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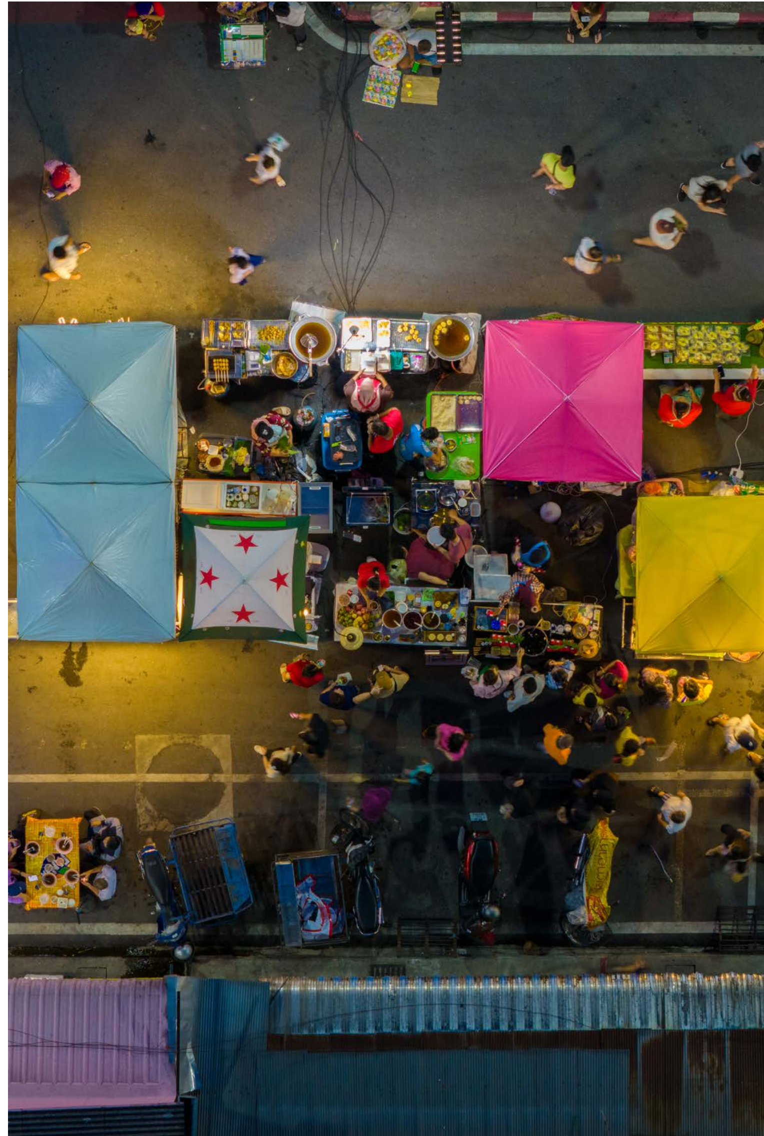

Niche no more

Is investment grade corporate emerging market debt an asset class whose time has come?

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Executive summary

Emerging markets (EMs) have shown remarkable resilience in the face of the economic shocks of the 2020s, in our view positioning themselves well potential future growth.

The macroeconomic landscape for EMs has evolved significantly, reducing the risks of sudden capital outflows that characterised past crises. Many are now creditor nations with healthy current account balances and substantial foreign exchange reserves.

We think the recent depreciation of the US dollar following the US Federal Reserve's rate cuts should further support EM growth and potential investment returns.

Geopolitical factors, particularly the US-China trade relationship, have also influenced EM dynamics. The reallocation of US trade from China to other EMs over recent years has highlighted the competitive advantages of these markets.

Investment grade (IG) corporate EM debt has matured as an asset class, in our view aims to offer attractive yields and improved credit quality compared to US and European counterparts.

Key risk: The value of investments and the income from them can go down as well as up, and the investor may get back less than the original amount invested. Past performance is not a guide to future performance. Investments in countries where markets are considered to be less developed are generally riskier than those in developed markets because they: (i) may not be as well regulated; (ii) may be more difficult to buy and sell; (iii) may have less reliable arrangements for the safekeeping of investments; or (iv) may be more exposed to political and taxation uncertainties. They can go down or up more often and by larger amounts than investments in developed countries, especially in the short term. Assumptions, opinions, and estimates are provided for illustrative purposes only. There is no guarantee that any forecasts made will come to pass.

As a group, emerging markets have generally weathered the shocks of the 2020s well. Having emerged from the pandemic and the bout of inflation that followed it reasonably well, we see them as well positioned moving forward.

Today, emerging markets (EMs) now make up around 50% of global GDP; by 2050, this proportion is set to grow to 65%. This 15% jump is reminiscent of the mid-1990s to mid-2000s heyday of EM growth; indeed, over the next 20 years 70% of global economic growth is anticipated to be in EMs.[1]

One factor underpinning this striking forecast is the increasing resilience and effectiveness of institutions in EMs – particularly central banks.

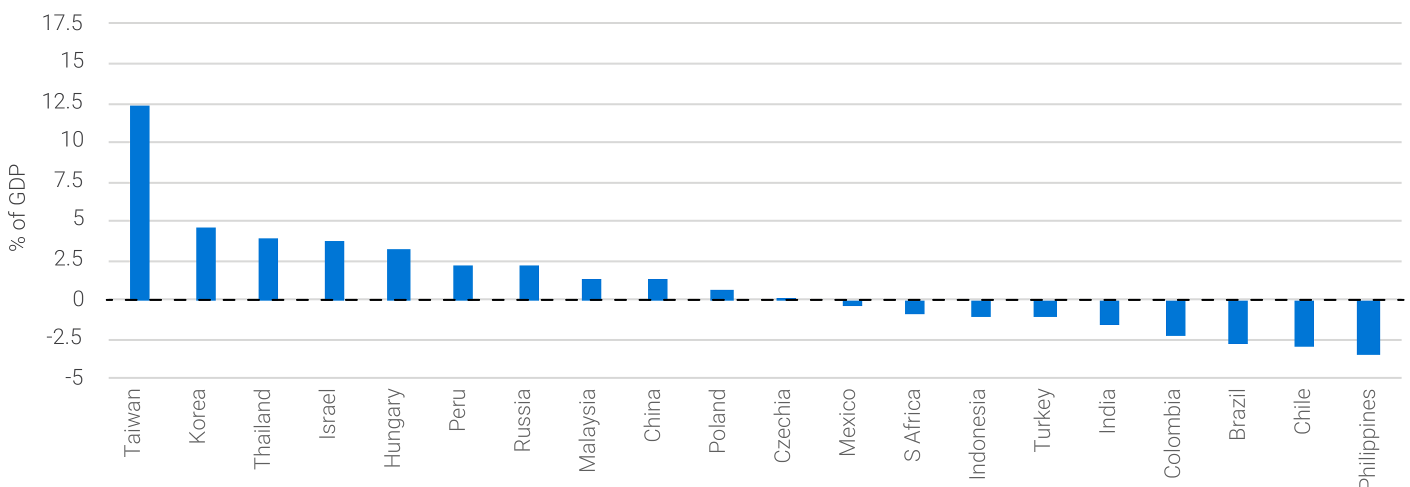
We saw this in their responses to the wave of inflation that followed Covid-related supply chain shocks and was sustained by the impact of the war in Ukraine. EM central banks stuck to economic orthodoxy on the whole, hiking rates in mid-2021 at a time when policymakers at the US Federal Reserve (Fed) had still not made inflation their primary concern. This more hawkish stance has paid off, with many EM central banks loosening policy early this year while the Fed was only able to do so in September. Simply put: we think the EM central banks were more on the ball, and their home economies have benefited from their ability to cut rates earlier.

A supportive macro picture

Another factor is the macroeconomic evolution and maturation of some EMs. Investors with long memories will remember the days when they were often tagged with 'sudden stop risk', with recurrent crises triggering large and rapid capital outflows – as we saw in Mexico's 'Tequila crisis' in 1992 or the 1997 Asian financial crisis. Under today's conditions, we see the risks of such situations as minimal.

This is because many EMs are now creditor nations; even those that are debtors, like Indonesia or Mexico, exhibit current account deficits that as a share of GDP are well within what we would consider safe bounds, as we can see below.

Current account - Q1 2024



Source: National sources, Bloomberg as of 17 September 2024.

1. Source: IMF forecasts, LGIM calculations as of 27 September 2024

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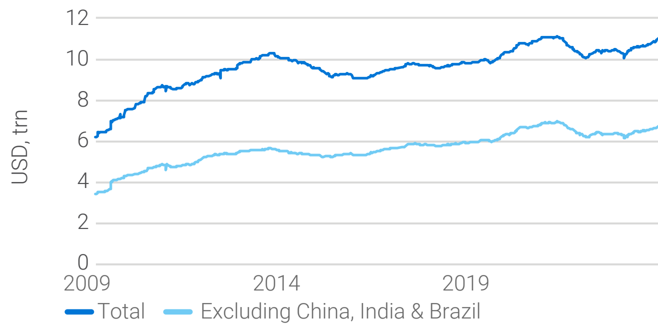
This healthy position is mirrored by the FX reserves held by many EM central banks, which now act as valuable sources of short-term balance sheet stability. In aggregate, they today hold around $11 trillion USD, up from $2 trillion USD in 2005. Crucially, this growth is not confined to the classic FX holder countries of China, India and Brazil – this trend is visible across all EMs, as shown below.

EM FX reserves

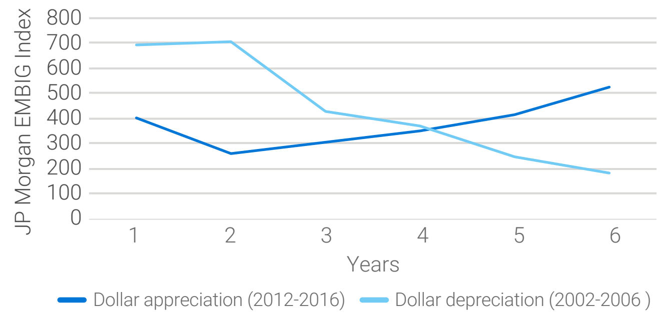


Source: National sources, Bloomberg as of 17 September 2024.

Staying with currencies, the value of the US dollar is a key variable for EMs, and for the last 12 or so years it has been in a position of relative strength. In principle, this is tough for EMs, making it harder to get offshore financing.

However, in September the Fed announced the beginning of its programme of rate cuts, which we think should drive a period of relative dollar weakness. This in turn could act as a tailwind for both EM growth and returns for EM investments. Our research indicates that fixed income exposure in EMs is rewarded substantially more during periods of dollar depreciation as we can see below.

JP Morgan EM Bond Global Diversified Index Div spread during dollar cycle



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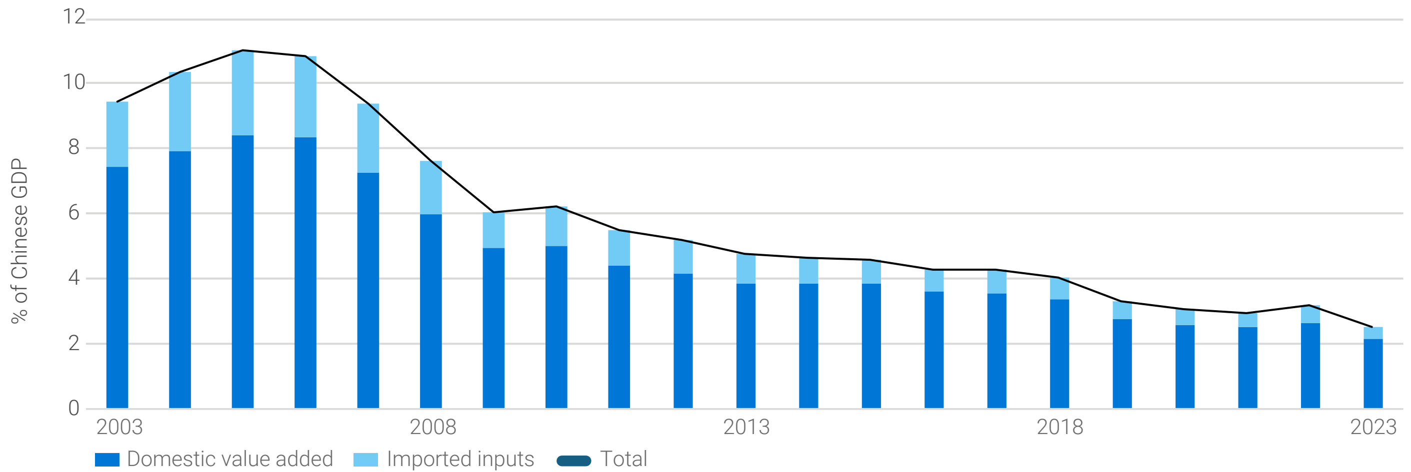
Geopolitical factors

An additional influence on the macro outlook for EMs is the geopolitical situation – or, to be more specific, the relationship between the US and Chinese economies. This has become a salient issue in American domestic politics, and one of the few areas of relative bipartisan agreement.

The evidence for this so-called 'decoupling' is plain to see, with Chinese exports to the US now substantially lower than where they were at the time when the Trump administration introduced a sweeping package of tariffs in early 2018 (and a fraction of their scale in the mid-2000s) - see below.

China: Exports to the US



Source: National sources, Goldman Sachs as of 17 September 2024.

With the outlook for EM markets in our view broadly positive, we find investment grade (IG) EM corporates particularly well placed to potentially benefit

We have found there was substantial reallocation of trade with the US from China to other EMs at the peak of the 2017-19 trade war[2]. We believe this is accounted for by their producers' ability to compete on better terms with their Chinese competitors thanks to these tariffs – and we see little reason to doubt that this trend will continue, given ongoing geopolitical and economic tensions between the two largest economies in the world.

With the outlook for EM markets in our view broadly positive, we find investment grade (IG) EM corporates particularly well placed to potentially benefit from these tailwinds.

2. Goldman Sachs, September 2024

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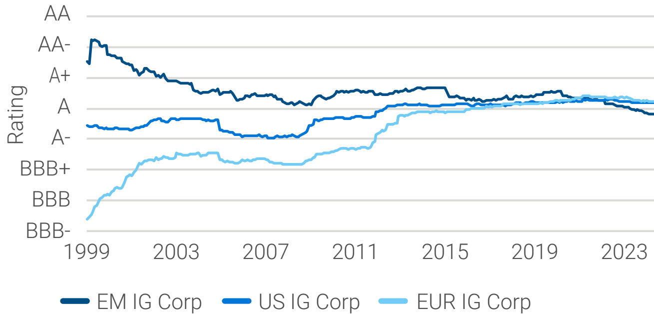
A maturing asset class

As an asset class IG corporate EMD has now matured, with a total volume of just over $1 trillion USD[3] – just short of global high yield, and roughly on a par with EM sovereigns. Credit quality has greatly improved in recent years, and is now on average higher than both US and European IG corporate debt - see the chart below.

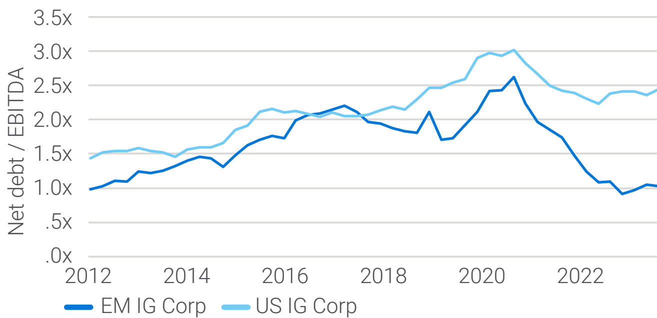
Average ratings



Source: BAML as at June 2024. Past performance is not a guide to the future. The value of an investment and any income taken from it is not guaranteed and can go down as well as up; and the investor may get back less than the original amount invested.

When we look at the balance sheets of the issuers that make up the asset class, we find that net leverage for EM IG corporates is now lower than that of US IG corporates – and has been for some time, as we can see below..

Net leverage



Source: BAML as at June 2024. Past performance is not a guide to the future. The value of an investment and any income taken from it is not guaranteed and can go down as well as up; and the investor may get back less than the original amount invested

3. Source: BAML based on ICE indices data as of June 2024.

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Thanks to factors like these, in recent years investors in IG corporate EMD have consistently been rewarded with generous spread pickups over their similarly rated counterparts in developed markets.

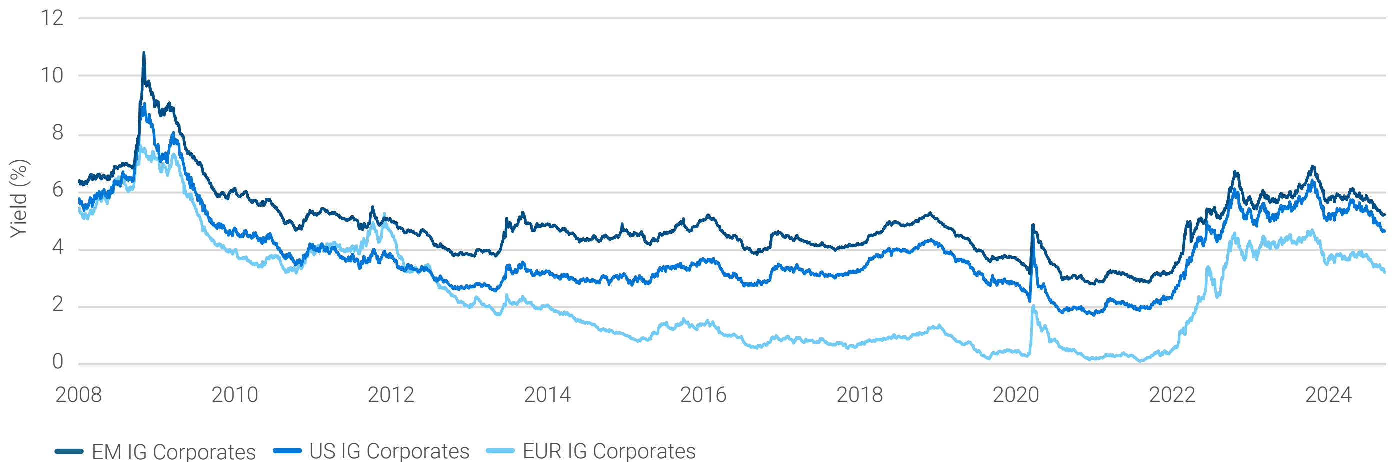
Why should investors pay particular attention now?

As of 11 November 2024, yields on IG corporate EMD are sitting at 5.2%; looking at 15 years of data, this appears to us to be relatively high, as indicated on the chart below.

These yields may be high (meaning the bonds' prices are low) – but over a long time horizon, there has consistently been a negative correlation between interest rates in the US and credit spreads. We think this means that the asset class will benefit from the turn in developed world monetary policy.

Overall, we see multiple ongoing structural factors accounting for the recent strong performance of IG corporate EMD – and we believe these trends are highly likely to continue. From healthy fiscal positions to geopolitical trends, these tailwinds are robust, and in our view present an attractive prospect for the asset class.

Yield (%)



Source: Bloomberg as of Sep 2024. EM IG comprises investment grade hard currency emerging market debt.

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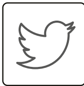

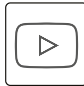

Key Risks

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