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INSIGHT

VIEWPOINT

Emerging Markets – Early to Mid Cycle

CHRISTOPHER HAYS | ANISHA GOODLY

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After several years of expansion, we are often asked where Emerging Markets are in the cycle, particularly in the context of the U.S. heading toward the later stages. If we consider early-cycle as the first year following a recession and late cycle as the year prior to a recession, then we would argue that the data points to Emerging Markets being in the late-early to early-midpoint stage in their business cycle while the U.S. is arguably in the later stage of its business cycle. The developed markets have been in recovery for 103 months while EM economies have been in similar mode for only 13 months. Why the disconnect? A number of EM countries suffered disproportionately in the aftermath of the taper tantrum and oil shock and spent the 2013-2015 period undergoing significant adjustments, both cyclical and structural. As a consequence, EM growth is now outpacing developed market growth, current accounts deficits have declined and investment flows have resumed. Given synchronous global growth, a more stable China, and an improved backdrop for commodities and trade, we see room for growth upside in EM, on both an outright basis and relative to developed markets. Furthermore, EM growth remains below trend, suggesting that higher levels of growth (ex-China) can continue without fueling a significant increase in inflation.

Looking at this from a bottom-up perspective shows a similar picture. Default rates in EM corporates have significantly declined (Exhibit 1) and fundamentals are improving. EM high yield corporate revenue growth re-entered positive territory in 2017, after running at the most negative levels since the Global Financial Crisis in 2015/2016 (Exhibit 2). This revenue growth comes after a multi-year period of "belt tightening" by EM management teams. EM issuers reined in their capex spending in 2015/2016 – capex as a percentage of earnings is now at cyclically low levels – and undertook a number of balance sheet strengthening exercises aimed at reducing overall debt levels and extending maturities. We are seeing signs of an increase in capex again in recent quarters, in line with improving cash flows, which suggests comfort with the growth outlook and investment prospects.

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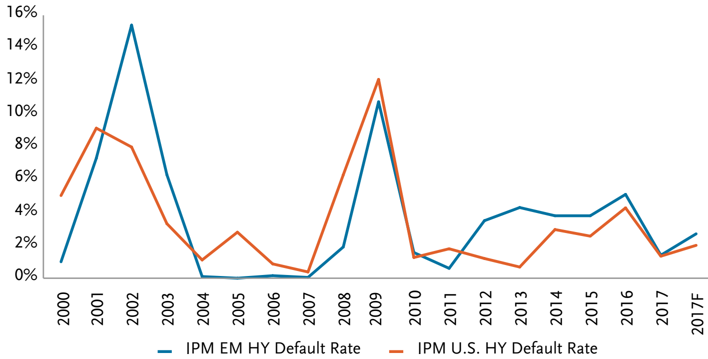
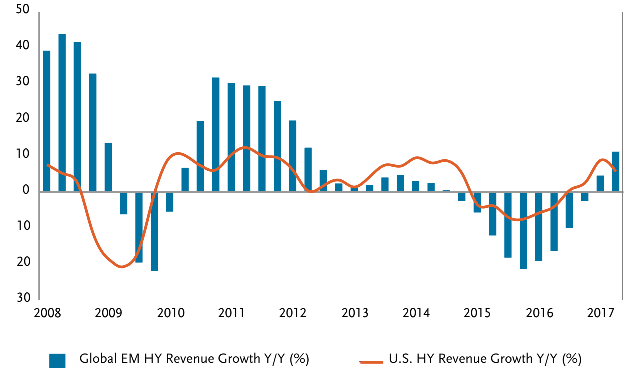
Exhibit 1: EM & U.S. HY default rates are in decline...



Source: JPM; Data as of December 31, 2017

Exhibit 2: ...as revenue growth is turning the corner

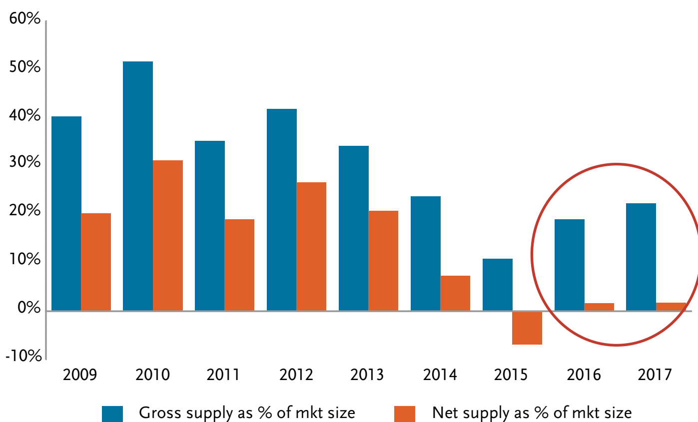


Source: BofA Merrill Lynch Global Research; Data as of June 30, 2017

In addition, we often hear investor concerns about the growth of the EM corporate market. It is true, EM corporates are the fastest growing segment within Emerging Markets debt. Since 2007, the asset class has nearly quadrupled from $330 billion to $1.5 trillion, making it larger than the $1.3 trillion U.S. High Yield market. That said, despite the increase in gross issuance, EM issuers have largely refrained from adding debt to their balance sheets. Instead, most gross new issuance over the past few years has been used to refinance near term maturities and improve debt maturity profiles. Corporate debt in China has increased, but this is more the exception than the rule and the growth in debt in China as well as corporate debt from other Asian issuers is supported by a strong local institutional bid. On the other hand, net issuance in Latin America and Europe has been only mildly positive in recent years (Exhibit 3), and is expected to be negative in 2018.

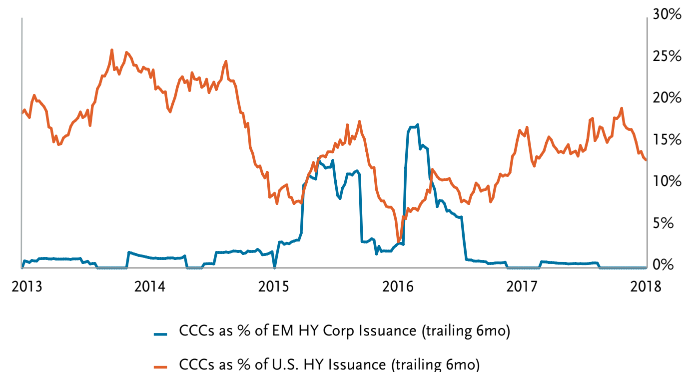
Moreover, we are not seeing a lot of covenant lite deals or the lowest quality issuers accessing the EM market (Exhibit 4). The U.S. HY market, for example, has seen CCC issuance as a percent of total U.S. HY supply rise to between 15-20% over the past year. **In EM, CCC issuance is near 0% of HY supply and more importantly, CCC issuers have historically represented less than 2% of total HY issuance, even when the new issuance market is strong.** This metric really only spikes due to a denominator effect (i.e. in risk-off periods when there is very little HY supply and one CCC is able to make it through).

Exhibit 3: Outside of Asia, EM corporate net supply is at historical lows



Source: BofA Merrill Lynch Global Research; Data as of December 31, 2017

Exhibit 4: EM issuance remains conservative and higher quality



Source: BofA Merrill Lynch Global Research; Data as of February 9, 2018

Given EM HY restraint on the new issue front, earnings growth is translating into clear deleveraging. Leverage is not only lower, but deleveraging is happening at a faster pace in EM HY than in the U.S. HY market (Exhibit 5). In addition, EM issuers have shown an ability to maintain liquidity even as cash flows have diminished in recent years. Cash, as a percentage of total debt, has risen gradually from 25% to nearly 30% for EM issuers in the past two years (Exhibit 6). To compare, U.S. HY issuers have seen a slow decline in their liquidity since 2015, with cash levels of about 10% of total debt most recently.

Exhibit 5: EM leverage is starting to decline, and more rapidly than in the U.S.

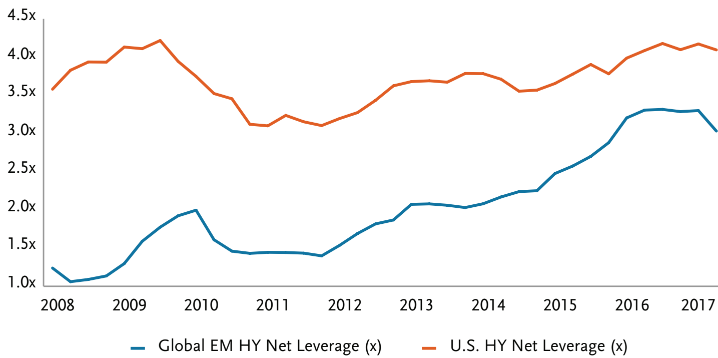
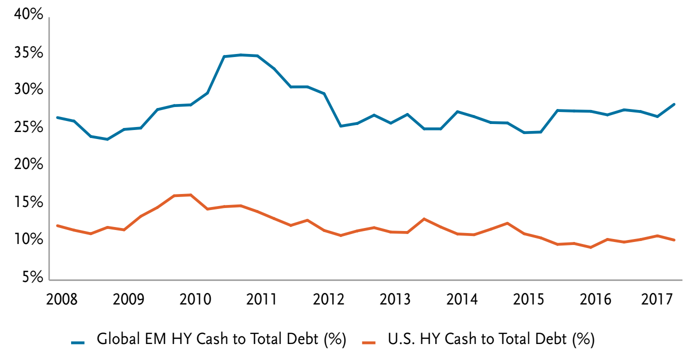


Exhibit 6: Cash is king for EM issuers



Source: BofA Merrill Lynch Global Research; Data as of June 30, 2017

Fundamentals for EM corporate issuers remain healthier than for those of their DM peers, and we believe EM investors are still being compensated better for the risks. EM corporate bonds trade +40-60bps wide to their same-rated peers in the U.S. on an outright basis, and adjusted for credit risk, EM bonds offer roughly 1.5-2x the spread per turn of leverage (SPL) across each rating category compared to their peers in the U.S. (Exhibits 7 and 8).

Exhibit 7: EM corporates are less leveraged than similarly-rated U.S. peers...

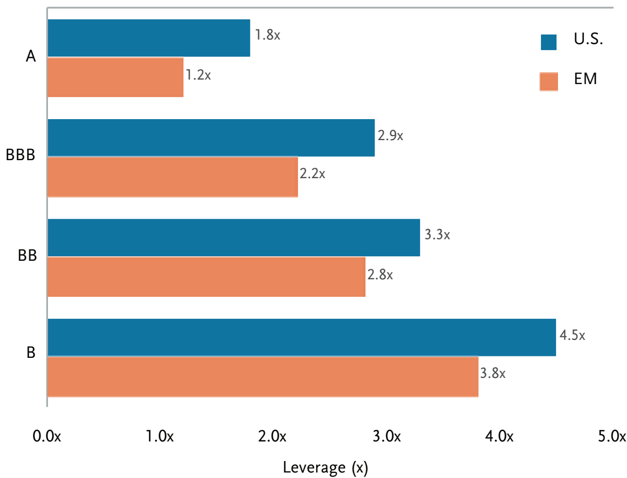
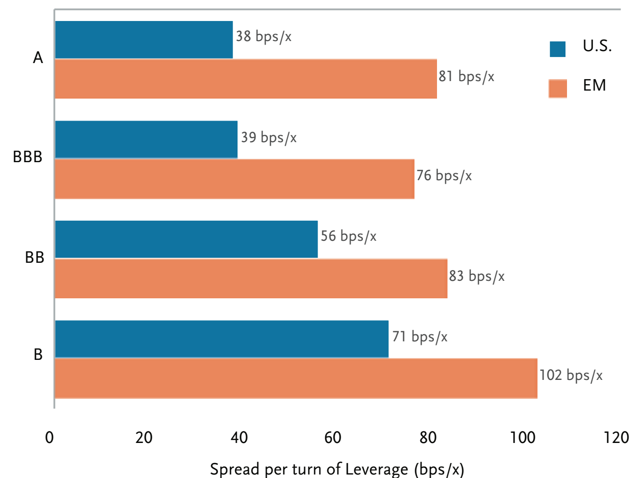


Exhibit 8: ...and EM investors are paid more for credit risk



Source: BofA Merrill Lynch Global Research; Data as of January 31, 2018

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While spreads and even SPL are at decade tights in both the EM and U.S. corporate bond markets, EM still looks attractive on a relative basis. On average, EM corporate bonds pay investors 100bps per turn of leverage (SPL), 2.1x that of U.S. corporates (Exhibit 9). This 2.1x premium compares to a 2013-present average premium of 1.9x, and is up from a level of 1.75x in mid-2016 (Exhibit 10).

Exhibit 9: EM has historically traded at a premium relative to the U.S....

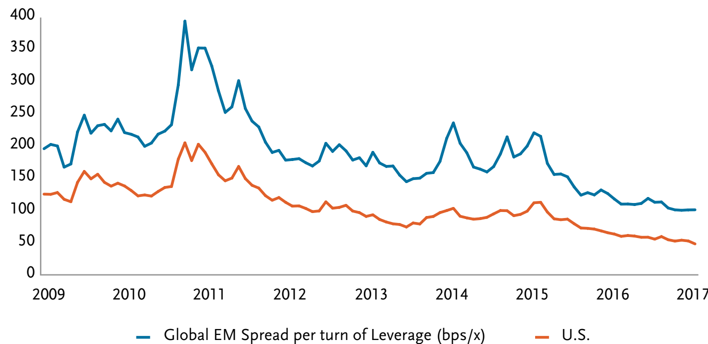
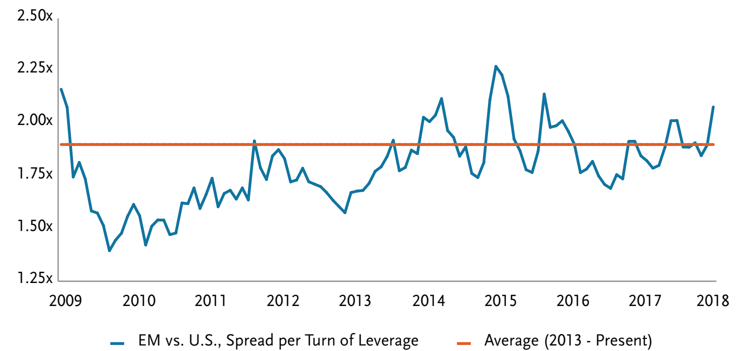


Exhibit 10: ...and now this premium is at historically attractive levels



Source: BofA Merrill Lynch Global Research; Data as of January 31, 2018

Bottom Line: From both a top-down and bottom-up perspective, the data suggest that Emerging Markets are in the late-early to early-midpoint stage in their business cycle. We see potential for growth upside at these levels that could present opportunities in both the sovereign and corporate markets. ■

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865 South Figueroa Street | Los Angeles, California 90017 | 213 244 0000 | @TCWGroup