FIVE PERSPECTIVES ON EMERGING MARKET US DOLLAR CORPORATE DEBT

AUTHORS

THE EMERGING MARKET DEBT PRODUCT TEAM

MANAGER INSIGHT

MAY 2020

INVESTORS OF MANY TYPES WERE BLINDSIDED BY THE COVID-19 CRISIS. EMERGING MARKET (EM) DEBT INVESTORS, FAMILIAR WITH VOLATILITY AND THE OPPORTUNITIES MARKET DISLOCATIONS CAN PROVIDE, HAVE BEEN ASSESSING PORTFOLIO ALLOCATIONS IN LIGHT OF SHIFTING VALUATIONS.

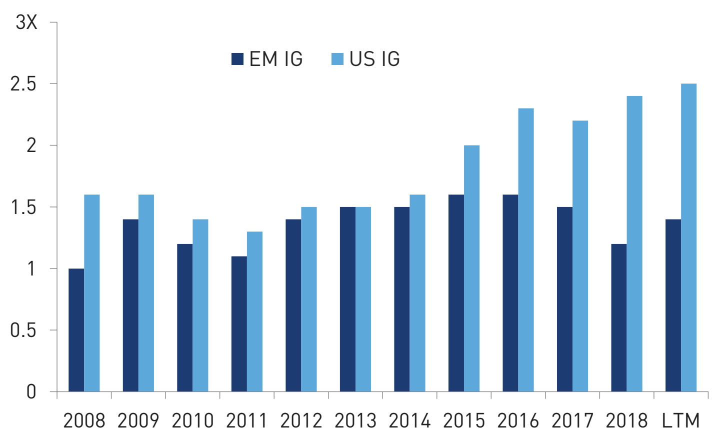
Based on our perspectives, we believe the EM US dollar corporate debt sector continues to present compelling prospects. To help discern opportunity relative to risk, we present five viewpoints on emerging market debt:

- Degree of leverage
- US dollar debt exposure
- Default outlook
- Valuation
- EM debt allocation

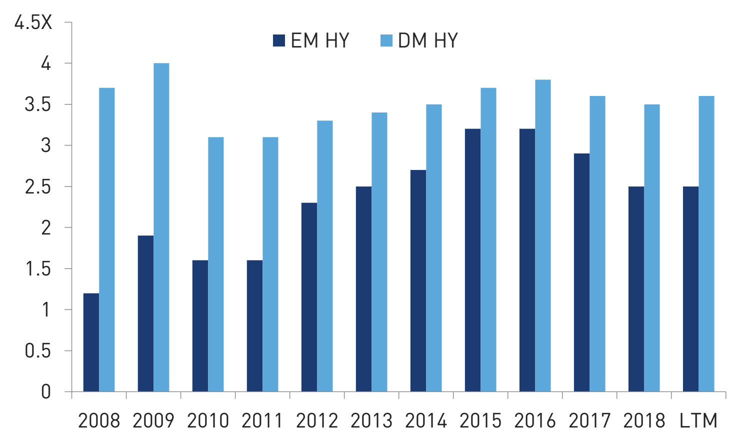
Leverage

When compared with the leverage profile of their US counterparts, EM corporations appear to be on a firmer footing. Following the commodity downturn of 2015 and 2016, EM corporations tied to the oil and gas and metals and mining sectors undertook broad-based deleveraging efforts. Simultaneously, the Chinese government adopted policy measures targeted at reducing leverage within the corporate system. As a result, we see EM corporates as well positioned to weather the COVID-19 crisis.

EM IG VS US IG NET LEVERAGE



EM HY VS US HY NET LEVERAGE



Source: J.P. Morgan, Bloomberg, as of 12/31/2019. Last 12 months (LTM) incorporates partial 3Q19 results for EM corporates and 2Q19 for developed markets (DM).

US Dollar Debt Burden

We believe most EM corporate issuers that access the US debt funding markets have learned from past currency crises. Most either have natural hedges via hard-currency revenue (e.g., commodity exporters) or financial hedges. Ensuring bonds are appropriately hedged is a key pillar of the Loomis Sayles credit research process. For the broad market, we see some lower-rated issuers vulnerable to currency losses, but we do not expect foreign exchange mismatches to drive an uptick in defaults.

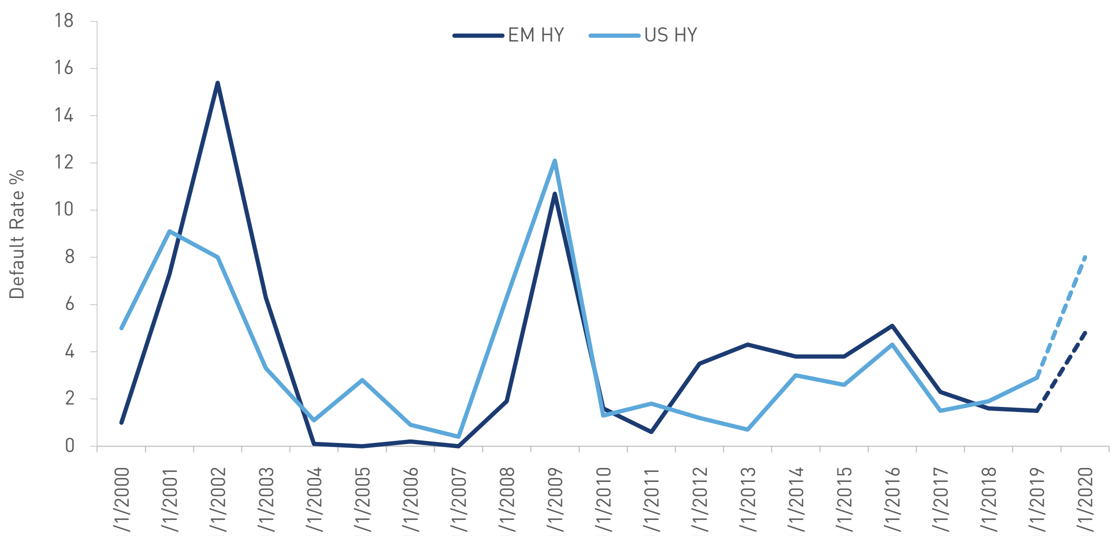
Default Outlook

While 2020 default rate expectations have been revised higher, from 2.4% to 4.8%,[1] this rate is below the most recent peak of 5.1% in 2016. We expect resilient credit metrics, prefunding activities and proactive liability management exercises to help mitigate default rates in EM. Importantly, oil and gas companies in EM, unlike those in developed markets, are mostly investment grade with partial government ownership. Notably, many EM corporate issuers have access to onshore funding markets. This is especially important for Chinese issuers who may find onshore funding channels more accommodative during this period of global financial stress.

HISTORICAL DEFAULT RATES & FORECAST

Source: J.P. Morgan, data as of March 31, 2020.

Past performance is no guarantee of future results.



Valuation

Given the pressure on credit ratings and concern about rising default rates, the investment environment could be witnessing uncertainty translating into opportunity. We believe that valuations are attractive. The global spread of COVID-19 resulted in a broad-based repricing of EM credit risk. As of May 8, 2020, the option-adjusted spread (OAS) on the J.P. Morgan Corporate Emerging Market Bond Index was approximately 223 basis points wider versus the start of the year.

Examining the relationship between spread and ratings, we see spread levels offering ample space for additional credit downgrades. This is especially true when we consider the number of downgrades that have already materialized. In March and April, the acceleration of downward ratings actions turned the trend negative, and it is nearing the trough previously observed in 2016 commodity downturn.

EM CORPORATE RATINGS TRENDS

Source: J.P. Morgan, as of April 28, 2020.

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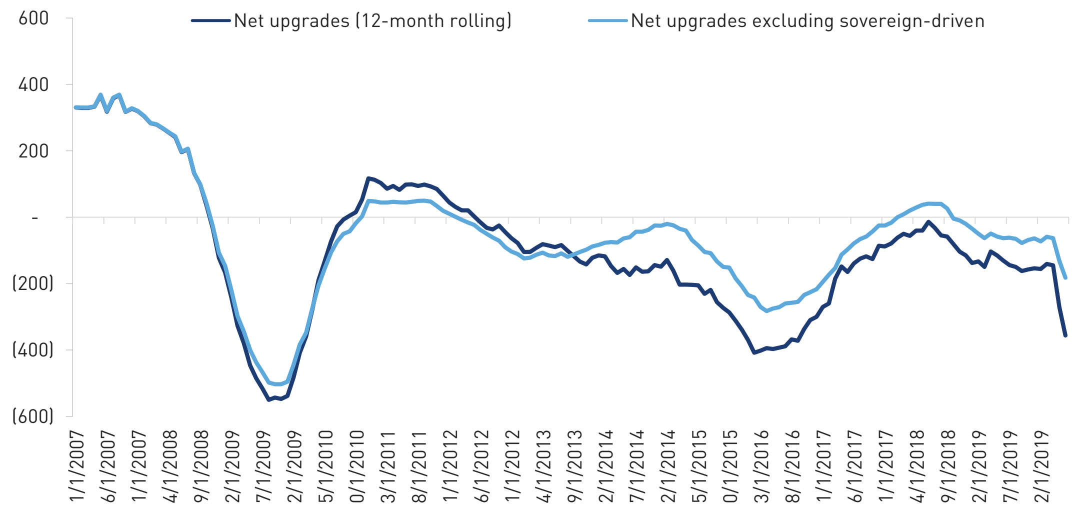
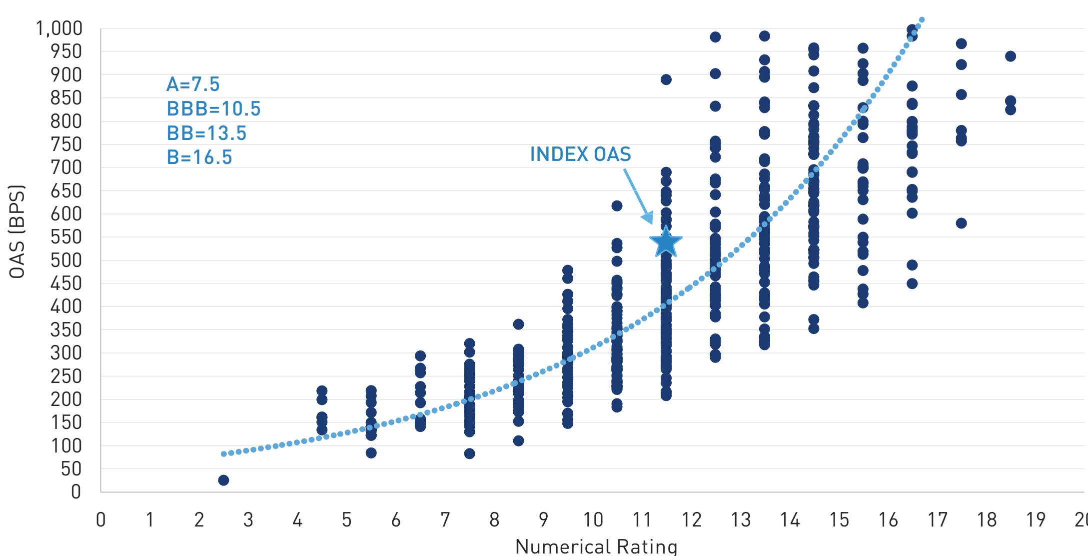


Given current valuations, the potential for further downgrades is, in our view, priced into the market as the index OAS (★) reflects a BB rating. For many names, forced selling and technical pressures have led to bond price dislocations that might offer investors attractive investment opportunities.

EM CORPORATE OAS

Source: Loomis Sayles, J.P. Morgan, Bloomberg. Data as of May 8, 2020.



Maintain EM US Dollar Corporate Debt Allocation

While we recognize uncertainty is uncomfortable, EM debt offers distinct characteristics to an overall portfolio. Central to these is its tendency to generate a meaningful part of returns during recovery periods that follow acute market dislocations. The typical EM yield cushion has the potential to be an additional buffer to either absorb additional spread widening or deliver elevated returns if spreads levels remain unchanged.

It has paid to stay invested over the long horizon and we don't believe this time is likely to be different. Historically, in the years that follow important economic shocks, EM returns exceeded those of US investment grade corporates or Treasurys. In other words, as the cycle switched from one cycle phase to another—downturn to recovery and credit repair—EM returns significantly outpaced those of higher-rated benchmarks.

			DRAWDOWN PERFORMANCE			1 YEAR POST-TROUGH PERFORMANCE			2 YEAR POST-TROUGH PERFORMANCE		
	PEAK	TROUGH	EM USD CORP	US CORP	TREASURY	EM USD CORP	US CORP	TREASURY	EM USD CORP	US CORP	TREASURY
COVID-19	29-Feb-20	31-Mar-20	**-11.5%**	-7.1%	2.9%	**-**	-	-	**-**	-	-
GFC	30-Jun-07	30-Nov-08	**-17.2%**	-7.6%	18.7%	**38.9%**	27.7%	2.4%	**57.2%**	39.4%	7.5%
TAPER TANTRUM	30-Apr-13	31-Aug-13	**-5.9%**	-4.9%	-3.4%	**10.9%**	9.1%	3.6%	**10.8%**	8.5%	5.9%
US DEBT CEILING	31-Aug-11	30-Sep-11	**-5.2%**	0.3%	1.7%	**16.4%**	10.8%	3.0%	**16.7%**	9.0%	0.8%
ENERGY CRISIS	30-Jun-15	31-Jan-16	**-2.7%**	0.6%	3.0%	**11.4%**	6.1%	-0.8%	**18.9%**	11.4%	-0.2%
					AVERAGE	**19.4%**	13.4%	2.0%	**25.9%**	17.1%	3.5%

Source: Loomis Sayles, J.P. Morgan, Bloomberg. Cumulative total returns are shown. Data as of April 13, 2020.
Past performance is no guarantee of future results.

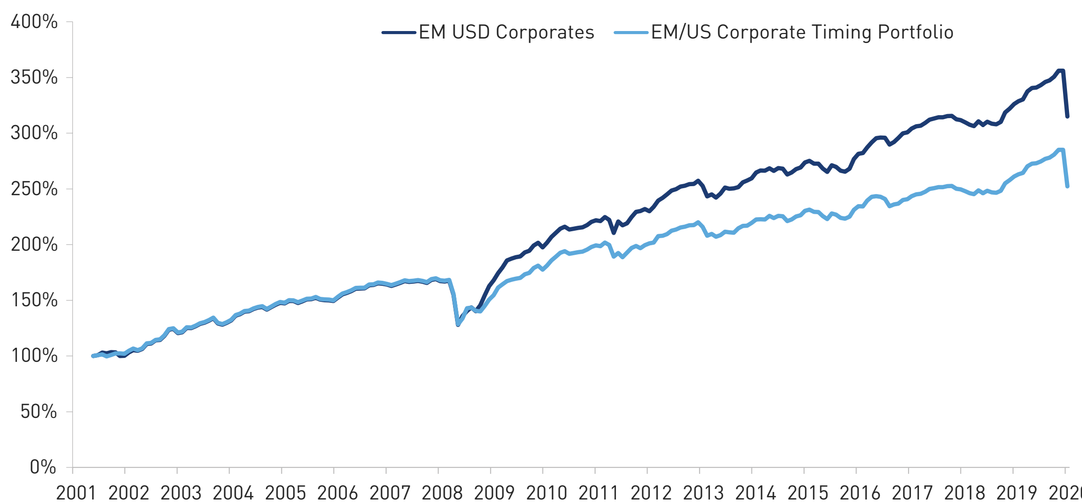
Importantly, investors who migrated to more conservative strategies during a recovery period missed potential returns without materially lowering long-term volatility. The result was not only lower returns, but also lower risk-adjusted returns than if they had stayed invested in EM.

Below, we compare a consistently invested EM corporate portfolio with a portfolio rebalanced to US investment grade after each shock, and then rebalanced back to EM after one year. Note that such an allocation strategy largely missed the EM recoveries. We believe a consistent EM corporate allocation can offer compelling risk-adjusted returns versus a market-timing alternative.

STAYING INVESTED IN EM

Source: J.P. Morgan, Bloomberg. Cumulative total returns. Data as of March 31, 2020.

Past performance is no guarantee of future results.



Conclusion

EM corporate credit brings a distinct set of characteristics to a portfolio. From our perspective, it continues to present a compelling investment opportunity. Of course, parsing through the fundamentals and accurately determining risks relative to potential gains remains critical.

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Endnotes

[1] *Source: J.P. Morgan as of March 31, 2020.*

Disclosure