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EMERGING MARKET DEBT SERENITY IN THE SEARCH FOR YIELD

Despite lower default rates than in the U.S., emerging markets' valuations remain attractive in an uncertain context

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In addition to the uncertainty surrounding the acceleration of the epidemic in Europe and the United States, many emerging markets are facing significant macroeconomic, political and geopolitical difficulties that are weighing on the rebound of certain assets. This is notably the case in Ukraine, where the political problems are threatening the continuation of the IMF's funding programme; in Argentina, where following successful restructuring, new capital controls aiming to limit the depletion of currency reserves have given rise to considerably greater uncertainty; or Turkey, where the weakness of the currency is a source of concern and where geopolitical tensions are accumulating.

These macroeconomic difficulties rarely remain confined solely to the level of sovereign debt. Corporate debt, even with solid credit fundamentals, is often affected by the domestic situation. Therefore, in environments of uncertainty, selecting companies with very specific characteristics can generate investment opportunities, and lead to the discovery of companies with credit ratings unjustifiably limited by the sovereign rating. These company and market specific characteristics are described below and provide serenity in the search for yield amid a tumultuous context.

First, companies' solidity and ability to adapt generally take precedence over the sovereign challenges over the medium term. In uncertain environments, selecting companies with low debt, significant liquidity and clear governance, is, among other things, a way to get through crises. Investments in bonds issued in dollars only also limits currency risk and encourages a selection of companies with a significant share of exports and thus revenues in dollars that can cover debt repayments in hard currency. Therefore, in countries such as Argentina or Turkey, the selection of companies in the industrial or energy sectors is for example very suitable, due to the high levels of exports and cash flows in dollars. In some sectors, such as air transport for example, the companies sought after are those that adapt to a new environment with agility. This was notably the case in Brazil, where certain airlines drastically cut their costs, renegotiated their leasing contracts, and reduced their investment spending to avoid defaulting on their debt and even maintain a load factor of around 80%.

Moreover, certain fundamental indicators determine our general sensitivity to risk. For emerging corporate bonds this especially relates to the level of the dollar, commodity prices, monetary policies and the overall interest rate environment. Currently all of these indicators are positive. The weakness of the dollar, the historical easing of monetary policies and the widespread rise of industrial raw materials prices, with iron ore in the lead with an increase of +40% since the start of the year, contribute significantly to the solidity of emerging-market companies. On top of these major support factors are the lifting of the lockdowns in Latin America, the restart of activity in most emerging countries and the rise of confidence indicators.

These encouraging developments come at a time when corporate debt in some emerging markets still harbours significant catch-up potential. The high yield segment

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is posting one of the highest yields of the market with spreads of 590 basis points. The asset class is even more attractive because emerging high yield companies have low debt on average, less than in the US, and they have strengthened their balance sheets in the past years, resulting in moderate expected default rates, of 3.5% in 2020, below the US default rate expected at 6.5%. Having been accustomed to operating in crisis situations, emerging companies have become more resilient and agile. The risk and reward profile of the asset class therefore remains particularly attractive.

Thus, in addition to the fundamental catalysts of the emerging corporate debt market being activated, the selection of companies with the ability to navigate through rough waters and generate sustainable returns is a way to participate in a catch-up movement that is still significant in some regions. Lastly, as the low-yield environment is expected to persist over an extended period of time in developed markets, investors could be seeking higher-yielding securities in the short/medium-term. Corporate emerging debt could be among the main beneficiaries.

[1] JP. Morgan, "EM Corporate Default Monitor", 13.10.2020

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