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A Compelling Value Proposition in EM IG Corporate Debt

INSIGHTS

Elevated yields, improving credit quality and lower interest rate risk are presenting a strong case for EM investment grade corporate debt—especially in a soft landing scenario.

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The U.S. economic cycle will once again be a key driver of emerging markets (EM) debt in the year ahead, and will likely resolve into a soft landing or mild recession. While a soft landing remains the central consensus base case, we are cognizant that recession risk still looms large. The good news is, the combination of slower growth and declining inflation is not all bad for credit, and can in fact provide a quite supportive backdrop.

Resilient U.S. economic growth has surprised to the upside, perhaps because of the large increase in the federal budget deficit. While the U.S. Federal Reserve (Fed) has been tightening policy rapidly, the federal budget deficit has increased from around 4.5% of GDP in 2019 to close to 6% today.[1] This is among the largest deficit increases in history, aside from those during Covid, World War II and the 2008 financial crisis.

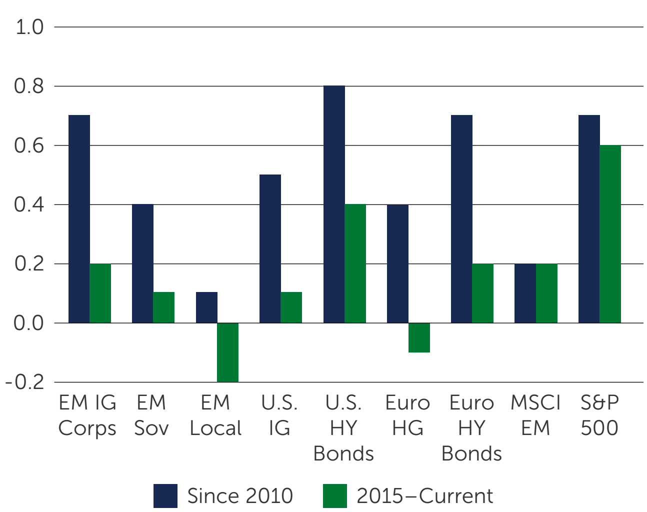
This environment of a not so hard landing is largely positive for fixed income investors, as higher yields currently on offer provide attractive income and return potential, while also buffering potential price declines. Specifically, the price/capital appreciation potential is meaningful with the average EM investment grade (IG) corporate bond price at 91.5.[2] The average duration of around five years is also likely to provide a tailwind should the dot plots following the Federal Reserve's (Fed) rate decision in December prove to be accurate.[3]

EM corporate debt, in particular, may have a compelling role to play in an asset allocator's playbook. As the lines blur further between EM and developed markets (DM), investors may benefit from the diversity in asset selection with EM IG corporates offering exposure to highly-rated jurisdictions such as Singapore, Malaysia, and Abu Dhabi, with long duration profiles and higher spread per leverage than DM peers.

Steep Jump in Yields

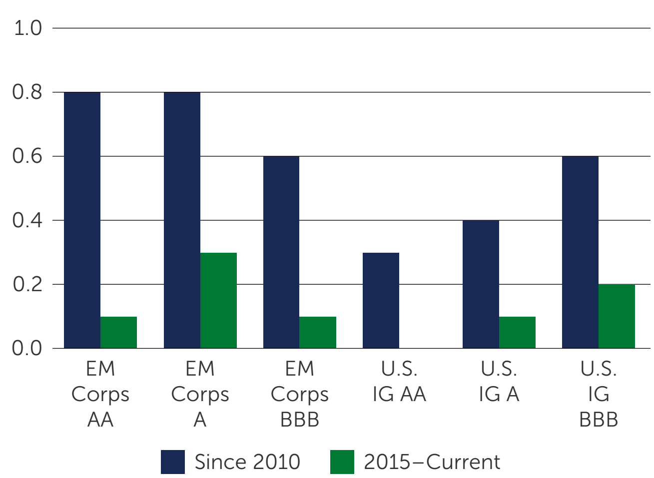
A broad measure of investment grade corporate bond yields surged in October to nearly 6.9%, a more than 14-year high, and has since retraced back to around 6%.[4] Even if we see further economic weakness or deterioration, yields at these levels—along with the duration rally that would likely follow—should offset any subsequent widening of spreads.

Figure 1: Risk-adjusted Returns Across Asset Classes



Source: JP Morgan. As of November 6, 2023.

Figure 2: Sharpe Ratios by Rating Bucket (EM Corporates vs. U.S. IG)



Source: JP Morgan. As of November 6, 2023.

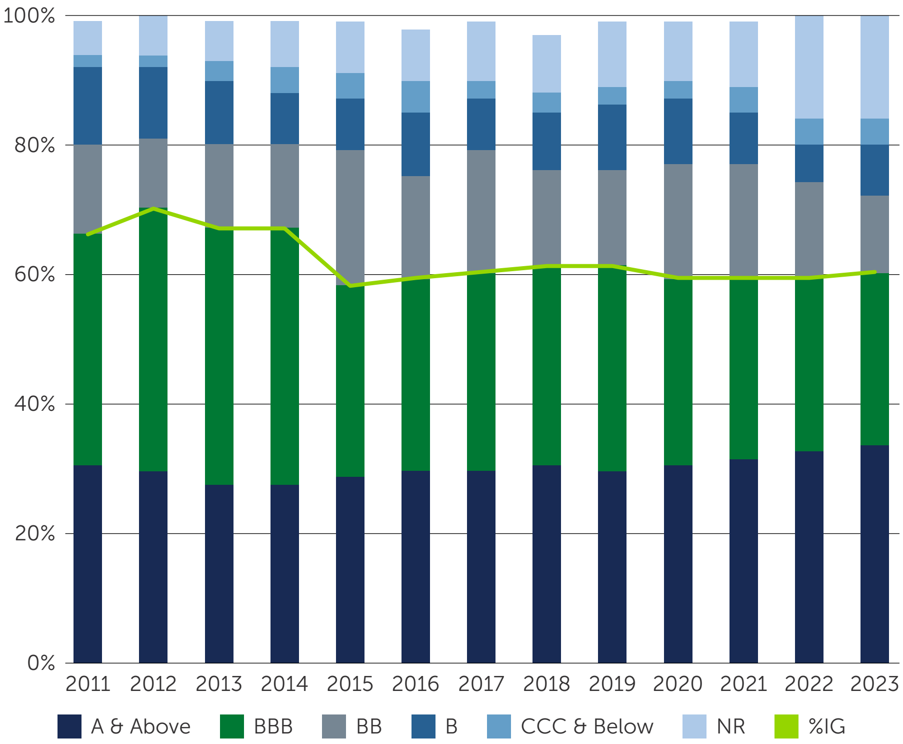
1. Source: U.S. Treasury Fiscal Data. As of November 2023.
2. Source: JP Morgan. As of December 2023.
3. Source: JP Morgan. As of December 2023.
4. Source: JP Morgan. As of December 2023.

A High-Quality Opportunity Set

In a $2.5 trillion asset class, 60% of EM corporate issuers are rated investment grade—which is somewhat counter to widespread belief, and corresponds to an approximately $1.5 trillion opportunity set **(Figure 3)**. Of that, quasi-sovereigns that are either directly or indirectly controlled by governments make up around 62%. These quasi-sovereigns fulfil policy functions and are concentrated in the financials, oil & gas, utilities and infrastructure sectors.

There is also a widespread—and incorrect—assumption that EM corporate debt primarily comprises small companies in esoteric countries. In reality, the EM IG opportunity set spans a number of high-quality issuers such as the largest global oil company, Aramco, and the largest iron ore producer, Vale, with many from highly-rated regions including South Korea, Hong Kong, Singapore, Qatar, Saudi Arabia, Taiwan, U.A.E., Philippines, Mexico, Chile, Malaysia, and Thailand. In addition, many of these corporate issuers predominantly are selling into or operating in DM economies. The asset class also offers the opportunity for EUR exposure, with around $170 billion of IG bonds denominated in EUR.[5]

Figure 3: EM Corporate Bond Stock by Rating Bucket



Source: JP Morgan, Bloomberg Finance LP, Bond Radar. As of November 2023.

5. Source: JP Morgan. As of November, 2023.

A Solid Fundamental Backdrop

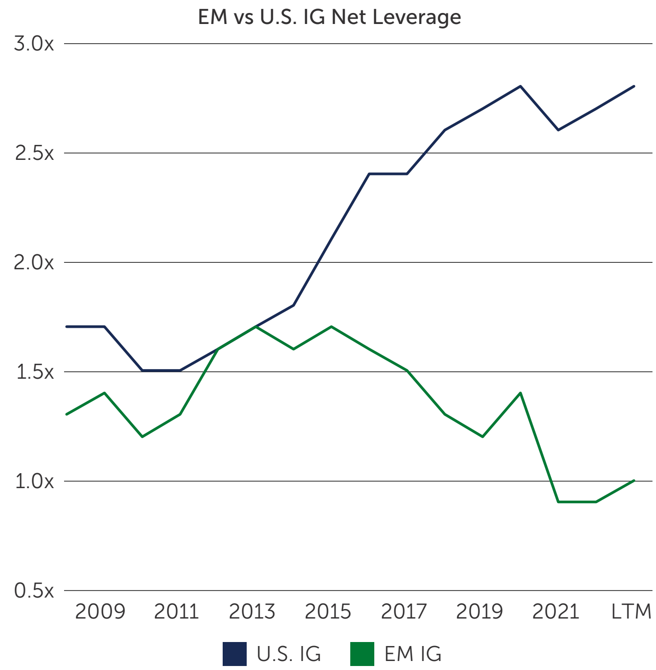
The potential benefits of attractive yields, a high-quality opportunity set, capital appreciation potential and higher spread per leverage than DM peers are in the context of a steadily improving fundamental picture. Indeed, the average EM IG company is operating with just one turn of leverage, which is relatively conservative even compared to similarly rated developed market peers.[6] Also on the positive side, corporate profits, in the form of EBITDA, moderated in the third quarter of 2023 after declining for the prior three quarters. As of the third quarter, top lines are flat year-over-year and EBITDA is 11% higher, while both are up sequentially (+1% quarter-over-quarter and +12%, respectively).[7] While leverage increased modestly in 2023, it remains in good shape for the most part and is well-below prior peaks **(Figure 4)**.

These solid fundamental trends are translating into global EM corporate default rate expectations of a normalized 4% rate.[8] Looking at the year ahead, larger IG-rated companies with strong market share, scale, healthy balance sheets, and pricing power look particularly well-positioned.

The Refinancing Wall: Myth or Reality?

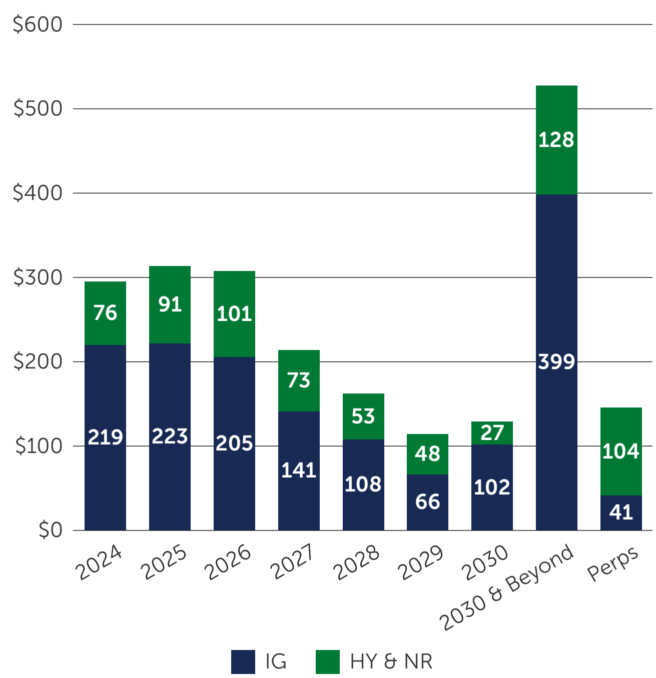
EM corporate debt maturity needs in 2024 and 2025 appear very manageable **(Figure 5)**. Broadly speaking, domestic markets are providing more attractive funding through banks and local bonds. Even as financial conditions remained tight in the U.S., bank lending in EM countries with the largest external corporate bond issuance volumes has mostly shown robust growth, of roughly 8–16% year-over-year.[9] Such activity exceeds external bond market volumes, and thus should prove supportive in the event that U.S. rates remain higher for longer. As a result, we do not expect to see a widespread increase in defaults in the year ahead.

Figure 4: Improving Leverage Levels



Source: JP Morgan. As of November 6, 2023.

Figure 5: EM Corporate External Bond Maturities (Bn)



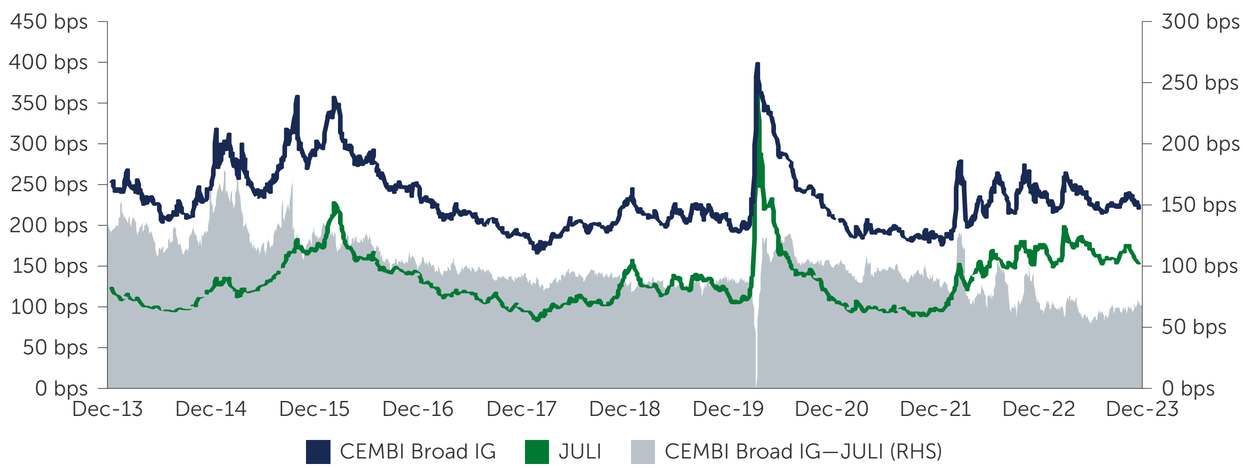
Source: JP Morgan. As of November 6, 2023.

6. Source: JP Morgan. As of November, 2023.
7. Source: JP Morgan. As of November 21, 2023.
8. Source: JP Morgan. As of November, 2023.
9. Source: JP Morgan. As of November 21, 2023.

A Compelling Value Proposition

The spread between EM IG corporates and U.S. IG corporates widened to 44 basis points (bps) as of mid-December, which is 25 bps wider than the start of 2023, and toward the wider end of the 20–50 bps range that has been maintained over the past five years **(Figure 6)**. The BBB segment has widened more meaningfully, especially in the case of Middle East and Latin America BBB issuers—which may provide more opportunities. In particular, the U.S. single-A curve has lagged over the past year due to heavy issuance from banks, and the stress in the regional banking system in early 2023 contributed as well. The widespread levels of the financial sector in U.S. IG with large new issuance is skewing the perception, currently indicating the EM IG corporate spread differential compared to U.S. IG corporates (ex-financial sector) is actually higher than the headline numbers indicate.

Figure 6: EM IG Corporates (CEMBI Broad IG) vs. U.S. IG (JULI)



Source: JP Morgan. As of November 6, 2023.

Key Takeaway

From the macroeconomic backdrop to the direction of monetary policy, there is much uncertainty clouding the outlook for the months and year ahead. Against this backdrop, the higher yields on offer in EM investment grade corporates, together with the higher quality of the market, lower duration risk, and solid fundamental backdrop present a compelling case for the asset class. That said, active management and rigorous, bottom-up credit selection remain crucial to managing risks and identifying issuers that are better-positioned to navigate the uncertain environment.

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