Ninety One

Previously Investec Asset Management

A hard look at hard currency

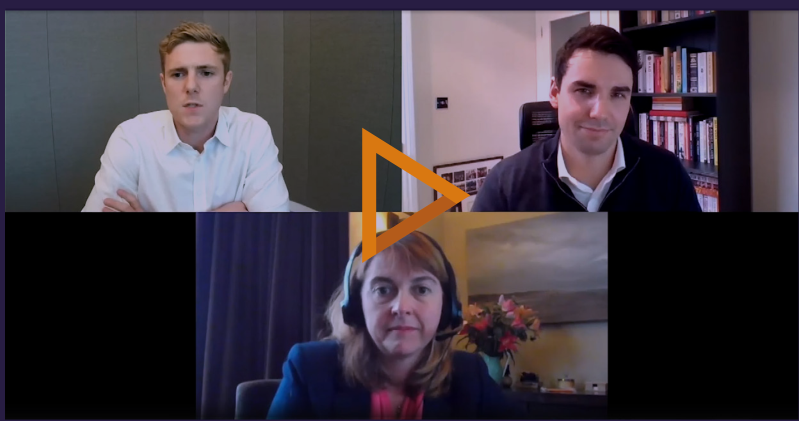
Emerging Market Sovereign and Corporate Hard Currency Debt

November 2020

A hard look at hard currency

- Increasingly, investors are accepting the need for structural allocations in emerging markets (EM) for both sovereign and corporate debt
- EM hard currency offers a pick-up in yield and spread over developed market (DM) credit, often accompanied by superior fundamentals
- Structural changes in EM hard currency sovereigns include an expansion of the frontier universe and Middle East issuers, and lower levels of non-local currency debt
- For EM corporates, growth in Asia and China has led to a more diversified asset base
- Elevated spread premia compared to pre-COVID levels suggests opportunities in both asset classes

Our panel of experts



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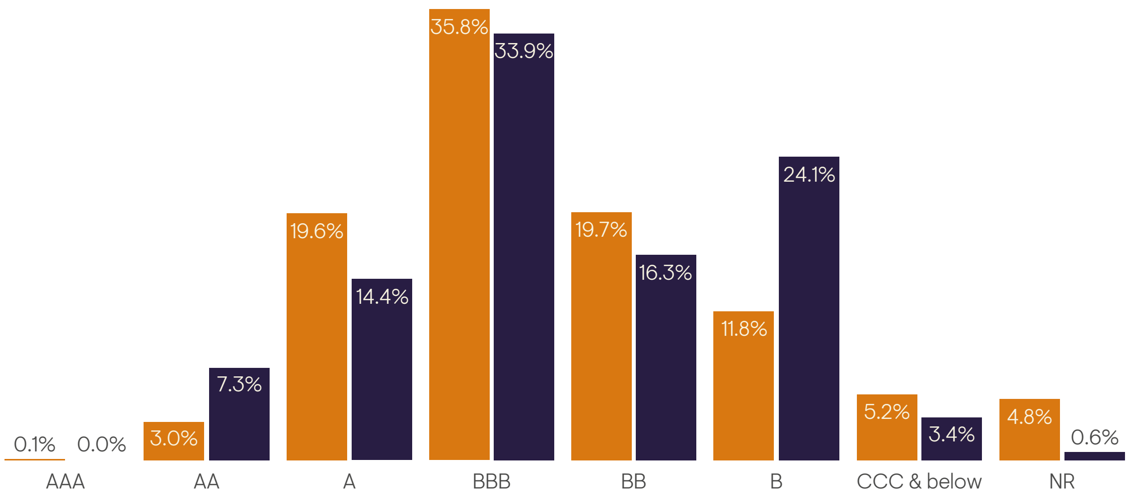
What are the differences in EM between sovereign and corporate debt?

From a macro perspective, both asset classes are essentially fixed income assets in the credit space, but this can overshadow what are distinct differences in the make-up of each universe.

Figure 1: EM hard currency ratings breakdown

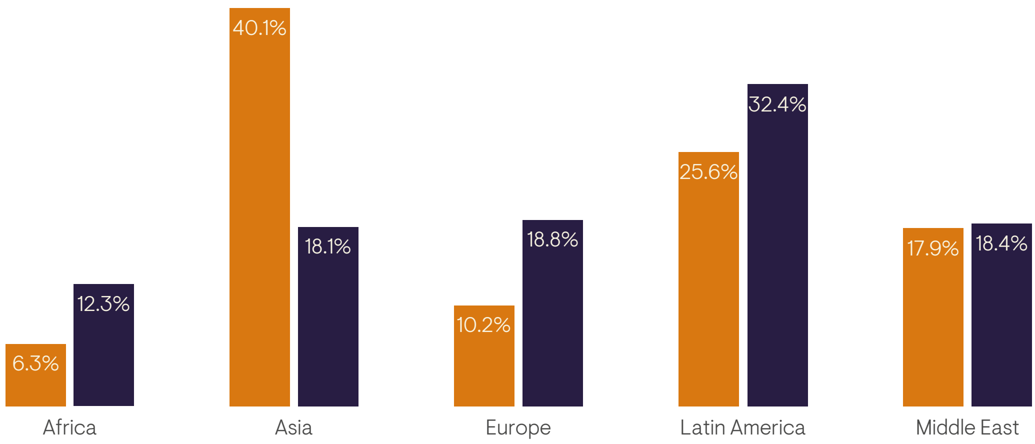


	Yield	Spread	Duration	Rating	IG/HY
EM HC Corporate (CEMBI BD)	4.24%	355	4.69	Baa3/BBB-/BBB-	59%/41%
EM HC Sovereign (EMBI GD)	5.19%	420	8.01	Ba1/BBB-/BB+	55%/45%

Source: JP Morgan as at 31 October 2020.

Figures 1 and 2 illustrate the distinctions by rating and regional breakdowns. They reflect how the asset classes have evolved since the messy debt defaults of the 1980s-1990s. Sovereign debt has led the way with superior yields, longer duration and a greater presence in the AA space. For corporates it is Asian markets that are key to issuance.

Figure 2: EM hard currency regional breakdown



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What is driving expansion of these indices?

A major catalyst for recent growth in **sovereign** bonds has been the expansion of frontier markets, loosely defined as high yield low-to-middle income markets without a presence in other EM indices, and now comprising half the JP Morgan Emerging Market Bond Index (EMBI). In percentage terms, the largest adjustment has been in the Middle East, which now accounts for almost 20% of the index, and where financing needs have increased as the oil price has weakened. Growth in these markets has been exacerbated by lower demand in Latin America and Central Europe, which have shifted more to local currency funding. This adjustment has meant that the proportion of debt denominated and settled in non-local currencies in the EMBI[1] has almost halved to 20%, even accounting for events during 2020.

1. All sources are from Bloomberg as at October 2020, unless stated otherwise.

For **corporate** bonds, growth in China has ensured that Asia is almost certain to remain as the largest component in the JP Morgan Corporate Emerging Markets Bond Index (CEMBI). Over the past decade China has risen from a 6% weighting in the CEMBI to 25%; more broadly Asian issuance has increased from one-third of the total annual supply to two-thirds. This geographic shift eastwards has been accompanied by an adjustment in composition. Once the preserve of quasi-sovereigns, the corporate CEMBI universe now includes companies in the real economy, for example by the addition of Chinese tech companies or Indonesian telecommunications businesses.

Detailing the effectiveness and efficiencies in collaborating on research

Discussions and collaborations between the Ninety One EM Sovereign and EM Corporate teams can develop crucial insights into each other's universe and analysis. The EM corporate debt team call on the resources of their sovereign colleagues to help formulate their bottom-up forecasts. For example, the banking sector is inextricably linked to corporate earnings, but more broadly it is also tied into the health of the economy, whereby banking risk and sovereign risk are interlinked. Likewise, the EM sovereign team will rely on research from the EM corporate team to show how the real economy is performing. In the sovereign space, banking risk cannot be distinguished from sovereign risk, nor can strategically important sectors, such as the beef industry in the case of Brazil, where it comprised 8.5% of domestic GDP in 2019[2].

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2. 'Brazil's Path to Sustainable Cattle Farming', Bain & Company. October 29, 2020.

Identifying the recent growth dynamics

Within EM during 2020, it was tougher for sovereigns than for corporates, with COVID woes impacting GDP and the realisation that it will be several years before some of the larger EMs can make up for lost output. On debt sustainability, we think there will be a clear divergence between the winners and losers. Countries able to tackle their large primary deficits, such as Egypt and the Dominican Republic, are in a much stronger position than South Africa or Brazil. While not responsible for the debt sustainability issues for weaker countries, COVID has acted as an accelerant for a number of underlying problems and emphasises the importance of selection.

Three factors have helped EM corporates manage the COVID woes and this has been reflected in promising Q3 2020 results.

1

The first of these was the effective devaluation for many EM currencies which has helped their competitiveness, particularly for companies exporting to China. In fact, China is on track to be the only major economy to grow in 2020 and this underlines its strategic importance in global and regional supply chains, while also being supportive for other markets in North Asia.

2

EM corporates are skewed more to manufacturing and industrials and have held up better than many service-dominant economies in developed markets.

3

This recovery has been reflected in EM corporate default levels, which we think have undershot expectations. Debt levels are lower across EM and combined with the anticipated regional and global recovery in 2021, will likely continue to support demand.

Reviewing the demand-supply balance for EM sovereign and corporate debt

Investment grade issuers in the Middle East were out in force during the year due to funding gaps as a result of the weaker oil price and accounted for nearly half the US$100bn issuance during 2020.
The demand for quality yield is likely to continue to keep this market buoyant, although reverting to mean may see issuance decline in 2021.

With global yields continuing to diminish, it was a record year for EM corporate issuance, largely driven by Asia. Companies have pushed out along the duration curve, as this offers security and provides more resilience by reducing refinancing concerns. A lot of EM corporates have implemented a more conservative balance sheet and debt level strategy for 2021. The roll-out of a COVID vaccine in 2021 could change the dynamics, leading to potential spread compression against the backdrop of 'lower for longer' interest rates and supportive central banks.

The view ahead - what is the outlook for 2021?

Although there has been a recent narrowing in spreads, they are still some way away from their pre-COVID tights. In the EM sovereign space, high yield bonds in the BB and B+ offer the best value in our view, reflecting their significant yield premium compared with developed markets. Some longer dated IG issuance also look attractive, reflecting steep spread curves.

For EM corporates, analysis suggests that about 12 months after a major market event, spreads would be in the range of 270-280 basis points (bps). This compares with current positioning above 300bps, suggesting the opportunity for further spread compression.

Given the importance of global trade to emerging market fundamentals, we see a Joe Biden presidency as supportive for EM assets, as it will deliver a more predictable foreign and trade policy. In addition, the possibility of a gridlocked senate will be positive for EM credit as the chances of unfettered expenditure on infrastructure have greatly diminished, as have the chances of significant tax hikes. For corporates, many have emerged stronger from the current crisis, reflecting a focus on cost cutting, margin improvement and getting their balance sheets in order. From an EM perspective, we do not expect interest in manufacturing companies to suffer should a pick-up in global growth focus more attention on the recovery in the services sector across developed markets.

General risks: The value of investments, and any income generated from them, can fall as well as rise. Where charges are taken from capital, this may constrain future growth. Past performance is not a reliable indicator of future results. If any currency differs from the investor's home currency, returns may increase or decrease as a result of currency fluctuations. Investment objectives and performance targets are subject to change and may not necessarily be achieved, losses may be made.

Shared specific risks: 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.

Specific risk: Emerging Markets Investment Grade Corporate Debt: Currency exchange: Changes in the relative values of different currencies may adversely affect the value of investments and any related income.

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