

# Emerging market debt: guiding beliefs for today's market

With some countries lifting coronavirus lockdown periods, our emerging market debt team looks at the temporary factors affecting the asset class and reviews some key features investors should consider for the long-term. Bottom-up analysis, a benchmark agnostic approach and diversification might not sound like new ideas, but the current context underlines their importance even more.

Mirroring other global credit markets, the demand, supply and oil shocks facing the global economy have brought significant stress to emerging market debt and have threatened to push emerging market (EM) growth to extremely negative levels—worse, in many cases, than experienced during the Global Financial Crisis.

The COVID-19 pandemic came at an inopportune time for EMs in many respects: growth was already slowing in a number of countries, inflation relatively weak and monetary policy on an accommodative setting. Nevertheless, many EM policymakers have moved quickly and aggressively.

Risks around an extended economic drag due to additional waves of COVID-19 and a failure for commodity markets to follow the path implied by futures markets are significant; therefore, we expect a difficult period in the short term for EM debt.

The open-ended commitment of developed market central banks and multilateral lenders will provide ongoing support for risk assets in general. However, the scale of the shock will likely result in an increase in defaults and restructurings across both sovereign and corporate sectors, though this should not represent a significant portion of the asset class.

## Finding value in EM debt

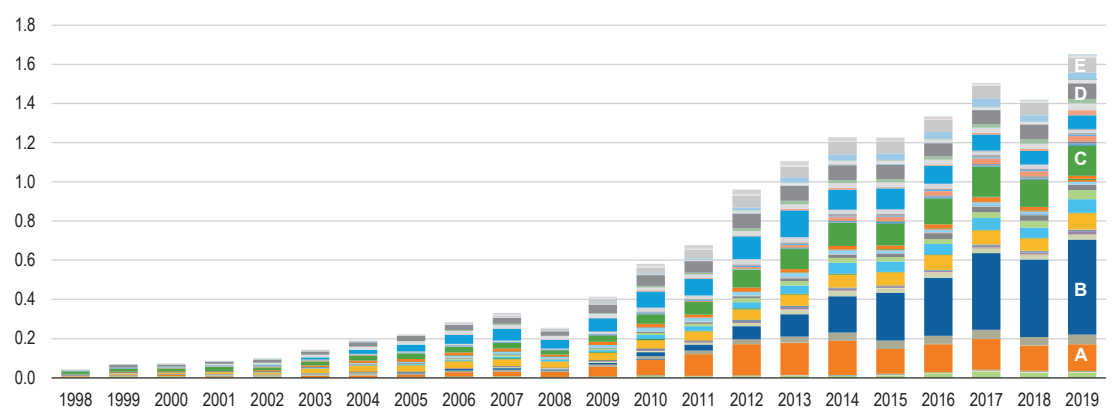
While there is a lot of uncertainty in the current environment—and volatility is likely to continue for a while longer—the yields on emerging market debt and other risk-asset classes can look attractive in a low interest rate environment.

In this context, three guiding beliefs are essential in our view:

- 1. Seek to take advantage of market inefficiencies.** Opportunities to identify and exploit inefficiencies in emerging markets result from investor segmentation, illiquidity, and complexity of emerging market debt securities.
- 2. Not constrained by a benchmark.** To maximize investment potential, a portfolio must diversify beyond the boundaries of any single benchmark, which tend to be concentrated in a few regions and issuers.
- 3. Multiple levels of diversification.** Broad allocation across issuers, sectors, countries and currencies offers the potential to earn greater returns at lower levels of absolute risk.

## EM corporate universe, by country

(Market value of outstanding bonds, in USD trillions)



Countries of note (58 in total):  
A = Brazil; B = China; C = Mexico; D = Russia; E = South Korea

Source: BAML EMCB Index, as of 31 December, 2019.  
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One of the areas we find value in is **EM corporate debt**. To some, a misconception remains that emerging market corporate debt is more risky than sovereign debt and too niche. EM corporate debt as an asset class is growing, it possesses unappreciated quality and it has the potential to offer attractive risk, return and correlations compared to EM sovereigns.

EM corporates as an asset class is **well diversified** by geographies and industries, representing over 50 countries, and totalling over USD 1.5 trillion as illustrated in the chart. Over the last years, EM corporate issuance has continued to grow, spurred by greater investor demand. Our research process looks for every possible alpha opportunity, including smaller or non-index names.

With regards to **quality**, EM corporates' ratings compare favourably with those of their developed markets counterparts, with an average rating of BBB and roughly 70% of assets rated investment grade. In addition, the asset class presents relatively low default rates and decent recovery rates, supported by strong bond covenant packages. Although we expect defaults in EM corporates, which have been very low for several years, to rise sharply in 2020, we consider this default risk to be priced in at current spread levels.

From a **risk-return**, perspective EM corporates

offer the same or better yield for lower or the same duration compared to developed markets. If we look at performance during the recent COVID crisis EM corporates has shown lower beta than EMD sovereign and the asset class sold off less than sovereigns.

In our view investors should look for a **robust credit research process** to access the untapped potential EM corporates can offer. For us that includes in depth fundamental analysis and relative value analysis, as well as ESG considerations and a good understanding of legal protections for bondholders.

## FOOTNOTE

- 1 Source: Bloomberg, as of 31 December 2019. Emerging market corporates as represented by ICE BofAML Emerging Market Corporate Bond Index
- 2 Source: BAML Research, as of 31 December 2019
- 3 Source: Moody's, JP Morgan, BAML Research, as of 31 December 2019

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