EM Credit Insight

Janus Henderson INVESTORS

Why Emerging Market Corporate Bonds?

The emerging market (EM) corporate debt market is a large asset class that offers breadth, diversity and liquidity, all with low volatility and good risk-adjusted income. Since the JPMorgan Corporate Emerging Markets Bond Index (CEMBI) was introduced in 2002, the EM corporate bond universe has grown exponentially; indeed, the universe is now more than two times larger (in notional terms) and has many more issuers than the external EM sovereign debt market.

Despite its scale and size, many investors are unaware of its stand-alone merits. Because the asset class grew out of a sovereign strategy, there may even be some investors who think of EM debt as purely a sovereign debt market. In this report, we seek to highlight the attributes of EM corporate debt, and compare it with its sovereign debt counterpart.

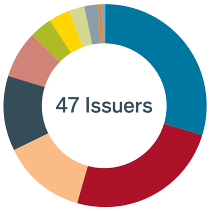
Greater Diversification

The EM external sovereign debt universe[1], as represented by the JPMorgan EMBI Index, comprises 67 countries across the ratings spectrum. Beyond that, the asset class offers little diversification. That means an EM sovereign debt manager is primarily focused on selecting countries and expressing duration preferences. Generating alpha under these circumstances can be challenging.

However, the EM corporate debt market, as represented by the JPMorgan CEMBI Index, offers additional opportunities. The CEMBI represents 52 countries, across 12 different sectors, and spans both ratings and duration spectrums; there are 635 unique issuers, compared to 152 for EMBI. Within each country, investors can choose from a wide range of issuers, such as importers or exporters, oil-dependent or oil-agnostic, high yield (HY) or investment grade (IG). Some of the larger issuers in EM – such as Brazil and China – have scores of companies and various sectors (Exhibit 1). As a result, credit selection can play a crucial role in alpha generation within the EM corporate bond universe.

Exhibit 1: Sector Breakdowns in Brazil and China

Brazil



China

- Consumer
- Diversified
- Financial
- Industrial
- Infrastructure
- Metals & Mining
- Oil & Gas
- TMT[2]
- Utilities
- Transport
- Pulp & Paper
- Real Estate

Source: JPMorgan CEMBI Index, as of April 30, 2018

[1] JPMorgan EMBI and CEMBI indices figures as of April 30, 2018

[2] Technology, media and telecommunications

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A universe with more opportunities for alpha generation

A good example of this can be seen in Brazil, a BB-rated country. In CEMBI, there are 132 bonds from 47 unique issuers across 11 sectors; by contrast, EMBI has 22 bonds from only four unique issuers in two sectors. Because the market opportunities in Brazilian corporates are more plentiful and varied than Brazilian sovereigns, security selection can prove to be highly effective. During the leadership crisis in 2015, managers who favored domestic Brazilian corporates that had little exposure to currency risk fared far better than exporters, for example. Sector-related trends can also provide opportunities. A good example is the Brazilian protein sector, which fared well in 2016 due to positive currency movements and strong global demand but suffered in 2017 due to corruption headlines and merger and acquisition (M&A) risks.

We believe that the best opportunities can be found by marrying bottom-up analysis with macro and technical considerations. We also believe that each investment should be viewed as part of a broader portfolio, with ongoing risk management playing a critical role in portfolio construction. The EM corporate debt market is an ideal asset class to find opportunities that express the core of what makes EM so attractive – we like companies that offer value, in sectors with strong structural growth, and with improving credit fundamentals. A balanced portfolio of companies like these has the potential to offer stable and high income with low volatility.

Growing Market

New countries are a rare occurrence

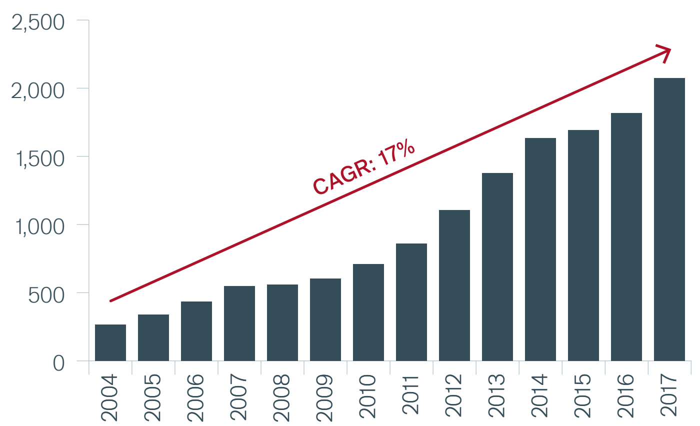
The growth of the EM sovereign market is highly dependent on the economic cycle. As the economic situation of a country becomes more difficult, the government is more likely to issue debt to raise capital. An example of this would be Saudi Arabia, which issued bonds for the first time in October 2016. This deal had been highly anticipated and was well-flagged due to Saudi Arabia's burgeoning budget deficit and stretched local funding sources, following the collapse of the oil price in 2014. While Saudi Arabia was a debut issuer, there are a finite number of countries within EM that can issue debut debt. Unless new countries are created, growth in the sovereign debt markets is limited.

On the other hand, the growth in EM corporate issuance has fewer boundaries. New companies can be formed through privatization or M&A. Financial disintermediation has also been a driver, as onshore banking institutions adopt more hawkish views, creating tougher borrowing conditions. Finally, globalization means that some issuers may choose to issue debt in other markets or currencies in an effort to mitigate currency risk.

The market has been more receptive of EM issuers for several reasons. Accounting standards have been converging, with many issuers using IFRS or similar accounting practices. Corporate governance has also been greatly improved with ease of access to information that did not previously exist. Finally, as the market matures, investors are embracing EM corporate debt for the diversification opportunities it can provide. The EM sovereign market has been in existence for around 30 years, and is well known by investors, making alpha generation difficult in a crowded market. By comparison, the EM corporate market is just a "teenager" and still has a lot of growth yet to come.

All of this has led to a corporate debt market that is now more than $2 trillion. Since 2004, the CEMBI market has grown at 17% annually, which equates to a doubling in size every four years. We think this trend will continue and should create opportunities for investors prepared to do their homework in terms of researching fundamentals.

Exhibit 2: Total EM Corporate Bond Stock (US$bn)



Source: JPMorgan, as of January 31, 2018

CAGR: Compound annual growth rate

More "Analyzable"

Corporate fundamentals are just as important as the macro environment

EM sovereign returns are driven mostly by macro and geopolitical factors. While it is possible to analyze a country's economic situation and make predictions about its future path, a shift in the political landscape can change the economic landscape significantly.

In the world of EM corporates, the macro environment and geopolitics have an influence in terms of sentiment but corporate fundamentals are equally as important. Janus Henderson believes bottom-up analysis, the macro environment and timing are all critical factors in EM corporate debt investing. When assessing an investment, it is recognized that geopolitics and the macroeconomic environment can drive performance, and we believe that valuations, corporate health and technicals are just as important.

Environmental, Social and Governance (ESG) considerations also play a key role in analyzing opportunities for all issuers. We believe that ESG concerns are inherent in fundamental, macro and geopolitical analysis. For example, certain countries have different cultural norms when it comes to governance; but instead of avoiding them altogether, we can assess a premium hurdle for this consideration. In other words, ESG considerations are an input to ascribing value and understanding the technicals for issuers. The goal for all analysis, of which ESG is an important part, is to assess if we are being adequately compensated for risks.

The Sovereign Ceiling

An EM company's rating can mask its underlying health

EM corporate issuers are not usually rated better than their corresponding sovereign. This is known as the "sovereign ceiling." This sovereign ceiling lends itself to analyzing corporates from the bottom up, as there are plenty of instances when the ceiling acts as just that – a cap; on a stand-alone basis, that company could be much better rated without this hindrance.

One way to value a company is to look at its credit spread compared to the sovereign, but this puts fundamentals on the back burner. For example, Petrobras is considered an extension of the Brazilian sovereign due to its importance to the country from a reputational, economic and growth perspective. But to view Petrobras merely as Brazilian sovereign risk over the course of 2016 would have resulted in missing alpha-generating opportunities. Over the year, there was a 400 basis point (bps) range in spreads between Petrobras and the sovereign centered around the company's fundamentals.

It is also worth noting that there is often a large premium for many corporates compared to their sovereign, despite a lack of ratings differential. In developed markets, one would have to go down several ratings notches to achieve the same premium. A good example of this is Turkey, where the 5.75% 2023 of Vakifbank (one of the largest banks in Turkey, with partial state ownership) trades at a spread[3] of 143 bps to Turkey for the same rating (Ba2/NR/BB+) and same duration. To put this into perspective, senior bonds from Norwegian Bank DNB trade at a spread[3] of 68 bps to Norway sovereign bonds (5.5 year duration, 2024 maturity for both) for the same ratings.

Better Quality

EM corporate bond market is only one-third high yield

Downgrades of Brazil and Turkey (two of the larger countries within EM indices) to high yield have pushed the EM sovereign market to almost half investment grade and half high yield. This effect has been less overt in the EM corporate market, which is currently around 43%[4] high yield. Why is this so?

Apart from Saudi Arabia (which is single A-rated), any new country issuing in the sovereign debt market is likely to be a "frontier" market. Frontier markets by their very nature tend to be low rated and high yield. In contrast, any new EM corporate coming to the market is as likely to be a government-owned investment grade Chinese corporate as it is a debut high-yield issuer in Brazil.

Sovereigns continue to be on a downward trend from a ratings perspective. The average EM sovereign rating is BB+ while the average EM corporate rating is BBB-[4]. We believe EM corporate ratings have bottomed out and are starting to improve. The ratings trend may also be obfuscated by the fact that there are many unrated EM corporates but no unrated EM sovereigns.

Default rates are low

Default rates in EM corporates remain well contained. Although we saw a pickup in 2016 to 5.1%, it was mainly driven by distressed credit in Latin America (default rate for the region was 9.2%) and weaker commodity names.[5] JPMorgan projected a default rate of 2.7% for 2017, but the year ended with a 2.0% default rate. For 2018, the JPMorgan default rate forecast is a benign 2.4%[6]. In addition, when EM corporates do default, the recovery rates are often better than in developed markets. This is because many corporate issuers are either quasi-sovereigns or of strategic importance to the country's economy.

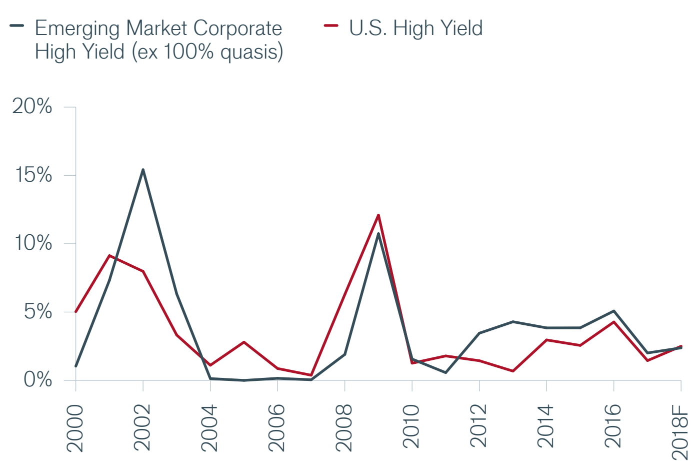
Exhibit 3: Recovery Rates Surged to 51% in 2017

	2015	2016	2017
Global EM	49%	28%	51%

Source: JPMorgan, EM Corporate Default Monitor, as of January 5, 2018

Note: Recovery rates include distressed debt exchanges, these are where a company offers creditors new or restructured debt that amounts to a diminished financial obligation.

Exhibit 4: EM versus U.S. High Yield Default Rates



Source: JPMorgan, as of January 31, 2018

Note: Excluding 100% quasi-sovereign issuers, emerging market high yield includes distressed exchanges, 2012 figures exclude US$5.2 billion in BNTAS Recovery Notes issued in 2010 restructuring.

[3] Bloomberg, z-spread as of April 25, 2018

[4] Source: JPMorgan, CEMBI Monitor, April 2018

[5] Source: JPMorgan, EM Corporate Default Monitor, January 9, 2017

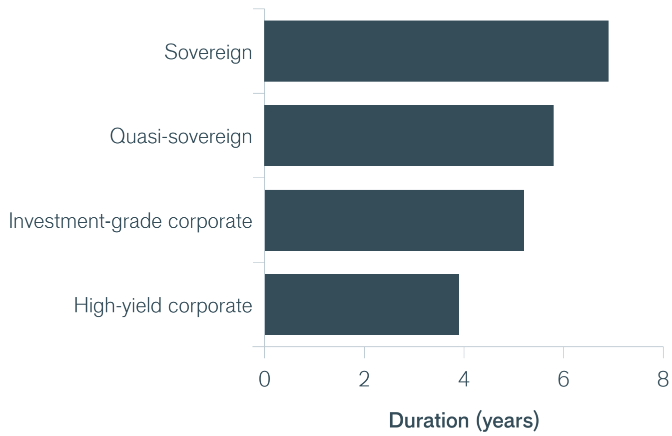
[6] Source: JPMorgan, EM Corporate Default Monitor, January 5, 2018

Shorter Duration

Less interest rate sensitivity

EM corporates are a shorter duration market than EM sovereigns. The duration on the EMBI index (sovereigns) is 6.7 years whereas on the CEMBI Broad (corporates) it is 4.6 years.[7] EM high-yield corporates have generally preferred to issue shorter maturities, while EM high-yield sovereigns will often try to extend out as far along the curve as they can. We think this shorter duration insulates EM corporates to a certain extent from broader fixed income market moves.

Exhibit 5: EM Corporate Bonds Have Shorter Duration



Source: JPMorgan CEMBI Monitor, as of April 30, 2018

Note: Indices used are CEMBI Broad Diversified for corporates and EMBI Global Diversified for sovereigns.

Conclusion

A larger and more diverse universe

A distinct and dynamic asset class, the EM corporate bond universe of hard currency debt is more diverse and much larger than the EM sovereign debt universe. EM corporates can also provide the opportunity to invest in financially sound companies that trade at wider spreads than their respective sovereigns. The higher spread and shorter duration characteristics of the asset class can present good opportunities for investments in today's environment.

Thus, with a very strong focus on fundamental credit analysis, it is possible to find investment opportunities in the EM credit markets with attractive risk/reward profiles relative to the broader EM sovereign debt and developed market credit markets.

[7] Source: JPMorgan, as of April 30, 2018

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