Emerging Market Hard Currency – The Right Allocation?

VIEWPOINT

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With deteriorating fundamentals in the sovereign universe, should investors consider increasing their allocation into corporates?

The investment universe for emerging market (EM) fixed income has changed considerably since the start of the century.

From a market primarily dominated by sovereign issuers in hard currency, today the asset class is more diverse, with investors able to access EM via sovereigns and corporates in hard and local currency as well as pure FX.

While the local currency component of the market can offer higher returns, this is offset by greater volatility (a low Sharpe ratio). Therefore, the hard currency segment remains a favoured choice for many investors seeking exposure to long-term secular growth that is so much a part of the emerging markets investment story.

Traditionally, the hard currency segment of the market has been dominated by sovereign issuers, both in terms of size and investor base. Today, the investor base remains heavily skewed towards sovereign debt, but we believe the fundamental investment case for an allocation has deteriorated.

The corporate component meanwhile has evolved into a sizable, diverse and high-quality investible universe, buoyed by solid fundamentals. We believe investors should consider increasing their allocation into this segment in order to benefit from the positive dynamics of corporate debt which today outweigh the investment case for sovereign bonds.

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Warren joined Muzinich in 2013. Prior to that he was the Senior Portfolio Manager for Global Emerging Markets at Schroders where he managed $2 billion and helped develop the firm's EM corporate capabilities. Warren has a B.Sc. in Mathematics for Business from Middlesex University London and an M.Sc. in Shipping Trade and Finance from CASS Business School. He holds the Chartered Financial Analyst designation.

1. Changing Fundamentals

Sovereigns

In the early 2000s, a series of economic crises across Latin America (Argentina's default, Uruguay's banking crisis, economic collapse in Brazil), Asia and Russia led to numerous defaults. Downgrades ensued and, as a result, overall credit quality suffered (Fig. 1, overleaf).

However, the 'cleansing effect' of these events led to a period of economic improvement as sovereigns focused on restructuring and strengthening their balance sheets and therefore the asset class became an attractive investment proposition.

Between 2002 and 2008, the EM sovereign investible universe was underpinned by better fundamentals and improving credit quality. The size of the market also offered suitable liquidity and diversification on top of attractive yields.

Fig. 1 - Changing Credit Quality in Corporate and Sovereign Markets

Source: ICE BofA Merrill Lynch Emerging Markets Chartbook, as of January 31st, 2018.

But, since then, the structural credit bias of the universe has fallen as underlying components of the market have changed.

Why is the Sovereign Universe Deteriorating?

Firstly, since 2002, there have been 39 new entrants into the sovereign market; 33 of these are high yield and 31 frontier (e.g. those in Sub-Saharan Africa).

Countries issue on the hard currency sovereign bond market as a last resort if they have no funding alternative. The inclusion of these lower-quality, lower-rated countries has led to credit quality degradation as well as adding more uncertainty and volatility to the sub-asset class.

This has been exacerbated by stronger sovereigns with improving fundamentals leaving the hard currency universe as they revert to local funding (e.g. South Korea and Thailand).

Impact of Commodity Prices

Secondly, the universe has been affected by changes in commodity prices.

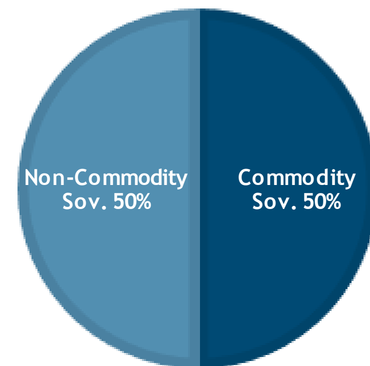
Many large EM economies are net commodity exporters and price fluctuations over the last decade have had an impact on their funding needs; as prices have declined, issuance levels have risen to compensate from lost revenues from the commodity dividend (Fig. 2).

Fig. 2 - Growth in Sovereign Issuance Replaces Commodity Revenue Stream

Source: ICE BofA Merrill Lynch, as of 31 December 2017.

The universe is also now less diversified and the dominance of the oil and commodity producers can mean an investment into EM sovereign debt is dominated by the outlook for oil and commodity prices (Fig. 3).

Fig. 3 - Percentage of EM Sovereigns that are Net Commodity Exporters



Source: JP Morgan, as of January 31st, 2017.

Corporates

The picture is very different in the corporate space, where fundamentals are improving and credit quality is moving higher.

Issuers Already Have A Quality Bias

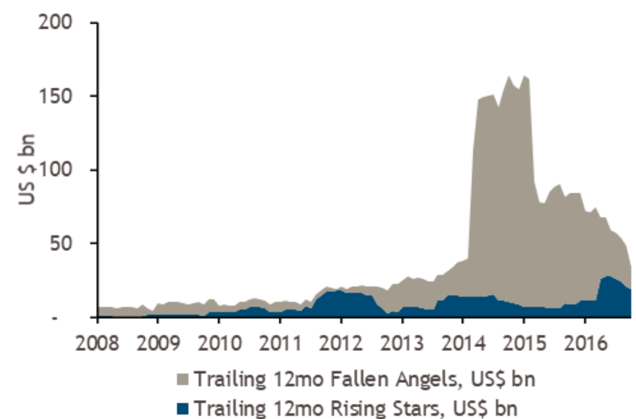
In stark contrast to the sovereign market, only the highest-quality companies can issue bonds in hard currency - those able to overcome high barriers to entry are the only ones eligible to list internationally.

These companies are often located in the strongest sovereign markets which no longer need to list on the hard currency market. Consequently, investors can now only obtain exposure to certain sovereigns via an allocation to the corporates in those countries.

Improvements in Fundamentals Expected to Continue

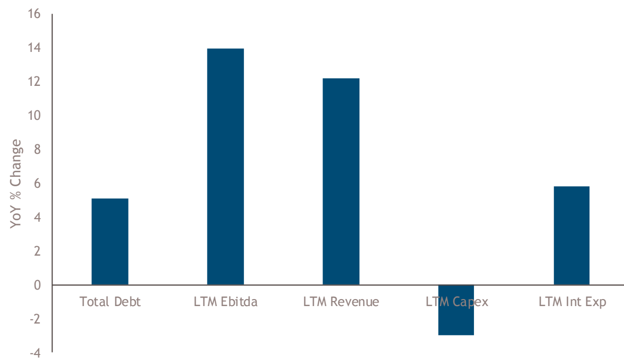
During 2014-2016, ratings agencies downgraded $150bn of investment grade EM credit to high yield (Fig. 4). However, this dynamic is starting to reverse due to the significant improvements we have witnessed in EM corporate balance sheets, which have strengthened considerably over the last 12 months (Fig. 5).

Fig. 4 – Fallen Angels of US$150bn between 2014 - 2016



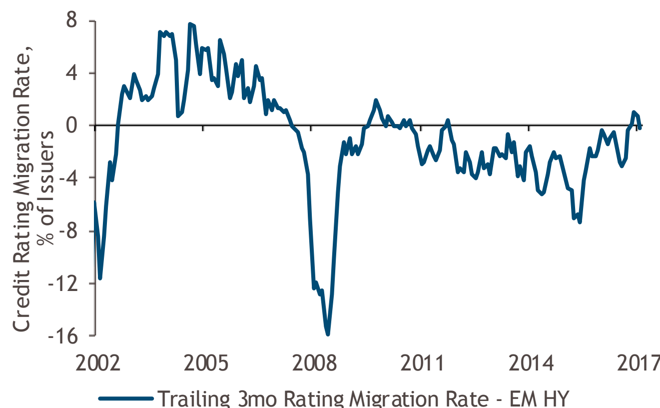
Source: BofA Merrill Lynch, Monthly Emerging Market Chart Book. Data as of December 31st, 2017.

Fig. 5 - EM Corporate Balance Sheets Have Strengthened



Source: ICE BofA Merrill Lynch, Monthly EM Chart Book, data as of June 30th, 2017 – no further update available as of December 31st, 2017.

Fig. 6 - More Upgrades than Downgrades Expected in 2018

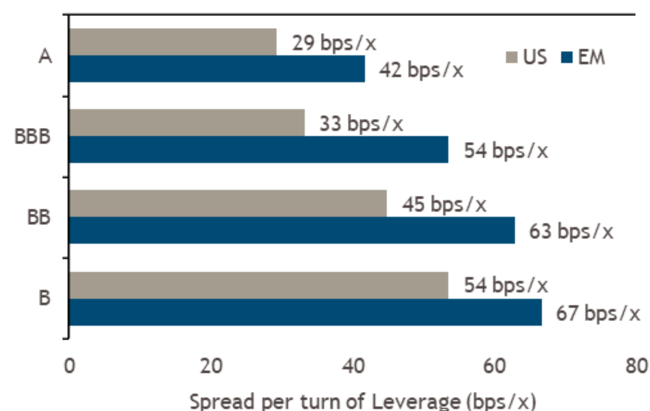


Source: BofA Merrill Lynch, Monthly Emerging Market Chart Book. Data as of January 31st, 2018.

Due to these positive fundamental improvements, a large proportion of the high yield corporate market is likely to be upgraded in the next 24 months (Fig. 6), further boosting the underlying credit quality bias of the asset class.

EM companies are also, on average, less levered than similar-rated companies in developed markets and investors are paid more per turn of leverage (Fig. 7).

Fig. 7 - Global EM Spread per Turn of Leverage vs. US



Source: BofA Merrill Lynch, Monthly EM Chart Book. Data as of January 31st, 2018.

Looking at the overall EM hard currency universe, while the underlying fundamentals within the corporate market continue to strengthen, the original reasons which made the sovereign market so attractive have disappeared.

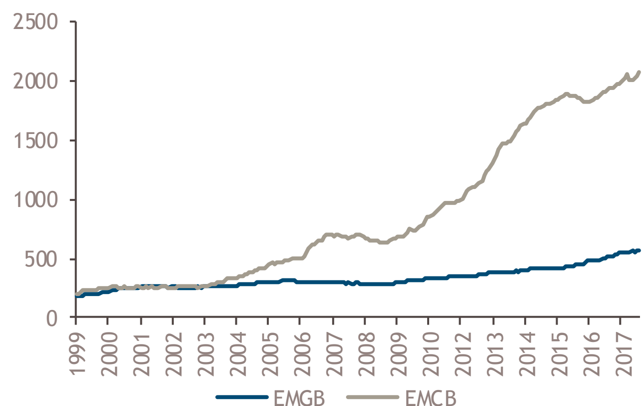
2. Size Matters

The size of an investible universe provides an indication of the opportunity set available. In early 1999, the EM sovereign and corporate markets were each comprised of around 200 issuers (Fig. 8).

Today, however, the picture is reversed with the corporate segment being the dominant asset class at over US$1.5trillion, containing over 21 sectors and more than 60 countries.

The sovereign universe stands at around US$945bn, 26% of those are frontier markets.

Fig. 8 - Corporate Issuance Has Vastly Expanded



Source: ICE BofA Merrill Lynch, as of 31 January 2018.

Drilling down into the technicals of each market, there are trends which require further analysis.

The sovereign universe today is smaller than the corporate segment of the market and, as we have already highlighted, issuance is largely being driven by the need to replace income from lost commodity revenue.

In contrast, following a long period of growth, corporate supply outside of China is forecast to be negative in Eastern Europe and Latin America in 2018 (Fig. 9) and very small elsewhere, providing a solid technical dynamic for the asset class.

Fig. 9 - EM Corporates Diversified by Sector

2018	Gross Issuance $BN	Net Issuance $BN
ASIA	268	109 (Ex. China 9)
LATAM	79	-6
EE	48	-8
MEA	47	14
TOTAL	**442**	**109**

Source: : Bond Radar, JP Morgan & JP Morgan US HY Strategy Portfolio Review. Data as of November 30th, 2017.

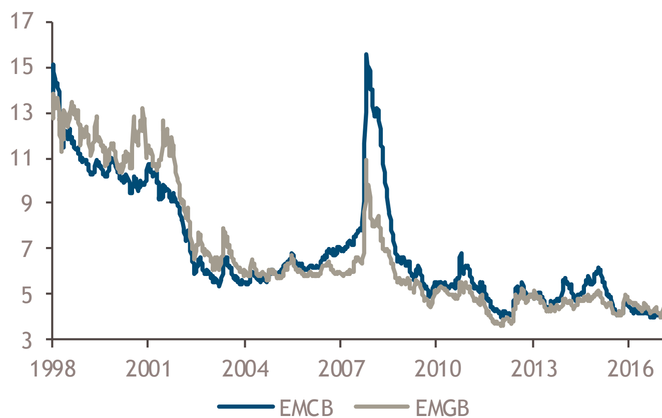
3. Risk Versus Reward

The risk/return profile of the EM hard currency asset class has also changed, reflected in the yield and duration characteristics of each sub-asset class.

As we move into a rising interest rate environment, fixed income investors will move away from higher duration assets and focus on the lower duration segment of the market.

Within emerging market hard currency debt, while the yields on both sub-asset classes are relatively similar (around 5% - Fig. 10), it is in duration where the largest differential lies, with a duration of ~7.17 years for the sovereign segment of the market compared to a duration of ~4.9 for corporates (Fig. 11).

Fig. 10 – Similar Yields Available



Source: ICE BofA Merrill Lynch, as of 16 February 2018.

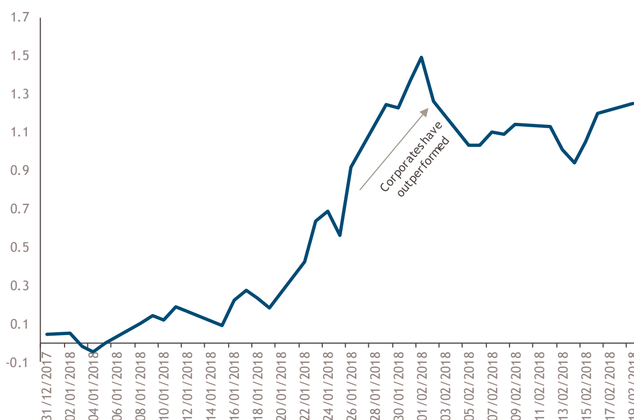
Fig. 11 – Duration is Lower in the Corporate Universe

Source: ICE BofA Merrill Lynch, as of 16 February 2018.

We believe this dynamic again highlights the benefits of moving away from sovereign bonds and into corporates, where exposure to interest rate risk is lower.

Due to the corporate segment's lower correlation with US Treasuries, it is also more insulated from exogenous shocks and performs better during periods of heightened market volatility, as witnessed during the US rates sell off in the middle of the first quarter of 2018 (Fig. 12).

Fig. 12 – Corporates Outperformed During Q1 Volatility



Source: ICE BofA Merrill Lynch Corporates versus Sovereign indices, as of 2 March 2018.

The Right Allocation?

Today, the EM sovereign and corporate markets have very different profiles than they did during the early part of the century. Nevertheless, investors are underweight EM corporate debt (source: Institute of Internal Finance) while EM sovereign debt continues to be the asset class of choice.

Yet, as we have demonstrated, the corporate market appears to offer more attractive investment potential.

The size of the market means investors have a wider investment universe from which to choose, compared to a shrinking and lower quality set in the sovereign space.

With size also comes greater diversification, with exposure to a range of sectors where investors can participate in a variety of cyclical and secular themes.

We believe the duration argument is also a key feature worth considering, with the corporate universe offering greater protection against rate rises.

These positive features, combined with an attractive yield, provide a strong argument as to why investors should redress the balance of their EM hard currency allocation.

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