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Fixed-income note: are emerging markets outpacing developed markets?

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Key takeaways:

- Emerging markets (EMs) are are a heterogeneous set of countries. Economic drivers in these countries often have different sources and dependencies and can be at different points in the economic cycle, especially when compared to developed markets (DMs).
- On aggregate, emerging economies are expected to widen their growth differentials compared to developed markets in 2023.
- Although inflation in emerging economies is higher than in developed economies, the magnitude of the increase since 2020 has been much smaller, and the likelihood of EM central banks cutting rates is generally higher compared to their developed markets (DM) peers.
- Valuations for US-dollar-denominated emerging-market corporate bonds are attractive compared to US corporates, particularly within the high-yield universe.

Assessing key macroeconomic factors

One decision that investors need to consider regarding their portfolios is their allocation between developed and emerging markets. Within emerging markets (EMs), one significant decision is whether to take on hard- or local-currency exposure. Investing in debt denominated in local currencies means accepting currency risk and more equity-like volatility in exchange for a lower performance correlation. In general, investors need to have a neutral to positive view on EM currencies to invest in local-currency debt. In contrast, US-dollar-denominated emerging-market investments provide more traditional fixed-income characteristics (i.e. more stable income patterns), but have a higher correlation with developed-market, fixed-income portfolios because their interest-rate risk is tied to US rates. However, regardless of investing in hard- or local-currency bonds, a general assessment of the macroeconomic situation in emerging versus developed economies should serve as a starting point.

Better growth expectations for emerging markets than for developed markets

At an aggregate level, emerging economies are expected to add to their growth pickup compared to their peers in the developed world. The International Monetary Fund (IMF) expects growth in developed markets to slow down from +2.7% in 2022 to +1.3% in 2023. Meanwhile, growth in emerging economies is expected to rebound from 2022, driven by the reopening of China's economy following the change in the country's zero-COVID policy. In particular, large, domestically focused economies such as India and Indonesia are also expected to enjoy solid economic growth in 2023 because they will be less affected by the slowdown in developed economies.

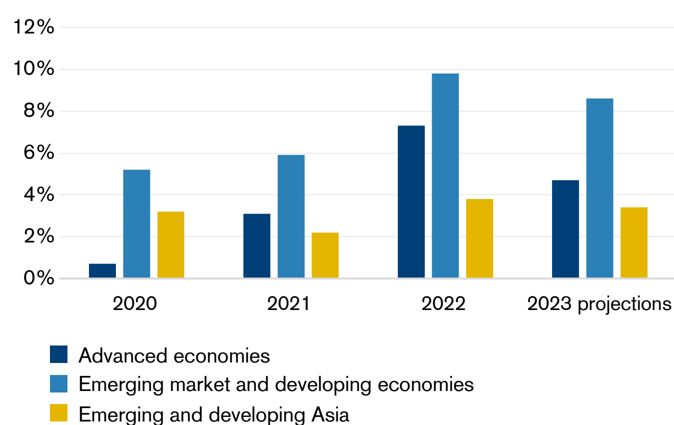
Why differentiation within the emerging-market allocation matters

Emerging markets are not a monolith. Economies labeled emerging markets often have very different drivers and can be at different points in the economic cycle at any given time. China is a good example of this (see box).

The differences in inflation and policy rates between key emerging markets are a good example to illustrate the heterogeneity within emerging economies. Examples range from the Central Bank of Brazil taking a very proactive stance to tackling inflation with aggressive interest rate hikes to the Central Bank of the Republic of Turkey not hiking rates despite a significant rise in inflation. Given this level of heterogeneity, a portfolio's asset allocation within emerging markets matters. At an aggregate level, although inflation in emerging economies is of course higher than in developed economies, the magnitude of the increase since 2020 has been much smaller (see Chart 1). Consumer Price Index (CPI) inflation in developed markets increased from a rate of 0.7% in 2020 to 7.3% in 2022 – a very sharp increase over a very short period of time. In contrast, inflation in emerging markets rose from 5.2% in 2020 to 9.8% in 2022 – a much smaller difference. Asia, the largest region in the emerging-market world, experienced only mild upward pressure on prices (from 3.2% in 2020 to 3.8% in 2022), leading to much fewer interest-rate hikes compared to developed economies.

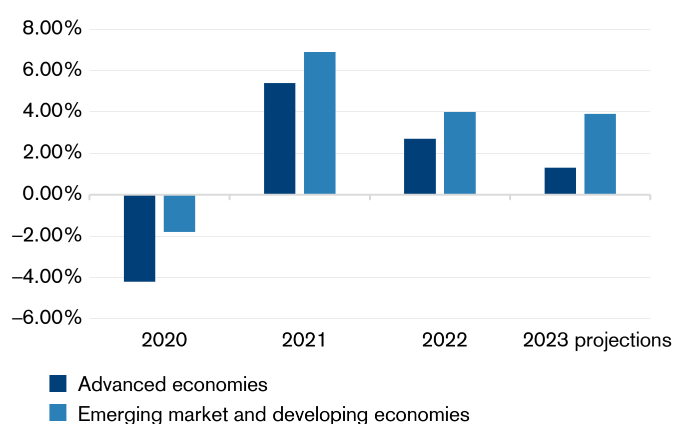
These forecasts are not reliable indicators of future performance.

Chart 1: Inflation (consumer prices)



Source: IMF, World Economic Outlook, April 2023

Chart 2: Real Gross Domestic Product (GDP)



Source: IMF, World Economic Outlook, April 2023

We believe that these macroeconomic tailwinds illustrate why emerging-market investments should be considered as part of a global fixed-income portfolio allocation. We view EM corporate bonds as an interesting asset class within emerging markets.

China's GDP growth prospects in 2023

The case of China: an economic-cycle outlier in 2023
China delivered strong GDP growth of +4.5% year-on-year in Q1 2023, outperforming the consensus forecast of +4.0%. However, China's economic recovery appears uneven because services drove the growth while manufacturing and the all-important property sector exhibited only a moderate recovery.

In the meantime, unlike in developed markets, inflation remained subdued in China. In fact, the country just narrowly avoided year-on-year deflation in April, while much of the rest of the world is experiencing painful price increases. We believe that China will be on track to meet its full-year growth target of around +5% and we expect that the People's Bank of China will be more likely to ease its monetary policy further, given the benign inflation environment.

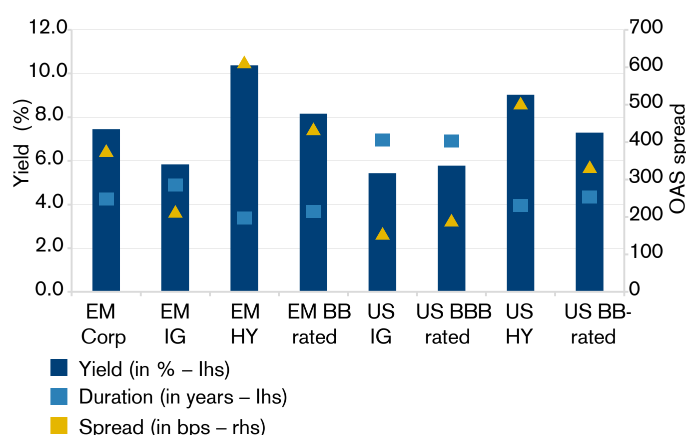
This provides a good illustration of the different stage of the economic cycle that China is in compared to developed economies. From an EM perspective, the positive impact of China's post-COVID recovery on the rest of the world will be an important driver in view of the economic slowdown in developed markets.

However, looking ahead to the second half of 2023, we see the risks of growth momentum slowing and of China's impact on the rest of the world being more limited than it was in the past.

Emerging-market corporates offer value over high-yield bonds in developed markets

The chart below shows yields, credit spreads, and duration across various US-dollar-denominated emerging-market and US corporate areas. Current valuations show a yield advantage for EM bonds because they are trading above the long-term average. Meanwhile, US high-yield bonds are trading at or slightly below their average.

Chart 3: Key characteristics – emerging-market corporates relative to US corporates



Source: JP Morgan indices, Bloomberg Finance LP; May 31, 2023

Valuation: A compelling case for US-dollar-denominated emerging-market corporate bonds

Investing in emerging markets is usually associated with higher risk than investments in developed markets, especially with regard to corporate governance and institutional frameworks. The higher credit spreads for EM corporate bonds reflect this fact and, in our opinion, compensate investors for the risk taken. In addition, emerging-market corporate bonds have a shorter duration than their US counterparts and are therefore less sensitive to changes in policy rates – a feature that's especially important given the elevated levels of interest-rate volatility.

US-dollar-denominated EM corporate bond yields currently offer a risk premium of around 378 basis points (bps), a yield to maturity of 7.46% (as of May 31, 2023) with an average duration of 4.27 years, and an average rating of BBB–.

Since mid-March, EM credit spreads have been trading within a narrow range in the wake of the US regional banking sector crisis and the US debt-ceiling saga. The low spread differential was recently pushed by the relatively wider spreads on US BBB-rated financials. While EM investment grade (IG) valuations

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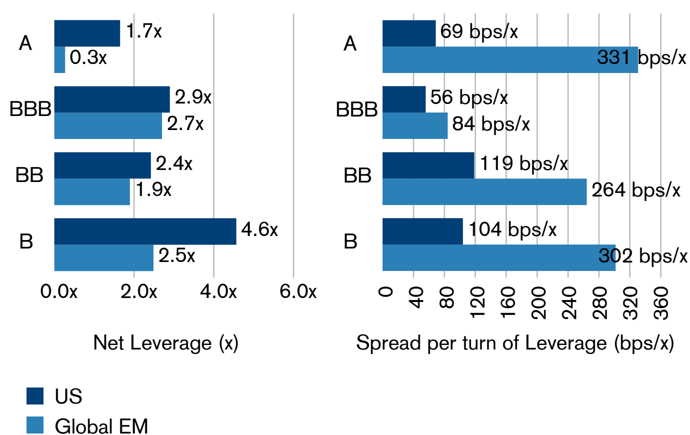
may look tight compared to valuations on US investment-grade bonds, part of this difference is explained by EM IG's two-year-shorter duration compared to US IG (see Chart 3).

When looking at the high-yield segment, emerging-market bonds offer more compelling yields and spreads than their DM counterparts even when adjusted for like-for-like ratings. If we look at BB-rated indices (see Chart 3) and remove single-B and distressed bonds from both universes, the yield (adjusted for duration) that EM corporates offer is considerably higher than for equivalent US corporates. EM corporates also offer generally stronger fundamentals compared to their US counterparts (see Chart 4).

Chart 4: EM fundamentals better than US fundamentals – leverage per rating bucket



Source: BofA Securities. Data as of December 31, 2022 (net leverage), and as of April 30, 2023 (spread)

Fundamentals

EM corporate fundamentals remain solid despite some head-winds in specific countries and sectors. With the market facing pressure on costs and elevated inflation, the key question will be the magnitude of the growth slowdown and the type of any potential US recession. That said, the weakening in credit metrics has been modest and comes off a very strong starting point. Although we see limited improvement in the fundamentals picture for EM corporates going forward, we also do not see them deteriorating rapidly.

The market for emerging-market corporate bonds in hard currencies is dominated by investments in US dollars, so a comparison with the US peer group is representative. While overall leverage figures give a good general indication of the trend in leverage, a better basis for comparing emerging-market and US corporates is to look at net leverage within the same rating buckets (see Chart 4). The compensation for emerging markets is much higher per unit of net leverage compared to the US. Particularly in the BB and B areas, the credit spread paid per unit of net leverage is clearly higher for emerging-market credits relative to US credits.

The broad category of emerging-market investments provides a suite of attractive investment solutions for fixed-income investors. While developed markets are still afflicted by slower growth and high interest-rate volatility, many emerging-market fundamentals remain robust, providing a solid foundation for emerging-market assets. In particular, we identify key fundamental and valuation features of US-dollar-denominated EM corporate bonds that shine brighter than those for their DM counterparts, and we believe those bonds should be deemed a key part of any long-term, fixed-income portfolio.

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Source: Credit Suisse, unless otherwise specified.
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