Go tactical with EM debt

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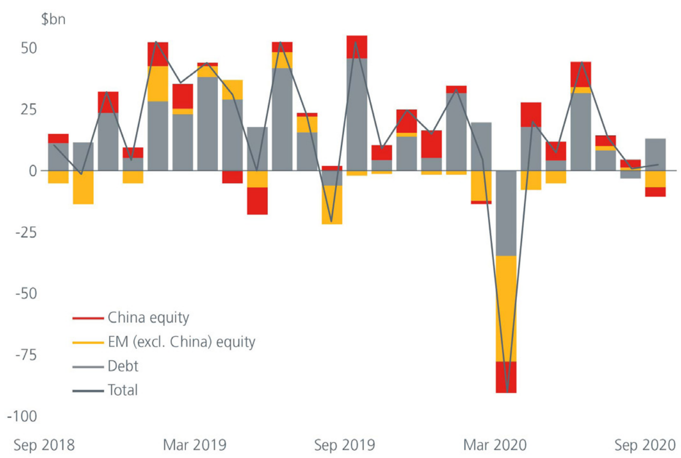
After experiencing outsized outflows during the height of the COVID-19 crisis in March, capital flows into Emerging Markets (EMs) debt have turned positive. The rebound, however, has been modest, reflecting the challenges facing EMs. Still, there are investment opportunities in this space and many ways to extract attractive yield via an active approach that identifies quality securities.

The fallout from COVID-19 and the uncertain global outlook have exacerbated the challenges faced by EMs. Going into the crisis, EMs were already facing stagnant growth and rising leverage. The case for investing in EMs is no longer the sexy "high growth story". Instead, we need to assess the countries in the region with a differentiated lens to determine the strengths and weakness of each.

The liquidity support provided by respective central banks to cushion the impact of COVID-19 on their economies has been a stabilising force for the EMs. Capital flows into EM debt have recovered at a better pace than for EM equities (see Fig 1). This is understandably due to investors' preference to maximise returns, while minimising risk in current uncertain times. Furthermore, it is a recognition of the opportunities in this space.

Each EM is unique in terms of its economic profile and policies. This diversity offers opportunity to harness attractive returns by accurately predicting and positioning for different economic cycles. EM debt markets are also less mature, more inefficient

Fig 1: Foreign investor capital flows to EMs



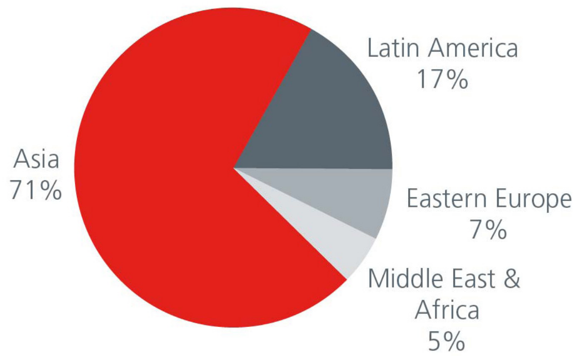
Source: Haver, IIF

and under-researched when compared to many developed markets. There are more opportunities for mispricing of assets, and this offers substantial investment opportunities.

AN EXPANDING UNIVERSE THAT LACKS INDEX REPRESENTATION

EM debt has continued to grow in size, and corporate issuers have been a big part of this growth. The EM fixed income universe is forecast to hit USD 45trn, or 29% of global fixed income by 2025. Given the development needs of the EMs, the growth potential for this market is immense. To put it in perspective, outstanding bonds in Developed Markets made up 171% of GDP in 2019, compared to 85% for EMs.

Fig. 2: Regional breakdown of EM debt



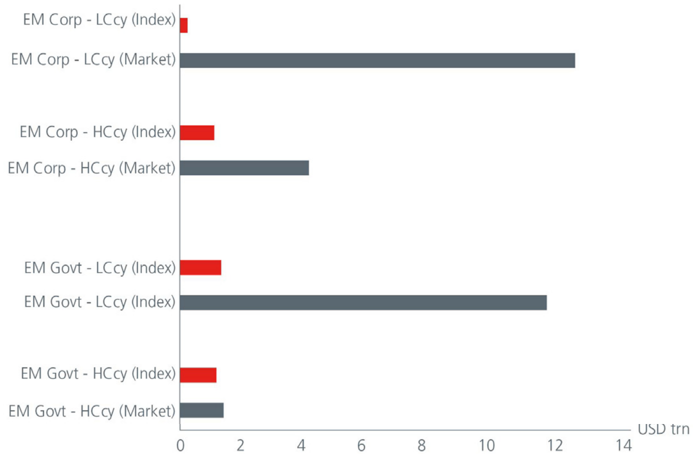
Source: Ashmore, BIS, IMF data as at Dec 2019

Within the EM universe, corporate bonds make up 56% of total bond while local currency issues dominate with a share of 82%. Region wise, Asia ex Japan tops the issuance with a 70% share and of this China takes the lion's share at 52%. The majority of Chinese bonds are denominated in local currency and issued by corporates.

Moreover, having an exposure to the entire EM universe allows one to enjoy attractive returns from diversification benefits without risking up significantly or having too much concentration in one market. This is because Asia is now almost 50% of the JP Morgan Corporate Emerging.

Despite the expansion in the EM universe, index representation remains poor, thereby limiting the opportunity to invest in these credits. Hard currency government debt is by far the best represented index at 84% while local currency corporates have the least at 11%. The lack of trading ease of local currencies compared to hard currency and the lack of presence in local markets are key obstacles.

Fig. 3: EM credits remain index under-represented



Source: Ashmore, BIS, IMF data as at Dec 2019. LCcy. Local Currency, HCcy: Hard Currency. EM Corp LCcy index is represented by ICE BoAML, EM Corp HCcy index is represented by JP Morgan CEMBI Broad Diversified, EM Govt LCcy index is represented by JP Morgan GBI EM Global Diversified and EM Govt HCcy index is represented by JP Morgan EMBI Global Diversified

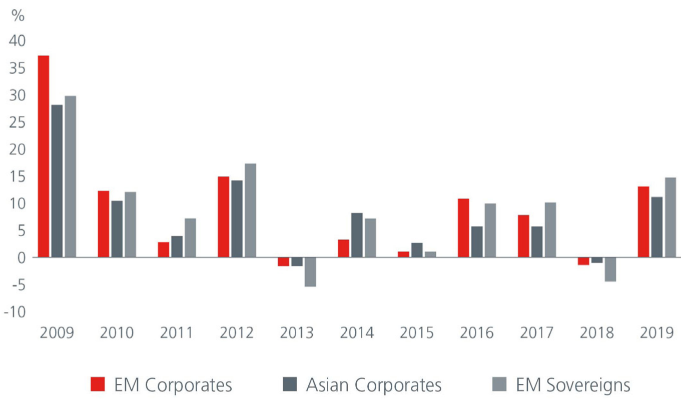
PREFERENCE FOR ASIAN TILT NEAR-TERM, BUT OPPORTUNITY IN BROAD EM SHOULD NOT BE IGNORED

Admittedly, investing in EMs comes with challenges considering its weaker governance structures and propensity to default. With Asia dominating majority of new issues, investors can adopt an Asian tilt near-term due to Asia's stronger economic profile and better success in managing the COVID-19 pandemic.

Markets Bond Index (CEMBI) and China's weight has gone up to 25% versus 10% in 2012. Thus, if one chose to invest only in Asia corporates via the JACI, it will result in a higher concentration to a single market; China's weight in JACI is currently 52.3%.

This opportunity cost of not investing across all EMs is also evident looking at the returns. Between 2004-2019, EM corporates delivered an annualised return of 6.5% whilst Asian corporates rose 6.2%. The disparity widens if one looks at cumulative returns with EM corporates delivering 174.3% against 133.8% for Asian corporates over this period.

Fig. 4: Total returns by calendar years (2009-2019)



Source: JP Morgan as at Dec 2019. EM Corporates measured by CEMBI, Asia Corporates measured by JP Morgan Asia Credit Index (JACI)

THE MANY WAYS TO HARNESS YIELD

Furthermore, investing in EM debt allows an investor to capitalise on the currency and interest rate movements, and credit spreads. Rates and foreign exchange play an important part for local currency issues while credit spreads matter more in the hard currency space. As a result, the spread differential for similar bonds denominated in local and hard currency can differ over time and offers yield pick-up opportunities. See Fig 5. In short, tactically trading EM credits can enhance an investment portfolio's risk-adjusted returns.

Fig. 5: Spread differential for an issuer's similar bonds denominated in MYR and USD

Source: Bloomberg, 30 Oct 2020

ACTIVE MANAGEMENT BACKED BY ROBUST CREDIT RESEARCH

The case for active management is backed by the fact the EM universe is generally under-researched and poorly represented on benchmark indices. Active managers can add value by calibrating the weights on good and deteriorating credits, relative to a portfolio that is benchmarked weights.

It is fundamental research that uncovers good investment opportunities. Being one of the largest fixed income teams in Asia with a strong presence across 11 Asian markets facilitates ready access of on-the-ground market information. The team is made up of investment professionals and dedicated research analysts. In recent years we have augmented our EM research by adding experienced personnel to the research team. That Asia and China have become a large portion of the EM universe allows us to tap on our Asian expertise and insights.

A rigorous credit research process that emphasizes on proprietary research and internal credit ratings (ICR) has been our key alpha generator. A top down approach is undertaken to determine the broad Global EM bond market outlook and ascertain the fair value of EM interest rates, credit markets and currencies. This is complemented by a bottom up analysis of individual issuers.

Based on these analyses, the ICR is applied to unrated bonds and bonds which are rated BBB+ and below by external rating agencies. The ICR serves as a proprietary reference of the credit quality of an issuer, which takes precedence over credit ratings from external rating agencies. The ICR systematically assigns an appropriate internal credit risk assessment to unrated issuers and issuers which have relatively weaker credit fundamentals but not necessarily a bad investment.

Simply put, our internal credit research helps us to identify value opportunities and generate potential long-term returns for our clients.

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