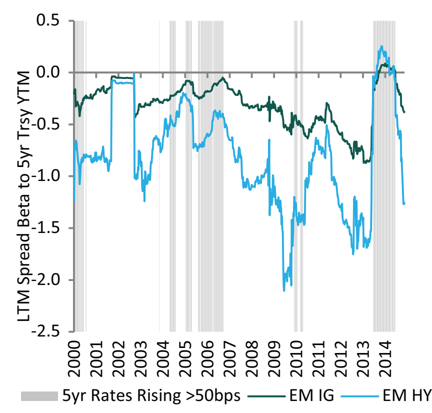
Reality: Given where we are today with US growth, the end of quantitative easing (QE) and bouts of hawkish rhetoric from the Federal Reserve (Fed), consensus dictates that a move higher for interest rates is on its way at some point this year. We believe that, while a move higher in US Treasuries will impact the total return for EM corporates, the asset class should prove more resilient, and is more likely to weather the potential storm, than other fixed income asset classes.

Fig. 8.1 Correlation with US Treasuries



Data source: JP Morgan, Bloomberg, as at July 2014

Fig. 8.2 EM corporate beta to rising US Treasuries



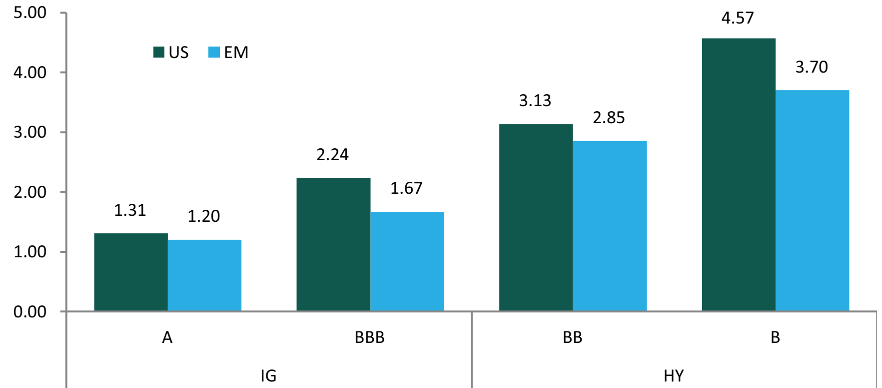
Data source: BAML, as at November 2014

To shape this view, firstly we look at the correlation of EM corporate debt relative to US Treasuries and find that the relationship is not stable through time, typically ranging between +0.8 and -0.2. Correlations tend to be high when the spread cushion is low, and lower when the spread cushion is high, as indicated by Fig. 8.1. Where we are today, with an index spread in excess of 390bps, we would expect that this is sufficient to absorb the upward pressure in the US Treasury curve. Also, looking at Fig. 8.2 with the exception of the Taper Tantrum of 2013, every other time rates have moved higher by 50bps or more EM corporate spreads have tightened. Finally, when we look back to the last time the Fed went through a rate hiking cycle (2004–2006), it is worth noting that over these three years, EM corporate debt delivered an annualised return of c.8%, despite the Fed hiking rates by 400bps over this period.

Myth 9: "These companies are too risky; the management of emerging market companies cannot be trusted"

Reality: This is perhaps one of the biggest misconceptions about EM corporate debt. In fact, we believe if you look at the balance sheets of these companies, they are actually managed more conservatively than companies in the developed world. Leverage is lower across the credit quality spectrum and they run structurally higher cash balances as a proportion of total debt than DM corporates. Furthermore, given that the vast majority of these companies adhere to international reporting standards, and many have public equity outstanding, it means that issues of transparency and access to management are no longer impediments to investment.

Fig. 9 Leverage in EM and DM (Net debt/EBITDA)

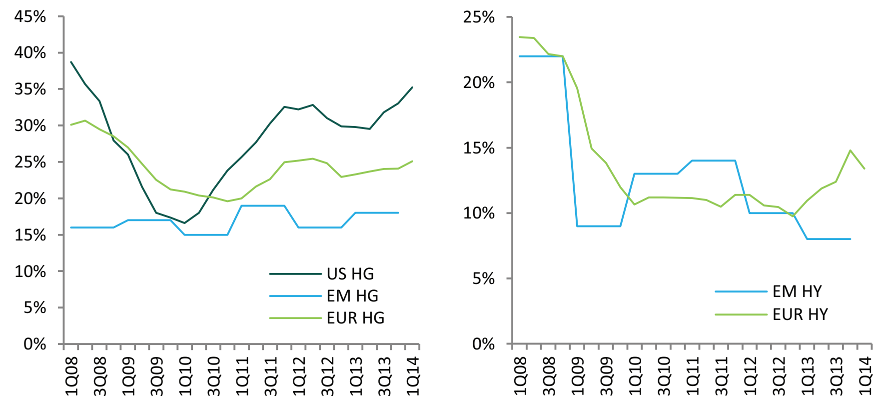


Data source: BAML, as at 31 December 2014

Myth 10: "We're at the end of the credit cycle, so all these companies are levering up and looking after shareholders instead of bondholders"

Reality: In EM, we believe we are further away from the end of the credit cycle when compared with DM. We do not see the same degree of balance sheet re-leveraging as we do in US investment grade credit, for example, and the bulk of the new issuance has been used to refinance existing debt and General Corporate Purposes (GCP), rather than for capex and mergers and acquisition (M&A) activity.

Fig. 10 Earnings Payout Ratio

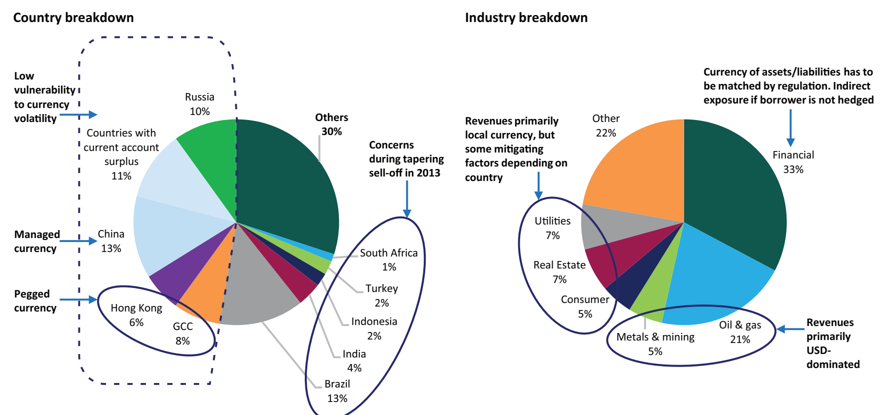


Data source: JP Morgan, as at 29 October 2014

Myth 11: "I think EM currencies are set to have a rough journey for the foreseeable future; in that environment, EM corporates will really struggle"

Reality: We do not believe it is possible to make such a blanket statement. In our view, in such an environment there will be winners and losers. These will differ between investment grade and high yield. However, broadly speaking, on a sector basis, financials, oil & gas and metals & mining are somewhat immune to FX volatility due to hedging regulations and dollar revenue streams, respectively. On the other hand, domestically-oriented sectors such as utilities and technology, media & telecoms, may struggle. On a country basis, again we feel that some countries, e.g. those that manage or peg their currency stand to gain, whereas others, such as those with current account deficits funded through portfolio flows, potentially stand to lose out.

Fig. 11 EM corporate external bond stock

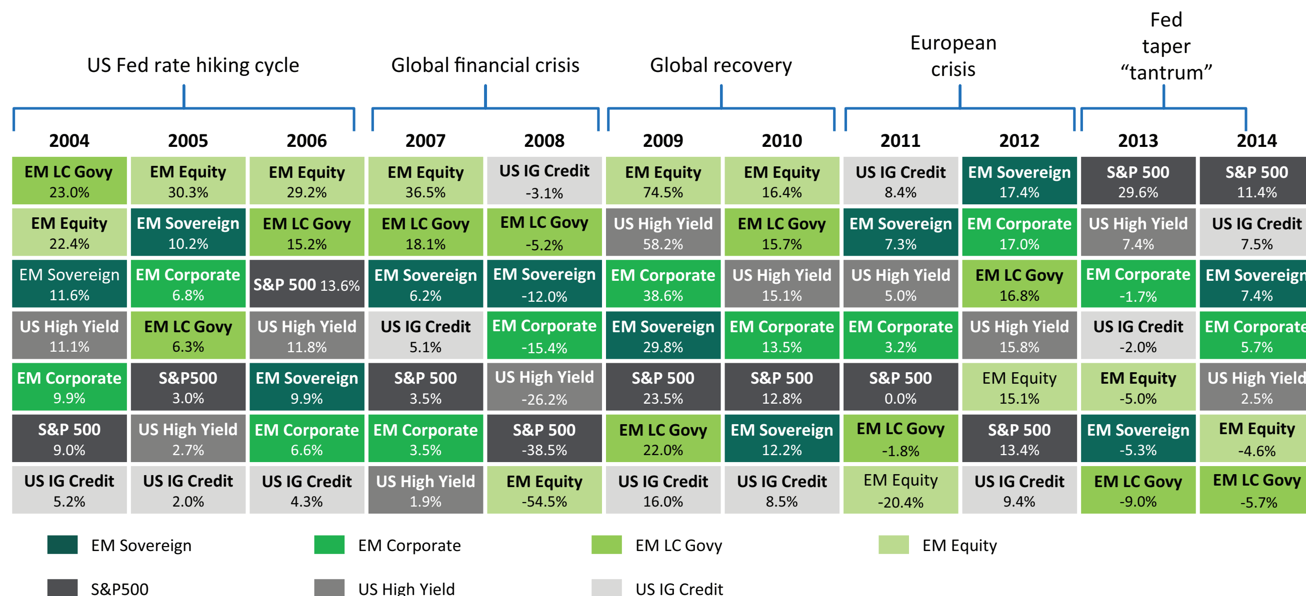


Data source: JP Morgan, as at 29 October 2014

Myth 12: "I already have an allocation to EM and that gives me the beta I need. They all have the same performance profile anyway"

Reality: As you can see from the heatmap below, components of the broader EM asset class can perform very differently at various points in the economic cycle. Likewise, EM corporate debt also performs differently to developed market risk assets. As such, we believe that there is significant diversification benefit to adding EM corporate debt into a multi-sector portfolio.

Fig. 12 Calendar year returns by asset class



2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
EM LC Govy 23.0%	EM Equity 30.3%	EM Equity 29.2%	EM Equity 36.5%	US IG Credit -3.1%	EM Equity 74.5%	EM Equity 16.4%	US IG Credit 8.4%	EM Sovereign 17.4%	S&P 500 29.6%	S&P 500 11.4%
EM Equity 22.4%	EM Sovereign 10.2%	EM LC Govy 15.2%	EM LC Govy 18.1%	EM LC Govy -5.2%	US High Yield 58.2%	EM LC Govy 15.7%	EM Sovereign 7.3%	EM Corporate 17.0%	US High Yield 7.4%	US IG Credit 7.5%
EM Sovereign 11.6%	EM Corporate 6.8%	S&P 500 13.6%	EM Sovereign 6.2%	EM Sovereign -12.0%	EM Corporate 38.6%	US High Yield 15.1%	US High Yield 5.0%	EM LC Govy 16.8%	EM Corporate -1.7%	EM Sovereign 7.4%
US High Yield 11.1%	EM LC Govy 6.3%	US High Yield 11.8%	US IG Credit 5.1%	EM Corporate -15.4%	EM Sovereign 29.8%	EM Corporate 13.5%	EM Corporate 3.2%	US High Yield 15.8%	US IG Credit -2.0%	EM Corporate 5.7%
EM Corporate 9.9%	S&P500 3.0%	EM Sovereign 9.9%	S&P 500 3.5%	US High Yield -26.2%	S&P 500 23.5%	S&P 500 12.8%	S&P 500 0.0%	EM Equity 15.1%	EM Equity -5.0%	US High Yield 2.5%
S&P 500 9.0%	US High Yield 2.7%	EM Corporate 6.6%	EM Corporate 3.5%	S&P 500 -38.5%	EM LC Govy 22.0%	EM Sovereign 12.2%	EM LC Govy -1.8%	S&P 500 13.4%	EM Sovereign -5.3%	EM Equity -4.6%
US IG Credit 5.2%	US IG Credit 2.0%	US IG Credit 4.3%	US High Yield 1.9%	EM Equity -54.5%	US IG Credit 16.0%	US IG Credit 8.5%	EM Equity -20.4%	US IG Credit 9.4%	EM LC Govy -9.0%	EM LC Govy -5.7%

Data source: Bloomberg, as at 31 December 2014
Note: EM Sovereign Credit: JPM EMBI Global Diversified Index; EM Corporate Credit: JPM Corporate EMBI Diversified Index; EM LC Govy: JPM GBI-EM Global Div; EM Equity: MSCI Emerging Markets; US Investment Grade Corporate: Barclays US Aggregate Investment Grade Index; US High Yield: Barclays US High Yield 2% Issuer Cap;

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