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Top three myths in EM corporate bonds debunked

UBS Asset Management | Fixed Income views

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The emerging market (EM) corporate bond story is akin to the younger brother who quietly grew taller, stronger and more resilient but always had to live in the shadow of his more well-known brother. While EM sovereign bonds have a history that goes all the way back to the 1980s starting with Brady bonds that were issued primarily by Latin American countries as a way to restructure their debt, EM corporate bonds are a more recent phenomenon. Indeed, JP Morgan indexes that are the industry standard for tracking EM corporates only came into existence in the past two decades.

In this paper, we aim to tackle some of the widely held misconceptions about the EM corporate bond asset class and conclude by making a case that the asset class deserves in-depth consideration in a diversified asset allocation portfolio.

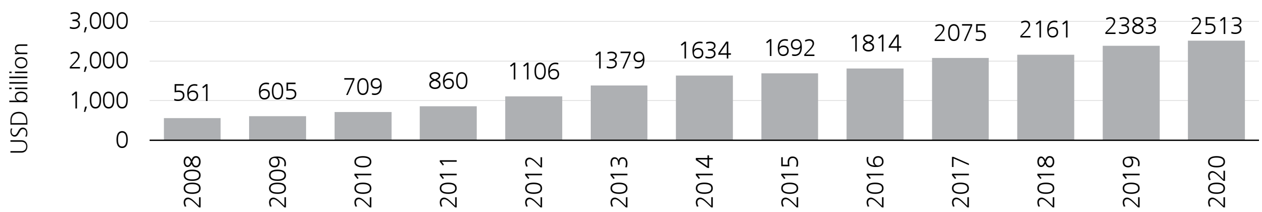
Characteristics	EM corporate bonds (USD)	EM sovereign bonds (USD)
Yield to Maturity	**4.1%**	**4.7%**
Average duration	**5.1 years**	**8.3 years**
Yield / duration	0.82	0.56
Average credit rating	BBB-	BB+
Number of issuers	485	166
Number of countries	42	74

Source: EM corporates proxied by JPM CEMBI Diversified Index. EM Sovereigns proxied by JPM EMBI Global Diversified Index, as of 31 January 2021

Myth 1: EM corporate bonds are a "niche" asset class

While this may have been true 10 years ago, the current reality is far from it. In the period between 2009 and 2019, the amount of outstanding EM corporate bonds grew by an astounding 294%[1], surpassed only by the growth in locally denominated EM corporates. Today, USD-denominated EM corporate bonds are a USD 2.5 trillion asset class[2]; twice the size of the US high yield (HY) market and also twice the size of the EM USD sovereign bond market.

Growth in EM external corporate debt stock (2008-2020, USD billion)



Source: JP Morgan. Data as of December 2020. 1 Source: JP Morgan, SIFMA. Data as of June 2020 2 Source: JP Morgan. Data as of June 2020

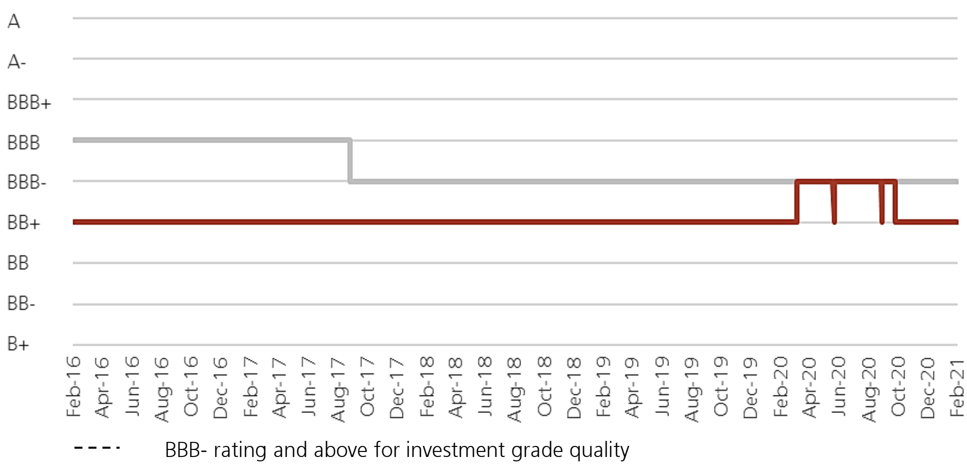
Indeed the asset class has grown to be the same size as the European investment grade (IG) market. The sheer size of the EM corporate bond market can hardly be characterized as "niche". Additionally, the asset class has amongst its ranks some of the largest and most recognized companies in the world issuing bonds. These include Industrial and Commercial Bank of China (ICBC), the largest bank in the world by assets with an asset base of USD 4.3 trillion[3], almost twice that of JP Morgan Chase, and Saudi ARAMCO, the largest oil producer in the world. Indeed, Baidu, Alibaba and Tencent, the internet behemoths, as well as Teva Pharmaceuticals, the largest manufacturer of generic drugs in the world all issue bonds in this market.

Myth 2: EM corporates are riskier than EM sovereigns

Empirical data suggests the opposite is in fact the case. Investors in USD-denominated EM bonds are subject to two main sources of risk: credit (spread risk) and duration (interest rate risk). In terms of interest rate risk, EM sovereigns tend to have more developed curves and tend to issue longer-dated bonds compared to their corporate counterparts. The JPM EMBI Global Diversified Index, a proxy for USD-denominated EM sovereigns has duration of 8.3 years[4], over three years longer than its corporate equivalent, the JPM CEMBI Diversified Index with duration of of 5.1 years[4]. Simply put, all other things being equal, an investment of 1000 US dollars in EM sovereigns could lose 83 US dollars of its value if interest rates rise by 1%, compared to just 51 US dollars for an investor in EM corporates.

From a credit risk perspective, EM corporates have consistently been an IG-rated asset class on average while EM sovereigns have toggled between IG and HY ratings.

Average credit quality of EM corporate bonds versus EM sovereign bonds

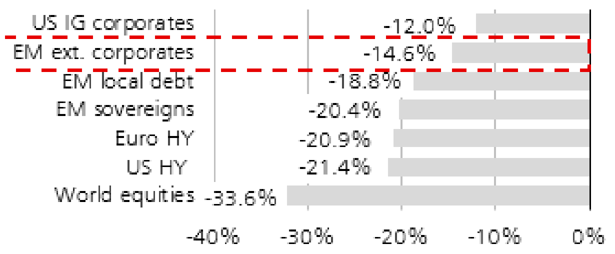


Source: JPMorgan and Fitch Ratings, as of 31 December 2020.

Further, over the past decade EM corporates have demonstrated remarkable resilience in times of crises. As the performance graph below shows, during the onset of the COVID-19 global pandemic when credit spreads widened at a pace faster than even the Global Financial Crisis (GFC), EM corporates outperformed virtually all comparable asset classes with the exception of US IG which had the benefit of direct fiscal support from the Fed. Additionally, EM corporates have had historically lower defaults than sovereigns as the below table shows:

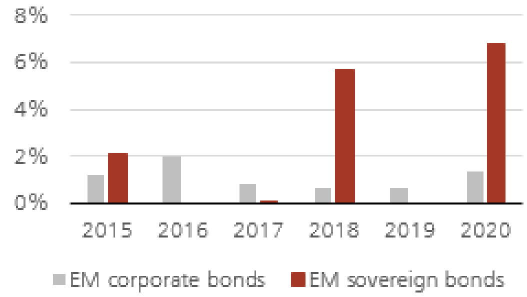
3 Source: S&P, as of 31 January 2020
4 Source: Bloomberg, as of 31 January 2021

Performance during COVID-19-induced market stress[1]



[1]COVID-19 defined as period from Feb 14, 2020 - March 23, 2020 when EM sovereign spreads went from trough to peak. Data Source: Bloomberg, Morningstar Direct. YTD as of 31 December 2020.

Comparison between EM corporate and EM sovereign credit default rates



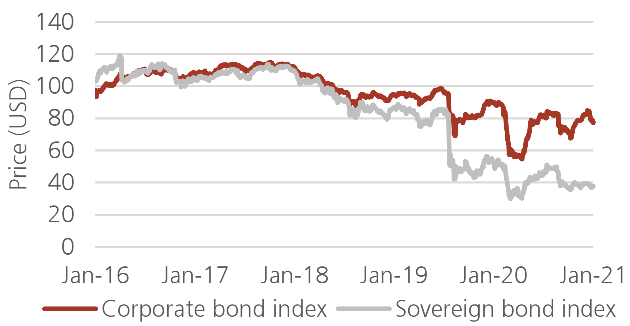
Source: JP Morgan CEMBI Diversified Index (ex-100% quasis) and JP Morgan EMBI Global Diversified Index. Data as of 31 December 2020.

Further, EM corporates have experienced higher recovery rates in instances of default compared to EM sovereigns. The much higher incidents of default in EM sovereigns can be partially explained by the generally higher levels of leverage relative to corporates.

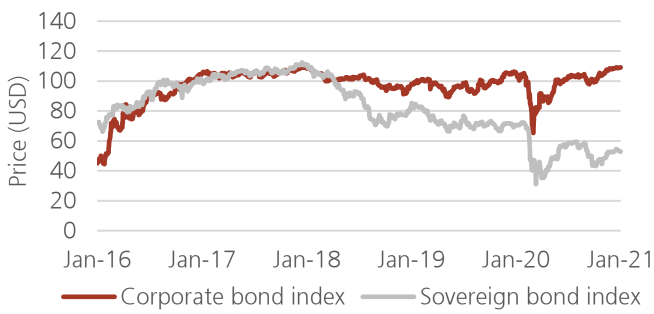
Myth 3: An EM corporate issuer is only as good as the country it is domiciled in

This is only partly true. Several factors go into determining how much a corporate issuer can deviate from its underlying sovereign. For instance, according to Fitch Ratings, factors such as how much of company's external EBITDA comes from foreign versus local sources, how strategically important the company is to the country and how it is legally set up all play a role in determining whether it is subject to a "country constraint". For instance, FEMSA – a beverage and retail company, and America Movil – a telecommunications operator are both domiciled in Mexico. Due to the highly diversified nature of their businesses and global footprint, the respective long-term credit ratings of these issuers is "A" and "A-"[5] respectively, compared to Mexico's sovereign rating of "BBB-"[5]. Said differently, these issuers have been deemed to be of significantly higher creditworthiness than the countries they are domiciled in. Further evidence of corporate resilience in the face of sovereign strife can be seen in two countries. Of the four notable EM sovereign defaults in 2020, two also had corporate bonds that were part of global bond indices, Argentina and Zambia. As the below charts show, while the corporate bonds sold off in line with the respective sovereign initially, they recovered meaningfully in each case to trade at or close to par while the sovereigns defaulted on their issues.

Argentina sovereign versus corporate bond prices



Zambia sovereign versus corporate bond prices



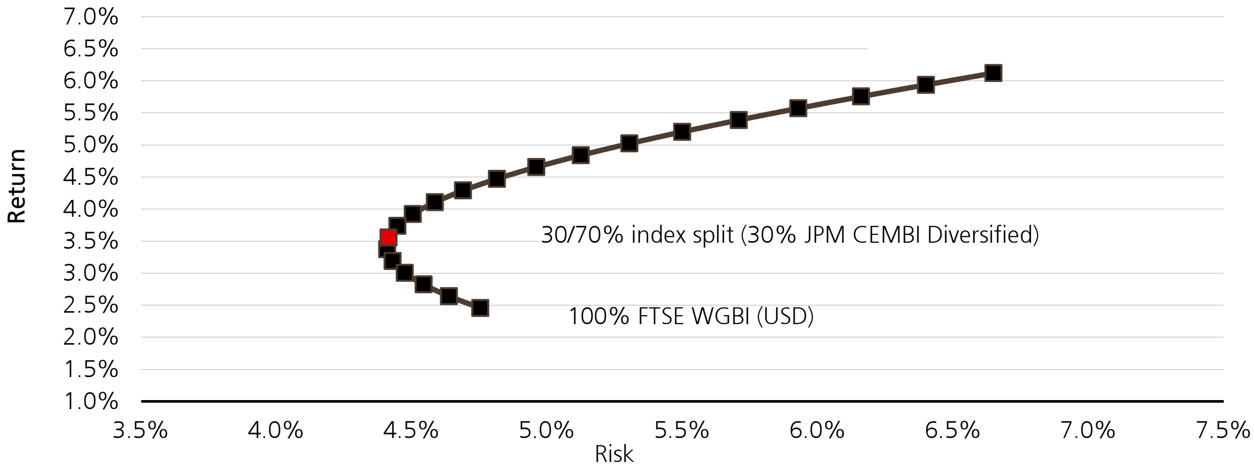
Source: JP Morgan CEMBI Diversified Index and JP Morgan EMBI Global Diversified (Argentina and Zambia sub indexes), as of 21 January 2021.

EM corporates have undoubtedly matured to be an asset class in their own right. As the search for yield continues globally, in our opinion, this asset class remains a superior alternative to EM sovereign bonds or developed market corporate bonds due to the desirable trifecta of high average quality, moderate interest rate risk and typically above-market yields.

5 Source: Fitch Ratings, 31 January 2021

Additionally as the below chart shows, adding an EM corporates allocation into a global FI portfolio historically improved upside potential and diversification, contributing to a more efficient portfolio.

Efficient frontier: World Government Bond Index and JP Morgan CEMBI Index



Source: JP Morgan Index Monitor as of December 2020 for a historical 10 year horizon. These correlations and calculations are based on historical data and there is no assurance they will be stable at these levels.

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