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Switch to EM corporates from US corporates

By Jan Dehn

Emerging Markets (EM) high yield (HY) corporates are safer than US HY corporates. They have lower default rates, are less sensitive to exchange rate movements and 80% of EM energy corporate AUM has a de facto sovereign backstop. The cyclical backdrop is improving in EM, while it is deteriorating in the US. EM corporates continues to have much better credit metrics for similar ratings, including much lower net leverage. FX mismatch fears are overdone and China concerns are rapidly receding on the back of sound management by the government.

In conclusion, EM corporates offer a superior value proposition: far better quality for roughly the same yield.

Introduction

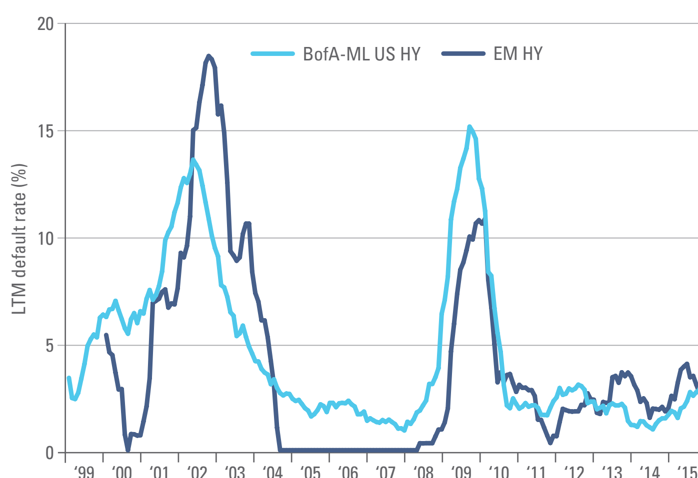
It is well-known that EM High Yield companies default less than US HY companies over the cycle, but the near-term outlook for EM corporates is now also materially stronger than the outlook for US companies. EM corporates have held up well in the face of Dollar appreciation, while US corporates appear to be struggling with the currency appreciation. EM corporates find themselves in a far more advantageous stage of the business cycle than their US counterparts, except for oil companies, but most EM companies with energy exposure have sovereign backstops, while US corporates do not. China has been a major source of pessimism about EM corporates, but risks are receding. Overall credit metrics and ratings for EM corporates remain superior to US corporates, yet they offer roughly the same compensation in terms of yield. The value proposition strongly favours EM.

EM and US HY default rates – the stylised facts

The long-run data shows unambiguously that EM HY corporates are safer than their US counterparts. At 3.9%, the long-run default rate for EM HYcorporates is lower than that of US HY corporates (4.6%).[1] EM HY corporates do not fare worse than US HY corporates during periods of developed market crises either. For example, US companies fared worse than EM companies in the aftermath of the Subprime Bubble, while EM corporates were hit harder in the aftermath of the Dotcom Bubble. The recent deepening of EM corporate debt markets, particularly domestic markets, and less reliance on foreign bank loans may have contributed to EM's better performance in 2008/09 compared to the Dotcom shock.

EM default rates have remained below EM HY's long-term default rates every single month from 2011-2015 bar one (June 2015)

Fig 1: **EM and US HY default rates (1999-Dec 2015)**



Sources: Ashmore, BAML.

Recent differences between EM and US HY corporates

There have been subtle but significant differences in recent default rate dynamics in the US and EM, which may contain important pointers for relative performance going forward.

The period from 2011-2015 is particularly interesting, because global financial markets have been driven mainly by Quantitative Easing (QE) flows over this period, which has inflicted very asymmetric shocks on US and EM corporates.

Specifically, EM corporates have been forced to deal with tighter financial conditions, slower domestic growth and weaker home currencies. By contrast, US corporates have faced much easier domestic financial conditions, but a sharply stronger US dollar. The default histories for US and EM corporates over this period are shown in figure 2 overleaf.

[1] Based on BAML's longest available time series of defaults from 1999-2015.

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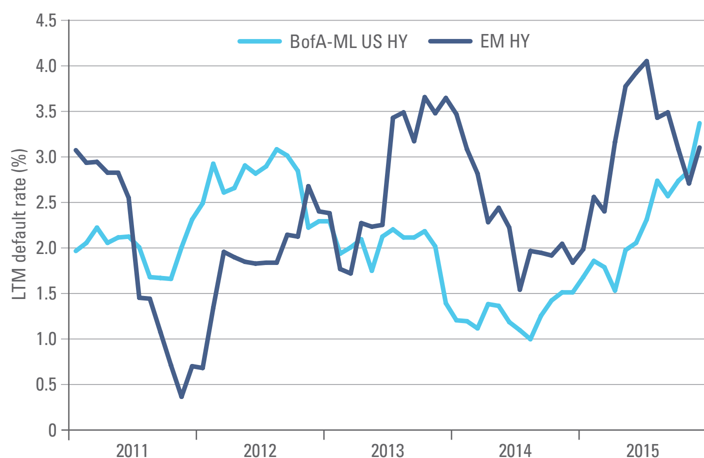
Fig 2: **EM and US HY defaults (2011-2015)**



Sources: Ashmore, BAML.

A number of observations are pertinent:

- EM default rates have risen since 2011, but only very moderately. In fact, default rates have remained below EM HY's long-term default rates every single month over this period bar one (June 2015). This illustrates that the strong US dollar environment, which prevailed in this period has not had a meaningful impact on default rates.
- The main variation in EM default rates over the period mainly reflects changes in financial conditions rather than currencies. During periods of tighter financial conditions (say, during the Taper Tantrum panic of 2013) and while fears mounted over a Fed hike in late 2015, default rates temporarily rose. However, default rates then quickly declined again as EM economies adjusted through their flexible labour markets and currencies.
- US corporates appear to be more sensitive to the strong Dollar than EM corporates. US corporate default rates have risen monotonically from 0.98% to 3.38% between mid-2014 and late-2015. The rise in default rates – which appears to be accelerating – coincides perfectly with the start of the Dollar's appreciation against EUR, JPY and commodities.
- US HY corporate default rates are now higher than the post-2008/2009 average of 2.67%, while EM default rates remain below their long-term average.

Sovereign backstops

There are good reasons to believe that the unfavourable trend in US HY default rates can continue. Depressed energy prices are sending US shale businesses into liquidation. Much of the recent investment in this sector now looks wasted. The low price environment of course poses similar challenges for EM's energy companies. But there is one important difference: 80% of EM HY energy companies by market cap are state-owned, meaning that they are quasi-sovereigns with a government backstop.[2] There will almost certainly be materially lower defaults in EM's energy sector than in the US.

A sovereign backstop is likely to make a material difference to realised default rates. There are many ways in which a sovereign can help a strategic energy company without having to assume their debt. For example, Russian state banks have helped Russian state owned oil companies to refinance locally when sanctions cut those companies off from the international capital markets.

Better macroeconomic backdrop

The main shocks afflicting EM in recent years – Taper Tantrum, falling commodity prices, the Dollar rally and Fed hikes – are now in the rear view mirror. EM's dramatically lower currencies are helping to make EM corporates more competitive, particularly since inflation is mostly under control across the EM universe. This is now showing up as dramatically better external balances, in spite of lower commodity prices. EM countries are cheap places to produce and rising net exports will contribute to GDP as well as FX reserve accumulation this year.

By contrast, the US macroeconomic backdrop is becoming a major concern. The Dollar is still elevated versus almost all other currencies in the world, which makes it hard for exporting companies to compete.US manufacturing is in recession and the services sector is showing signs of weakness. The US is moving closer to full employment, which may soon push up wages, but prospects for improvements in productivity look poor as 95% of US companies' profits have been used to buy back stock and pay dividends rather than invest. In many ways, the US now looks the way some EM countries looked before the Taper Tantrum – a bit expensive, a bit uncompetitive, a bit in need of reform.

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Better credit quality

EM corporate ratings are constrained by sovereign ratings ceilings. They do not reflect the true credit quality of those companies. Even so, EM HY corporates are on average rated BB- compared to US HY corporates, which are on average rated B+. This higher rating reflects in part that EM HY corporates have much lower net leverage than their US counterparts. US HY corporates have net leverage ratios of 5.5x, while EM HY corporates only have 2.5x net leverage. The EM asset class also offers materially greater diversification compared to developed markets by virtue of the greater number of countries with the same sectors. For example, an oil company in Russia is very different from an oil company in Mexico.

Fig 3: **Average ratings for EM HY and US HY corporates**

Sources: Ashmore, BAML.

[2] In terms of the number of companies, 33 out of 79 energy names in the BAML corporate index are private sector (41%), while 46 are public sector.

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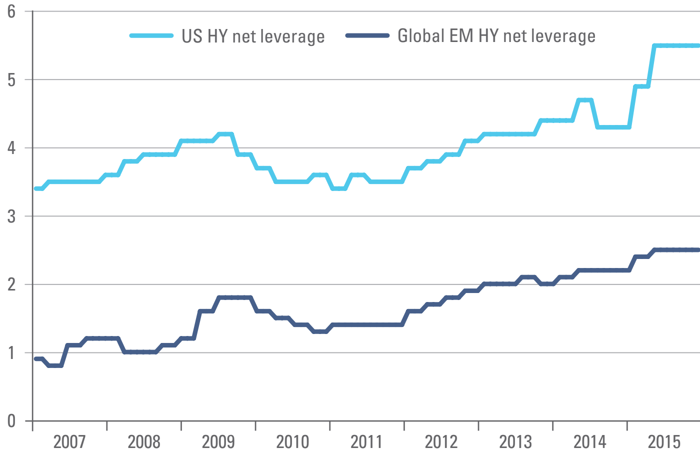
Fig 4: **Net leverage: US versus EM HY corporates**



Sources: Ashmore, BAML.

Strong technicals

Technicals look set to be very supportive of market performance in 2016, especially in the first half of the year. Some USD 80bn of corporate credit cash flow will be returned to investors through coupons and amortisations this year. For the full year some USD 158bn will be returned to investors in coupons and principal repayments. In addition, we expect around USD 40bn-50bn in bond buybacks in 2016, because local funding sources are becoming more attractive than international ones, given currency volatility and relative interest rates. Indeed, the negative sentiment towards EM in 2015 has reduced the appetite to issue new foreign currency bonds. Between lower issuance and record repayments the market will be pushed into a net negative supply situation in 2016, a process that already began at the end of 2015 (negative net supply of USD 30bn in Q4 2015).

The technical situation means that there is enough capital for prices not only to stabilise but actually to trade higher in 2016, even without capital flows returning to EM. Many international investors are now underweight and looking for the right entry point to get back into the market.

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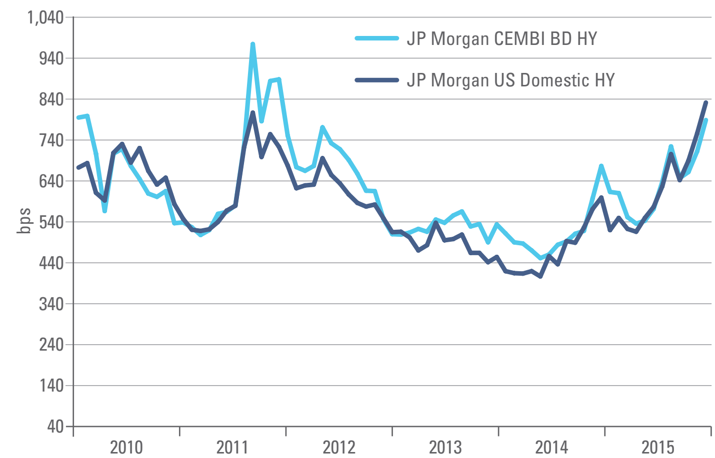
Feel like getting paid?

EM and US HY bonds now pay investors roughly the same yield of approximately 10%. Specifically, EM HY pays a yield of 9.6% (808bps) compared to 10.1% for US HY (895bps). At these yields, we think EM HY corporates offer superior value because of their stronger fundamentals. Value investing is about spotting the moments when prices get out of line with fundamentals. That time is now.

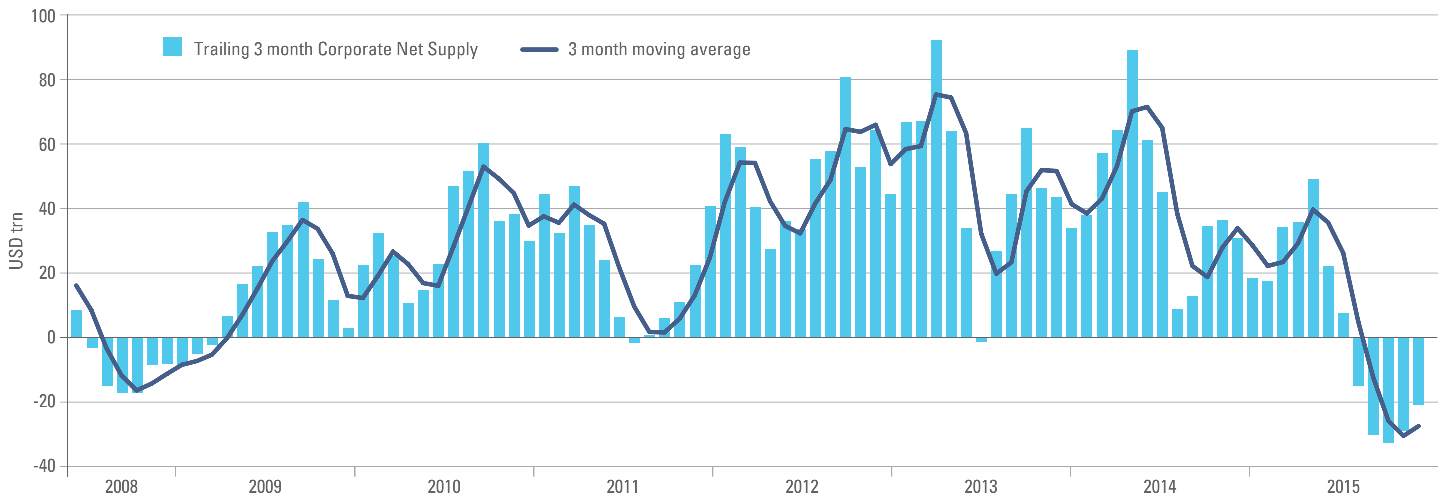
Fig 6: **Spreads: US versus EM HY**



Sources: Ashmore, JP Morgan, Bloomberg.

Default rates for US HY and EM HY corporates have remained virtually identical in the period following the Subprime crisis, despite the dramatic and sustained rally of the US dollar against EM currencies

Fig 5: **Supportive net supply**



Source: Ashmore, BAML.

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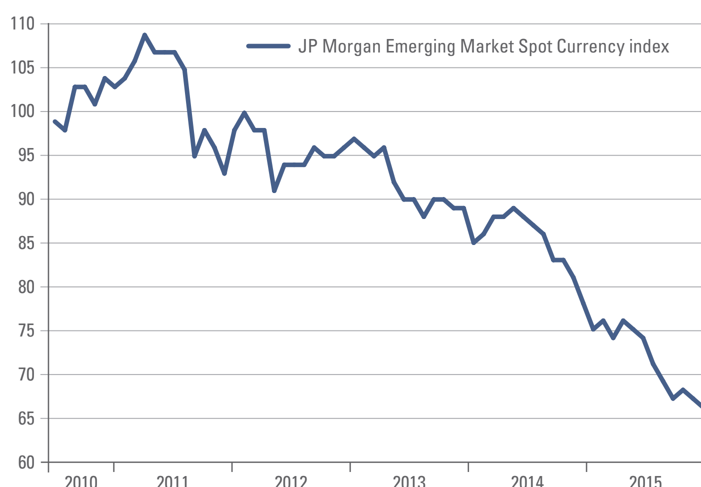
What about corporate FX mismatches?

One of the striking features of the global corporate landscape is that default rates for US HY and EM HY corporates have remained virtually identical in the period following the Subprime crisis, despite the dramatic and sustained rally of the US dollar against EM currencies (illustrated in figure 7 below).[3,4] EM currencies are down more than 40% against the US dollar.

Fig 7: **EM currencies versus the US dollar**



Sources: Ashmore, JP Morgan, Bloomberg.

The Commentariat has been crying wolf about EM corporate debt ever since the start of the US dollar rally.[5] The arguments are familiar by now; EM companies are supposed to have borrowed far too much, in Dollars. So, according to the narrative, we should expect widespread defaults among EM corporates on account of alleged FX mismatches on their balance sheets.

It now clear that this is simply not happening. The question is why? Firstly, many of the EM corporates that issue in Dollars are exporters with revenues in Dollars. For example, a Brazilian company doing commerce with a Colombian company will often conduct their business in USD. The share of USD revenue is therefore often very significant for EM companies. By issuing in Dollars, such companies are reducing rather than increasing their FX mismatches because they can now match currencies in both their revenue and liability streams.

Secondly, many EM corporates actively hedge their FX exposures. There are not many CEOs in EM that are not acutely aware of FX risks – after all FX volatility is a permanent feature of the macroeconomic landscape of most EM businesses.

Thirdly, net debt issuance has been lower than gross debt issuance, because many EM corporates have issued longer-dated bonds and reduced short-term Dollar credit lines and bank loans. Net issuance is lower and rollover risks have declined.

Fourthly, EM companies often arbitrage borrowing costs between local and external capital markets. Many commentators wrongly assume that EM companies have to have constant access to the Dollar bond market. The USD bond market is in fact just one of four different pools of capital that EM companies can tap into, and it is by no means the largest. Local markets are far more important and corporates can also tap local bank sources. Borrowing from international markets is often opportunistic, to be used as and when market conditions are attractive. Good EM companies tend to issue international debt precisely this way, only tapping markets when conditions are favourable. Companies without immediate liquidity needs sometimes issue longer term debt only to retire shorter term maturities, which improves their maturity risk profiles.

The ability of EM companies to survive without access to the USD bond market is often demonstrated, most recently by sanctioned Russian corporates that have been completely cut from refinancing in USD. Not only did Russian companies not go into default in 2015, they managed to pay everything in time and in full and conducted multi-billion USD buybacks of bonds.

EM companies do not have to have constant access to the Dollar bond market. The USD bond market is in fact just one of different pools of capital that EM companies can tap into – local markets are far more important and corporates can also tap local bank sources

Lazy analysis

So why does the question of FX mismatches keep recurring? The most likely explanation is laziness. There is no place on Bloomberg or other readily available information sources where journalists or analysts can quickly look up FX mismatches on EM corporate balance sheets. The challenge is made greater by the fact that there are now more than three thousand corporates represented in the main BAML EM corporate bond index. It is extremely unlikely that the Commentariat bothers to unpack the balance sheets of each EM corporate to examine the sensitivity of its balance sheet to exchange rate movements. It is far easier to look at gross issuance and recent Dollar moves and simply assume that there must be an FX mismatch problem. This approach may sell papers, but it is rubbish investment analysis.

The special case of China

Chinese corporates have until recently maintained large naked Dollar exposures, unlike corporates in most other EM countries. These currency mismatches were established, because Chinese corporates could borrow abroad at lower yields than were available at home. As long as the RMB moved in close lock-step with the US dollar it made sense to borrow abroad.

That all changed in 2015 when China officially adopted a more flexible exchange rate regime as part of its qualification for SDR inclusion.[6] This sparked immediate global panic as investors began to worry about FX mismatches and hence the possibility of widespread corporate defaults in China, exacerbated by unfounded fears of a mega-devaluation.

The panic was – as usual – excessive. Chinese policy makers were well-prepared and allowed Chinese corporates access to some USD 700bn in central bank reserves, which dropped from USD 4.0trn to USD 3.3trn. China has now largely eliminated corporate FX mismatches with only modest impact on the currency and very little corporate stress.

[3] Based on JP Morgan's index of EM spot exchange rates versus the US dollar.
[4] By contrast, the underperformances of EUR and JPY versus the Dollar over the same period have been far more uneven.
[5] Martin Wolf's article in the Financial Times on 11 December 2013 *"Asset managers could blow us all up"* was a particularly prominent example.
[6] The other reason was that China, sensibly, did not want to continue to tie their exchange rate to a bubble currency like the Dollar.

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Yet, flows are still coming out of China. This is not foreigners pulling out. After all, China's domestic markets are not yet part of the main indices, few investors have quotas and quotas are difficult to fill, in part because Western institutional asset managers rarely buy single country funds in EM. Money is leaving because the Chinese government bond market staged a very strong rally over the last few years, which is now impacting the refinancing decisions of Chinese corporates. Lower onshore yields and more FX volatility have made it far more attractive for China's corporates to refinance in RMB. In other words, they are repaying external debt. While this drain FX reserves it also reduces foreign liabilities one for one, so there is not major concern, in our view.

Chinese Property Development companies were seen as the weakest links in the credit spectrum of Chinese companies, given their stock of more than USD 60bn in USD denominated bonds and revenues in local currency. But in the six months since the opening of the onshore bond market for those companies they have issued in excess of USD 30bn equivalent in local bonds. USD bonds are being replaced by RMB bonds.

In conclusion, it is encouraging that China has been able to eliminate the FX mismatch risk on corporate balance sheets with only a modest impact on the currency and with minimum stress for Chinese corporates. Going forward, Chinese corporates will predominantly refinance in RMB. This reduces the stock of outstanding Dollar liabilities, a positive technical, which partly explains Chinese corporates' continuing outperformance versus other EM corporates (see figure 8).[7]

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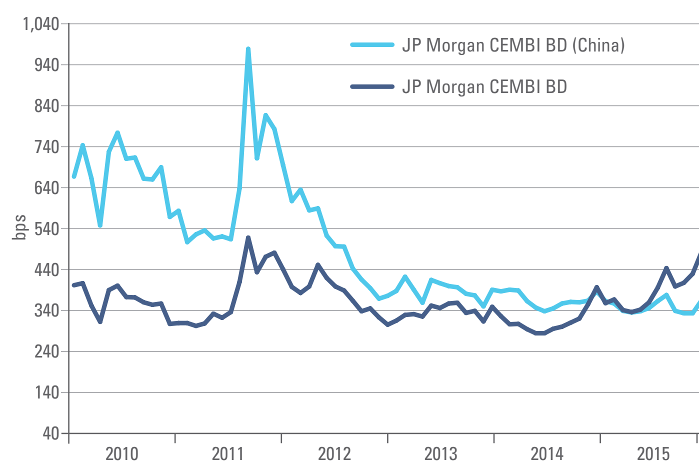
Fig 8: **China versus EM corporates: Spreads**



Sources: Ashmore, JP Morgan, Bloomberg.

[7] Note that net repayments of US dollar denominated debt also reduces China's overall FX liabilities, so the resulting decline in reserves is not a problem.

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