Exploring Emerging Market Corporate Bonds

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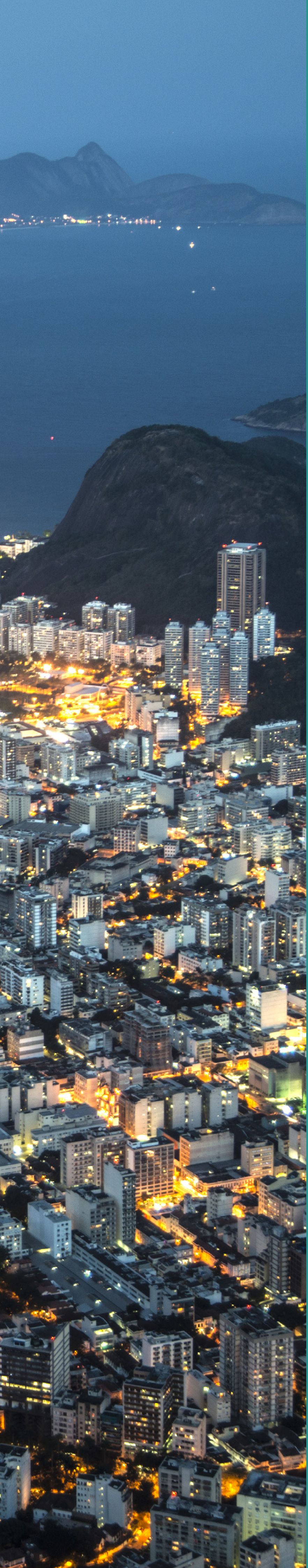


Key points

- Emerging market corporate bonds have faced challenges in recent years, leading many investors to avoid the asset class.
- The recent global interest rate cycle shift, alongside China's new monetary and fiscal stimulus, presents a timely opportunity to reassess EM corporate bonds.
- The fundamentals of EM corporate bond issuers are healthy, characterised by low leverage, historically low default rates, and a predominance of investment-grade issuers.
- Concerns of renewed trade conflicts impacting global growth and inflation poses some risks; however, the anticipated soft-landing scenario may help maintain EM corporate default rates low and drive investor demand for higher yields.
- EM corporate bond spreads have limited room for compression, but we anticipate they will remain stable, with returns primarily driven by carry and interest rates.
- Despite current tight spread levels the asset class provides a valuable pick-up to both US investment-grade and high yield bonds, along with multiple alpha-generative opportunities when employing a bottom-up analysis.

Introduction

The past few years have been challenging for emerging market (EM) corporate bonds due to rising geopolitical tensions, significant real estate defaults in China and high global interest rates, which have led many investors to shy away from the asset class. Lingering misconceptions about the dynamics of EM corporate and sovereign bonds continue to weigh on sentiment.

The shift in the global interest rate cycle, underlined by the Federal Reserve's 75-bps cut, could provide a renewed opportunity for EM corporate bonds, making it a good time to reassess the asset class. Additionally, recent monetary and fiscal stimulus measures announced by China are likely to boost market sentiment and encourage more inflows into the asset class, although it is still too soon to evaluate their broader implications for EM economies.

The fundamentals of EM corporate bond issuers are improving compared with their developed market peers, supported by relatively low leverage and historically low default rates. Furthermore, the majority of EM corporate bond issuers are investment grade, while primary market activity has effectively addressed most upcoming maturities.

The outcome of the US elections introduces some downside risks for emerging markets, primarily due to concerns that renewed trade conflicts will have a negative impact on global growth and may reaccelerate inflation. Nevertheless, with markets largely anticipating a soft-landing scenario, this should keep EM corporate default rates at low levels and encourage investors to seek higher yields.

Despite rising US Treasury yields during Q3 2024, EM hard-currency corporate bonds outperformed most other fixed income asset classes, generating positive year-to-date (ytd) returns. On average, EM corporate bonds posted total returns of +7.6% ytd, outperforming the +3.8% performance of global corporate bonds. Notably, EM high-yield corporate bonds reported strong double-digit ytd returns of +11.8%, surpassing the +7.3% return of US high-yield bonds.

EM HY CORPORATE BONDS HAVE OUTPERFORMED MOST FIXED INCOME ASSET CLASSES YTD IN 2024

Source: JPMorgan research

Current EM corporate spreads have limited headroom to compress; however, we expect them to remain stable, with the majority of returns coming from carry and interest rates. Despite the current historically tight spread levels, the asset class provides a valuable pick-up compared to both US investment-grade and high-yield bonds, along with multiple alpha-generating opportunities when employing a bottom-up analysis.

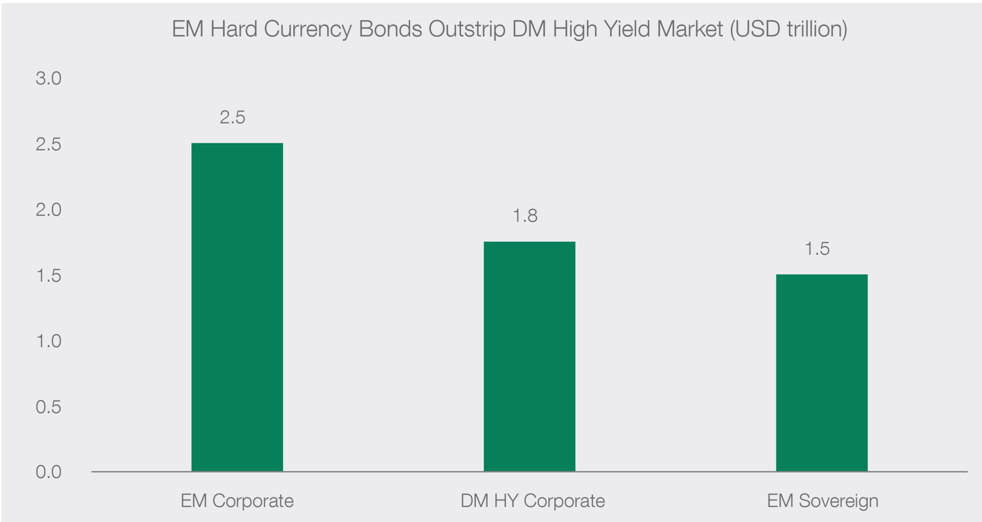
Our analysis focuses on emerging market hard currency corporate bonds, assessing the development of this asset class and illustrating why EM corporate bonds are particularly well-suited for a bottom-up investment approach.

A FAST-EVOLVING ASSET CLASS

EM hard currency corporate bonds have evolved significantly over a short period, transitioning from a niche to a mainstream asset class. Prior to the global financial crisis (GFC), these bonds were mainly traded by macro hedge funds using single-name credit default swaps (CDS). Following the GFC, the asset class saw rapid growth, expanding at an annual rate of about 10% from 2008 to 2019. This growth was fuelled by disintermediation and emerging markets' increasing share of global GDP.

Today, the hard currency EM corporate bond market has grown into a USD 2.5 trillion mature asset class, up from USD 0.6 trillion in 2008, and is more than twice the size of hard currency EM sovereign bonds, which are worth approximately USD 1.5 trillion, but also surpasses the US high-yield market. The universe has expanded significantly with over 850 distinct issuers. In contrast, the local currency EM corporate bond market has surged from USD 1.6 trillion in 2008 to around USD 11 trillion today.

EM CORPORATE BONDS HAVE TRANSFORMED FROM A NICHE INVESTMENT TO A MAINSTREAM ASSET CLASS



Source: JPMorgan research

The hard currency EM corporate bond market also includes quasi-sovereign bonds issued by entities that are not fully government-owned but which typically receive government support. Although this market has lagged behind local currency growth since the pandemic, it has strong potential to regain its previous momentum as recent challenges begin to ease.

Rate cuts may provide further support

One of the primary challenges facing emerging markets has been high interest rates. However, the recent shift in the global interest rate cycle, highlighted by the US Federal Reserve's 75-bps rate cut – the first reduction since 2020 –, along with further cuts anticipated in the coming quarters, is expected to lower global benchmark borrowing costs.

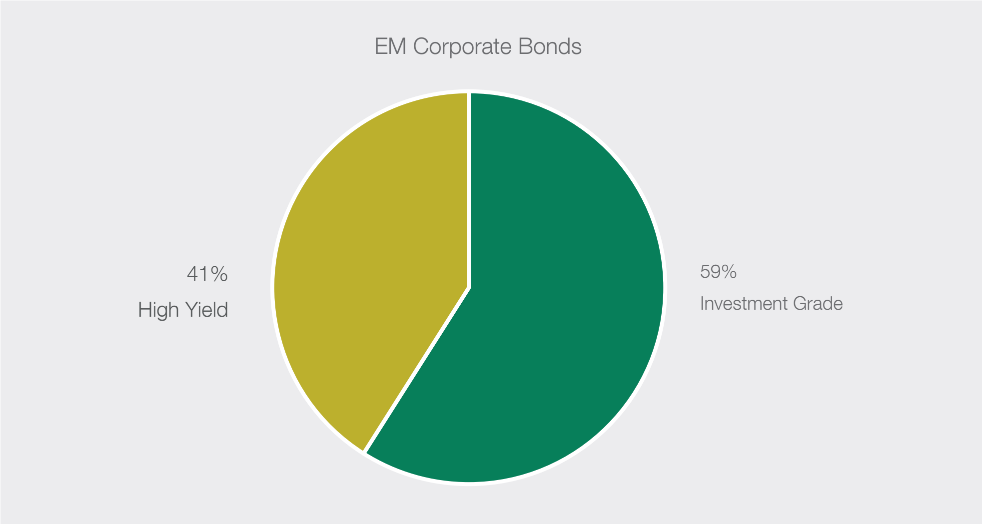
WHY IS THIS IMPORTANT FOR EMERGING MARKET CORPORATE BONDS?

Many emerging market countries currently have interest rates that are higher than necessary, based on traditional indicators like employment and inflation. These nations have been hesitant to lower their rates ahead of the Fed, fearing a devaluation of their currencies against the US dollar. However, with the Fed now initiating rate cuts, it is more likely that these countries would reduce their rates, which would benefit the fixed income market by making hard currency issuance more attractive. While there are exceptions, such as Brazil, which is raising rates again, the overall trend in the sector is expected to align with the Fed's actions. Lower global interest rates should ease liquidity and refinancing pressures for many EM issuers, particularly those that are more exposed to hard-currency debt.

Investment grade landscape and lower leverage

Emerging market (EM) corporates have shown stronger credit metrics than developed markets (DM) in both investment grade (IG) and high yield (HY) categories. Contrary to common assumptions, nearly 60% of the EM corporate bond market is classified as investment grade, with an average rating of BBB. This strength is partly due to the significant presence of quasi-sovereign issuers in the market. Additionally, about half of the EM hard currency sovereign bond market is also investment grade, which helps mitigate the risks associated with specific countries or industry sectors.

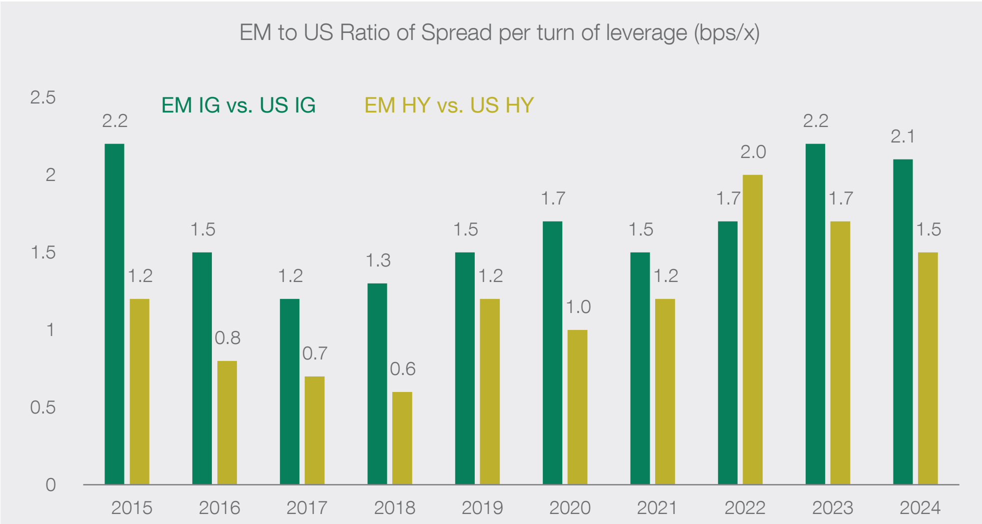
THE MAJORITY OF EM CORPORATE BONDS ARE INVESTMENT GRADE



Source: JP Morgan research

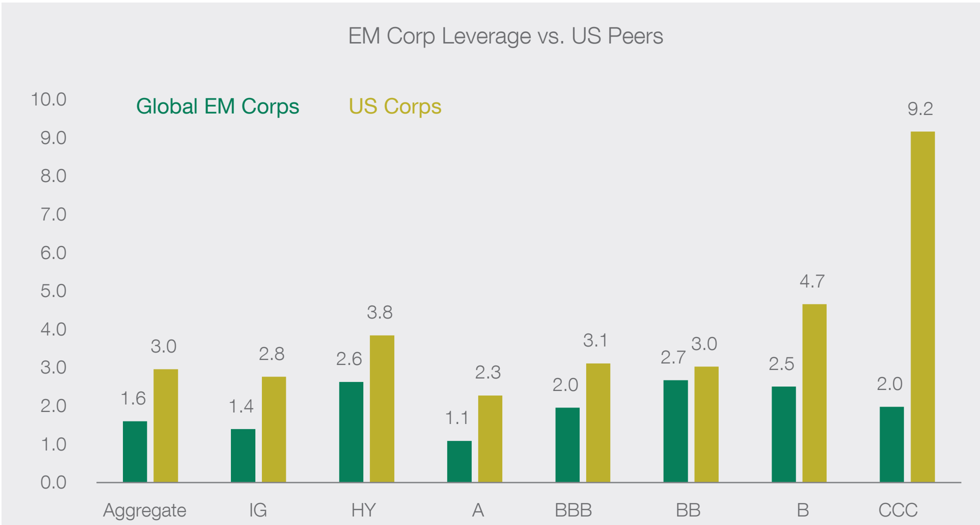
Moreover, EM companies typically have lower leverage compared with their developed market counterparts, even within the same rating categories, and have a higher proportion of secured liabilities. Emerging market corporates have consistently offered a higher spread per turn of net leverage (STL) compared with their developed market counterparts, thanks to lower leverage and wider spreads. Currently, the ratios of EM vs. US spreads per turn of leverage is at ca 2.1x, which is comfortably higher than the 1.6x level seen over the past ten years.

EM CORPORATES CONTINUE TO TRADE WITH A WIDER SPREAD PER TURN OF NET LEVERAGE RELATIVE TO THEIR US PEERS



Source: BofA research

EM CORPORATE BONDS HAVE LOWER LEVERAGE COMPARED WITH THEIR US PEERS IN ALL CREDIT RATING BUCKETS



Source: BofA research

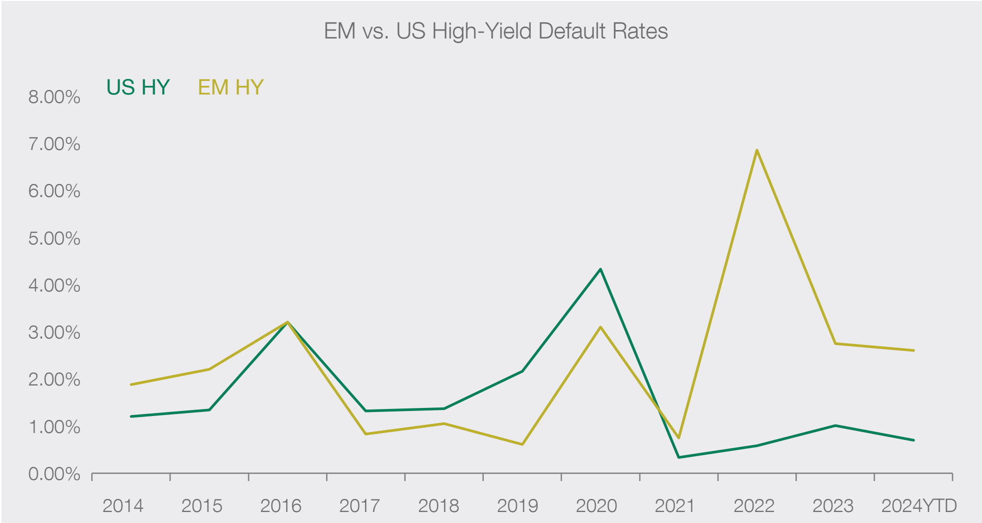
Although the overall credit rating trend for EM corporates (by volume) only turned positive in 2024, the average ratings for the asset class have improved over the past five years. The average credit rating for outstanding EM corporate bond issues hit a low of BBB- in 2019, but has since risen to the BBB range. The rating agencies expect this positive rating trend to continue, driven by strong fundamentals and conservative corporate practices. Additionally, recent upgrades in sovereign ratings are likely to further enhance the ratings of corporate issuers.

Default rates trending to historical lows

From a fundamental perspective, default rates in the EM space over the past decade have remained relatively low, excluding the impact of the Chinese property sector and the Russian-sanctioned entities that significantly skewed indices in 2022/23. Starting this year, most EM high-yield corporate bond issuers managed to easily tap the international debt capital markets that has led to a notable reduction in default rates year-to-date. The rating agencies expect that the default rate for EM corporate bonds will fall closer to the 2% range over the next few quarters and remain at comfortably low levels; in contrast, the trend among US high-yield corporate bonds is expected to gradually increase.

The table below illustrates a comparison of default rates between the US high-yield market and the EM high-yield market since 2014, highlighting the relative stability of EM defaults.

EM HIGH-YIELD CORPORATE BOND DEFAULT RATES ARE TRENDING TOWARDS THEIR HISTORICALLY LOW RANGE



Source: JPMorgan research

Distinguishing between EM sovereign and corporate bond dynamics

There are still lingering misconceptions about credit risks, liquidity, and the dynamics between EM sovereign and corporate bonds. On average, the credit quality of EM corporate bonds surpasses that of their equivalent sovereigns, while also offering shorter duration and lower volatility risks. This combination presents unique opportunities for those willing to explore them using a bottom-up approach.

It is important to recognise that, just because an EM country's sovereign bonds are stressed or facing default, it does not necessarily imply that corporate bonds from the same country are experiencing the same issues. This was evident in 2023 in Argentina, where the government narrowly avoided defaulting on its debt. Many Argentine companies, especially in the energy sector, showed resilient fundamentals and effective risk management, demonstrating their ability to meet their liabilities. This led to a noticeable difference in performance between corporate and sovereign bonds, which often moved in opposite directions.

Similarly, the Turkish economy has faced significant macroeconomic challenges over the past three years due to ongoing hyperinflation and the sharp devaluation of the Turkish lira. However, many Turkish corporates and banks have remained fundamentally sound, proving that their creditworthiness was not necessarily tied to the country's economic troubles, despite what market prices might indicate.

We have also seen a similar pattern in parts of Africa, where there are only a few corporate hard currency bonds, primarily in the energy, metals, and mining sectors. Interestingly, when an African country defaults on its sovereign debt, it can sometimes benefit these companies, especially if their products are priced in dollars.

The situations in Argentina, Türkiye and certain African nations highlight that EM corporate bonds are often priced similarly to sovereign debt, typically with an extra yield premium. However, investors who focus on fundamental analysis can distinguish between companies that are truly impacted by economic issues and those that are being unfairly penalised by market perceptions.

Evaluating geopolitical risks in emerging markets

The geopolitical landscape has been quite unstable in recent years, which continues to pose primary risks for emerging markets today. The conflict in Ukraine, which began in February 2022, highlighted how quickly market conditions can shift in emerging markets. The conflict led to a mandatory removal of Russian bonds from all major indices, while robust sanctions have effectively prevented Russian issuers from servicing their eurobond obligations, leading to a series of forced technical defaults. Additionally, many Ukrainian companies have been classified as special situations.

While geopolitical risks remain a concern, election-related risks have decreased. 2024 has been dubbed a 'global election year', and we have already witnessed some surprising outcomes in emerging markets. In South Africa, support for the African National Congress has waned significantly; in India, Prime Minister Narendra Modi's party failed to secure a majority in the country's lower house; and in Mexico, the ruling party's unexpected victory has heightened local political risks. Despite these developments, the main point is that most elections in emerging markets are now behind us, which should lower election-related risks in coming years.

In less intense geopolitical crises than the Russia-Ukraine conflict, EM investors can respond quickly and evaluate risk levels and adjust their investments accordingly. This proactive approach allows them to identify fundamentally strong and more defensive credit stories that are unfairly affected by broader market concerns.

Growing local demand enhances liquidity

Another misconception is that liquidity in emerging market corporate bonds primarily comes from developed markets. While the EM corporate asset class attracts a diverse range of investors, including many foreign ones, local demand has become a crucial factor supporting liquidity. Local investors now represent a significant source of demand for EM corporate bonds, especially in regions such as Asia and the Middle East, and in countries like Türkiye.

With global interest rates staying high over the past two years making it more challenging to raise debt through hard currency bonds, many issuers have turned to local investors for support, who have responded positively. For example, after the Turkish market sell-off in the late spring of 2023, local investors stepped in to buy dollar-denominated bonds from various Turkish issuers, helping to stabilise the domestic market and limiting mark-to-market losses.

Overall, global investors maintain relatively low allocations to EM corporate bonds, suggesting that there is potential for both crossover and dedicated investments to increase, particularly if interest rates continue to decline. Importantly, a sustained cycle of rate cuts could motivate more retail investors to re-enter this asset class.

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