

Executive Summary

- Emerging market (EM) fixed income assets have undergone a positive secular shift in credit quality and fundamental financial positioning, driven by multiple emerging economies exhibiting elevated and consistent GDP growth.
- However, compensation for risk in EM remains at historic levels relative to traditional risk assets, setting the stage for attractive relative return potential and added stability for investors who strategically allocate to the sector within their risk budget.

Introduction

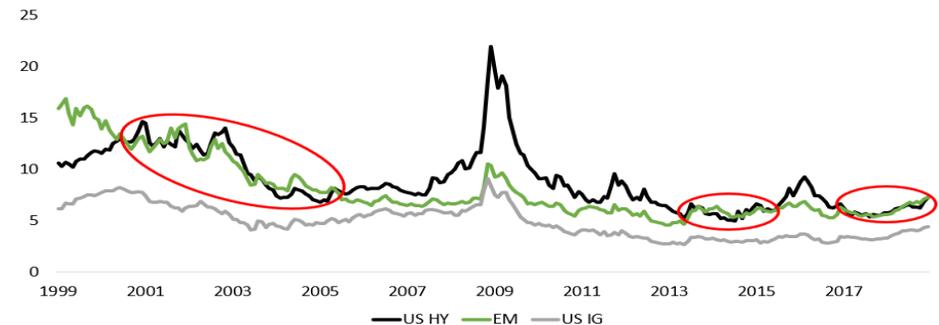
MSCI defines countries as either developed, emerging, or frontier based upon the country's economic development, size and liquidity of marketable securities, and accessibility to the market. Emerging market (EM) bonds are therefore the debt instruments backed by sovereign governments, corporations—or a mixture of the two, in these developing economies (ex: Brazil, China, etc.) that are not as advanced as developed market (DM) economies (ex: The United States, Japan, etc.). Emerging market bonds have the potential to be an attractive investment due to their competitive yield and at times significantly stronger return potential than their developed market counterparts. While it may not be a profound assertion that riskier assets have a higher yield than lower risk alternative options, the compelling information here is that risk in emerging markets may be overstated.

This publication explores the valuation comparisons between EM debt and traditional domestic fixed income investments, while providing the underlying data to delineate fact from anecdotal evidence. All references to emerging market assets are hard-currency bonds, these bonds transact entirely in US dollars, this trait lowers currency volatility but does not completely hedge currency risk.

Opportunity for Outperformance

Emerging market bonds have recently, and at times historically, presented yields akin to those of US high yield (HY) bonds, despite a secular shift within the asset class that has boosted EM credit quality metrics. The difference in yield despite higher quality is what could be described as compensation for emerging market risk—an aggregation of risks from credit, country, and other geopolitical/macro-economic risks. The Yield Comparison Chart in Figure 1 shows the EM debt, HY, and US investment grade (IG) corporate bond index yields over the last 20 years consistent with our timeline across this research.

Figure 1. Yield Comparison



Source: Factset

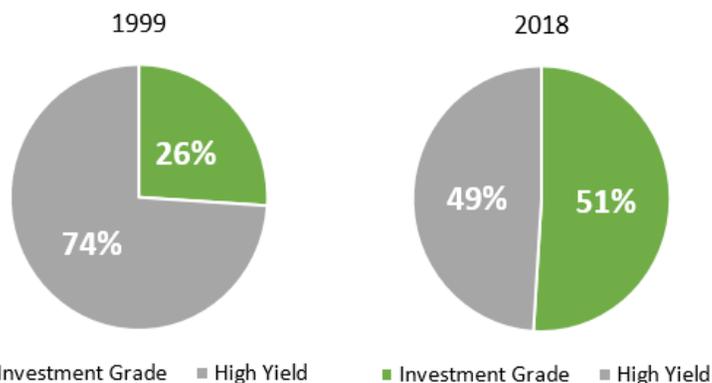
The yields on HY and EM debt track each other closely from 2000 to 2005 and again in the 2013 to 2015 and 2017 to 2018 time periods, which indicates EM and HY bonds have traded similarly at times, despite the evolving difference in quality. However, HY bonds have had historically higher drawdowns, for example during the Global Financial Crisis (here after abbreviated as GFC) the HY index had a drawdown of -33%, while the EM and IG indices had drawdowns of -21% and -15%. The result of excessive spread widening during the GFC created attractive discounts on HY bonds relative to EM and IG corporates, which propelled outperformance in U.S. high yield bonds post-crisis. Of late, the yield advantage in HY has waned, leaving investors similarly compensated for what has historically been dissimilar risk of drawdown relative to EM bonds. The caveat to this argument is that the GFC was a liquidity-driven event that hit HY bonds especially hard, while emerging markets have had their fair share of calamity with one example being the 1994 Mexican peso crisis when the EM debt index experienced a -31% drawdown. It is not unreasonable to expect that the next downturn could again have an epicenter in parts of the world that may have a greater impact on EM economies.

That possibility cannot ever be ruled out—for that matter, there is an infinite range of potential outcomes that may transpire, but investors should be aware of the potential pitfalls in EM compared to other risk assets. This should lead to an assessment of the current financial health of all variables in an effort to rationalize why either sector may be more resilient to future downturns.

Improving Fundamental Credit Story

Emerging market debt has long been perceived as a low-quality corner of the global debt opportunity set, but this perception may now be more conjecture than fact. The landscape is changing as EM countries have grown, as their name would suggest, and the index tracking them has evolved accordingly. Instead of being constructed with only a few major EM economies in mind, the index is now more diversified and boasts an investment grade credit rating. This is illustrated in Figure 2: The Index Credit Quality Chart. In 1999, the EM sovereign index was only 26% investment grade (BBB-rated or higher) but at the end of 2018 the index was predominately investment grade at 51%. The majority of the EM corporate debt index has been rated investment grade since inception, with 57% rated BBB- or better as of year-end 2018.

Figure 2: EM Sovereign Index Credit Quality

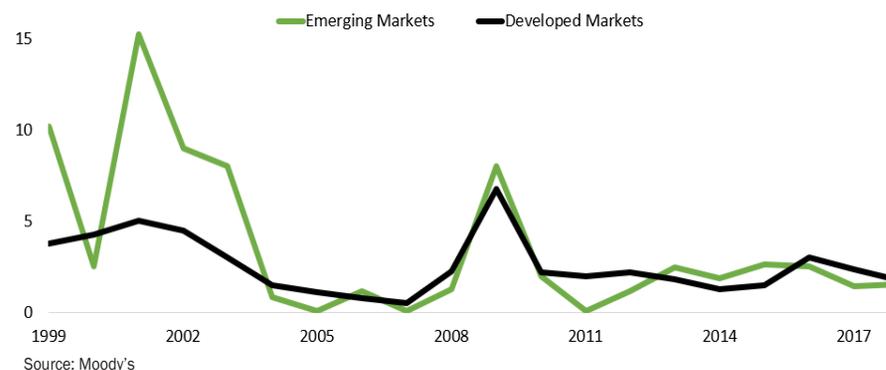


Source: J.P. Morgan

The appearance of improving credit profile is compelling, but they have not been attained solely from upgrades as index methodology and capital markets have ejected/graduated some of the lowest/highest quality nations. It is also worth noting that broad-based economic distress could generate downgrades in mid-quality credits (BBB- and similar). Another concern could be the reality of these ratings, given the lackluster track-record of the rating agencies and the opaque nature of emerging markets. It is important to recognize that there has been a higher default rate compared to low-yielding developed markets, but on an absolute basis sovereign defaults are rare with only 21 unique country defaults globally since 1999. Of the 21 global sovereign defaults, only 11 were constituents in the EM sovereign index one year before default.

The directional trend in corporate defaults also supports the strengthening credit quality narrative shown by Figure 3: The Non-Financial Corporate Bond Default Rate Chart. There are a multitude of improving factors that may have contributed to these lower default rates including higher GDP growth, continuously improving GDP per Capita and lower leverage.

Figure 3: Non-Financial Corporate Bond Default Rate (% of outstanding issuance)

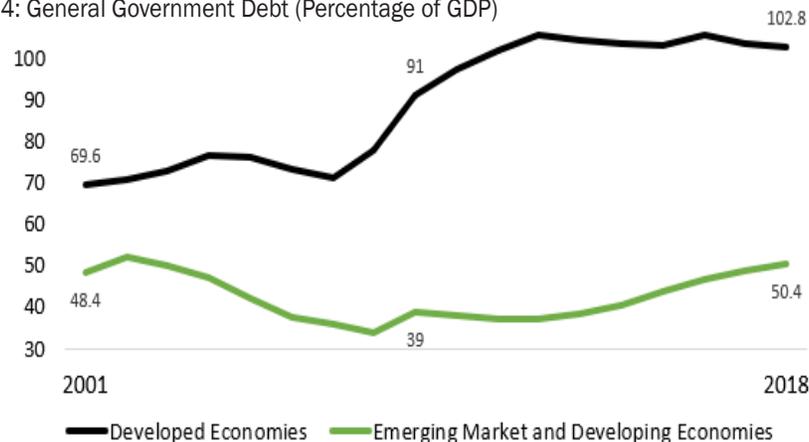


Source: Moody's

Financial Health in Emerging Markets

Fundamental metrics including debt-to-GDP ratios are significantly lower in emerging markets when compared to developed economies. This is a rational conclusion as investors require EM countries and corporations to be well capitalized to garner investor capital and thus receive favorable interest rates, which in turn reduces the likelihood of excessive borrowing. By starting in better financial condition, EM bonds are more attractive, all else equal, should nations continue to progress upwards toward developing status. In Figure 4: The General Government Debt Chart, scrutiny is placed on debt as a percentage of GDP - a common metric of sovereign financial health.

Figure 4: General Government Debt (Percentage of GDP)



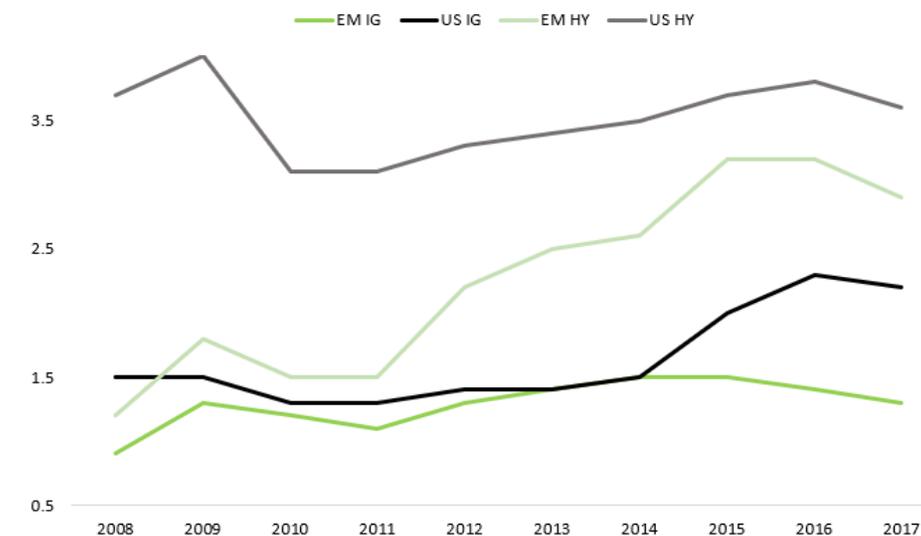
Source: International Monetary Fund (IMF)

To put the chart from Figure 4 into perspective, it illustrates that developed governments have debt levels that are above 100% of their yearly GDP. Conversely, EM governments have approximately half the debt-to-GDP at just over 50%. The reasonable counter argument here is that debt-to-GDP in EM has experienced recent growth, as the chart shows, while developed market ratios have been flat as of late. While this counter-argument is factually true, it overlooks the fact that EM economies have faster growth rates and therefore a higher ability to outgrow their debt than the more established, slower growing developed economies. Notably, developed economies added debt during the GFC and have done little since to address their debt levels, which may increase future borrowing costs.

EM corporations have also displayed stronger fundamental positioning relative to domestic counterparts. Figure 5: The Global Net Leverage chart shows the majority of the increased leverage in emerging markets has occurred in below investment grade names, which now constitutes the minority of the index, and remains below domestic high yield comparisons on an absolute basis.

The divergence in fundamentals on the investment grade side of the table has been driven by net leverage growth in U.S. investment grade corporations since 2014, while emerging markets have been roughly flat since the GFC.

Figure 5: Global Net Leverage



Source: J.P. Morgan

Conclusion

Investors, like all people, develop inherent biases over time that have the ability to positively or negatively impact performance. Reflecting on this publication, the behavioral anchoring bias is one of the primary themes. Emerging markets have made significant improvements over the years, but those who remain anchored to historical characteristics of the sector may miss out on opportunities in the space. In conclusion, we believe that investors seeking to broaden their exposure and capitalize on potentially overstated risk in the sector may find value in a right-sized strategic allocation to emerging market debt, driven by their competitive yield profile, improving credit quality, and strong financial positioning.

ⁱIndex: J.P. Morgan EMBI Global Bond Index

ⁱⁱIndex: Bloomberg Barclays US High Yield Corp Index

ⁱⁱⁱIndex: Bloomberg Barclays US Investment Grade Corp Index

^{iv}Source: Factset Drawdown data

^vSource: Factset Drawdown data

^{vi}Source: J.P. Morgan (JPM EMBI Global Bond Index)

^{vii}Source: J.P. Morgan (JPM CEMBI Global Bond Index)

^{viii}S&P Global Ratings – 2018 Annual Sovereign Default Study

Disclosure

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