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Four Reasons to Revisit EM Corporate Short Duration Debt

INSIGHTS

Against a potentially higher-for-longer backdrop, a short-dated approach to EM corporate debt can provide an opportunity to pick up income, incremental yield and diversification, with less volatility.

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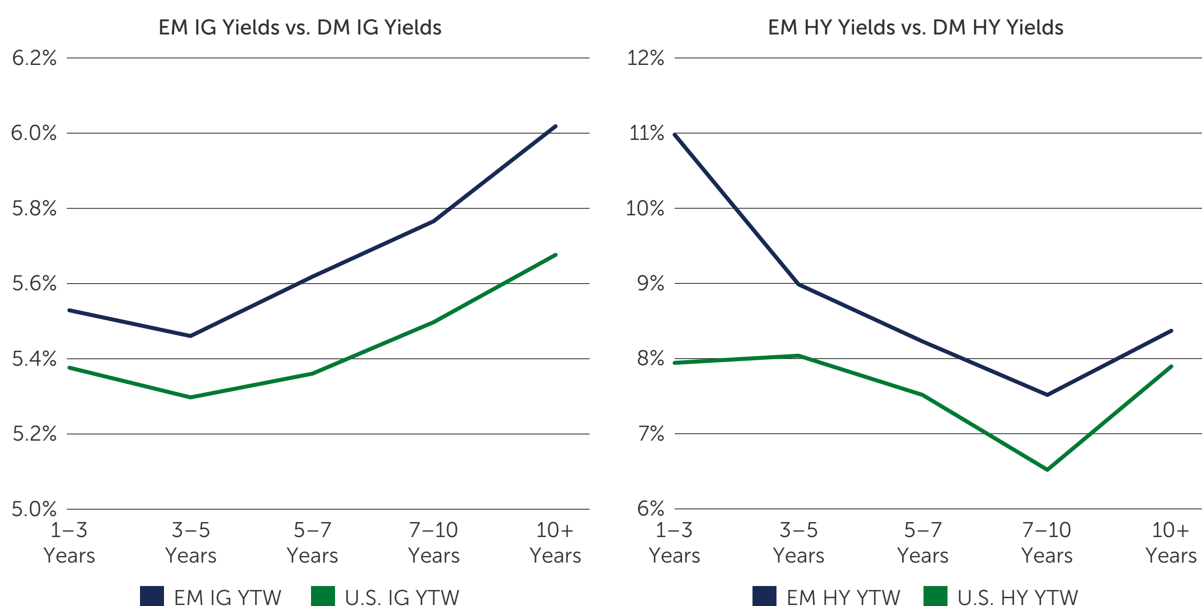
It has undoubtedly been a volatile few years for emerging markets (EM), given the impact of rising developed market interest rates, global geopolitical tensions, and China's real estate meltdown. But with EM corporate bond valuations having rebounded year-to-date, investors are rightly turning back to the asset class and questioning whether opportunities still exist.

The answer in our view is yes, and we believe there is a strong case to be made for short-dated debt in particular. EM corporate short duration debt , which typically has a duration of under three years, not only offers the potential for compelling value and attractive yields, but also positions investors to maximize income through a 'coupon clipping' strategy—all with less volatility.

1. Valuations Remain Compelling

While credit markets, broadly, have rallied this year on the back of a more dovish U.S. Federal Reserve (Fed), all-in yields on EM short duration corporate debt remain favorable relative to their developed market (DM) counterparts. For instance, yields on 1–3 years EM investment grade (IG) bonds are currently ranging from 5.5%–6%, compared to 5.4% for developed market IG bonds **(Figure 1)**. EM high yield (HY) bonds are in the range of 8%–10%, versus 8.1% for DM high yield bonds.

Figure 1: Yields Remain Compelling in EM vs. DM



Source: J.P. Morgan. As of May 20, 2024.

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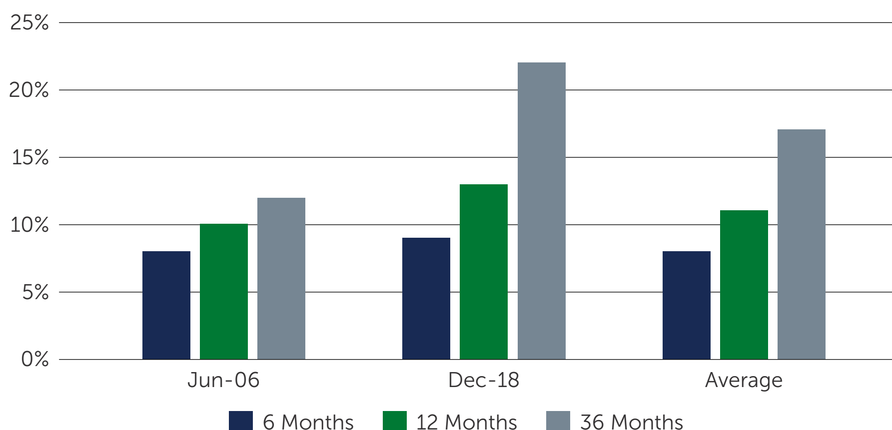
In addition, if a 'higher-for-longer' rate environment does persist, it is important to consider the historical behavior of EM corporate debt in similar scenarios following the end of central bank rate-hiking cycles. For example, EM corporate debt returned between 8–22% in the one to three year period following the Fed's interest rate peak **(Figure 2)**. And in the current cycle, which saw Fed rates reach their peak in July 2023, EM corporate debt appears to be on track with historical patterns given total returns have reached 9.9% in the last 12 months.[1] This suggests the potential for attractive risk-adjusted returns in the current cycle.

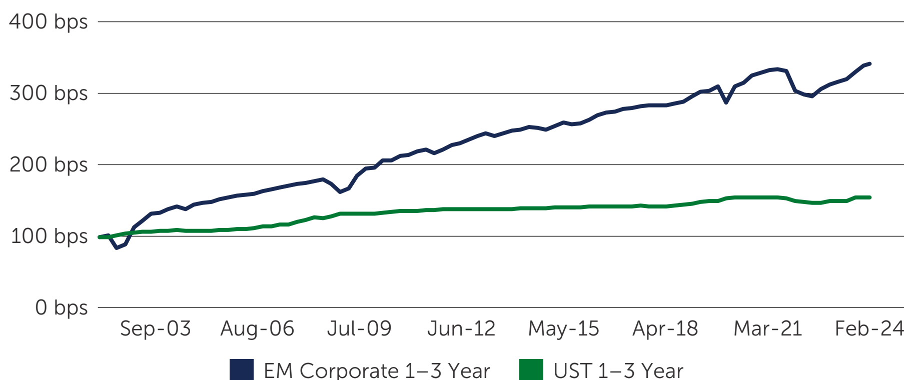
Figure 2: EM Debt Total Returns Following Peak Fed Rates



Source: J. P. Morgan. As of December 31, 2023.
PAST PERFORMANCE IS NOT INDICATIVE OF FUTURE RESULTS.

History also shows that EM short-dated corporate debt has offered attractive returns over time compared to similar duration U.S. Treasuries **(Figure 3)**. This makes the asset class compelling, especially for investors concerned by U.S. Treasury volatility and the potential impact on returns.

Figure 3: EM Short Duration Debt vs. U.S. Treasuries



Source: J. P. Morgan. As of May 31, 2024.
PAST PERFORMANCE IS NOT INDICATIVE OF FUTURE RESULTS.

1. Source: J.P. Morgan. As of April 30, 2024.

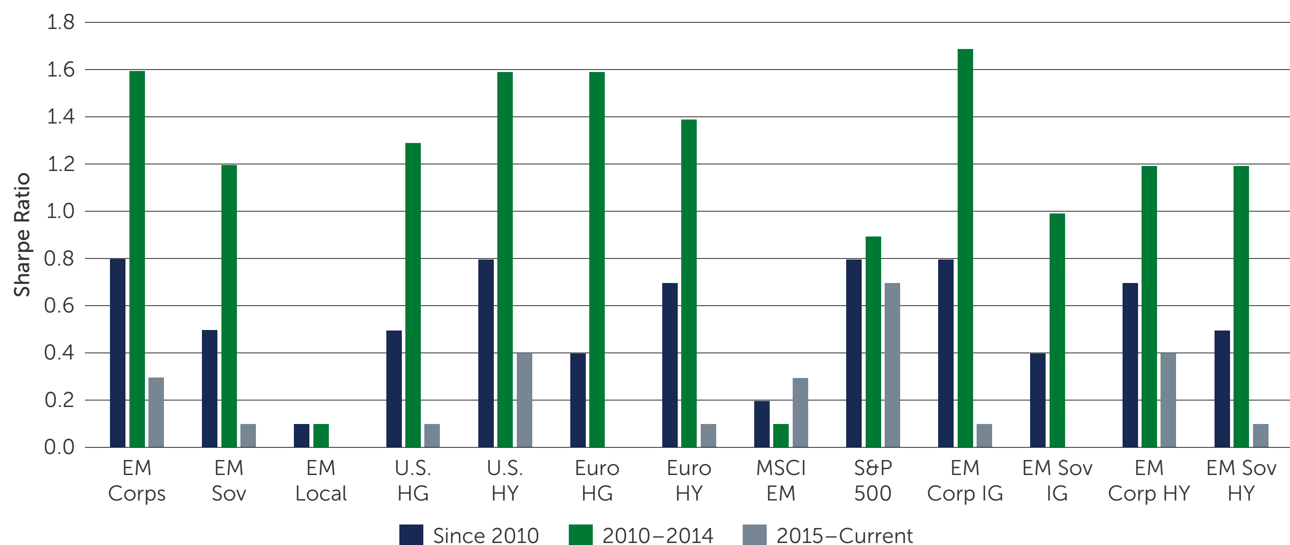
2. Lower Volatility & Attractive Risk-adjusted Returns

Short duration bonds tend to exhibit a lower volatility profile given the shorter time to maturity. This is partly because they experience lower and less severe price swings in response to factors like changes in the economic backdrop and interest rate expectations. This is an important consideration in the current environment, in particular, where uncertainty around inflation is causing high interest rate volatility and, in some cases, weighing on returns in longer-duration strategies. A short-dated strategy therefore enables investors to gain exposure to EM companies while minimizing the impact of sharp moves in risk-free rates. Further contributing to the lower volatility profile, shorter-dated bonds experience a gentle "pull-to-par" effect, in which the price of the bond gravitates toward par as the maturity date approached.

Short-dated bonds also tend to be less prone to material price swings in response to company earnings outlooks. As short-dated bonds have less time to maturity, investors are better positioned to evaluate the direction of a company's earnings and liquidity position. Consequently, short duration bonds are less exposed to deterioration in the underlying financial position of the corporate issuer, or unexpected detrimental changes in companies' business plans. This further contributes to the lower realized volatility in a short duration strategy.

The combination of high prospective returns alongside low realized volatility has resulted in historically superior Sharpe ratios for the asset class. For example, since 2015, EM corporate debt has exhibited better risk-adjusted returns than EM sovereigns, U.S. HY, and the S&P 500 index **(Figure 4)**. When further breaking down the data to look at EM short duration debt specifically, the results are also compelling. For instance, the Sharpe ratio for short duration debt is 0.88 for IG and 1.02 for HY.[2] Therefore, while investors may give up some absolute return potential by focusing on short-duration bonds, history suggests strong potential for attractive risk-adjusted returns, especially during periods of high market volatility.

Figure 4: Attractive Risk-Adjusted Returns Over Time



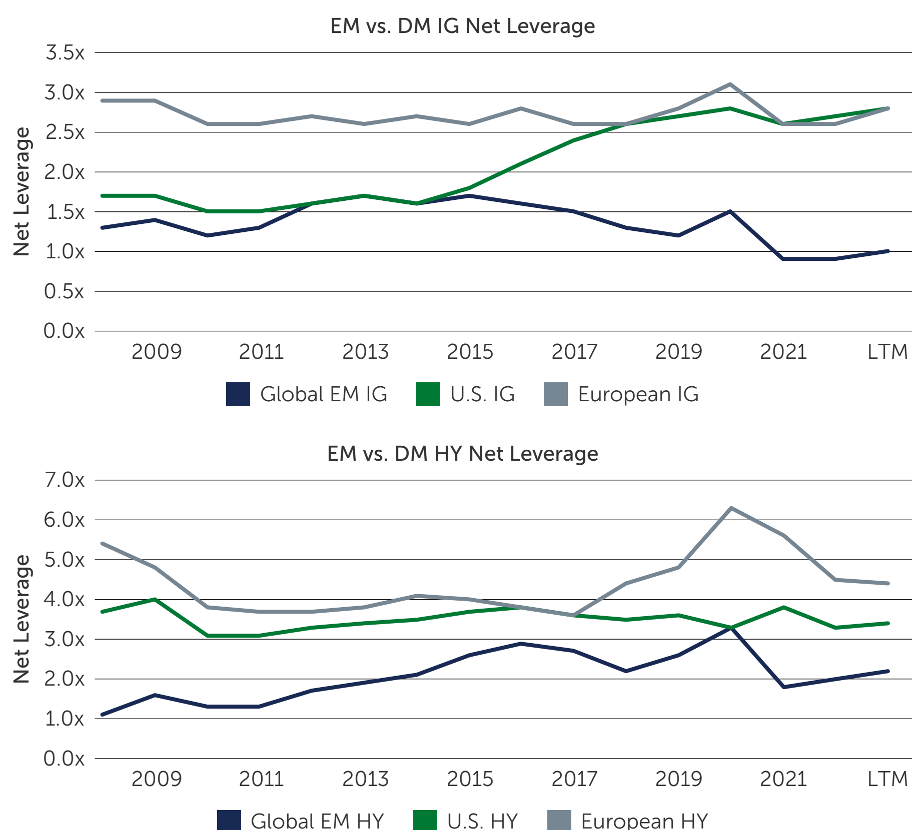
Source: J.P. Morgan. As of May 31, 2024. Sharpe ratio based on weekly returns annualized. NEXGEM: J.P. Morgan Next Generation Emerging Markets. **PLEASE ADD: PAST PERFORMANCE IS NOT INDICATIVE OF FUTURE RESULTS.**

2. Source: J. P. Morgan. As of May 31, 2024.

3. Robust Corporate Fundamentals

Investors often perceive EM corporate credit risk as inherently higher, resulting in EM corporate debt carrying extra credit risk premia—or wider spreads—versus DM corporates. However, a closer inspection suggests this perception is somewhat misguided. Specifically, approximately 58.5% of the EM corporate universe is rated IG with significant sector diversification across credit ratings.[3] In addition, since the global financial crisis, EM corporates have been cleaning up their balance sheets, with many cutting capital expenditures and optimizing their capital structures, resulting in stronger fundamentals and superior credit metrics compared to their DM counterparts. Currently, EM IG and HY corporate net leverage is 1.0x and 2.2x, which compares favorably to DM IG and HY's 2.8x and 3.4x, respectively **(Figure 5)**. Simply stated, EM corporate debt is providing the potential for extra yield pick-up versus DM debt—in the range of 15–290 basis points (bps)—for little to no extra credit risk.

Figure 5: Lower Leverage Levels in EM vs. DM



Sources: J.P. Morgan, Bloomberg, CapitalIQ. As of December 31, 2023, for EM and as of October 31, 2023, for DM. 2022 and LTM additionally exclude Russian corporates.

3. Source: J. P. Morgan. As of March 31, 2024.

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4. A Global & Diverse Opportunity Set

The EM corporate debt asset class is around USD2.5 trillion in size, and comprises a significant portion of the global investment universe.[4] However, while EM debt tends to be perceived as higher risk, many EM corporates are large, global companies with diversified sources of revenue—and in effect have been unfairly discounted by markets because of the country in which they're domiciled. The path between EM corporates and their sovereigns may also be diverging as the companies become more integrated in the global economy, contributing to higher resiliency during periods of sovereign stress.

In addition, it is also worth noting the opportunities emerging in select EM companies that have links to the U.S. In particular, with the U.S. remaining the standout performer among DM nations, U.S.-linked EM countries should benefit from nearshoring or friendshoring—as well as increased remittances and tourism, which are likely to be positive for corporate issuers.

Key Takeaway

EM corporate debt continues to offer an opportunity to invest in well-diversified companies with robust balance sheets and potentially achieve attractive risk-adjusted returns. However, there are risks on the horizon—from election uncertainty to geopolitical risk—that could introduce bouts of volatility going forward. In this environment, and given the likely higher-for-longer rate environment, we believe there are reasons for investors to consider taking a short-dated approach to the asset class.

Barings' Approach

At Barings, we believe fundamental, bottom-up analysis is key to identifying attractive opportunities, as well as understanding the risks, in EM corporates. We understand the importance of rigorously assessing the entire EM debt asset class, including both sovereigns and corporates, to have a more holistic view of the risks and earnings outlook for each EM company.

For this reason, we have one of the largest dedicated EM debt teams—with 10 investment professionals covering over 1,400 EM corporate issuers, and 10 investment professionals covering over 85 EM sovereigns. The teams work together to underwrite every issuer that comes to the market, which means analyzing the key credit considerations for each issuer—including reviewing strengths and risks, capital structure, balance sheet, cash flow projections, ESG considerations and macroeconomic variables. This process helps to build a cohesive and comprehensive macro and micro picture by country, sector and credit. Additionally, our dedicated EM analysts collaborate with over 57 global credit analysts from across the Barings platform to identify best ideas across EM debt.

4. Source: J. P. Morgan. As of March 31, 2024.

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