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Outlook for Emerging Markets Corporate Bonds: Why now?

HSBC AM Emerging Markets Debt Team

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Executive Summary

Now that Emerging Markets Debt has recovered from the post-COVID drawdown, what comes next?

With decade-high bond yields, falling inflation, and central bank rate cuts, we are entering a promising environment for the asset class.

We find that EM Corporates are especially attractive for long-term investors.

We base our view on three main factors that should be supportive:

1. the peak of Federal Reserve policy and the global interest rate cycle should prove favorable for higher yielding fixed income asset classes

2. improvements in emerging markets governance and financial conditions are positive for bottom-up investment stories ahead

3. we believe the relative attractiveness of EM corporate bonds in terms of fundamentals and technical factors represents a compelling investment opportunity

Source: HSBC Asset Management as of September 1, 2024. This commentary provides a high-level overview of the recent economic environment and is for information purposes only. It does not constitute investment advice or a recommendation to any reader of this content to buy or sell investments nor should it be regarded as investment research. Any forecast, projection or target where provided is indicative only and is not guaranteed in any way.

Introduction

Over the past two years, investors have enjoyed a welcome rebound in fixed income returns, with emerging markets debt asset classes up between 10 and 20% in total return terms from the lows (see Figure 1). Declining inflation, amid a cooling in labor markets, has allowed the Federal Reserve to pause rate hikes and move to an easing regime, providing a boost to bond investors.

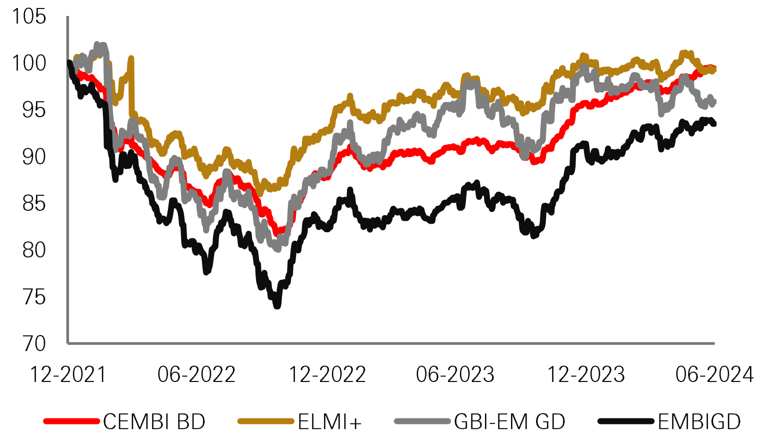
EM bonds are now offering historically high yields and top-line carry creates an appealing proposition. The yield to maturity on the Corporate Emerging Market Bond Broad Diversified Index (JP Morgan CEMBI BD) has averaged around 8.5% year-to-date,[1] the highest in two decades (see Figure 2). The 2022 experience of 'stress beta' (where correlations across asset classes increase) has faded into the past. In contrast, the more recent environment has been one of differentiation between interest rates and credit spreads which can provide stability of income and diversification benefits in EMD investments. We see underlying duration, the effect of declining interest rates, to help drive higher EM returns going forward. A 100 bps (1 percentage point) decline in 10-year US Treasury yields, for example, translates into over a 5% capital gain to EM corporates, above and beyond the carry return.

EM corporates have been resilient as an asset class. Reflecting on a longer-term history, the CEMBI has shown itself to provide higher carry, and exhibit lower volatility – especially during drawdowns – versus Asian corporates and US high yield (see Figure 3). EM corporates have outperformed Asian corporates and US high yield over recent time periods and avoided the drawdown from China real estate and from the debt distress in broader EM debt. As the universe offers a diversified global set of countries and industries, it's not as beholden to a single economic cycle or central bank policy as US corporates can be. The fact that EM corporates is a hybrid asset class (over 50% investment grade) makes the yield versus these other asset classes even more interesting. As EM corporates are also under owned, lacking dedicated investors, the spread by rating group tends to be higher than DM counterparts, apples-to-apples.

1 As of June 2024.

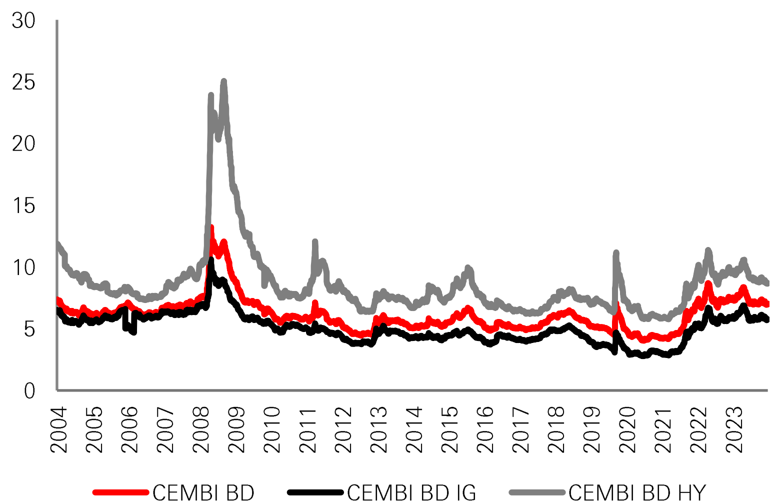
Source: HSBC Asset Management.. Any forecast, projection or target where provided is indicative only and is not guaranteed in any way.

Figure 1.
EMD asset classes have recovered



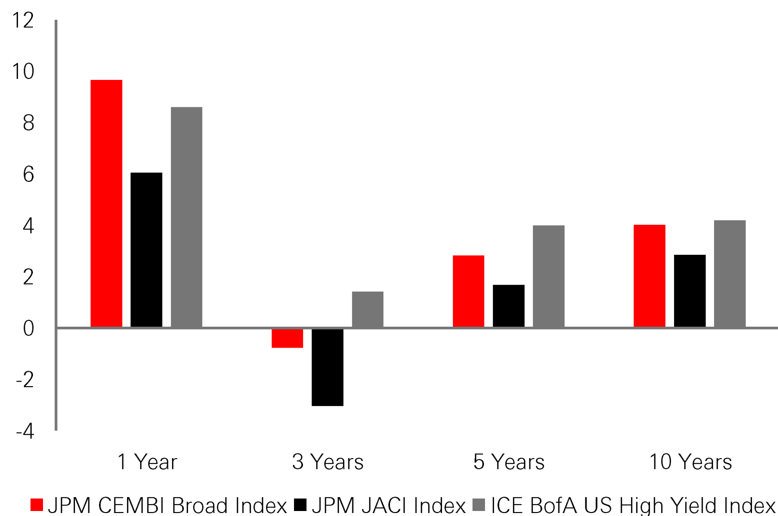
Source: JP Morgan, HSBC Asset Management, as of June 2024.

Figure 2.
20-year history of EMD yields



Source: Bloomberg, HSBC Asset Management, as of 07 July 2024.

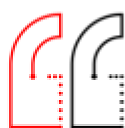
Figure 3.
Historical Fixed Income Index Returns



Source: JP Morgan, HSBC Asset Management, as of June 2024.

Over the past decade, EM corporates have matured as its own asset class. Looking at the market capitalization as represented by the JP Morgan indices, EM corporates were just 25% of the size of the US high yield bonds asset class 15 years ago; today, they have closed the gap and are now nearly at the same size as US high yield (see Figure 4). Thanks largely to new issuers, many of which are small- and medium-businesses and private companies which represent about half of the total issuer count in EM corporates, its market capitalization has roughly doubled over the past decade. This is healthy growth: issuers are largely prudent, and leverage ratios stand well below their US and EU corporate peers both in investment grade and high yield segments (see Figures 5 & 6). EM companies have been able to maintain this discipline even during the period of zero interest rates.

EM corporates offer something quite distinct. The overlap with companies in the EM equity benchmark is only 29%, and EM corporates provide exposure to over three times as many companies (see Figure 7). What is added on top of the publicly listed companies are in many cases more niche companies with a strong competitive edge in their geographies and with growth potential due to private and family ownership. This is a source of return that is largely seen with EM corporate bonds. It is a complementary – not overlapping – investment set to EM equities.

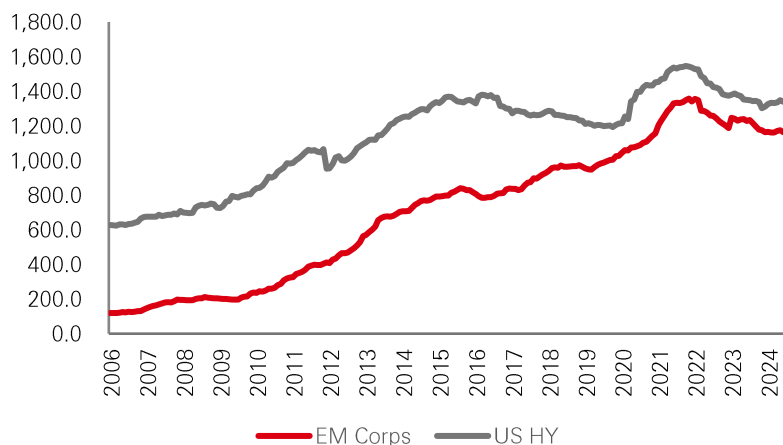


We see the potential for strong total returns within EM corporate bonds over a twelve-month horizon. Fundamentals are driving EM performance once again—they have improved and remain strong.

- L. Bryan Carter,
Head of Global Emerging Markets Debt

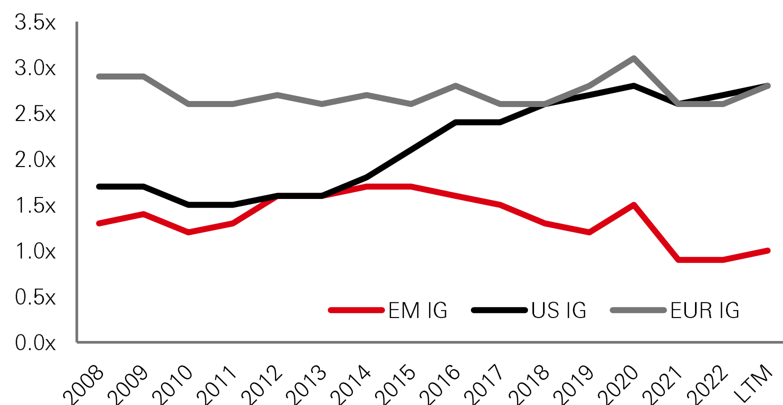
Source: HSBC Asset Management. Any forecast, projection or target where provided is indicative only and is not guaranteed in any way.

Figure 4.
Size of Corporate debt universe ($US bn)



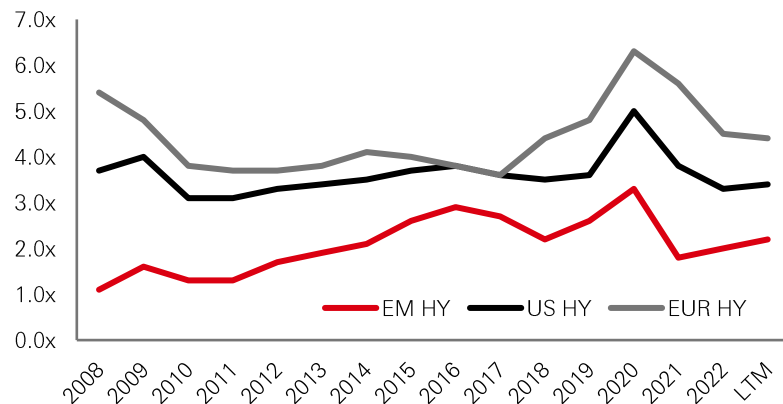
Source: JP Morgan, BofA Merrill Lynch, as of June 2024.

Figure 5.
Global Investment Grade Leverage



Source: JP Morgan, as of June 2024.

Figure 6.
Global High Yield Leverage



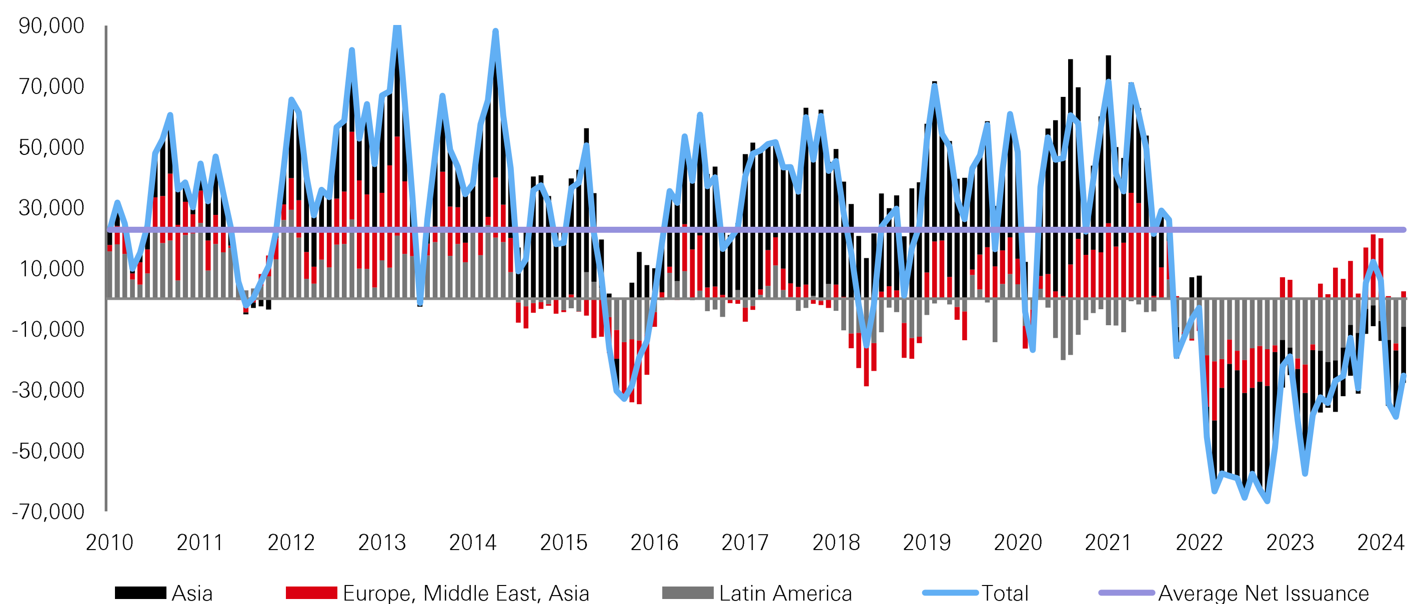
Source: JP Morgan, as of June 2024.

Figure 7.
EM Corporate debt offers broader exposure than EM Equity

	# of Issuers	Member of MSCI EM	% of Overlap
JPM CEMBI	456	176	39%
JPM CEMBI Broad	733	211	29%

Source: JP Morgan, MSCI, HSBC Asset Management, as of 30 June 2024.

Figure 8.
Net Corporate Supply (3 Month Rolling, $Bn)



Source: BofA Merrill Lynch, as of June 2024.

EM corporates: very strong technical underpinnings. Technical factors such as supply (market issuance) and positioning are favorable for investments in the asset class. EM debt has only just begun to experience inflows following other fixed income assets, and we expect more rotations into EM bonds especially from shorter duration fixed income as the rate cut cycle unfolds. A scarcity effect is materializing in EM assets as a legacy of the period when interest rates were rising sharply. In 2022-2023, the corporate EM debt markets experienced an unprecedented period of slow issuance, as the credit crunch made it increasingly unattractive for borrowers to refinance or re-tap the bond markets (see Figure 8). The result is that ongoing coupon payments, amortizations, and redemptions are anchoring EM bond valuations by outpacing the rate of supply, a phenomenon we call 'net negative' issuance. This suppressed volatility in EM corporates as cash was reinvested into the smaller pool of securities and duration extended into a dwindling capitalization of bonds. This may explain the outperformance and lower volatility of EM credit in recent quarters. Reduced EM primary market (new) issuance can reinforce positive results ahead.

For EM corporates, a cycle of deleveraging is paying off with companies able to draw on cash reserves or credit lines, or delay capital projects, to bridge the high-interest rate period. What we may see more of, given the preponderance of legacy low coupon bonds from the QE period, is increased frequency of market tenders to buy back low dollar price bonds and spread-out maturities over a longer repayment horizon. This typically benefits existing bondholders as issuers pay a premium for the transaction.

Summary: Why corporates?

EM corporate bonds seem poised to enter a period of favorable returns from the standpoint of the macroeconomic cycle, country fundamentals, bottom-up company strength, and technical factors. High carry is compounded by the capital gain effect of declining interest rates, providing a once-in-a-cycle opportunity for equity-like returns. EM corporates exhibit lower volatility and lower leverage levels, they are able to withstand periods when markets are closed and hold value regardless of the interest rate environment. For these reasons, we believe the risk-return proposition of EM corporates make it a super-optimal asset class for long term investors.

Source: HSBC Asset Management. Any forecast, projection or target where provided is indicative only and is not guaranteed in any way.

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