

Investment Insight

Emerging Market corporate debt: A resilient asset class to counter market volatility

Emerging Market corporate debt as an asset class is the most attractive it has been in 20 years as higher yields are back and the interest rate cycle is about to turn

Given the constructive and supportive global economic backdrop since the pandemic, risk assets like equities have performed well. However, they have been susceptible to bouts of increased volatility. We are in the midst of such a bout as investors worry about the potential of a sharper than expected US economic slowdown, uncertainty around the US elections in November, and the US Federal Reserve's imminent interest rate decisions and how it will be taken by markets.

The resilient return profile of Emerging Market (EM) corporate debt has fared strongly against many other asset classes, offering a compelling case for investment in the asset class today. More specifically, as we highlight in this Investment Insight, we believe that there are several important factors that mean the asset class is well-positioned to weather potential volatility risks and continue to deliver strong performance, providing attractive risk-adjusted returns and diversification benefits at a time of uncertainty. These factors include:

- Improved fundamentals, including stronger balance sheets, improved operations and cash generation;
- Proactive refinancing of debt, creating a yield buffer for investors;
- Increased diversification from both a sector and geographic perspective; and
- Supportive technicals with favourable market supply and demand dynamics.

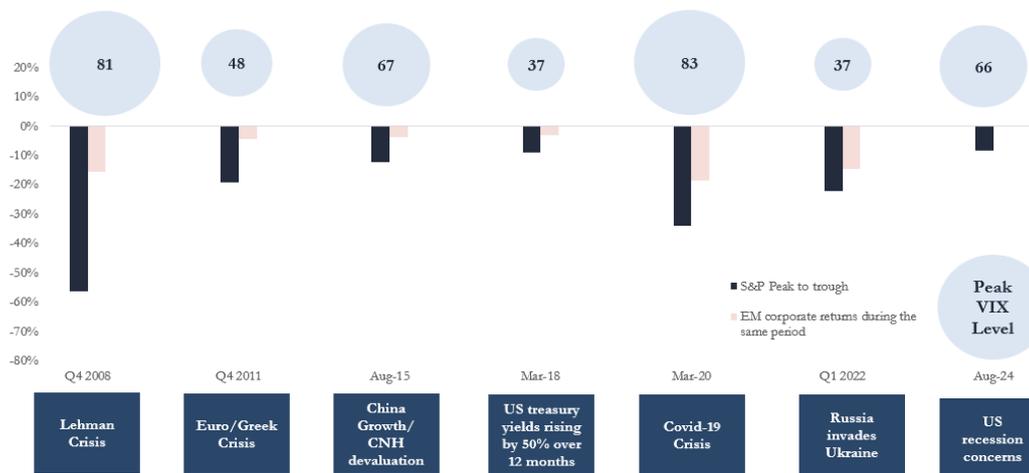
As of 31st August, our J. Stern & Co. Emerging Market Debt Stars portfolio has returned +8.3% year to date in US dollar terms, outperforming both the comparator index* and other developed market fixed-income asset classes.

A track record of resilience

EM corporate bonds have performed well in previous periods of high market volatility. We looked at seven different periods of elevated volatility levels in the markets, as characterised by the VIX index, which measures the market expectations of future volatility, reaching at least 36 or more.

*JPM EM Corporate Bond ETF by 2.1%

Emerging market corporate bonds show greater resilience to volatility than equities



S&P returns peak to trough and EM corporate index returns, during the same period

Source: J. Stern & Co., Bloomberg. EM corporate debt performance is measured by JPMorgan Corporate Bond ETF.

The chart is based on 20-year data, during which time the average VIX index level has been 19 with a standard deviation of about 8.7. Based on this data we set a cut-off at c. 2 standard deviations over the mean, leading to a cut-off at around 36.

Overall, the relative outperformance of the EM corporate debt asset class during these periods of intense volatility is significant. In most cases, the drawdown in this sector has been less than 40% of the drawdown witnessed in US equities.

Default rates have been lower than expected

While trading in EM corporate debt during periods of high volatility can be affected by lower trading liquidity leading to widening credit spreads, default rates for EM corporate debt have held up well historically. They have been broadly in line with developed markets' high-yield corporate debt and were even lower between 2015 and 2020, contrary to the perception of many investors.

Default rates	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2022 (ex-Russia and China property)	2023 (ex-Russia and China property)
EM Corporate HY	3.7%	2.5%	4.0%	1.4%	1.2%	0.8%	2.5%	4.5%	6.0%	8.7%	1.8%	2.3%
US Corporate HY	3.0%	2.6%	4.3%	1.5%	1.9%	2.9%	6.8%	0.4%	1.7%	2.8%	-	-

Source: JP Morgan, 2024 YTD as of July 2024

It is important to note that EM corporate debt default rates in recent years have been skewed by idiosyncratic events including Russia's invasion of Ukraine and the Chinese property sector crisis. Our focus on quality has meant that Russia and China are both large geographies that we have avoided in the past and will continue to avoid for our Emerging Market Debt Strategy, mostly due to concerns about geopolitical risk, alignment of incentives, corporate governance and other issues. Excluding the impact of Russia and China, EM corporate debt

default rates have remained in line with defaults in developed markets since the end of the pandemic.

What makes EM corporates even more resilient now to higher volatility

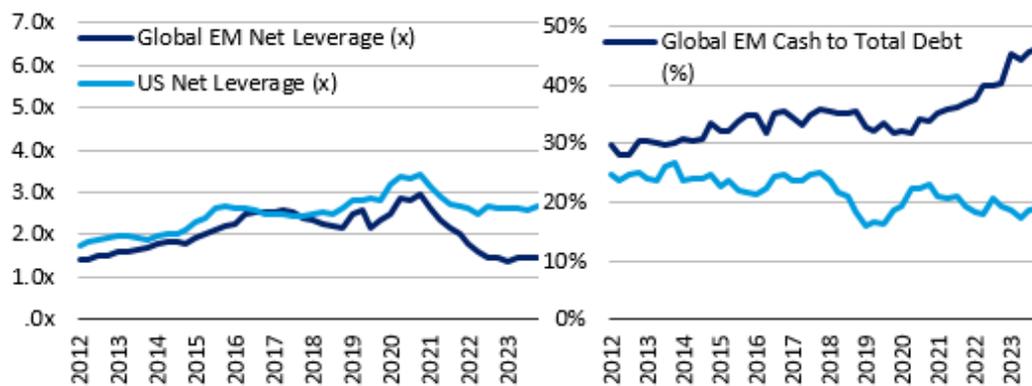
EM corporate debt's outperformance during previous periods of elevated volatility and the comparable default rates with developed markets is evidence that it offers a strong degree of resilience for an asset class that is perceived as riskier than many other 'risk-on' assets.

There are several characteristics of EM corporate bonds which, in our opinion, make the asset class even more resilient now.

1. Fundamentals 'stronger than ever'

The fundamentals of EM corporate debt issuers, including balance sheet strength, operating performance and cash flow generation, are now arguably the strongest they have ever been, especially when compared to European and US corporates. EM corporates have lower leverage overall as well as higher balance sheet liquidity. Leverage for EM corporates is currently at its lowest level in over a decade. Stronger balance sheets provide issuers with a stronger starting point and a greater degree of flexibility of capital allocation, which is especially important during economic downturns. This is why we believe that being invested in higher-quality businesses with strong fundamentals provides better downside protection.

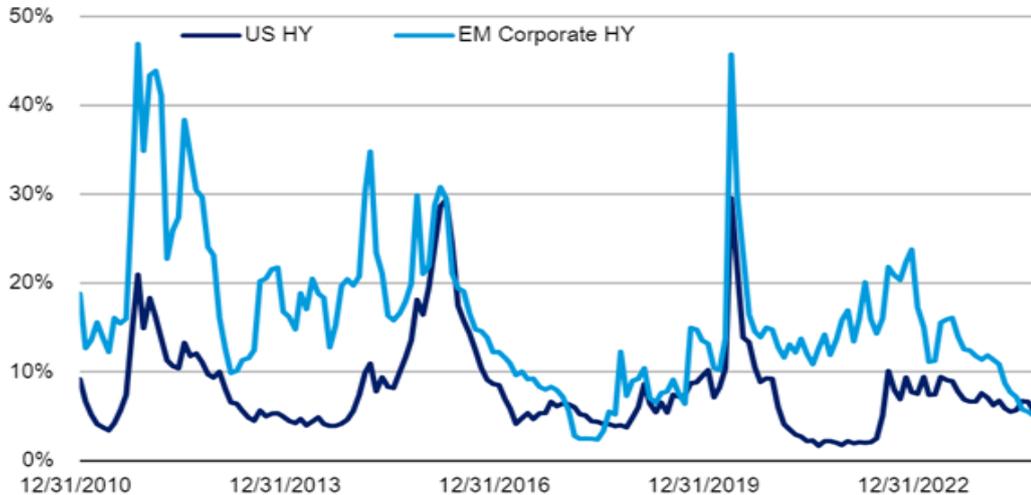
EM corporates: lower leverage and higher cash-to-debt ratios than US corporates



Source: Bank of America, June 2024

Similarly, the share of EM high yield bonds currently trading at distressed levels (spread > 1,000 bps) has been dropping and recently dipped lower than the same ratio for US high yield. This is also indicative of improving fundamentals across EM issuers. As discussed above, the Russian invasion of Ukraine and China's property crisis have been principal drivers of EM high yield bonds trading at distressed levels in recent years. The market has begun to recover and we have seen a strong rally amongst Ukrainian corporate bonds, which has contributed towards the lower share of distressed EM bonds today.

Lower share of EM high yield trading at distressed levels vs US high yield

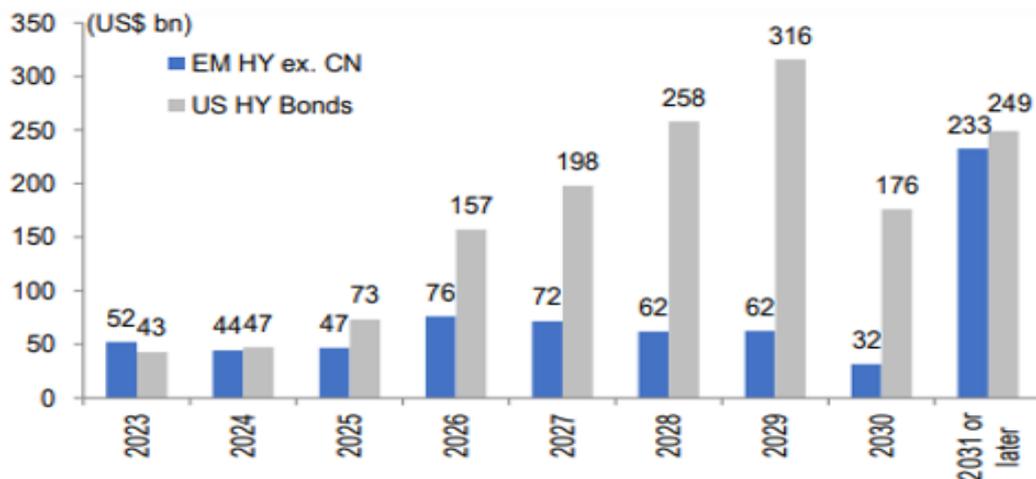


Source: BofA Global Research, ICE Data Indices, LLC

2. Proactive refinancing

EM corporates have typically been more proactive than developed markets (DM) peers at refinancing their debt stacks and extending out their maturities. This provides EM corporates with additional financial flexibility and a runway from having to address principal repayments, making them better equipped to navigate wider economic downturns.

Lower share of EM corporate debt maturities due before 2031 than the US (EM HY Corp ex. CN vs US HY Corp maturities by year)



Source: JP Morgan

The graph above shows that 66% of EM HY (excluding China) corporate maturities are due before 2031 in comparison to 84% for US HY.

3. Yield buffer

Due to the higher interest rate environment, most EM corporates that have refinanced over the past few years in the Eurobond market have done so at higher rates than previously. Below is a comparison of some names in our portfolio who have recently refinanced.

New coupons are being issued at higher rates

Issuer	Previous Coupon	New Coupon	New Issuance Date	Country
Helios Towers	7%	7.5%	May 2024	Tanzania
Sisecam	6.95%	8.625%	April 2024	Turkey
Millicom	5.125% / 6.25%	7.375%	March 2024	Guatemala
Cemex	5.125%	9.125%	March 2023	Mexico
AES Andes	7.125%	8.15%	June 2024	Chile

Source: J Stern & Co., Bloomberg

Bond investors' returns are generated through two sources: (i) capital appreciation/depreciation from price movements (ii) income from coupons. Being invested in bonds with higher coupons provides our portfolio with better visibility of returns and a greater buffer against volatility. This is because a greater proportion of our returns are being generated from income which is effectively 'locked in', rather than future price moves which are not linear.

The result of companies paying higher coupons is that interest coverage ratios have declined, although they still are at healthy levels. We are also seeing more companies swap from fixed to floating-rate debt to benefit from potential interest rate declines. We navigate this through active management, monitoring the balance sheet strength and liquidity profile of our corporates to assess their ability to service debt. We are also more selective on new credits, only investing in issuers which have sufficient headroom to pay higher coupons.

4. Improving diversification

In the past, the EM corporate bond asset class has been widely perceived as a play on energy. Today, the market is more mature and is more diversified from a sector standpoint with oil & gas only accounting for 12% of the benchmark as of July 2024 (vs 17% in July 2016). Hence the risk of contagion has decreased over time and a single event such as a shock to oil prices now has far less potential impact on other issuers, making the asset class more resilient.

Good examples of growing sectors are industrials, telecoms and consumer staples, highlighted by investments that we hold.



Towers of strength

In our strategy, we invest in the corporate bonds of quality companies like IHS Towers, a leading global, African independent tower operator headquartered in Nigeria. We like its strong underlying operations supported by structural growth drivers including low mobile penetration rates and increasing data usage. The company benefits from stable and predictable revenue with long contract life and low churn from high-quality tenants. There is also good geographic diversification across Africa, Latin America and the Middle East.



Bharti Airtel is the second-largest telecom in India. We like its diversified services portfolio, solid track record of growth in the consolidated telecom market and strong balance sheet. The company has been able to successfully defend and grow its market share over recent years which is a testament to its business model and brand recognition.



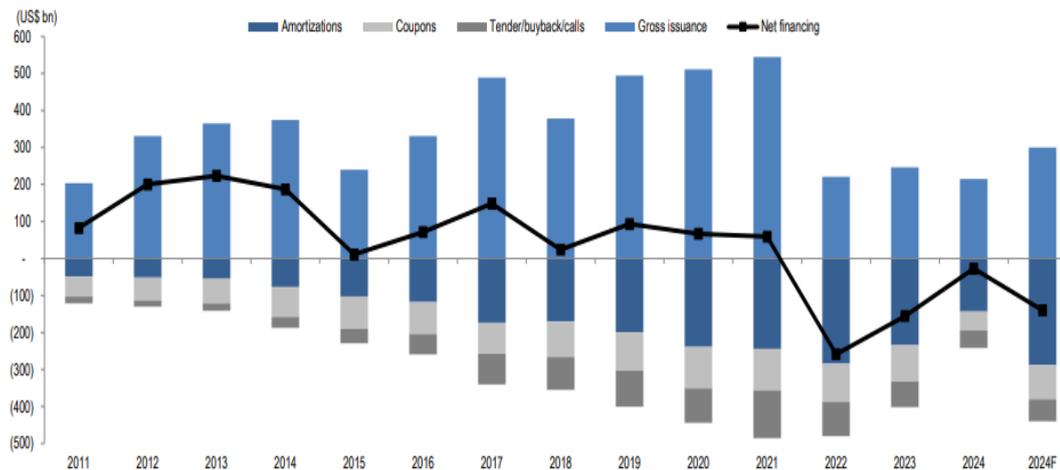
Coca-Cola Icecek produces, distributes and sells drinks belonging to the Coca-Cola brand in Turkey and the Middle East. We believe that it is a defensive, investment-grade credit. The low demand elasticity of the soft drinks market makes it resilient. We also like its geographical diversification across 11 countries, strong brand recognition and prudent financial policies in maintaining low leverage on its balance sheet. The company has successfully evidenced its ability to increase both volumes and prices in high inflationary countries such as Turkey.

5. Supportive supply and demand, with negative net financing

Negative net financing means issuers are paying back a greater amount to investors than the amount they are receiving. This has been the case for EM corporate bonds since 2022 and is supportive of bond demand and prices as it implies that the number of bonds on the market is gradually decreasing and there is greater investor demand per bond.

Net financing is calculated by taking the total amount received by bond issuers from investors (i.e., total bond issuance) and deducting all amounts paid back by issuers to investors (i.e., bond repayments and coupon payments).

Negative net financing for EM corporate issuers since 2022



Source: JP Morgan, Bond Radar, Bloomberg Finance L.P. 2024 as of 3rd July 2024

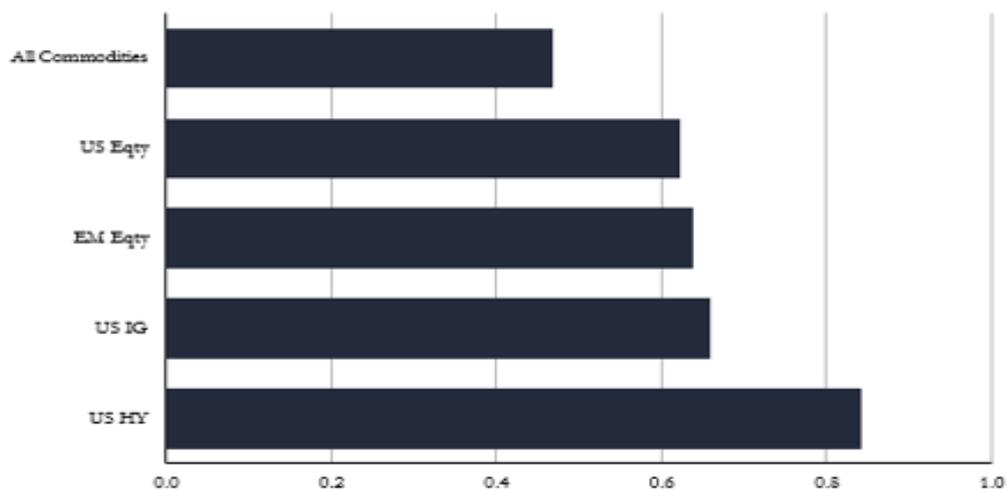
This is also indicative of improved cashflow generation, with more issuers able to repay/partially repay their debt at maturity using cash on the balance sheet rather than having to refinance the full amount, and improved depth of local markets, with issuers able to raise alternative sources of capital.

Access to capital markets and other sources of financing is an important indicator of the credit strength of a business and how well-equipped a company is to deal with refinancing risk.

6. EM corporate debt provides an attractive diversifier to other asset classes

With geopolitical and macroeconomic risks at the forefront of investor concerns, we believe that EM corporate debt provides an attractive diversifier to other core developed market asset classes. An interesting picture emerged when we looked at the correlation between these asset classes over a 20-year period:

Low correlation between Emerging Market High Yield and other risk assets (Emerging Market High Yield Correlation, USD)



Source: J. Stern & Co; Bank of America. Calculated using monthly performance from 31st May 2002 to 31st August 2024

As seen above, the correlation between EM corporate debt (USD) and US equity as well as global equity is around 0.6 on a 20-year basis. It can therefore be argued that EM corporate debt should act as a good diversifier to the core equity allocations. This is why we believe that the asset class is particularly attractive for investors looking for a diversifier from traditional investments because it offers better downside protection as well as attractive risk-adjusted returns.

Active management

We have constructed the J. Stern & Co. Emerging Market Debt Stars strategy so that it is capable of weathering a potential US or global recession well. We do not expect a recession but have focused our portfolio construction on a shorter spread duration, which should protect the portfolio should volatility increase and spreads widen.

We believe the main downside risks facing the asset class are primary global geopolitical issues rather than EM-specific. Our portfolio is geographically diversified and we have recently increased our positions in selected issuers operating in frontier markets such as Ghana and Nigeria, investing in more idiosyncratic-driven credit cases with a lower correlation to DM. The attractive yield generated by the overall portfolio provides downside further protection.

Ultimately, our conviction remains that the quality of corporates matters and that bottom-up credit selection, i.e., company-specific performance rather than wider economic factors, will continue to be of paramount importance in driving performance over the long-term.

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September 2024

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