Emerging Market Debt - 2020 Vision Revisited:
Same Destination, Different Route

November 2015

This material must read in conjunction with the disclosure statement
The Path to 2020

Back in 2013, we jumped in our time machine and leapt to the year 2020. Free from the market noise of the first taper tantrum, we looked back at the subsequent evolution of the emerging markets (EM) predominantly focusing on EM corporates that were (and still are) catching investors’ attention. We laid out a scenario in which EM corporates, supported by continuous expansion of EM economies, populations and investor knowledge, would become, not without obstacles and market gyrations, a core component of the global corporate fixed income market. By 2020, most investors would look at them on a global sector/industry basis rather than along specific product or regional lines.

Seven years was a significant time horizon in a market that was and still is focused on the near term. Markets and credit spreads are more often driven by geopolitical issues, general fear and psychology, rather than by the underlying fundamentals.

Now, we revisit several of our original themes (the impact of growth, liquidity and rising interest rates) and incorporate some new ones to reflect how certain forces can quickly alter EM sentiment. Despite recent economic and political shifts, our initial scenario for 2020 remains largely intact - we just expect to arrive there via a slightly different route.

Figure 1: The Path to 2020

Source: PineBridge Investments, data as of 19 November 2015.
The View From 2020: EM Growth in Reverse

Had it not been for a few rays of sunshine, it would have been easier to describe the last ten years as the lost decade for EM with both growth and inflation slowing down much more than originally anticipated, eventually forcing policymakers into action. On the positive side, it allowed central banks to maintain easy monetary policy and forced governments to move ahead with long-awaited economic reforms and find alternative routes to boost economic growth via fiscal expansion – something which was frowned upon in the beginning of the decade of austerity.

Broadly speaking, the growth outlook for EM took a few knocks in the middle of the decade (Figure 2). China’s policymakers explored various avenues to rebalance the economy towards a domestic-oriented path. It also established a sustainable growth trend, albeit lower than everyone had been used to. However, it was not until 2016/2017 when China’s market liberalization truly took over as the main policy driver, that EM found new inspiration, with China’s reform measures enabling monetary policy to eventually find a new vigor and the exchange rate to adjust to market conditions. This helped address the significant downward pressures on prices in the Chinese economy.

![Figure 2: EM Growth Expectations Are Hostage to Multiple Global Developments](source: IMF, World Economic Database, 2010 and 2015 editions)

The rest of Asia was just a passenger in this ride, as their economies were already far more synchronized with Chinese growth rather than US growth. Belatedly, Asia officials realized that their exchange rates had become uncompetitive against the rest of the EM currencies as they had been linked to the strong US dollar by proxy of their strong correlation with the renminbi. Other EM exchange rates had already been allowed to
move more freely and, consequently, acted as shock absorbers. In particular, Colombia and Russia were better able to cope with the significant oil price shocks due to their flexible exchange rates.

Despite those Asian currencies weakening significantly against the US dollar in the first half of the decade, it took a while before there was sufficient evidence to suggest the currency adjustments had any beneficial effects on growth, in part due to the very low import propensity in both China and the US. However, US policymakers eventually had enough of bearing the brunt of the currency adjustment and signaled their intention to keep interest rates lower for longer and to run monetary policy closer in line with other central banks. That halted the US dollar rally.

Developed markets showed little evidence of improved growth trajectories midway through the decade, leading to serious debate about secular stagnation. So EM had to rely on domestic demand dynamics to accelerate growth. This realization was eventually backed by serious reform in select bright spots. Mexico and India were the poster children for economic reforms at the decade’s midpoint, while it took more time for Brazil and Turkey to get their acts together due to political deadlock. Colombia joined the reform pack in 2017 as the peace process with the FARC (Columbia’s largest armed rebel group) paved the way for political stability that invigorated the economy. Therefore, rebalancing the global economy was not just the job of China’s policymakers.

**Timing Is Everything: “Carry Is Dead, Long Live Carry!”**

Local currency markets have certainly had an interesting 10 years. The US dollar was a rock star in the early half of the decade, strengthening against a wide range of currencies due to the divergence in monetary policy outlook between the Federal Reserve and other central banks. Its path to stardom rocketed from the summer of 2014, particularly against commodity-driven currencies, as China growth concerns and lower commodity prices emerged as long-standing themes. However, as China’s officials allowed the renminbi to trade more freely from 2016 onwards, foreign exchange (FX) volatility increased and US policymakers became more aware of the negative impact of the strong dollar on the US economy.

Initial concerns of capital outflows from China overstated reality, but they did lead to a reversal of safe haven inflows from Asia as well as higher FX volatility, pushing global investors to look for alternative investment destinations in Central and Eastern Europe that benefitted from lower commodity prices and weak links with China. Ultimately, the liberalization of China’s capital markets and the move towards more two-way trading of the renminbi provided greater clarity and was used as a justification by US policymakers to ease financial conditions and talk down the US dollar.

Timing the decision to move back into local currency debt was always going to be
a difficult one, but potentially very lucrative. We originally expected it to hinge on the ability of EM policymakers to revive economic growth, as the shrinking growth differential between the US economy and EM economies had been a major factor behind the strength of the US dollar against EM currencies. However, EM policymakers were late to rediscover the need for economic reform and EM growth remained mediocre, with a few exceptions, due to deteriorating global trade conditions during the decade.

In the end, it was political twists and turns that signaled the end of the US dollar rally (Figure 3). During its peak in 2015, the Fed chair decided to stall the rapid ascent of the broad trade-weighted dollar, citing her concern that further currency strength would be a drag on the US economy. By the middle of 2016, the support from the monetary policy divergence theme had faltered.

![Figure 3: Late 2015 Signals Suggesting the End of the US Dollar Rally](image)

Political twists and turns signaled the end of the US dollar rally

Meanwhile, structural reform in Mexico and India became a significant differentiator between good and bad EM stories. The carry element ceased to drive investment returns as it failed to compensate for extensive periods of currency weakness. Instead, active investors capitalized on individual growth stories by taking a more long-term approach and ignoring the short-term volatility.
EM Corporates Growth: Pleasure and Pain

Stellar growth created some growing pains, but credit fundamentals remained strong in 2020.

EM corporate assets have almost doubled in a decade, reaching US $2.25 trillion by 2020. This is partly a function of heavy refinancing of five-year debt issued in 2012/2014, but also a result of markets opening up to the new issuance following a lull in 2015/2016 caused by several factors, most notably the downturn in oil and commodity prices. One of the most striking features has been the stability of the EM corporate sector and, importantly, its relative inelasticity to oil and commodities. The picture has remained benign as we have tracked corporate fundamentals. During the decade, US dollar issuer corporate default levels remained well below 5% and around the long-term historical average of 3%, and leverage averaged below 2.5x throughout.

The rebound in oil and commodities in the second half of the decade from multi-year lows provided a boost to EM extractive industries. However, this was somewhat offset by a rally in EM currencies that led to weaker export revenues in US dollar terms. The fact that most dollar bond issuers cut capex and leverage in the preceding years meant that borrowing requirements in the raw materials sector loosened. Consumer-demand-led sectors took up the slack. In 2020, financials represent 40% of the benchmark EM corporate index, up from 31% in 2015. Consumer represents 20% (from 6%), while energy represents 10% (from 15%) and basic materials 10% (from 12%). (Figure 4, 5).

Figure 4: Changes in Selective Country Weights in the EM Corporate Benchmark

<table>
<thead>
<tr>
<th>Country</th>
<th>2015</th>
<th>2020</th>
</tr>
</thead>
<tbody>
<tr>
<td>Brazil</td>
<td>13.2</td>
<td>17.0</td>
</tr>
<tr>
<td>Russia</td>
<td>9.6</td>
<td>14.0</td>
</tr>
<tr>
<td>India</td>
<td>5.5</td>
<td>8.0</td>
</tr>
<tr>
<td>China</td>
<td>19.6</td>
<td>27.0</td>
</tr>
</tbody>
</table>

Figure 5: Changes in Selective Sector Weights in the EM Corporate Benchmark

<table>
<thead>
<tr>
<th>Sector</th>
<th>2015</th>
<th>2020</th>
</tr>
</thead>
<tbody>
<tr>
<td>Financials</td>
<td>31.1</td>
<td>40.0</td>
</tr>
<tr>
<td>Consumer</td>
<td>6.1</td>
<td>20.0</td>
</tr>
<tr>
<td>Oil &amp; Gas</td>
<td>15.8</td>
<td>10.0</td>
</tr>
<tr>
<td>Basic Materials*</td>
<td>11.9</td>
<td>10.0</td>
</tr>
</tbody>
</table>

*Basic Materials include Metals & Mining and Industrials.

Source: PineBridge Investments estimates for 2020. JPM CEMBI Broad index weights as of 30 September 2015.
The perception that EM borrowers are always reliant on dollar funding proved to be unfounded. Onshore funding became de rigueur in many markets, especially in 2016/2017 as local currencies began to stand up against the US dollar. The local market has grown as demand for local market assets has increased. Traditionally defensive sectors such as utilities, telecoms and consumer businesses with local revenue streams are back in vogue and maintain a local-currency-funded bias.

China’s massive property sector saw much consolidation following volatility in the second tier, with the number of tier 2 developers falling 25% to 15,000. That said, the mid-decade China slowdown headlines wrong-footed nearly all forecasters, as the country moved to a more sustainable domestic growth model.

China is now almost a third of the EM corporate market capitalization, up from approximately 20% in 2015, buoyed by strong local demand that also helped open the door for other regions to return, notably the safe havens of the CEEMEA region (Central and Eastern Europe, the Middle East and Africa), Mexico and India. Half of new issues from China are no longer marketed in the US because demand is so strong among local Chinese investors.

Reforms resulting from the Brazilian “car wash” scandal cleaned out a lot of local corruption. Petrobras returned to its place as the champion of EM corporate respectability, helped by currency depreciation that made its products more competitive. The anticipated hefty fines on companies embroiled in the scandal failed to materialize, and the litigation locked up in courts was no longer front page news.

US and European Union sanctions against Russia were finally lifted in 2018. Those expecting a torrent of new bond issuance were disappointed: Russian bond issuers were well accustomed to living with little access to finance. Throughout the sanctions period, the Russian central bank had continued to provide adequate liquidity in dollars and rubles, as well as providing an FX repo facility as a backstop; as local interest rates dipped into single digits, the banks started to lend in rubles.

In fact, Russia’s corporate balance sheet was actually reinforced by sanctions that prevented companies from borrowing more dollars opportunistically. Overall leverage decreased as management focused on cutting capital expenditure and on managing debt. New issuance fell by one third in the year sanctions were imposed, illustrating that the only companies able to issue were premium credits with strong balance sheets and decent credit ratings, or companies with international operations and foreign currency revenue streams.

Sub-Saharan Africa provided a trickle of new issues in the primary dollar bond markets, but due to a lack of significant financing requirements in the top tier.

Russia’s corporate balance sheet was actually reinforced by sanctions that prevented companies from borrowing more dollars opportunistically.
corporates, it failed to generate the momentum for a meaningful position in the EM corporate index. Meanwhile, the Middle East continued to fire on all cylinders, but in sukuk format rather than in conventional bonds, boosted by the repricing of oil as well as strong local demand.

Overall, the EM corporate US dollar market of 2020 has continued to build on the growth seen in the earlier part of the decade and more than maintained its relevance for asset allocators to global credit. Investment grade remains the asset of choice as volatility has remained the same or lower compared with developed market peers. The additional yield and spread more than compensate for the necessary liquidity premium caused by the still-challenged secondary market.

What Happened to Liquidity?

One of the most frequently asked questions posed by potential EM investors in 2015 was about market liquidity. Five years on, liquidity has improved thanks to the further rapid development and maturity of the market.

In the years up to and including 2015, investors with strong cash inflows tended to pile into the primary market as liquidity was relatively scarce in secondary markets. That often led to a low, occasionally negative, new issue premium, as investors sought to deploy cash as efficiently as possible.

In 2015, stricter regulation constrained the banks’ ability to allocate scarce capital to their trading books leading to the withdrawal of liquidity in the secondary markets. The rise of e-trading platforms initially did nothing to help this situation, as there were simply too many of them to be effective and the rules and protocols pertaining to them were too weak. In the new lower liquidity environment, market participants realized that market behavior needed to be agreed upon, pricing transparency needed to be improved and basic protocols had to be enforced.

Banks agreed to an “honest pricing” model whereby if they brokered a trade there is only a small transaction cost; on a buyside-to-buyside platform, both (buyside) participants agree to trade closer to mid-price whilst paying a small nominal fee to a platform. The buyside agreed to work with banks on setting an acceptable pricing for liquidity if the respective bank was using its balance sheet. Pricing transparency improved through the use of principles established in the new regulations and protocols that were suitable for EM markets, using price reporting companies like TRACE².

Liquidity has improved from the 2015 lows to a situation now where 60%-75% of trading volume in liquid EM issues trades via three or four platforms. High yield, illiquid names continue to trade primarily over-the-counter, adopting a fairer price model i.e.,

[^2]: TRACE, Trade Reporting and Compliance Engine, is the FINRA developed vehicle that facilitates the mandatory reporting of over the counter secondary market transactions in eligible fixed income securities. All broker/dealers who are FINRA member firms have an obligation to report transactions in corporate bonds to TRACE under the SEC approved set of rules.
the brokering/buy-side-to-buy-side price or bank balance sheet liquidity price. The improved price transparency has helped volatility return to lower levels than the ones we saw in 2015.

Bid/offer spreads have stabilized and tightened in conjunction with liquidity improvements as a result of measures implemented by both the investment banks and the buy side. A typical recently issued investment grade bond now trades at a bid/off er spread of 20-30 basis points (bps), compared with 30-50 bps in 2015. Meanwhile, EM high yield still trades wider, at 100-300 bps, depending on the individual credit. High yield remains predominantly a voice-traded market, but now at least issues are tradable through periods of market instability rather than by appointment or by order only.

The Everlasting End of the Low Rate Era

Back in 2013, one of the most important issues for investors was protecting their portfolios from rising US Treasury yields. With core yields already low, running short duration portfolios was not particularly attractive, so there was a move into higher-yielding US, European, EM and EM corporate assets. As time went on, worries about the prospect of rising US Treasury yields alternated with growth concerns, leading US Treasury performance to seesaw.

A significant yield cushion helped EM bonds during periods of negative US Treasury returns. Perhaps more interestingly, their performance during mid-decade Treasury rallies did not detract much. This was due to the higher yields that helped offset some of the spread widening. Predictably, the high yield segment of EM corporates was the better hedge due to lower duration, while dollar-denominated sovereign bonds were a halfway house (Figure 6).

Figure 6: EM Debt Cushioned From US Rate Rises

<table>
<thead>
<tr>
<th>Period</th>
<th>US Treasury yield move period return</th>
<th>EM Corp HY spread move period return</th>
<th>EM Sov spread move period return</th>
</tr>
</thead>
<tbody>
<tr>
<td>24-Jul-12 to 31-Dec-13</td>
<td>1.39% to 3.03%</td>
<td>727bps to 489bps</td>
<td>357bps to 308bps</td>
</tr>
<tr>
<td></td>
<td>-3.5%</td>
<td>+10.6%</td>
<td>+1.6%</td>
</tr>
<tr>
<td>31-Dec-13 to 30-Jan-15</td>
<td>3.03% to 1.64%</td>
<td>489bps to 677bps</td>
<td>308bps to 398bps</td>
</tr>
<tr>
<td></td>
<td>+7.6%</td>
<td>-0.5%</td>
<td>+8.4%</td>
</tr>
<tr>
<td>30-Jan-15 to 10-Jun-15</td>
<td>1.64% to 2.48%</td>
<td>677bps to 522bps</td>
<td>398bps to 343bps</td>
</tr>
<tr>
<td></td>
<td>-3.3%</td>
<td>+7.7%</td>
<td>+0.2%</td>
</tr>
</tbody>
</table>

Source: PineBridge Investments, using JPM CEMBI BD, EMBIGD, Citibank SBTSY10 (10-year, on-the-run US Treasury benchmark) indices.

A significant yield cushion helped EM bonds during periods of negative US Treasury returns.
More growth-sensitive asset classes, such as non-dollar EM fixed income, did not perform well initially as EM growth remained frustratingly low. Indeed, EM currencies detracted from carry. However, as the dollar rally topped out, the yield cushion and improved competitiveness finally began to attract investors again. Uncertainty over growth meant that returns in these assets were less spectacular than in the past. As the weaker growth scenario was priced in, valuations rallied and yield pick-up proved useful in the environment of low core yields.

As the growth picture improved towards the end of the decade, the question of what to own when rates go up became more relevant once again. Back in 2013, we looked into how higher-yielding bonds perform in such an environment. Previously, the common perception had been that prices of such bonds would initially stay stable as US Treasury yields begin to rise. However, as this move extends further, the high yield spreads begin widen too, sending bond prices sharply lower. So we decided to look at larger UST yield moves, more specifically those exceeding 50 bps since the early 2000s [Figure 7].

Spreads tighten during the whole upward Treasury yield move, resulting in positive returns
This common perception was a myth. Indeed, spreads tightened during the whole upward Treasury yield move, resulting in positive returns. This was most pronounced for developed and EM high yield corporate bonds; EM sovereign bonds also showed a similar pattern. By 2015, we had an opportunity to update our previous analysis (orange dots in Figures 8 and 9); the conclusion very much held and, we believe, provided a useful guide for investors able to diversify away from core markets.

Despite the fundamental changes, history continues to repeat itself. EM bonds are again delivering higher carry, diversification and the moderate default rates that first attracted mainstream global investors. They have proven a more than reasonable investment for patient investors able to look beyond the short-term headlines.
EM Can Be Challenging, Yet Always Offer Opportunities

Popular misconceptions of EM debt are often exacerbated by the market’s breadth and complexity. It is much easier for those not involved in EM to generalize and make sweeping conclusions that fail under the mildest scrutiny.

Admittedly, some components, individual countries or companies, certainly face challenging times – the same can be said of developed market debt or equities. Yet by definition, an asset class that encompasses over US $15 trillion in assets in more than 70 countries will always have compelling investment opportunities.

Certain factors, including macro-economic trajectories, the outlook for US Treasuries, global central bank policies and commodities, have challenged all markets, but our long-term outlook for EM debt remains intact – same destination, different route.
Assets under management as of 30 September 2015.

This information is for educational purposes only and is not intended to serve as investment advice. This is not an offer to sell or solicitation of an offer to purchase any investment product or security. Any opinions provided should not be relied upon for investment decisions. Any opinions, projections, forecasts and forward-looking statements are speculative in nature; valid only as of the date hereof and are subject to change. PineBridge Investments is not soliciting or recommending any action based on this information.

Disclosure Statement
PineBridge Investments is a group of international companies that provides investment advice and markets asset management products and services to clients around the world. PineBridge Investments is a registered trademark proprietary to PineBridge Investments IP Holding Company Limited.

Opinions are the personal views of the authors and do not necessarily reflect the views of PineBridge Investments and there is no undertaking to advise any person of any changes in such views. In addition, the views expressed do not necessarily reflect the opinions of any other investment professional at PineBridge Investments, and may not be reflected in the strategies and products that PineBridge offers. It should not be assumed PineBridge will make investment recommendations in the future that are consistent with the views expressed herein, or use any or all of the techniques or methods of analysis described herein. PineBridge Investments and its affiliates may have positions (long or short) or engage in securities transactions that are not consistent with the information and views expressed in this document. Information from third party sources has not been independently verified.

For purposes of complying with the Global Investment Performance Standards (GIPS®), the firm is defined as PineBridge Investments Global. Under the firm definition for the purposes of GIPS, PineBridge Investments Global excludes some alternative asset groups and regional legal entities that may be represented in this presentation, such as the assets of PineBridge Investments.

Readership: This document is intended solely for the addressee(s) and may not be redistributed without the prior permission of PineBridge Investments. Its content may be confidential. PineBridge Investments and its subsidiaries are not responsible for any unlawful distribution of this document to any third parties, in whole or in part.

Opinions: Any opinions expressed in this document may be subject to change without notice. We are not soliciting or recommending any action based on this material.

Risk Warning: All investments involve risk, including possible loss of principal. Past performance is not indicative of future results. If applicable, the offering document should be read for further details including the risk factors. Our investment management services relate to a variety of investments, each of which can fluctuate in value. The investment risks vary between different types of instruments. For example, for investments involving exposure to a currency other than that in which the portfolio is denominated, changes in the rate of exchange may cause the value of investments, and consequently the value of the portfolio, to go up or down. In the case of a higher volatility portfolio, the loss on realization or cancellation may be very high (including total loss of investment), as the value of such an investment may fall suddenly and substantially. In making an investment decision, prospective investors must rely on their own examination of the merits and risks involved.

Information is unaudited, unless otherwise indicated, and any information from third party sources is believed to be reliable, but PineBridge Investments cannot guarantee its accuracy or completeness.

PineBridge Investments Europe Limited is authorised and regulated by the Financial Conduct Authority (“FCA”). In the UK this communication is a financial promotion solely intended for professional clients as defined in the FCA Handbook and has been approved by PineBridge Investments Europe Limited. Should you like to request a different classification, please contact your PineBridge representative.

Approved by PineBridge Investments Ireland Limited. This entity is authorised and regulated by the Central Bank of Ireland.

In Australia, this document is intended for a limited number of wholesale clients as such term is defined in chapter 7 of the Corporations Act 2001 (CTH). The entity receiving this document represents that if it is in Australia, it is a wholesale client and it will not distribute this document to any other person whether in or outside of Australia.

In Hong Kong, the issuer of this document is PineBridge Investments Asia Limited, licensed and regulated by the Securities and Futures Commission (“SFC”). This document has not been reviewed by the SFC. PineBridge Investments Asia Limited holds a Representative Office license issued by the Central Bank of the UAE and conducts its activities in the UAE under the trade name PineBridge Investments Asia Limited – Abu Dhabi. This document has not been reviewed by the Central Bank of the UAE nor the SFC. In the UAE, this document is issued by PineBridge Investments Asia Limited – Abu Dhabi Representative Office.

PineBridge Investments Singapore Limited is licensed and regulated by the Monetary Authority of Singapore (the “MAS”). In Singapore, this material may not be suitable to a retail investor and is not reviewed or endorsed by the MAS.

PineBridge Investments Middle East B.S.C.(c) is regulated by the Central Bank of Bahrain as a Category 1 investment firm. This document and the financial products and services to which it relates will only be made available to accredited investors of PineBridge Investments Middle East B.S.C.(c) and no other person should act upon it. The Central Bank of Bahrain takes no responsibility for the accuracy of the statements and information contained in this document or the performance of the financial products and services, nor shall it have any liability to any person, an investor or otherwise, for any loss or damage resulting from reliance on any statement or information contained therein.

Last updated 16 June 2014.