Investment Perspectives

Emerging market corporate bonds: Risks are real but overblown

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Executive Summary

- After a decade-long surge in issuance in emerging market corporate bonds, there's concern about systemic risk in these investments.
- Weakening economies, a strong dollar and looming refinancing are all valid considerations, but these risks are largely overstated.
- On whole, fundamentals in this sector appear sound and issuance reflects a "financial deepening," or growing supply of borrowing options. The dollar's strength should have varying impact on most borrowers and might actually help exporters; and refinancing risks appear manageable.
- Valuations for select emerging market corporate bonds reflect these concerns, creating appealing opportunities compared with other fixed income securities – and providing diversification and potential upside appreciation.
- Investors should understand the concerns – and choose experienced managers who can factor in currency and refinancing risk as well as the financial health of individual emerging market companies to select corporate bonds.

Companies within emerging markets (EM) have issued bonds at a rapid clip since 2005 — a five-fold increase to more than $1.6 trillion, by far outpacing the growth of any other bond asset class over the past decade. But along with that rapid growth has come mounting concerns about systemic risk in these investments.

There are three main areas of concern with EM corporate debt. First is a rise in issuance coupled with slowing economic growth. As the economies of many emerging markets have cooled, some investors are raising questions that issuers may face difficulties meeting debt repayments. The second concern is the strengthening U.S. dollar which impacts some borrowers' abilities to pay back debt, especially over the short term. And third, there is a large portion of EM corporate debt maturing over the next few years just as U.S. interest rates are set to rise, which might lead to possible repayment issues and higher cost of borrowing.

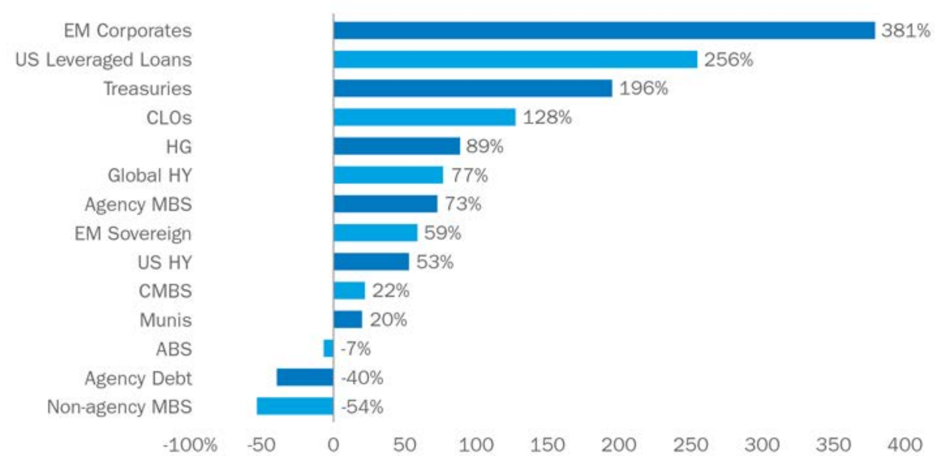
These are all valid concerns — but our research suggests that they do not pose systemic risks to the asset class and will impact only some of the corporate bonds that have been issued within emerging markets. But as a result of all of these worries, valuations have become depressed and present very compelling opportunities on a selective basis. To identify these opportunities, investors should select managers with expertise in this asset class who can analyze potential currency and refinancing risks as well as strength of the issuers' balance sheet and cash flow.

Overstated concerns

Let's examine more closely the concerns that have depressed valuations and why we believe they are overstated. The rapid rise in issuance of corporate debt within emerging markets has led some investors to question whether a bubble has emerged, as issuers have moved swiftly to exploit low interest rates.

Figure 1

EM corporate debt growth since 2005



Source: JPMorgan, TIAA CREF

Of particular concern is accelerated issuance in select countries — such as China and Brazil, whose economies are struggling — as well by quasi-sovereign corporations, which are companies at least partially-controlled by a government. China has accounted for a sizeable portion of corporate bond issuance within emerging markets; in 2009 China accounted for 1% of all emerging market corporate debt issuance, and by 2014 China accounted for 31%. In Brazil, growth also has been strong, though dominated by a single issuer, Petrobras, which has issued debt to fund its investments in the pre-salt layer, a massive source of oil discovered in 2006.

We've found that in most cases, though, what's driving the rise in debt at corporations in emerging markets is what we call "financial deepening" or a growing supply of borrowing opportunities, which shows a country's financial system is maturing. It's crucial to recognize that two-thirds of the investment grade corporate bonds issued within emerging markets were used to refinance debt rather than other purposes such as M&A or dividend payouts. That reflects the desire of mature corporations to lower their funding costs and to diversify their sources of capital.

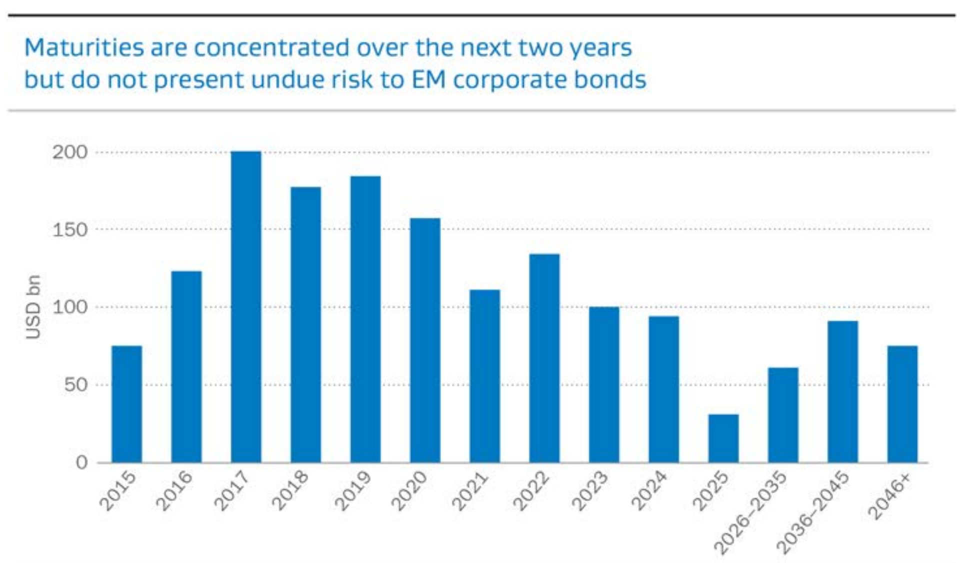
The specific concerns with some debt issued by quasi-sovereign companies especially in China and Brazil are valid, though careful selection and analysis of the issuers can identify the issuers most at risk.

Another top concern for emerging market corporate bond investors is currency risk — particularly in light of the strong dollar that could impact the ability of some issuers to pay back debt denominated in U.S. dollars. Currencies in several key emerging markets have indeed depreciated significantly versus the dollar since 2012, including Brazil, Colombia, India, Indonesia, Turkey, South Africa, and Russia. This has likely created balance sheet risks for issuers that do not generate U.S. dollar cash flows. We believe that volatility in emerging market currencies may persist for a number of reasons including normalizing U.S. monetary policy.

However, we do not expect currency valuations to be a widespread risk for emerging market debt for a number of reasons. First, many issuers are exporters with natural hedges or firms with financial hedges in place, mitigating the potential for currency losses. Second, monetary authorities in some countries have already taken steps to curtail foreign currency borrowing by implementing policy measures. Third, we believe that, in many cases, there is strong willingness and capacity for governments to support strategically-important corporate issuers in meeting their liabilities.

The final major concern swirling around emerging market corporate debt is the relatively high level of maturities that are concentrated in the next few years. Although refinancing risks exist and can impact some bonds, we believe this, too, is not a widespread problem, and overall debt repayments appear manageable over the next few years.

Figure 2



Source: JPMorgan

The issue of refinancing focuses mainly on corporations and quasi-sovereign entities in China and Russia, which combined hold 32% of the bonds maturing between 2016 and 2019.

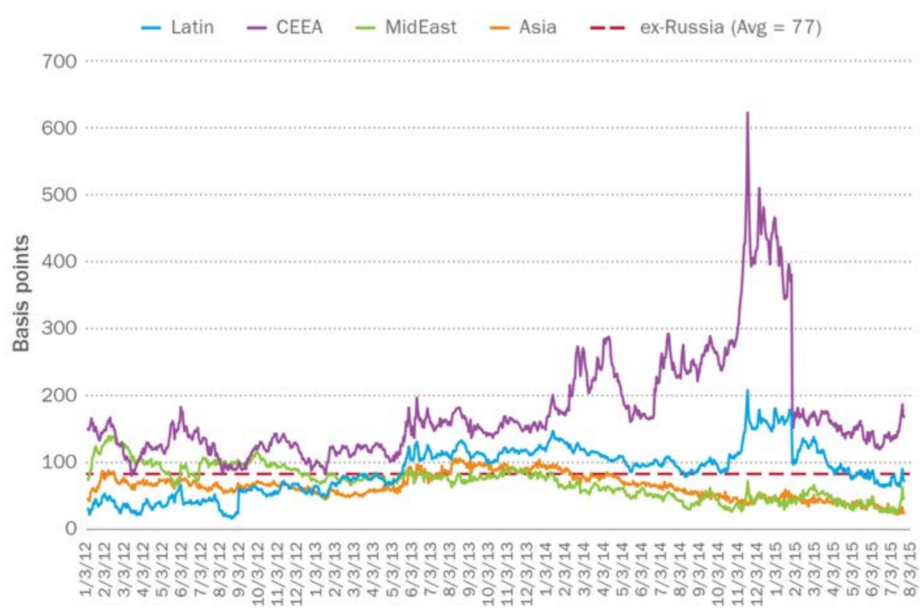
On the corporate side, while gross debt has risen in recent years, many companies in these countries have built up their cash balances. We have seen recent signs of capital expenditure reductions — especially in some commodity producers in response to lower prices. That makes it more likely that these companies can manage debt repayment. For quasi sovereign issuers that are significant and strategically important, governments are likely to provide some degree of support.

Compelling valuations

Investors, of course, have a world of opportunity in which to invest – so it's relevant to compare EM corporate bonds to their U.S. and global counterparts. The current spread, or interest rate differential, for EM corporate bonds has narrowed compared to their U.S. counterparts. There are, however, significant regional differences.

Figure 3

EM IG spread to US IG: Differentiation by region



Source: JPMorgan. The underlying data consists of investment-grade emerging market corporate bonds, chosen by JPMorgan, which mirror the EM constituents of the High Grade US Liquid Index (JULI), including some quasi-sovereigns that are not 100% government-owned. The spreads are aggregated and averaged by region based on market-value weights.

Spreads between investment grade corporate bonds in Latin America and the U.S. generally have widened compared to the beginning of this period but recently recovered to the overall average. In contrast, the Middle East and Asia have become relatively more expensive over the time period, though they still offer investors some compensation for emerging market risk.

There has been a significant drop in spreads between bonds issued in the CEEA (Central Eastern Europe & Africa) compared to U.S. securities since the end of March, as many Russian issues were downgraded to below investment grade (thus falling out of the sample set), but spreads have widened in recent weeks. Brazil's Petrobras also was downgraded by Moody's to below investment grade. Even without Russia and Brazil, spreads in these regions compared with the US remain relatively attractive compared to recent history.

Conclusion

Within the emerging market corporate bond universe, overall fundamentals appear sound. There has been a rapid increase in issuance, but that spike generally is tied to financial deepening and mature companies tapping into debt markets to lower borrowing costs and attract new investors. The strong U.S. dollar has gained markedly against many EM currencies, but should have only a moderate impact on many issuers. Refinancing risks appear manageable.

These factors — combined with low valuations relative to other bond alternatives — bolster the case for investing in corporate bonds in emerging markets. However, because of the risks, we urge investors to choose a selective approach when considering the asset class as part of their diversified long-term portfolio.

Because of these many nuances, we believe investors will be best served choosing an active manager with a proven track record supported by deep expertise and resources. At TIAA-CREF, we believe a security selection approach grounded in fundamental research can identify the EM corporate debt issuers most likely to outperform over the long term. To learn more about investing in EM corporate bonds, talk to your TIAA-CREF advisor, call 888-842-5433, and press 2, or visit the Financial Advisor website.