

» Outlook 2023 Emerging Market Corporate Bonds



December 2022

Marketing material



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Executive Summary

- Emerging market (EM) corporates have undergone an extremely challenging 2022, as the combination of sharply higher rates and widening credit spreads provided no hiding place.
- Economic soft landings are rare but not impossible. Our base scenario with a shallow and short recession in the US and a growth recovery after the first quarter leads us to forecast high single-digit returns for the full year 2023. We prefer higher-quality names with attractive carry but limited default risks.
- EM corporates have built a valuation buffer versus EM sovereign bonds and US high yield. Credit spreads appear fair in the current business cycle, while cash prices trading at historical lows given the rate adjustment offer some protection. With balance sheets remaining robust and low leverage, EM companies should be able to sustain margin pressures.
- Acknowledging the current uncertainties, EM central banks approaching the end of their tightening cycles will improve risk sentiment, triggering potential fund inflows into EM hard-currency corporates. Default rates are likely to prove similar to 2022, again tilted to China properties, Russia and Ukraine.

Review of 2022

The year 2022 proved to be a challenging year for EM corporate bonds. Two developments were the main drivers: the invasion of Ukraine by Russia and the first bear market in interest rate markets in decades. Despite the fundamentally solid financials of most of our investment universe, these two factors, in addition to the general widening of risk premiums, led to the most challenging year since the financial crisis in 2008.

As we had expected, local macroeconomic and political factors were particularly central for the overall outcome rather than industry- or company-specific issues. In Asia, the focus was mainly on China's Zero-Covid policy and the weak real estate sector. In addition, Asian countries continued to benefit from their historical propensity for lower inflation. The Middle East, buoyed by exceptionally high oil prices, proved remarkably stable, further supported by a broad local investor base. In Latin America, political developments, in particular, drove risk premiums. Despite the challenging situation in some countries, the region proved robust overall thanks to fundamentally solid companies and its links with the US. Fiscally vulnerable countries with high external financing requirements came under particular pressure, suffering from higher financing costs and uncertainties regarding refinancing. This affected Africa, in addition to certain countries in Asia and Latin America.

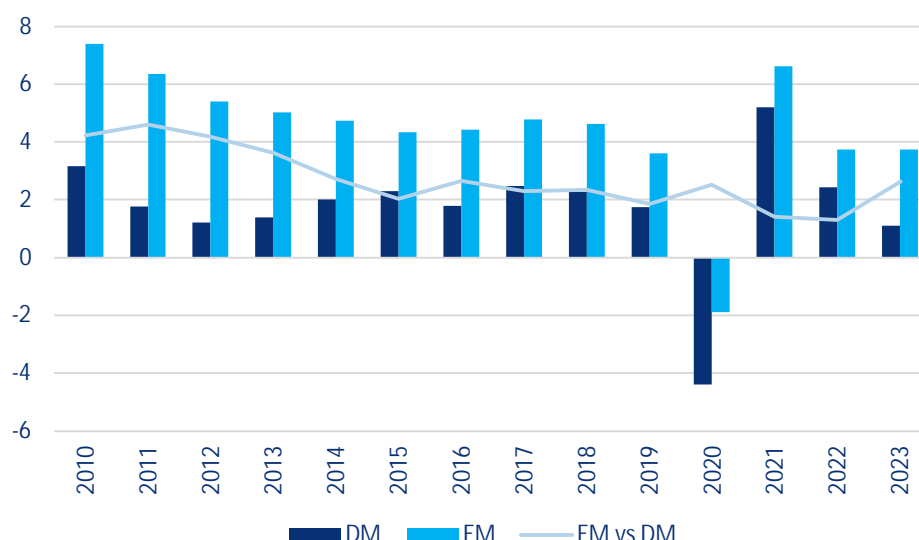
Our Defensive strategy benefited in terms of relative performance from our careful positioning in Russia. On the other hand, our Opportunistic strategy benefited from strong security and sector selection but suffered from its general risk overweight. The Dynamic strategy was launched in early May, in the midst of a highly challenging environment, and offers attractive valuations and solid fundamentals, giving it an interesting convex risk profile at this point in time.

Outlook 2023

» We see attractive entry points for longer-term investors.

Economic soft landings are rare but have been witnessed before. The widespread sell-off in EM corporates creates attractive entry opportunities for investors with a longer-term investment horizon. In our view, this is an exceptional environment for generating high single-digit returns from good-quality assets, a chance to embrace income not seen for a long time. Yields in EM corporates have risen markedly, while expectations for slower global growth are largely priced in. Moderating inflation, less policy tightening, and a lower US dollar point to a faster-than-expected decline in inflation. China's gradual reversing of its zero-Covid policy could prompt a rebound in economic growth and support the widening of the growth gap between emerging and developed markets (see Chart 1).

Chart 1: EM and DM GDP growth forecasts (in %)



Source IMF WEO Oct. 2022

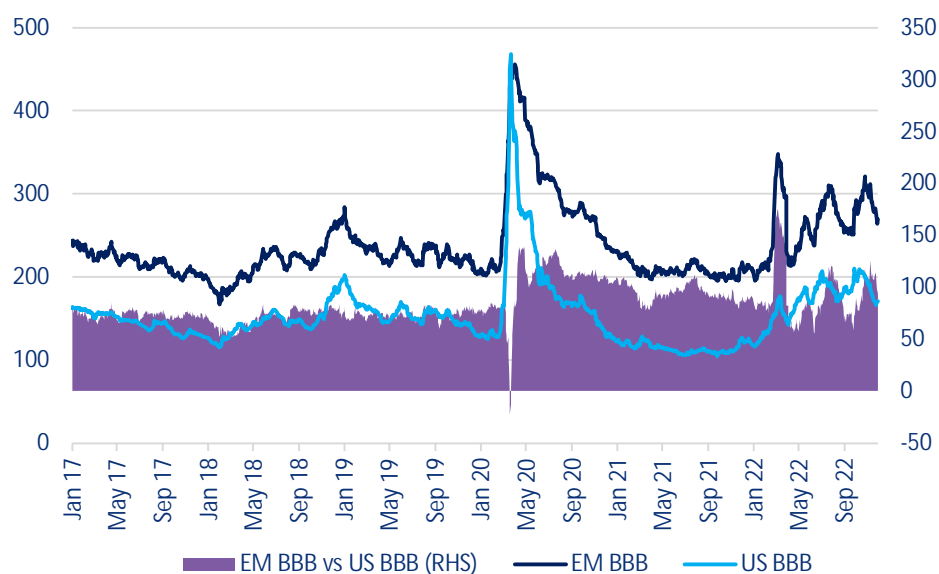
Valuations

» China's zero-Covid policy has led to distortions in valuations across Asia.

The valuations of EM corporate bonds are attractive – both in absolute terms and compared with their US peers (see Charts 2 and 3). In our view, they already reflect the global economic slowdown to a significant extent. There are substantial differences between the various regions, which suits us as active managers very well. Recently, the distortions in valuations in Asia, triggered by China's zero-Covid policy, the problems of the Chinese real estate market and partly also by large outflows of money from international investors, were conspicuous. Due to various measures taken by the Chinese government and the central bank PBOC, the entire region has recently

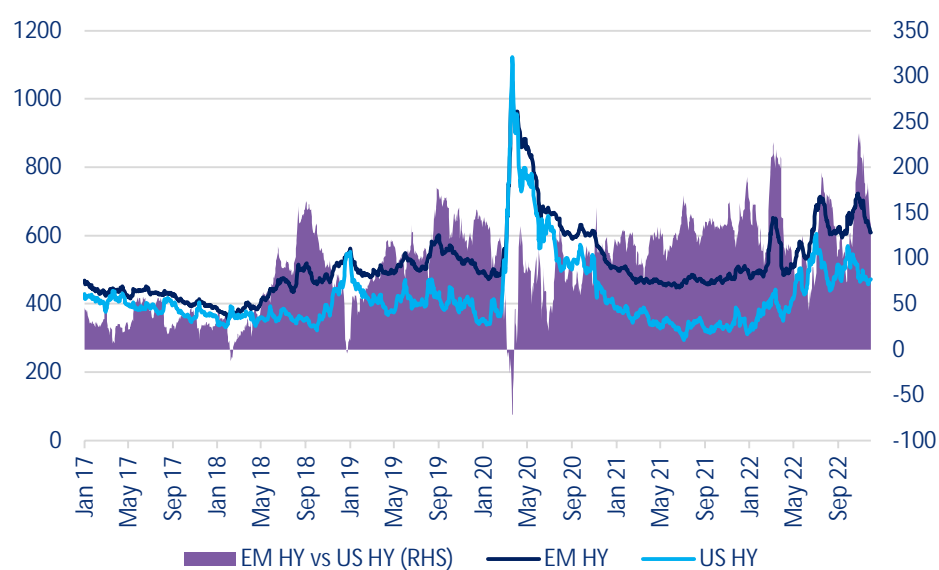
recovered significantly. Based on our assessment, we consider the opportunity set that presents itself in the sub-region Southeast Asia (ASEAN) as exciting and see the potential for narrowing credit spreads. The primarily healthy balance sheets of Latin American companies are currently already reflected in credit spreads. Based on fundamental analysis, we are convinced that we can identify further undervalued bonds in the region and selectively include them in our strategies.

Chart 2: BBB credit spreads – EM versus US (basis points)



Source J.P. Morgan, Bloomberg

Chart 3: EM and US high yield option-adjusted spreads



Source J.P. Morgan, Bloomberg

Technicals

In addition to the idiosyncratic risks of the asset class, important drivers of demand for emerging markets corporates include the development of the US dollar and risk-free interest rates. Here, we expect a significant easing compared to 2022. The interest rate differential between the euro and the US dollar should narrow, leading to lower currency hedging costs in the medium term and increasing international interest in US dollar bonds. However, attractive valuations versus comparable asset classes in a weakening macro environment are prerequisites for more robust demand for EM corporates. In contrast, the supply of new issues and expectations regarding defaults put a particular lid on investors' risk appetite.

The default rate is likely to remain relatively high at 10.6% (based on a forecast by J.P. Morgan) in 2023. Still, defaults should be limited to clearly identifiable areas, and we do not expect a significant deterioration in balance sheets in general. EM high yield defaults ex-China, Russia and Ukraine are forecasted at 3%, which is close to US and EUR high yield default expectations, in the range of 2-2.5% (J.P. Morgan).

Portfolio positioning

To pursue total returns, employing a slightly more defensive risk approach heading into 2023 and preserving an above-average liquidity level offer potential for taking advantage of market dislocations. As markets will remain highly data-dependent for some time, conservative positioning by moving up the credit quality spectrum, focusing on names with low refinancing requirements and solid balance sheets allow the potential weathering of volatility without a material credit deterioration. Risks challenging our base case scenario are not asset class specific, but include overly optimistic inflation forecasts, the US falling into a deeper recession, and a much slower path to China re-opening, all of which require close monitoring.

» We focus on security selection and better credit qualities.

With rates peaking, we expect investment grade and higher-quality high yield corporates to outperform. Before adding single B and lower-rated securities in our opportunistic strategies, we intend to wait for purchasing managers' indicators (PMI) to bottom. From a regional perspective, we will still prefer Latin America, the Middle East and Africa, while Europe is lagging. The China re-opening theme could provide a silver lining, likely benefiting Asia.

In the Defensive strategy, we will deliberately keep the beta low relative to the market based on the macro environment. Current yields are already offering attractive returns. With less volatility in interest rates, we expect better demand dynamics for highly rated bonds and focus primarily on security selection. Regionally, we prefer bonds from the Middle East and isolated regions in Southeast Asia. In Latin America, we are waiting for more attractive valuations.

Commodities

We remain constructive on energy, supported by constraints on global excess capacity after many years of underinvestment, ESG-related decommissioning, ongoing geopolitical uncertainty, and the likelihood of rebalancing growth towards Asia. Weak Q1 growth, combined with better functioning supply chains, is likely to keep commodity prices muted, amplifying disinflationary trends. But an increase in Chinese economic activity could lead to a recovery in demand for energy and metals.

Conclusion

EM total return opportunities provide grounds for optimism for 2023. Despite challenging conditions, EM growth is holding up better than growth in developed markets, leading to a widening growth gap in favour of EM. Current valuations provide attractive entry points for investors with a longer-term investment horizon. Bottom-up fundamentals for many EM corporates are still solid, and investors' positioning is light. Diversification across regions, countries and sectors and stringent relative value security selection will be again paramount to success.

Signals to watch to turn more optimistic include easing geopolitical tensions, moderating inflation, and growth in China to improve. China may boost global expansion as it emerges from zero-Covid, while the ongoing war in Ukraine is likely to keep energy prices high.

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