Don't fear Emerging Markets

The Conundrum

There is a conundrum in world financial markets: the likes of insurance companies and pension funds in the developed world keep piling on fixed income securities with negative or extremely depressed yields. The stock of negative yielding fixed income securities is now close to 16 trillion dollars, including those issued by governments and corporations alike.

The lack of yield has turned those bonds into equity-like instruments but with none of the upside potential associated with equity market volatility.

There are multiple reasons why this is happening. For one, regulatory constraints make it more economical for investors in the developed world to buy their own negative-yielding domestic securities. Capital charges on risk weighted assets for banks and insurance companies, for example, make It more balance-sheet optimal to invest in domestic securities. Secondly, there are a few alternatives to the liquidity and safety of developed-market government bonds, in what some describe as a shortage-of-safe-assets problem.

Finally, there is an inherent home bias and inertia when investors distribute risk across portfolios.

Whether for one reason or another, the question is why in the face of such unattractive returns, asset allocators are not more aggressively venturing out to higher yielding securities outside their jurisdiction, and more specifically to EM debt.

EM Stands Out in the Chase for Yield

Surely there's been an aggressive "chase for yield" already, dating all the way back from the financial crisis in 08, and re-accelerating after the Covid shock of March last year. Capital flows into EM were indeed very strong in the 2009-2013 period, when EM bonds generated 10-15% year average annual returns, but those flows subsided sharply after the FED's "taper tantrum" in 2013. Fast forward to March 2020, the chase for yield has been reinvigorated following the FED's aggressive policy actions to fight the Covid shock. This time around, however, the flow into fixed-income funds has been very much skewed towards US credit (e.g. CIOE bonds issued by US companies) following the FED's decision in March to buy IG credit and high-yield ETFs as part of its policy kit. The market's mantra throughout this period has been to buy what the FED buys, explaining why for every dollar than went into EM mutual funds last year, nine went into US credit funds.

In that context, yields on emerging market bonds look attractive. EM bonds denominated in dollars and issued by governments are yielding on average 4.7%, which compares favourably to bond yields issued by US investment-grade companies at 1.9%. The contrast is even starker when comparing EM debt, which is rated IG on average, against US high-yield, with yields on the latter at 3.8%. The yield differential between US high-yield and EM debt is now at all time lows, helped by the shorter duration of high-yield but despite its lower asset quality (see chart).

So what holds investors back into EM? Traditionally, there have been three arguments against investing in emerging markets: drawdown and default risk, and mark-to-market volatility.

Drawdown Risk: Liquidity no longer an EM Problem

EM is a risk asset class and as such it's no surprise it has an imbedded drawdown risk. That drawdown risk comes mostly from the illiquidity of the asset class, its relatively weak investor sponsorship, and ultimately from the lack of lender-of-last-resort capabilities.

That said, the illiquidity concept, of which EM has always been the canary in the coal mine in global fixed income markets, is sadly becoming a more common place phenomenon across fixed income markets. A case in point, in the March-shock last year, the drawdown in US IG credit was sharper than that experienced by EM debt when measured through the price action in CDX (an index capturing a basket of CDS). In the peak of the crisis of March, IG CDX widened 3.5x its pre-Covid level vs. 2.5x in EM debt. So on a relative basis EM has actually less, not more, drawdown risk.

Enter the GCC Credits

There's another attenuating factor to the liquidity story. Up until now the big debt issuers in EM were mostly sub-investment grade credits, think Argentina

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or Turkey, which essentially narrowed the investor base to those bonds to a subset of "dedicated" EM investors. This has changed. Since 2016 there is new set of issuers in town: the Gulf countries. These countries are issuing sizeable amounts every.

This phenomenon has had two consequences: firstly, the Gulf countries have changed the risk profile of EM debt, as these credits now account for 1/5th of the EM hard currency debt indices…and growing. Secondly, the likes of Saudi Arabia, Qatar, UAE and Kuwait are solid investment grade credits, which means that not only have these names skewed the credit quality of EM more into IG, but they have broadened the investor base far and beyond the EM-dedicated one.

In fact, along with the GCC credits, the share of EM credit names in global IG credit indices, such as the Bloomberg Barclays Global Aggregate Index is now running close to 15%, similar weight as all issuers from France, Germany, Italy and Spain combined, providing to those bonds firmer holding hands in terms of sponsorship.

Manageable Default Risk

Another factor holding investors back when it comes down to EM is the default risk the asset class generates headlines for. As per the latest Moody's default study, the one-year sovereign default rate stood at 2.1% as of the end of April 2020, higher than the historical average annual default rate at 0.8% over the 1983-2020 period, which includes developed market sovereigns such as Greece and Cyprus as well. In comparison, default rates in high yield credit in the US have been running at over 3%. When we assess default risk we break it down to two parts: affordability to pay, and FX convertibility risk. Or put it in very simple terms, EM sovereigns tend to default when the costs of servicing the debt become prohibitive relative to their capacity to generate revenue, or when they run out of hard-currency cash to repay their external debt creditors.

Looking at the EM investable universe at the moment we see that on average EM countries spend 11% of their revenues to debt servicing costs, and that FX reserves relative to months of imports are running on average at 9.4 months. Traditionally countries go on to default when debt servicing costs rise north of 25% of revenues and FX import cover is below to 3 months of imports.

If we concentrate on the most vulnerable countries, we find that approximately those accounting for 5% of the market cap of the bellwether EM hard currency indices show a high score on either one or the two measures. Of this 5%, 3/4s of the names already trade at distressed levels, leaving 1-2% of the indices vulnerable to gap risk due to a default.

Mark to Market Risk vs. Credit Risk

For the non-vulnerable credits, i.e. the bulk of EM debt, we think the credit risk is largely overpriced, particularly relative to US credit risk, and it reflects mostly mark-to-market considerations. Not only EM sovereigns have the power of taxation and the ability to seize assets, but they have recourse to backstops such as the IMF and the FED swap lines, which corporates do not have.

Further when it comes down to balance sheets, EM sovereigns have seemingly more comfortable USD asset and cash positions than many of their developed-market corporates peers.

Conclusion

In the context of depressed bond yields globally, it's just a matter of time investors will accelerate their migration to higher yielding asset classes. We think EM is well poised for that journey, especially once investor start recognizing that the traditional drawbacks associated with EM bonds are not as acute as they may have been historically, or not so relative to other asset classes. While mark-to-market volatility is inherent to EM debt, the strength of balance sheets relative to market pricing should give comfort to investors.

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