Emerging Markets Corporates: Arbitraging Perception to Move Up in Yield ... and Quality

The financial impact of the pandemic on insurers is likely to be significant. Although the fear of rising claims related to COVID-19 seems to be receding, the further decline in interest rates, credit rating downgrades in US corporate bond holdings, and the potential for some asset impairment in commercial mortgage loans are likely to put pressure on insurers’ risk-based capital ratios. Fortunately, we see a solution to these headwinds: emerging markets corporate bonds. Yields on emerging markets corporates have tended to be higher for credit risk as low as, if not lower than, that of similarly rated developed markets corporate bonds. Moreover, in our view, the asset class currently seems less susceptible to credit ratings pressure.

To date, few insurers have made dedicated allocations to the space, and we think the reluctance stems from some misperceptions about the asset class. We have found that higher yields in emerging markets corporates have tended to reflect factors other than fundamentals, and insurance general account managers can potentially capitalize on this disconnect, effectively arbitraging it to their benefit.
A Large, Varied, and Growing Space

In considering an allocation to emerging markets corporate bonds, it is first worth noting the market’s scope: The market capitalization of the tradable universe of hard currency-denominated emerging markets corporate debt is estimated at $2.7 trillion. As shown in Exhibit 1, the least constrained index, the JPMorgan CEMBI Broad, captures $1.1 trillion of that, putting it within a few billion dollars of the market cap of the emerging markets sovereign bond index, the JPMorgan EMBI Global, and about $200 billion below the size of the ICE BofA US High Yield Index. Although the CEMBI Broad Index remains well short of the $6.6 trillion Bloomberg Barclays US Corporate Bond Index, it merits mentioning that emerging markets corporates have issued more than $9 trillion worth of tradable debt in their domestic markets. While foreign investors have not yet been active in this part of the market, it does put the size of the broadly defined opportunity set closer to $12 trillion.

Second, the emerging markets corporate bond market is diverse. Nearly 700 issuers from 57 countries now comprise the CEMBI Broad Diversified Index, the most popular benchmark for emerging markets corporate portfolios. The breadth is apparent in the sector breakdown, shown in Exhibit 2. Beyond the commodity-sensitive industries one might expect from these resource-endowed countries, there are industries focused on domestic growth as well as defensive sectors.

The opportunity set continues to broaden. The face amount of bonds captured by the CEMBI Broad Diversified Index has grown 21% annually since its inception at the end of 2001, and despite a brief lull in 2020 due to the pandemic, net issuance is expected to continue at a robust pace in the coming years.

Important Differences between Emerging Markets and Developed Markets Credit

Beyond the obvious difference of geography, the contrasts between emerging markets corporates and other forms of credit are what we believe really merit discussion. In our view, the first difference can be crucial for investors: Unlike in developed markets, where high yield and investment grade are cleanly delineated, emerging markets corporate investors tend to amalgamate securities across the ratings spectrum. Similar to emerging markets sovereign bond indices, emerging markets corporate indices typically lump all corporates together, without respect to their current credit quality or trajectory of creditworthiness. As shown in Exhibit 3, the

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**Exhibit 1**
Index Market Capitalizations: EM Corporate Bond Index Approaches EM Sovereign Bond Index in Size

<table>
<thead>
<tr>
<th>Index</th>
<th>Market Capitalization (in $B)</th>
</tr>
</thead>
<tbody>
<tr>
<td>CEMBI Broad</td>
<td>6,800</td>
</tr>
<tr>
<td>EMBI Global</td>
<td>5,100</td>
</tr>
<tr>
<td>US High Yield</td>
<td>3,400</td>
</tr>
<tr>
<td>US Corporate</td>
<td>1,700</td>
</tr>
</tbody>
</table>

As of 30 June 2020
Source: Bloomberg Barclays, ICE BofA, JPMorgan

**Exhibit 2**
CEMBI Broad Diversified Index: EM Corporate Bonds Are Diversified

*Source: JPMorgan*

**Exhibit 3**
CEMBI Broad Diversified Index: A Balance between Investment Grade and High Yield Ratings

*Source: JPMorgan*
emerging markets corporate bond space started out heavily skewed toward investment grade at around 80% of market capitalization, but the split today is more evenly balanced as markets have become more receptive to lower credit quality issuers.

Another critical difference is that most emerging markets issuers tap international capital markets to fund growth rather than for other purposes; they issue debt abroad mainly because the domestic pools of savings available to them tend not to be as deep. This contrasts with corporate borrowing in developed markets especially the high yield market—where companies often employ leverage to either increase return on equity or fund mergers and acquisitions, neither of which is necessarily creditor-friendly.

A Compelling Opportunity to Add Yield without Sacrificing Quality

The most compelling difference between emerging and developed markets corporate bonds for investors, in our view, is the higher yield in emerging markets without a potential commensurate step down in credit quality. At every credit rating from A to B, emerging markets corporates have shown less net leverage than similarly rated US corporate bonds (Exhibit 4). However, the spread compensation that investors have realized for each unit of leverage has been substantially greater (Exhibit 5). These differences are not a recent phenomenon: Emerging markets corporate balance sheets have carried less leverage for as long as meaningful data for comparison have existed. Similarly, investors have demanded additional spread for emerging markets corporates going back to 2008, as shown in Exhibit 6.

In reviewing statistics like these, many emerging markets corporate bond market practitioners are confounded as to why more income-oriented investors have not shifted at least some portion of their credit allocations to this space.

Understanding the Inefficiency: Misperceptions and Partial Explanations

Three reasons are often cited for the enduring disconnect between spreads and leverage in emerging markets versus developed markets. In our view, these reasons provide only a partial explanation and may be only partially accurate.

First is the notion that emerging markets corporates are more default-prone than their developed markets counterparts. The credit and leverage statistics we noted earlier suggest that this is unlikely to be the case from a fundamental point of view, and the actual default data confirm it. Exhibit 7 shows that the average default rate in high yield emerging markets names has been about the same as that for US high yield—which would not justify
higher spreads for emerging markets. Moreover, and importantly for investors considering allocations, the default rate forecast for the next 12 months for emerging markets high yield corporates is about half that for US high yield despite the global pandemic. We think this is in part because most emerging markets corporates borrow to fund growth rather than for the purpose of financial engineering, as mentioned earlier. Recovery rates in emerging markets have also aligned reasonably well with US high yield historically.

Of course, insurance portfolios skew toward investment grade. Even here, emerging markets corporates seem more resilient. Bank of America Merrill Lynch estimates around $123 billion worth of bonds in the US have become fallen angels—that is, they have been downgraded below investment grade—since the beginning of the pandemic. JPMorgan’s $23 billion tally of emerging markets fallen angels over that time seems comparatively modest even after accounting for the differences in market size. We think the explanation hangs on structural differences. Lower leverage tends to put emerging markets corporates in a better position to withstand cyclical economic stress, while their smaller share of brick-and-mortar businesses, which are subject to technological disruption, along with the prevalence of companies that are inextricably linked to the higher potential growth of emerging markets countries, should help limit downward ratings migration.

A second rationale for the yield difference between emerging markets and developed markets corporate bonds is that emerging markets corporates tend to be less liquid than US investment grade and high yield corporates. Exhibit 8 shows that even though bid-ask spreads have declined over time, they are still higher than what we expect to see in developed markets, and likely to increase more during periods of market stress—such as the COVID-19 wave in March and April 2020. Lower liquidity is indeed a risk for which we believe investors should demand compensation. However, it should not dissuade an investor with an investment horizon long enough to benefit from the favorable yield of emerging markets corporates—especially an insurance investor whose portfolio turnover can tend to be low.

The third prevailing explanation for higher spreads in emerging markets corporates is the suspicion that they are highly exposed to adverse exchange rate movements—specifically, that the currency of the issuer’s home country will weaken and increase debt-servicing costs. If it were true, this would indeed justify much higher yields in emerging markets corporates, but the concern does not stand up to analysis. The majority of emerging markets corporates incur hard currency liabilities against hard currency assets or revenue streams, thus mitigating the risk of a mismatch. In addition, many exchange rate regimes in emerging markets countries today limit currency volatility. JPMorgan has parsed these risks (Exhibit 9) and estimates that, at most, about 12% of emerging markets corporate debt stock is susceptible to domestic currency weakness.

Some Realities

Setting aside the often-cited reasons, we attribute the yield pickup in emerging markets corporates versus developed markets credit to three different factors:

1. Market structure: JPMorgan extended its emerging markets fixed income index suite to emerging markets corporates in 2007, providing a yardstick not only for the opportunity set in isolation, but also for how it might fit into a portfolio. Nonetheless, the structure of the benchmarks—especially the mixing of credit quality—is misaligned with the way many
corporate bond investors look at the world, even though it may make sense to traditional emerging markets investors. Investors with their own internal credit research may be reluctant to devote the resources to get comfortable with any but the most recognizable names, and few sell-side firms have a truly global research coverage model for emerging markets corporates. The combination of a growing number of issuers, a healthy share of issuers with only one bond in the index, and thinner research coverage means that idiosyncratic credit quality deterioration could be overlooked, which in turn leads investors to demand higher yields in general for bearing that risk.

2. Technicals: Total assets benchmarked to the emerging markets corporate bond indices remain quite small. Only an estimated 5% of the stock of emerging markets corporate debt, roughly $120 billion, is held by dedicated or “natural” investors. The remaining 95% is held by crossover investors who buy opportunistically but do not need to own emerging markets corporate bonds specifically. As a result, emerging markets corporates can be susceptible to market downdrafts when those investors decide to sell. Many investment grade credit managers, for example, traffic in emerging markets corporate bonds on a tactical basis. When widely held bonds have been downgraded from investment grade to high yield, many of these managers have sold en masse to meet their credit quality restrictions, and price movements have been dramatic in some cases—something we observed in bonds from Petrobras following the company’s downgrade in 2015. While such price “gap risk” emphasizes the need for diligent credit selection, it also likely exerts some upward pressure on emerging markets corporate yields. One other technical factor worth noting is the steady bid for emerging markets corporate bonds from investors in Asia, who tend to concentrate their purchases in regional issuers. While Asian corporate bonds carry higher credit ratings on average, this regional investor segmentation likely produces pricing inconsistencies at a global level that investors can use to their advantage.

3. Perception: There is some truth in the notion that by simply wearing an “emerging markets” label—that is, being based in a developing country—emerging markets corporates should have higher yields than developed markets corporate bonds to compensate for higher sovereign risk. However, we believe such a blunt assumption misses a key nuance. In our view, a successful investment process for emerging markets corporates involves a rigorous corporate credit analysis alongside an evaluation of sovereign risk for each issuer. In other words, emerging markets corporates are not necessarily riskier because they are in an emerging markets country, but rather being in an emerging markets country may present additional risks to incorporate, analyze, and—to the extent warranted—price and manage. However, the type and magnitude of risks can vary greatly by country and issuer. Nonetheless, many investors’ uncertainty over how to incorporate sovereign risk or their lack of that capability has tended to lead to higher yields.

How to Capitalize on the Opportunity

We believe that stepping up in yield without stepping down in quality is the single most compelling reason to consider an allocation to emerging markets corporate bonds. It is important for investors to understand why this yield pickup has been and will likely continue to be a structural constant in the pricing of emerging markets corporates versus developed markets credit. In our view, part of the attraction of emerging markets corporate bonds lies in the inefficiencies that can lead to these higher yields. The pervasive disconnect between the pricing of risk and the actual risk taken may allow investors to tailor their exposures precisely to their needs, whether they include a ratings preference, a desired duration, a geographic skew, or a bias to avoid certain sectors.

Nonetheless, some basic realities of the asset class are inescapable: It is still credit, with all the risks that entails. Assessing repayment capacity by analyzing each credit’s strengths, weaknesses, and susceptibilities, as well as the influence of sovereign risk, is of critical importance. An active manager can help navigate these risks. We believe that focusing on capital preservation when investing in emerging markets corporates not only increases the likelihood that a portfolio will actually earn that structurally attractive yield, but also puts it in a position to potentially capitalize on market dislocations when they do occur.

For insurance investors, the pandemic and the economic shock it triggered have altered the outlook for assets they have traditionally focused on. We believe now is the time for insurers to consider the potential opportunities to add valuable yield without sacrificing credit quality with emerging markets corporate bonds.
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Notes
1 Compared to the CEMBI Broad Index, the CEMBI Broad Diversified Index constrains market capitalization at the country level by scaling back the face amount of eligible bonds.
2 JPMorgan launched the index in 2007 with data backfilled to 31 December 2001.

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The ICE BofAML US High Yield Index is a broad-based index consisting of all US dollar–denominated high-yield corporate bonds with a minimum outstanding amount of $250 million and maturity of no less than one year. The index is unmanaged and has no fees. One cannot invest directly in an index.
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