Investing for a world of change

Company strength, country collaboration and attractive income

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What are the implications of the higher-rate environment?

Many companies in emerging markets (EMs) have put themselves in a strong position to navigate the tougher economic environment and absorb the impact of rates remaining higher for longer. By reducing leverage and shoring up balance sheets when business was booming, and by securing cheap finance when rates were low, corporates have strengthened their financial metrics. We believe that translates to a neutral outlook for credit rating dynamics in the asset class.

A decade of very low rates created a great opportunity for companies to extend their debt maturities and strengthen their financial position at lower coupons. While more companies will need to refinance over the coming year, low levels of leverage on average should limit the overall impact of this on corporate financial health. All of this means that we expect default rates to continue to trend down.

The content of this communication is intended for readers with existing knowledge of financial markets.

After limited issuance supported the asset class in 2023, what do you expect in 2024?

Broadly, we expect the tailwind of lower issuance rates to continue to support the asset class. There are three drivers of this. First, many companies – particularly in the big economies like Brazil, India, Indonesia, China, and Mexico – are electing to finance themselves domestically, where rates are highly competitive relative to the external dollar debt market. Secondly, companies are continuing to tap into cheaper forms of secured financing, often in the private debt space. Thirdly, these companies typically have a lot of cash on the balance sheet and positive cash flows – they've been using this to buy back debt rather than pay dividends and it makes sense that this trend will continue in 2024. The catalyst for a shift towards more issuance would be a clear signal that the US Federal Reserve's rate hiking cycle is over, and signs that rates are starting to come down.

The exceptions to the lower-issuance trend are parts of Asia and the Gulf Cooperation Council, where investors can expect to see very high-quality issuance continue, with investment-grade Islamic finance a notable growth area. Among high-yield markets, Turkish issuers have begun to re-enter the market, having been priced out for several years as a result of negative sovereign headlines. This illustrates how things can shift relatively quickly in this investment universe.

What will encourage investors back into the asset class?

Like all fixed income markets, the path of US interest rates remains the key driver. Investors who have retreated from the asset class in recent years will need to see a turn in the US rate-hiking cycle and more evidence of a managed slowdown of the US economy and global economic resilience before returning en masse. A calmer period in geopolitics will also be vital in helping support EM asset class demand and returns.

Which themes are most exciting for this asset class?

Positive developments supporting the outlook include the stimulus that is now happening in China. If China can get its economy back on track, the implications for all emerging markets are positive. Equally, higher oil prices are providing support for the EM producers.

More broadly, we're seeing a range of EM countries starting to come together cooperatively – with lots of synergies (resulting in investment flows) between the Middle East, Brazil, and China. A key driver of this is the climate transition – investing in new industries that are vital for the transition to net zero and that governments see as both growth catalysts for the next decade and imperative for reducing their need for dollar energy markets.

As for the macroeconomic backdrop, we're seeing a widening differential between EMs (strong balance sheets) and developed markets (e.g., the US and its widening fiscal deficit). This, coupled with closer cooperation across emerging markets – with companies helping each other and growing – could make the EM corporate debt market a great place to be.

Last but not least, while the prospect of rates staying higher for longer is not a concern for us at the individual company level – as explained earlier – at the asset class level it's a significant positive. Income is what really matters to credit investors and the compounding effect on returns when reinvesting coupons at high yields is compelling. That makes the starting point for the asset class in 2024 exciting.

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