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EM corporate debt: A compelling and complementary asset class

EM corporate debt can bring distinct benefits to portfolios, making it a valuable addition to US high-yield credit allocations

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Introduction

Emerging market (EM) corporate debt is often compared with the US high-yield market as both fall into the category of growth fixed income assets. However, they differ significantly in structure and risk profile. We believe that EM corporate debt represents a compelling investment opportunity, and its distinctive qualities make it a valuable complement to high-yield credit allocations. We examine this through four different lenses.

1. Diversification

Firstly, the EM corporate debt market brings significant benefits in terms of geographical diversification. While the US high-yield market is driven solely by the US economy, the EM corporate debt investment universe is global – comprised of over 60 countries. In addition, at approximately US$2.5 trillion, the EM corporate debt opportunity set is much larger than the US high-yield market (at c.US$1.3 trillion)[1].

For investors, the global footprint of the EM corporate debt asset class provides diversified exposure to different economic cycles, growth drivers, and monetary policy regimes – factors that are typically uncorrelated.

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1. JP Morgan, BofA, as at December 2024.

In that vein, the EM corporate debt market provides opportunities for enhanced sector diversification in a portfolio, offering exposure to sectors that do not have substantial representation in the US high-yield market. For example, EM corporate debt has relatively high exposure to the banking and utilities sectors, two relatively defensive sectors that can help anchor returns.

Figure 1: US high-yield sector breakdown

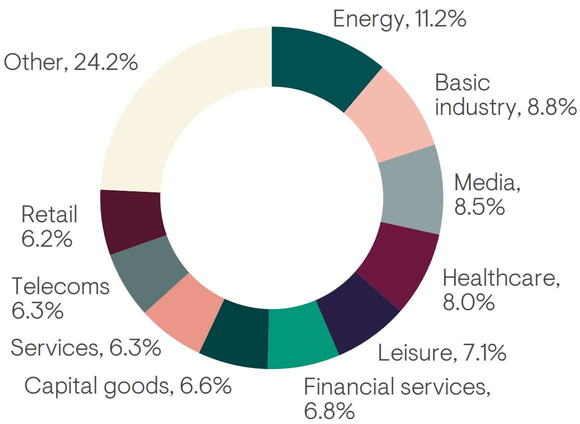
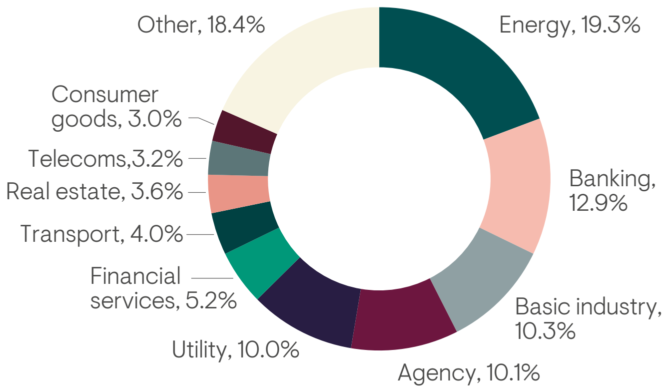


Figure 2: EM corporate debt sector breakdown



Source: ICE BofA Merrill Lynch as at 31 December 2024.

2. Credit quality and fundamentals

By definition, the US high-yield market is comprised solely of sub-investment grade companies, but EM corporate debt is a more complete asset class, consisting of both investment-grade and high-yield issuers. Today, almost 60% of the EM corporate debt market is rated investment grade and the market has an overall average credit quality of BBB-; this compares to B+ for the US high-yield market, implying a much higher credit quality for the EM corporate debt asset class. The table below shows that this has resulted in lower average default rates over the last 10 years. Therefore, an EM allocation can improve a portfolio's overall credit quality.

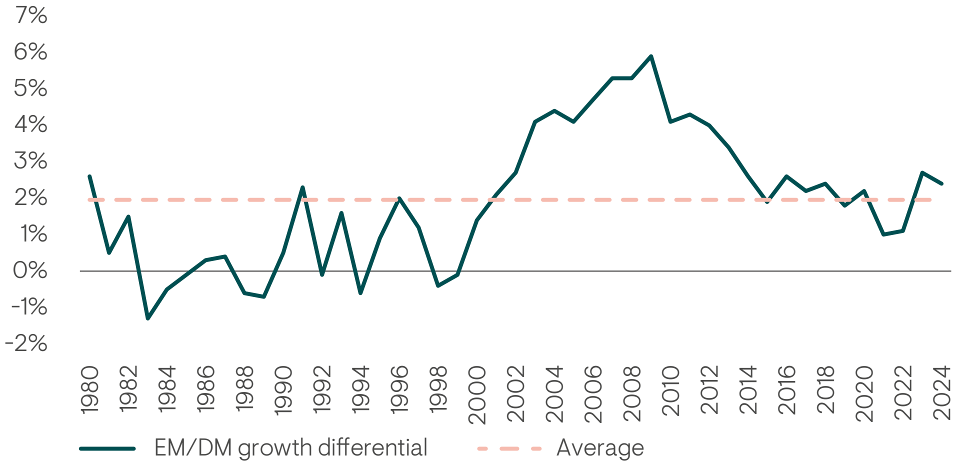
Figure 3: Average default rate of EM corporates vs. US high yield

	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	Avg
EM corporates	1.4%	2.0%	0.8%	0.7%	0.7%	1.4%	2.9%	5.7%	3.0%	1.4%	2.0%
US high yield	2.6%	4.3%	1.5%	1.9%	2.9%	6.8%	0.4%	1.6%	2.8%	1.5%	2.6%

Source: JP Morgan as at December 2024.

In addition, EM corporate debt benefits from the growth differential that EM economies offer over developed markets (DM), which is currently slightly above its long-term average of 2% (Figure 4). Coupled with increasingly healthy primary fiscal balances in EM economies, this creates a strong fundamental foundation for companies there.

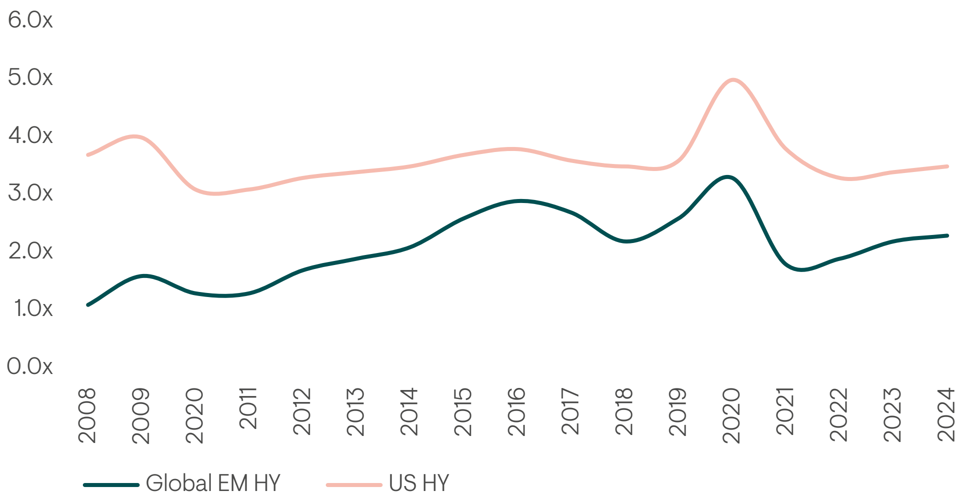
Figure 4: EM and DM growth differential



Source: IMF as at September 2024.

It is also informative to consider the fundamental strength of companies within these two investment universes. Given their experience in dealing with prior episodes of economic stress, EM companies tend to be managed more conservatively with lower levels of leverage and more robust balance sheets compared to their peers in developed markets. The chart below shows that within the high-yield space, the average leverage of EM companies has been consistently lower than in the US over time, making them better positioned to withstand bouts of market turbulence. This trend is also present across the investment-grade segment of the market.

Figure 5: Net leverage comparison



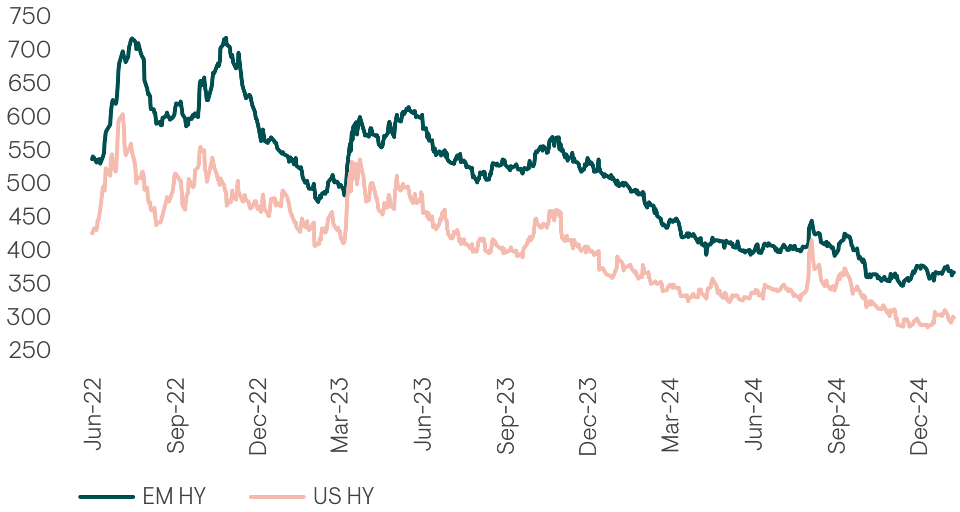
Source: JP Morgan at December 2024. Note: Excluding 100%-quasi sovereigns, financials, real estate, and defaulted companies. EM numbers as of Q3 2024, while US is as of Q2 2024.

A further advantage for EM companies is that they have more diverse funding channels than those based in the US. For example, in addition to funding from international bond markets and banks that US companies have access to, EM corporates also benefit from access to funding from local banks and local currency bond markets. Local banks can often provide more flexible terms and have a better understanding of the local business environment and regulations, while issuing in local currency can help reduce FX risk. Having diverse funding channels can be extremely important for EM companies during periods of market stress to protect against sudden stops in capital flows if funding from international markets is limited.

3. Valuations

EM corporate debt also looks compelling when examining current valuations. Reflecting historically unprecedented high levels of demand, there has been significant compression of spreads in the US high-yield market since mid-2022, and at its current spread of c.310bps, the asset class is trading at its tightest (most expensive) level since 2007. While valuations in EM corporate debt have also compressed, the asset class still offers value relative to US high yield – the sub-investment-grade portion of the EM corporate debt market currently trades at a spread of c.380bps, meaning it provides a c.70bps spread pickup for an equivalent credit rating. This structural spread premium has been consistently present over time and reflects the 'postcode premium' of being domiciled in EM[2].

Figure 6: Credit spreads of EM high-yield corporates vs. US high-yield



Source: JP Morgan, ICE BofA Merrill Lynch as at December 2024.

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2. EM country-specific concerns often overshadow otherwise solid company fundamentals, pushing yields higher than those offered by developed market bonds of a similar credit quality. We describe this as a 'postcode premium'.

4. Structural shifts

Rising middle-class consumption and infrastructure development are just two structural shifts taking place across EM economies – investors in EM corporate debt can seek to tap into the opportunities these present in the corporate sector.

Another major theme that EM corporate debt is at the heart of is the global energy transition. For the world to transition to net-zero carbon, commercial funding will finance large swathes of new infrastructure and industrial change among companies that produce the highest emissions today but have credible transition plans. But like other transitions, this will not happen overnight – transition finance is a long-term investment theme. There are already numerous investment opportunities here, either through financing the energy transition of companies with credible net-zero targets and policies in place and/or in areas such as renewable energy, in which EM corporates play an increasingly important role. This theme is also relevant for investors seeking a sustainable tilt in their portfolios.

In summary

Given a range of structural considerations and its diverse risk profile, we believe that an allocation to EM corporate debt can bring distinct benefits to portfolios. The EM corporate debt asset class offers a large, liquid universe of issuers which can improve portfolio geographical diversification and increase its average credit rating. EM corporate debt is underpinned by issuers that often benefit from robust fundamentals even when they carry identical international credit ratings to their developed market counterparts. This “postcode premium” means that EM corporate investors can enjoy a pickup in spreads and yields without a trade-off either in increased credit risk or duration. The asset class benefits from the strong structural position of EM economies and also provides exposure to some major structural investment themes.

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