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FIXED INCOME

Three Reasons for EM Corporate Short Duration Debt

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While the potential for inflation and rising rates could create a headwind for EM debt, a short duration approach can provide an opportunity to pick up incremental yield and diversification, with less volatility.

Like all risk assets, emerging market (EM) asset classes experienced somewhat of a rollercoaster ride in 2020, weakening as the global pandemic took hold in March and then rallying strongly in the subsequent months. While some economic uncertainty remains, countries and individuals are learning to deal with COVID-19, with the continued rollout of vaccines further brightening the picture. As valuations have snapped back from stressed levels, investors are rightly asking if opportunities in EM debt still exist. The answer, we believe, is yes—but selectivity is critical.

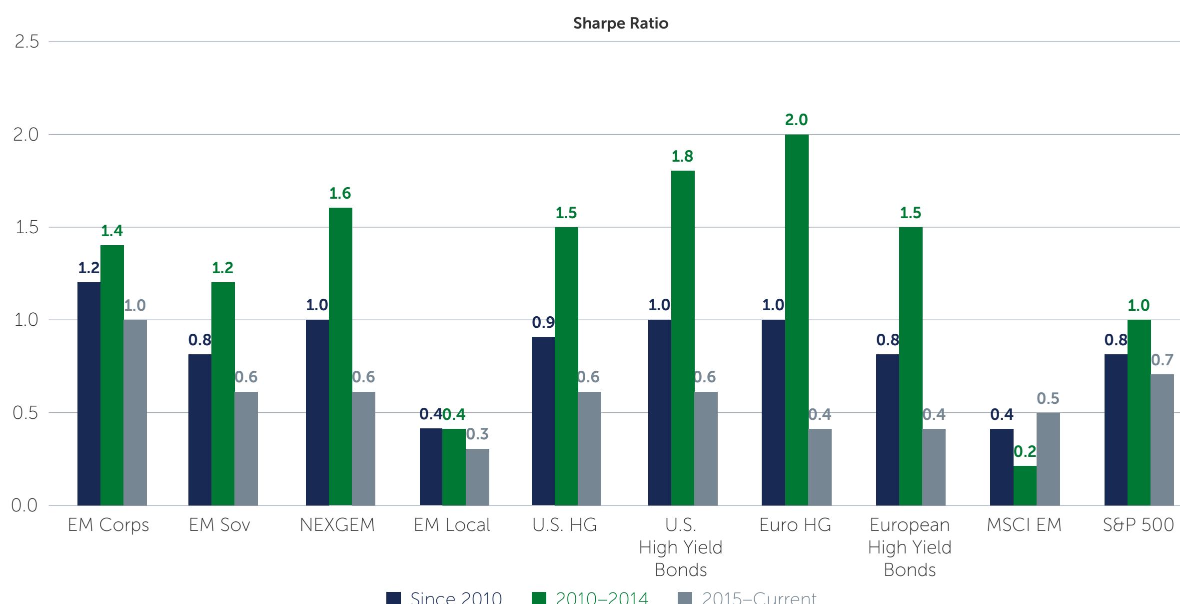
For investors looking to pick up incremental yield opportunities versus developed markets (DM) and gain exposure to the diversification on offer in EM—but who are more risk-averse, particularly against the backdrop of potentially rising rates—EM corporate debt, and more specifically short duration debt, could be part of the solution. In particular, we think there are three reasons short-dated EM bonds are worth consideration for investors.

1. Lower Volatility

Short duration bonds tend to exhibit a lower volatility profile than other fixed income instruments. First, by definition, they have a shorter time remaining until maturity. Because of this, they experience less severe price swings in response to changes in the economic backdrop or factors like a company's earnings outlook. In fact, they often experience a gentle "pull to par" effect—meaning their prices tend to gravitate toward par as the maturity date approaches. In addition, short-dated bonds have lower duration risk. This means the price of a short-dated bond is fundamentally less sensitive to changes in interest rates compared to longer-dated bonds, which enables investors to gain exposure to EM companies without necessarily being exposed to the dramatic ups and downs of interest rate expectations. As short-dated bonds have less time to maturity (typically under three years in Barings' short duration strategies, for instance), investors also tend to have more visibility on the direction of a company's earnings and liquidity position. As a result, short duration bonds are less exposed to deterioration in the underlying financial position of the corporate issuer, or even to detrimental or unexpected changes in the business plan. A company's ability and willingness to meet their financial obligations is easier for investors to forecast over these shorter time periods.

The result of this lower volatility can be seen in the historical Sharpe ratios for the asset class. Since 2015, for instance, EM corporate debt has exhibited better risk-adjusted returns than EM sovereigns, U.S. high yield (HY), and the S&P 500 index **(FIGURE 1)**. When further breaking down into short duration debt, the results are also impressive. In essence, while investors may give up some absolute return by focusing on the short duration segment of the market, on a risk-adjusted basis, those returns have historically looked quite attractive relative to other asset classes.

FIGURE 1: Attractive Risk-Adjusted Returns Over Time



SOURCE: J.P. Morgan. As of May 31, 2021. Sharpe ratio based on weekly returns annualized. NEXGEM: J.P. Morgan Next Generation Emerging Markets.

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2. Spread Premium to Developed Markets

Relative to short-dated DM bonds, short-dated EM corporate debt provides the potential for an incremental pick-up in credit spread. For example, the average yield-to-worst of the 1–3 year segment of the J.P. Morgan Corporate Emerging Markets Bond index (CEMBI) is 1.30% for investment grade (IG) issuers and 5.80% for HY issuers—compared to 0.77% and 3.37% for U.S. IG and HY, respectively.[1]

FIGURE 2: Average Yields for Short Duration Debt (EM IG Versus U.S. IG)

SOURCE: J.P. Morgan. As of July 31, 2021.

Interestingly, investors may not necessarily be taking more credit risk in EM debt than they are in DM debt, but often are being rewarded for the perception that EMs are considered riskier. Indeed, a closer inspection of the facts reveals that this perception is somewhat misguided. EM corporates have been cleaning up their balance sheets, with many cutting capital expenditures (CapEx) and right sizing their capital structures, resulting in stronger fundamentals and superior credit metrics compared to their developed market counterparts. EM corporate fundamentals showed particular resilience through 2020, with EM HY net leverage ratios remaining flat, at 2.8x, in contrast to developed market peers—where net leverage increased from 3.6x to 5.0x for U.S. HY and from 4.4x to 6.0x for European HY[2].

Also worth noting, the significant amount of credit stimulus, forbearance and moratorium measures granted by governments and banks in the wake of the pandemic provided a lifeline to many corporates. This helped to preserve balance sheets in the corporate sector—a notable difference from EM sovereigns, where the scale of fiscal stimulus support to combat the COVID impact has affected creditworthiness. In fact, whereas 2020 saw an elevated level of sovereign defaults, there was no associated spike in corporate defaults. Additionally, EM high yield corporate defaults in 2020 were significantly lower than their U.S. peers and broadly in line with European high yield defaults.

1. Source: J.P. Morgan. As of June 30, 2021.
2. Source: J.P. Morgan. As of December 31, 2020.

FIGURE 3: EM Corporate Defaults Were Low Relative to Peers in 2020

	EM Corporate High Yield	EM High Yield Sovereigns	U.S. High Yield	European High Yield
Default Rate 2020	3.5%	22.0%	6.8%	3.3%

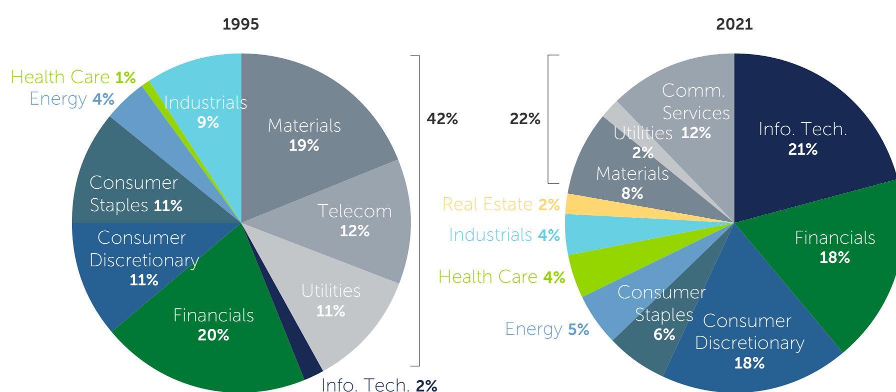
SOURCE: J.P. Morgan. As of December 31, 2020.

Given the significant amount of negative-yielding assets in developed markets, we believe that taking credit risk, on a selective basis, is a way for investors to potentially earn the yields that they need to meet their target returns. And, as discussed earlier, the shorter time to maturity means that investors have greater visibility on a company's financials—and therefore credit fundamentals—than is the case with longer-dated debt. As a "coupon-clipping" product, short duration debt may not offer the potential for massive capital appreciation, but the high degree of visibility on cash flows can be particularly valuable in an uncertain economic environment.

3. Better Diversification

EM corporate debt is one of the fastest growing asset classes, expanding from $1 trillion in 2012 to $2.6 trillion at the end of 2020. By comparison, the EM sovereign debt market is $1.4 trillion, while U.S. HY is $1.5 trillion.[3] The EM corporate debt universe has also become increasingly diversified across countries, sectors and ratings—with over 1500 issuers—and unlike some investors' preconceptions, it is no longer a commodity-dominated asset class driven by swings in oil prices. In fact, oil and gas companies account for only 13% of the universe, and metals and mining businesses a mere 6%.[4]

FIGURE 4: Shift From Old Industries to New



SOURCE: Barings, Factset. Sector breakdown of MSCI Emerging Markets index from December 29, 1995 and March 31, 2021. Figures may not add up to 100% due to rounding.

3. Source: J.P. Morgan. As of December 31, 2020.
4. Source: J.P. Morgan. As of June, 2021.

"Interestingly, investors may not necessarily be taking more credit risk in EM debt than they are in DM debt, but often are being rewarded for the perception that EMs are considered riskier."

While EM assets tend to be perceived as higher risk, many EM corporates are large, global companies with diversified sources of revenue, and in effect have been unfairly discounted by markets because of the country in which they're domiciled. The path between EM corporates and their sovereigns is diverging, and as EM corporates mature, they continue to display higher resiliency during periods of sovereign stress. For example, in 2019 the sovereign index for Argentina returned -40.4%, compared to -2.3% for the Argentinian segment of the EM Corporate index.[5] In practice, we continue to find value in corporates that are domiciled in stressed regions that have been unjustly discounted based on the location of their corporate headquarters—when in fact many offer robust, global revenue streams.

EM corporates also tend to be compared with U.S. HY from a risk perspective, but such a comparison looks misguided when considering the underlying fundamentals of the EM corporate universe. Consider for instance, that 57% of the EM corporate universe is rated investment grade.[6] This suggests investors can potentially benefit not only from the common misconception that EM corporate debt is riskier than it is in reality (based on credit ratings alone), but also from diversification across credit ratings. Again, with short duration instruments, opportunities can exist to get comfortable with underlying credit risks (for HY issuers, in particular) given the limited time to maturity.

The Takeaway

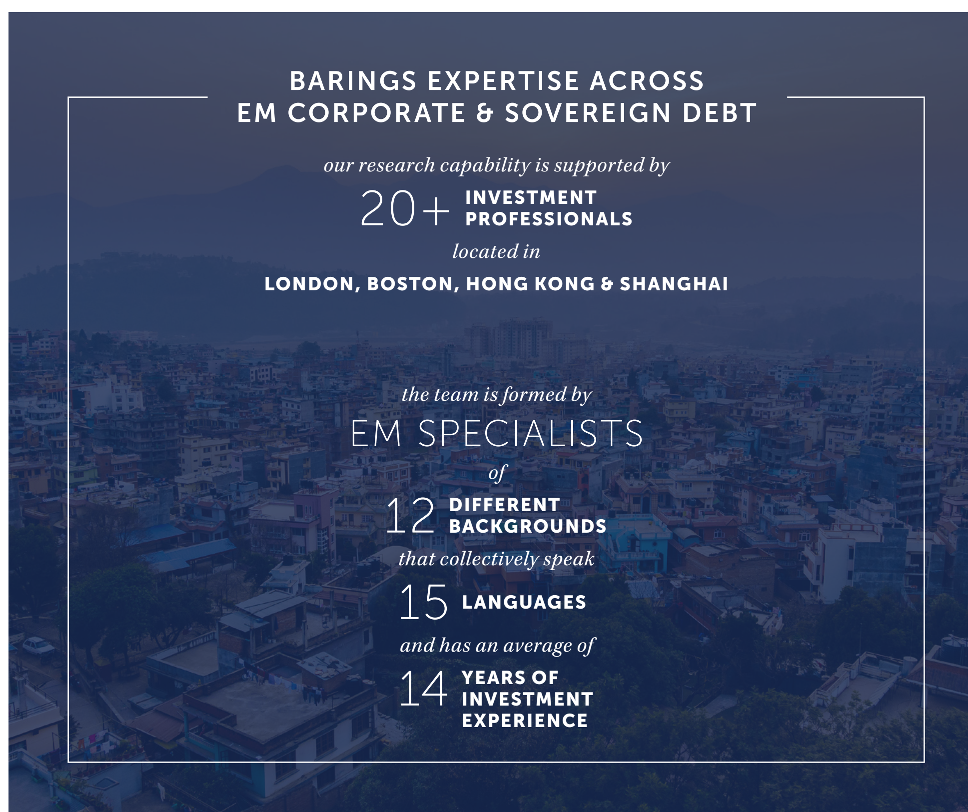
EM corporate debt continues to offer an opportunity to potentially achieve superior risk-adjusted returns and invest in well-diversified companies with robust balance sheets. While inflation and rising rates may create a headwind, EM corporates have historically shown resilience to rising U.S. Treasury yields, with credit spreads tightening during periods of rising developed markets rates in eight out of the last 10 years. There are also other risks on the horizon—from the global pandemic to political risks like we have seen recently in Peru and Chile—that could introduce bouts of volatility going forward. Against this backdrop, we believe risk-averse investors could consider taking a short-dated approach to investing in the asset class.

5. Source: J.P. Morgan.
6. Source: J.P. Morgan. As of June 30, 2021.

Barings' Approach

At Barings, we believe fundamental, bottom-up analysis is key to identifying attractive opportunities, as well as understanding the risks, in EM corporates. We understand the importance of rigorously assessing the entire EM debt asset class, including both sovereigns and corporates, to have a more holistic view of the risks and earnings outlook for each EM company. For this reason, we have one of the largest dedicated EM debt teams—with 10 investment professionals covering over 1,100 EM corporate issuers, and 10 investment professionals covering over 85 EM sovereigns. The teams work together to underwrite every issuer that comes to the market, which means analyzing the key credit considerations for each issuer—including reviewing strengths and risks, capital structure, balance sheet, cash flow projections, ESG considerations and macroeconomic variables. This process helps to build a cohesive and comprehensive macro and micro picture by country, sector and credit. Additionally, our dedicated EM analysts collaborate with over 57 global credit analysts from across the Barings platform to identify best ideas across EM debt.

ESG analysis is integrated into our investment process by our large team of experienced and dedicated EM analysts, allowing for in-depth analysis of potential ESG risks. In a market where ESG coverage by third party providers is relatively limited, we believe our analysts' long-term knowledge of portfolio companies and sectors, as well as access to management and financial sponsors, provides a superior level of analysis and a more robust methodology than relying solely on third-party data sources. As we strive to be responsible corporate citizens, we strongly believe that integrating ESG risks into our fundamental, bottom-up investment process and engaging directly with companies to improve their ESG stance are crucial to delivering value to our investors.



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