TCW

INSIGHT

An Update on the EM Corporate Bond Market

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Over the last decade, the growth, diversification, performance, relative valuations, and fundamental resilience of the Emerging Markets (EM) corporate bond market have solidified its place as a standalone asset class within global fixed income. Since 2009, the size of the USD-denominated EM corporate bond market has more than quadrupled from roughly $240bn to $1.1 trillion (trn)[1], while the U.S. corporate bond market has roughly doubled in size ($2.9 trn to $6.1 trn)[2]. The number of countries represented in the CEMBI has grown from 34 to 55 in the last decade, and the asset class has become increasingly diversified across sectors and issuers as well.

Chart 1: EM Corporate Gross and Net Annual New Issuance

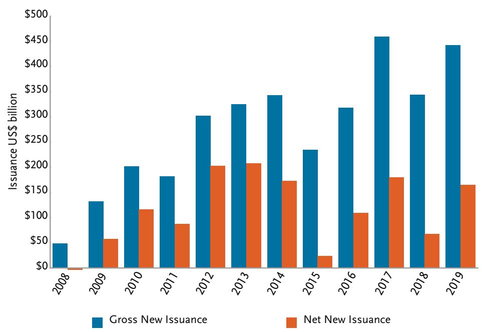
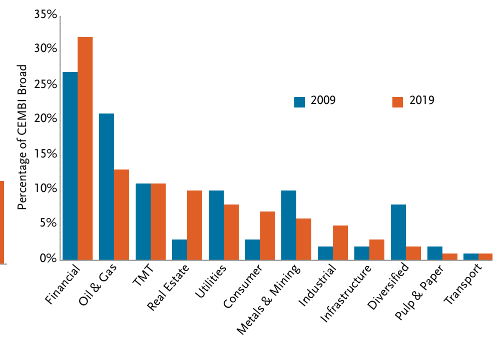


Chart 2: 2009 vs. 2019 Sector Composition of the CEMBI Broad



Source: TCW, Bank of America; As of November 29, 2019

Over the last five years, EM High Yield (HY) corporates have returned 36.5%, trailing only U.S. equities among major global asset classes and outperforming U.S. HY by over 500 basis points (bps). EM Investment Grade (IG) corporates and U.S. IG corporates have seen comparable returns over this period, up +26% and +27% respectively, with better Sharpe ratios for the EM IG asset class. At the same time, the broader EM corporate market (CEMBI BD), which is 58% investment grade and 42% high yield, has delivered comparable five year returns to U.S. HY (+30% vs. +31%), which has an average weighted credit quality of B+. In other words, investors did not have to dip down in credit quality to achieve comparable returns.

1 As of 11/29/19. EM corporate market size based on index-eligible debt in the JP Morgan CEMBI Broad Index.
2 U.S. corporate market size based on index-eligible U.S.-domiciled, USD-denominated debt in the Bank of America C0A0 & H0A0 indices.

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Ms. Goodly is the Portfolio Specialist for the TCW Emerging Markets and International Equities Groups. In this role, she serves as the primary liaison between TCW's Emerging Markets investment team and TCW's client relations and marketing professionals and is responsible for communicating investment strategies, performance and outlook to clients. Prior to joining TCW in 2013, Ms. Goodly spent eleven years at Morgan Stanley, most recently as an EM Fixed Income institutional salesperson. At Morgan Stanley, she also served as the Asia Credit Product Manager, marketing Asian credit products globally to the firm's largest institutional clients. In addition, she spent several years working as part of Morgan Stanley's Institutional Investor-ranked U.S. Credit Strategy research team. Ms. Goodly currently serves on the board of Consano and is an Ambassador for Girls Who Invest. Ms. Goodly graduated with a BA in Economics from Stanford University.

Christopher A. Hays
Vice President
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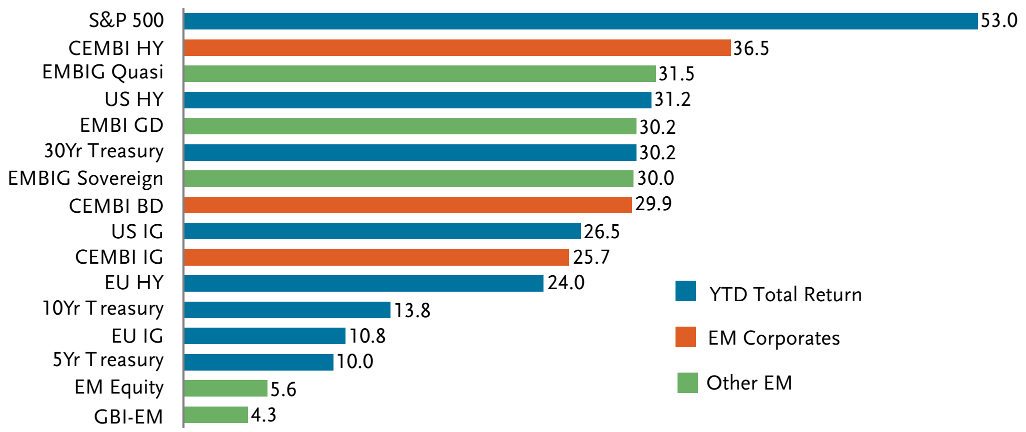
Mr. Hays is a Corporate Strategist for the TCW Emerging Markets Group. Prior to joining TCW in 2016, he was a Vice President at Bank of America Merrill Lynch, where he worked in research as an Emerging Markets Corporate Credit Strategist. In that capacity, he was responsible for constructing the firm's top-down views and forecasts for the global emerging markets corporate asset class. Chris graduated with a BA in Economics from Columbia University.

Chart 3: Five Year Total Returns (%)



Source: TCW, JP Morgan, Bloomberg; As of November 29, 2019

Fundamental Decoupling: Since Mid-2016, Leverage Has Fallen in EM and Risen to Cyclical Highs in the U.S.

There are some important fundamental differences between EM and U.S. corporates. Despite the growth in the asset class, EM corporate issuers have made significant progress in repairing their balance sheets in the aftermath of the 2014/2015 commodities price shock and slowdown in global growth. During the 2015-2016 period, EM corporate management teams cut capital expenditures, prepaid high coupon debt, and sold non-core assets to weather two years of negative growth in earnings. This conservative behavior allowed EM issuers to maintain liquidity, while largely refraining from adding additional debt to their balance sheets, and set the market up to deleverage meaningfully as global growth improved and commodity prices recovered from depressed levels beginning in 2016. U.S. corporate management teams took a different approach to the growth slowdown, taking advantage of cheap debt financing over the past decade to effectively buy the growth that has been absent organically, issuing new debt to fund historically high levels of share buybacks and M&A.

As such, U.S. and EM leverage trends have decoupled over the last several years. EM corporate balance sheets have significantly deleveraged over the past three years (mid-2016 through mid-2019) while U.S. corporate net leverage has risen to cyclical highs during this period (chart 5).

Recent earnings data shows the EM corporate market in the mid-to-late stages of the business cycle, with earnings (EBITDA) growth coming in marginally negative in each of the first two quarters of 2019 after a string of 10 consecutive quarters of positive YoY EBITDA growth. This turn was largely due to slowing global growth, along with lower commodity prices in the first half of 2019 relative to the first half of 2018. As a result, EM net leverage ticked higher in 1H19, but it still remains well below its mid-2016 peak, and also well below the average levels maintained by U.S. corporates[3].

Chart 4: Quarterly and 12 Month EM Corporate EBITDA Growth

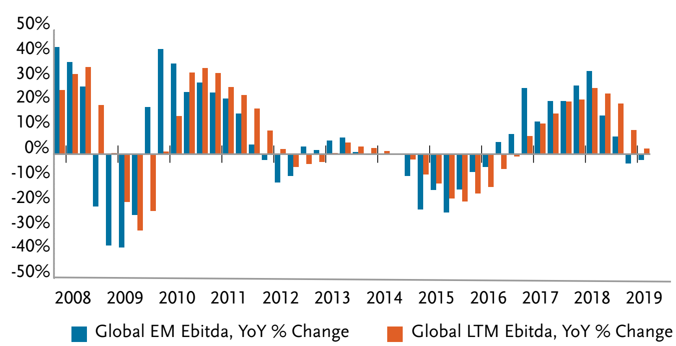
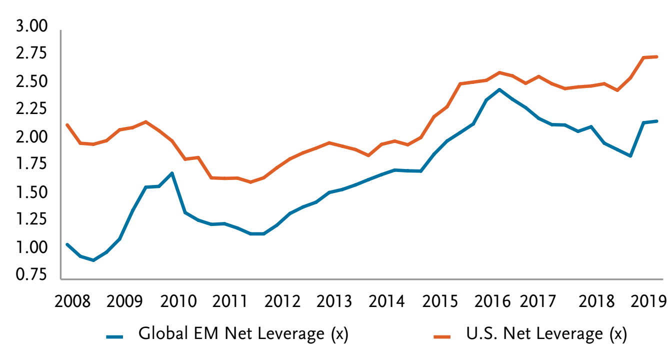


Chart 5: EM Corporate vs. U.S. Corporate Net Leverage



Source: Bank of America; As of 2Q 2019

3 The adoption of IFRS 16 – incorporating capital leases onto balance sheets – also drove an uptick in leverage in both the U.S. and EM (the accounting change increased reported debt levels). However, the primary drivers of the recent increase in leverage were more related to macroeconomic backdrop as mentioned.

The EM Corporate Bond Market is Higher Quality

EM investors have historically had little appetite for highly leveraged, low-rated corporate debt. For example, CCC-rated issuance in U.S. credit has totaled $342 billion over the last decade, which compares to the $9.2 billion worth of CCC-rated EM corporate debt that has been issued during the same period (chart 6). To put these figures into context, CCC-rated new issuance as a percentage of annual U.S. HY supply has ranged between 10-20% in most years over the past decade, whereas it has been at or close to 0% in all but two years since 2010 (chart 7). Furthermore, EM investors have historically been unwilling to fund weak capital structures or aggressive new issuance (buybacks, M&A, covenant-lite), and EM issuers have largely adjusted to this dynamic by managing their balance sheets more conservatively in turbulent times to avoid being shut out of international markets.

Chart 6: EM vs. U.S. Cumulative CCC-rated New Issuance (US$ BN)

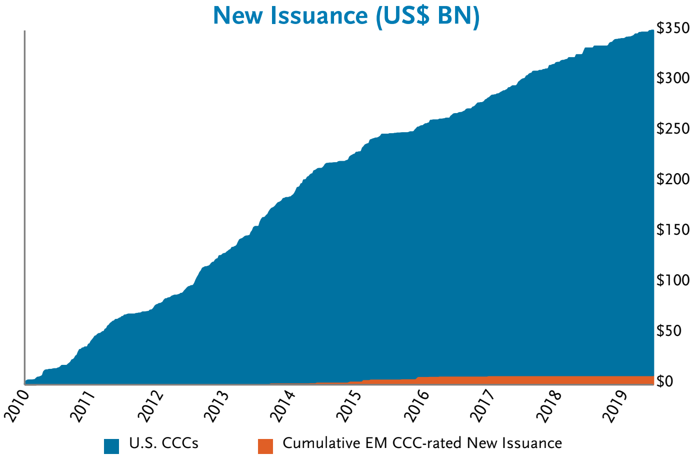
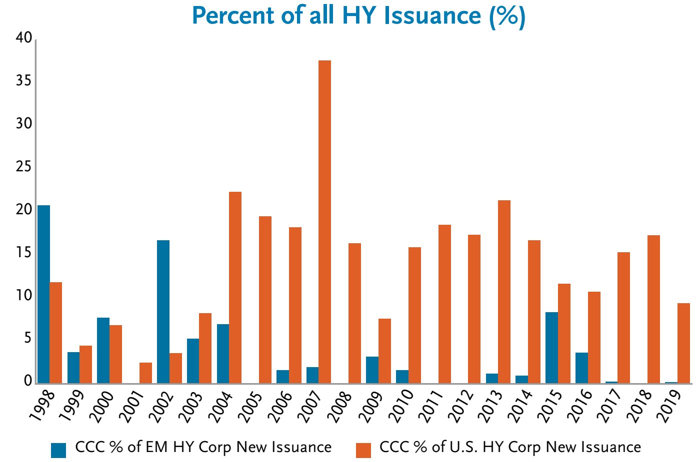


Chart 7: EM vs. U.S. Annual CCC-rated New Issuance as a Percent of all HY Issuance (%)



Source: TCW, Bank of America; As of November 29, 2019

The EM Corporate Bond Market is Less Volatile Than the U.S. Corporate Bond Market, in Both IG & HY

EM return volatility has been lower than U.S. return volatility for the past several years, both for investment grade and high yield. On the investment grade side, volatility has run at lower levels than in the U.S. for most of the post-Global Financial Crisis era with that advantage expanding even further since 2016 (chart 8).

Chart 8: EM IG vs. U.S. IG 52 Week Total Return Volatility

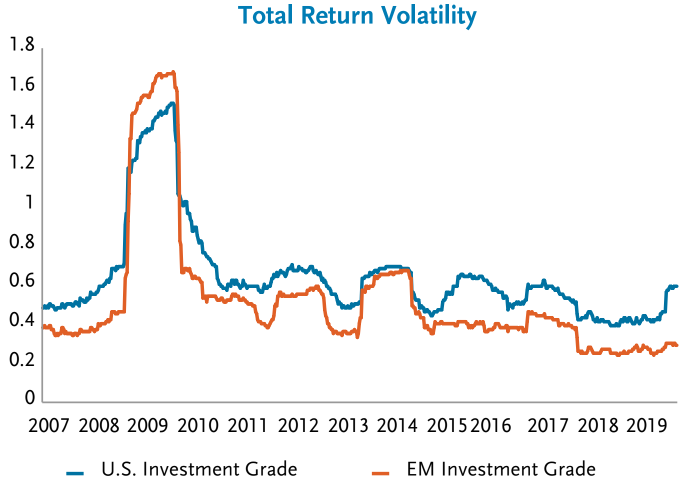
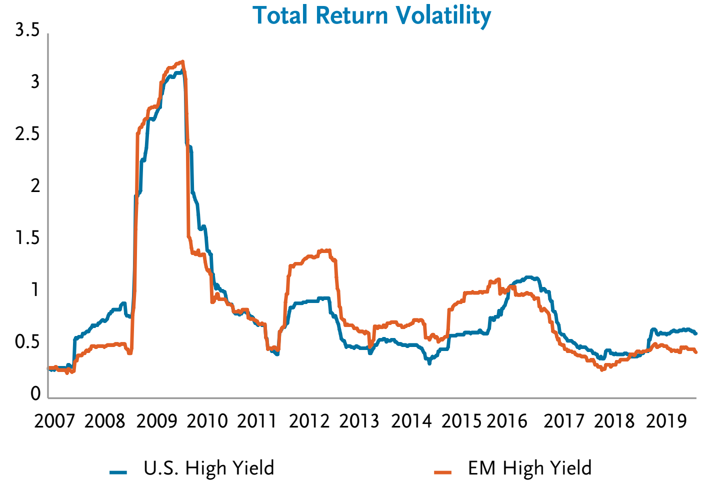


Chart 9: EM HY vs. U.S. HY 52 Week Total Return Volatility

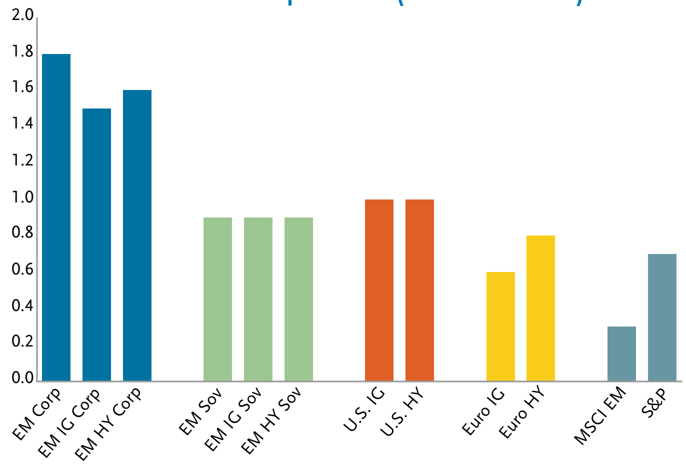


Source: Bank of America, As of November 29, 2019

The Best Sharpe Ratios in Global Fixed Income

As we highlighted earlier, five year returns of EM IG and U.S. IG corporates have been comparable, while EM HY corporates have returned investors about 500bps more than U.S. HY in the past five years. Taken together with the lower volatility of returns experienced by EM corporates, the five-year Sharpe ratios (2015-Present) of EM IG and HY corporates are well ahead of U.S. and European corporate markets.

Chart 10: Sharpe Ratios (2015 to Present)

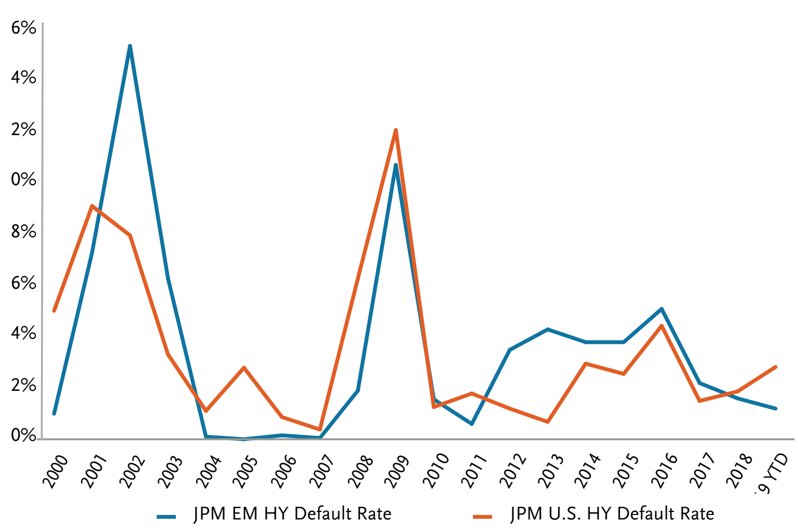


Source: JP Morgan; As of November 29, 2019

EM HY Default Rates Fall to 1.2% in 2019, the Lowest Level Since 2011

EM HY corporate default rates fell to just 1.2% in 2019, the lowest default rate for the market since 2011, and below the U.S. HY default rate for the first time since 2011 as well. We view this outperformance of EM HY versus U.S. HY in 2019 as a consequence of conservative balance sheet management in EM. At the same time, the recovery rates in both markets are similar.

Chart 11: EM HY vs. U.S. HY Annual Default Rates



Source: JP Morgan; As of December 31, 2019

EM Corporates Offer Investors Higher Spreads per Turn of Leverage Across All Rating Categories

Relative valuations between the EM and U.S. markets show a clear advantage for EM bonds. On an outright yield basis, U.S. corporate bonds yield 3.5% on average currently, which is the lowest absolute yield level for the market in the last decade. EM corporate and sovereign bond yields are in the 5% range and, while toward the tighter end of their last ten year range, remain above levels reached in late 2012/early 2013. On a relative basis, EM corporates trade with a +153bps premium to U.S. corporates currently, which is about +15bps wide to the 138bps decade average for the relationship.

Chart 12: EM Corporate, EM Sovereign and U.S. Corporate Historical Yields

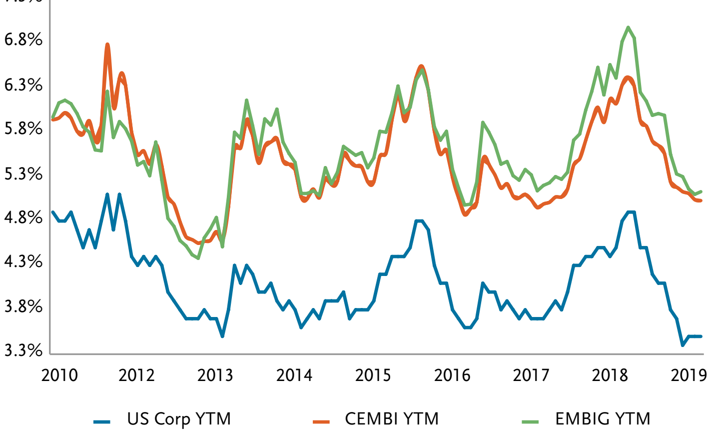
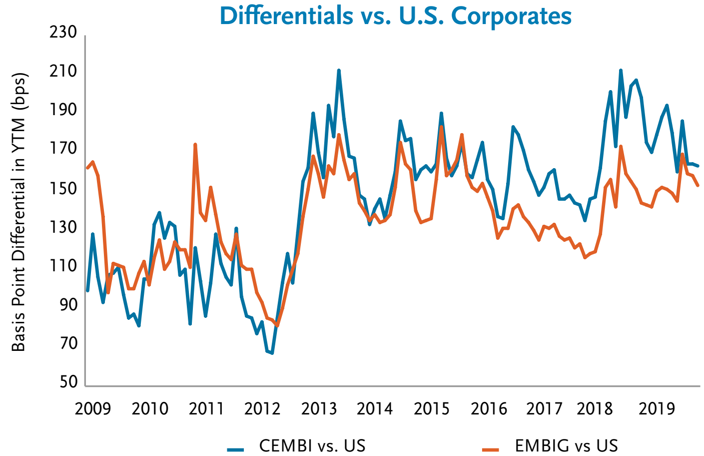


Chart 13: EM Corporate and EM Sovereign Yield Differentials vs. U.S. Corporates



Source: TCW, JP Morgan, Bank of America; As of November 29, 2019

Adjusting these relative value comparisons to reflect the fundamentals of each market, we look at spread levels in relation to net leverage. Investors are paid more than twice as much spread per turn of leverage to own EM corporates (130bps/x) compared to U.S. corporates (56bps/x) currently. Put differently, for every unit of a bond issuer's credit risk, investors are paid 75bps more, or 2.4x as much, lending to EM corporates versus U.S. corporates.

Chart 14: EM vs. U.S. Net Leverage by Rating Category

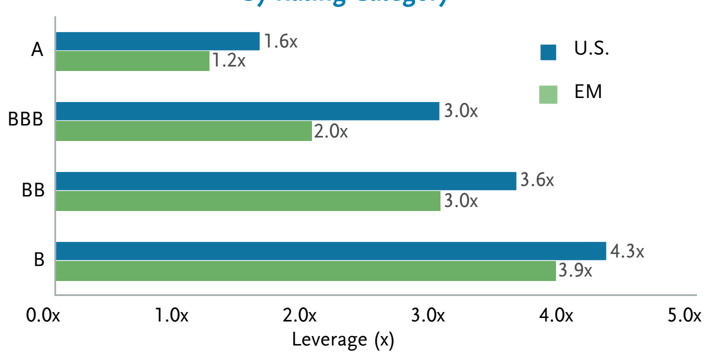
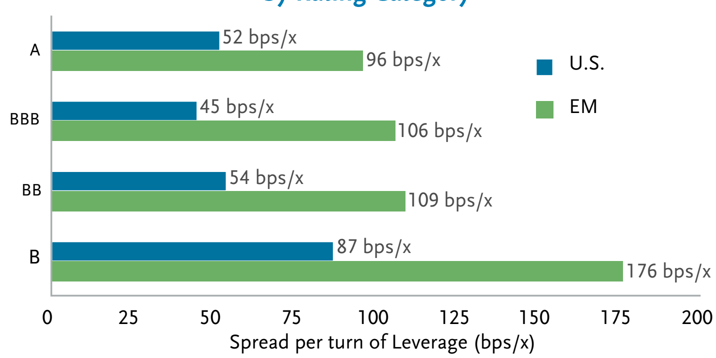


Chart 15: EM vs. U.S. Spread per Turn of Net Leverage by Rating Category



Source: Bank of America; Leverage as of 2Q19, Spreads as of November 29, 2019

This 2.4x spread per turn of leverage ratio (EM/U.S.) is the highest reading of the last decade for this relationship, indicating that current valuations in the EM corporate market, when adjusted for leverage, are the most attractive point relative to U.S. corporates over the last 10 years. This relationship also holds true across all rating categories, with EM net leverage being anywhere from a ½ turn to a full turn lower than that of same-rated peers in the U.S. from single-A to single-B (chart 14), while the spread per turn of leverage offered across all rating categories is about twice as much in EM than in the U.S. (chart 15).

Chart 16: EM vs. U.S. Historical Spread per Turn of Net Leverage

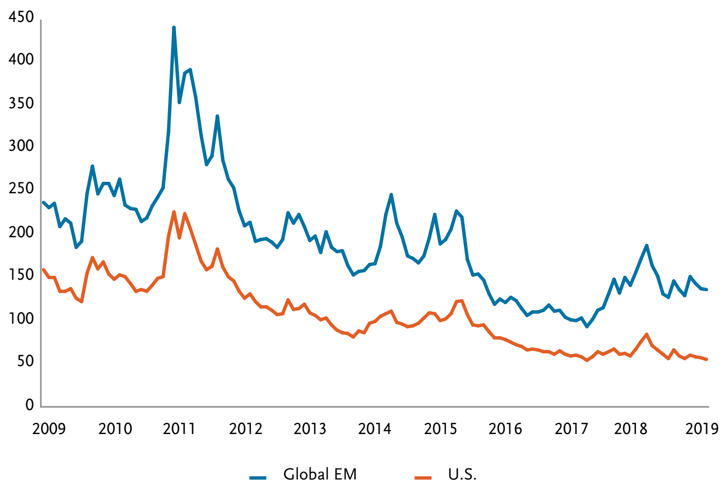
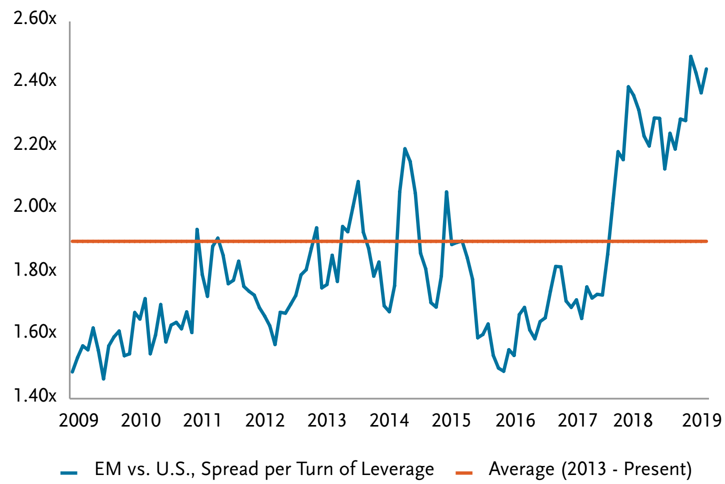


Chart 17: EM vs. U.S. Spread per Turn of Net Leverage Ratio



Source: Bank of America; Leverage as of 2Q19, Spreads as of November 29, 2019

Summary: The EM corporate market has evolved into a standalone asset class with opportunities across an increased number of countries and sectors. Relative to developed markets credit, the asset class provides both a pickup in credit quality and spread, in addition to more conservative issuance and lower volatility. Furthermore, an allocation to EM corporates, particularly in conjunction with EM equity exposure, can offer both yield enhancement and downside protection[4]. ■

4 Please see our white paper entitled A Balanced Approach to EM Investing 10-31-19, which demonstrates how the combination of EM debt and EM equity has historically outperformed a standalone EM equity allocation.