RBC Global Asset Management

Six reasons to invest in Emerging Market High Yield corporate bonds (and one reason not to…)

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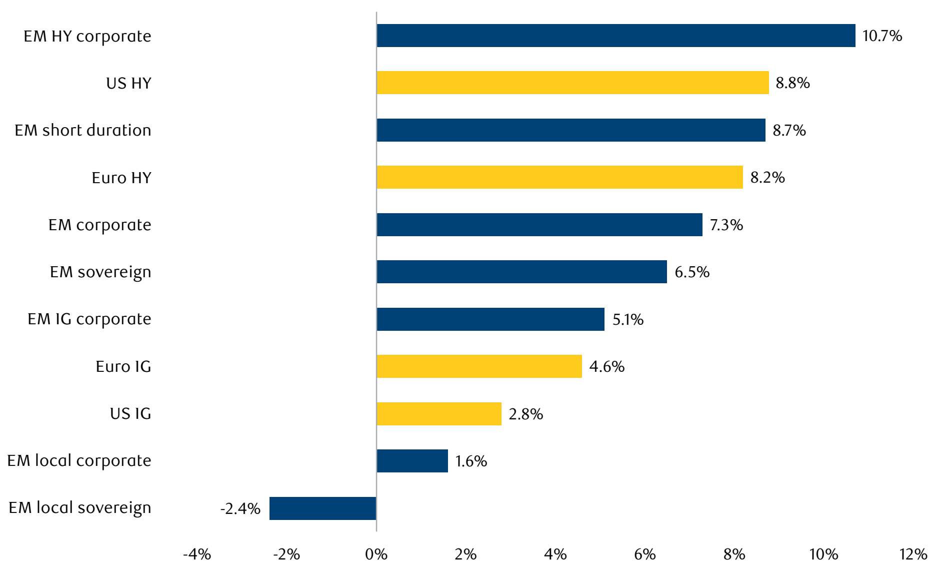
Emerging Market High Yield (EM HY) corporates was one of our top asset class picks within EM for 2024, and indeed, we can see in the chart below that this has played out well.

We argue below that the case for investing in the asset class remains solid for 2025 with a compelling risk-reward outlook, both from fundamental and technical perspectives and with regard to opportunities for spread compression.

Moreover, as we enter a period of policy uncertainty and potential market volatility, owning assets that offer a healthy carry can provide an important buffer for investor portfolios to weather market fluctuations. Furthermore, active management can enable investors to capitalise on temporary market dislocations to pick up cheap assets.

> **"Emerging Market High Yield (EM HY) corporates was one of our top asset class picks within EM for 2024."**

Chart 1: Major asset class returns in 2024



Source: JPMorgan, MSCI, BofA, S&P and Bloomberg, as of 31 December 2024.

Looking ahead to 2025, we highlight six reasons that we believe support being invested in the EM HY corporate asset class:

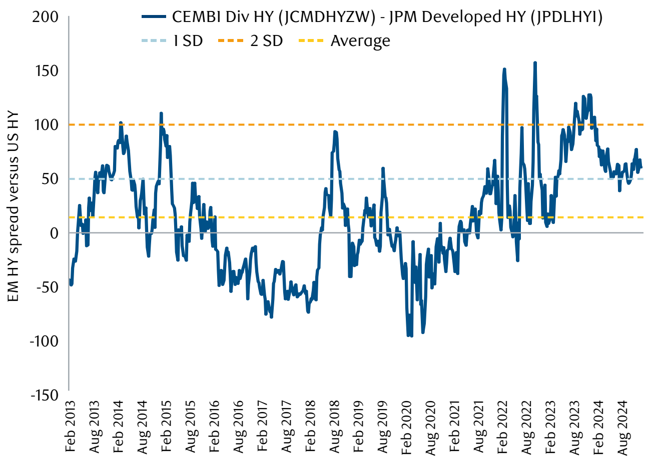
1. Attractive yield on an outright and relative basis

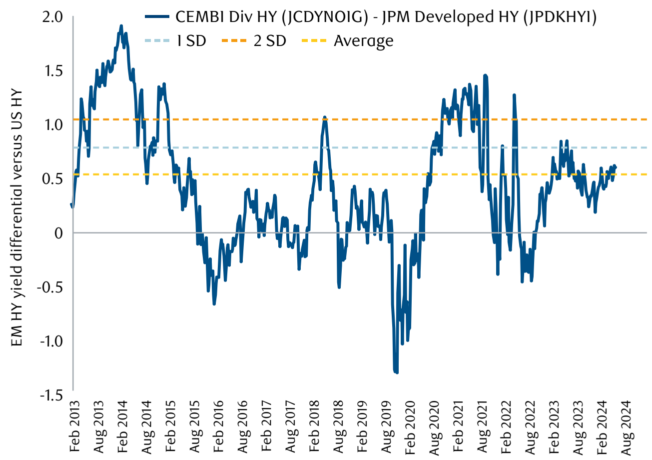
With average yields at **8.4%** and duration of **3.4 years**, investors can potentially benefit from strong carry and a healthy cushion to withstand potential Treasury-driven market volatility[1].

[1] Bloomberg, as of January 2025.

On a relative basis, EM HY offers a +60bps spread pick-up over US HY (Chart 2), which is one standard deviation cheap relative to the 10-year average. Likewise, the EM HY yield differential is trading 80bps wide to US HY, also one standard deviation cheap to the 10-year average.

Chart 2: EM HY versus US HY spread and yield differential





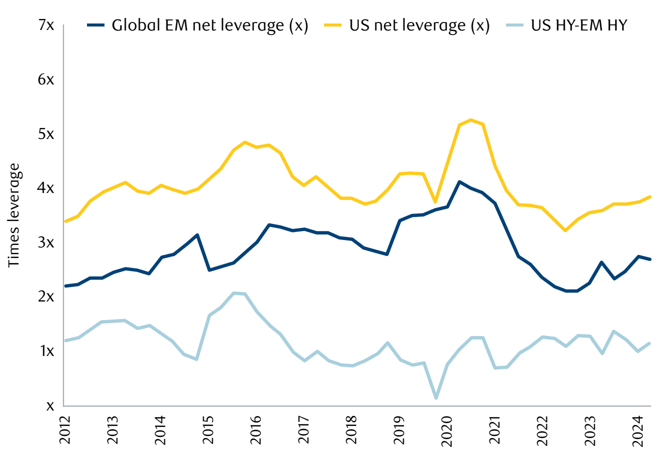
Source: JPMorgan as of 14 January 2025. CEMBI Diversified HY z-spread-to-worst; JPMorgan Developed High Yield Index spread-to worst.

2. Strong fundamentals

We have previously highlighted the strong and improving fundamental position of EM corporates, with materially lower leverage and improved balance sheet liquidity. Currently, the difference in net leverage stands below the last five years' average, and EM HY corporates metrics are close to their 10-year lows (Chart 3).

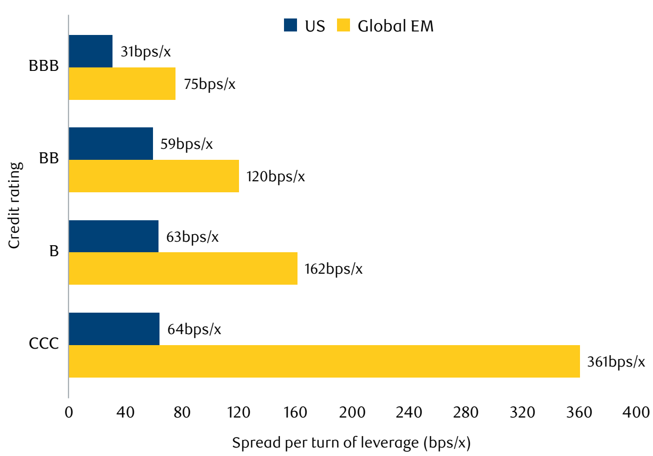
Given the higher spreads, the risk-adjusted valuations in EM are particularly compelling, as can be seen in the spread per turn of leverage (SPTL). Chart 4 illustrates that, despite strong performance in 2024, the ratio of the SPTL of EM HY is still above companies with equivalent ratings in the US HY market.

Chart 3: EM & US HY net leverage



Source: Bank of America, as of 31 December 2024.

Chart 4: EM and US HY spread per turn of leverage



Source: Bank of America, as of 31 December 2024.

3. Falling defaults – we expect defaults in 2025 to be at historical lows

EM HY corporates are entering 2025 from a position of strength, as evidenced by the low rate of defaults in 2024 within the CEMBI Broad Diversified High Yield Index, which was 1.2% for 2024. Indeed, the high default rates of the post-Covid era, largely driven by the Chinese property crisis along with a steady stream of negative geopolitical events, are now behind us, with EM corporates having undergone a sharp de-leveraging event as a result.

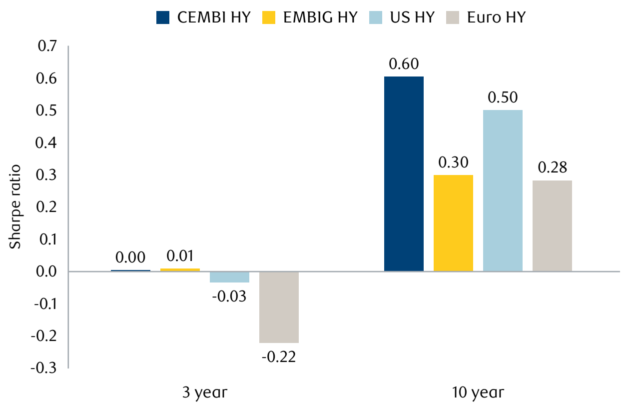
As we look ahead to 2025, our base case default forecast for the CEMBI Broad Diversified High Yield Corporate universe is estimated at 1.2%, once again below historical averages and slightly below market consensus (closer to 1.7%). This is roughly in line with U.S. credit markets and meaningfully lower than European credit markets. In fact, most of the credits we see at risk within the EM universe have been struggling for a while now, and hence their deterioration should hardly come as a surprise.

In terms of underlying trends, weakness in China, particularly real estate, and maturity extensions in Ukraine, remain continued risks that the market is well aware of. On the other hand, an unexpected increase in funding cost and prolonged weakness in crude oil could be non-consensus default drivers. Whilst defaults in oil & gas could pick up in 2025, we note that overall balance sheets remain solid overall and refinancing risks are manageable. Additionally, an active management approach is a strong mitigant to these potential tails.

Lastly there are a number of idiosyncratic stories in TMT with heightened default risk, should things not go according to managements' base cases. Nevertheless, the overall benign outlook for defaults should usher in a period more akin to the lower default environment of the pre-Covid era, where Sharpe ratios for the asset class were meaningfully higher (Chart 5).

Chart 5: Sharpe ratios of CEMBI HY versus other asset classes

Strong returns and more modest volatility have enabled CEMBI to post a superior Sharpe ratio over the past 10 years, and this trend remains firmly intact.



Source: JPMorgan, as of 30 November 2024.

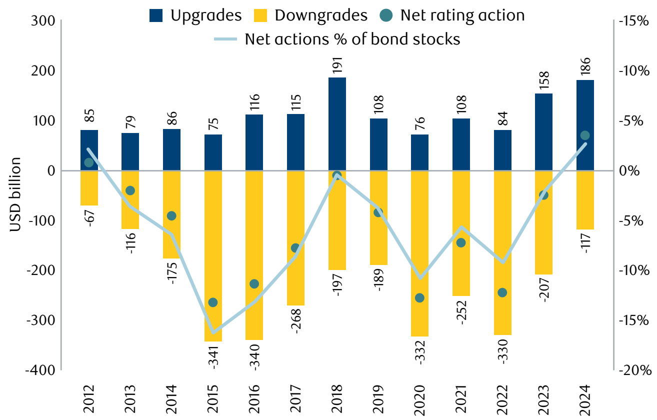
4. Ratings trajectory looks positive for the first time in 12 years

In 2024, EM corporates saw the ratings trend finally turn positive, after 12 years of negative rating actions (Charts 6 and 7). Upgrades outsized downgrades by USD70 billion, or roughly 2.8% of the outstanding bond market in 2024, meaningfully higher than the USD18 billion, 12 years ago.

Given EM corporates' solid fundamentals – with low net leverage and strong liquidity – and our outlook for 2025, we expect the positive ratings trend to continue. This should come as a reflection of credit-specific improvements, as well as positive action and normalisation in some idiosyncratic sovereigns.

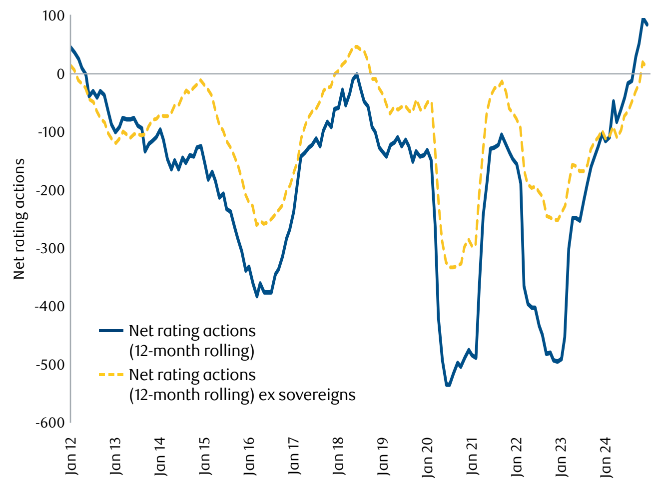
Chart 6: Net rating actions volume positive for the first time since 2012

Amount of EM corporate bonds affected by rating actions and % of bond stock, annual



Source: JPMorgan, Bloomberg Finance LP, as of 31 December 2024.

Chart 7: Net rating actions on a 12-month rolling basis closed 2024 tally at significant positive



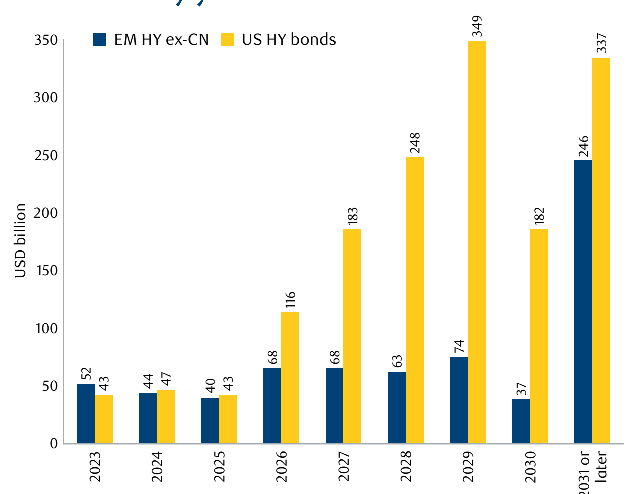
Source: JPMorgan, Bloomberg Finance LP, as of January 2024.

5. Supportive technicals

Over the coming year, we would expect net supply of EM HY paper in the market to be negative, at -USD53 billion[2], underpinning technical support in the market – this is due to the relatively modest levels of new issuance (exp USD114 billion) being outweighed by the higher levels of cash inflow from amortisations and coupon payments.

Looking ahead over the next five years, aggregate debt maturities within the EM HY corporate universe are estimated to remain manageable, at USD40 billion[3] in FY25 and peaking at USD68 billion in FY26, suggesting supply and refinancing risk will remain relatively low in the medium term (Chart 8). (For context, when comparing to the U.S. HY market, even after adjusting for the larger size of the universe, the aggregate level of maturities in the U.S. over the next five years will be well over 2x that of EM.)

Chart 8: EM HY corporate versus U.S. HY maturities by year



Source: JPMorgan, as of 31 December 2024.

[2,3] JPMorgan as of 31 December 2024.

6. Global HY investors are unwittingly missing out on the benefits of EM exposure

One interesting structural trend to note is the material underweight allocation to EM within Global HY funds – this underweight is currently near 10%, despite the weighting of EM corporates in the global index growing from 3% to 17% in the last 20 years. Aside from the tracking error this can present within portfolios, the ongoing underweight can be more punitive, given the EM HY corporate bond benchmark index currently has a higher average credit rating, BB- vs B+, and higher yield to maturity, 8.4% vs 7.70%, compared to the Global HY Bond benchmark index, not to mention the diversification benefits of holding a truly global portfolio.

"One interesting structural trend to note is the material underweight allocation to EM within Global HY funds."

The underweight to EM in global funds, whilst punitive, is understandable, given most global HY managers do not have the dedicated resources and expertise in EM, and are therefore not positioned to fully analyse the risks and opportunities within individual corporate investments.

Whilst the EM corporate asset class is certainly experiencing an overall positive trajectory, individual stories nevertheless represent distinct idiosyncratic characteristics – the need for a deep understanding of the sovereign backdrop and specific corporate company developments must not be underestimated. For this reason, allocators to global funds may wish to consider apportioning a certain level of their capital to EM specialist managers, in order to fully capture the benefits of the asset class within their overall portfolios.

...and the key reason NOT to invest in EM HY corporates: the pitfalls of passive investing

Despite the positive structural trends within the sector – with fundamental metrics looking healthy and defaults expected to be low – one must not fall into the trap of being complacent or taking a passive stance toward the investment proposition. As with any dynamic, evolving, asset class, the EM corporate bond universe will inevitably contain certain names that are unsound from an investment perspective, and others that can represent unmitigated risks to portfolios. Avoiding these, and managing the broader risks these investments can pose, requires close scrutiny of the component issuers and active management of a portfolio.

Likewise, during periods of market volatility, this active management, combined with strong underlying asset class expertise, can allow active manager to take advantage of temporary mis-pricings of assets to buy high quality investments at discounted levels. Such opportunities may enhance a portfolio's long-term returns.

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