MEANINGFUL DISTINCTIONS: EMERGING MARKET CORPORATE BONDS VERSUS EMERGING MARKET SOVEREIGNS

WRITTEN BY

THE LOOMIS SAYLES
EMERGING MARKETS DEBT TEAM

EMERGING MARKET (EM) CREDIT, A GENERAL CATCHALL PHRASE, INACCURATELY BLURS TOGETHER TWO DISTINCT INVESTMENT OPPORTUNITY SETS—EM SOVEREIGNS AND EM CORPORATES.

After several years of sovereign downgrades, there has been a decoupling of the corporate asset class from the sovereign space. The EM corporate sector continues to evolve with underlying fundamentals and technicals playing a significant role in performance. In the current phase of the credit cycle, this maturing theme has continued.

We believe EM corporates offering greater diversification, spread premium and lower volatility will continue to offer better risk-adjusted returns compared to the EM sovereign universe.

MANAGER INSIGHT

AUGUST 2020

Broad Diversification

Simply put, the EM hard-currency corporate universe is larger than that of EM sovereign. We believe the breadth of EM corporate securities presents more opportunities for research-based security selection to enhance diversification. Consider that there are 167 issuers in the J.P. Morgan sovereign index[1] compared to 702 corporate issuers included in the J.P. Morgan EM corporate index.[2] (J.P. Morgan indices cited in the footnotes below are used to represent the corporate and sovereign universes throughout this paper.)

Higher Credit Quality

On the face of it, a comparison of average credit quality for EM corporates (BBB-/BAA3) to EM sovereigns (BBB-/BA1) does not reveal much. However, analysis by credit tier shows a distinct quality differential. Sovereigns have a 27.7% weighting in B and C rated debt, almost 10 percentage points higher as compared with that of the corporate index.

CREDIT QUALITY BREAKDOWNS

Source: J.P. Morgan, as of June 30, 2020.

	EM SOVEREIGNS	EM CORPORATES
Long IG Corporate	**55.3**	**58.7**
AA and Above	7.3	1.8
A	14.4	20.9
BBB	33.5	36.0
High Yield	**44.7**	**41.3**
BB	16.5	20.0
B	24.0	11.7
CCC	0.8	5.0
CC	1.4	0.2
C	1.5	0.2
NR	0.6	4.1

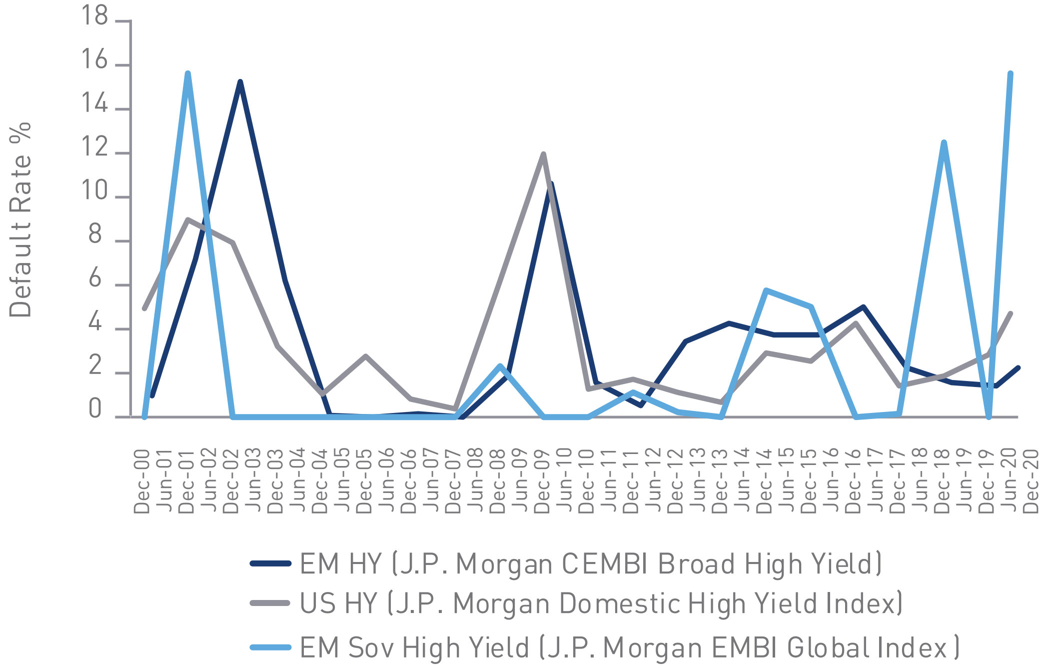
[1] *J.P. Morgan Emerging Markets Bond Index Global Diversified (Sovereign, EMBI GD).*
[2] *J.P. Morgan Corporate Emerging Markets Broad Diversified Index (CEMBI BD).*

Lower Default Risk

Increasing stress on sovereign balance sheets in the wake of weaker global growth has led to a wave of downgrades and defaults within the EM sovereign segment. As of June 30, 2020, the default rate within the EM sovereign high yield index was 15.8%, versus 2.3% for EM high yield corporates. EM corporate credit default data also compares favorably to US peers (see chart).

HISTORICAL DEFAULT RATES & FORECASTS

Source: J.P. Morgan, as of June 30, 2020.

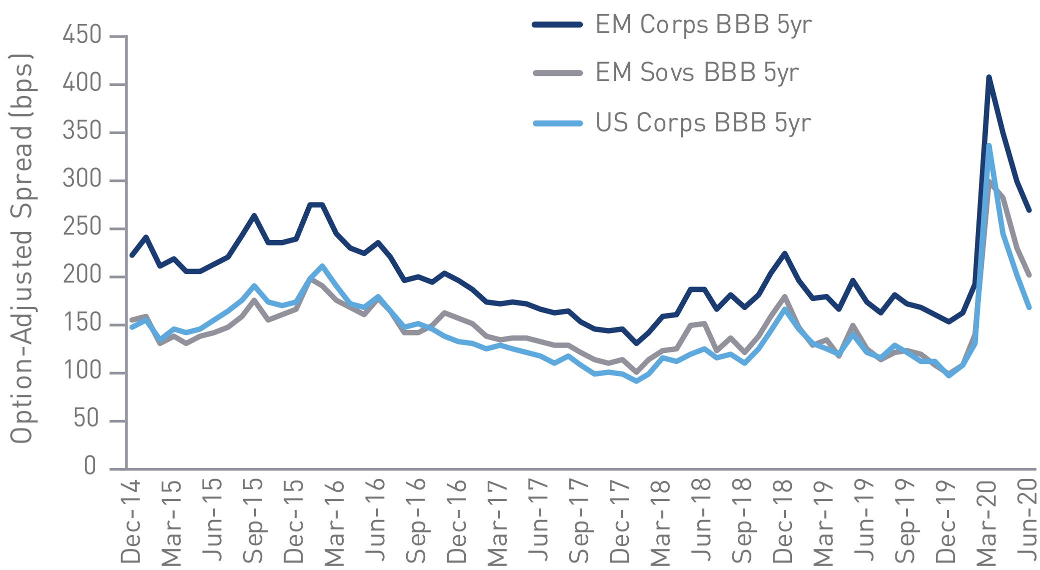


Yield Spread Premium

On a rating- and duration-adjusted basis, the EM corporate credit sector has offered a persistent spread premium compared with that of its developed market and EM sovereign peers (see charts below). The excess premium typically offered by EM corporate credits has the potential to translate into higher returns. As many investors know, yields can drive long-term returns in fixed income.

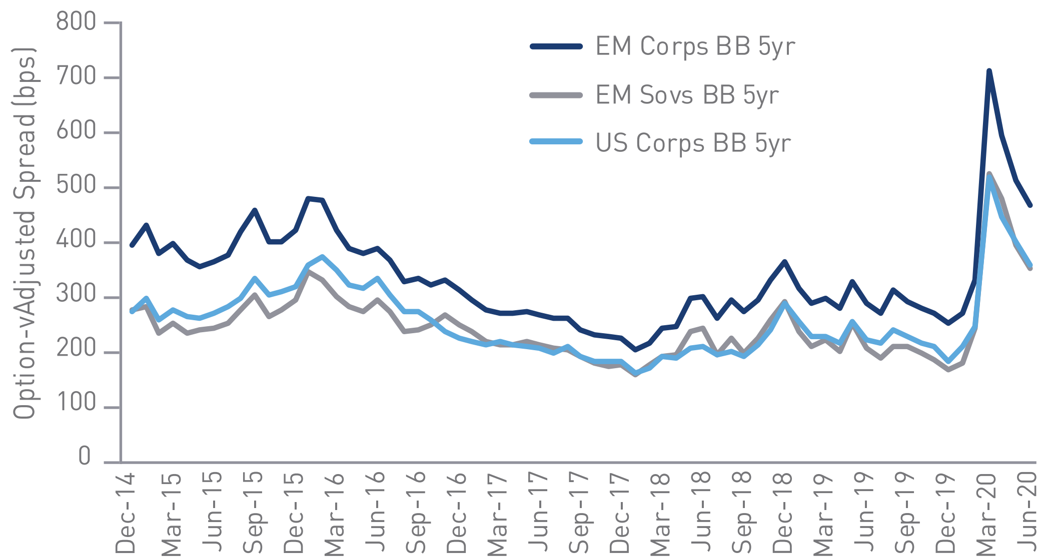
SPREAD COMPARISON: BBB, 5 YEAR

Source: Loomis Sayles, as of June 30, 2020.



SPREAD COMPARISON: BB, 5 YEAR

Source: Loomis Sayles, as of June 30, 2020.

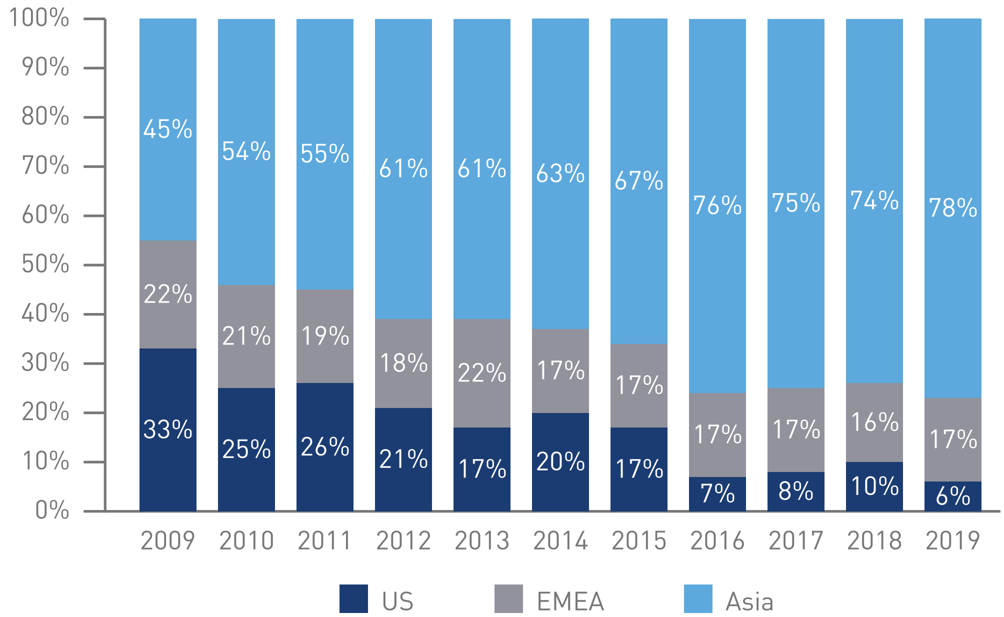


Steadier Technicals

Historically, the asset class has been dominated by larger-scale, geographically diverse, institutional buyers. This solid buyer base has helped provide a strong anchor for EM during periods of volatility. This view has been supported by evidence on new-issue allocations.

ASIA NEW ISSUE ALLOCATION BY REGION

Source: J.P. Morgan, data as of May 31, 2020.



In recent years, Asia's domestic buyer base has grown in importance. Asia, and predominately China, has been the primary driver of net new issuance within the EM corporate landscape. New deals out of the region typically find a strong base of support from local buyers eager to hold US-denominated assets from domestic issuers.

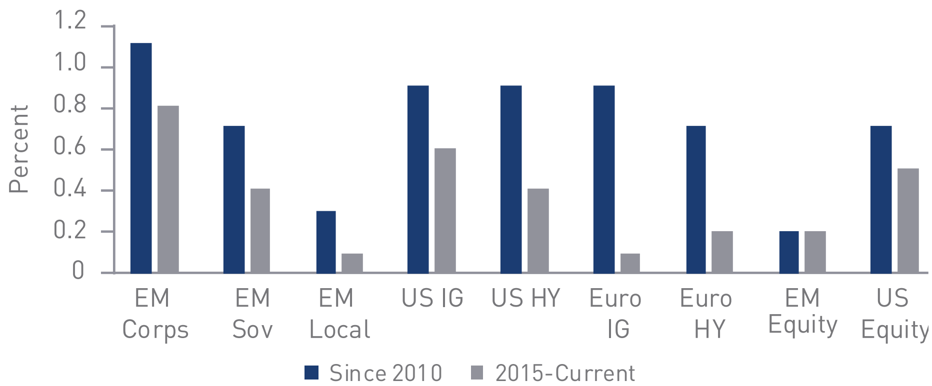
While we have an indication of who is buying EM corporate paper, even more telling is who has been less involved in the asset class—retail investors. Using the ETF market as a proxy for retail investing, EM corporate ETFs have been far fewer and smaller on a market-capitalization basis than their EM sovereign ETF counterparts. Lower relative retail participation and higher institutional ownership can provide a supportive dynamic when outflow pressures contribute to choppy prices.

Strong Risk-Adjusted Returns

We believe the combination of factors discussed above have contributed to the attractive risk-adjusted returns of the EM corporate sector—notable across the credit universe. During the past five years, on a risk-adjusted basis, EM corporates have outperformed EM sovereign, US credit and Euro credit.

SHARPE RATIO COMPARISON

Source: J.P. Morgan, as of June 30, 2020. Weekly returns annualized. EM Corps: JPM CEMBI Broad. EM Sovs: JPM EMBIG Diversified. EM Local: JPM GB EM Global Diversified. US IG: JPM US Liquid Index (JULI). US HY: JPM Domestic High Yield. Euro IG and Euro HY are iBoxx corporate indices. EM Equities: MSCI EM Index. US Equities: S&P 500 Index.



Opportunistic EM Sovereign Investing

We do see times when sovereigns offer value in an EM corporate portfolio. Our exposure to EM sovereigns across our various EM corporate strategies is generally under 5%. The following three reasons primarily drive our allocations to sovereigns:

- A favorable view on a country where there is limited corporate opportunity.
- Little relative value in the corporates relative to the sovereign.
- Curve management – often EM corporates have only one or two bonds outstanding. Sovereigns generally have a more robust curve and offer the opportunity to tactically position on the curve.

Loomis Sayles EM US Dollar Corporate Credit Solutions

Loomis Sayles' EM corporate credit capabilities include EM corporate short-duration strategies, EM corporate benchmark products, buy and maintain portfolios and ESG (environmental, social and governance)-sensitive accounts. The EM US dollar corporate universe can present a robust opportunity set where bespoke mandates can be tailored to help achieve investor yield and risk objectives.

AUTHORS

ELISABETH COLLERAN, CFA
VP, Portfolio Manager

EDDY STERNBERG
VP, Portfolio Manager

THU HA CHOW
Asia Strategist

KATHLEEN PALMER
VP, Product Manager

JACKIE LAFFERTY
VP, Senior Investment Analyst

ASHLEY FRITZ, CFA
Investment Analyst

Disclosure

This material is provided for informational purposes only and should not be construed as investment advice. Any opinions or forecasts contained herein reflect the subjective judgments and assumptions of the authors only, and do not necessarily reflect the views of Loomis, Sayles & Company, L.P. Investment recommendations may be inconsistent with these opinions. There is no assurance that developments will transpire as forecasted and actual results will be different. Information obtained from outside sources is believed to be correct, but Loomis Sayles cannot guarantee its accuracy. This information is subject to change at any time without notice.

Diversification does not ensure a profit or guarantee against a loss.

This is not an offer of, or a solicitation of an offer for, any investment strategy or product.

Any investment that has the possibility for profits also has the possibility of losses.

Market conditions are extremely fluid and change frequently.

Past performance is no guarantee of, and not necessarily indicative of, future results.