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Previously Investec
Asset Management

Emerging Market Investment Grade Corporate Debt

A solution to the US Investment Grade fixed income dilemma

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For more than a decade, the firm has been committed to clients in the US, Canada and Latin America, developing trusted partnerships by delivering local expertise with a global platform. Established in South Africa in 1991, as Investec Asset Management, it started with domestic investments in an emerging market. In 2020, almost three decades of organic growth later, the firm demerged from Investec Group and became Ninety One. Today Ninety One offers distinctive active strategies to institutions, advisors and individual investors around the world.

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*Source: Ninety One, 31 March.2020.

Contents

The fast view 3

Are US investors missing the potential for higher returns within Investment Grade? 4

Will US IG debt returns offer investors what they need? 5

Lower duration, higher yield 6

A cushion for rising rates 8

A significant asset class 9

A powerful diversifier 10

Emerging market corporates are well positioned for the uncertain environment 14

Demand for the asset class continues 18

Outlook: look-through to the fundamentals 20

General risks. The value of investments, and any income generated from them, can fall as well as rise. Past performance is not a reliable indicator of future results. Investment objectives and performance targets may not necessarily be achieved, losses may be made.

Specific risks. **Currency exchange:** Changes in the relative values of different currencies may adversely affect the value of investments and any related income. **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. **Derivatives:** The use of derivatives may increase overall risk by magnifying the effect of both gains and losses leading to large changes in value and potentially large financial loss. A counterparty to a derivative transaction may fail to meet its obligations which may also lead to a financial loss. **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. **Interest rate:** The value of fixed income investments (e.g. bonds) tends to decrease when interest rates rise. **Liquidity:** There may be insufficient buyers or sellers of particular investments giving rise to delays in trading and being able to make settlements, and/or large fluctuations in value. This may lead to larger financial losses than might be anticipated.

fast

Fast view

- The pandemic has upended the fixed income landscape for many investors, with yields on typically safer assets continuing to decline to ever lower levels; In our view, exposure to emerging market investment grade corporate debt can help investors boost returns within their core fixed income allocation while maintaining IG credit quality and comperable risk levels.
- As emerging markets have grown substantially over the past two decades, corporates domiciled there have tapped international capital markets to fund their growth, creating a US$1.4 trillion universe across 29 countries.
- Emerging market investment grade is more resilient than its US counterpart. Should rates rise from here – which is unlikely in the near-term – the higher yield premium and lower duration of the asset class provides a much bigger cushion versus developed peers.
- One of the key attributes to consider when adding a new asset class to a portfolio mix is how it correlates with other asset classes; our analysis shows on a 10-year historical view, emerging market investment grade corporate debt offers additional diversification to US fixed income.
- Emerging market corporates are well positioned for the uncertain environment, with lower leverage than US counterparts, greater cash piles and a recent track record of managing and reducing leverage during times of crisis.
- We believe the asset class is no longer considered as a tactical allocation within a portfolio but a more structural long-term holding. Demand remains global in nature and comes from a highly diverse set of investors.

view

Are US investors missing the potential for higher returns within Investment Grade?

US investment grade debt investors worry about three key issues:

- low overall yields (thus likely lower returns)
- stability of returns
- the negative impact from potentially rising rates

The recent Covid-19 induced market shock has changed the landscape for many fixed income investors. Portfolios were perhaps not as stable as hoped and given the continued unprecedented monetary policy, yields on typically safer fixed income assets have continued to fall. This has left many investors scratching their heads, asking how to achieve their intended return target without taking on significantly more risk. Many have turned to lower credit quality or illiquid asset classes to combat this, while maintaining a healthy overall exposure to investment grade.

We believe there is another alternative: emerging market investment grade corporate debt.

This paper will outline why we believe this fast growing and increasingly diverse US$1.4 trillion asset class, which has higher yields, lower duration, and less leverage than US investment grade, could provide a high-grade complementary antidote to the low return dilemma.

Will US IG debt returns offer investors what they need?

Investors in traditional investment grade fixed income portfolios are concerned about the path of future returns. Although credit spreads have widened from recent tights, this has been more than offset by continued collapse in treasury yields. Even with the recent pick up, US yields remain at historically low levels. Expected returns are a function of the overall yield, combined with interest rate movements over time. The 30 June 2020 Yield to Worst (YTW)[1] of 1.25% of the Bloomberg Barclays US Aggregate Index is at its lowest ever level and given the uncertain political and economic environment it is hard to see annualized returns over the next few years exceeding low single digits. This has driven the 'search for yield', pushing investors into lower-quality/less-liquid fixed income strategies.

But investors will only risk so much in these strategies, leaving many with a sizable portion of their portfolio in US investment grade corporate debt that will not meet their return needs.

Emerging market investment grade corporate debt offers a liquid, investment grade rated, US dollar denominated alternative that many investors have not considered. As emerging markets have grown substantially over the past two decades, emerging market-based corporations have turned to international capital markets to help fund and grow their businesses. As a result, J.P. Morgan launched a suite of emerging market corporate debt indices in 2008, and today the investment grade portion of the asset class has grown to over US$1.4 trillion across 29 countries. The universe is diversified globally across regions, countries, and sectors, with lower leverage than developed market peers.

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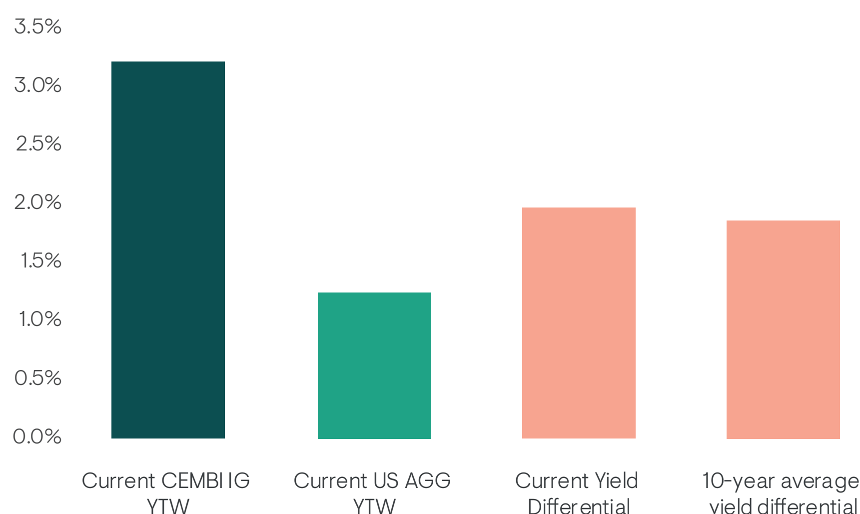
1. The lowest potential yield that can be received on a bond without the issuer actually defaulting.

Lower duration, higher yield

Emerging market investment grade corporate debt offers higher yield and lower duration versus developed market counterparts. Historically, this has led to strong returns versus US investment grade. Relative to the Bloomberg Barclays US Aggregate Index, emerging market investment grade has offered investors a consistent yield premium of 1.5-2%.

Figure 1: Emerging market investment grade corporate debt offers a yield premium



Past performance is not an indicator of future returns.

Source: JP Morgan, Bloomberg, 30 June 2020.

> Emerging market investment grade has outperformed US investment grade 96% of the time over rolling 3 and 98% over 5 years.

Over the last twelve years, emerging market investment grade corporate debt has outperformed 96% of the time over rolling three year-periods and 98% of the time over rolling five-year periods, as highlighted in the table below. This time period includes many major tests for emerging markets, ranging from the Global Financial Crisis, European concerns, the commodity collapse that impacted emerging markets directly and COVID-19.

Figure 2: Persistent premiums in emerging market investment grade corporate debt (USD)

	Last 12-Years (Jun 2008 - Jun 2020)		
	Rolling 1 year	**Rolling 3 year**	**Rolling 5 year**
Number of periods	132	108	84
Periods in which EM IG Corporate Debt outperformed*	108	104	82
Batting average**	82%	96%	98%
Average outperformance	+287 bps	+237 bps	+230 bps

Past performance is not an indicator of future returns.

Source: JP Morgan, Bloomberg, 30 June 2020.

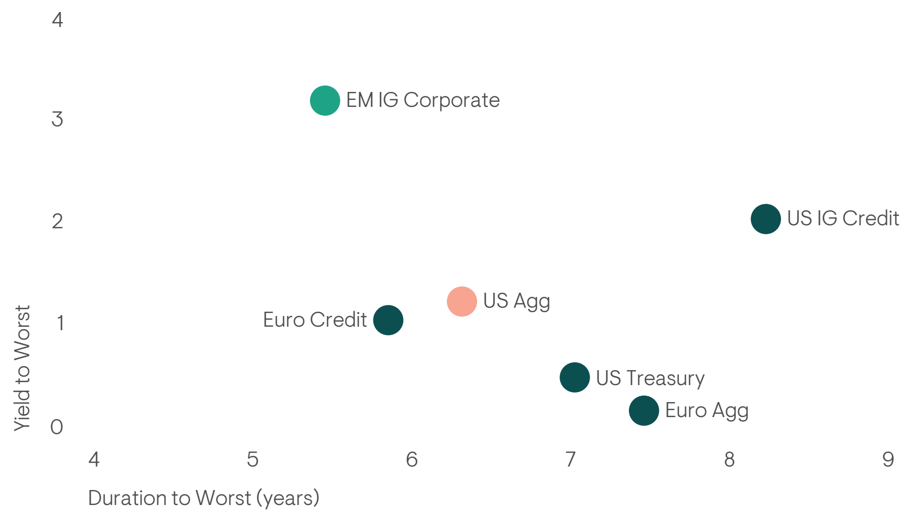
* IG component of JP Morgan CEMBI Broad Diversified Index minus Bloomberg Barclays US Aggregate Index.

**Batting average is expressed as the percentage of periods in which EM IG Corporate Debt outperformed the Bloomberg Barclays US Aggregate Index.

But can this continue? We believe the best way to predict future fixed income returns over a market cycle is to consider the yield, duration, and potential interest rate environment.

The chart below is index level data for US and European investment grade sectors, as well as emerging market investment grade corporates. We believe the extra yield (197 bps) generated by emerging market investment grade corporates versus US Aggregate should allow outperformance to continue.

Figure 3: Global investment grade options



Source: JP Morgan, Bloomberg, Ninety One as at 30 June 2020.

A cushion for rising rates

Whilst there appears to be little near-term concern around the potential for rising rates, the extent of the unprecedented volume of fiscal and monetary easing seen in response to the COVID-19 pandemic means the future path of inflation and interest rates is uncertain. Should rates rise from here, the higher yield and lower duration of emerging market investment grade provides a bigger cushion in emerging market than developed market to offset a rise in rates. The following table shows how much yields need to increase over 12-months to wipe out the carry and deliver clients a negative return. The US Aggregate Index yield only needs to increase 20 bps for returns to be negative, while emerging market investment grade needs to nearly triple that level.

Emerging market investment grade more resilient than US investment grade.

Figure 4: Amount yields need to increase to break even on total return over 12 months

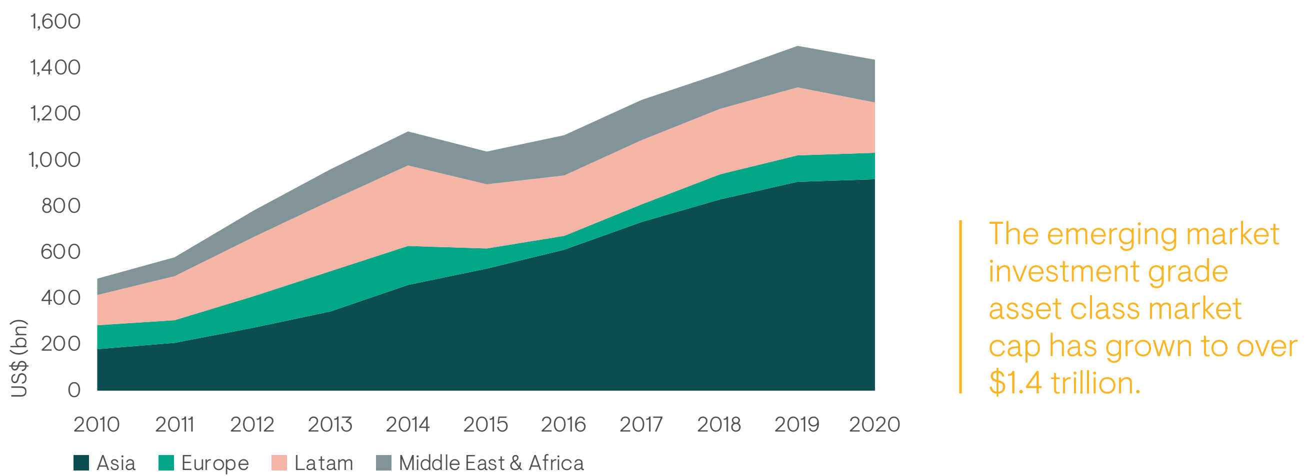
Asset Class	Index	Yield increase needed to nullify returns over a 12-month period (bps)
EM IG Corporate	JPM IG CEMBI Broad Div	59
US IG Credit	Bloomberg Barclays US Credit	25
US Agg	Bloomberg Barclays US Agg	20
Euro Credit	Bloomberg Barclays European Credit	18
US Treasury	Bloomberg Barclays US Treasury	7
Euro Agg	Bloomberg Barclays European Agg	2
Euro Treasury	Bloomberg Barclays European Treasury	2

Source: JP Morgan, Bloomberg, Ninety One as at 30 June 2020.

A significant asset class

The emerging market investment grade corporate debt market has grown steadily over the last decade, as issuance has particularly increased in Asia. The asset class market cap has grown to over $1.4 trillion, from less than $500 billion in 2010. The chart below shows the total market cap by region, as of June 2020.

Figure 5: Growth in emerging market investment grade corporate bonds (US$ Billions)

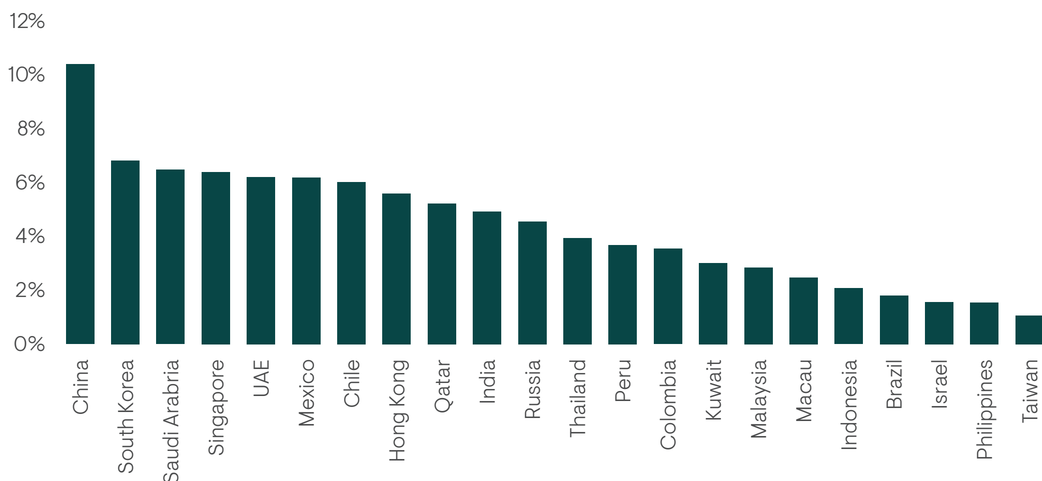


Source: JP Morgan, as at 30 June 2020.

The emerging market investment grade asset class market cap has grown to over $1.4 trillion.

There are 29 countries in the index, and the chart below indicates those countries with a weighting above 1% as of 30 June 2020.

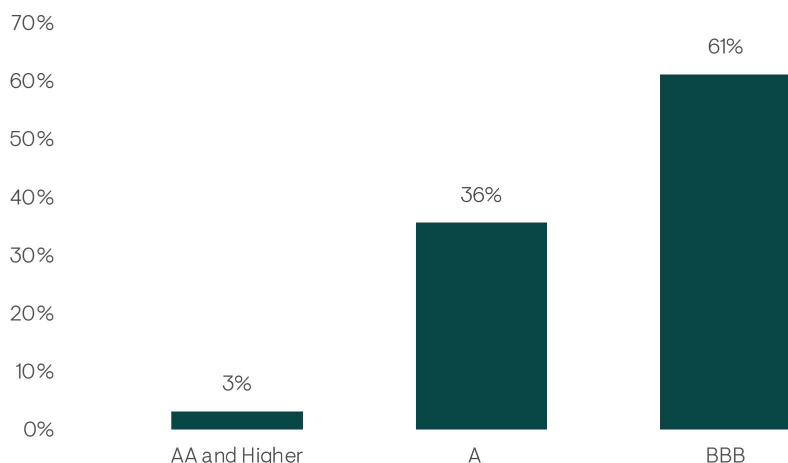
Figure 6: Emerging market investment grade corporate universe & index weights



Source: IG component of JP Morgan CEMBI Broad Diversified Index as at 31 June 2020. (Showing countries with a weight above 1%).

The average rating of the JPM index is BBB+ and the breakdown as of 30 June 2020 is in the chart below. The BBB portion of the index has trended higher in the past few years, as some key sovereigns experienced downgrades following the commodity/emerging market issues of 2014-16. Key sovereign downgrades as a result of the economic stresses of COVID-19 could lead to further evolution of the index. However, a flexible and active manager can mitigate some of the risks.

Figure 7: Emerging market corporate investment grade ratings breakdown

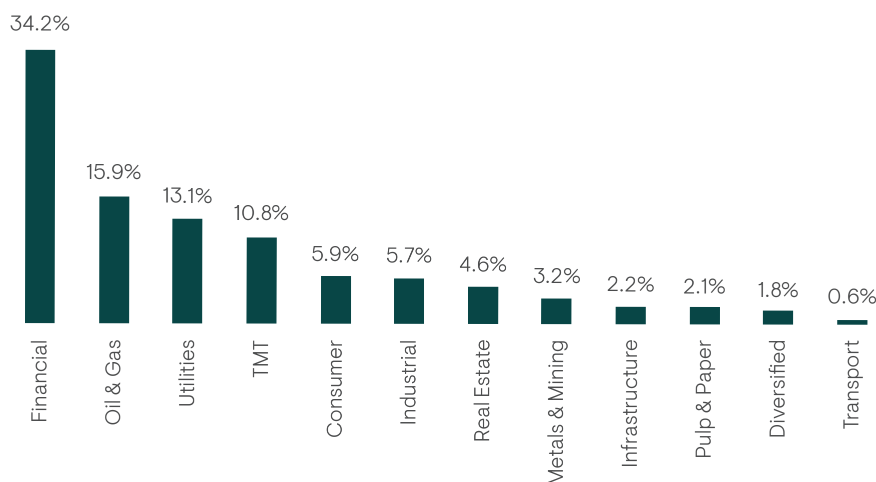


Source: IG component of JP Morgan CEMBI Broad Diversified Index as at 30 June 2020.

From an industry perspective, commodity and financial companies make up roughly 50% of the market, but that percentage has decreased over time as the market has grown and become more diversified. The industry sector breakdown as of 30 June 2020 is in the chart below.

Emerging market investment grade offers an expanding opportunity set across ratings and sectors.

Figure 8: Emerging market corporate investment grade sector breakdown



Source: IG component of CEMBI Broad Diversified Index as at 30 June 2020.

A powerful diversifier

One of the key attributes to consider when adding a new asset class to a portfolio mix is how it correlates with other asset classes. As can be seen by the table below, which provides a 10-year historical view of correlations across asset classes, emerging market investment grade corporate debt offers additional diversification to US fixed income.

Figure 9: Correlation table for 10 years ending 30 June 2020

S&P 500	MSCI EM Equity	50/50 EMD Mix	BBG Barclays US HY 2% CAP	BBG Barclays US Treasury	BBG Barclays US CREDIT	BBG Barclays US AGG	JPM Cembi Broad DIV IG Component	Indices
1.00	0.76	0.57	0.78	(0.45)	0.30	(0.11)	0.49	S&P 500
	1.00	0.81	0.76	(0.29)	0.41	0.06	0.62	MSCI EM Equity
		1.0	0.76	(0.02)	0.65	0.35	0.84	50/50 EMD Mix
			1.00	(0.26)	0.62	0.18	0.79	BBG Barclays US HY 2% CAP
				1.00	0.49	0.88	0.18	BBG Barclays US Treasury
					1.00	0.83	0.88	BBG Barclays US CREDIT
						1.00	0.59	BBG Barclays US AGG
							1.00	JPM Cembi Broad DIV IG

Source: JP Morgan, MSCI, S&P, Bloomberg, Ninety One as at 30 June 2020.

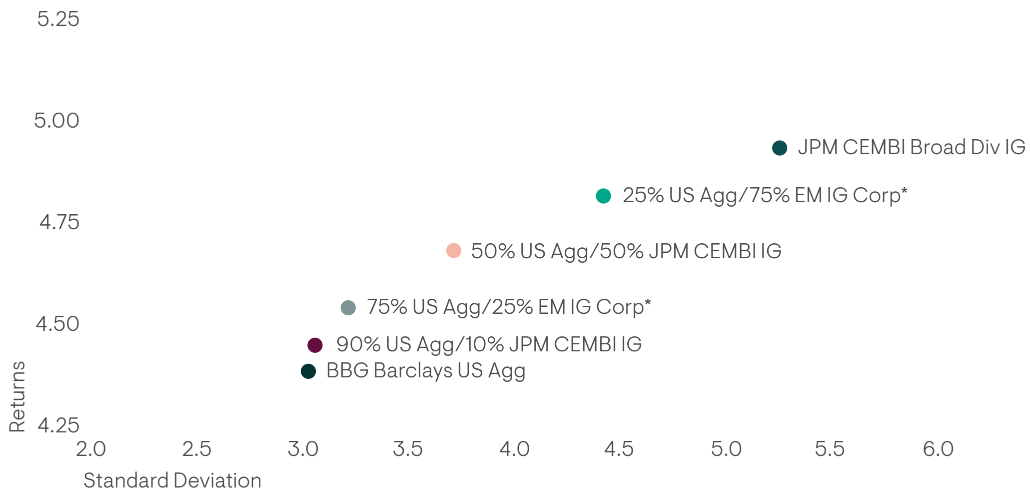
Correlations can move over time. The following chart illustrates the rolling 3-year correlation of emerging market investment grade corporates to US fixed income. It has consistently remained between 0.4-0.8, thus a combination of the two asset classes can make a more efficient mix.

Figure 10: Rolling 3-year correlation between emerging market investment grade corporate and US Aggregate

Source: IG component of JP Morgan CEMBI Broad Diversified and Bloomberg Barclays IG US Aggregate as at 30 June 2020.

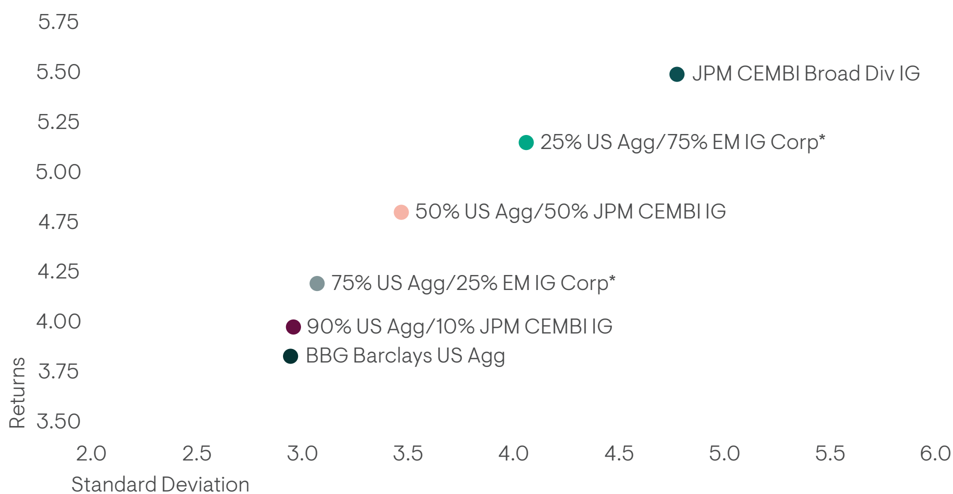
The charts below offer different historical combinations of emerging market investment grade corporates and the US Aggregate over 5 and 10 years, showing how the diversification benefits highlighted above play out on the efficient frontier. Adding emerging market investment grade improves the overall risk-return outcome.

Figure 11: Risk and return for 5 years ending 30 June 2020



Source: JP Morgan, Bloomberg as at 30 June 2020.
*EM IG Corp is represented by IG component of JPM CEMBI Broad Diversified.

Figure 12: Risk and return for 10 years ending 30 June



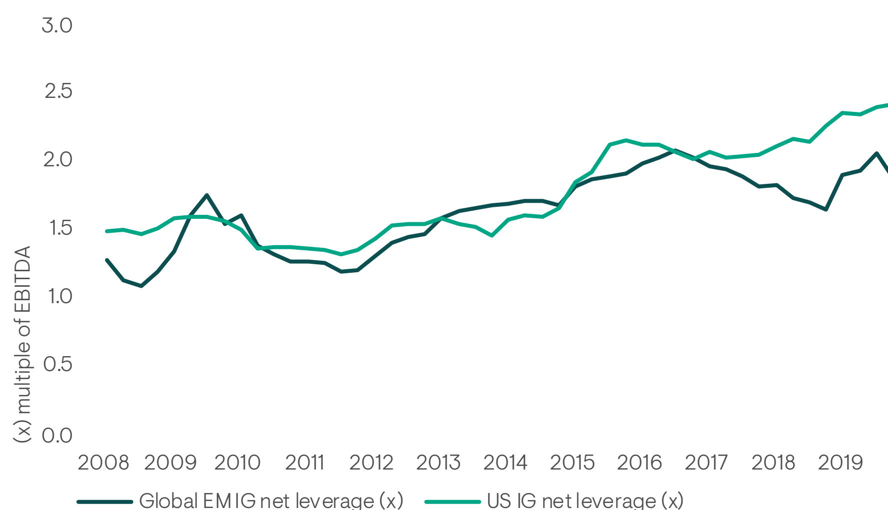
Source: JP Morgan, Bloomberg as at 30 June 2020.
*EM IG Corp is represented by IG component of JPM CEMBI Broad Diversified.

Past performance is not an indicator of future returns.

Emerging market corporates are well positioned for the uncertain environment

Through time, emerging market companies have on average maintained better credit fundamentals than their similarly rated developed market peers, as they have needed to maintain resilience during challenging macroeconomic backdrops. Head-quartered and operating in emerging markets, these companies are familiar with volatility and have historically had periods when they struggled to finance themselves with longer-term debt. Thus, their short-term debt is higher as a percentage than in developed markets, and their refinancing risks have historically been higher. This has led to a culture of retaining cash while containing leverage. The chart below shows the lower net leverage in emerging market investment grade companies versus developed market peers.

Figure 13: Emerging market investment grade corporate versus US investment grade corporate net leverage metrics



Source: Bank of America Merrill Lynch as at 30 June 2020 (earnings date 31 December 2019). 'x' means as a multiple of EBITDA.

Whilst not yet evident in the above chart we would expect the leverage to pick up, both in the US and emerging markets, as EBITDA falls and debt increases. Although emerging market companies came into 2020 cautiously positioned, retaining higher cash balances and managing capex expansion, as well as taking advantage of attractive funding conditions in 2019, the effects of the recent environment will naturally increase the pressure. That said, emerging market companies have shown during the previous deleveraging cycle post the 2015 oil crisis that they can manage and reduce leverage over time. It remained lower through that period than for US companies and we expect this dynamic to persist through this current period.

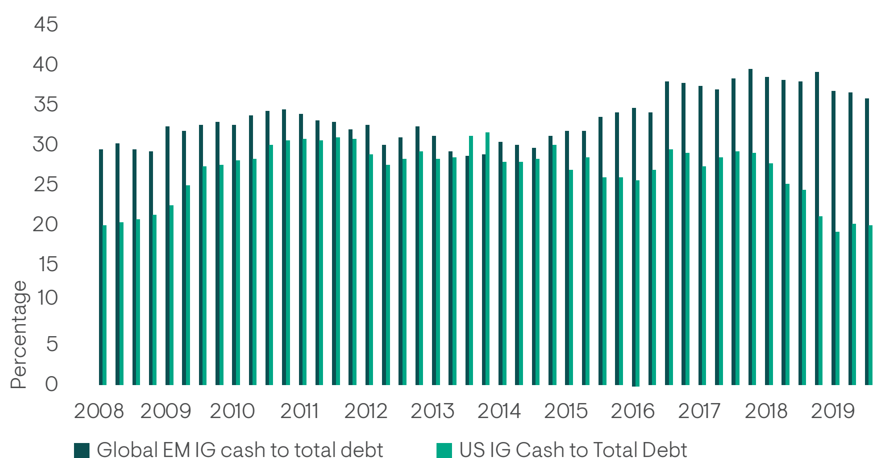
Equally, we see emerging market companies focus on reducing some short- term vulnerabilities by reducing the percentage of short-term debt they carry. This is partly a function of cyclicality, but it has also been driven by the growth of the publicly listed USD emerging market corporate debt market since 2010. This has allowed issuers to switch financing from traditional bank loans, usually shorter in tenor, to longer dated publicly listed bonds. We expect this trend to continue as the market continues to evolve. This reflects the fact that as the asset class evolves the sheer size and scale of cash flows warrants a higher issuance level (see below).

Emerging market companies have been increasing the amount of cash they retain as a rainy-day fund in case of refinancing challenges. This is one of the reasons it makes sense to focus on net leverage rather than gross leverage, in our view.

It is worth highlighting that emerging market companies are not solely reliant on the external debt markets for funding and whilst the developed market investment grade market is a direct beneficiary of US monetary stimulus, emerging market companies have also been able to take advantage of supportive local bank lending and other onshore funding sources.

Emerging market companies maintain higher levels of cash.

Figure 14: Emerging market investment grade corporate versus US investment grade corporate cash to total debt (%)

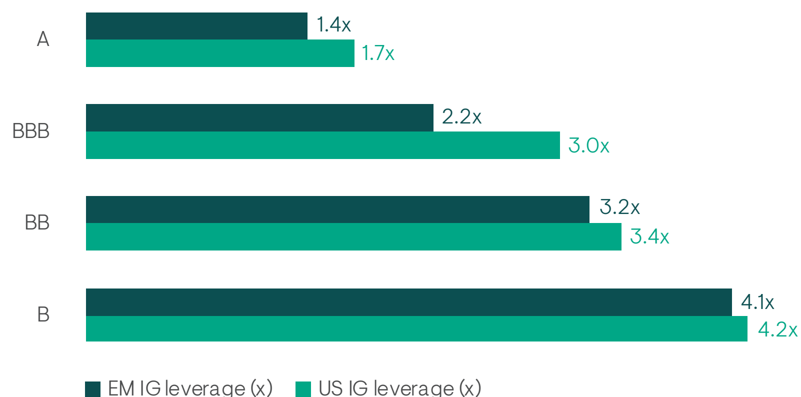


Source: Bank of America Merrill Lynch as at 30 June 2020 (earnings date 31 December 2019).

The chart below compares across all ratings buckets emerging market and US companies net leverage metrics. Emerging market companies once again look better. Most emerging market companies are capped by the rating of their governments. Despite the better fundamentals, their geography effectively drags down the rating.

> Despite their better fundamentals, emerging market companies are effectively capped by the credit rating of their country.

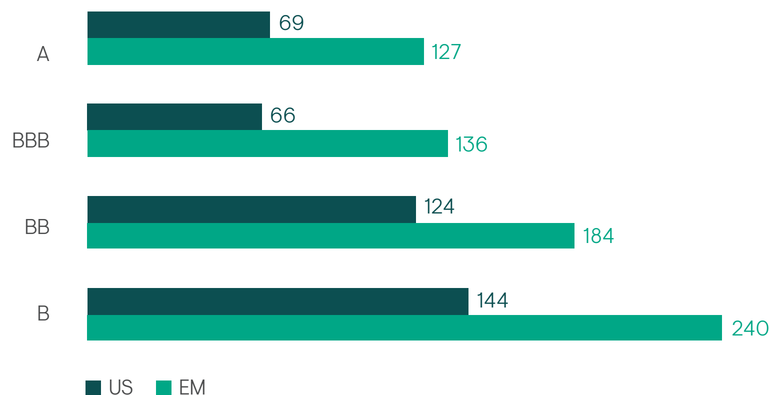
Figure 15: Emerging market investment grade corporate versus US investment grade corporate net leverage multiples by rating



Source: Bank of America Merrill Lynch as at 30 June 2020 (earnings date 31 December 2019). 'x' means as a multiple of EBITDA.

Investors often perceive emerging market companies to be riskier because of their operating environments – rating agencies account for this – yet premiums exist for investors above developed market peers for companies that have better credit metrics, creating a "post-code premium". The chart below shows this by comparing the spread-per-turn of leverage offered by emerging and developed market companies.

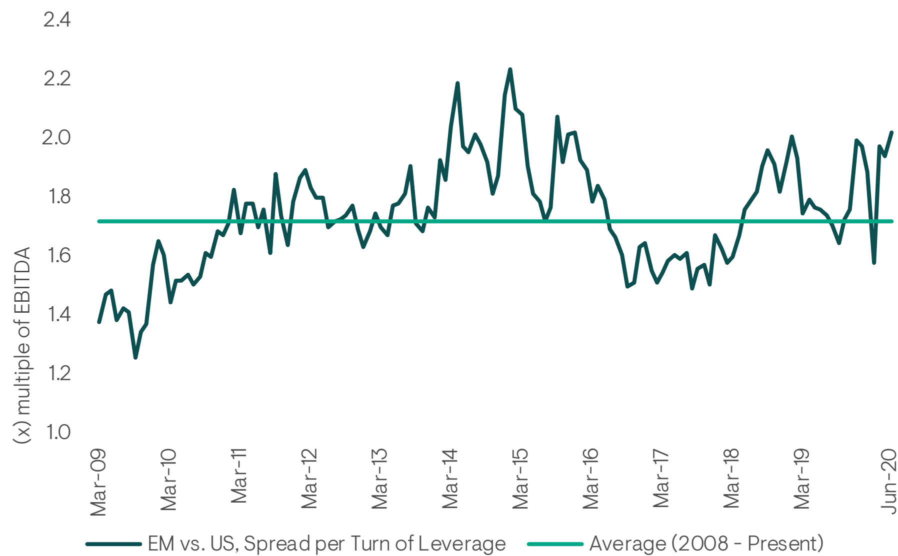
Figure 16: Emerging market investment grade corporate versus US investment grade corporate spread per turn of net leverage



Source: Bank of America Merrill Lynch as at 30 June 2020. (earnings date 31 December 2019.) 'bps/x' is the spread divided by net leverage, measured as a multiple of EBITDA.

We can see over time that the ratio of emerging market to US spread per turn of leverage has averaged 1.7x and the current premium on offer is in excess of this.

Figure 17: Emerging market investment grade corporate versus US investment grade corporate historical spread per turn of net leverage (ratio)



Source: Bank of America Merrill Lynch as at 30 June 2020 (earnings date 31 December 2019). 'bps/x' is the spread divided by net leverage, measured as a multiple of EBITDA.

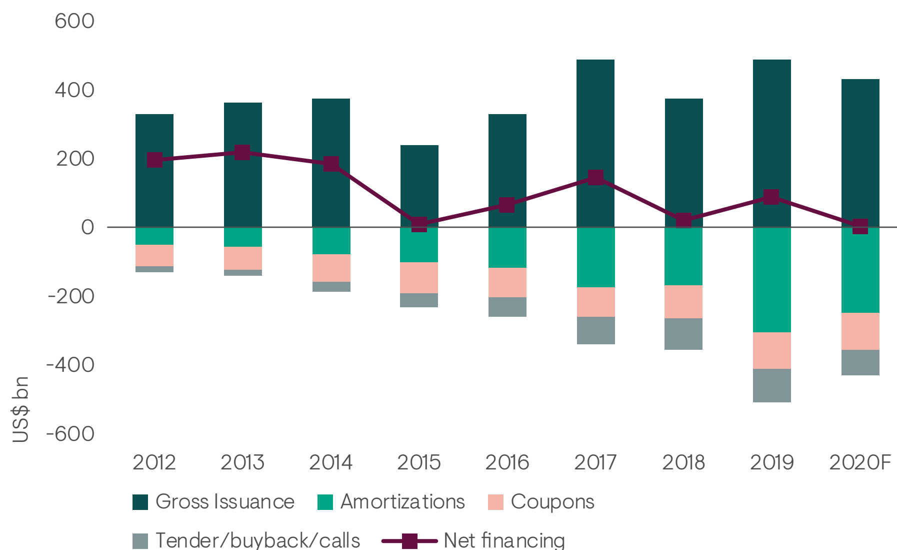
The emergence of the emerging market corporate hard currency universe has improved the resilience of these companies. Offering an alternative funding source to local currency financing and the traditional bank loans, this market has helped these companies diversify their financing profile by currency, type of debt, tenor, and financer. This is particularly relevant for companies with meaningful revenues in US dollar who wish to reduce the currency mismatch. This is often found in commodity producers, exporters, and globally diversified businesses.

Premiums exist for investors above developed market peers for companies that have better credit metrics, creating a "post-code premium".

Demand for the asset class continues

Investors may misinterpret the growth of the asset class as a sign that emerging market companies are increasing their leverage. We believe this document puts these concerns in context. When we look at the growth of the market, we see approximately $100 billion of annual net financing needs, but as we saw in 2015 and continue to see in 2020, this can quickly reduce as corporates find alternative funding sources.

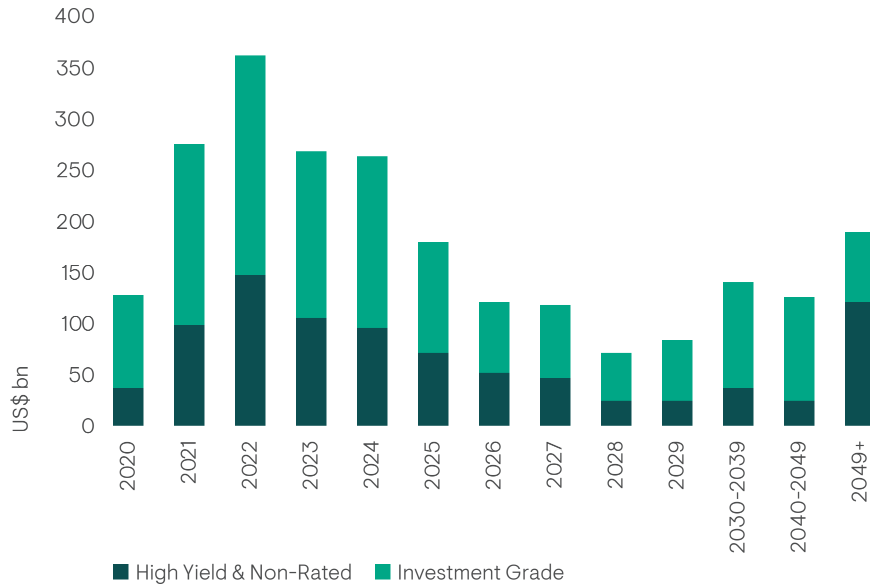
Figure 18: Emerging market investment grade corporate gross issuance, cash flows and net financing



Source: JP Morgan, 30 June 2020.

We see strong technical demand for the asset class over the next four years as emerging market investment grade companies have heavy bond maturities and cash flows.

Figure 19: Emerging market corporate external bond maturities (US$ Billions)



Source: JP Morgan, 30 June 2020.

When looking at demand for the asset class, we believe there is a paradigm shift, with the asset class no longer considered as a tactical allocation within portfolio but a more structural long term holding. That demand remains global in nature and the asset class appeals to a highly diverse set of investors. Emerging market corporate debt is the only emerging market fixed income asset class continuing to show year-on-year net inflows, cumulatively and annually over the last five years. Demand in Asia is driven by locals, but we also see significant interest from US credit investors given only 2% of the US Aggregate Index is emerging market corporates. We also see demand from Asian life insurers, alongside institutions and private banking. At an aggregate level, other investors (US cross over, US insurers, European institutional and emerging market sovereign investors) represent roughly equal sized demand to Asian domiciled. Going forward we expect global insurers to play a more significant role in the asset class.

Outlook: look-through to the fundamentals

While the asset price recovery in the second quarter brought some relief from the torrid months of February and March 2020, the medium-term risks to the global economy from COVID-19 remain significant. Despite the range of potential economic outcomes, we believe emerging market corporate bonds offer investors a compelling yield and return potential given the fundamental resilience of the underlying businesses.

The more we learn about COVID-19, the more it looks to be a persistent phenomenon. Asia seems to be the clear winner due to the well-established track and trace systems in place there. While the US and Latin America are lagging, Europe and the rest of the world appear to be putting the worst behind them, albeit the situation remains fluid.

It has long been our base case expectation that global growth will be lacklustre and central banks around the world will effectively assume the burden of responsibility, with low interest rates persisting. This is in evidence, along with unprecedented government support to offset the impact of the pandemic. These measures all lead to higher debt levels, exacerbating the structural issues that already weigh on global growth.

Despite the fear associated with COVID-19, we have seen an economic and behavioural need for society to return to a form of normality. Therefore, we think growth will rebound, but we are unlikely to see a full resumption of activity to pre-lockdown levels. This scenario appears to be playing out although we had expected the virus to be more under control by now. Therefore, we expect credit fundamentals to remain weak and higher leverage to persist for longer than we first anticipated, possibly prolonging the challenging backdrop through 1H 2021.

That said, we believe emerging market companies remain relatively resilient due to their superior financial strength and liquidity before COVID-19, so we expect low levels of default but continued downward revision of credit ratings. The persistence of the virus, and associated depth of the economic retrenchment will obviously influence how severe this rating downgrade activity becomes, but for now we have modelled for an economic downturn akin to historic credit downturns.

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