February 2018

Emerging Market Corporate Debt in 2018

2017 was a year we find best characterized by strong economic recovery as well as relatively calm markets across the globe. In 2018, we expect a continuation of the second half of 2017, where global growth is strong and interest rates incrementally tighten.

While we have determined valuations across almost every asset class are near the tight end of their range and risks of corrections are elevated, we remain constructive regarding emerging markets (EM) corporate debt. We believe macro fundamentals will continue to support spread tightening, relative value is attractive, higher spread products have more of a cushion against rising interest rates and technicals should continue to be supportive of the asset class. Taking a more granular view, we believe the dynamics of strong synchronous global growth, market demand and current valuations will drive EM corporate debt spreads tighter. The high yields and low durations of EM corporate debt offer many advantages to any portfolio, but we believe capital appreciation will continue in 2018.

Changing Demographics:

Aging populations in the United States, Western Europe and Japan are leading to rising debt burdens as they are not being met with an accompanied rise in working age populations - there are simply not enough millennials to fund the burden of the baby boomers. The opposite is taking place in emerging markets, where many countries have entered what the United Nations refers to as the "demographic window" - the most favorable period for growth where less than 30% of the population is under 15 years old and less than 15% of the population is under 64 years old. These windows usually last thirty to forty years. Due to this phenomenon, the middle class has grown rapidly in EM countries, as opposed to shrinking in developed markets. The ability to invest in EM economies will also allow investors to maintain exposure to certain industries where the developed markets are losing their competitive advantage. Take McDonald's for example – 40% of their protein (beef and chicken) supply chain comes from the Brazilian producer Marfrig. While Marfrig is domiciled in Brazil and considered an EM credit, it should, in our opinion, be viewed as a global corporation supplying restaurants across the globe and therefore exhibit lower risks than a pure domestic EM investment.

In order for the developed world to keep pace, we believe it will need to invest an increasing percentage of its financial assets in EM in order to maintain higher rates of return. Baby Boomers were in many ways responsible for higher DM asset prices over the last 50 years and while demographics alone will not be the deciding factor for investment returns going forward, they will likely drive a large portion for the next few decades as this phenomenon shifts to EM.

Fig. 1: World middle class growth 2009-2030

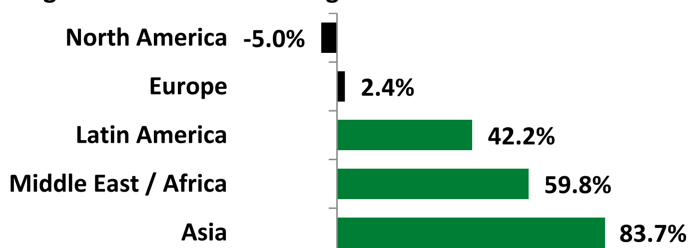

Fig. 2: EM household consumption (US$ billion)

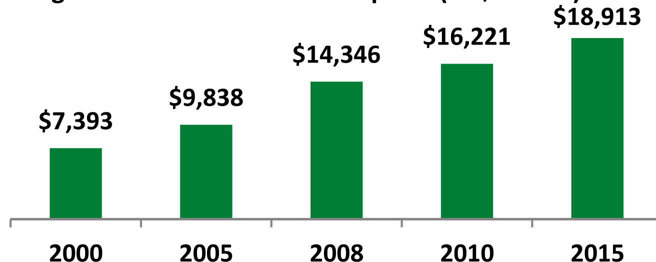

Fig. 3: Global population by age

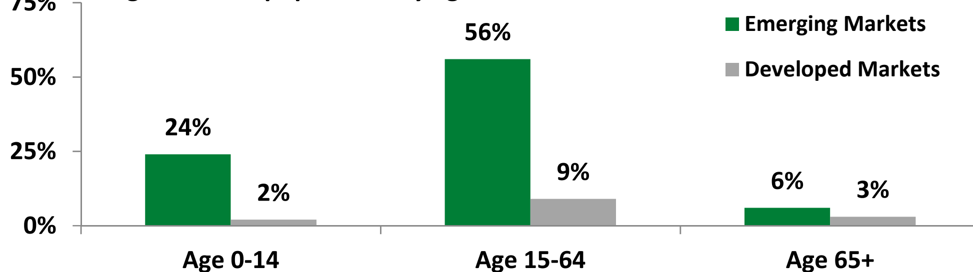

Fig. 1 source: OECD. Figure 2 source: Worldbank. Figure 3 source: IMF: EM represents data defined by the IMF as Emerging Market / Developing Economies, DM represents data defined by the IMF as Advanced Economies. Data as of 12/31/2015

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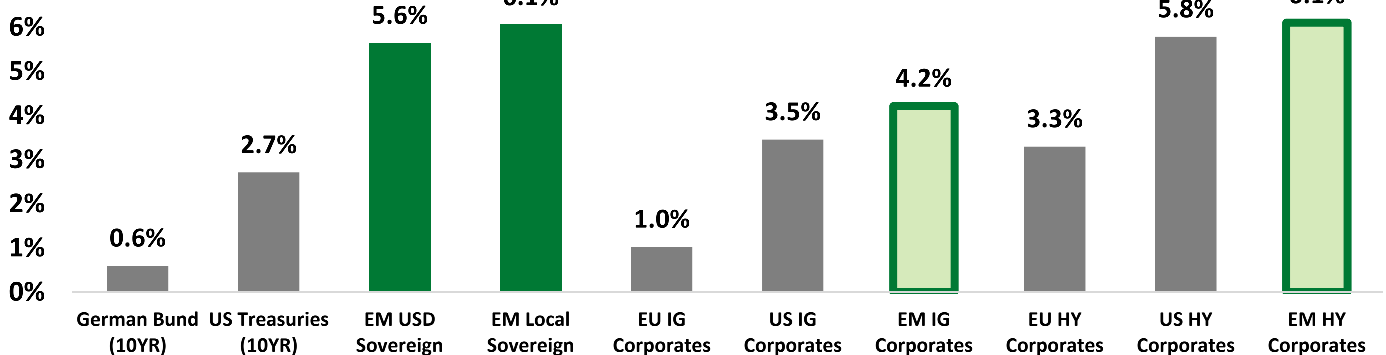
Historical valuation trap

While we believe fundamentals should drive investment theses, historical valuations more often serve as a guide. Today, the main argument against EM corporate debt is that its valuations relative to developed markets (DM) are too tight. This argument is an easy trap to get caught in as emerging markets high yield corporate debt is only yielding 0.32% more than its US peers. At first glance it is understandable that a 0.32% premium may seem too low for investors without experience in the asset class, but that is only one data point and in our opinion hides the details of a larger picture.



The argument that EM high yield corporate debt is historically tight compared to its developed market peers holds up only when observed with a time horizon of less than five years, when emerging markets were in crisis (Fig. 5). The Taper Tantrum, fears of a hard landing in China, extremely low commodity prices, weak currencies and political uncertainty led to particularly elevated yields in EM. During these periods, EM spreads have often traded through the US and European market. As these fears dissipated, yields tightened in order to reflect the lower risk environment. Prior to these events, EM high yield spreads were near or lower than where they are today.

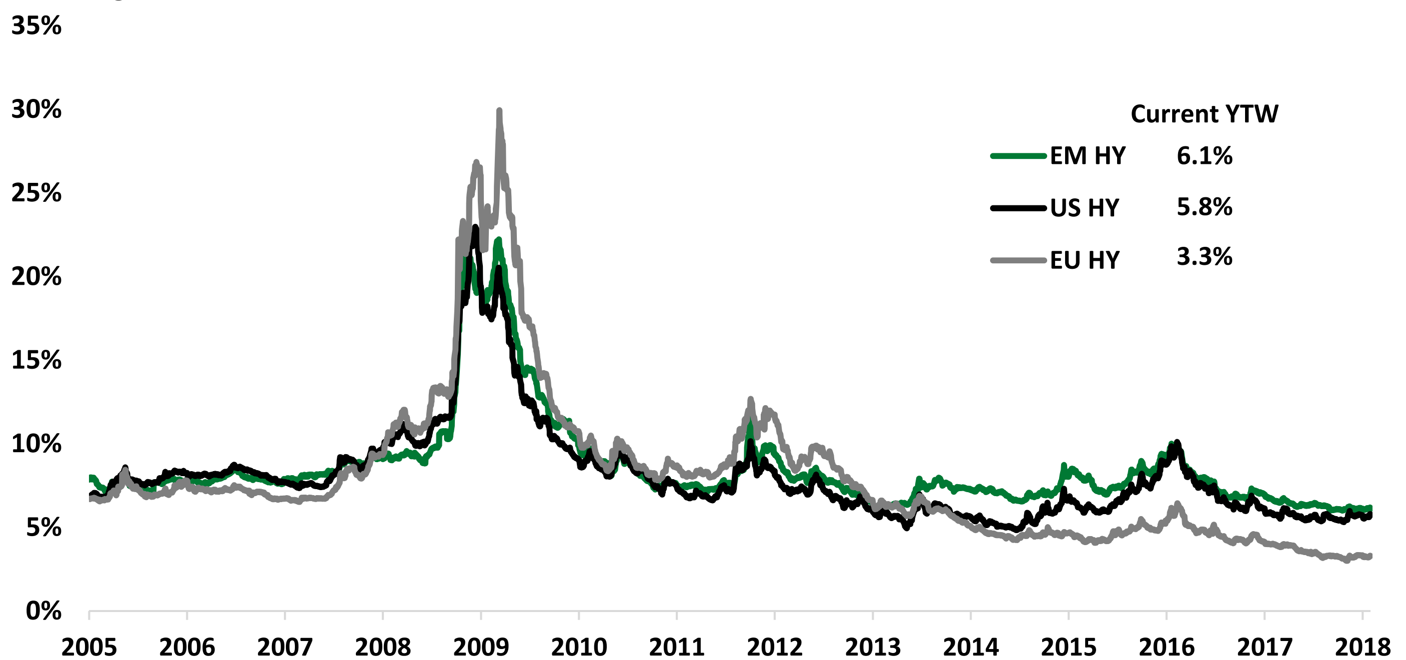


Fig 4 & 5 Source: Bloomberg, as of January 31, 2018. EMD USD Sovereign = EMBI Global Index. EM Local Sovereign = GBI-EM Global Diversified. EU IG Corporates = Bloomberg Barclays Pan-European Aggregate Credit Index. US IG Corporates = Bloomberg Barclays US Corporate Index. EM IG = CEMBI Diversified IG index. EU HY Corporates = Bloomberg Barclays Pan-European High Yield Index. US HY = Bloomberg Barclays US Corporate HY index. EM HY = CEMBI Diversified HY

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The premium to own EM high yield bonds over EU high yield is near its highest level at 2.8%, which is 2.4% above its average premium (Fig. 6). As ECB quantitative easing has pushed European yields so low in the Eurozone, we find it hard to support an allocation to European high yield over EM high yield at these levels. The premium to own US high yield is 0.32% today, only 0.19% lower than its historical average of 0.51%. While EM HY is trading on top of US HY, this is not a deviation, but closer to the norm.

Fig. 6: EM HY premium to European HY

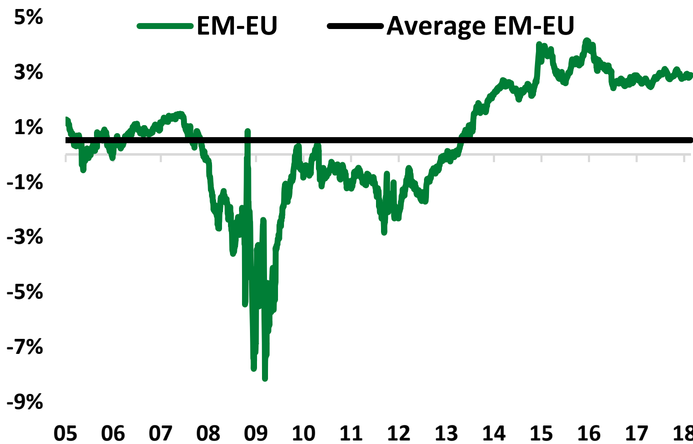
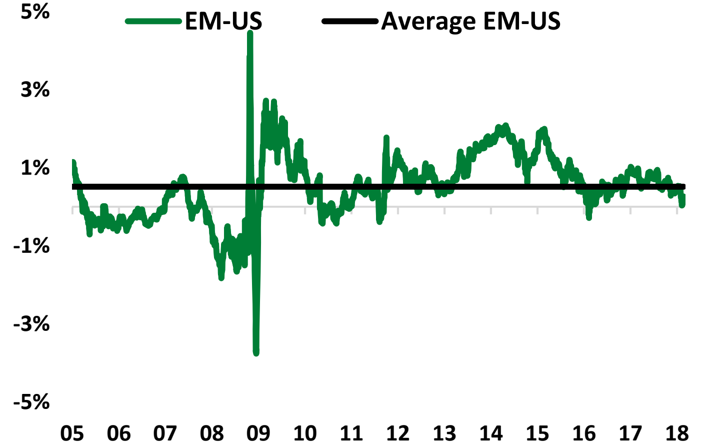


Fig. 7: EM HY premium to US HY



We find EM valuations are even more attractive in investment grade credit, where yields are 3.2% higher than in the EU (4.2% vs 1.0%), 1.1% higher than their average premium. Compared to the US, investment grade yields in EM are 0.76% higher (4.2% vs 3.5%) and only 0.3% below their average premium since 2005. Similar to the high yield segment, investment grade debt suffered from the same elevated yields during the Taper Tantrum and EM crisis of 2014 and 2015. Just like in high yield, before the Global Financial Crisis, IG premiums were lower than they are today.

EM volatility characteristics continue to be comparable, although slightly higher, than those in the developed markets. However, returns are considerably higher. Durations are also similar in the high yield segment with EM and DM indices around 4 years in duration. In investment grade, EM duration is significantly shorter, approximately 5 years, compared to EU IG at 6 years and US IG at 7 years. In a period of rising rates, shorter duration assets will generally outperform longer duration assets for the same increase in yields.

Fig. 8: Three year risk and return of EM vs DM

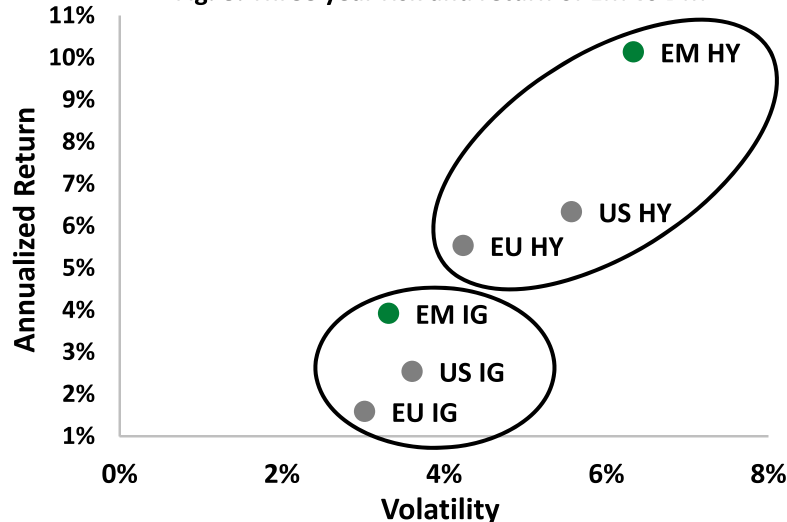


Fig. 6,7,8:source: Bloomberg as of January 31, 2018.

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Generally speaking, EM corporate balance sheets are more fundamentally sound than those in the developed markets. While this should result in a lower relative risk premium for EM issuers of similar ratings, that has not been the case. This extra premium is widely believed to be compensation for liquidity and jurisdictional risks, when in fact, ratings agencies already take this information into account when assigning bond ratings, making higher yields a redundant premium. On top of this trend, DM corporates have seen more downgrades over the last five years, while EM ratings have held steady (Fig. 9). Additionally, leverage in EM corporate debt is less than it is the US (Fig. 10).

Fig. 9: Rating migration of EM and DM corporates

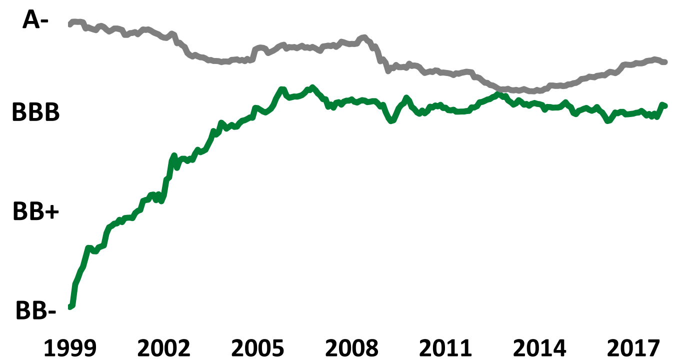


Fig. 10: EM vs DM gross and net leverage *(lower is better)*

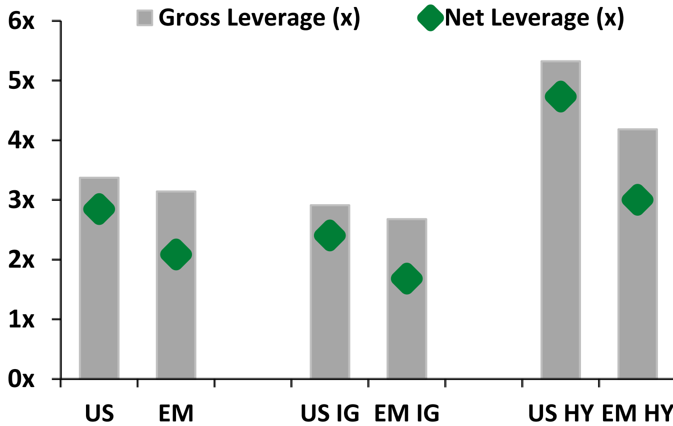
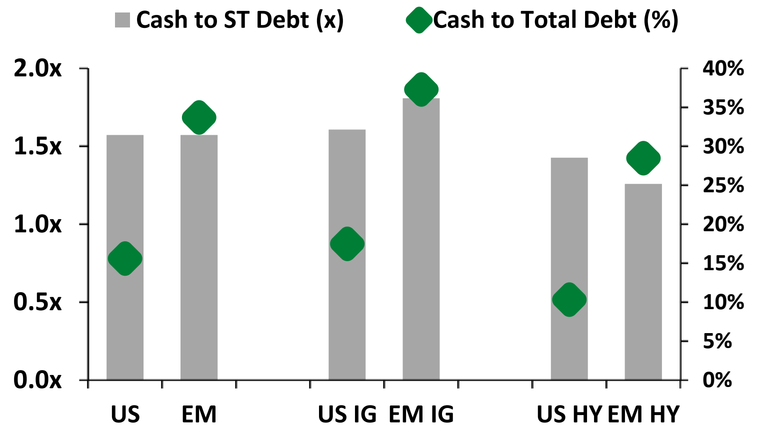
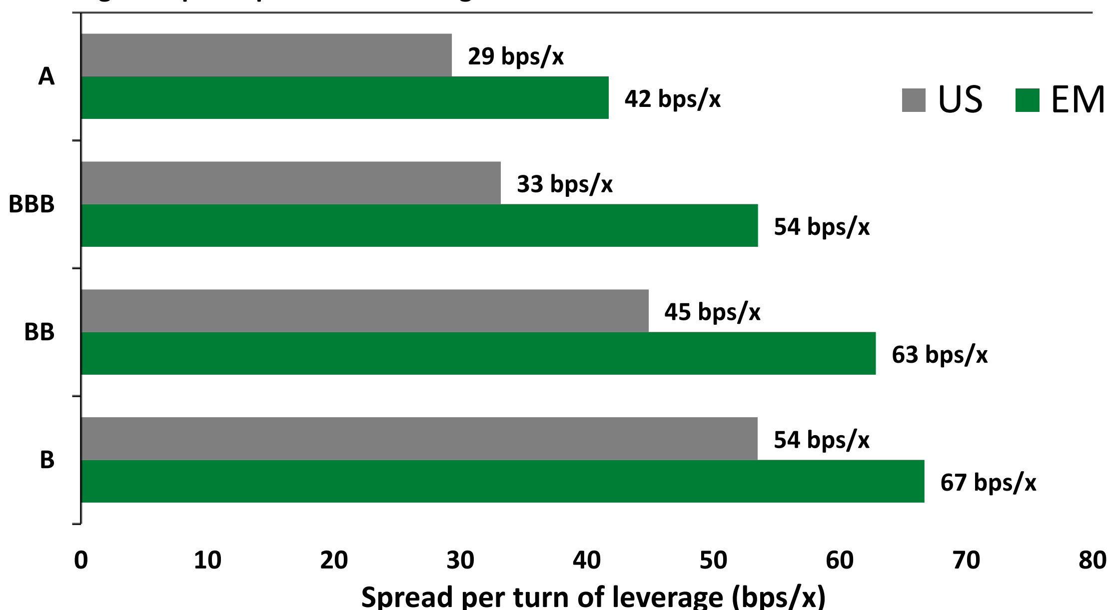


Fig. 11: EM vs DM cash to debt *(higher is better)*



When factoring the more robust balance sheets of EM corporates, along with the greater risk premium provided by the asset class, EM corporate bonds offer better compensation per unit of leverage (risk) than US corporate debt.

Fig. 12: Spread per turn of leverage



Source for Fig. 9, 10, 11 & 12: Bank of America. Spread data s of January 31, 2018, fundamental data as of June 30, 2017.

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We expect these fundamental benefits of EM to continue to narrow the premium to DM, particularly in the high yield segment, as U.S. high yield faces some structurally challenged sectors that represent a large portion of the market. These issues have led to the higher default and distressed ratios in the US, while emerging markets are not facing the same pressure due the different environment in EM. Defaults in the developed markets are expected to remain higher in 2018.

Fig. 13: Rolling 12-month default rate

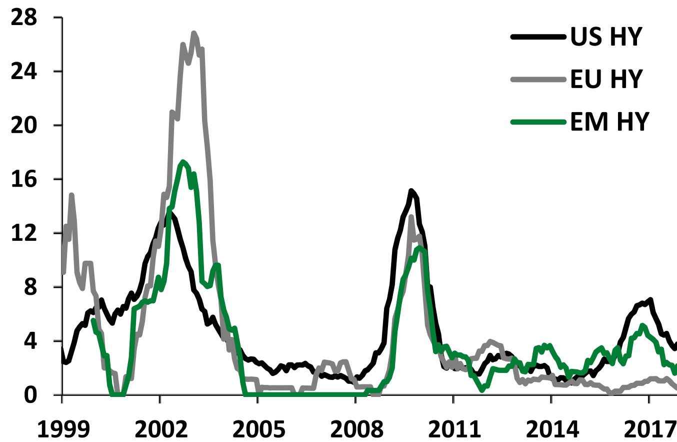
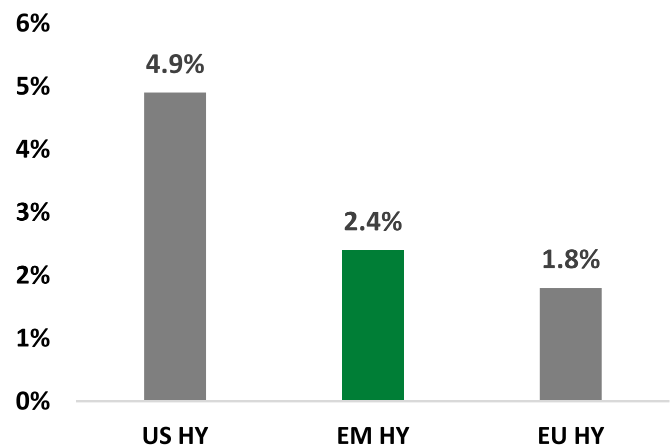


Fig. 14: Distress Ratios (spread > 1,000 bps)



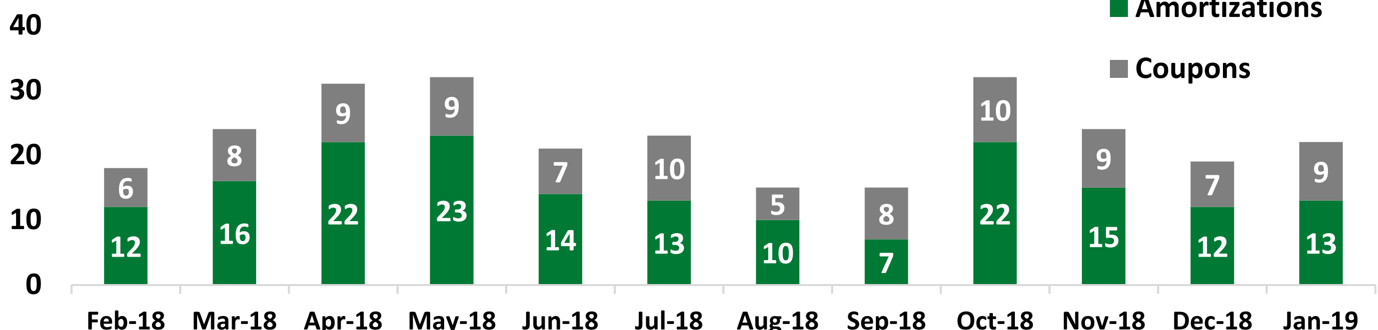
Technicals and further adoption of the asset class

While we expect strong earnings and the fundamentals of growth to drive spread compression, technicals should add a tail wind. Asset flows to emerging markets were undeniably strong in 2017, but followed moderate inflows in 2016 and very low flows in 2013, 2014 and 2015. JPMorgan expects another strong year of inflows in 2018 as positioning in EM debt remains on the light side of historical averages and the cash flow EM investors will be receiving from their current holdings is high. While we expect another healthy year of issuance, a fourth consecutive year of low net financing within emerging markets coupled with strong demand should provide upside for EM bond prices. Additionally, due to the high coupons and short duration of EM debt, investors receive a large amount of cash flows from interest payments and amortizations which need to be continually reinvested, supporting the market.

Fig. 15: EM corporate debt net financing

US$ bn	2012	2013	2014	2015	2016	2017	2018F
Gross issuance	329	367	374	240	325	481	442
Amortizations	56	55	77	102	118	173	175
Coupons	51	67	81	88	86	84	92
Tender/buyback/Calls	17	20	30	38	55	82	66
Net financing	**205**	**226**	**186**	**12**	**66**	**141**	**109**

Fig. 16: Amortizations and coupons paid to investors by month (US$ billions)



Source: Fig. 13 & 14: Bank of America., as of January 31, 2018. Fig 15 & 16: JPMorgan as of December 31, 2017.

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Assets dedicated to the EM corporate asset class is also growing as investors continue to become more familiar with EM. Investor's first exposure to EM began with U.S. Dollar sovereign debt, which has been the preferred allocation within EM simply because it is the first asset class they had been exposed to via Brady Bonds. As local currency debt was issued in greater size, we saw investors switch from a 100% USD index to a 50% USD/50% local currency index to fairly represent the new opportunity set. Since then, one of the main drivers of return in EM U.S. Dollar sovereign debt, spread compression, has largely run its course as EM countries continued to evolve. During this time, corporate debt issuance gained traction, more corporates have come to market and liquidity has improved. As investors were given the opportunity to participate in the secular credit improvement story of the emerging world, they have taken it: the hard currency corporate debt market is now larger and growing faster than hard currency sovereign debt and is the same size as the US high yield market. This trend was partially reversed when EM was under pressure in 2014 and 2015, however, investors are starting to rotate back into EM corporate debt again. As this long-term trend continues, the AUM benchmarked to corporate indices should approach the level of USD sovereign debt (Fig. 19).

Fig. 17: Growth of corporates vs sovereigns

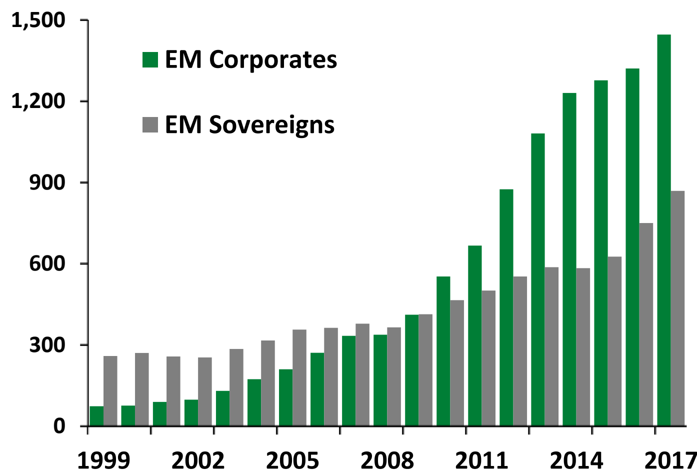

Fig. 18: Investor Positioning in EM Corporates

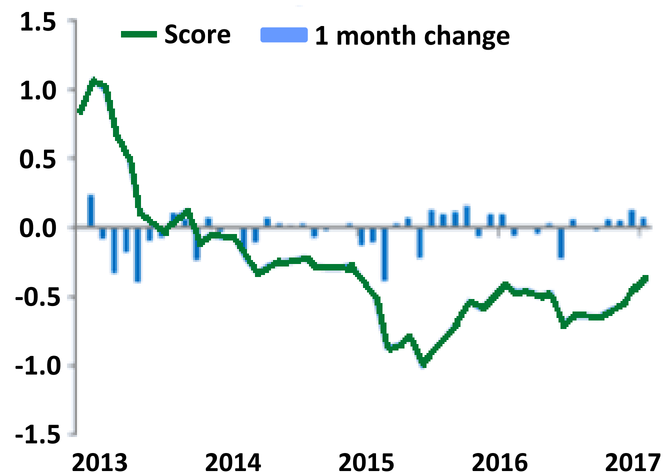

Fig. 19: AUM Benchmarked Against JPMorgan EM Indices (US$ Billion)

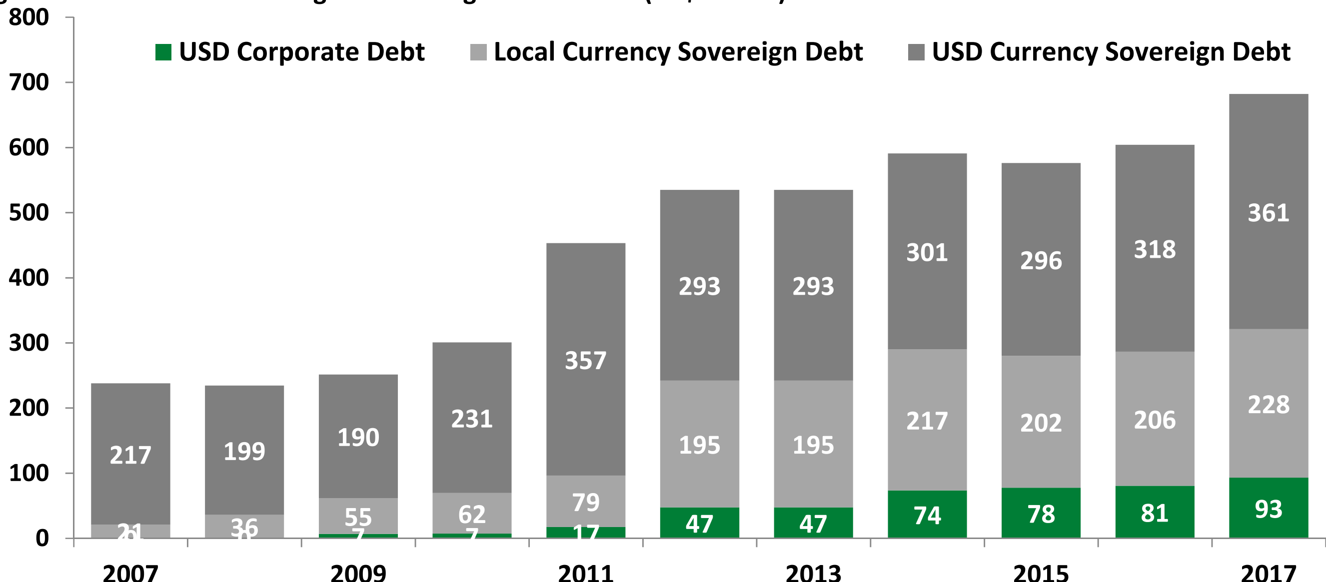

Fig. 17 source: Bank of America, as of January 31, 2018. Fig. 18 & 19 source: JPMorgan as of January 31, 2018.

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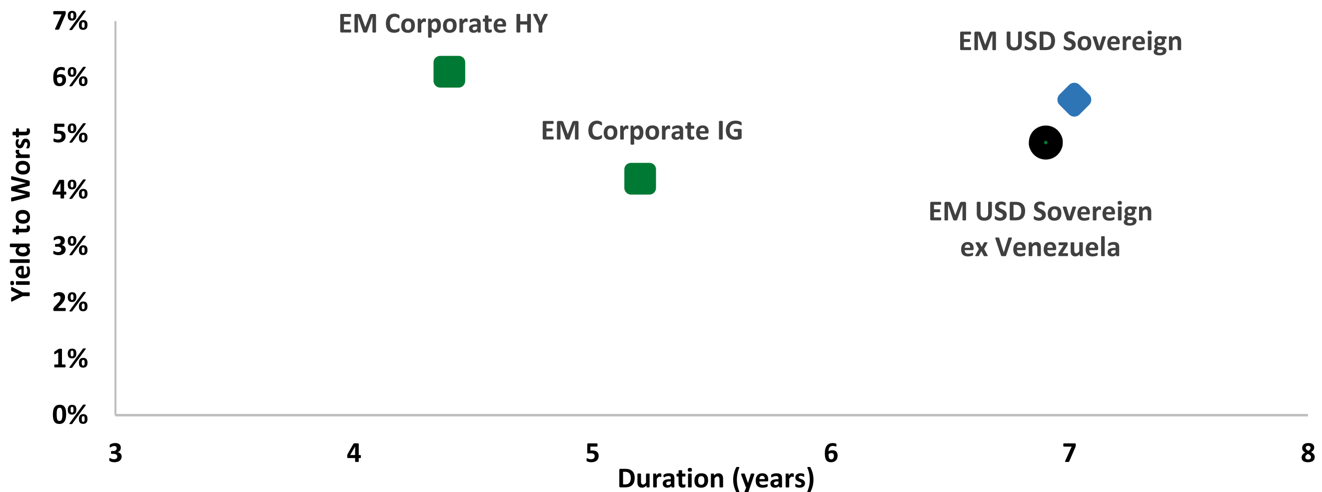
Don't fear rising rates

While much attention has been given to U.S. tax reform, ultimately we believe the real risk to the bond market is the Federal Reserve and the pace of monetary policy tightening. This puts the Federal Reserve in a tight spot as it must navigate growing US inflationary pressures with only modest growth. To do so, the Fed has stated that it will continue its planed rate hikes and reduce the size of its balance sheet.

As the Fed appears to be taking a hawkish stance, some investors have wondered if it is time to take profits in emerging markets. With regard to rising rates, in our view it is important to note that over the last 40 years, EM debt has only had one negative year during a US hiking cycle and performance that year (1994) was due to the Mexican Peso crisis more than the Fed's rate hikes.

EM corporate bonds stand out as more defensive in a rising rate environment due to their shorter duration or lower sensitivity to interest rates. The CEMBI Diversified (EM corporate bond index) has a duration of 4.9 years, 2.2 years shorter than the EMBI Global (EM USD sovereign index). This shorter duration does not come at the expense of yield as while the EMBI Global technically yields 5.6%, that figure includes the contribution of Venezuelan which the market now transacts its sovereign debt without accrued interest, indicating that interest payments are not expected to be received for these bonds. This dubious yield from Venezuela in the EMBI Global accounts for 0.8%, meaning that the yield received from the EMBI Global is actually 4.8%, 0.2% less than the CEMBI Diversified, while still having an extra 2 years of duration risk. The higher yield and lower risk of EM corporates are a structural benefit in a rising rate environment that add to the positive fundamentals of the sector.

Fig. 20: EM sovereign vs corporate yields and duration



Moreover, emerging market and developed market monetary policy has differed tremendously since the Taper Tantrum of 2013. These higher real policy rates, fiscal buffers and low inflation in EM economies mean that EM central banks have greater monetary policy leeway to ease rates than DM moving forward. EM central banks do not need to be reactive if G3 central banks were to become more hawkish. We believe this will keep EM central banks on a neutral or even an easing bias.

Fig. 21: EM vs DM Real Policy Rates

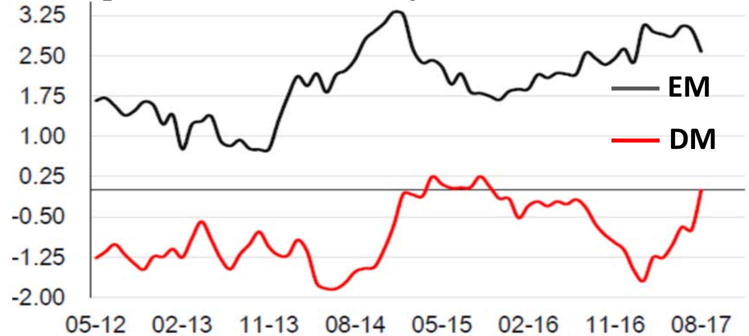


Fig 20 source: JPMorgan Indices as of January 31, 2018. Fig. 21 source: HSBC. EM = PPP weighted average of Brazil, China, India, Indonesia, Mexico, Poland, Russia, S. Africa and Turkey. DM = PPP weighted average of Germany, Japan, UK, and the US. As of October 31, 2017.

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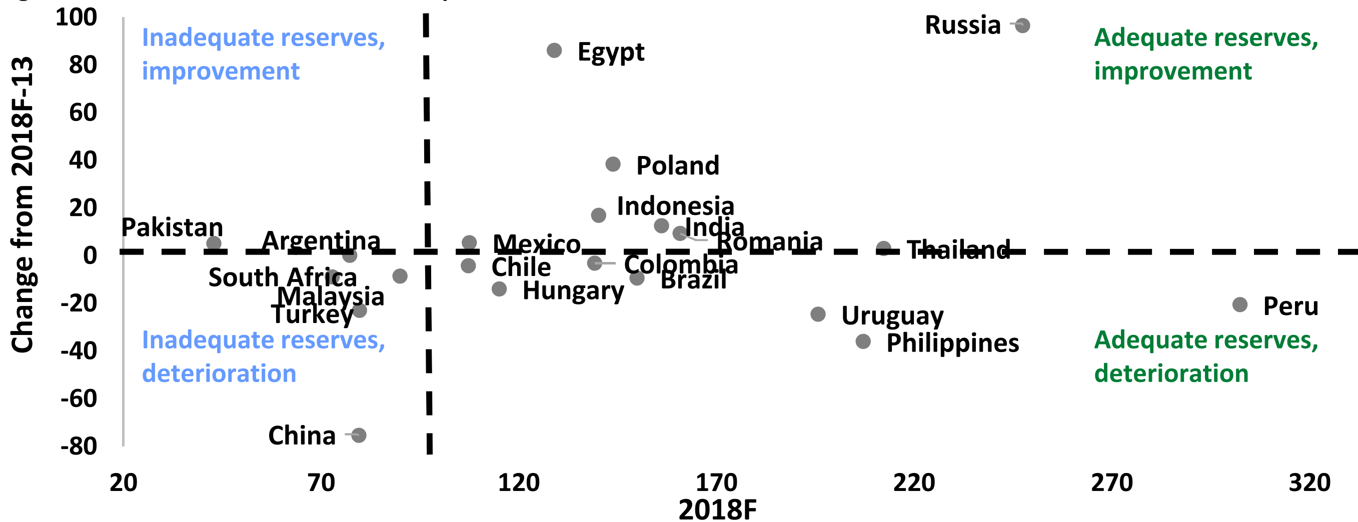
While EM debt performance suffered during the Taper Tantrum, EM central banks acted rationally by shoring up external imbalances, leaving EM economies in much stronger positions today than they were in 2013. Two pillars of a strong economy, balance of payments and FX reserves, which were a weak point within EM in 2013, have adjusted to stronger positions(Fig. 22). In general, current accounts deficits have been narrowed and FX reserve ratios are much stronger.

Fig. 22: FX Reserves 2013 vs 2018 as a percent of GDP



The market backdrop today looks similar to that of 2005, where US 10 year rates rose about 40 basis points from the middle of February through year end. In mid-February of that year, when US rates began to rise, the EMBI Global spread was 349 basis points, 40 basis points wider than where we are today. As US-10 year rates rose 40 basis points the rest of the year, the EMBI Global spread tightened by 112 basis points, ending the year at 237 basis points. The EMBI Global continued to rally throughout 2006, ending the year at a spread of 171 basis points, while US 10-year yields continued to rise another 30 basis points.

EM vs DM Growth

An expected combination of strong synchronous global growth and benign inflation is the best possible macro environment for EM assets. As cycles of high growth are matching up across the globe, we also expect this cycle to have longevity. Drilling into the details, EM has an expected growth of more than 3% above DM due to two factors: developed market growth will flow into emerging markets through EM exports, but now, due to positive demographics and reforms within EM itself, growing domestic demand is the 2nd structural change that adds further fuel to the growth story within emerging markets. Historically, the underlying argument is that EM is riskier and therefore a higher growth premium is needed to justify allocations. In past, when this growth premium has reached 3%, capital flows have accelerated into emerging markets, EM spreads have tightened and performance has been well in excess of developed markets. This relationship has the opposite effect as well, as can be seen in 2008 during the global financial crisis and the decline in growth premiums in 2013-15. That said, even when growth premiums are declining, EM performance still tends to be positive – just not as high as when growth premiums are rising (Fig. 22).

Fig. 22: EM performance when growth premiums are both increasing and decreasing

	2001 - 2017 Average Performance
Performance when growth premium is increasing	12.9%
Performance when growth premium is decreasing	5.8%

Fig 21 source: Haver. Fig. 22 source: IMF, Bloomberg

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Conclusion

While some advisors may believe that emerging market debt is valued too tightly to U.S. debt, history is not on their side. Given the favorable demographics across the region and the continued acceptance of EM corporate debt, we believe every portfolio should have a strategic allocation and look to add to that allocation tactically on sell-offs.

While the evidence laid out in this paper suggest good reasons to invest in EM, these catalysts have not been priced in yet. While EM debt performed admirably in 2016 and 2017, we believe the cycle is still in its early stages. The cyclical story of a synchronized global recovery since the brief rebound after the Global Financial Crisis is still gaining traction. If US growth is propelled by tax cuts and the recovery in Western Europe can further fuel the rally, this will likely further drive EM growth.

As neither valuations nor positioning are overstretched, the higher yields, converging ratings, stronger balance sheets and greater spread per turn of leverage in our determination position emerging markets corporate debt as the best high yielding asset class across the globe. EM asset prices should be well supported by necessity for yield and an improving fundamental story.

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