TCW

INSIGHT

VIEWPOINT

Opportunities in the EM Corporate Bond Market

CHRISTOPHER HAYS | ANISHA GOODLY

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With approximately $1.5 trillion outstanding debt, Emerging Markets (EM) corporate bonds now represent approximately 15% of the hard currency global corporate bond market. While the EM corporate credit market is now larger than the U.S. high yield market, it remains an undercovered asset class, as it has only recently become large enough to be considered a standalone market. We believe it's time for investors to take notice. Since 2002, EM HY corporates have delivered annualized returns of 9%, placing it ahead of U.S. HY corporates, U.S. equities, and EM sovereign and EM investment grade corporate debt. During a challenging 2018, EM corporates returned -1.6%, outperforming U.S. Investment Grade and U.S. HY in 2018, which both returned -2.3%.

Not only have returns been strong in EM credit historically, but EM corporates also tend to be higher quality and less leveraged than global peers Many EM economies are in the early to mid- stages of their business cycles, whereas the U.S. economy is arguably entering the later stages of its business cycle. EM credit fundamentals continue to improve, with steady deleveraging driven by a combination of earnings growth, cash flow generation and conservative balance sheet management in recent years. Valuations appear attractive relative to developed market peers, with EM corporates trading 50-130 basis points (bps) wide to same-rated U.S. corporates on average. More importantly, EM corporates offer nearly twice the spread per turn of leverage at each ratings level compared to their developed market peers.

The size of the EM corporate bond market has more than quadrupled in the past decade from a size of about $340 billion in 2009 to roughly $1.5 trillion currently. Over the same period, the U.S. HY market has grown by about 70%, from $600 billion to its current size of about $1 trillion. This rapid growth has raised concerns among some investors over EM corporate indebtedness, and while these concerns are understandable, we believe they are overblown. There are certainly risks in some sectors and economies (China in particular), though in our view, the risks appear to be isolated, rather than broad based. Outside of China, the issuance has been driven by organic growth in the asset class, with the number of countries represented in the index[1] rising from 34 to 50 in the last decade, while the number of issuers in the market has jumped from approximately 200 to nearly 650.

1 JP Morgan Corporate Emerging Markets Bond Index Broad Diversified

Anisha A. Goodly
Managing Director
Emerging Markets Group and International Equities

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.

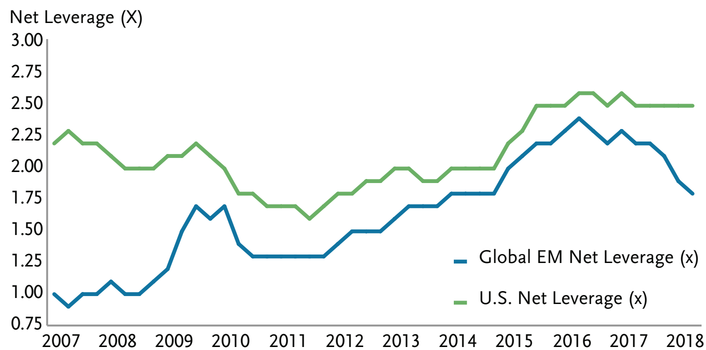
Christopher A. Hays
Vice President
Emerging Markets Group

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.

There are a number of important distinctions – related to both the fundamentals and valuations of the EM and U.S. corporate markets – that we believe are overlooked or misunderstood by many global investors and are worth highlighting. For example:

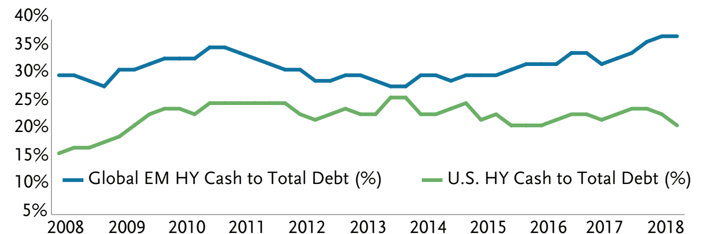
EM corporate net leverage (1.8x) remains well below that of U.S. corporates (2.5x) and has been falling at a faster pace. Furthermore, EM net leverage has been falling steadily over the past two years, whereas U.S. net leverage has held steady. For BBB and below rated credits, EM companies have on average **a full turn less leverage** than their peers in the U.S., which is substantial. In fact, EM companies tend to have comparable or better leverage ratios than even their U.S. peers rated one full notch higher.

These trends reflect more conservative balance sheet management by EM corporates. When earnings dipped across the globe from 2014-2016, EM issuers were unique in focusing on debt reduction and liability management. A rebound in earnings growth has fueled noticeable EM deleveraging, whereas U.S. corporate leverage remains at recent highs.



Source: BofA Merrill Lynch, Data as of June 30, 2018

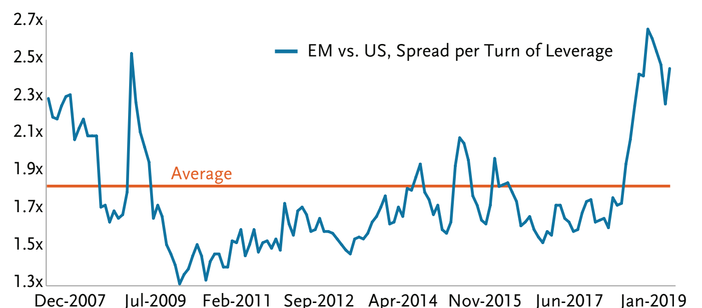
EM corporate liquidity remains exceptionally strong. EM corporate issuers have become predisposed to manage liquidity conservatively, having been through numerous periods of restricted access to international markets. For example, EM HY companies have over 30% cash relative to debt, compared to approximately 10% for U.S. HY companies. For investment grade issuers in EM, average cash to total debt levels are currently about 40%, compared to 25% for U.S. IG issuers.



Source: BofA Merrill Lynch, Data as of December 31, 2018

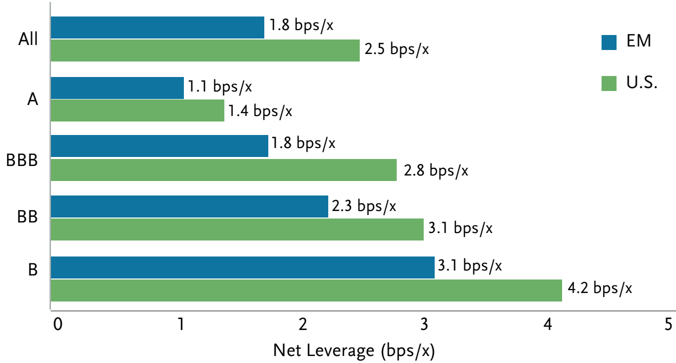
EM credit compensates investors better than U.S. credit. EM corporate bond spreads adjusted for issuer leverage[2] are currently compensating investors in EM debt at historically attractive levels compared to U.S. credit markets. The current ratio between EM corporate spread per turn of leverage and U.S. spread per turn of leverage is over 2x – a level last seen during the Global Financial Crisis. The ratio indicates that EM credit offers investors twice as much spread or yield than U.S. credit does for a similar degree of credit/default risk; in other words, investors can pick up spread and improve credit quality by investing in EM corporates. We see this trend across each ratings category.

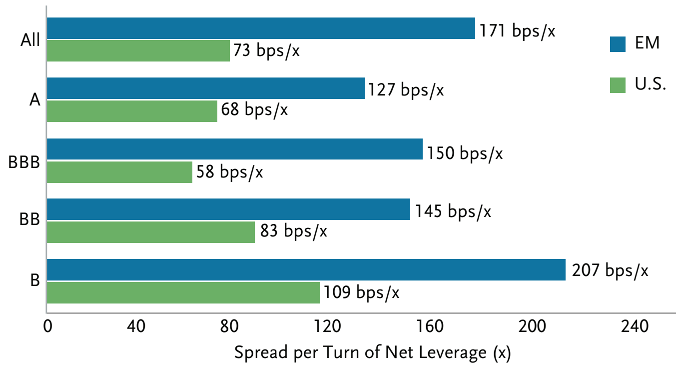
To be fair, we agree that some degree of premium is justified by factors such as 1) less developed bankruptcy regimes and 2) lower transparency/weaker corporate governance standards. That said, these factors have existed for EM investors since the advent of the asset class, and they have certainly improved over time. In fact, over the past decade, EM HY corporate default rates, recovery rates, and return volatility are nearly indistinguishable from the U.S. HY market (more below). Furthermore, recent trends in EM and U.S. credit fundamentals suggest further fundamental improvements in EM issuers relative to U.S. issuers. We believe the spread per turn of leverage premium between EM and U.S. corporates will gradually decline over time as the asset class further develops.



Source: BofA Merrill Lynch, Data as of December 31, 2018

2 Spread per turn of leverage is a metric measuring the amount of spread compensation per unit of leverage; i.e. how much investors are being paid for credit/default risk. The higher the ratio, the more spread compensation per unit of risk.

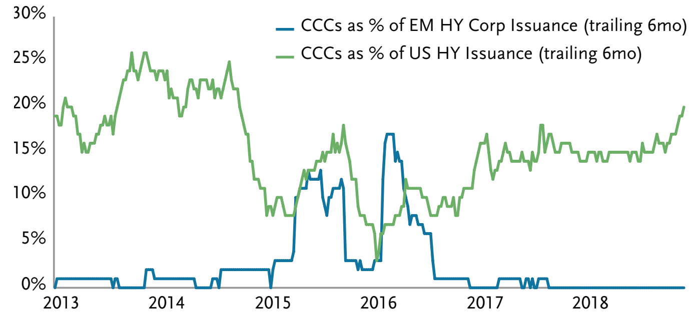




Source: BofA ML; Leverage Data as of 2Q 2018, Spreads as of: 12/31/2018

EM issuance tends to be far more conservative than U.S. credit. Close to 70% of the EM corporate bond market is rated investment grade. In addition, the EM market tends not to fund CCC issuers: in 2018, CCCs comprised 17.2% of U.S. HY new issuance, compared to 0% in EM corporate bonds. As such, the average credit rating of EM HY is BB-, compared to B+ for the U.S. HY market. In addition, we see the potential for additional dislocations in the U.S. HY market, given that current fallen angel[3] candidates would comprise almost 10% of the U.S. HY market if in fact downgraded to high yield. On the other hand, fallen angel candidates in EM would represent approximately 3.5% of the EM HY corporate market.

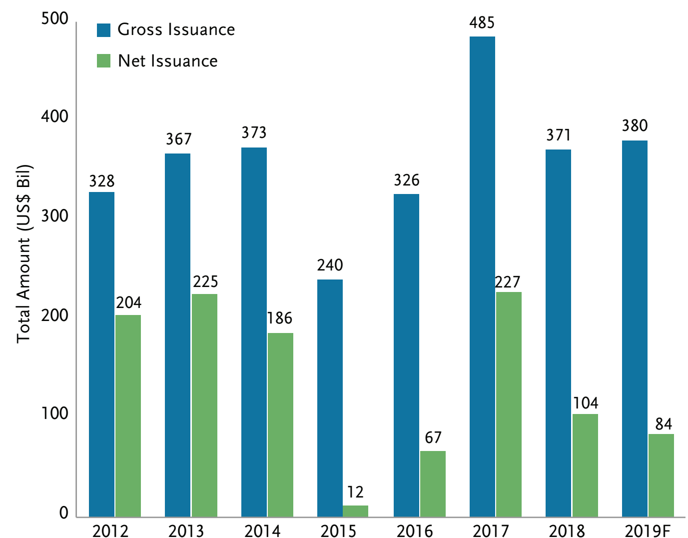
3 Fallen angels defined as investment grade rated bonds with a BBB- average rating and on negative watch/outlook by at least one rating agency.



Source: JP Morgan, Data as of December 28, 2018

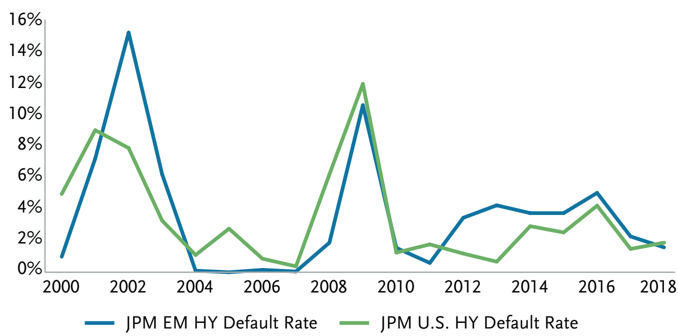
Furthermore, net new issuance for EM corporates has been minimal in recent years, as the use of proceeds has primarily been to take out existing debt. We would note that China has been the clear exception to this broader trend. China represents nearly 30% of all USD denominated EM corporate debt outstanding currently (34% of EM IG; 19% of EM HY). Year-to-date, Chinese corporates represent nearly 50% of global EM corporate new issuance, which is exactly in line with their contribution to FY 2018 new issuance. While the market's growth has been rapid, we view the likelihood of an unmanageable default crisis in China as low, given the country's substantial financial resources and our expectations for only a moderate slowdown in growth, tempered by fiscal and monetary stimulus.

Corporate Net Financing*



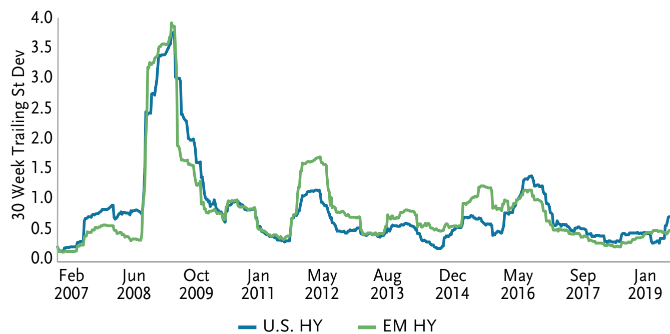
*Net financing is issuance after amortizations, coupons, tenders, buybacks, and calls
Source: JP Morgan, Data as of December 16, 2018

U.S. HY default rates rose above EM HY default rates in 2018 for the first time since 2011. In addition, in more recent cycles, U.S. HY default rates have peaked at higher levels than EM; in 2008/09 U.S. HY default rates hit 15% on an issuer basis versus 10% for EM HY corporates. In 2016/2017, U.S. HY default rates peaked at 7%, while EM HY default rates topped out at 5%. 2019 forecasted default rates appear manageable at 2.6%, which compares to 1.5% for U.S. HY.



Source: BofA Merrill Lynch; Data as of January 4, 2019

Volatility is lower in EM HY than U.S. HY. This is a reflection of better fundamentals and more conservative issuance trends, as the lowest rated segments of the market tend to be the most volatile.



Source: BofA Merrill Lynch; Data as of December 31, 2018

We believe there are attractive idiosyncratic corporate stories in EM corporate market that investors can capitalize on, particularly as the fundamentals and characteristics of the asset class are less understood. Furthermore, EM corporates are in the early to mid-stages of their business cycle. However, EM is not one homogeneous asset class, especially as global EMs are not moving through their credit cycles in tandem. Differentiating between credits is key. We believe EM corporates have the potential to outperform global fixed income peers in the coming years, but assessing the upside potential, as well as navigating through the risks, will be critical to capturing this outperformance. ■

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