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EMERGING MARKET DEBT: CORRECTING SIX COMMON MISCONCEPTIONS

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Over the past two decades, emerging market (EM) hard currency debt has become a relatively common asset class in large institutional investors' and discretionary portfolio managers' portfolios. Nevertheless, there are still several common misconceptions about EM debt, which could explain why some investors are underweight, or avoid, the asset class. In this paper, we discuss – and correct – some of these misconceptions.

Myth 1. EM hard currency debt is a niche asset class, especially when it comes to corporate bonds

Some investors believe that EM hard currency debt is just a small subset of the bond universe which offers a spread. However, in reality, EM hard currency debt is a $4tn investment universe, across sovereign, quasi-sovereign and corporate debt (source: JP Morgan data, as of 30.04.24).

Putting this into context, the $4tn EM hard currency debt universe is roughly twice the size of US dollar- and euro-denominated high yield markets combined. Over $2.5tn of this $4tn was issued by corporates (including quasi-sovereign issuers), making the EM hard currency corporate bond market larger than its sovereign counterpart.

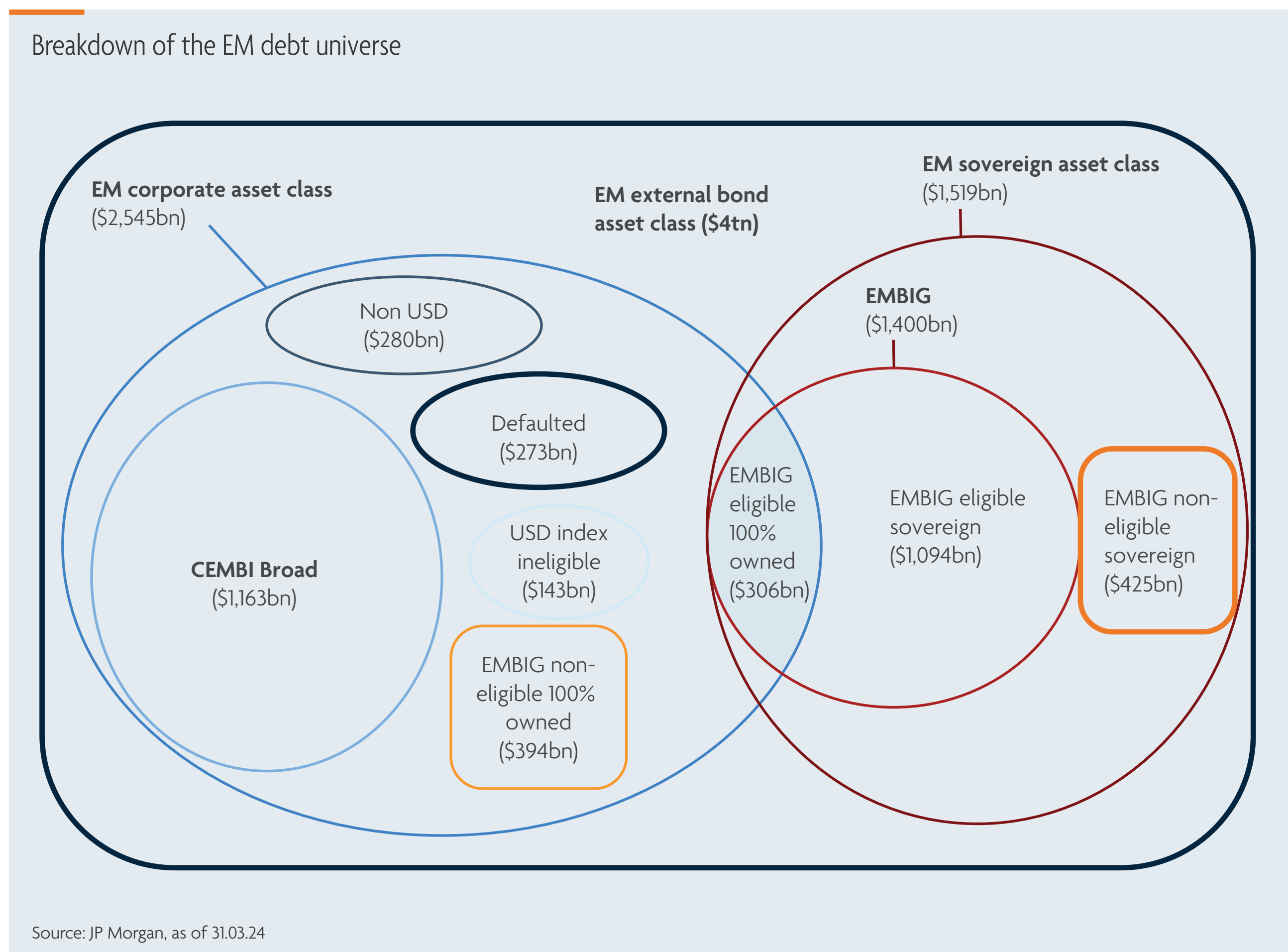
JP Morgan EM debt Indices

For both corporate and sovereign EM debt, JP Morgan tends to be the main index provider, with two well-known index series:

- **The JP Morgan Emerging Markets Bond Index ("EMBI")** and its series of indices, including the JP Morgan EMBI Global Diversified Index, is the main reference for allocations to hard currency sovereign bonds and quasi-sovereign (i.e. 100% government-owned) corporate bonds.
- **The JP Morgan Corporate Emerging Markets Bond Index ("CEMBI")** and its series of indices, including the JP Morgan CEMBI Broad Diversified Index, is the main reference for allocations to corporate bonds that are not quasi-sovereign (i.e. not 100% government-owned).

It is worth noting that not all the bonds included in the investment universe are part of the indices commonly used as benchmarks. As with any index, these JP Morgan indices have inclusion criteria that determine which EM hard currency bonds are included in a given index. In terms of corporate debt, for example, the CEMBI excludes all bonds with an initial maturity below 2.5 years and a remaining maturity below 0.5 years. Another factor that can drive index inclusion is the minimum amount outstanding, which is $300m for the CEMBI and $500m for the EMBI. As a result of these kinds of exclusions, investors in passive strategies could miss out on opportunities offered by areas of the market that are not eligible for index inclusion.

Breakdown of the EM debt universe



Source: JP Morgan, as of 31.03.24

Myth 2. EM debt is riskier than developed market credit

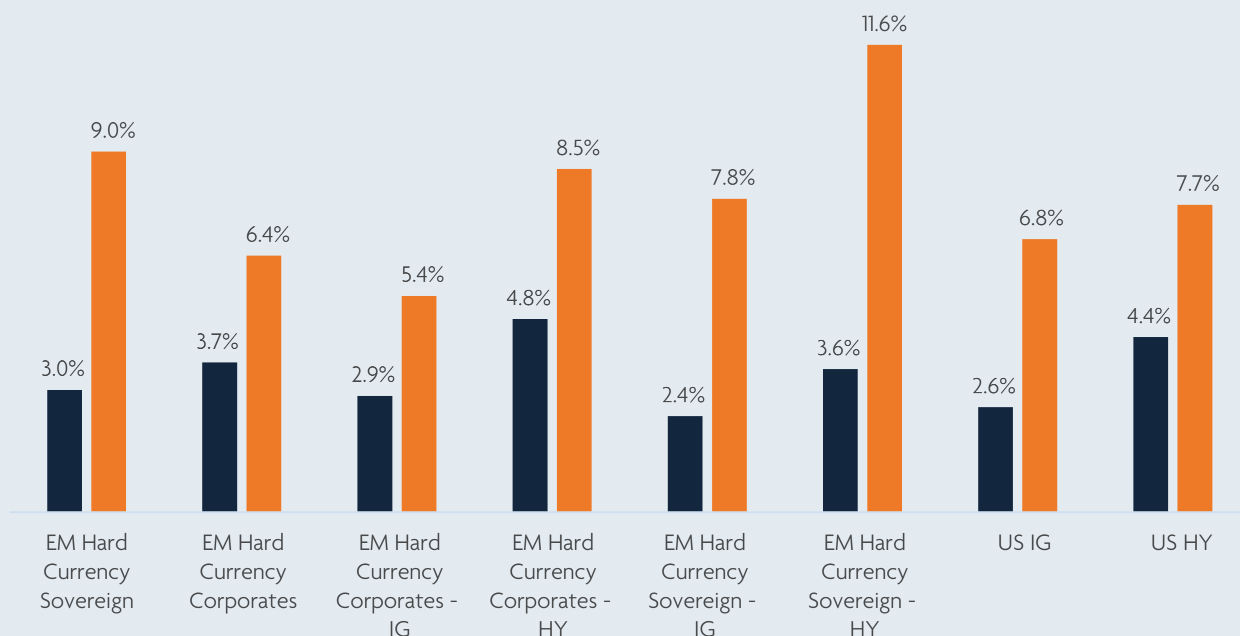
Investors often view EM debt as being a riskier asset class than developed market credit. However, this perception is not entirely backed by data, and there needs to be some differentiation in terms of index composition.

The volatility profile of the emerging markets space is quite diverse. EM corporate bonds have been much less volatile than EM sovereign bonds in the last 10 years; this is not by chance but comes from clear compositional differences.

When comparing EM debt with developed markets and differentiating between investment grade (IG) and high yield (HY) debt, EM IG corporate bonds have not only been less volatile than EM IG sovereign bonds, but also than US IG debt. In the high yield space, EM HY corporate bonds have been only modestly more volatile than US HY debt, and less so than EM HY sovereign bonds.

Returns and volatility – EM bonds vs DM bonds (last 10 years)

■ Total return p.a. ■ Volatility



Source: Jupiter, Bloomberg, as of 31.03.24. EM Hard Currency Sovereign is J.P. Morgan EMBI Global Diversified Composite; EM Hard Currency Corporates is J.P. Morgan Corporate EMBI Broad Diversified Composite Index Level; EM Hard Currency Corporates - IG is J.P. Morgan Corporate Broad EMBI Diversified High Grade Index Level; EM Hard Currency Corporates - HY is J.P. Morgan Corporate Broad EMBI Diversified High Yield Index Level; EM Hard Currency Sovereign - IG is J.P. Morgan EMBI Global Diversified Inv Grade; EM Hard Currency Sovereign - HY is J.P. Morgan EMBI Global Diversified High Yield; US IG is Bloomberg US Corporate Total Return Value Unhedged USD, US HY is ICE BofA US High Yield Index.

Myth 3. EM hard currency sovereign bonds and EM corporate bonds have similar compositions

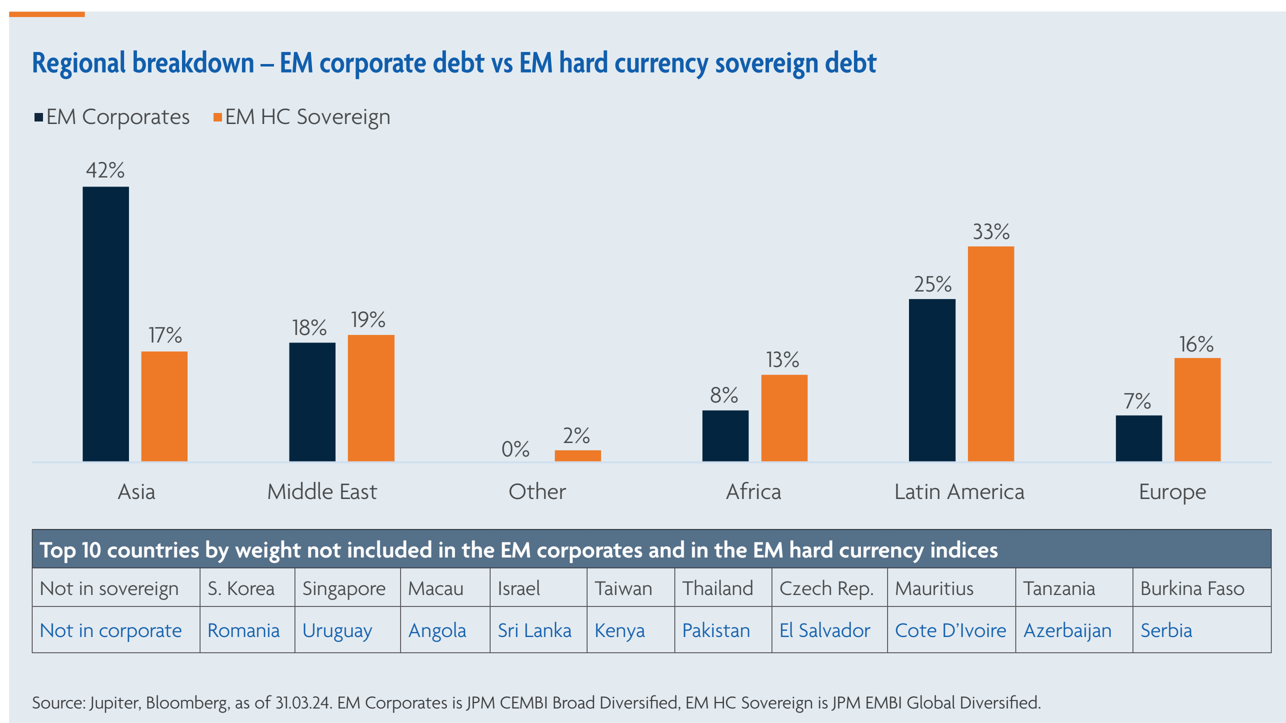
Investors sometimes view emerging markets as a homogeneous universe or as something that is always defined in a very specific way. However, in practice, there is no universal definition for emerging markets. In terms of what qualifies as an emerging market government or company in bond and equity indices, the answer could be very different depending on the asset class and index provider.

As mentioned previously, JP Morgan is the main index provider for EM bond indices, and the EMBI GD and CEMBI BD are the two main references for hard currency sovereign and quasi-sovereign debt, and for EM corporate debt, respectively. Despite having been created by the same index provider, the two series of indices follow different rules in determining which countries are classified as “emerging markets”. For EMBI, countries below a certain threshold of Gross National Income are considered, while for CEMBI, simple regional criteria are used.

The resulting EM corporate index tends to have higher exposure to Asia and especially Asian investment grade countries like South Korea, Singapore, Taiwan and Thailand, while the EM hard currency sovereign index tends to have higher exposure to Latin America, Europe and Africa, particularly in high yield countries.

These different country compositions also result in different credit rating profiles: the CEMBI BD is an IG index with an average rating of BBB-, while the EMBI GD has an average rating of BB+, putting it in HY territory. Both key sources of volatility – credit risk and duration risk – are lower for the corporate universe relative to the sovereign one.

Regional breakdown – EM corporate debt vs EM hard currency sovereign debt



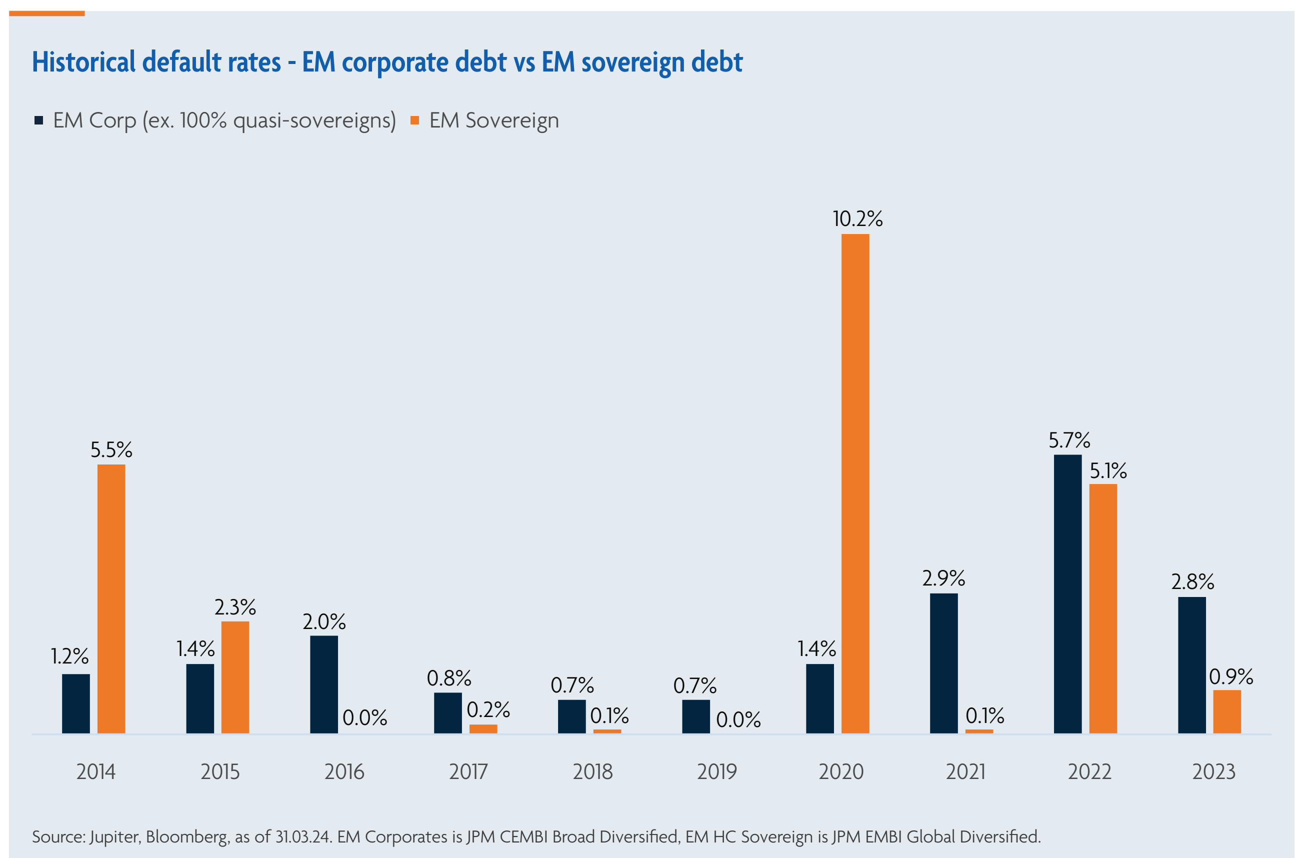
Top 10 countries by weight not included in the EM corporates and in the EM hard currency indices										
Not in sovereign	S. Korea	Singapore	Macau	Israel	Taiwan	Thailand	Czech Rep.	Mauritius	Tanzania	Burkina Faso
Not in corporate	Romania	Uruguay	Angola	Sri Lanka	Kenya	Pakistan	El Salvador	Cote D'Ivoire	Azerbaijan	Serbia

Source: Jupiter, Bloomberg, as of 31.03.24. EM Corporates is JPM CEMBI Broad Diversified, EM HC Sovereign is JPM EMBI Global Diversified.

Myth 4. Corporate bonds are "riskier" than sovereign bonds

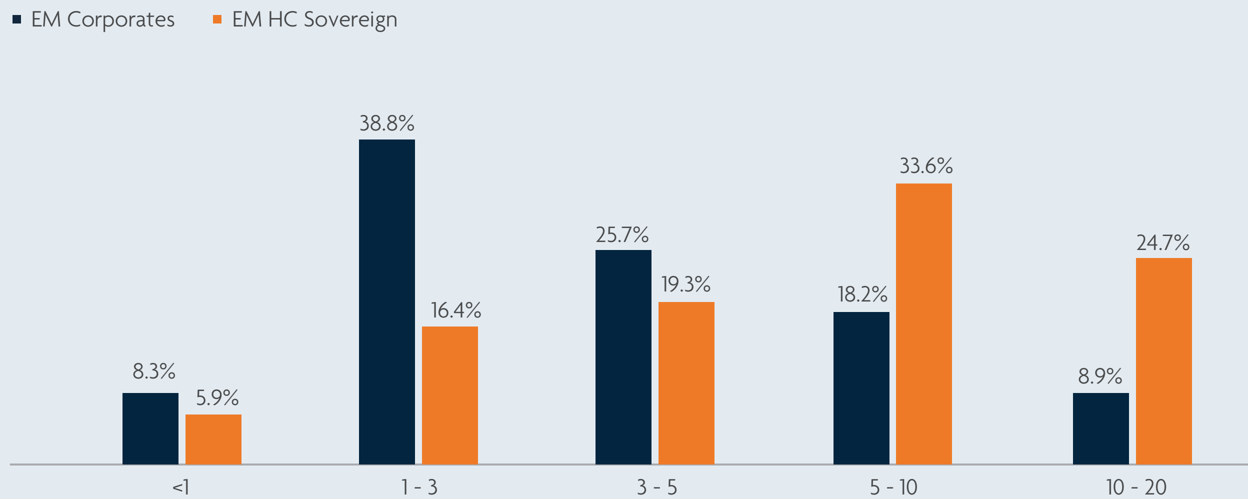
Another common misconception is that EM hard currency corporate bonds are usually riskier than EM hard currency sovereign bonds. One might expect a corporate bond to carry a similar or higher risk of default than a sovereign bond issued by the government of the country in which the corporate is based. However, in practice, this does not mean that corporate debt is riskier than sovereign debt from an asset class standpoint.

The volatility data shows corporate bonds to be less risky than sovereign bonds. Higher credit quality (as mentioned previously) means that corporate bonds have recorded lower default rates than sovereign bonds over the past 10 years, with the default rate for corporate bonds averaging at 2.0%, compared to 3.1% for sovereign bonds. Again, the lower volatility of corporate bonds is mostly a result of having a different composition and index structure.



Another element that generates this lower volatility is the lower duration and spread duration of corporate bonds, as on average they tend to be issued with shorter maturities. As of the end of March 2024, the CEMBI BD Index had an effective duration of 4.2 years compared to 6.6 years for the EMBI GD Index.

Duration breakdown – EM corporate debt vs EM hard currency sovereign debt

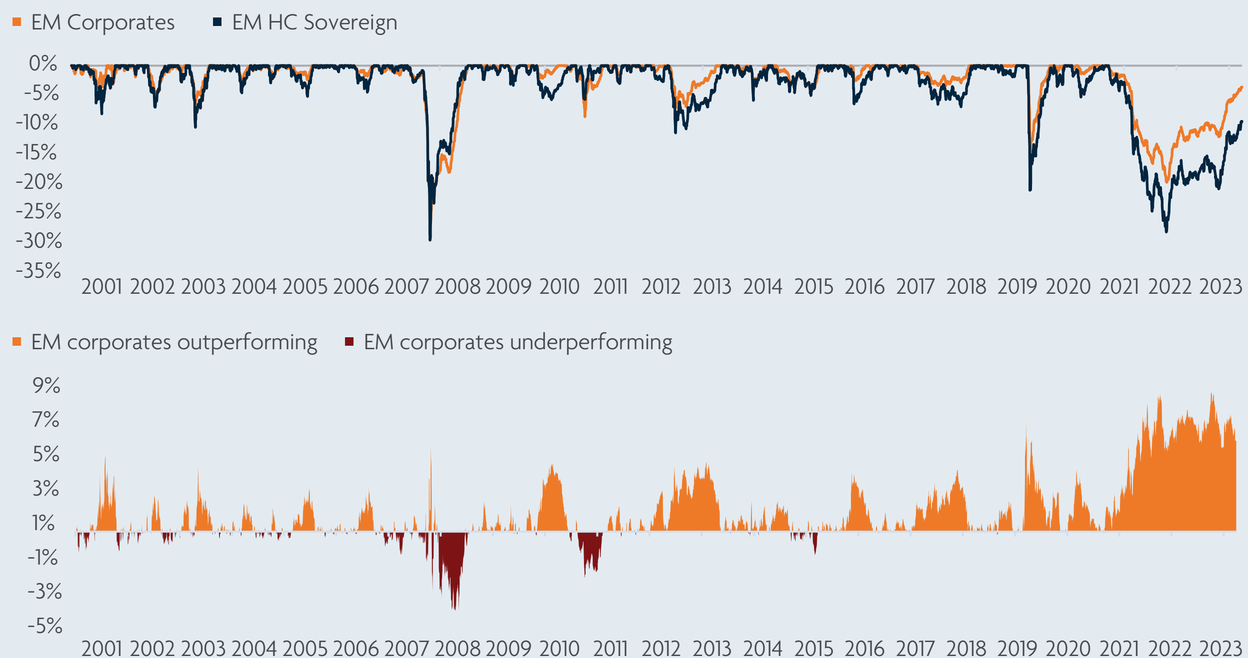


Source: Jupiter, Bloomberg, as of 31.03.24. EM Corporates is the JPM CEMBI Broad Diversified Index, EM HC Sovereign is the JPM EMBI Global Diversified Index.

Lower spread duration and higher credit quality imply lower credit risk for corporate bonds overall. Duration Times Spread, or DTS, a popular measure of credit risk, is only 8.9 for corporate bonds compared to 15.0 for hard currency sovereign bonds (as of 31.03.24).

A combination of these factors has generated a smoother drawdown profile for corporate debt compared to sovereign debt, except during the GFC, when the large weighting in financials resulted in a drag for the corporate index.

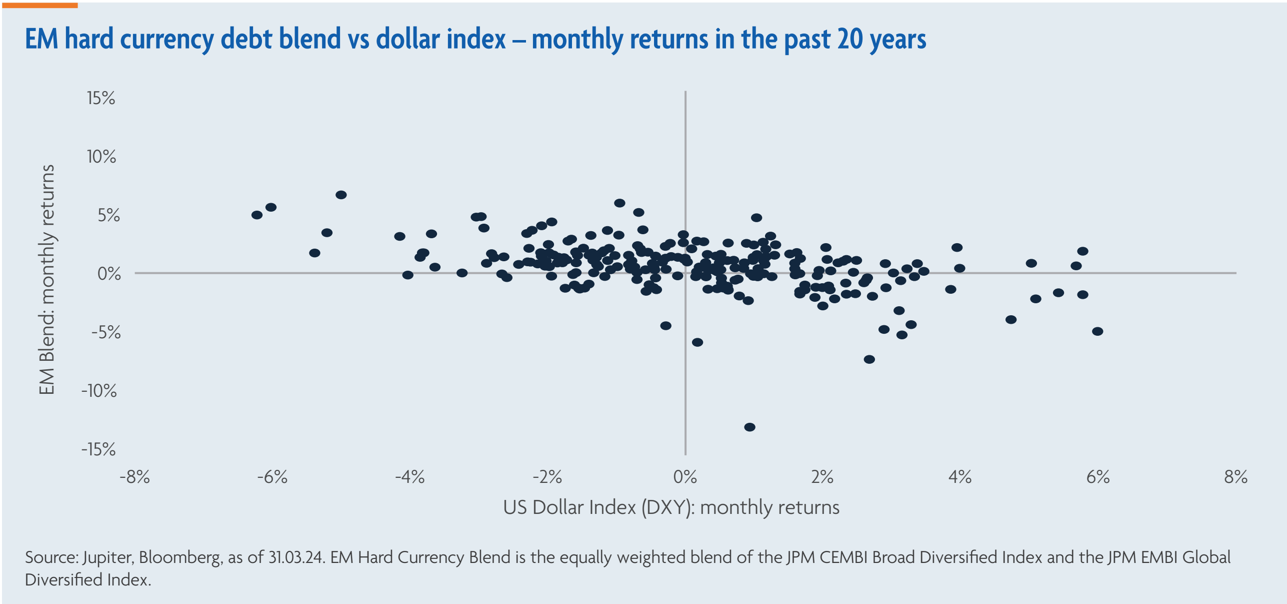
Historical drawdowns – EM corporate debt vs EM hard currency sovereign debt



Source: Jupiter, Bloomberg, as of 31.03.24. EM Corporates is the JPM CEMBI Broad Diversified Index, EM HC Sovereign is the JPM EMBI Global Diversified Index.

Myth 5. US dollar strength is always bad for EM debt

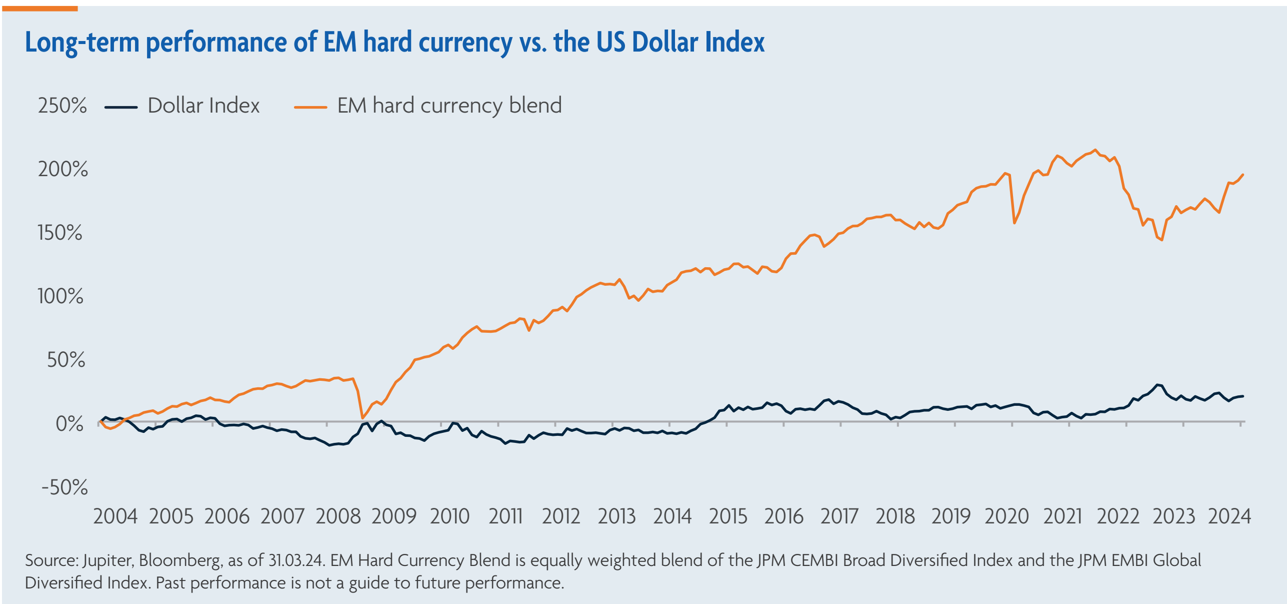
While US dollar strength is negative for local currency debt returns when expressed in US dollars, this is not always the case for EM hard currency debt. Over the past 20 years, we have seen positive and negative short-term returns from EM hard currency debt during periods of US dollar appreciation.



EM hard currency debt blend vs dollar index – monthly returns in the past 20 years

Source: Jupiter, Bloomberg, as of 31.03.24. EM Hard Currency Blend is the equally weighted blend of the JPM CEMBI Broad Diversified Index and the JPM EMBI Global Diversified Index.

Over the long term, the impact of US dollar moves has been modest. Over the last 20 years, the US Dollar Index has appreciated by roughly 20%, but this has not prevented the EM hard currency asset class from delivering strong cumulated returns.



Long-term performance of EM hard currency vs. the US Dollar Index

Source: Jupiter, Bloomberg, as of 31.03.24. EM Hard Currency Blend is equally weighted blend of the JPM CEMBI Broad Diversified Index and the JPM EMBI Global Diversified Index. Past performance is not a guide to future performance.

Myth 6. EM is a tactical asset class

A lot of investors perceive EM debt as a "tactical" component of their portfolio that should be included only when market conditions are supportive and EM tailwinds are evident.

However, strong cumulated returns for EM hard currency debt over the long run suggest this is an incorrect approach. The asset class generated almost +190% in cumulated total returns in 20 years, as shown in the previous chart (for the EM equally weighted hard currency blend, with 50% corporate debt plus 50% sovereign debt). If investors had missed out on investing in the asset class during its three best-performing months , they would have made a cumulated total return of +142%, 48 percentage points less - a meaningful difference in returns.

In this sense, the level of predictability of EM spreads and returns over the short term is not too different from the predictability of stock returns, demonstrating that market timing is not a good strategy. Additionally, we have seen periods of very positive returns for the asset class coming immediately after sizeable drawdowns (e.g. the Global Financial Crisis, Covid-19 and the war in Ukraine). Exiting the asset class during those moments could have been quite detrimental to long-term performance.

How should you allocate to EM hard currency debt?

Given the sheer size of the asset class, and the wide and diverse range of opportunities offered by the universe, we believe investors should consider a structural allocation to EM debt.

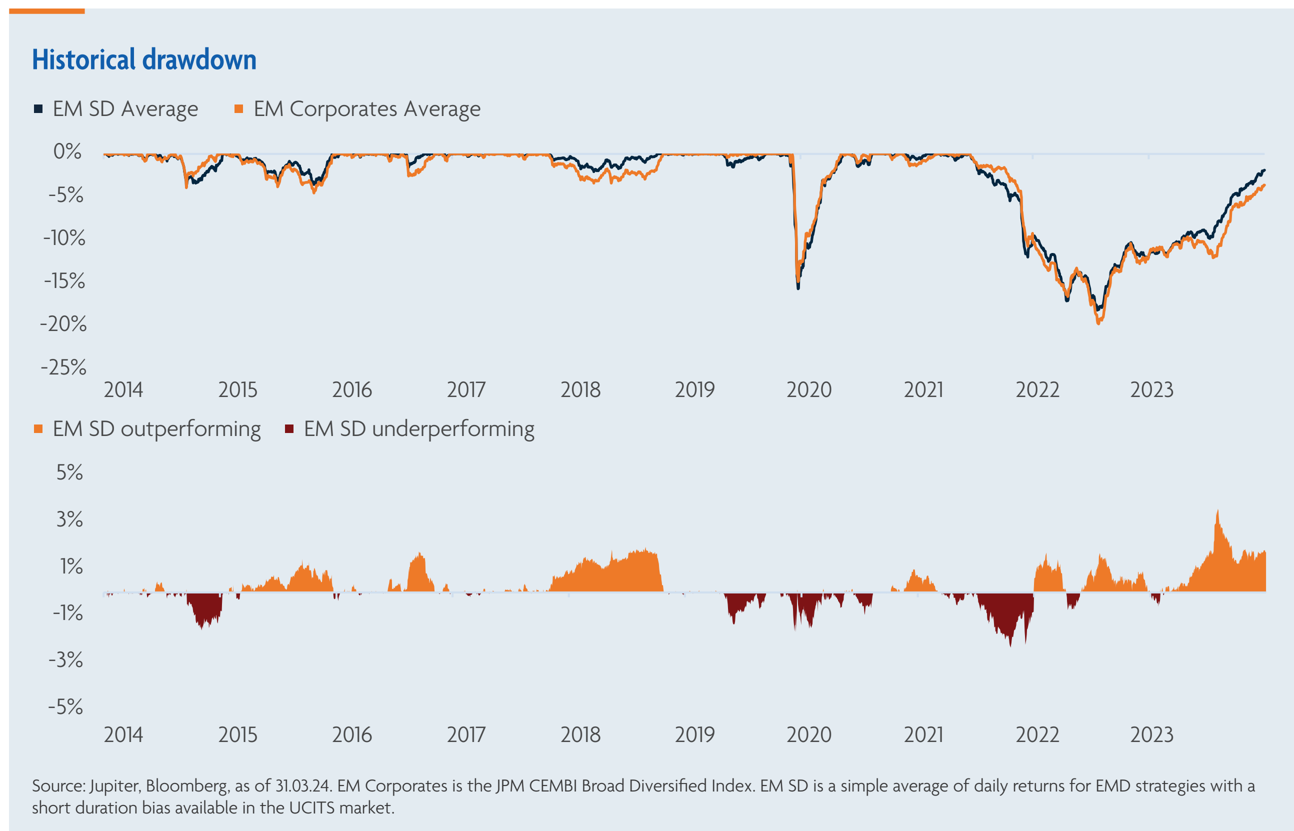
While over time, many investors have started to include EM hard currency debt in their structural strategic asset allocation, they have often limited their exposure to the sovereign component of the universe. However, neglecting the corporate universe means missing out on a historically highly efficient area of the universe, thanks to differences in country composition, higher credit quality, lower duration (and spread duration) and lower historical default rates.

In this sense, we believe that the ideal approach for a structural allocation to the universe could be to consider distinct separate structural allocations to corporate and sovereign debt, within a broader allocation. For those investors who prefer to have a single EM allocation, corporate bonds could provide a valid alternative to sovereign debt, thanks to their higher efficiency.

In terms of short duration exposure, over the past decade, we have seen decent growth in the market for strategies dedicated to the short duration segment of the EMD market. Short duration strategies can be a helpful tool for investors as, in theory, they should present a lower degree of risk/volatility; this comes partially from the same argument that drives the lower risk for EM corporate debt compared to EM sovereign debt (i.e. lower duration, but especially lower spread duration). In practice, however, it is not always the case.

While, on average, short duration products tend to outperform during drawdown phases, there have been also some instances where they underperformed. This comes from the fact that while

duration might be capped, the overall degree of credit risk is usually left to the manager. In this sense, different short duration strategies can present different risk profiles and will not always be a more conservative allocation compared to a corporate bond allocation. Nevertheless, they can be a good diversifier compared to an allocation to sovereign bonds.



Source: Jupiter, Bloomberg, as of 31.03.24. EM Corporates is the JPM CEMBI Broad Diversified Index. EM SD is a simple average of daily returns for EMD strategies with a short duration bias available in the UCITS market.

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