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EMERGING MARKET HIGH YIELD BONDS
A MARKET IN THE MAKING

EXECUTIVE SUMMARY

EMERGING MARKET EXTERNAL CORPORATE DEBT has grown to become a nearly USD2 trillion market, making it a mainstream fixed income sector that should not be ignored by wealthy investors around the world. An estimated 40% of the EM external corporate debt is classified as high yield, making it a roughly USD800 billion market.

Although not as big or perhaps as liquid as the USD2 trillion US high yield bond market, the EM corporate high yield market has specific critical attributes that high net worth (HNW) investors and their wealth advisors should consider when creating or adapting fixed income portfolios.

Surprisingly, based on data from the past decade, the EM high yield sector offers a considerably lower default rate than US high yield, and EM balance sheets are roughly 30% less leveraged. Yet the overall yield is slightly higher, and the absolute cumulative returns since 2008 are an estimated 115% based on a variety of metrics. Of course, the US corporate bond market offers more accurate data that dates back many decades, while the emerging market data is more recent and, in reality, less reliable. Moreover, the US high yield market offers similar levels of liquidity and offers buyers a much greater facility for hedging individual bonds and funds.

Bond markets became much more volatile than expected since earlier this year, with a considerable downturn in the EM corporate bond space. But enthusiastic proponents of the market argue that this represents an excellent opportunity for investors to rebalance portfolios towards the EM arena, or to venture in for the first time. In support of this belief, advocates of the EM corporate bond markets cite the 4.8% GDP growth forecast for 2018 for emerging market economies, according to Bloomberg consensus estimates. This compares to the 2.3% growth estimate for developed economies.

Moreover, advocates of the EM corporate high yield sector point to the powerful fund inflows to the emerging markets for the past two years, surging from a negative outflow in 2015 to a record inflow of USD113 billion in 2017, according to data from JP Morgan.

A key impediment to the emerging bond markets for HNW and other investors has been the difficulty in analysing the underlying corporate credits, especially those HY names that have average ratings of below BBB-. However, corporate and governmental financial structures and transparency have both improved, and there are those who believe that a profoundly analytical bottom-up approach to these assets is not only possible but also entirely credible.

Hubbis and co-host EG Capital Advisors invited wealth experts to two separate but connected discussions in Singapore and Hong Kong to mull over these very topics. The message was clear—emerging market high yield has more positive attributes and a brighter immediate future than many might have imagined. ■

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The quest: Emerging market high yield strategies for HNW portfolios in Asia

Hubbis and EG Capital Advisors invited experts from the wealth management community to private thought leadership discussions in Singapore and Hong Kong this May to discuss fixed income, especially emerging market high yield opportunities for wealth clients across the Asia Pacific region.

Hubbis - EG Capital Advisors roundtable in Hong Kong

DETERMINING THE BEST FIXED-INCOME STRATEGY as the world turns towards a new era of rising rates after a near four-decade bond market bull run is essential for any wealth advisor wishing to optimise the portfolios of HNW investors.

The world of emerging market corporate debt should not be overlooked. Hubbis and our co-host, EG Capital Advisors, invited experts to two private thought leadership discussions to discuss fixed income, especially emerging market high yield opportunities for wealth clients across the Asia Pacific region.

The two behind-closed-doors, off-the-record discussions took place in Hong Kong and Singapore in early May. The experts attending included senior product gatekeepers and fund selectors at private banks and multi-family offices.

As the comments from the guests were not for direct attribution, the events created open, frank and insightful conversations amongst wealth management peers operating in the Asia region.

Michael Kasumov, CEO of EG Capital Advisors (EGCA), attended the events and was joined by John Capaldi, EGCA's Managing Director, and Dimitry Griko, the firm's CIO.

"Being specialists in fixed income and credit, especially related to emerging markets, means we have very strong views about where the market is heading, where it has come from and where it is right now," Kasumov reported, also welcoming the expert guests to what he anticipated would be robust and interactive discussions.

"We believe we have a strong case and that the world of emerging market corporate debt is one that many family offices and wealth firms globally should at least consider seriously."

His colleague Griko, who manages emerging markets corporate high yield for the firm, explained that between EGCA's Cayman incorporated funds and the firm's UCITS 'Strategy' fund in Europe, the firm has approximately half a billion dollars of AUM in EM corporate high yield.

EM external high yield corporate debt – a USD800 billion market

Griko noted that some 40%, or almost USD800 billion, of the estimated roughly USD2 trillion of EM corporate bonds, are high yield.

"Our allocations are driven by the number of appealing debt issues within each country or sector, taking into account macro views. We do think that the market structure and the structure of the indices is risky by itself.

So, for example, he said, they are wary of property and China's external debt in general because it is onerous to get the transparency on individual issuers to make the required analysis.

"And we have concerns about the verification of certain financial metrics," he added. Accordingly, the EGCA portfolio has Brazil

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Hubbis - EG Capital Advisors roundtable in Singapore

as the largest holding at 17%, followed by Turkey and Mexico at just over and just under 10% respectively, while India is 7% of the portfolio and China only 3%, the latter far below its EM corporate bond market weighting.

"This is a risky asset class," he explained, "so we need to pick and manage the portfolio in a conservative way, with appropriate diversification and full scale, fundamental, bottom-up analysis to avoid speculation where possible."

Kasumov explained that the EG Fixed Income Strategy seeks to maximise risk-adjusted total returns from investments in US dollar-denominated emerging market corporate securities using fundamental credit analysis, based on proprietary bottom-up issuer research. "We are very much fundamental bottom-up research house, with a team of seven people exclusively dedicated to that particular strategy to deliver superior returns as well as minimising exposures to defaults."

Risky yes, but also rewarding

Griko then explained that the firm aims for transparency and direct communication of risks and rewards. "We attempt always to be honest," he said. "High yield emerging market corporate debt is a risky asset, so we never say we expect zero defaults."

According to him, that recognise the risks, and our mission-driven to ensure that this asset class is managed in a detailed, analytical, professional and also conservative manner. "We filter all our assessments through two committees, namely a credit committee which is like a risk committee and the investment committee which is effectively more of a portfolio allocation committee," he added.

Capaldi added a few words of introduction. "We are doing something that we believe is distinctive in this marketplace. Investors we have canvassed in the developed markets around the world are, we find, largely top-down and macro-focused," he said. "We offer a very different proposition as we are a completely bottom-up manager in this asset class and we believe that this analytical approach to credit analysis work for this market produces the optimal results."

Griko then introduced his perspective of the EM corporate debt arena and in particular of high yield corporate debt, asserting that in EGCA's view, the high yield sector is undervalued and therefore offers Asian HNW investors a new world of opportunity.

He explained that the universe is any credit domiciled within emerging markets and up to 10% of the portfolio in credits based in the developed economies but with a substantial portion of their assets or revenues in the EM arena.

Fundamental strengths

"Economic growth and the fundamental picture for the EM countries

Hubbis - EG Capital Advisors roundtable in Hong Kong

are amongst the best they have been for a long time," he reported, noting that 2018 is expected to be the first year that all OECD countries are going to show positive economic growth.

"We see most risks coming within the developed markets, especially now that the 10-year US Treasury has now moved to trade around the 3% level," he said.

He noted that from the economic cycle perspective emerging markets are at a much earlier stage than developed markets.

"The end of QE has accelerated fund flows to the EM markets, with money flowing in quite dramatically for the past couple of years," he notes. " The the inflows into EM countries are yet to have an effect on domestic demand, which represents 75% of EM GDP. So that kicker to economic growth is yet to come."

The fear factor?

But in the wider fixed income space, there are plenty of challenges as rates rise, QE turns to tightening and volatility rises. This is generally a challenging time for fixed income," noted another attendee, "and we see many managers and investors now focussing on very short-term strategies, including money market instruments and cash. Some have shortened their duration to zero."

An expert agreed that so far 2018 has been a surprisingly disappointing year so far. "Yet only in December I was at an event, and everybody was still very bullish on almost everything."

According to him, the performance of emerging markets and high yield, in general, it has been very challenging so far in 2018. "With US Treasury yields of 3% now cited as a major factor, we think this means a lot of investors see a connect between US treasuries and emerging markets which traditionally has not been the case," he said. "In fact, the correlation has been very low historically, often negative."

He noted that there are, therefore, many other factors at play, with lots of geopolitical uncertainties making investors jittery. "Consequently, we have seen that recent Asian fixed income issue order books have been unconvincing, and some did not even make it to the finish line," he added.

Another factor discussed as a cause for the challenging conditions is the recent return, since the equities market sell-off of late January, of dollar strength. Dollar strength, noted one attendee, has from a macroeconomic perspective traditionally been negative for emerging market corporate debt.

"The combination of these factors has in the first quarter of this year led to a sell-off in emerging market debt in general and some high yield situations in particular," noted an expert. "In Indonesia, with the Rupiah weakness, companies that are not export driven or dollar earners have been particularly hard hit, especially real estate paper."

According to him, prospects of a trade war between China and US add to the picture which is much more complicated than previous situations in recent memory where you saw sell-offs.

Opportunities abound

Griko commented that many anticipated the renewed dollar strength to be temporary and highlighted that the EM fixed income market sell-off creates a world of opportunity.

His theory is that as developed market central banks are now managing their balance sheets more proactively, the reverse and unwinding of QE trade is resulting in the flows heading away from developed markets, with considerable volumes flowing into the emerging markets.

"That," he said, "is why during the height of QE we saw the dollar

The EG Capital Advisors team (left to right): Dimitry Griko (Chief Investment Officer, Fixed Income), Michael Kasumov (Chief Executive Officer), John Capaldi (Managing Director)

strengthen and since late 2016 we have generally seen dollar weakening as QE either ended or the markets anticipated its ending."

Arguing his case further, he elucidated his views on the unwinding of QE, which he explained generally supports asset classes such as emerging markets corporate high yield.

"Yes, we had a blip just recently in terms of people going away from risk and a bit of dollar strengthening, but fundamentally nothing has changed."

Safer than many would expect

"When QE started the central banks were buying hard currencies and developed market assets, so fund flows went from the emerging markets into developed markets and hard currencies, resulting in dollar strength while the Fed was printing money," he said. According to him, that trade is being unwound as the central banks need to manage their balance sheets, which results in assets flowing away from developed markets towards emerging markets and towards riskier assets, and the result is generally dollar weakening since early 2017.

"Yes, a blip just recently in terms of people going away from risk and a bit of dollar strengthening, but fundamentally nothing has changed," he reasoned. Turning back to the opportunity that EM high yield corporate debt represents in general and that the Q1 sell-off has brought into sharper focus, an attendee cited data to support the thesis of under-valuation.

Referring to statistics from Standard & Poor's he reported that the 10-year average cumulative default trade for emerging markets corporate high yield is 13.1%, while the same number for US high yield is 24.3%. But he then also highlighted that recovery in the EM high yield arena and the US high yield market are in fact at very similar levels, even though average leverage ratios for EM companies, at around 2.2 times are considerably lower than the roughly 3.3 times levels seen in the developed markets. "Yet there is a considerable yield premium on EM high yield debt," he noted. "Yes, there are pockets of political risk across the world of emerging markets but firstly, one can diversify that risk with a broad portfolio, and secondly one is paid for that."

An attendee noted that EM high yield is historically also less volatile than the developed market and US market high yield paper, with average annualised volatility in the past decade at around 6% compared with nearer 10% for the US high yield market, based on the IBOXX US HY data.

Value for those who analyse

The combination of evidence and historical data leads some experts to conclude that the market sell-off has been overdone. "I think that as in past emerging market sell-offs the market is now exaggerating things again," he said. "As we are looking at sovereign emerging markets, non-investment grade sovereigns

at yield differentials of 100 to 150 basis points, the general repricing is starting to provide a good opportunity to rebalance or expand a high yield portfolio."

He argued that the repricing is in some cases based on wrong, sometimes hysterical, interpretations, as well as specific accurate and fair assessments of potential threats that are lurking around the corner. "But," he maintained, "overlying all this, the world is fundamentally still in a good situation."

To support his theory, he noted that corporate earnings are reliable and most of the larger economies are still going through a substantial expansion period.

"China's forecast GDP growth is still projected to be close to 7%," he noted, adding that the EU is in surprisingly decent shape and the US economy is strong, so are corporate earnings. "Fundamentally, therefore, I believe there is no reason to exit or stay away from the fixed income market in general," he said. "And I think rates and spreads are starting to provide an environment where buyers should consider coming back in, and there is opportunity especially in the EM high yield space."

However, another perspective came from one guest, who argued that many leading indicators already somehow indicate some weakening in several industrialised economies. "That might potentially be good for government bonds, but far less so for corporate credit spreads and the equity markets," he said.

"Many therefore fear a possible further repricing required for bonds and equities, especially as tightening more aggressively replaces QE."

"From our perspectives as a manager working for family offices and private wealth, we have been boosting cash up to 20% to 30% of portfolios in some instances," he added.

Hubbis - EG Capital Advisors roundtable in Singapore

While conceding that there are some questions over the sustainability of the economic cycle in the developed economies, an expert countered with the view that the funds flow into emerging markets over the past two years have resulted in excellent performance of EM corporate and high yield debt.

EM defaults lower than developed markets

He added that western investors generally have a significant misperception that the risk of default within EM is higher than in developed economies. "In fact, the evidence thus far is to the contrary, and I expect default rates to be minuscule over the next two years or so."

Another attendee added his perspective that the Asian economic and financial crisis of 1997-8 was largely a currency mismatch calamity, but that Asian governments and corporates had to a very considerable extent learned their lessons and adapted their structures and strategies over the past two decades.

Nevertheless, despite the historical data on defaults and recoveries, the reality is that the corporate debt markets of the developed economies offer far deeper tangible data than the relatively younger and less analytically mined emerging markets.

"A vital difference we should highlight is that in the US, for example, you have far more historical data, which is far more informative and reliable," he said. "For every industry sector, you can do relative value trades based on a huge data pool to determine exposures related to different classes of debt." In Asia that has not yet happened, he said, noting the

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reason being the development of the economies and the far smaller universe of high yield paper.

Illiquidity means diversification essential

This naturally impacts on liquidity, but this is not a massive hurdle for Asian HNW and ultra-HNW investors, who have tended to hold fixed income to maturity.

One attendee noted, however, that these types of bonds are more difficult to acquire and less liquid, so buyers must, by definition, take a long-term view. "But we also see many European clients taking this long-term perspective."

"The key to the EM high yield market is understanding," explained another expert at the discussion. "We want the credit we buy to perform and be based on its inherent metrics that we either like or dislike and we want to understand the recoveries, the asset-liability profile, the transparency exposure, the local currency loans, the pledges, so on and so forth." EGCA's Grico extrapolated on this analytical approach to restructurings and recoveries. He explained that distressed situations require analysis of the downside scenarios, which involves intensive work to understand recoveries, not only liquidation but also going concern sales.

Having a deep understanding of the local restructuring processes is also helpful, as at any one time, generally, around 5% of the EGCA AUM is in the distressed space.

Recoveries better than anticipated

He added that since his firm started trading through its Cayman infrastructure in 2014 the portfolio had 13 defaulted names, of which six were acquired in the knowledge or expectation of default.

"Good thing you diversified."

He reported that EGCA's average recovery on all of those 13 names was 64%, compared with the 36% average based on the JP Morgan Corporate EM Bond Index (CEMBI), which tracks US dollar EM debt.

"This highlights the value of our fundamental research and deep understanding of this market," Grico claimed. "It is, in fact, a money-making strategy for us, as in this portion we are annualising returns of close to 20%."

"We also see that the situation is exacerbated by ETFs kicking bonds out if there is any sign of distress, adding further price

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pressure and pushing them often below the innate recoveries levels," he added. According to him, recent examples of bankruptcies and restructurings in Asia, even in frontier markets, seem to suggest that the yield premium in the region should not exist and that recoveries are reasonable and in line with where they should be.

"It is a reality that while there are more investors, including 144A buyers, coming into this market liquidity is generally weak because the banks do not appear to want to make a market in high yield."

He added that the asset class has a low correlation to other risky asset classes, while the market is highly correlated within itself, so while many western asset managers might be risk-on or risk-off, i.e. they buy everything, or they sell everything, for EGCA as a manager the swings create opportunities. "Using that volatility to our advantage," he said, "we can constantly strive to optimise risk-reward."

Exposure to volatility generally depends on timing. In the period from 2013 to 2014, EM debt was highly volatile, as market chatter began in earnest of US rate hikes in the future.

But with strong flows into EM debt for the past two years or so, volatility has dropped to minimal levels, helping managers achieve stable and strong returns.

The long-term view

EGCA's funds under management returned 15.6% in 2016, for example, while the 2017 return was a healthy 11.7%. The returns on the funds since inception in February 2014 total 26.3%. And although year 2018 to date has been more difficult than expected, the current EGCA portfolio yield is 6.3% and returns so far this year are still in the positive territory.

One attendee noted that in the year ahead any increased volatility should be an opportunity for those who are going to be patient to buy cheaply.

Another added that volatility offers the ability to optimise the risk-reward of the portfolio, which is a significant advantage for public versus private debt. "Good names go down just as well as the bad ones and offer the ability to flip and optimise the quality of the portfolio."

The discussion turned towards secondary market liquidity, an area which many focusing on this sector find frustrating.

"It is a reality that while there are more investors, including 144A buyers, coming into this market liquidity is generally weak because the banks do not appear to want to make a market in high yield," one attendee observed. "The economics do not work for them with capital requirements

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and so forth." This means he said that investors must be really comfortable with most facets of the paper bought. "Nevertheless, there is always the risk that if external events turn sour, there is no exit price and no exit."

Another attendee added that the illiquidity is another reason that diversification is therefore even more important as a strategy.

"If you are comfortable with your fundamental analysis you should be okay with the sell-offs, and you can withstand that market volatility and maybe even optimise it if managing the portfolio correctly," he said. "Some of the private banks out there can provide leverage of up to about 75% LTV against these assets, so you can still get liquidity to sit through any downturn."

Another negative factor for the market is that it remains challenging to hedge exposure. "There is no single name CDS market here," explained one expert at the discussion, "there is not even a basket available."

On the other hand, he noted, in the US you can find single name CDS on pretty much every credit, but in Asia, that gap is a significant constraint on the market. "This is another reason that emerging markets are much more a long-only game, but with the right diversification, modest leverage and active portfolio management managers can produce very good results," he added.

But another attendee added noted that there are risks and decisions to be made. "We can either invest in these EM high yield bonds directly and hold them to maturity, thereby crystallising our credit view, or we invest in a fund," he said. "If we invest in a fund our risk is not the default and recovery, our risk is the mark-to-market, our risk is the co-investors in the fund pulling out and then the fund manager crystallising a loss they should not crystallise, that is the biggest practical problem."

To leverage or not?

Another added that buyers should remember that as this is a risky and illiquid asset class excess leverage is dangerous.

"Many investors out here in Asia simply want leverage to enhance returns, and as volatility has been low the banks will lend," he noted. "But leverage plus minimal liquidity in the underlying assets can eventually be a dangerous combination."

In his opinion, this proves that the private banks by definition are not that cautious on credit control if they lend so actively to this type of illiquid market and they do not have the technical skill set to evaluate the market properly.

Extending this theme, one attendee asked if boutique players will at any foreseeable time challenge the private banks' dominance of distribution of these assets in the region. "The answer," replied one expert, "is that the private banks are still the biggest distributors of funds in Asia, the gatekeepers are conservative, and they are not going to get fired for dealing with the biggest brand-name fund management firms."

"Moreover, the banks survive on selling and then offering leverage on these products, and that leverage is easier on the biggest funds, not the boutique offerings," he noted.

The discussion also touched on the role of private debt and alternative credit. "Public market debt has a market price, but any substantial portfolio out here that is well diversified and achieves additional yield can include private

debt," he said, "as this is relatively insulated from interest rate rises, it does not trade so there is no mark to market."

Private debt also increasingly on the radar

Another guest noted that in the developed markets the private debt trade is extremely overcrowded and the premium for being in a non-liquid portfolio is too low now.

"But in emerging markets, the story for private debt looks much more interesting," he explained. "While it is tough to source, the yields are in the range of mid-teens for private debt within emerging markets on average, and that compares to the yield of around 6% today within the public EM debt market, but of course you could pay for it by the risk of losing everything."

Another expert argued that even though there is no mark to market exposure for private debt, there is still a fundamental link between interest rates rises and the ability of people to pay back their loans. Moreover, it is challenging to properly analyse the credit risk of P2P portfolios because default rates within the public do not factor in certain stress situations. But another guest noted at the discussion that private debt is often structured to be off balance sheet, with the borrower prepared to pay a premium to be outside the capital or loan markets.

"With the appropriate understanding of the structures and intricacies and top-down analysis," he explained, "the risks often appear worthwhile."

Much hinges on the interest rate outlook

Private discussions almost always touch on assessments from some attendees of the worst-case scenarios. One risk that a guest raised is that developed world central banks have got it all wrong. "Asset price inflation is a concern that the central banks have not understood or addressed," he said. "Look at the prices of assets, whether equities on massive multiples, or fine art or property and it is clear the central banks have failed."

He noted that the social impact of asset price inflation has huge ramifications. "How many normal workers or normal people can live in major cities in the developed world or even emerging markets today, for example?" he asked. "While central banks have been so busy pumping out money and cutting interest rates down, inflation has only picked up in the one country, and that is where the central bank is now raising rates."

The result could be that interest rate policy amongst the central banks might move further towards rises.

Many might say 3% is the new 5%, but time will tell and there is always the potential for black swan events that turn the world on its head.

"No one can tell when the next 'black swan' event is going to be that will cause chaos in financial markets," noted Griko.

"That is why it is called a black swan event."

"But I would say that focusing in on the EM corporate debt arena, the risk in the next 12 to 18 months is low - debt maturities have lengthened," he added.

According to Griko, it is still early in this economic growth cycle, export numbers have turned around and growing, business sentiment is strong, and the EM governments have been working hard to reform. ■

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