Investors seeking to match future liabilities need stable, predictable cash flows. However, this objective is more challenging to achieve now than ever before. Drastic rate cuts by central banks and a flight to safety in response to the global health crisis have brought interest rates in developed markets to near all-time lows. Meanwhile, yields in fixed income asset classes perceived as “risky” are relatively high, but come with concerns about rising default rates as a result of the weak and highly uncertain macro environment. Furthermore, equity markets no longer provide the income they once did, as companies have eliminated or cut dividends to preserve cash flow or fund share buybacks.
Emerging markets debt (EMD) represents a potential solution for investors seeking to earn attractive carry without losing sleep over default risk. Current valuations make today’s market environment an ideal entry point for yield-starved investors.

EMD: An Alternative Source of Income

In the current environment, we believe hard currency—mainly dollar-denominated—emerging markets debt represents an attractive opportunity for income-oriented investors. It offers a unique combination of attractive yields, low default rates, strong risk-adjusted returns, and access to a large, diverse investment universe.

Attractive Yields

Perhaps the single most compelling feature of EMD for income-oriented investors is the attractive yield currently available in the asset class. Yields across hard currency EMD are compelling both in absolute terms and relative to other fixed income alternatives (Exhibit 1). In the safest part of the asset class—investment grade sovereigns and corporates—yields exceed 3% on an absolute basis, more than 100 basis points (bps) higher than similar-quality credit in developed markets. For investors with higher return targets and a higher risk tolerance, the high yield segment of EMD offers yields over 8%, which is also a roughly 100 bp premium compared to developed markets bonds with similar ratings.

Investors willing to look beyond developed markets will find that EMD has long offered additional yield and spread compensation. However, the current spread advantage for EMD is towards the wider end of historical ranges (Exhibit 2). The spread pick-up for EMD has typically averaged around 50 bps for investment grade and 100-150 bps for high yield. It is currently around 70 bps and 300 bps, respectively, making the current entry point even more compelling.

In short, in a world with more than $11 trillion in negative-yielding debt outstanding, EMD offers an attractive yield pickup relative to developed markets—a potentially powerful tool in generating consistent, positive investment returns. What’s more, investors need not assume significant incremental credit or interest rate risk to collect this additional yield.

Exhibit 1
EMD Yields are Attractive on Both an Absolute and Relative Basis

Exhibit 2
Spread Pickup in EMD Has Been Persistent and Is Currently High Relative to History
Low Default Rates

It is reasonable to wonder why the spread pickup in EMD has been so persistent over time. Higher default rates is not the answer. In fact, EMD high yield has lower realised default rates than developed markets high yield corporates (Exhibit 3). (Default rates in investment grade are effectively zero.) While emerging markets sovereign defaults in countries like Argentina, Lebanon, and Ecuador have recently made headlines, these countries comprise a relatively small share of the investment universe, and sovereign defaults are relatively rare. Since 2000, the average default rate for high yield emerging markets sovereign debt has been less than 2%, and even with an uptick in defaults is expected to be around 6% in 2020. Note that this is for the high yield portion of the asset class, which is only around half of the overall market. In contrast, developed markets high yield corporate default rates tend to be 3%–5% on average.

So why does this pricing anomaly exist? Shouldn’t this inefficiency cause investors to gravitate towards EMD, thereby causing the spread pickup to disappear? Credit spreads provide compensation for default risk and liquidity risk. It is fair to assume that liquidity in EMD is lower than in developed markets credit, but this would only partially explain the premium in EMD. Long-term investors should be happy to collect additional spread in exchange for sacrificing a small degree of liquidity.

However, we believe the main driver of the EMD premium comes down to perception and the investor base. Despite the vast improvements in macro prudential policy over the past couple of decades, there is still a perception that EM countries suffer from high default rates and bouts of contagion even though the evidence clearly suggests otherwise. Meanwhile, much of EMD’s investor base, especially corporates, is comprised of crossover or “tourist” investors (e.g., global fixed income investors, developed markets credit investors, etc.) who tend to exit the asset class when times get more challenging, they suffer outflows, or both. This has created an opportunity for long-term investors to harvest the attractive yields in EMD with limited risk of potential losses from credit impairment.

Strong Risk-Adjusted Returns

As a result of its attractive yields and low realised default rates, EMD has historically provided consistently positive returns. Since the late 1990s, hard currency sovereign EMD has generated positive returns in over 99% of the rolling three-year return periods and 100% of the rolling five-year periods (Exhibit 4). In fact, the only time an investor would have earned a negative return over a three-year period would have been if the investor exited the asset class during the depths of the Global Financial Crisis. Thus, we believe it is highly unlikely that the asset class will register a negative return over a time horizon of at least three years.

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Large, Diverse Universe

Despite often being overlooked for dedicated portfolio allocations, the EMD universe is one of the broadest and deepest non-core fixed income markets. The hard currency universe alone stands at roughly $3 trillion and includes over 70 countries and nearly 900 issuers across the sovereign and corporate markets. Even investors focused solely on the investment grade universe have a generous opportunity set with a market cap of nearly $1.5 trillion across more than 25 countries and over 425 issuers (Exhibit 5). The depth and breadth of this universe may also provide diversification benefits to a portfolio of developed markets bonds.

Other Considerations

Environmental, Social, and Governance Factors

Investors need not sacrifice returns in emerging markets when incorporating environmental, social, and governance (ESG) factors. In fact, our research shows a clear correlation between borrowing costs and ESG factors. Therefore, we believe that institutional strength is one of the biggest drivers of creditworthiness and thus, emerging markets credit spreads.

We believe thorough, bottom-up fundamental research should consider all factors that could affect an issuer’s ability and willingness to pay. ESG factors can pose significant risks if overlooked, and as such should be fully integrated with the analysis of more traditional economic factors, in our opinion. At Lazard, we use a proprietary approach for analysing more than 80 countries across 14 indicators, rather than relying solely on third-party data, which we believe has inherent shortcomings. The output of our approach is an ESG score for each country, which we compare to each issuer’s credit quality peer group. This analysis is aimed at identifying each issuer’s ESG strengths and potential risks versus its peers. Monitoring momentum and trends in an effort to identify issuers that are on an improving trajectory that may not yet be fully reflected in valuations is also critical in our analysis. We do not want to penalise a country that has a low ESG score because it is in an early stage of development but may be working to improve its outcomes.

Currency Hedging

Avoiding currency risk is key to preserving the attractive characteristics of EMD for income-oriented investors. Since the vast majority of hard currency EMD is denominated in US dollars, hedging costs are a critical part of the equation. For the past several years, higher interest rates in the US compared to the rest of the world has cost investors hedging to their home currencies much of the emerging markets yield pickup. As short-term interest rates have converged globally, however, the negative carry for euro-based investors has come down considerably (Exhibit 6).
Strategic Considerations

For investors seeking steady, predictable cash flows, we believe hard currency EMD is a compelling opportunity. The asset class offers several unique benefits, including attractive yields, low default rates, a steady return profile, and a large investment universe.

The Lazard EMD team has tailored an approach designed specifically to achieve these objectives. Our Credit Income strategy seeks to capture the risk premium available in EM credit markets with an emphasis on capital preservation. The foundation of our approach is rigorous, bottom-up fundamental research focused on identifying issuers with solid-to-improving fundamentals and a low risk of permanent credit impairment.

Exhibit 7 summarises the yields currently available in the market based on a generic set of guidelines. Notably, this approach is highly customisable to a client’s specific needs, including target yield, target duration, and credit quality.

<table>
<thead>
<tr>
<th>Portfolio</th>
<th>Yield</th>
<th>EUR Hedged Yield</th>
<th>Duration</th>
<th>Average Quality</th>
</tr>
</thead>
<tbody>
<tr>
<td>Portfolio A</td>
<td>3.4%</td>
<td>2.6%</td>
<td>5 Years</td>
<td>BBB</td>
</tr>
<tr>
<td>Portfolio B</td>
<td>4.5%</td>
<td>3.7%</td>
<td>5 Years</td>
<td>BB+</td>
</tr>
</tbody>
</table>

As at 30 June 2020

Expected returns do not represent a promise or guarantee of future returns and are subject to change. For illustrative purposes only.

Source: Lazard, JP Morgan

Our Credit Income strategy may provide several additional benefits, including a more predictable return profile and a stable, consistent income stream. Additionally, the benchmark-agnostic approach means we are not bound to hold positions in the largest, most heavily indebted issuers. Instead, we are free to select each bond on its own merit. Thus, security selection takes on greater importance. Default risk can be greatly reduced through detailed, bottom-up fundamental analysis. We focus on identifying issuers that we believe exhibit solid fundamentals, ample liquidity, and a high degree of visibility and predictability of cash flows.

The strategy also seeks to minimise trading costs by reducing portfolio turnover. We purchase bonds with the mindset that they will be held to maturity. As a result, we typically sell positions only when there is a material change in fundamentals that increases the risk of capital loss.

Ultimately, we believe an allocation to EMD, implemented through our Credit Income approach, represents a compelling solution for investors seeking to capture attractive carry while avoiding material default risk. We believe now is an optimal time for this approach due to attractive valuations and low hedging costs for euro-based investors.

Potential Benefits of a Credit Income Approach

- More predictable return profile
- Consistent income stream
- Low turnover to minimise trading costs
- Benchmark-agnostic approach
  - Avoid inherent flaws in benchmark construction (e.g. market cap weighting)
  - Ability to completely avoid (rather than underweight) sectors and issuers where risks are not adequately compensated
- Highly customisable based on client objectives and constraints
  - Yield target: Predictable source of income to meet cash flow needs
  - Duration target: Better matching of assets and liabilities
  - Credit quality: Minimise risk capital requirements

About the Team

The Lazard Emerging Markets Debt team is led by Denise Simon and Arif Joshi who have worked together for 18 years and have successfully navigated emerging markets debt portfolios through several different economic cycles. The team of 20 investment professionals includes five portfolio managers supported by a team of dedicated emerging markets sovereign and corporate analysts who apply rigorous, bottom-up fundamental research while leveraging the benefits of Lazard’s broader emerging markets platform of over 70 investment professionals. The team’s strategies bring clients innovative investment solutions across the asset class, providing the potential for attractive returns, yield, and diversification.
Important Information
Published on 26 August 2020.

Information and opinions are as of the date of this publication and are subject to change. The strategy invests primarily in emerging markets debt positions. The strategy will generally invest in debt investments denominated in either US dollars or local emerging markets currencies. As such, an investment in the strategy is subject to the general risks associated with fixed income investing, such as interest rate risk and credit risk, as well as the risks associated with emerging markets investments, including currency fluctuation, devaluation, and confiscatory taxation. The strategy may use derivative instruments that are subject to counterparty risk.

Investments in global currencies are subject to the general risks associated with fixed income investing, such as interest rate risk, as well as the risks associated with non-domestic investments, which include, but are not limited to, currency fluctuation, devaluation, and confiscatory taxation. Furthermore, certain investment techniques required to access certain emerging markets currencies, such as swaps, forwards, structured notes, and loans of portfolio securities, involve risk that the counterparty to such instruments or transactions will become insolvent or otherwise default on its obligation to perform as agreed. In the event of such default, an investor may have limited recourse against the counterparty and may experience delays in recovery or loss.

The strategy will invest in securities of non-US companies, which trade on non-US exchanges. These investments may be denominated or traded in both hard and local currencies. Investments denominated in currencies other than US dollars involve certain considerations not typically associated with investments in US issuers or securities denominated or traded in US dollars. There may be less publicly available information about issuers in non-US countries that may not be subject to uniform accounting, auditing, and financial reporting standards and other disclosure requirements comparable to those applicable to US issuers.

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