



Emerging market corporate debt - a curious anomaly

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All smart investors are constantly on the search for curious anomalies: those limited periods of time when an asset is too cheap or too expensive, allowing money to be made from buying or selling it.

Sometimes these moments are very short indeed. In these days of automated trading some do not last any longer than the amount of time it takes gravity to pull a ball down from the air. Emerging market corporate bonds present, however, an unusual and special anomaly: the permanent opportunity to earn higher yields than for developed market bonds, for the same level of risk.

Emerging market investment grade debt, which is generally issued in dollars, has over the past five years offered a yield about 0.8 percentage points more on average than US investment grade debt. For high yield bonds the average has been about double that, at a little over 1.5 percentage points. Emerging market high yield debt is cheaper than US high yield even though the issuers are less leveraged.

Why does this anomaly exist?

It survives because many investors assign an emerging market premium to all corporate bonds of all countries. This 'shoot first, ask questions later' approach to risk – the notion that every emerging market investment, including even dollar bonds, is perpetually a little more dangerous because of the rare occurrence of currency crises for a small minority of emerging economies – presents a splendid opportunity for investors prepared to put in the research on each company. The tendency for lazy investors to generalise is a great friend of the discerning investor who does not.

Emerging market corporate bonds have another advantage over developed market counterparts, as well as the higher yield: they offer all the colours of the rainbow, rather than monochrome. Emerging economies with thriving and attractive corporate bond markets include countries largely reliant on commodities, such as Russia, countries whose promise lies in ambitious economic reforms, such as Mexico, and countries supported by a complex mix of commodities, tourism and international trade, such as Dubai. The US corporate bond market, by contrast, can only ever be a play on one economy and one interest rate regime.

The businesses that are issuing bonds within each of these emerging countries are themselves highly varied. They include energy companies with abundant oil and gas reserves, banks enjoying the fruits of lending within busy, high-growth national economies, and telecoms companies benefiting from the rapid growth of the emerging world's middle class.

Each economy tells its own intriguing, arresting and complex tale – and, like the competing characters in a great Russian novel of the nineteenth century, each company within each economy has its own separate story to tell, against the backdrop of the overall story.

Because of this variety, investment in a selection of these bonds buys a high degree of diversification very quickly – diversification which reduces the overall risk of investors' portfolios by creating a better balance of different kinds of risk.

There is, furthermore, a much greater cast of characters to choose from than before within this fascinating story: emerging market corporate debt is now worth almost \$1 trillion, having grown in leaps and bounds over the past half-decade. It is larger than the hard currency emerging sovereign market.

Some sceptics have suggested that emerging markets in general, whether equities, corporate bonds or government bonds, should be avoided while the US tightens monetary policy. They argue that emerging market companies will be hit by financial crises in their home countries, as dollars that have been used to fund their nations' current account deficits flow back to the US. In fact, however, many emerging economies, including Brazil, Mexico and the UAE, have either sustainable current account deficits, funded by growing amounts of foreign direct investment, or outright current account surpluses.

Moreover, even if some countries do initially suffer financial shocks as US monetary policy hits their current account balances, their export-focused businesses could even benefit. The goods these companies sell abroad are generally priced in dollars, giving them stable revenue in the currency they use to meet their coupon payments. Their costs, meanwhile, are largely local-currency costs such as wages. These costs can be met more easily if the dollar rises, since the rise will boost these companies' revenues in local-currency terms.

The classic example of bond issuers that could benefit from this phenomenon is energy companies, which issue 23 percent of emerging market corporate debt – more than any other sector.

There will, therefore, always be opportunities, even if US monetary tightening requires some reallocation of investments from one group of companies and countries to another.

If emerging markets are so enticing, why not buy stocks rather than bonds?

Returns on emerging market equities are periodically high – they have averaged more than 10 percent a year over the past decade. But investors must pay for that return with high volatility – an annualised average of almost 25 percent. By comparison, emerging market corporate debt has offered a still attractive average return of 7 percent, with volatility of under 10 percent.

What's more, this volatility is likely to fall because of the increasing tendency for institutions interested in the long term, in particular US pension funds and insurers, to put money into this sector. Unlike some international investors, these institutions are the diametric opposite of flighty. Their cool, calm and collected investment decisions should stabilise debt prices. The smart, slow money is moving in.

Greater investment by large international institutions should also confer another benefit on the sector: by increasing demand, it should gradually raise prices and compress yields. The emerging market discount is likely to grow thinner.

This is good news for today's emerging market bond investors. For early birds, the best thing about an anomaly is when everyone else begins to agree that it is an anomaly, and starts to beat up the price of the anomalous assets. This allows investors to exit the market on a high note.



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