

»Emerging Market Corporate Bonds: Outlook for 2021

Emerging Markets Portfolio Management Team
10 December 2020

EM outlook 2021: We see opportunities

Executive summary

- **Valuations:** We find current valuations attractive as emerging market spreads have lagged their developed market peers in the recovery. We see the potential for a substantial spread tightening, especially in high yield.
- **Macroeconomics:** The economic recovery is under way, supported by fiscal and monetary stimulus, and a potential vaccine offering clear upside potential. Globally elevated debt levels remain as an overhang.
- **Technicals:** The technical environment remains highly supportive. Increasing asset allocation to emerging markets and compelling valuations, against a backdrop of modest new issuance, are factors that have underpinned emerging markets, despite a challenging market environment.
- **Conclusion:** For 2021, we see total returns for this asset class achieving mid to high single digits.

Review of 2020

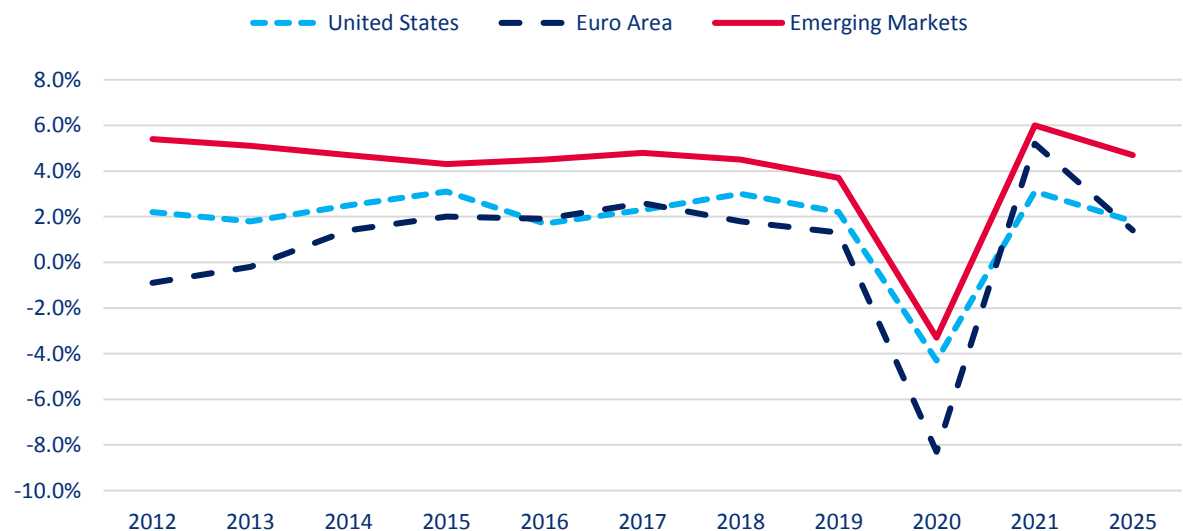
In our emerging markets (EM) outlook for 2020, we expected a spread tightening, combined with an accommodative interest rate environment, to generate a mid-to-high single-digit performance, in total return terms. As was the case for most investors, we did not foresee a pandemic putting unprecedented stress on economies and financial markets around the globe. Despite this, a quick recovery of asset prices, alongside the fiscal and monetary expansion, leaves EM corporates with a positive year-to-date return. The following is a review of our calls for 2020:

- **View:** We expected the Fed to continue with a moderately expansive monetary policy in the face of a slowing business cycle.
Result: In reaction to the pandemic, the Fed dropped interest rates to almost zero, and re-established other crisis fighting tools to avoid an imminent market breakdown. This clearly exceeded our expectations regarding monetary expansion.
- **View:** We felt valuations were compelling and saw room for a meaningful tightening of spreads.
Result: While spreads did not tighten from the levels at the beginning of the year, this is not surprising given the circumstances. Nevertheless, since the peaks in March, investment grade spreads have largely recovered towards pre-crisis levels, although high-yield spreads remain materially wider.
- **View:** We expected elections to have a smaller impact on EM than in 2019. We abstained from making a specific call on the US election.
Result: While elections in EM were indeed not very impactful, the expectations running up to the US election nevertheless caused volatility in financial markets. Nonetheless, EM corporate fundamentals remain generally unaffected by the election outcome.
- **View:** We expected a favourable technical environment, driven by strong issuance and investor inflows in the asset class.
Result: Gross issuance is indeed on track for a record year as the low interest rate environment opened the doors to opportunistic re-financings and liability management transactions, while leaving net new supply surprisingly modest and easily absorbed by reinvestments and inflows into the asset class throughout the year.

Looking towards 2021: We are optimistic

- **Global economy:** While the second wave of the pandemic hinders the recovery in developed markets (DM), EM economies remain resilient. The contraction in the current year in EM is generally expected to be smaller compared to DM, and a few countries, such as China, will even expand. For 2021, the economic recovery in EM economies is generally expected to be faster, reflecting not only their resilience, but also their longer-term higher growth potential. As only one example of many, the International Monetary Fund expects EM economies to expand by 6.0% in 2021, compared to 5.2% in the EU and 3.1% in the US, having contracted by 3.3%, 8.3%, and 4.3% respectively in 2020.

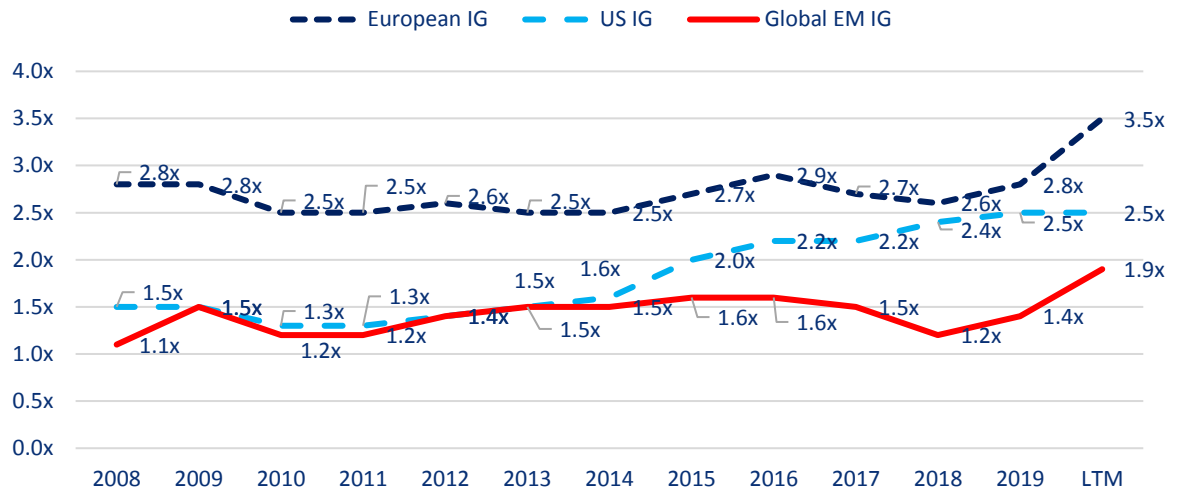
Chart 1: GDP growth (p.a. in %)



Source: IMF, November 2020

- **Fundamentals:** We remain constructive on EM corporate fundamentals. We see superior growth at the macro level driving earnings growth and allowing companies to slowly return to more normalised profitability levels. In addition, companies continue to retain access to liquidity, both through the corporate bond and bank loan markets, which eases the transition back to normalised earnings levels. This dynamic will allow EM corporates to post improved fundamentals in 2021, continuing the trend of lower leverage levels than DM peers (see Chart 2). Net leverage is expected to remain below 2.0x in EM corporates, compared to 2.5x in Europe and respectively 3.5x in the US. Similarly, EM HY default rates are expected to fall from currently 3.5% down to 2.8%, below the 3.5% long-term default average.

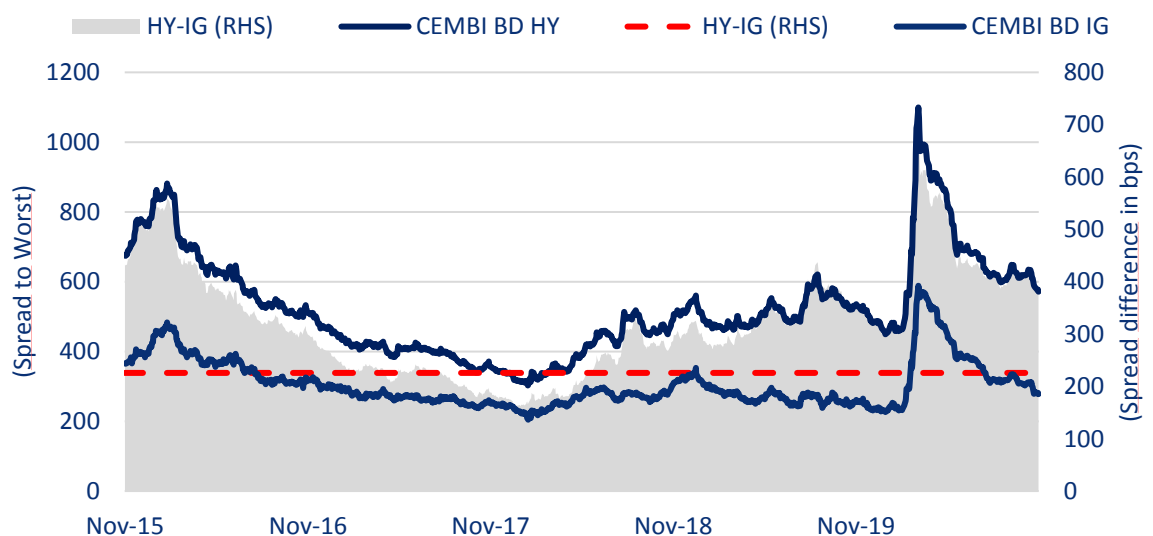
Chart 2: Net leverage



Source JP Morgan, October 2020

- **Valuations:** Going into 2021, we regard valuations as attractive. The spread over DM has in general gained additional attractiveness in the low-yield environment. Throughout the crisis, EM corporates have continued to offer a premium compensation for the risk assumed, on better fundamentals. Following the lack of direct purchases of EM corporate bonds by central banks in contrast to DM, the recovery of the former has slightly lagged their peers in the latter. As EM corporate spreads remain approximately 40 bps wider in IG, respectively 100 bps wider in HY when compared to their pre-Covid levels, we see considerable scope for spread tightening.

Chart 3: Five-year credit spread evolution of EM IG and EM HY

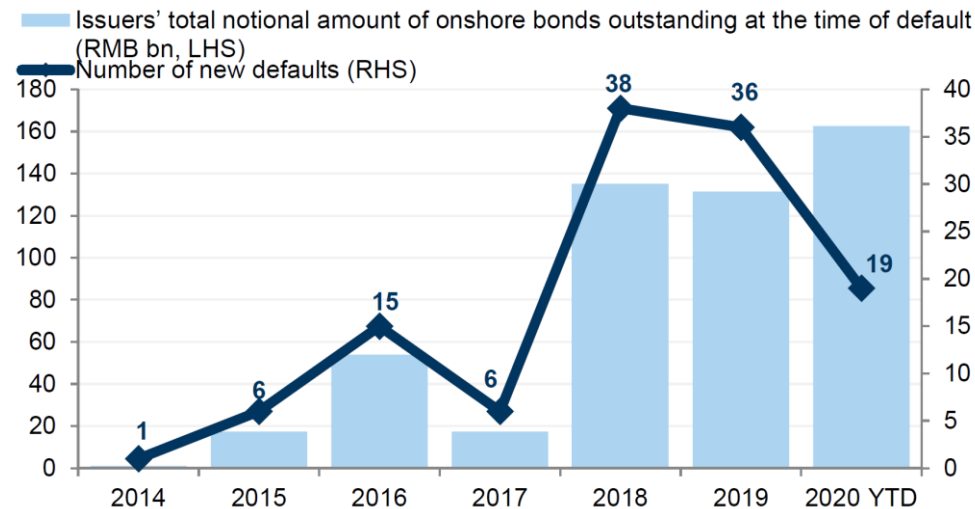


Source JP Morgan, November 2020

- **Interest rates:** The strong monetary expansion has brought all major economic regions near or below zero interest rates. While some economic headwinds remain, interest rates will likely rise as economic growth begins to normalise. Given this environment of record low interest rates, we remain cautious in terms of duration in our portfolios, while closely monitoring first signs of reflation. A steepening yield curve, initiated by a reflationary uptick, presents a clear downside scenario for

longer-duration corporate bonds, although active management can mitigate this risk with timely portfolio adjustments where appropriate.

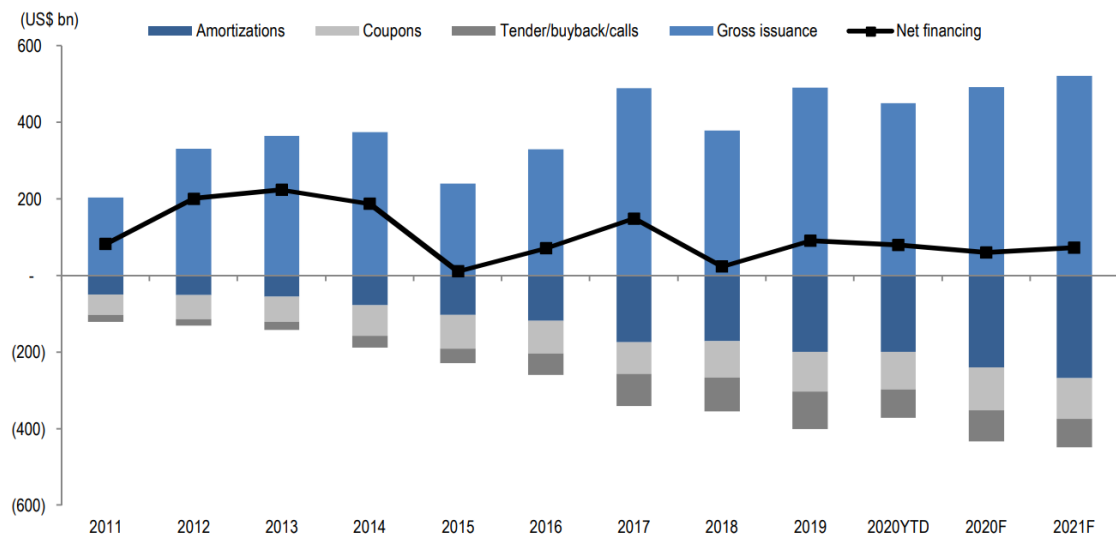
- **Sovereign fiscal deterioration:** While corporate fundamentals have remained solid, many EM sovereign balance sheets have deteriorated in 2020. While this is not a trend isolated to EM, potential sovereign downgrades will be important to monitor, especially for countries such as Mexico, Colombia, and India, where Covid-19 added fuel to an already challenging fiscal situation. A mitigating factor is that much of the debt increase has been at the local level, which tends to be more sustainable. Nevertheless, it remains an important factor to monitor in 2021.
- **Local market developments:** In recent years, local markets have deepened significantly, a trend we expect to continue in 2021. The ability to access funding in local currency reduces hedging costs and allows for diversification in funding sources for EM corporates, which provides additional stability to the asset class.
- **Elections:** 2021 will be an even quieter year for elections, as most of them – in EM as well as the US – are now behind us. At the same time, there are a few political developments worth monitoring, including the drafting of a new constitution in Chile as well as presidential elections in Peru. While we do not expect these to have a global impact, they could signal wider trends at the regional level.
- **Sino-US dynamics:** 2020 has been a difficult year for US-Sino relations, which culminated with the US Treasury Department imposing sanctions on several Chinese government-related entities. The question for investors in 2021 is whether a Biden-led Government represents the beginning of a more drawn out ‘battle’ between the US & China and what it means for Chinese credit spreads.
 - In our opinion, a Biden administration will represent a ‘step change’ in US relations with China. While conceptually both parties agree (Democrats and Republicans) that the trade balance between the US & China has to be addressed, we feel a Biden administration may evoke a more diplomatic strategy: One that does not involve sanctions at its core. Given that the recent sanctions were imposed through executive orders, they can easily be revoked by the new administration. However, until we see this policy change, our sense is that the spreads of state-owned entities will continue to underperform, and we prefer to focus on those private businesses that will be the beneficiaries of robust GDP growth in China in 2021.
- **Chinese on-shore defaults:** 2020 has seen a number of high-profile defaults in the Chinese onshore bond market. The key question is: Should investors be concerned? We see this as a continuation of the credit clean-up that began in 2018. We have held the view throughout that allowing over-levered entities to default and restructure their indebtedness are steps in the right direction, and will help to improve credit pricing and the allocation of capital. We view the recent measures of the Chinese government to limit leverage at real estate developers as a continuation of this theme. We remain constructive on the bonds of real estate companies in China and view these regulations as ‘softening’ the boom-and-bust cycles that have characterised the sector in the past. As always, there will be winners and losers from this regulation, and focusing on credit fundamentals and picking the winners will be key.

Chart 4: China onshore bond new defaults since 2014

Note: we exclude defaults from privately placed Corporate Bonds (i.e. those regulated by CSRC) issued prior to 2015, as they related to small sized unlisted companies with very limited information disclosure.

Source Wind, Bloomberg, company announcements, Goldman Sachs Global Investment Research

- **Commodities:** We remain constructive on all commodity markets in 2021, as an improved demand will create a 'rising tide' which lifts all boats, and energy in particular. However, we also feel structural trends, such as increased electric vehicle penetration, will continue to assert themselves in key commodities, such as copper. With the largest producer of the metal (Chile) and the largest consumer (China) both residing in EM, we will continue to find attractive investments to provide exposure to these structural trends.
- **Liquidity:** 2020 was a great reminder of the importance of fundamental analysis during periods of uncertainty. While we expect 2021 to be a positive year for the asset class, some volatility is likely to remain. Ultimately, conviction and trust regarding fundamental credit work will be key for portfolio managers to get through bouts of short-lived market illiquidity.
- **Technicals:** 2020 has been another strong year for EM debt issuance. Gross issuance is approaching USD 500 billion once again, while net issuance is expected to reach USD 60 billion. Investor inflows, similarly, have held up, amounting to more than USD 11 billion as of November 2020. For 2021, we expect these two factors once again to generate a very favourable technical environment. Similarly, regional trends like the dominance of Asia and a growing local demand will likely continue. We expect these structural trends to strengthen, providing stability to regional spreads and a solid technical backdrop.

Chart 5: EM corporate external bond gross and net supply

Source JP Morgan, November 2020

Conclusion:

Emerging markets have demonstrated their resilience in 2020 as they have withstood, although not evaded, the volatility and will end the year with positive total returns. Nevertheless, EM corporate spreads still have significant room for a tightening in 2021, particularly in the high yield segment. The start of the economic recovery, the accommodative monetary environment, the progress in the development of vaccinations, as well as the positive technical context in EM, by virtue of healthy supply and growing demand, create a strong foundation for EM corporates. While Covid-19 clearly presents additional challenges to many EM economies, while several geopolitical and idiosyncratic regional concerns remain, we believe that the opportunities should compensate for the downside risks in the asset class for the coming year. We therefore expect EM Corporates to deliver returns in the mid to high single digits in 2021.

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