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EM Short-dated Debt: A Diamond in the Rough?

Omotunde Lawal, CFA
Head of Emerging Markets Corporate Debt

BARINGS INSIGHTS

COVID-19 and lower oil prices have led to indiscriminate selling across EM corporate debt, creating a potentially compelling opportunity in the shorter-dated, higher-yielding segment of the market.

Emerging markets (EM) debt has faced its share of challenges in recent weeks. COVID-19—and the reality of travel bans, school closures and remote working—has affected companies across the globe. Plummeting oil prices, spurred by the Russia-Saudi Arabia price war, have exacerbated the effects, creating a steep headwind for commodity-producing companies in particular. In response, EM corporate debt spreads have widened significantly—most notably in March, when they surpassed levels experienced during periods of volatility in 2016 and 2018, and in some cases, reached the widest levels since the global financial crisis (GFC).

While spreads have started to normalize more recently, they remain wide relative to both history **(FIGURE 1)** and developed market asset classes—creating what we view as a compelling opportunity.

Yield Curve Inversion

EM hard currency bond funds experienced outflows of $26.1 billion in March, predominantly from ETFs and retail funds. This broad selloff created significant dislocation in corporate debt prices; even companies with sound fundamentals and minimal direct exposure to COVID-19 traded down.

Given the swift and sharp nature of the event—and the ensuing redemption requirements—managers in many cases were forced to sell assets with the highest cash prices. As a result, the short-dated segment of the market, which has historically been less prone to volatility, also sold off. This caused a significant number of yield curves to invert, whereby the short end of many issuers' curves yielded more than the longer-dated part of the curve **(FIGURE 2)**. In our view, this has created significant value opportunities in short-dated bonds, as the inherent pull to par on these assets should result in quicker price recoveries.

FIGURE 1: EM Corporate Debt Spreads are Wide Relative to History

SOURCE: J.P. Morgan. As of May 8, 2020.

FIGURE 2: EM Debt Spreads Across the Yield Curve

Duration	Current Spread to Worst (05/08/20)	YTD change	3-Month Low	3-Month High
1–3 Years	537	279	249	695
3–5 Years	554	316	220	684
5–7 Years	575	282	284	730
7–10 Years	425	219	195	528
10+ Years	439	182	246	519

SOURCE: J.P. Morgan. As of May 8, 2020

Spread Pick-Up

This opportunity looks particularly compelling given the potential spread pick-up relative to developed market corporates. The recent—and unprecedented—move by the U.S. Federal Reserve to purchase corporate bonds provided significant support to U.S. credit markets. However, the Fed purchase program limits eligible bonds to businesses domiciled, or with a majority of employees in, the U.S.—precluding most EM corporate bonds.

Prior to the Fed announcement, U.S. and EM investment grade credit spreads had widened in tandem, with U.S. IG credit even briefly trading wider than EM IG corporates. However, since the announcement, U.S. credit has experienced a significant rally, versus a much more modest recovery in EM. As a result, the spread differential between the two asset classes has widened to levels not seen since September 2015 **(FIGURE 3)**.

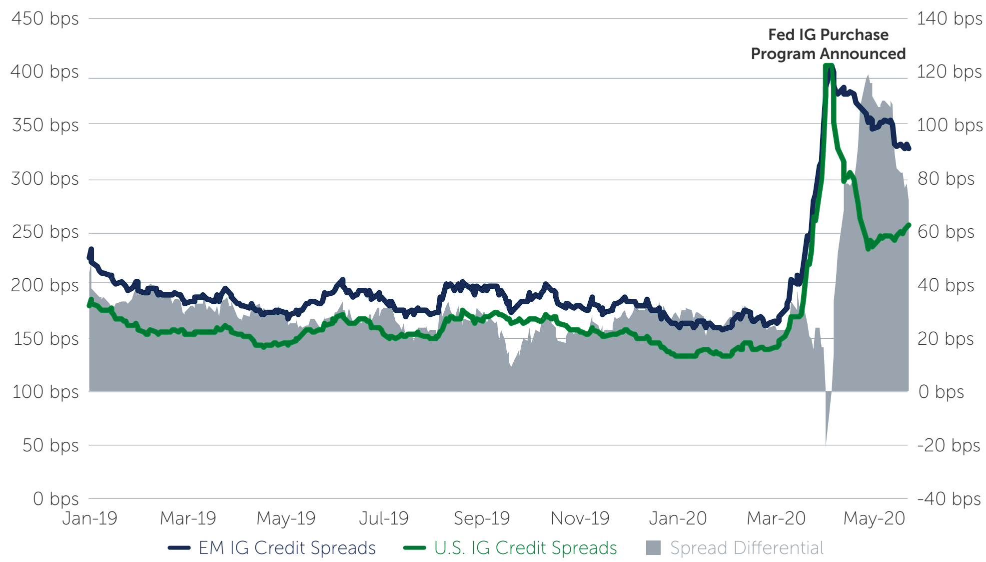
Within EM corporates, we see further opportunity in the higher-yielding segment of the market. Recently, the spread differential between EM high yield and EM IG bonds has widened materially relative to history—and, in fact, is now akin to GFC levels **(FIGURE 4)**.

Identifying a New Normal

Now that the markets have digested the initial shocks from the pandemic, analysis has shifted to what the "new normal" may look like once the global lockdown begins to ease. Broadly speaking, we believe many EM corporates are relatively well-positioned to withstand current and future headwinds.

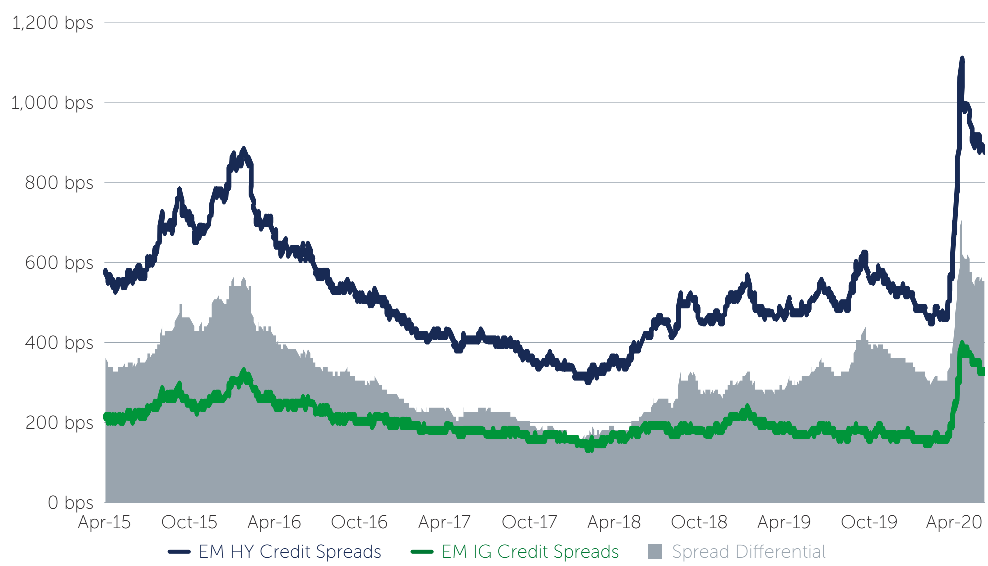
While corporate default rates will almost certainly trend higher as waning demand weighs on cash flow for many industries, we believe emerging market companies as a whole are in better health relative to past crises and/or periods of volatility. For instance, many companies have cleaned up their balance sheets, cut capital expenditures and right-sized their capital structures in the last few years, resulting in better credit metrics relative to their developed market peers.

FIGURE 3: Spread Differential Between EM IG and U.S. IG



SOURCE: J.P. Morgan. As of May 8, 2020.

FIGURE 4: Spread Differential Between EM IG and EM HY



SOURCE: J.P. Morgan. As of May 8, 2020.

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For example, at the end of 2019, net leverage for EM high yield corporates was 2.5x, compared to 3.6x for U.S. high yield[1]. EM corporates have also tended to be more cautious, retaining higher cash balances with limited capital expenditures—which should provide a stronger starting point for many companies in the universe.

Given the number of unknowns, it is challenging to assess the prolonged impact that the crisis may have on sectors and companies. However, it is apparent that certain industries will be more directly impacted than others. Indeed, much focus today is on how management teams across industries will adapt their business models in response to the new normal. An interesting example is the aviation industry, and how it may adapt to a post-crisis world—and, further, what the potential implications of that evolution could mean for global oil demand, aircraft manufacturers and leasing companies.

Based on our assessments of sector vulnerability, we believe many of companies in the CEMBI index are in sectors with moderate or low direct impact to COVID-19 and the related global slowdown. This includes sectors like consumer, TMT and utilities—where in many cases, companies have traded down despite appearing largely sound from a fundamental perspective. The sectors most vulnerable to the crisis—which by our assessments constitute roughly 24% of the index—include oil & gas, metals & mining and real estate.

The oil & gas industry has faced a further challenge from the Russia-Saudi Arabia price war—which escalated even as markets become oversupplied and global storage facilities neared capacity. This resulted, of course, in the historic collapse in crude prices in April, with WTI crossing into negative territory for the first time and Brent dipping below $20. While prices have continued to fluctuate, we believe that at current levels they are unsustainable for the majority of oil producers. Although OPEC has agreed to take measures to reduce future oil supply, the collapse in demand will take time to correct.

Oil & gas makes up roughly 13% of the CEMBI index, and until supply/demand dynamics begin to normalize, companies in this sector—particularly producers—will face difficulties. However, it is worth noting that many EM oil producers may actually be better positioned to weather this volatility than their developed market counterparts given their integrated energy business models, lower costs of extraction and the implicit support from sovereigns from which many benefit.

Key Takeaway

We continue to closely monitor the economic consequences of both COVID-19 and the decline in oil prices. In the near term, we believe the volatility across the markets has created a number of value opportunities as spreads have widened beyond what fundamentals would suggest. The shorter-dated, higher-yielding portion of EM corporate debt looks particularly attractive, in our view, where spreads remain near financial crisis wides.

That said, it is critical that investors remain vigilant. The current environment is shrouded in uncertainty, and there are plenty of risks on the horizon—liquidity challenges chief among them. In this type of environment, selectivity and true, bottom-up credit analysis are key to avoiding unwanted risks—and uncovering the diamonds in the rough.

1. Source: J.P. Morgan. As of December 31, 2019.

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