

»Emerging Market Corporate Bonds: Outlook for 2022

Emerging Markets Portfolio Management Team
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EM outlook 2022: Grounds for optimism

Executive summary

- **Valuations:** Attractive overall, especially in the high yield segment and relative to developed markets but with regional variations
- **Macroeconomics:** Emerging markets growth has proven resilient, but differentiation among individual countries and segments will be key to capturing returns and mitigating risks. The growth gap relative to developed markets should widen in favour of EM
- **Fundamentals:** Excluding the Chinese property sector, credit fundamentals remain strong
- **Conclusion:** For 2022, we see total returns on the broad index level achieving mid to high single digits

Review of 2021

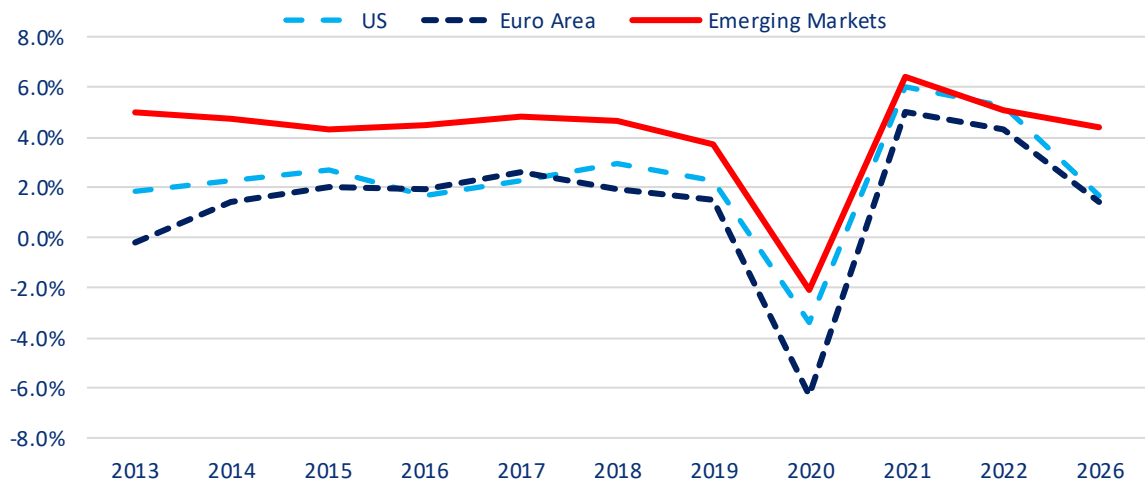
In our emerging markets (EM) outlook for 2021, we saw the potential for substantial spread tightening driven by a global post-pandemic economic recovery, combined with highly supportive market technicals. In particular, we felt that compelling valuations would support increased allocation to the asset class, while primary-market supply would again prove to be modest. While we expected a challenging interest rate environment for 2021 as both the Fed and the ECB would eventually slow and ultimately reverse their respective highly accommodative monetary policies, we did not expect the high degree of volatility that accompanied us throughout the year in terms of outright interest rate levels, but also in respect of interest curve shapes that witnessed a seesaw battle between curve flattening and steepening throughout 2021. Despite these challenges, the asset class still managed to generate a modestly positive return for the year. The following is a review of our calls for 2021:

- **View:** We expected emerging market economic growth rates to again outpace those seen in the developed economies.
Result: Emerging market economies generated GDP growth in 2021 of 6.4%, modestly higher than expected by the International Monetary Fund, while developed economies grew by 5.2%.
- **View:** We felt corporate bond valuations were attractive on an outright basis, as well as in comparison to developed markets.
Result: Credit spreads did tighten. However, there was a more meaningful tightening generated, in relative terms, within the investment grade segment. While non-investment grade credits also benefitted from a general tightening trend, the fall-out in the Chinese property market had a significant negative impact on this segment in aggregate.
- **View:** We were constructive on the prospects of EM corporate fundamentals and expected a meaningful recovery from the early challenges of the pandemic.
Result: Credit metrics recovered faster and more broadly than we had anticipated. In fact, some key credit metrics, such as EBITDA, came in higher than pre-pandemic levels.
- **View:** We highlighted the increase in Chinese onshore defaults in 2020 and acknowledged the risk that this trend could ultimately pose to the overall investment sentiment to the broader Chinese market in 2021. We held the view that the Chinese property market offered compelling opportunities, but credit differentiation was going to be key to achieving success in this segment.
Result: Developments in the Chinese property market proved to be much more challenging than most – including us – had expected. While credit differentiation and strong security selection were paramount to avoiding capital losses, the aggregated challenges faced by this segment proved to be too significant to generate positive returns.

Looking towards 2022: A more challenging year, but we remain optimistic

- **Global economy:** The global expansion is set to continue after the strong recovery in 2021, albeit at a slower pace. While Covid-19 outbreaks will remain an ongoing risk, we believe that many EM countries are better positioned than the consensus view, with EM vaccination rates in line with those seen in DM countries. Supporting this thesis, the International Monetary Fund expects EM economies to expand by 5.1% in 2022, compared to 4.3% in the EU and 5.2% in the US.

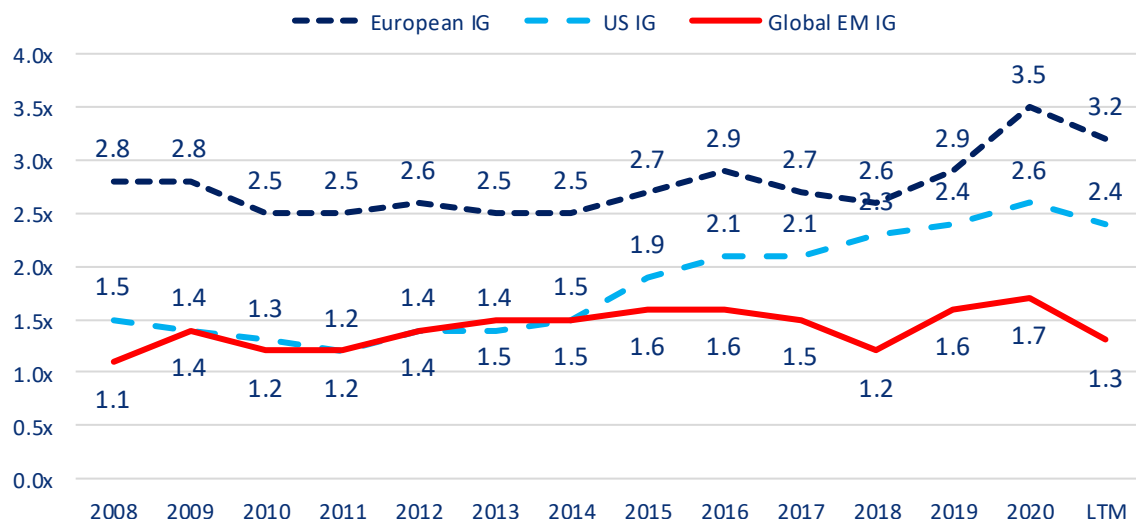
Chart 1: GDP growth (p.a. in %)



Source IMF, November 2021

- **Fundamentals:** Throughout 2021, earnings have been recovering substantially, with all regions posting double-digit revenue growth. Leverage ratios improved significantly on the back of increasing EBITDA as well as flat debt levels. For 2022, we remain constructive on EM corporate credit metrics. Fundamentals should remain solid and driven by modest growth in EBITDA as well as continued flat debt levels. We do not foresee a substantial re-leveraging taking place as most corporates are not engaging in aggressive capex plans or M&A. Correspondingly, net leverage among EM corporates should remain at 1.5x, and thus significantly below DM peers (see Chart 2). EM high yield default rates for 2022 are expected at 3.9%, whereby most of the defaults are anticipated from the Chinese property sector as well as Argentina. Outside of these regions, however, defaults should be limited at 1.1%.

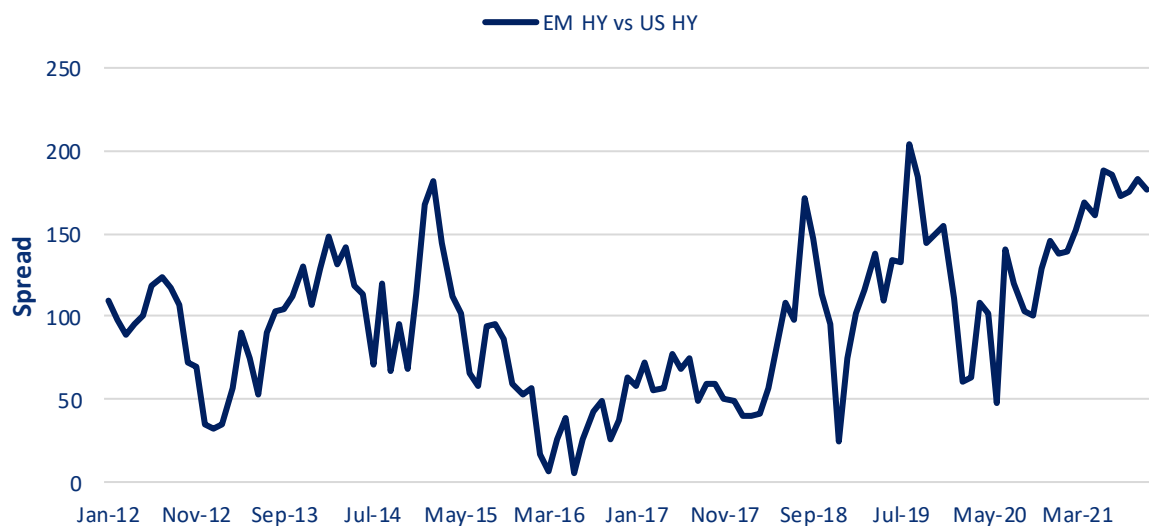
Chart 2: Net leverage



Source JP Morgan, October 2021

- **Valuations:** We believe EM corporate valuations remain attractive on an outright basis as well as in relative terms when compared to DM corporates as demonstrated in Chart 3. However, while valuations screen cheap, they also differ meaningfully across the different regions. Stabilization in Asian high yield, a steady improvement in India and Indonesia, a partial recovery in Middle Eastern real estate companies, and a greater exposure to frontier markets appear to constitute clear opportunities to us. In contrast, Latin America will be more challenging, given the upcoming elections and the related political uncertainties and policy execution risks.

Chart 3: Five-year credit spread differential of EM HY vs US HY



Source JP Morgan, November 2021

- **Developed market interest rates:** We expect 2022 to be another year where post-pandemic monetary policy normalization will translate into performance headwinds for fixed income products. US Treasury yields have nearly doubled year-to-date, but remain below pre-pandemic levels. The Fed will likely begin its long-awaited tightening cycle over the course of the coming year, though one could argue that much of that is already reflected in the current shape of the US Treasury curve. While not immune to further rising rates, a key characteristic of EM corporates is their shorter duration as well as a lower correlation to movements in US Treasury yields. As such, EM corporates will not completely escape the impact of rising yields, but can weather them better than longer durations and more highly correlated fixed income instruments.
- **Growth:** Growth will be driven by continued economic reopening on the back of expanding vaccination campaigns as well as continued strong commodities prices and solid credit fundamentals. Further stimulus should come from inventory build-up as well as further drawdown of private savings. In general, we believe the growth differential between emerging and developed markets will increase again from 2022 onwards. In Latin America, we expect growth to diverge among the various economies, depending on the different exposures to commodities, progress on the reopening, fiscal constraints, inflation and varying stances in the monetary cycle. In this setup, Colombia and Mexico should outperform. Given the severe water shortages, weather conditions will continue to play a key role for inflation and growth dynamics in Brazil. China's economic growth will, as always, be of high consequence to not only EM, but also to global economic activity. We expect a stable Chinese economy and a modest uptick due to policy loosening, but we believe that part of the tightening in credit conditions is here to stay. India and Indonesia are set to be the outperformers in the region, delivering strong growth on the back of a recovering

service sector and, in the case of Indonesia, strong commodity prices. In EEMEA, Russia will continue to benefit from high energy prices, further improving the country's fiscal and current account position; however, geopolitical risks will remain a swing factor. For Turkey, we are less optimistic, expecting a continuation of unorthodox monetary policies for the moment.

- **Inflation:** A lot of emerging market countries, especially in Latin America, are already facing very high inflation rates. In Brazil, inflation is expected to end 2021 at above 10%. Nevertheless, we believe that inflation will peak at the end of 2021 in most economies, and gradually decline throughout 2022. Contrary to their counterparts in developed markets, many central banks in emerging markets have already reacted and tightened monetary policies very sharply – a path we expect to continue for 2022.
- **Elections:** Elections will once again play a meaningful role in the coming year. US Congressional elections will be a focal point for broader risk markets. Within EM, Latin America will see several important elections in 2022, including presidential elections in Colombia and Brazil, the latter one being expected to create headlines throughout the year. In addition, the process of drafting a new constitution creates uncertainties around the future investment environment in Chile.

Country	Election type	Date
Costa Rica	Presidential & legislative	February
South Korea	Presidential	March
Colombia	Legislative	March
Hong Kong	Executive	March
Philippines	Presidential & legislative	May
Colombia	Presidential	May
Lebanon	Legislative	May
India	Presidential	July
Kenya	Presidential & legislative	August
Brazil	Presidential & legislative	October

Source JP Morgan, National Democratic Institute, IFES

- **China domestic policies:** The Chinese economy is in a transitional period, with policymakers focusing more on the quality of growth rather than the quantity. The 'Common Prosperity' policy is part of this transition and aims to reverse the structural inefficiencies created in the previous years of fast-paced growth.
In that context, the education and property sector policies aim to reduce the cost of supporting a family, and reduce systemic risk by controlling the leverage and overall exposure in the real estate sector. While we expect marginal policy easing, we also expect that the structural credit tightening introduced this year is here to stay, especially in the property sector. We expect to see further Common Prosperity measures to evolve over the intermediate term, some of which may prove to be negative for the asset class in certain sectors.
- **China property/high yield segments:** We do not see a risk for systemic contagion in the Chinese property sector as policymakers have the tools to avoid such an event. We think that the sector's fundamentals will remain challenging while controlling home prices, and leverage within the sector

will continue to be a top priority. Higher quality developers are set to survive and potentially pick up market share, but lower-rated developers will face financial stress from a combination of lower sales and tougher financing conditions. We expect the market to remain volatile, but dislocations can create opportunities in the higher-quality segment of Chinese developers. More importantly, we see opportunities in the non-property part of Chinese high yield bonds. We envisage a slower but stable Chinese economy, which means that other segments of the economy are set to perform well. We believe the recent spillover of property volatility offers attractive opportunities in credits that have cleaner balance sheets and trade at attractive valuations.

- **Technicals:** EM corporate debt issuance has again been very strong during 2021. Gross issuance is expected to end the year at a record of USD 540 billion, while net financing should reach USD 65 billion. Inflows into EM hard currency bonds have also recovered strongly and reversed the outflows during the pandemic, standing at USD 27 billion as of November 2021. For 2022, we expect the technical environment to remain supportive, driven by a combination of solid demand and low net financing. Inflows into the asset class should remain moderate, supported by a current lack of global positioning in EM fixed income, continued global liquidity creation as well as positive return expectations. Conversely, net financing should decline as many issuers had pre-financed cashflows in anticipation of higher rates, and maturity volumes are expected to increase.

Conclusion:

We believe EM corporate risk premiums remain attractive and, in contrast to DM corporates, still have room to tighten in 2022. Once again, the high yield segment in particular offers the most compelling opportunities for more meaningful credit spread tightening. Furthermore, the combination of favorable supply technicals, along with comparatively strong and yet still improving credit metrics should drive further allocation to the asset class. As such, we expect returns to be in the mid-single digits for the broad EM corporate segment, while high single-digit returns in the EM high yield segment seem achievable to us.

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