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Ninety One

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Investing for a
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Credit market labels need a refresh

Now more than ever, it is worth revisiting old perceptions and taking a fresh look at the world of emerging market credit. Alan Siow explains why an updated perspective is needed today, and highlights the opportunity costs of sticking with old labels when searching for yield and growth opportunities in credit markets.

Alan Siow
Co-Head of Emerging
Market Corporate Debt

Background

The shift to a new macroeconomic regime is among factors that have redrawn the fixed income investment landscape in the past few years. Major economies like the US are only just getting to grips with inflation – with rates set to remain higher for longer than many had hoped. They also face the daunting prospect of returning fiscal deficits to a post-pandemic sustainable path. Add to that a proliferation of election-related uncertainty and increasing divergence across global economies, and old labels used by asset allocators no longer seem useful or fitting. This is particularly the case for ‘emerging markets’ – a label synonymous with higher volatility, lower perceived credit quality, and greater political uncertainty.

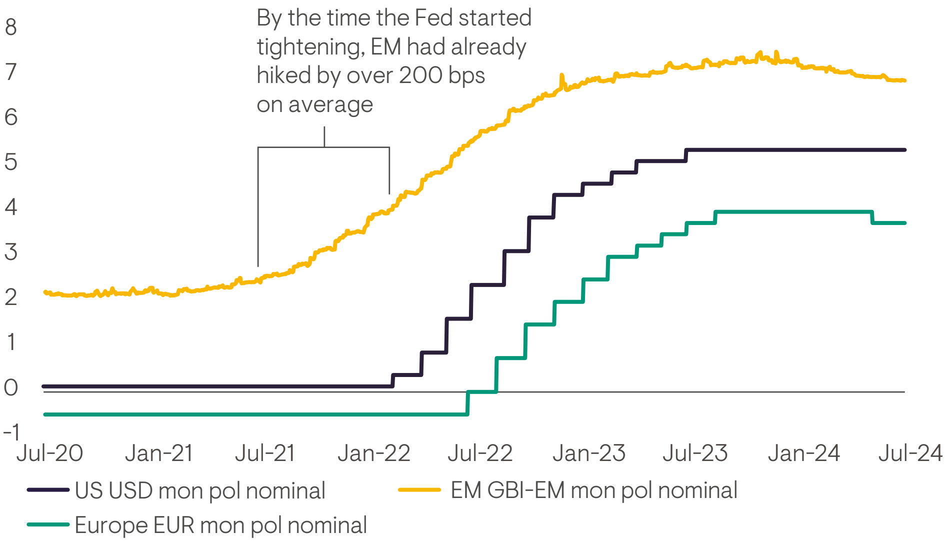
Emerging markets in a new era

Last year, my colleague, Peter Kent, discussed the 'blurring of lines' between developed and emerging market (EM) debt that has taken place in recent years. Outlining developments – such as proactive rate cutting – that have underpinned a strengthening of EM fundamentals, Peter illustrated how this was feeding through into resilient sovereign debt market performance. He also drew contrasts with the shift that has taken place in the developed market universe to result in a much more volatile fixed income market regime there.

Since then, elections in emerging markets including India, South Africa and Mexico have evidenced peaceful democracy in action, with predominantly market-friendly outcomes. The greatest uncertainty facing investors stems from the looming US election.

Turning to the macroeconomy, while inflation finally seems to be trending down in the US, many EM central banks are further ahead in their rate-cutting cycles. This, together with fundamentals that are generally on a positive trajectory (see Appendix), puts EM economies at an advantage.

Monetary policy rates across the US, EU and EM (%)



Source: Bloomberg, Ninety One, April 2024. EM is the weighted average of emerging market countries in the JPMorgan GBI-EM GD benchmark.

EM central banks began to tighten policy 12 months before the Fed.

An updated view on EM corporate credit issuers

Strong foundations and growing tailwinds

The fundamental improvements seen in EM economies naturally provide firmer foundations for the companies operating in them – and for the debt they issue. But that's only part of the story. The world order is undergoing a significant shift. The unipolar dominance of the past, characterised by the United States as the sole superpower, is transitioning to a multipolar world marked by various centres of economic, political, and military influence. Power shifts, by their nature, create both volatility and opportunity.

Countries that diversify their economies, build strong regional alliances, and can navigate between different global powers are likely to benefit. Winners will also include those countries and markets that are geographically well-positioned to benefit from trends like nearshoring[1] or friendshoring[2]. For example, Mexico has benefitted as US companies build manufacturing operations nearer to home. Similarly, India has benefitted as companies like Apple, following the COVID-triggered supply-chain crisis, has implemented a plan to ship 40% to 45% of iPhones from India, compared to a single-digit percentage in 2022[3]. These nearshoring and friendshoring strategies, aligned with companies' and countries' de-risking strategies, will reconfigure supply chains, as well as trade and investment flows, especially for strategic goods and services.

Market-leading global companies

It is an often-overlooked fact that emerging markets are home to many market-leading companies, with a global footprint and geographically diverse revenue sources.

Leading global brands that are owned or controlled by emerging market corporates

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[1] Nearshoring: process of a company relocating business operations to a nearby country, often with a shared border.
[2] Friendshoring: the rerouting of supply chains to countries perceived as politically and economically safe or low-risk, to avoid disruption to the flow of business.
[3] Wall Street Journal, November 2022.

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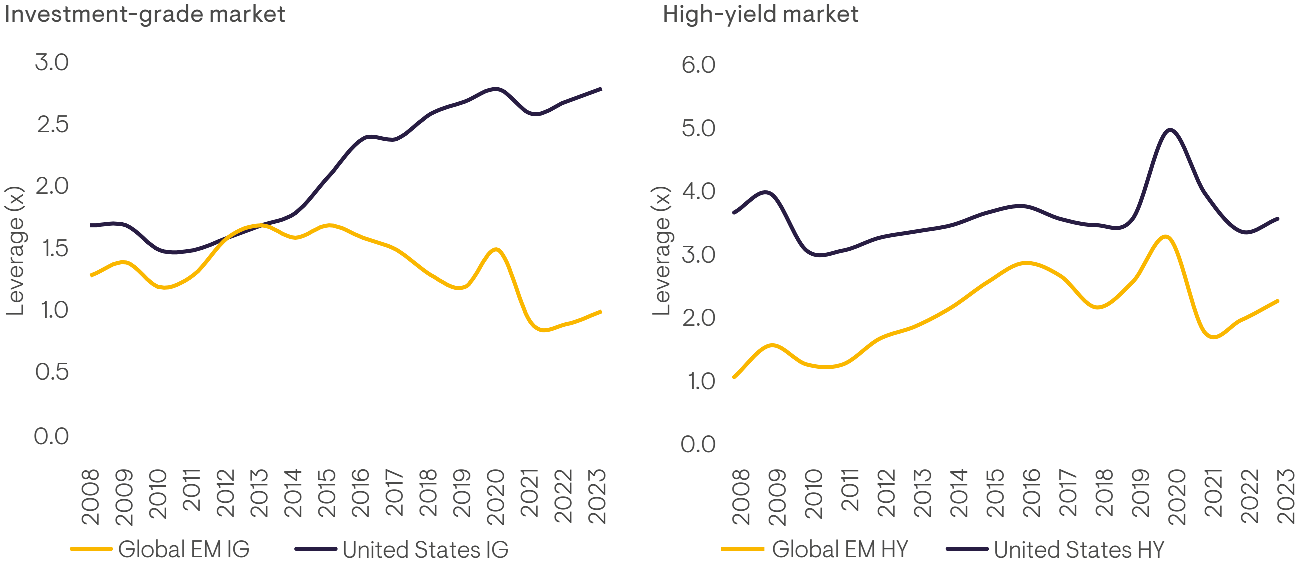
Prudent financial management

It's also a well-kept secret that EM companies typically have very low leverage. These companies are familiar with volatility and have historically experienced periods when they struggled to finance themselves with longer-term debt. Thus, their short-term debt is higher as a percentage than it is in DM companies, and their refinancing risks have historically been higher. This has led to a culture of retaining cash while containing leverage. This has been particularly evident since the COVID crisis, as many companies have pared back their expansion and capital expenditure, leaving them with healthy cash balances and strong buffers.

In contrast, leverage rates among companies based in the US and other developed markets have risen, and with the era of exceptionally loose monetary policy now behind us, companies face a very different (more challenging) reality in the new macro regime. Furthermore, in developed markets, the higher-for-longer rates backdrop is likely to be further exacerbated by persistent fiscal imbalances. All at a time when potentially profound political changes are on the horizon.

Leverage levels



Source: JPMorgan, September 2023.

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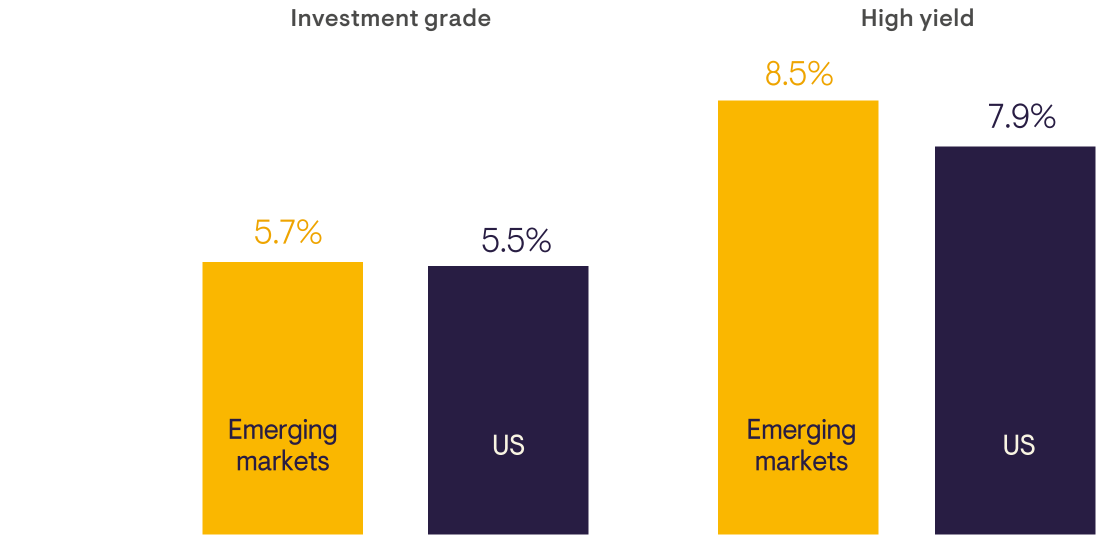
A look behind the labels

Given the dynamics discussed above, we think the case for including EM credit alongside DM allocations in portfolios is strong. But pre-existing perceptions can be hard to shift. To help inform an up-to-date view, we share some key metrics below of the large, diverse and maturing asset class of EM credit.

Yields



Average credit quality	A-	A-	BB-	B+
Duration	4.8 years	6.7 years	3.5 years	3.3 years

Source: JP Morgan, BofA, 30 June 2024. EM data is from JP Morgan CEMBI IG/HY indices, while US IG/HY data is from BofA indices.

Not only is the EM asset class a globally diverse universe that spans continents, in many ways, EM and DM/US credit markets are alike. In some respects, EM credits have more favourable characteristics. A look at the key characteristics of the asset class today and how it stacks up suggests it can play a useful role in a broader credit/growth fixed income allocation.

> EM corporate credit offers comparable or superior yields, for similar credit quality and duration.

Comparison of two major tech sector companies – one based in an emerging market, the other in the US.

	Mercado Libre	eBay
Industry	Online marketplace	E-commerce
Country	Argentina	US
Market position	Leading e-commerce player in home market	Leading e-commerce player in home market
FY23 Total footprint	GMV*: $45 bn	GMV: $73 bn
Market capitalisation (USD)	$87.8 bn	$27.9 bn
FY23 Revenues (USD)	$14.4 bn	$10.1 bn
FY23 Net Leverage	Negative (-0.3x)	1.3x
Rating (M/S/F)	Ba1/BB+/BB+	Baa1/BBB+/NR
Credit spread to US Treasury	240 bps	115 bps
10yr bond yield**	6.2%	5.0%

This is not a buy, sell or hold recommendation for any particular security.

Securities chosen are for illustrative purposes only.

Source: Bloomberg, Ninety One. Market cap, rating, credit spread and bond yield as at 5 August 2024.

*GMV is gross merchandise value.

**The Mercado Libre bond used matures in 2031; The eBay bond used matures in 2032. Yield is yield-to-worst.

> Despite robust fundamentals and a similar rating, the EM company trades at a significant discount. This is a typical observation across the opportunity set.

Case study

Conclusion

Asset allocators have typically overlooked the EM corporate bond market, with negative perceptions behind the EM label partly to blame. Yet various developments over recent years put those views to the test. The EM credit opportunity set today compares very favourably across a variety of metrics; in many cases, macro and micro fundamentals in EM are superior to developed markets, such as the US. Asset allocators who take a fresh perspective on EM can find a compelling investment case. EM credit deserves a place in portfolios.

Related reading

Deliberating EM debt series | May 2024

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

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.

Grant Webster
Co-Head of Emerging Market Sovereign & FX

Emily Patton
Portfolio Specialist

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.

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Deliberating EM debt series | September 2023

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Investing for a world of change

Blurred lines: the EM'ification of DM

It's worth looking closely at recent bond market volatility when making asset allocation decisions – you might be surprised at how traditional 'safe-havens' fare. Volatility is just one of the lenses through which developed market (DM) fixed income is looking decidedly more EM-like.

Peter Kent
Co-Head of Emerging Market Fixed Income

Reflecting on 20 years of experience in rates markets – first in DM and then in EM – I've been really struck by the regime change that has happened in DM markets like gilts, US (2-year Treasuries) and the Japanese currency market over the last two years. Volatility in these markets has been like nothing I've witnessed before, and at times on a par with what I have experienced in EM. That's what prompted this analysis and inspired the term 'EM'ification of DM'.

To frame the analysis, I consider the typical complaints we hear about EM – them underperforming developed markets, not being worth the risk, and being a place of poor policymaking. Considering each in turn is quite revealing and points to a blurring of lines between DM and EM.

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April 2024

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Emerging Market Investment Grade Corporate debt

Providing opportunity for growth and diversification to fixed income portfolios

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General risks. All investments carry the risk of capital loss. The value of investments, and any income generated from them, can fall as well as rise and will be affected by changes in interest rates, currency fluctuations, general market conditions and other political, social and economic developments, as well as by specific matters relating to the assets in which the investment strategy invests. If any currency differs from the investor's home currency, returns may increase or decrease as a result of currency fluctuations. Past performance is not a reliable indicator of future results.

Specific risks. Emerging market: These markets carry a higher risk of financial loss than more developed markets as they may have less developed legal, political, economic or other systems. **Default:** There is a risk that the issuers of fixed income investments (e.g. bonds) may not be able to meet interest payments nor repay the money they have borrowed. The worse the credit quality of the issuer, the greater the risk of default and therefore investment loss.

Appendix

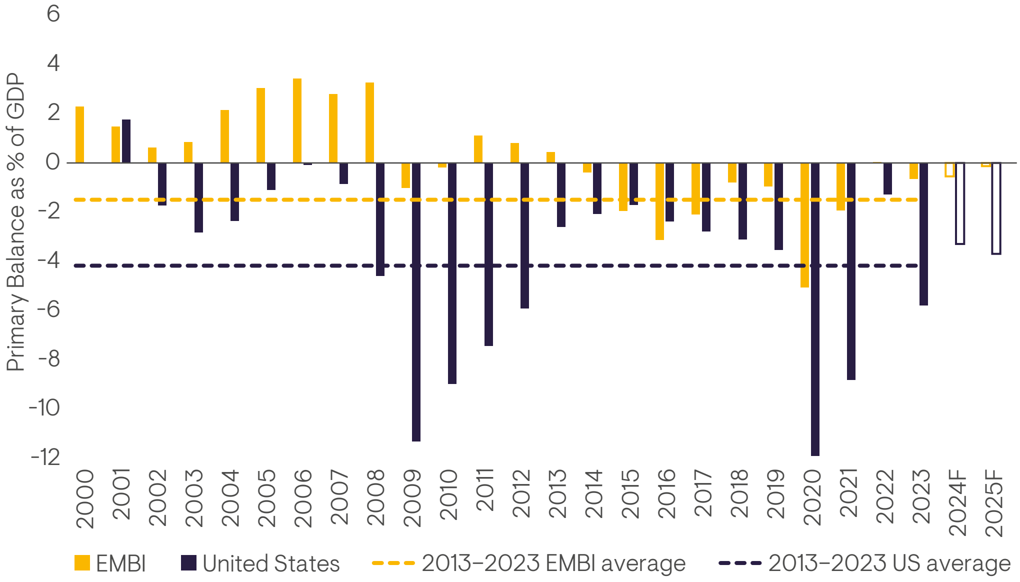
Macro fundamentals at a glance

In emerging markets, the early part of the 21st century was characterised by reforms and economic strength. Subsequently, vulnerabilities arose in the five years after the Global Financial Crisis, with large current account deficits (financed by loose global liquidity) and weaker fiscal balances exposed during the painful taper tantrum, when EM assets sold off heavily. Crucially, though, this precipitated a significant rebalancing of EM economies, laying a foundation of resilience that served emerging markets well during the COVID pandemic-related shock.

Fiscal policymaking in emerging markets remained prudent during the pandemic, resulting in primary fiscal balances being in surplus across many economies and debt-to-GDP stabilising at modest levels - as shown in the charts below. In contrast, the major stimulus measures unleashed by policymakers in the US and other developed market economies in response to the COVID crisis created sizeable deficits and a heavy debt burden, with no signs of either issue being tackled anytime soon.

EM and US primary balance (% of GDP)

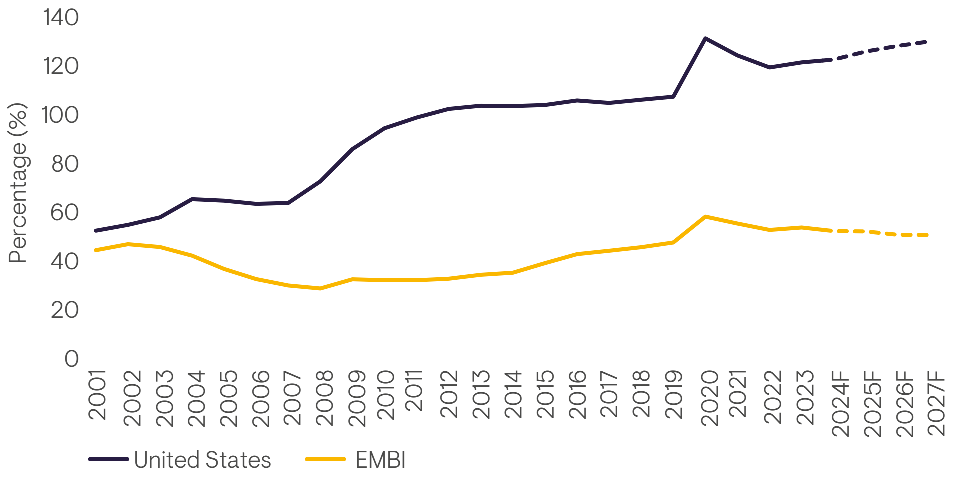
EMBI weighted scores across 79 EM countries



Source: IMF, Ninety One, April 2024. 2013-2023 is used to show the last 10 year average.

EM Debt to GDP

EMBI weighted scores across 79 EM countries



Source: IMF, Ninety One, April 2024.

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