November 2022

Emerging Market Investment Grade Corporate Debt

Asset class introduction

Contents

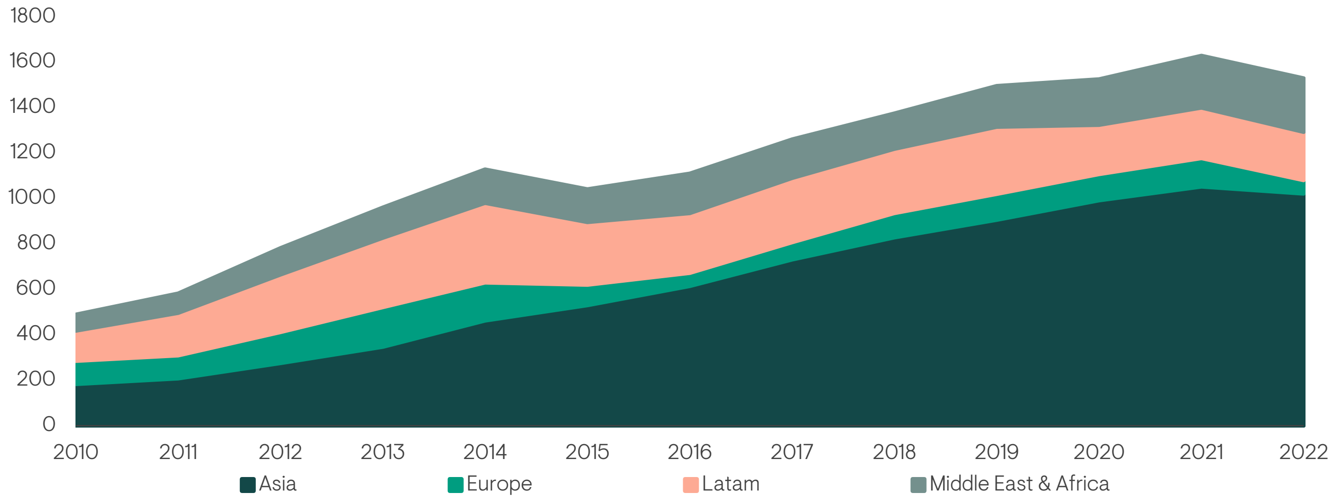
Asset class make-up and fundamentals

A large and diverse investment universe

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, JP Morgan launched a suite of emerging market corporate debt indices in 2008. From a market cap of less than US$500 billion in 2010, the investment-grade portion of the entire asset class has grown to c.US$1.6 trillion[1] today across 29 countries. While asset class net issuance has turned negative in 2022, this is likely a shorter-term phenomenon and the actual path of growth is likely to continue.

The investment universe is diversified globally across regions, countries, and sectors, with lower leverage than comparably rated developed market peers. We believe this fast-growing and increasingly diverse asset class – which has higher yields, lower duration and less leverage than US investment-grade debt for comparable credit quality – could provide a high-grade complementary solution for institutional investors.

Fig 1. Growth in EM IG corporate bonds (US dollar, billion)

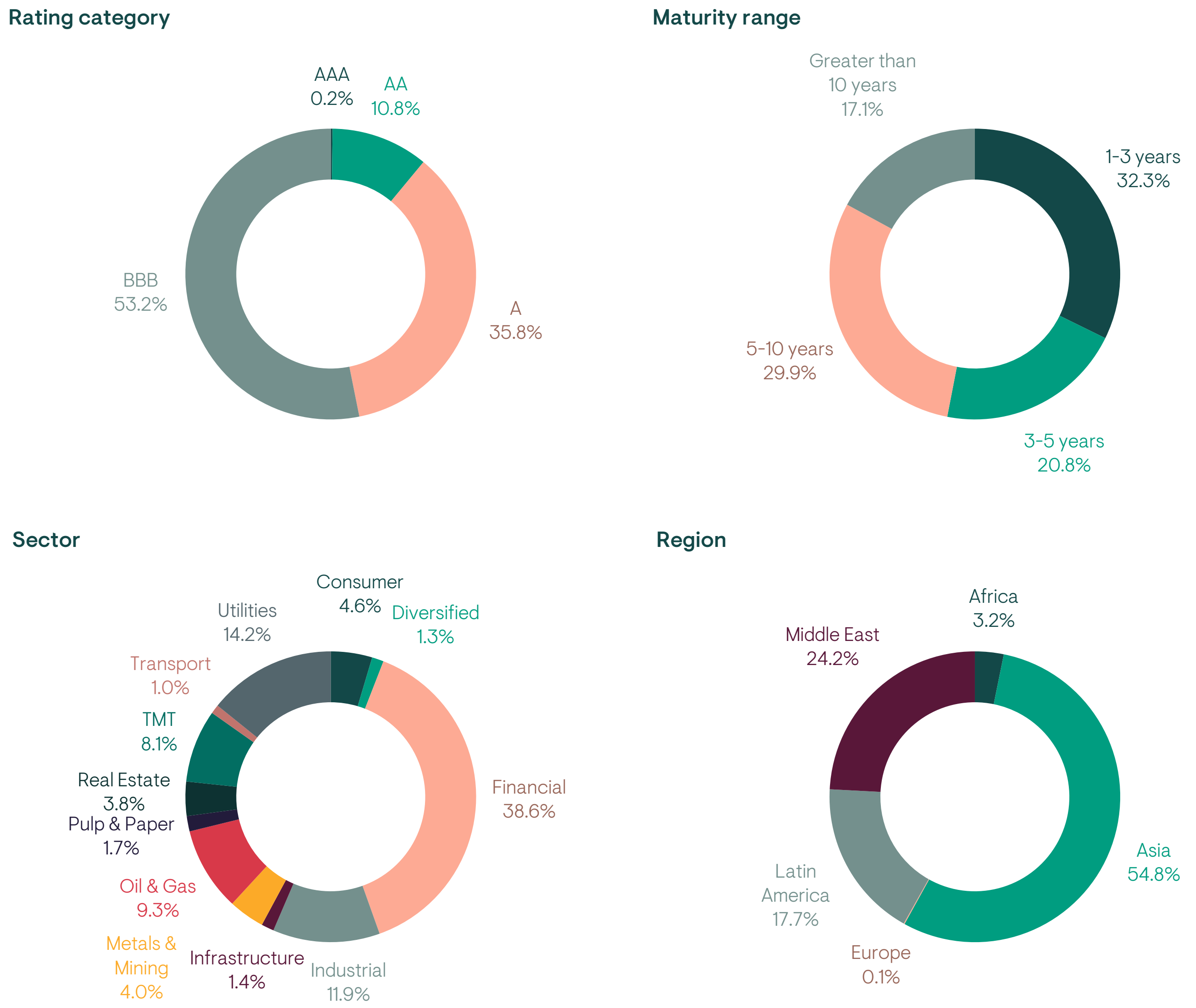


Source: Ninety One, JP Morgan, as at 31 August 2022. All comparative data for EM Investment Grade Corporate asset class is based on the JPMorgan Investment Grade CEMBI Broad Diversified Index and Bloomberg Barclays US Aggregate Index for the US Aggregate Index unless stated otherwise. For further information on indices, please see the important information section.

There are now over 1,200 bonds in the JP Morgan CEMBI IG alone, issued by over 400 companies from a range of sectors. From an industry perspective, commodity and financial companies make up around half of the market, but that proportion has decreased over time as the market has grown and become more diversified. Maturities extend from less than a year to over 30 years, providing plenty of choice, including relative-value opportunities within individual issuers' yield curves.

[1] JP Morgan, as at 31 March 2022.

Fig 2. JPMorgan CEMBI IG rating, maturity, sector and regional breakdown



Source: Ninety One, JP Morgan as at 31 October 2022.

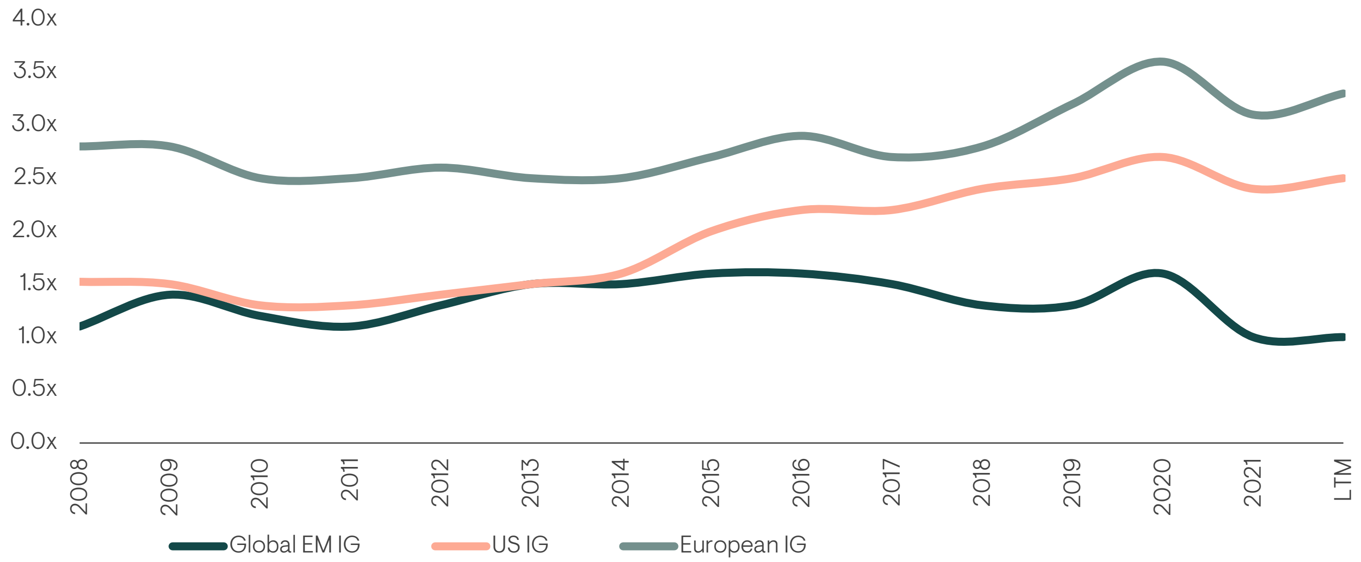
Fundamentally strong companies

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 times of challenging macroeconomic backdrops.

Head-quartered and operating in emerging markets, these companies are familiar with volatility and have historically experienced periods when they struggled to finance themselves with longer-term debt. Thus, their short-term debt is higher as a percentage than it is in developed markets, and their refinancing risks have historically been higher. This has led to a culture of retaining cash while containing leverage. This has been particularly evident since the COVID-19 crisis, as many companies have pared back their expansion and capital expenditure, leaving them with healthy cash balances and strong buffers.

While higher refinancing risks would typically be a fundamental challenge in a rising rate environment – as there is a need to refinance at higher costs – such pressure on EM corporates is meaningfully lower in this cycle relative to prior cycles as most issuers have been able to pre-finance in the ultra-low interest rate regime of the past three years. This has left them well-placed from a financing perspective over the short and medium term.

Fig 3. EM vs. US and European IG net leverage comparison



Source: JP Morgan as at 30 June 2022. *LTM = Last twelve months.
For further information on indices, please see the important information section.

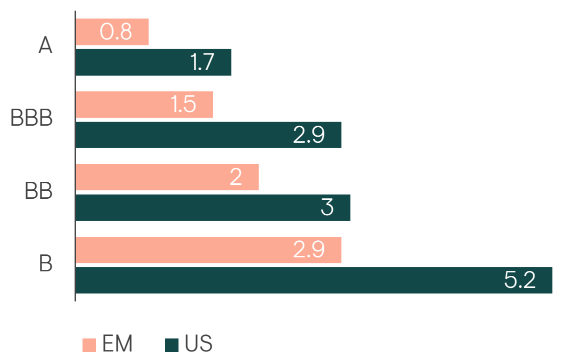
The EM 'zip-code' premium

Investors often perceive emerging market companies to be riskier because of their domestic operating environments. Although rating agencies account for this, premiums still exist for EM companies with better credit metrics than developed market peers; in effect, a 'zip-code premium'. Figure 5 shows this by comparing the spread-per-turn of leverage offered by emerging and developed market companies.

EM company financial strength has led to many improving credit stories, but sovereign credit deterioration/policy shifts have stymied some positive ratings actions and led to downgrades of corporates in some instances. EM companies retain access to multiple financing sources such as equity, local currency bonds and loans, yet many are capped by the rating of their governments; despite the superior fundamentals, their geography effectively drags down the rating. This creates compelling valuation opportunities for investors.

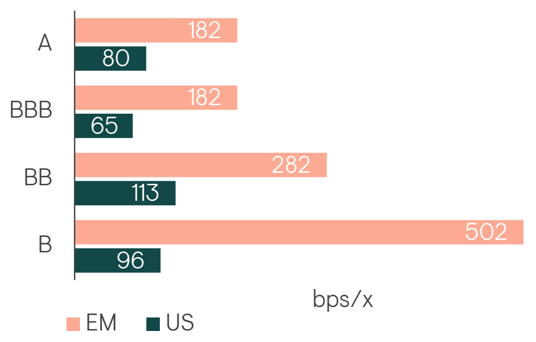
The temporary spike in leverage seen by EM companies in 2020 has reversed. Net leverage remains lower than it is in the US across rating buckets, and deleveraging through 2021 and beyond has resulted in many EM companies' leverage metrics reaching multi-year lows.

Fig 4. EM Corporates exhibit lower level of leverage than US across most rating buckets



Source: Spreads as at 30 September 2022, BoA Merrill Lynch. Net Leverage as at Q4 2021.

Fig 5. Spread per turn of net leverage



Source: Spreads as at 30 September 2022, BoA Merrill Lynch. Net Leverage as at Q4 2021.

Role in investor portfolios

Lower duration

Emerging market investment-grade corporate debt (EM IG) typically offers lower duration relative to its developed market counterparts.

Table 1. EM IG yield and duration compared to other investment-grade asset classes

	Yield	Duration
EM IG Corporate	6.6%	4.7
US IG Credit	5.9%	6.9
EM Hard Currency IG Sovereign Debt	6.1%	7.7
Bloomberg Barclays US Aggregate	5.0%	6.0
Bloomberg US Treasury	4.4%	5.9
Bloomberg Global Aggregate	3.8%	6.6

Source: Bloomberg, 31 October 2022. EM IG Corporate = JP Morgan CEMBI IG. US IG Credit = Bloomberg US Corporate Total Return Value Unhedged USD. EM Hard Currency IG Sovereign Debt = JP Morgan EMBI IG. For further information on indices, please see the important information section.

The lower duration of EM investment grade debt provides a bigger cushion than developed markets to mitigate the impact of a rise in rates or persistent rate volatility. Investors should also consider the convergence in monetary policy this year - many central banks in emerging markets were proactive in tackling inflation rather than chasing the US Federal Reserve, as was the case in prior crises. Many EM central banks are now near the end of, or have even finished, their hiking cycles, with Brazil a recent example. Ultimately, this lends itself towards a more stable economic backdrop in the domestic market for EM companies.

Diversification properties

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. A look at the 10-year historical correlations across asset classes indicates that EM investment-grade corporate debt offers additional diversification to US fixed income.

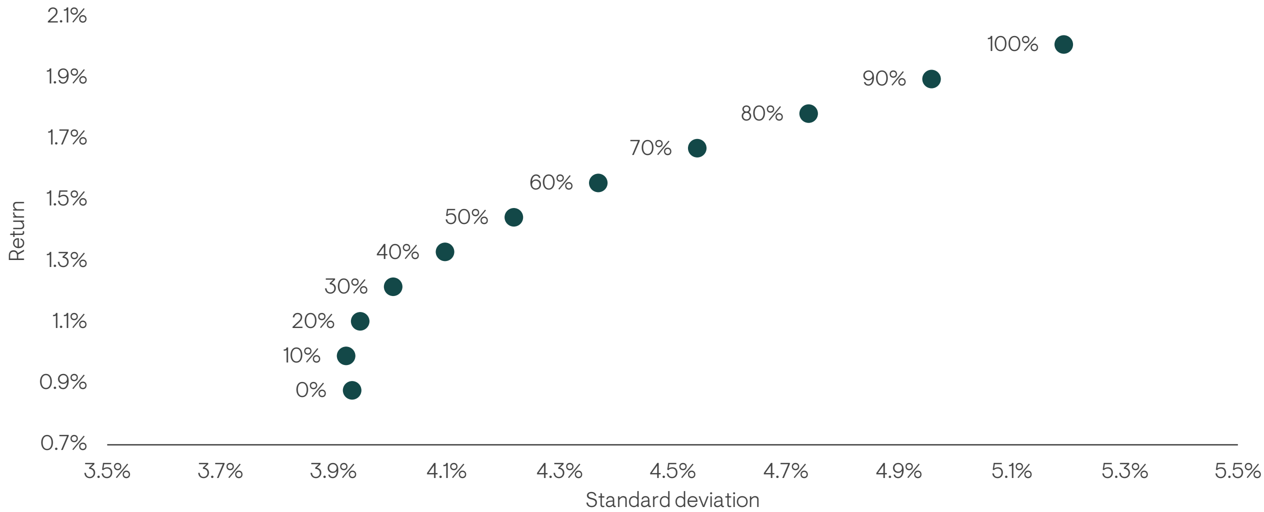
Table 2. Correlations – 10 years to end of October 2022

	JPM CEMBI Broad Div IG	BBG Barclays US Agg	BBG Barclays US Credit	BBG Barclays US Treasury	50/50 EMD Mix	MSCI EM Equity	S&P 500
JPM CEMBI Broad Div IG	1.0						
BBG Barclays US Agg	0.7	1.0					
BBG Barclays US Credit	0.9	0.9	1.0				
BBG Barclays US Treasury	0.4	0.9	0.6	1.0			
50/50 EMD Mix	0.8	0.5	0.7	0.2	1.0		
MSCI EM Equity	0.6	0.3	0.5	0.0	0.8	1.0	
S&P 500	0.5	0.2	0.5	-0.1	0.6	0.7	1.0

Source: JP Morgan, MSCI, S&P, Bloomberg, Ninety One as at 31 October 2022. 50/50 EMD Mix = 50% JP Morgan GBI-EM, 50% JP Morgan EMBI (JPEIDIVR Index). For further information on indices, please see the important information section.

Historical combinations of EM IG corporates and the US Aggregate over 10 years show how the diversification benefits play out on the efficient frontier. We find that adding EM IG can improve the overall risk-return outcome, with a 10-20% allocation optimal in this regard.

Fig 6. Efficient Frontier 10-year, JP Morgan CEMBI IG & US Agg



Past performance is not a reliable indicator of future results, losses may be made.

Sources: Ninety One, JP Morgan, Bloomberg; 31 October 2012 to 31 October 2022. X% in JP Morgan CEMBI IG, 1-X% in US Agg.
US Agg = Bloomberg Barclays US Aggregate Total Return Index Value Unhedged USD, CEMBI IG = J.P. Morgan Corporate Broad EMBI Diversified High Grade Index (JBCDIGIG). Using monthly observations. For illustrative purposes.
For further information on indices, please see the important information section.

Cyclical considerations

All fixed income asset classes have come under sustained pressure over the year to date, in what has been a very challenging period.

Credit markets in particular have been buffeted by two key themes: increasingly hawkish central banks are grappling with stubbornly persistent inflationary pressures; and fears are growing that central banks' quantitative tightening initiatives could tip economies into a recession and destroy demand. Within EMs, we have the added overlay of the impact of the war in Russia/Ukraine weighing on bond prices, as well as the additional effect of China's common prosperity policies weighing on China offshore credit markets. Despite this, it is also worth noting that year to date (to the end of October), the JP Morgan CEMBI IG has outperformed US IG credit (Bloomberg Barclays US Corp index). This highlights the fundamental resilience elsewhere in the EM universe, particularly in regions such as Latin America. That said, we would expect macro news to dominate the micro for the remainder of the year.

Solid fundamentals should protect against credit quality deterioration

EM corporate debt fundamentals remain robust in aggregate. And while rising costs have weighed on companies' profit margins, revenues remain resilient and leverage levels manageable. But aggregate defaults are likely to remain elevated, albeit concentrated, driven by continued stress in Russia-Ukraine and in Chinese real estate. Elsewhere, sovereign developments continue to hinder corporate credit rating momentum, although strong fundamentals have driven some recent corporate upgrades.

Valuations at historic attractive levels

For the asset class overall, superior duration-adjusted spreads relative to EM sovereign and US credit markets can help to protect against rate volatility, as noted earlier. We also see significant value within the asset class. Where distressed risk is more prevalent (Russia/China), current bond valuations overstate the potential default risks, in our view. Overall, the strong sell-off seen over the year to date has pushed yields to post-GFC highs. Based on the historical relationship between yields and subsequent market returns, this leads us to expect strong forward-looking returns over the medium term. However, with liquidity still thin, the market environment is likely to remain volatile and that will be reflective in price action.

Supportive supply/demand dynamics

The technical (supply/demand dynamics) backdrop is a little more mixed. On one hand, year-to-date net negative issuance for the EM corporate asset class has hit a post-GFC record (volume of new issuance smaller than the number of maturities and bond buybacks), meaning the asset class is likely to contract for the first time in a decade. On the other hand, demand is likely to remain subdued in the near term, thus a price catalyst may take longer to materialise, however, we are seeing signs of this turning.

Clean positioning

Positioning in the EM corporate debt asset class has also cleared up (i.e., those that wanted to cut risk have done so, and there are more structural buyers and fewer 'tourist' investors). There have also been significant outflows in China and Asia-centric products, but that appears to remain localised. Once investors get more clarity on stability, we think that allocations will begin to resume their upward trajectory.

Conclusion

Investment-grade corporate bonds issued by emerging market companies offer investors a compelling way to meet their objectives without taking on excessive risk. The market spans a diverse range of regions and companies – with many of these market-leading global businesses.

We believe this fast-growing and increasingly diverse asset class, which has higher yields, lower duration and less leverage than US investment-grade debt for comparable credit quality, could provide a high-grade complementary solution to address investor's needs.

This is an exciting and increasingly relevant opportunity for investors with the relevant expertise.

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