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FIXED INCOME

Three Reasons for EM Short Duration Debt

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BARINGS INSIGHTS

Emerging markets debt has shown much resilience despite facing its share of pandemic-induced difficulties. A short-dated approach, in particular, can provide an opportunity to pick up incremental yield and diversification, with less volatility.

Emerging market asset classes have experienced somewhat of a rollercoaster ride thus far in 2020—weakening as the global pandemic took hold back in March and then rallying strongly in the subsequent months. With a still-uncertain economic environment, lingering risks on the horizon, and valuations that have snapped back from stressed levels, investors are rightly asking if opportunities in emerging markets (EM) debt still exist. The answer, we believe, is yes—but selectivity is critical.

For investors looking to pick up incremental yield opportunities versus developed markets (DM) and gain exposure to the diversification on offer in EM—but who are more risk-averse, particularly against the current backdrop—EM corporate debt, and more specifically, short duration debt, could be part of the solution. In particular, we think there are three reasons short-dated EM bonds are worth consideration for investors.

1. Lower Volatility

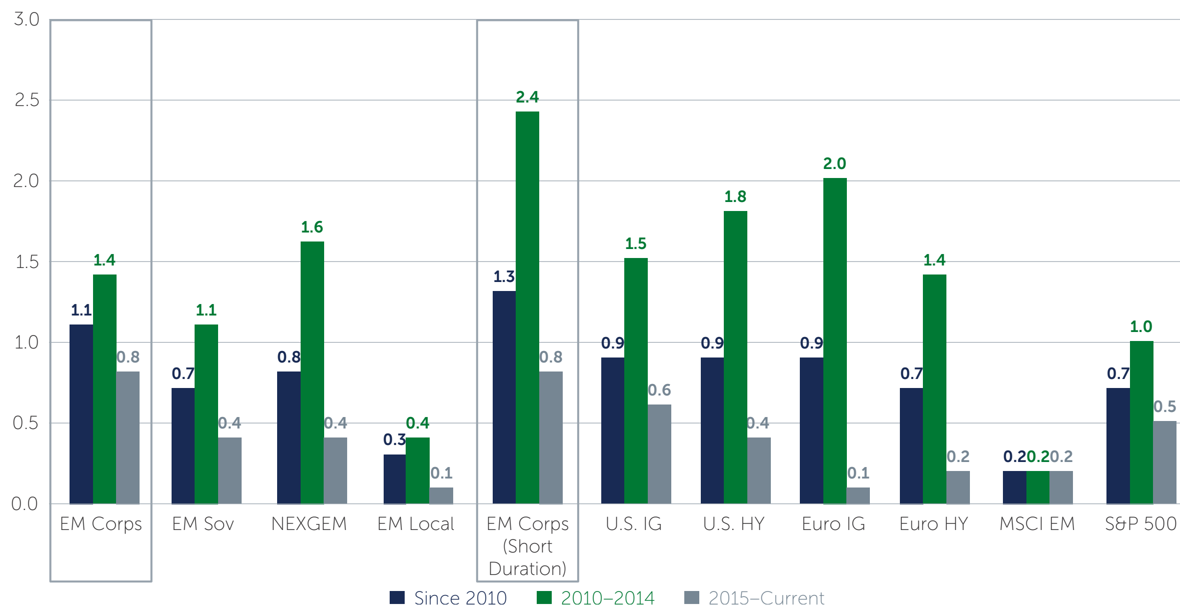
Short duration bonds tend to exhibit a lower volatility profile than other fixed income instruments. First, by definition, they have a shorter time remaining until maturity. Because of this, they experience less severe swings in pricing caused by changes in the economic backdrop or even the company's earnings outlook. In fact, they often experience a gentle "pull to par" effect—meaning their prices tend to gravitate toward par as the maturity date approaches.

Second, short-dated bonds have lower duration risk. This means the price of a short-dated bond is fundamentally less sensitive to changes in interest rates—compared to longer dated bonds—which enables investors to gain exposure to EM companies without necessarily being exposed to the dramatic ups and downs of interest rate expectations.

And third, as short-dated bonds have less time to maturity (typically under three years in Barings' short duration strategies, for instance), investors tend to have more visibility on the direction of a company's earnings and liquidity position. As a result, short duration bonds are less exposed to deterioration in the underlying financial position of the corporate issuer, or even to detrimental or unexpected changes in the business plan. A company's ability and willingness to meet their financial obligations is easier for investors to forecast over these shorter time periods.

The result of this lower volatility can be seen in the historical Sharpe ratios for the asset class. Since 2015, for instance, EM corporate debt has exhibited better risk-adjusted returns than EM sovereigns and U.S. high yield (HY)—and even the S&P 500 index. When further breaking down into short duration debt, the results are also impressive. So while investors may give up some absolute return by focusing on the short duration segment of the market, on a risk-adjusted basis, those returns have historically looked quite attractive relative to other asset classes.

FIGURE 1: Short Duration EM Debt Offers Attractive Risk-Adjusted Returns



SOURCE: J.P. Morgan. As of May 31, 2020. Sharpe ratio based on weekly returns annualized. NEXGEM: J.P. Morgan Next Generation Emerging Markets. EM Corps (Short Duration) includes assets with a maturity between 1–3 years.

2. Spread Premium to Developed Markets

Relative to short-dated DM bonds, short-dated EM corporate debt provides the potential for an incremental pick-up in credit spread. For example, the average yield of the 1–3 year segment of the J.P. Morgan Corporate Emerging Markets Bond index (CEMBI) is 1.39% for investment grade (IG) issuers and 8.43% for HY issuers—compared to 0.86% and 6.29% for U.S. IG and HY, respectively.[1]

FIGURE 2: Average Yields for Short Duration Debt (EM Versus U.S. IG)

SOURCE: J.P. Morgan. As of July 31, 2020. JULI: J.P. Morgan U.S. Liquid Index.

Interestingly, investors may not necessarily be taking more credit risk in EM debt than they are in DM debt, but often are being rewarded for the perception that EMs are considered riskier. However, a closer inspection of the facts reveals that this perception is somewhat misguided. EM corporates have been cleaning up their balance sheets, with many cutting CAPEX and right sizing their capital structures, resulting in stronger fundamentals and superior credit metrics compared to their developed market counterparts. For example, the default rate for EM HY issuers in 2019 was roughly 1.5%, compared to 2.9% for U.S. HY.[2] Net leverage ratios have also been declining in the last few years, to 2.6x for EM HY in 2019, versus 3.6x for U.S. HY.[3]

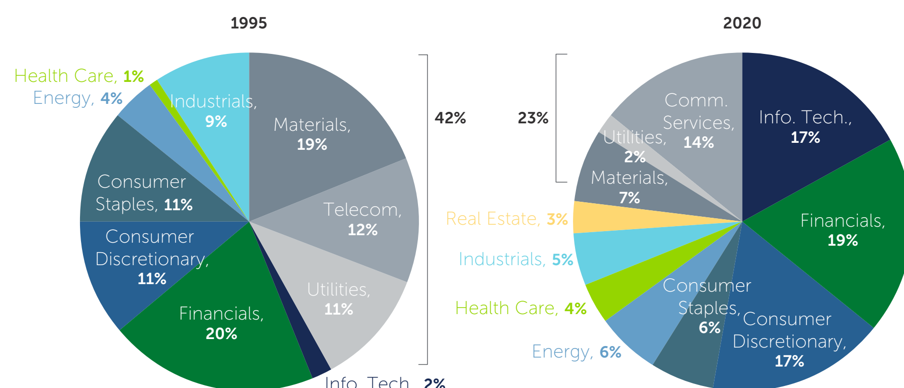
With the lower-for-longer rate environment seeming likely for the foreseeable future, and the significant amount of negative-yielding assets in developed markets, we believe that taking credit risk, on a selective basis, is one way for investors to potentially earn the yields that they need to meet their target returns. And, as discussed earlier, the shorter time to maturity means that investors have greater visibility on a company's financials—and therefore credit fundamentals—than is the case with longer-dated debt. As a "coupon-clipping" product, short duration debt may not offer the potential for massive capital appreciation, but the high degree of visibility on cash flows can be particularly valuable in an uncertain economic environment.

1. Source: J.P. Morgan. As of August 13, 2020.
2. Source: J.P. Morgan. As of June 30, 2020.
3. Source: J.P. Morgan. As of May 31, 2020.

3. Better Diversification

EM corporate debt is one of the fastest growing asset classes, expanding from $1 trillion in 2012 to $2.4 trillion at the end of 2019. By comparison, the EM sovereign debt market is $1.1 trillion, while U.S. HY is $1.7 trillion.[4] The EM corporate debt universe has also become increasingly diversified across countries, sectors and ratings—with over 1500 issuers—and unlike some investors' preconceptions, it is no longer a commodity-dominated asset class driven by swings in oil prices. In fact, oil and gas companies account for only 13% of the corporate bond index, and metals and mining businesses a mere 6%.[5]

FIGURE 3: Emerging Markets Have Become Increasingly Diversified



SOURCE: Barings, Factset. Sector breakdown of MSCI Emerging Markets index from December 29, 1995 and June 30, 2020. Figures may not add up to 100% due to rounding.

While EM assets tend to be perceived as higher risk, many EM corporates are in fact large, global companies with diversified sources of revenue—and in effect have been unfairly discounted by markets because of the country in which they're domiciled. The path between EM corporates and their sovereigns continues to diverge, and as EM corporates mature, they continue to display higher resiliency during periods of sovereign stress. For example, in 2019 the sovereign index for Argentina returned -40.4%, compared to -2.3% for the Argentinian segment of the EM Corporate index.[6] In practice, we continue to find value in corporates that are domiciled in stressed regions that have been unjustly discounted based on the location of their corporate headquarters—when in fact many offer robust, global revenue streams.

EM corporates also tend to be compared with U.S. HY from a risk perspective, but such a comparison looks misguided when considering the underlying fundamentals of the EM corporate universe. Consider for instance, that 58% of the EM corporate universe is rated investment grade.[7] So investors not only potentially stand to benefit from the common misconception that EM corporate debt is riskier than it is in reality (based on credit ratings alone), but also can potentially benefit from diversification across credit ratings with an allocation to the asset class. Again, with short duration instruments, opportunities can exist to get comfortable with underlying credit risks (for HY issuers, in particular) given the limited time to maturity.

4. Source: J.P. Morgan. As of December 31, 2019.
5. Source: J.P. Morgan. As of July 31, 2020.
6. Source: J.P. Morgan.
7. Source: J.P. Morgan. As of July 31, 2020.

The Takeaway

EM corporate debt continues to offer an opportunity to potentially achieve superior risk-adjusted returns and invest in well-diversified companies with robust balance sheets. And going forward, we do not expect to see a widespread spike in defaults in EM corporates—thanks to both the stronger fundamentals of these businesses as well as the wave of credit support and liquidity measures being announced by governments and central banks around the world. Not all companies will be impacted to the same extent though, making selectivity crucial.

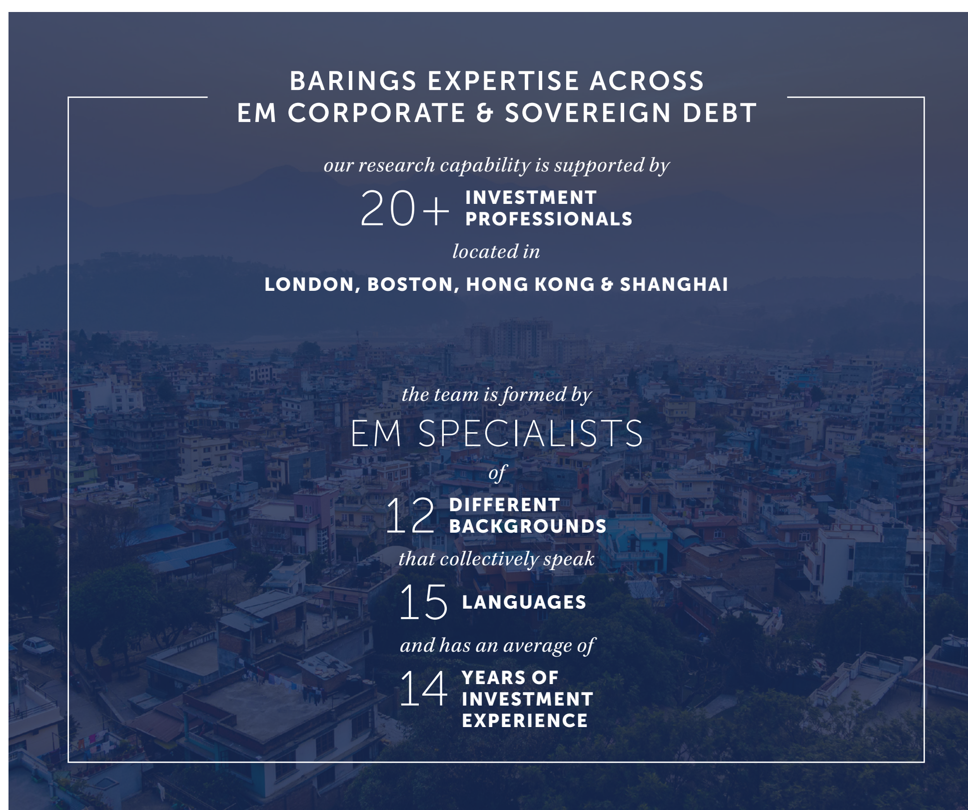
However, from the global pandemic to political risks in EMs, a number of uncertainties remain—with likely bouts of volatility along the way. Against this backdrop, we believe risk-averse investors could consider taking a short-dated approach to investing in the asset class.

Barings' Approach

At Barings, we believe fundamental, bottom-up analysis is key to identifying attractive opportunities—as well as understanding the risks—in EM corporates. We understand the importance of rigorously assessing the entire EM debt asset class, including both sovereigns and corporates, to have a more holistic view of the risks and earnings outlook for each EM company.

For this reason, we have one of the largest dedicated EM debt teams—with 10 investment professionals dedicated to covering over 1,100 EM corporate issuers, and 10 dedicated investment professionals covering over 85 EM sovereigns. The teams work together to underwrite every issuer that comes to the market, which means analyzing the key credit considerations for each issuer—including reviewing strengths and risks, capital structure, balance sheet, cash flow projections, ESG considerations and macroeconomic variables. Essentially, this process helps to build a cohesive and comprehensive macro and micro picture, by country, sector and credit. Additionally, our dedicated EM analysts collaborate with over 59 global credit analysts from across the Barings platform to identify best ideas across EM debt.

We believe that now, more than ever, as prices tend to decouple from fundamentals, a large pool of experienced, analytical resources is crucial to identifying mispriced opportunities—in particular companies with strong fundamentals that can continue to grow after the pandemic. In our opinion, this process enables us to become more comfortable taking on credit risk in order to potentially earn an incremental credit spread.



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