Why Fixed Income Investors Should Consider a Dedicated Allocation to Emerging Markets Debt

Historically, investors have looked to emerging market (EM) debt markets as an opportunity to enhance yield within their fixed income allocations. That remains true today, as the global low-rate environment continues to challenge investors’ search for income. But investors have many more reasons to make a dedicated allocation to EM debt than yield enhancement alone. In 2018, we believe EM debt may prove even more attractive as the investable universe has grown, volatility has declined, and both economies and corporate balance sheets have strengthened.

Emerging markets are more accessible than ever

Emerging market economies have undergone many transformations over the past two decades, as their share of world gross domestic product (‘GDP’) has doubled from approximately 20% to 40% from 2001 to 2017. Among the profound changes for EM economies has been the evolution of their capital markets. As debt markets have grown to over US$16 trillion across three major market segments, so has the accessibility for foreign investors (US$5 trillion available).1

The hard currency sovereign bond market is the oldest EM debt sector, and it still receives the most attention from investors, fixed income market participants and financial journalists. Emerging market corporate debt is the fastest growing segment of the market, providing investors with a broad opportunity set of primarily US dollar-denominated securities. The local currency bond market is the largest single sector of EM debt and is primarily issued by sovereign issuers, although there is a growing local corporate market that foreign investors are beginning to tap into. Regardless of currency or credit quality constraints, emerging market debt offers a comparatively attractive level of yield for investors seeking income in a low-rate environment.

The EM Debt Markets Offer a Wide Selection of Opportunity

<table>
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<th>Benefits</th>
<th>Corporate</th>
<th>Local Currency</th>
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<tr>
<td>• Yield advantage</td>
<td>• Yield advantage</td>
<td>• High yielding treasuries</td>
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<td>• Faster growing economies</td>
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<td>• Simple investment universe</td>
<td>• Broad investment universe</td>
<td>• Diversification of rates</td>
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<td>• No FX risk</td>
<td>• No FX risk</td>
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<td>Risks</td>
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<td>• Sovereign credit risk</td>
<td>• Corporate credit risk</td>
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<tr>
<td>• US duration</td>
<td>• Sovereign credit risk</td>
<td>• Local duration</td>
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<tr>
<td>Market Size</td>
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<tr>
<td>US $900 billion</td>
<td>US $2.0 trillion</td>
<td>US $2.2 trillion (foreign accessible)</td>
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<td>Constituents</td>
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<tr>
<td>Countries: 30</td>
<td>Countries: 52</td>
<td>Countries: 18</td>
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<tr>
<td>Issuers: 149 (Sov + Quasi-Sov)</td>
<td>Issuers: 596</td>
<td></td>
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<tr>
<td>Credit Quality</td>
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Source: JPMorgan and PineBridge Investments as of 31 December 2017.
Volatility has declined in the EM debt markets

The common perception is that the higher yields within the EM debt universe are compensation for higher levels of volatility. While that may have been the case several years ago, the maturation of EM debt markets has not only enhanced the opportunities to structure investments for different levels of risk but also led to a decline of volatility across the market. Over the past five years, emerging market investment grade corporates have exhibited lower volatility than similarly rated developed market corporates, and high yield emerging market corporates have been only marginally more volatile than developed market peers. Over the past five years, foreign exchange has kept overall local currency debt volatility above 10% on an annualized basis, but over the past year local currency debt volatility has been just over 5%.^2

EM economies should enjoy faster growth and lower inflation

Emerging markets have, on the whole, faster growing economies than their developed market peers and also offer greater long-term potential. This is thanks, in part, to their burgeoning urban populations, while many developed markets are contending with the challenges of aging populations.

Over the near term, we expect emerging economies to benefit from the continued expansion of global trade as synchronized global growth accelerates in 2018. Whereas developed markets are in the late stages of an economic expansion that has been supported by central bank accommodation, emerging markets on the whole are in the much earlier stages of the economic cycle, with several having fallen into recession in 2013-2014. Emerging markets are now also benefiting from an increase in conservative monetary policy which has helped create a particularly benign inflationary environment. The combination of faster growth and lower inflation sets a favorable backdrop for investors in both local and external emerging market debt.

Volatility Across EM Sectors Is Lower Than Many Would Expect

Source: Bloomberg, Barclays, JP Morgan and PineBridge Investments as of 31 December 2017. For illustrative purposes only. We are not soliciting or recommending any action based on this material.
**EM corporate balance sheets are attractive**

The macroeconomic backdrop is favorable for both sovereign and corporate debt holders. Looking specifically at the balance sheets of emerging market corporates relative to their advanced market peers, we find additional positive fundamental dynamics. Specifically, EM corporates have historically carried less leverage than similarly rated developed market corporates. Additionally, EM corporates have, on the whole, begun to reduce leverage more than a year earlier than the recent deleveraging among developed market corporates. We expect that to continue as EM economic growth accelerates.

![EM IG Net Leverage vs US IG Net Leverage](image1)

![EM High Yield Leverage vs US High Yield Leverage](image2)

Source: Bank of America Merrill Lynch. Underlying companies data as of June 2017. For illustrative purposes only. We are not soliciting or recommending any action based on this material.

**Ignore EM at your peril**

Although emerging markets account for roughly 40% of global GDP, EM debt represents less than 10% of most major market bond indexes¹, which is materially less than its share of the total market capitalization within fixed income. As a result, many investors who rely on traditional index models of allocating capital within their fixed income portfolios are materially under-allocated to emerging market debt. Making a dedicated allocation to EM debt not only has the potential to enhance yield, but also to provide diversification benefits. The lower correlation of EM debt to other major asset classes and historically strong performance of EM debt during periods of rising interest rates are particularly relevant today.

While the evolution of EM debt has created new opportunities for investors, it has also increased the complexity of the market. Investors, therefore, need to understand the risks pertaining to individual EM markets in order to be able to capture these opportunities.

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¹ JPMorgan and PineBridge Investments as of 31 December 2017.
² Bloomberg, Barclays, JPMorgan and PineBridge Investments as of 31 December 2017.
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