Investment View

Opportunities in Emerging Markets Corporate Debt

Warren Mar, Portfolio Manager for the Emerging Markets Corporate Debt Strategy, discusses the characteristics of the asset class, specific areas of interests and the effect of recent macroeconomic events on the sector.

Why should investors consider investing in emerging markets corporate debt?

Warren Mar (WM): An allocation to emerging markets (EM) corporate debt can provide an attractive opportunity to add diversification and enhance returns to fixed income portfolios. The financial crisis of 2008-09 and the recent sovereign debt problems in Europe have demonstrated the importance of portfolio diversification1, away from core markets. EM corporates not only exhibit a different risk profile to the developed world, but the sector is diversified amongst itself. These differences include country, region, industries and credit quality. As such, an EM corporate portfolio can help reduce regional and idiosyncratic risks while also benefiting from differences in business cycles across regions.

We believe that EM corporate debt provides investors with the opportunity to capitalise upon the growth of private sector companies as they become leaders in the domestic market and relevant in the global arena. We believe that the emerging markets are in the midst of a multi-decade convergence process towards developed market status, driven by a diverse array of dynamic companies.

1 Diversification does not eliminate risk of loss.
Over the last decade, EM economies have benefited greatly from macroeconomic stabilization and liberalisation of trade and financial markets. Developing governments have made significant progress in areas such as strengthening property rights, reinforcing legal frameworks and improving creditor rights. Many of these EM countries have been able to increase their access to the international markets for both debt and equity, broaden their investor base and extend their maturity profiles. In several instances, EM corporates have grown to become global leaders in their respective sectors and we believe that an allocation to the market provides the opportunity to benefit from this transformation.

**Do you think that EM corporate debt has the attributes to be considered as a fixed income asset class in its own right?**

**WM:** We think this is actually true today. The EM corporate bond stock currently stands at over $1.6 trillion USD.\(^2\) The asset class has grown over 162 percent over the past five years, making it the fastest growing sector within fixed income over that time period.\(^3\) Relative to other asset classes, the size of the EM corporates universe is greater than other segments of the global credit markets, including the U.S. high yield market ($1.3tn) and EM external sovereigns ($760 billion).\(^4\) Given this size and scale, the EM corporate sector is now attracting strategic rather than just tactical flows from the investment community.

The growing relevance of the EM corporate sector as an investible universe has been reinforced by the establishment of the JP Morgan Corporate Emerging Markets Bond Index (CEMBI). Introduced in 2007, the CEMBI was created in response to investor demand for a representative benchmark for the asset class, and is comprised of U.S. dollar-denominated EM corporate bonds. The creation of the JP Morgan CEMBI greatly helped market recognition, providing legitimacy to the asset class. The development of the index led investors to think about EM corporate debt differently; investors began to consider the universe globally and defined it as an asset class in its own right.

We believe that the EM corporates sector will continue to offer absolute and relative value as the EM corporate market evolves. EM countries continue to benefit from attractive demographics, such as population growth and the emergence of the middle class, and larger labor forces, which will continue to drive domestic demand and economic output.

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\(^3\) Source: JP Morgan. As of March 31, 2015.


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**What exposure does EM corporate debt have in the asset allocation mix globally? Do you see a trend developing?**

**WM:** The allocation to EM corporates is still relatively small; however, this has been steadily increasing in the aftermath of the global financial crisis. This said, according to J.P. Morgan, U.S. institutional investors, for example, still remain significantly underweight to both EM investment grade (IG) and high yield (HY), and as highlighted in the three following charts, are not taking advantage of the potential benefits of adding EM corporate debt to global corporate, IG corporate, and global aggregate (sovereign & corporate) portfolios. Recent surveys suggest that IG investors currently have 4.5 percent of their portfolios in EM vs. the 11.2 percent benchmark weight in JP Morgan’s IG Index, while HY investors have a 3.7 percent allocation to EM vs. a 12 percent weight in JP Morgan’s Global High Yield Index.\(^5\)

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Display 1: Global Corporates: 15 percent allocation to EM corporate debt added 23 basis points of return while reducing standard deviation 4 basis points per annum.

**Efficient Frontier: EM Corporates & Global Corporate**

![Efficient Frontier Chart](chart.png)

The hypothetical asset allocation shown is provided solely for illustrative purposes only. Past performance does not guarantee future results. The indices do not depict the performance of a specific investment. These hypothetical asset allocation results have certain inherent limitations. See page 7 for more information.

Source: MSIM, JP Morgan. Annualized 10-year data from April 1, 2005 to March 31, 2015. Note: Global Corporate represented by the Barclays Aggregate Corporate Bond Index, EM Corp. represented by the JPM CEMBI Broad Diversified Index.

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OPPORTUNITIES IN EMERGING MARKETS CORPORATE DEBT

Display 2: US IG Corporates: 15 percent allocation to EM Corporate IG Debt added 6 basis points of return while reducing standard deviation 1 basis point per annum.

Efficient Frontier: EM Corp. IG & US IG

The hypothetical asset allocation shown is provided solely for illustrative purposes only. Past performance does not guarantee future results.

Source: MSIM, JP Morgan. Annualized 10-year data from April 1, 2005 to March 31, 2015. Note: US IG represented by the Barclays Aggregate US IG Corporate Bond Index, EM Corp. IG represented by the JPM CEMBI Broad Diversified IG Index.

Display 3: Global Aggregate (Sovereign & Corporate): 20 percent allocation to EM corporate debt added 58 basis points of return while reducing standard deviation 2 basis points per annum.

Efficient Frontier: Global Aggregate

The hypothetical asset allocation shown is provided solely for illustrative purposes only. Past performance does not guarantee future results. See page 7 for more information.

Source: MSIM, JP Morgan. Annualized 10-year data from April 1, 2005 to March 31, 2015. Global Agg. represented by the Barclays Global Aggregate Bond Index, which is comprised of about 2/3 Government & Gov. Related issuances and 1/3 Credit issuance. EM Corp. represented by the JPM CEMBI Broad Diversified Index.

What areas of EM corporate debt do you find interesting at the moment? Conversely, are there areas you seek to avoid?

WM: We concentrate on identifying countries that are experiencing positive fundamental change. Our long-term mind set focuses on recognizing companies that exhibit unique features such as positioning to benefit from the EM middle class, growing to become market leaders within a given country or sector and developing into global market leaders that display defensive market niches. This may be through an allocation to EM corporates in countries experiencing positive fundamental change driven by positive reforms at home, for example, Mexico, India and Indonesia. Alternatively, we may select credits from those countries that we expect to deliver above-trend growth.

In terms of what we seek to avoid, we tend to have limited exposure to credits domiciled or exposed to weaker jurisdictions such as Ukraine, Argentina and Venezuela. While we do not seek to avoid investment in countries that are under stress, we consider investments in countries such as Brazil and Russia, for example, carefully.

Display 4: EM Corporate Bond Stock By Rating

What do you see as the chief risks of the Emerging Markets Corporate Debt sector?

WM: There are a number of current headwinds buffeting EM that broadly include: growth challenges, low commodity and energy prices, political and geopolitical event risk and FX weaknesses. However, these challenges to EM’s macro story come at a time when the majority of EM sovereign balance sheets and fiscal balances have the ability to withstand such a period of uncertainty. Yes, there are still those more vulnerable countries within EM that exhibit the old-style characteristics of EM, but we believe that such instances are the exception rather than the rule and the risks of contagion remain low.

A common misconception that investors appear to have regarding EM corporates is that the asset class is of non-investment grade quality. As the asset class has evolved, the credit quality has improved substantially. Over 65 percent of the
asset class currently is of IG status (See Display 4). Default rates within the high yield segment of EM are comparable to other high yield asset classes, and are forecast to remain moderate in 2015 reflecting idiosyncratic situations rather than systematic-driven failures. Although we might see ratings actions as a result of the current headwinds, which may see newly crowned IG sovereigns slipping back down to speculative grade, this is far from the “balance of payments” crisis that have followed previous weaknesses in EM growth and currencies. In fact, in our view, we believe that the current weaknesses may create value for investors with a medium to long term outlook.

The fall in systemic risks is important to acknowledge and understand as commentators increase the rhetoric around the EM corporate debt sector’s vulnerability to two separate but related topics: one, the rapid expansion in the asset class; and two, currency volatility given the build-up in USD debt. While we share some concern for marginal borrowers that have benefited from the dollar liquidity provided by the zero interest rate and QE policies in developed markets since 2009, overall we believe that systemic risks are overstated. We believe that the expansion of the outstanding bond stock has been more about liability management and capex, the pick-up in quasi-sovereign borrowing activity and the natural expansion of the issuer universe rather than opportunistic borrowing that has led to a significant deterioration in leverage. On the currency front, we also believe that the concerns over the EM corporate sector’s vulnerability to FX need to be balanced by a better understanding of country and sector characteristics. The majority of EM issuers either have revenues in hard currency or currency hedges in place. We actually have the benefit of witnessing first-hand the impact of EM currency volatility on the EM corporate sector in 2013. While many of the major currencies lost 15 to 20 percent of their value that year, it did not directly lead to a rise in default rates.

**Given the prospect of rising rates in the U.S., the recent decline in oil prices and quantitative easing (QE) from the ECB, the backdrop for fixed income is challenging. How do you expect these events to impact EM corporate credit?**

**WM:** EM corporates cannot be classified as a homogenous asset class. Different risk factors will impact each country and sector in different ways. For example, you cannot make the argument that the recent decline in energy prices is bad for all emerging markets. Almost half the countries within the EM universe are net energy importers and will stand to benefit from this change, helping Asia in particular. Lower oil prices help to improve their external positions and ease the fiscal burden of fuel subsidies, common in the region.

Notwithstanding the headwinds facing the global credit markets, we believe that a combination of a more aware Federal Reserve focused on managing the transition to higher rates without causing another “taper tantrum”, and the effects of QE across Europe and Japan will continue to underpin USD credit markets, including EM credit. We believe that positive real yielding assets may stand to benefit from unconventional policy action (Display 5) resulting in a positive outlook for the EM corporates sector.

**Display 5: Positive Real-Yielding Assets May Stand to Benefit from Unconventional Policy Easing**

Past performance is not indicative of future results.
Each of the fixed income categories shown are subject to certain risks. See page 7 for discussion of these risks.

Source: Bloomberg, MSIM. As of January 31, 2015.

Provided for illustrative purposes only. Note: Real yields are the nominal yield of the asset less country specific CPI inflation (U.S. = 1.6%, GER = 1.4%). Dividend yields are viewed as real because inflation is already netted out. External Debt represented by the JPM EMBI Global Index, Domestic Debt represented by the JPM GBI-EM Global Index, and Corporate Debt represented by the JPM CEMBI Broad Index. DM Global Govt. Ex-US represented by the JPM GBI Global Index, HY Corp represented by the JPM High Yield Index, US Equity represented by the S&P 500, EM Equity represented by the MSCI EMF Index, Japan 5 year Government Bond, U.S. 5Y represented by 5-year U.S. Treasury bond, DEM 5Y represented by German government 5-year bond.

**You have invested in EM corporate debt for over twenty years. What holds your interest in the asset class?**

**WM:** I was extremely fortunate to have fallen into EM at a very early stage of my career. Accepting a posting to Asia in the mid-1990s turned out to be one of the most formative periods of my professional life, exposing me to events that continue to serve as an important reference point to managing risk across global EM today. Although the asset class has come a long way in the past 20 years, the rate of change has not been even or consistent across all segments of the market providing an array of risks and opportunities to exploit and avoid. The ability to assess and invest in the EM corporate sector based on personal experience provides the opportunity to understand the importance and future of emerging markets in the global economy.

The product range continues to advance; opportunities and risk constantly change and evolve: market size, the investable universe (including countries, sectors and issuers), and the market structure. For example, I can see a time when EM debt becomes a predominantly local currency business reflecting the rise of institutional investors in emerging markets.
I enjoy the fact that there is always something changing, there is always something new to understand. There are still a number of iterations to play out before this becomes a boring asset class. Eventually the market will develop to become homogenous, the dislocations that are currently present will fade and the market will converge. However, the sector is nowhere near this stage. As long as the emerging markets continue to evolve, opportunities will exist.

**What major lessons have you learned over the years and how has this shaped your investment approach?**

**WM:** Recent events have reinforced what I learned a long time ago, that meeting management face-to-face is not an option, it is a must. There is no substitute to physically seeing where and in what you are investing with your own eyes. The use of company visits allow us to evaluate the risks more fully than those indicated on the financial statements. Our analysts won't just sit at their desks and build a model based off financial statements to build up a picture. They want to add color to the picture through first hand analysis. I think a major competitive advantage to our approach is that we are dedicated EM Corporate investors and we focus all of our resources to understanding this segment of the credit markets.

Over the years, I have had the opportunity to learn about the drivers of EM crises, how they start, spread and play out and what this means from a risk management perspective during a crisis period. This prior experience becomes particularly valuable when the emerging markets are facing a number of headwinds, as currently, and it is necessary to determine how these factors will affect EM corporates.

Another key point I have noted from my experience is that the ability to pay and the willingness to pay do not always go hand in hand. Considering the fact that I have been an investor in the markets for over 20 years, I think it is interesting to observe the differences in the emerging markets today and 20 years ago. In previous times, a country in crisis would often have fallen into default, but today they are better positioned to withstand external shocks and have resources and time to react and implement necessary reforms.
About the Author

WARREN MAR
Managing Director

Warren is portfolio manager and head of Emerging Markets Corporate Debt strategy. He joined Morgan Stanley in 2012 and has 20 years of investment experience. Prior to joining the firm, Warren was the global head of Emerging Markets Corporate Research & Strategy at J.P. Morgan Chase. During his time at J.P. Morgan Chase, Warren was part of the leadership team that created the J.P. Morgan Corporate Emerging Markets Bond Index (CEMBI) Broad Diversified, which has become the recognized and most widely used market benchmark for the asset class. Under his leadership, the team ranked #1 in Euromoney’s Fixed Income Research Poll for each of 2010, 2011 and 2012. Previously, he has worked in a number of global locations and has held positions at Investment New Zealand, BNP Paribas and Riyad Bank. Warren received a Bachelor of Commerce from the University of Auckland.

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