

The case for EM investment grade USD bonds

By Gustavo Medeiros

Emerging Markets (EM) investment grade (IG) bonds have delivered superior returns to US IG fixed income, both on nominal and risk-adjusted bases.

On a forward looking basis, EM IG should continue to outperform as the asset class offers higher spreads than US assets with similar leverage metrics for corporate bonds and superior indebtedness metrics at sovereign levels. The Fed is unlikely to be buying EM IG bonds directly, but the asset class should benefit technically from both scarcity value and valuation advantages as US bond markets get progressively more distorted by direct Fed purchases.

The EM IG asset class is sizeable, diverse and liquid enough to receive large allocations. Still, the technical positioning is favourable with the supply of EM IG bonds limited by the fact that most IG EM sovereigns and corporations now meet the bulk of their financing needs in local debt markets.

Overall, EM IG bonds represent a great opportunity for investors seeking to monetise the EM risk premium with moderate volatility in a world, where higher yielding IG-rated securities are increasingly difficult to come by.

Size and composition of the EM IG bond markets

The EM IG bond market is a sizeable asset class with USD 1,740bn of assets comprising USD 1,079bn of corporate debt and USD 661bn of sovereign bonds (Figure 1). In terms of geographical distribution, 48% of outstanding bonds are from Asian issuers, 32% from Emerging Europe, Middle East and Africa (EMEA), and 20% Latin America. EMEA represents 55% of the sovereign universe due to large issuance from Middle East sovereigns over the last three years, whereas Asia dominates the corporate universe with 65% of all bonds. Furthermore, EM corporate IG is a diverse asset class encompassing the world's largest banks, such as ICBC and Bank of China, the largest resource companies, such as Vale and Saudi Aramco, as well as the largest internet companies in the world, including Alibaba, Baidu, and Tencent. These companies are not only extraordinary businesses, but also strategic for the countries from which they originate, thus providing a double layer of credit risk protection.

Fig 1: EM IG universe: corporate and sovereign

EM IG	Sovereign	Corporate	Total	%
Asia	129	702	832	48%
Latin America	169	175	344	20%
EMEA	363	202	565	32%
Total	661	1,079	1,740	100%

Number of:	Sovereign	Corporate	Total
Countries	24	34	36
Issuers	32	565	597
Bonds	375	1,616	1,991

Source: BAML, Ashmore. Data as at August 2020.

Fig 2: EM corporate IG: JP Morgan CEMBI BD IG

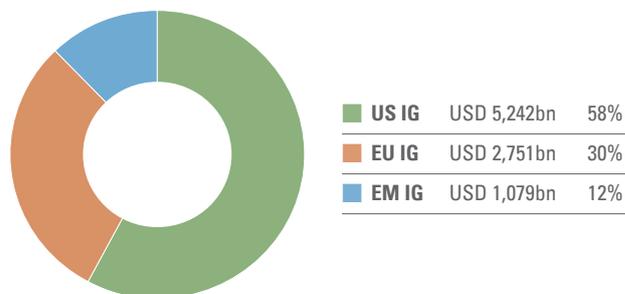
Sector	Weight
Financial	30.3
Oil & Gas	13.1
Utilities	11.6
TMT (Telecom)	10.5
Consumer	10.1
Industrial	6.8
Metals & Mining	5.9
Real Estate	5.8
Diversified	2.2
Infrastructure	1.8
Pulp & Paper	1.3
Transport	0.6

Source: BAML, Ashmore. Data as at August 2020.

EM corporate IG companies have solid businesses which are strategic for the countries they operate

While large enough to be eminently investable, the EM IG fixed income asset class is relatively small compared to the IG bond universe in developed markets (DM). The corporate EM IG universe accounts for about 12% of the total corporate IG universe ex-Japan as shown in Figure 3, while the sovereign EM IG universe is dwarfed by the large sovereign bond markets in the US, Japan, and Europe. EM IG bond markets therefore benefit from scarcity value.

Fig 3: **IG corporate bond universe ex-Japan (USD bn)**



Source: BAML, Ashmore. Data as at August 2020.

EM IG is a scarce asset class as EM countries and corporations finance most liabilities in their deep and liquid local bond markets

The size of the EM IG universe is constrained by two factors. First, rating agencies tend to be ruthless in assessing credit worthiness in EM bond markets. DM sovereign issuers, such as the US, Japan, the UK, or Italy tend to retain their IG ratings despite the fact that their debt to GDP ratios are in excess of 80%, while most EM sovereign issuers with debt to GDP ratios in excess of 60% tend to soon find themselves at serious risk of downgrade to junk status. As for high quality EM corporates, barring a few rare exceptions, their ratings tend to be subject to so-called 'sovereign ceiling' constraints, which means that their ratings are required to be below that of the sovereign, regardless of the quality of the corporate. The second reason why the EM IG fixed income universe is small is that EM countries and corporations tend to finance the bulk of their liabilities in their deep and liquid local bond markets. As EM local currency bond yields have declined, so has the cost of funding for large IG-rated EM corporations, which often prefer to borrow locally, thereby reducing their exposure to oscillations in foreign exchange markets.

Superior risk-adjusted returns

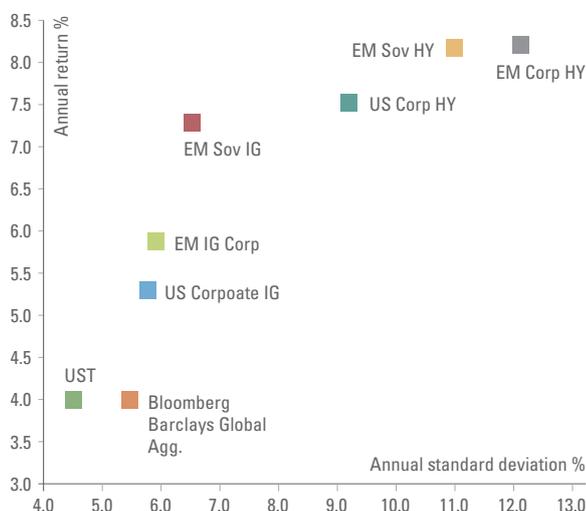
Figure 4 charts the efficient frontier for EM and DM bonds markets for the period since the inception of JP Morgan's IG and HY indices sovereign and corporate bond indices in June 2003. EM corporate IG bonds have delivered 5.9% annualised return, or 0.6% higher return than US IG corporates, despite identical volatility.

EM sovereign IG bonds have accrued an average annual return of 7.3%, which exceeds US sovereign bond market returns by a whopping 3.3% with only 2.0% higher volatility. Furthermore, EM sovereign higher returns and volatility than EM corporates can be explained by the longer duration profile of sovereign bonds.

The JP Morgan EMBI GD IG Index (sovereign) has a duration of 9.5 years whereas the JP Morgan Corporate EMBI BD IG (CEMBI IG) has a duration of only 5.7 years.

Overall, based on the past 17 years, a portfolio of EM IG assets would have been superior to a portfolio of DM IG bonds, while diversifying a US IG bond portfolio by adding EM IG assets would have improved the total risk-adjusted return of a portfolio of DM bonds significantly.

Fig 4: **USD efficient frontier (June 2003 through August 2020)**

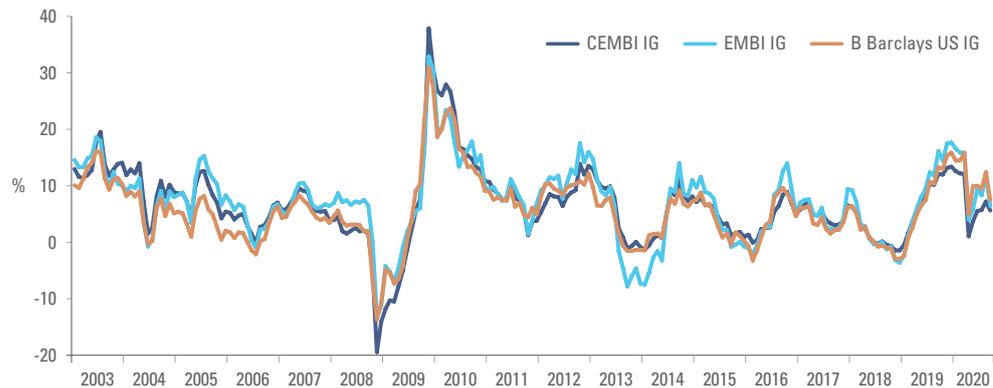


Source: Ashmore, JP Morgan, Bloomberg. Data as at August 2020. JP Morgan Indices except for Bloomberg Barclays Global Agg.

Diversifying a US IG bond portfolio by adding EM IG assets would have improved the risk-adjusted returns

Figure 5 highlights the consistency of returns of the asset class. Since 2009, the total return on a rolling 1-year basis of the CEMBI BD IG has been negative only on three occasions (Dec-2013, Jan-2016 and Nov-2018) and never below -1.5%. EM corporate IG outperformed US corporate IG in all the downturn episodes since 2002, except for 2008. Importantly, the asset class weathered the coronavirus shock test with outstanding marks. The CEMBI BD IG rolling 1-year total return was +1.0% in March 2020 and +4.0% for the EMBI GD IG, only a marginal underperformance compared to US corporate IG with a return of +5.0%. The high correlation between EM IG and US IG bonds – 85% since 2001 – is also evident from Figure 5.

Fig 5: 1-year rolling total returns (monthly data)



Source: Bloomberg, JP Morgan, Ashmore. Data as at August 2020.

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Forward looking prospects

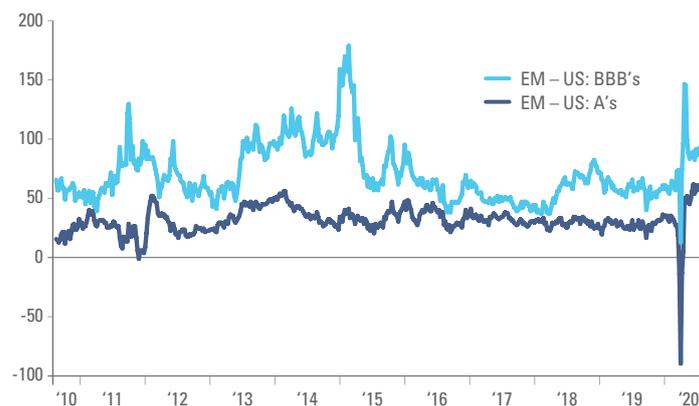
As per figure 6, EM corporate bonds offered 200bps of spread over UST at the end of August, which is almost 50% higher than US corporates (131bps). The higher spread for EM IG corporate bonds is not justified by leverage, which is almost identical for EM and US corporate bonds. Within EM regions EMEA offers the highest spread per turn of leverage (credit spread in basis points divided by the debt/EBITDA ratio) owing to lower leverage ratios and similar spreads to Latin American IG rated bonds. Figure 7 illustrates the current spread differential of A-rated EM corporate bonds and US corporates, which is close to the widest level in 10-years, while the EM-US BBB spread differential is close to the 10 year average, but still somewhat elevated.

Fig 6: Spread per turn of leverage (bps)

Region	Gross leverage	Spread	Spread per turn leverage
US Corp	3.0x	131	43
EM Corp	3.1x	200	64
LatAm	3.1x	239	78
EMEA	2.0x	222	112
Asia	3.6x	176	49

Source: BAML, Ashmore. Spreads as at August 2020. Leverage as at December 2019.

Fig 7: EM IG-rated corporate bonds versus US corporate IG-rated bonds: spread differential in bps, by rating



Source: BAML, Ashmore. Spreads as at August 2020. Leverage as at December 2019.

A-rated EM corporate bonds offers the widest spread differential to US Corporates in 10-years, while the EM-US BBB spread differential is still somewhat elevated

EM IG bonds will naturally benefit from 'low for longer' yields on government bonds and should experience spread tightening

Monetary policy tailwinds

The coronavirus-induced recession forced governments and central banks across the world to implement extraordinary fiscal expansions and monetary policy easing, but particularly in developed economies. DM central banks are no longer in the business of merely supporting economies with rate cuts and purchases of government debt securities. Rather, the Bank of Japan (BOJ), the European Central Bank (ECB), and the US Federal Reserve (Fed) have now expanded their purchase programmes to also include large volumes of corporate debt. Furthermore, the BoJ has capped the yield of the 10-year Japanese government bond at around 0% in a bid to control the term structure of the yield curve. So far, the Fed has refrained from adopting a policy of explicit yield curve control, but has instead opted to allow inflation to increase above its 2% target before tightening monetary policy, which may nevertheless be a precursor for future yield curve control if the curve bear steepens in response to inflation in the future. In any case, it seems likely that term yields in the US will be limited to the upside for the foreseeable future.

This environment should suit EM investment grade bonds. They will naturally benefit from 'low for longer' yields on government bonds and should experience spread tightening. In fact, in our view, it is not farfetched to imagine EM IG spreads to trade at similar levels to DM IG spreads, given the better credit fundamentals in EM. Reacceleration of EM growth in the next few years should be of benefit to both sovereigns and corporates, since higher relative growth means greater improvements in leverage ratios.

Risks

Investors in Dollar-denominated IG-rated bonds face two principal risks. The first risk is that the Fed loses control of inflation expectations, which could force a sharp U-turn on monetary policy and rising rates. This situation could arise from a failure on the part of the US government to reign in large fiscal deficits over a multi-year period, forcing the Fed to keep buying government bonds to fund the deficits. The inflation picture would deteriorate faster if higher commodity and/or durable goods prices ensue in response to a weaker Dollar or renewed trade war. This would send term yields higher across all fixed income securities, leading to significant losses to holders of long duration IG bonds.

The second risk pertains to ratings downgrades. Over the last five years, several EM countries were downgraded to sub-IG, including Azerbaijan, Bahrain, Brazil, Oman, Turkey and South Africa. This resulted in a less diversified but more resilient universe as the remaining IG-rated sovereigns and corporates are less likely to be downgraded, in our view. At present, six countries could be downgraded to junk status over the next years, namely Colombia, Romania, Kazakhstan, Russia, and India, which are rated BBB- or equivalent by at least two rating agencies, whereas Morocco has one junk rating (Ba1 by Moody's) and two IG ratings (BBB- by S&P and Fitch). These countries combined represents 21% of the JP Morgan EMBI GD IG Index and 14% of the CEMBI BD IG. If all countries got downgraded, the number of countries would decline by 19 and 29 on the sovereign and corporate benchmarks respectively. The asset class would remain highly investable and diverse even if all the countries above got downgraded.

Most EM countries are likely to fight hard to retain their IG status. Russia, for example, has pristine credit metrics, so that a downgrade would have to be justified solely on political grounds. Romania, Kazakhstan, and Morocco have strong balance sheets and are currently taking measures to reduce their fiscal deficits and limit their indebtedness. The growth outlook for both India and Colombia are good and both countries finance their deficits primarily in local currency, which is clearly supportive for the ratings of their external debt.

Two main risks for the asset class:

- 1. the Fed losing control of inflation expectations;**
- 2. rating downgrades**

Appendix

Fig A1: **The EM IG-rated fixed income universe**

Date	Corporate IG Eurobonds (ex-Japan)				Sovereign	Total
	US IG	EU IG	EM IG (a)	Total	EM IG (b)	EM IG (a+b)
31 December 2000	1,119	349	32	1,500	28	61
31 December 2001	1,421	509	52	1,982	36	88
31 December	1,512	695	63	2,269	72	135
31 December 2003	1,648	1,005	85	2,738	92	178
31 December 2004	1,569	1,175	115	2,859	139	255
31 December 2005	1,468	1,057	143	2,668	153	296
31 December 2006	1,579	1,323	196	3,098	155	351
31 December 2007	1,789	1,592	220	3,601	163	384
31 December 2008	1,948	1,660	220	3,828	132	353
31 December 2009	2,145	2,140	287	4,572	143	430
31 December 2010	2,284	1,991	387	4,662	259	646
31 December 2011	2,453	1,940	456	4,848	276	732
31 December 2012	2,698	1,954	639	5,291	338	977
31 December 2013	2,965	2,002	778	5,746	405	1,183
31 December 2014	3,218	1,812	895	5,925	417	1,312
31 December 2015	3,741	1,747	821	6,309	372	1,193
31 December 2016	4,054	1,747	853	6,654	397	1,251
31 December 2017	4,336	2,140	948	7,424	453	1,401
31 December 2018	4,491	2,197	981	7,670	514	1,495
31 December 2019	4,686	2,418	1,059	8,163	572	1,631
08 August 2020	5,242	2,751	1,079	9,072	661	1,740

Source: BAML, Ashmore. Data as at August 2020.

Fig A2: **Credit migration rates**



Source: BAML, Ashmore. Data as at August 2020.

Calculation methodology: The numerator is the sum of net rating actions (upgrades minus downgrades) by issuer divided by three (number of rating agencies). The denominator is the total number of issuers. I.e.: -1.0 migration is equivalent to 1% of issuers downgraded by 1 notch or 0.5% of issuers downgraded by 2 notches.

Contact

Head office

Ashmore Investment Management Limited

61 Aldwych, London
WC2B 4AE

T: +44 (0)20 3077 6000

 @AshmoreEM

www.ashmoregroup.com

Bogota

T: +57 1 316 2070

Dubai

T: +971 440 195 86

Dublin

T: +353 1588 1300

Jakarta

T: +6221 2953 9000

Mumbai

T: +9122 6269 0000

New York

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