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A role for EM sovereign debt after a decade of US high-yield dominance

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Typically considered by asset allocators to belong to the same risk bucket as emerging market sovereign debt, the US high-yield market's relative allure has increased. But the caveat 'past performance is not a reliable indicator of future returns' is particularly valid in this case – as the following analysis of valuations, fundamentals and market technical dynamics reveals.

A decade of dominance

Approaches to categorising asset classes differ substantially across the investment landscape, but it's quite typical for asset allocators to assign emerging market (EM) debt – in all its flavours – to the same overall risk bucket as US high-yield debt.

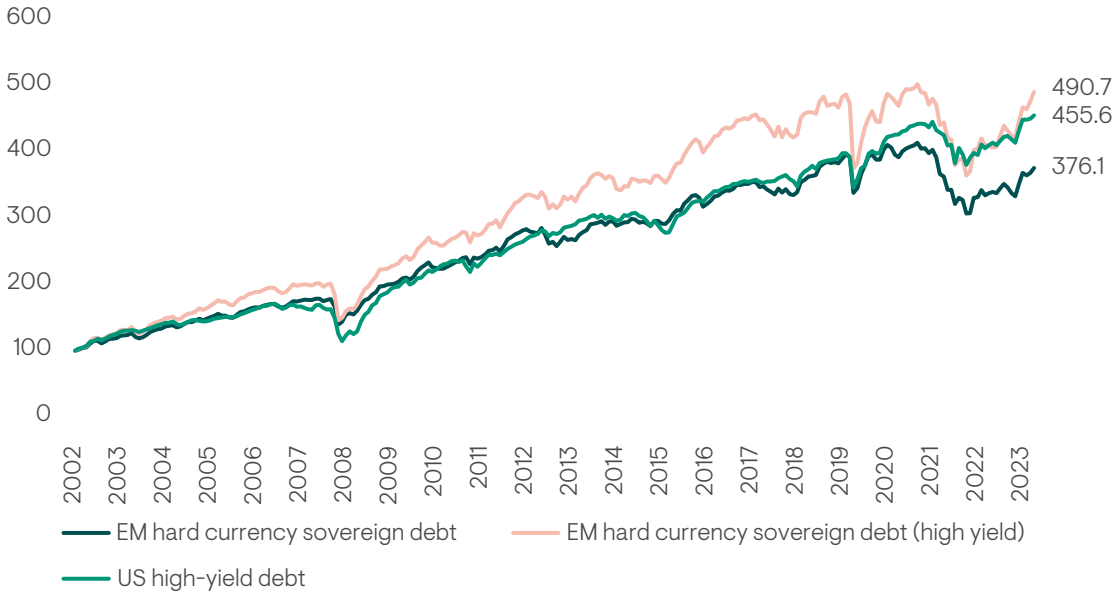
The relative attraction of the latter has risen in recent times, given the performance of US assets, including high-yield debt, over the past decade. US high-yield debt has delivered compelling returns – both absolute and risk-adjusted – relative to most other fixed income asset classes. Unsurprisingly, a typical question we have been asked in recent months by asset allocators is whether a 'US Treasury+' spread asset class such as EM hard currency sovereign debt warrants a place in their portfolio or whether a more focused exposure to US high-yield debt is more appropriate. In this paper, we consider the historical performance comparison before explaining why a forward-looking approach is more informative for asset allocators when comparing the two asset classes.

Past performance

Over the last five years, the US high-yield debt market has delivered impressive performance, outpacing the broader EM hard currency sovereign debt market, as shown in Figure 1. There are several drivers of this. US assets have benefited from a strong economic recovery and robust growth, supported by healthy capital inflows. In contrast, the COVID pandemic took a heavier toll on EM economies, where the scope for fiscal and monetary support was much lower. The exclusion of Russian bonds from the leading EM debt indices following Russia's invasion of Ukraine, combined with debt defaults in some more fragile EM economies, weighed further on EM asset class returns.

However, the main EM hard currency debt index (JP Morgan EMBI Broad Diversified) includes investment-grade as well as high-yield debt markets, and that made it more vulnerable to heightened volatility seen in the US Treasury market over recent years. A more like-for-like comparison over the longer term reveals that total returns in EM high-yield sovereign debt – also shown in Figure 1 – have been closer to those of the US high-yield market, albeit with higher volatility.

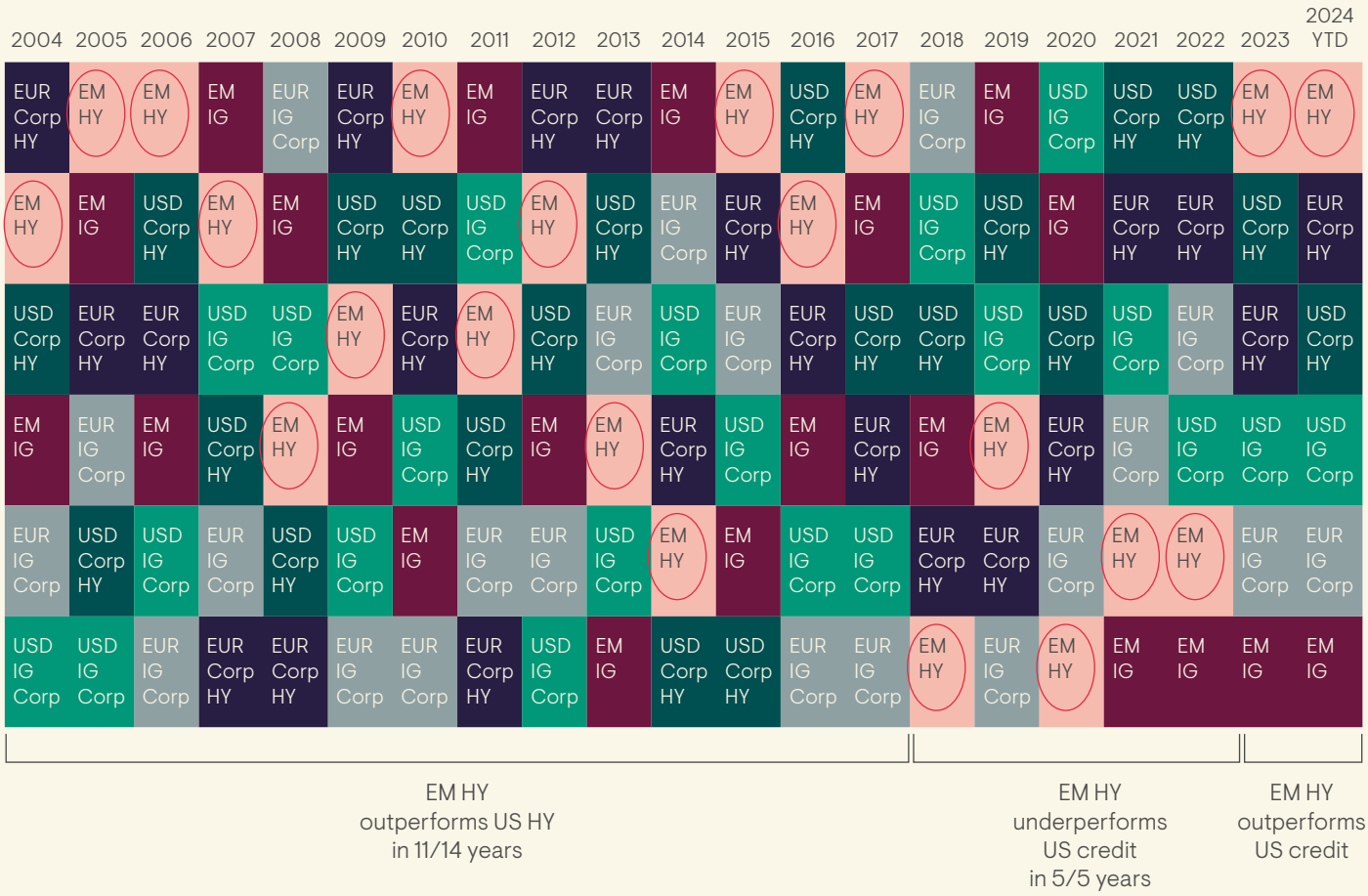
Figure 1: Total return indices (rebased to 100)



Source: JPMorgan, Bank of America. March 2024. US high-yield debt: Bloomberg US Corporate High Yield Total Return. EM hard currency sovereign debt: JPM EMBI GD. EM hard currency sovereign debt (high yield): JPM EMBI HY. For further information on indices, please see Important information section.

Furthermore, considering discrete calendar years (Figure 2), EM high-yield sovereign debt has demonstrated outperformance over time, with the exception of the 2018-2022 EM default cycle.

Figure 2: Annual return rankings of different asset classes



Source: JPMorgan, Bank of America. 2024 YTD is to end February 2024. For further information on indices, please see Important information section.

While not the primary focus of this paper, we also observe that the returns (total and risk-adjusted) of the EM corporate high-yield market – another US Treasury+ spread asset class – have exceeded those of the US high-yield market.

Key considerations for the next chapter

As shown above, US high-yield debt has had a dominant decade characterised by strong domestic dynamics while EMs have faced a combination of secular and idiosyncratic challenges. There are three broad considerations that point to a more favourable outlook for EM debt than for US high yield. We consider each of the following in more detail below:

- **Valuations:** US high-yield debt is looking historically expensive; in contrast, more value is persisting in emerging markets, particularly in high yield. In addition, EM has historically performed better on a forward looking basis in an environment of higher US Treasury yields.
- **Fundamentals:** EM has largely faced its default cycle, particularly in vulnerable and lower income markets; today, EM economies are much more robust with prudent monetary policy. Meanwhile, US defaults remain benign but bank-lending standard deterioration suggests challenges could be on the horizon.
- **Technicals:** the US high-yield debt market has been supported by strong inflows; EM is much lighter from a positioning perspective and could benefit should that turn. Both asset classes have been supported by low issuance.

Valuations

Over the long run, yield is a useful indicator of forward-looking returns in fixed income, as we noted here. And, as outlined above, for a like-for-like assessment, it is important to consider assets that offer comparable credit risk. Figure 3 shows that the broad EM hard currency sovereign debt index offers comparable yields to the US high-yield debt market, but with a higher credit quality. On a credit-quality-comparable basis, the high-yield EM hard currency sovereign debt market offers a yield almost 300bps higher than the US high-yield market, suggesting a more favourable risk-adjusted return outlook for an EM allocation.

Figure 3: Average credit quality, yield and duration

	Average credit quality	Yield	Duration
US high yield	B+	7.7%	3.2
EM hard currency sovereign	BB+	7.7%	6.6
EM hard currency sovereign (high yield)	B+	10.4%	5.5

Source: JP Morgan, Ninety One, as at 31 March 2024.

It is also clear from Figure 3 that the US high-yield debt market has an attractive yield relative to its duration (switching from US high yield to EM high yield would provide a significant yield pick-up but at almost twice the duration). However, current conditions mean that to achieve a yield of 7.7%, investors in US high-yield debt would need to have a much higher duration than 3.1 years in reality. That's because the US curve is extremely inverted – at the time of writing, the 1-year yield is 5.0%, the 2-year is 4.6% and the 3-year is 4.4%, yet the 5-year is 4.2%)[1]. Therefore, investors would need to buy longer maturity bonds in the US to avoid having to reinvest in a few years' time at lower yield levels.

A further consideration when comparing the valuations of the asset classes is to look at spreads relative to each asset class's 10-year history. As Figure 4 illustrates, spreads in the US high-yield market are much tighter than other asset classes and almost the tightest they have been in the past decade. One reason for this is the very strong technical backdrop for the US high-yield market in the form of a dramatic reduction in issuance, against strong demand as investors have chased returns. Figure 5 shows that US high-yield spreads are close to their decade lows, and around half the level of EM high-yield spreads. After the significantly strong performance seen in the US high-yield market over the last 10 years, EM valuations appear more compelling.

Figure 4: Spreads relative to 10-year history

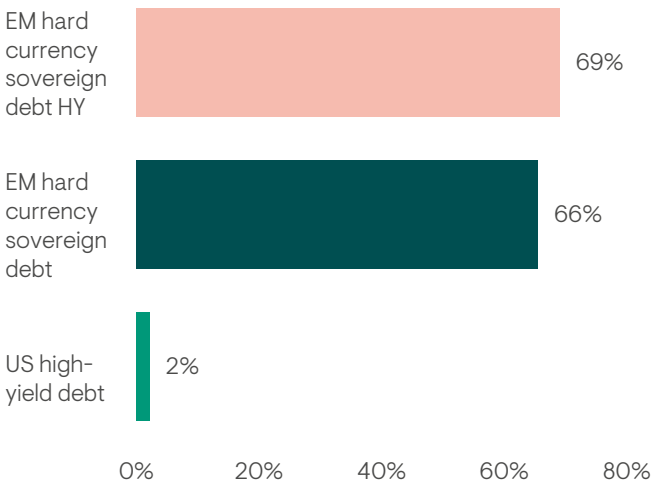
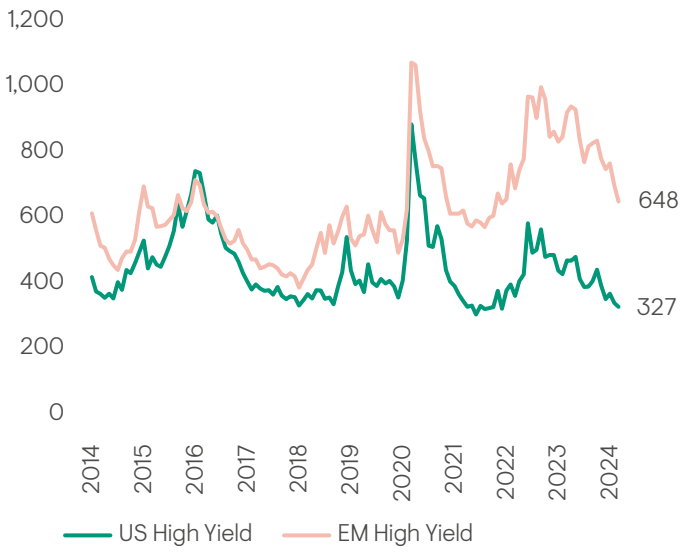


Figure 5: Z-spreads, bps



Source: Ninety One and Bloomberg as at 31 March 2024, US HY uses BofA Indices, EM Sov uses JP Morgan EMBI GD. Left hand chart ranks the historic spreads relative to the asset class own history over the last 10 years.

1. Par yields sourced from US Department of Treasury as at 28 March 2024.

When weighing the return outlook, history has shown that following regimes when US Treasury yields have peaked, the 12-month forward return was historically higher in EM in such an environment, which is partially a function of longer duration being supportive.

Figure 6: Average 12-month return after 5-year US Treasury yields reach 3.5% to 4.5%

	12- month return potential*
US high yield	6.0%
EM hard currency sovereign	8.9%
EM hard currency sovereign (high yield)	11.9%

Past performance does not predict future returns; losses may be made.
Source: Ninety One and Bloomberg, analysis range January 2003 – March 2024, US HY uses BofA Indices, EM Sov uses JP Morgan EMBI GD. *Historical average 12-month return after 5-year US Treasury yields reach 3.5% to 4.5%.

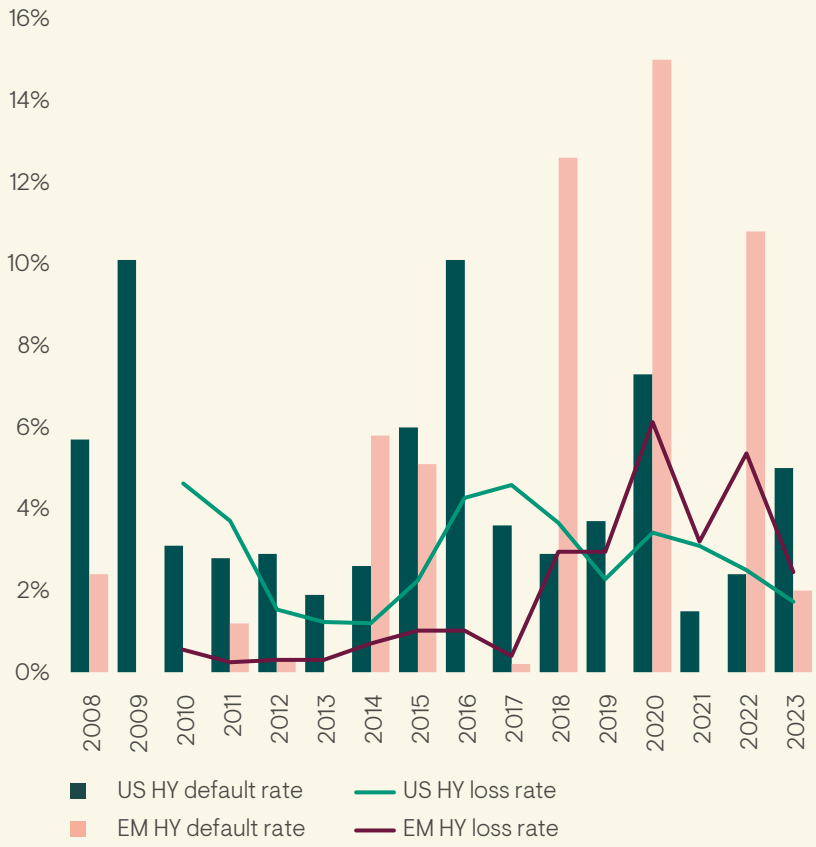
Fundamentals

As noted above, COVID-related economic stress precipitated a default cycle in emerging markets – more than 10 countries have defaulted in the last few years, with three of those centred around the Russia/Ukraine war (Russia, Ukraine and Belarus). After a period of significantly above-trend default rates across emerging markets between 2018-2022, EM defaults have stabilised and this has led to improved performance across 2023 and 2024 to date. The cohort of EM economies that did not default is much more robust today, benefiting from prudent monetary policy and manageable debt maturity walls. Current valuations suggest the market is pricing in ample compensation for default risk.

Across EM economies, fiscal strength is seeing the biggest improvement, with increasingly healthy primary fiscal balances. Funding strength is better than in the pre-2012 period, thanks to growth in local funding markets, and external resilience is improving post-COVID on stronger basic balances (current account + FDI). While the challenging global macro backdrop is a headwind to headline growth in EMs, the structural economic growth premium of EM relative to developed markets remains intact and above its long-term average. All of this points to EM economies being in a good position structurally.

Despite this recent period of higher default rates, EM sovereign debt has run a lower average default rate (3.5% vs. 4.5%) and higher recovery rate (47.6% vs. 38.1%) than US high yield through time (Figure 7 and 8). Logically, this makes sense as when a country defaults there is a high likelihood of a successful restructure, as opposed to a corporate, where a default is more likely to be terminal.

Figure 7: Default and 3-year rolling loss rates



Past performance does not predict future returns; losses may be made.
Source: JP Morgan, Ninety One, as at December 2023.

Figure 8: Recovery rates

	US	EM Sovereign
2008	27.0%	30.8%
2009	22.0%	
2010	41.0%	
2011	49.0%	37.6%
2012	53.0%	40.0%
2013	53.0%	
2014	48.0%	66.4%
2015	25.0%	78.1%
2016	31.0%	
2017	36.0%	61.5%
2018	41.0%	30.4%
2019	23.0%	
2020	22.0%	36.0%
2021	50.0%	
2022	55.0%	40.0%
2023	35.0%	55.0%
Average	**38.1%**	**47.6%**

As Figures 7 and 8 show, in 2023 there was a higher rate of defaults in the US high-yield market than in the EM high-yield sovereign debt market. And while the outlook for any material EM defaults across 2024 appears benign, given the fundamental strength mentioned above, there are signs that challenges could be on the horizon for US high-yield issuers.

Considering the default outlook for US high-yield issuers, one of the more reliable leading indicators paints a relatively bleak picture. Trends in bank lending standards have historically proven dependable bellwethers for default rates. Key among these, survey results from the Federal Reserve's Senior Loan Officer Opinion Survey on Bank Lending Practices have tended to provide useful information on the direction and magnitude of corporate defaults over subsequent quarters. A tightening in bank lending standards has historically been strongly correlated with defaults over the subsequent few quarters. The prospect of rising defaults among US high-yield issuers is a key risk factor for asset allocators to consider. Related to that, an important development over recent years has been a relaxation of covenants in the US high-yield market – a notable trend when yields were low and investors were clamouring for high-yield assets. The result is that the recoveries on defaults in the US high-yield market are now worse than the historical average.

Technicals

In 2023, net flows into the EM hard currency sovereign debt market were deeply negative, in contrast with US high yield, where they were broadly flat. As capital flows back into EM, this should be supportive for the asset class. In contrast, supply/demand dynamics have provided a significant tailwind to the US high-yield market. There has been a pronounced reduction in issuance while investors have chased returns. This has been compounded by the 'rising star effect' as the supportive environment for US high-yield debt has resulted in a big portion of the US high-yield index being upgraded to investment grade (e.g., Ford – accounting for US$40 billion of the market – was upgraded to investment-grade by Fitch in September 2023 and S&P a month later), therefore reducing the size of the high-yield market and meaning more money is chasing fewer assets.

Conclusion

We believe that this is not the time to reduce exposure to EM and concentrate exposure towards the US market. EM is on a much stronger structural footing heading into the next cycle with the default experience in the price already. We believe that these pressures have not yet been felt in developed markets to the same level.

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