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March 2016

THE CASE FOR EMERGING MARKET CORPORATE DEBT

INVESTORS LOOKING TO GARNER ATTRACTIVE RETURNS FROM CREDIT MARKETS ARE FACED WITH AN ADVERSE SELECTION PROBLEM. THOUGH LARGE PARTS OF GLOBAL CREDIT HAVE SOLD-OFF IN RECENT MONTHS AND SPREADS OVER CORE GLOBAL RATES HAVE INCREASED, THE OVERALL RETURNS AVAILABLE ARE STILL LOW.

Approximately $6trn of government securities now trade at negative yields at maturities out to 10-years. Fifty-two percent of all government debt yields less than 1%. Investors can choose to forego quality and hunt for returns in high yield markets or leverage exposures, though strategies such as risk parity have lately been found wanting.

The active management of emerging market (EM) corporate debt offers an attractive alternative. These credits are under-researched, under-owned and unloved by mainstream investors. This creates mispricing and opportunity in spite of EM Corporate debt's status as a rapidly maturing asset class. The share of corporate finance via bond markets in EM has nearly doubled since the global financial crisis as banks have aimed to deleverage and shrink their loan books.

FUNDAMENTAL AND TECHNICAL SUPPORT

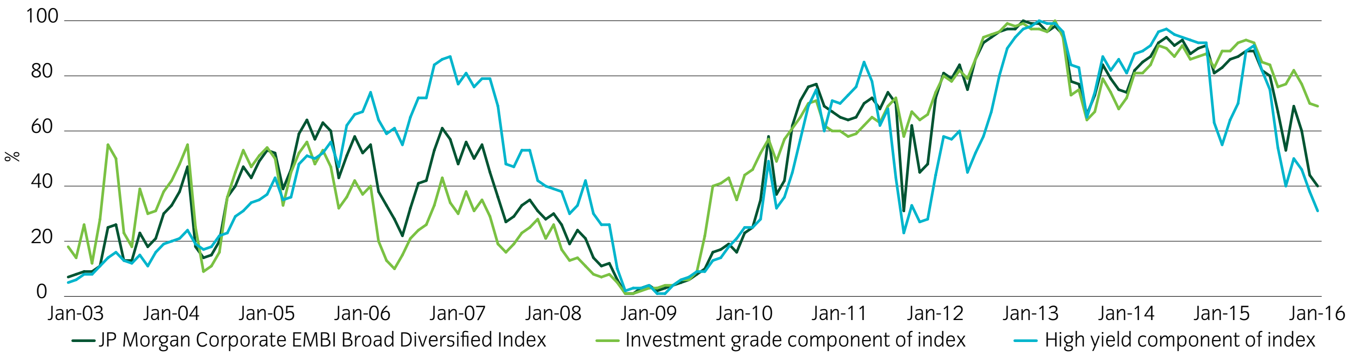
The valuation case is becoming compelling. As an asset class EM corporate debt is currently priced in the 40th percentile of its history back to 2002. In other words the asset class has been more highly priced for 60% of the time over the past 14 years (Figure 1). The high yield component of the EM corporate index is even cheaper; it is currently trading in the 32nd percentile (more highly priced from more than two-thirds of its history).

We believe that this is a reflection of sentiment rather than fundamentals. Headlines on emerging markets have been unremittingly bad. They have focused on the fear of a hard landing in China, the sharp decline in commodity prices and the perceived negative impact of an appreciating US dollar on debt sustainability. This negative sentiment translated into net capital outflows from emerging markets in 2015 for the first time since 2006, according to the Institute for International Finance.

These concerns are now in the price. Commodities could test new lows and the dollar could strengthen further, but the sheer size of these moves suggests that the risks are now pointed in the other direction. The weakening of EM currencies has enabled many countries to improve competitiveness and external balances.

The volatility of currencies has led to heightened fears over debt sustainability and a potential spike in defaults due to a mismatch between dollar denominated liabilities and local currency denominated assets – the so called 'original sin' of emerging market debt issuance. Our view is that much of this concern is misplaced.[1]

Figure 1: Long-term valuation of EM corporate debt (percentile yields over history)

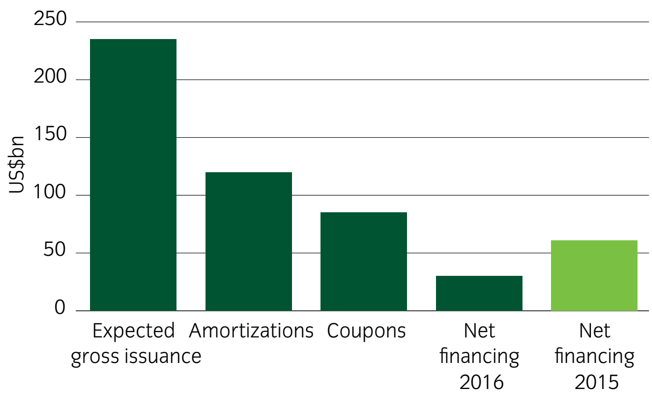


Source: Insight and Bloomberg as at 31 January 2016.

[1] A recent research paper supports this. It used firm-level data from the top 100 EM corporate bond issuers in US dollars to assess their susceptibility to local currency weakness. It concludes: "Over two-thirds of the top 100 issuers of US dollar-denominated bonds (by both number and value) appear to be able to at least partially hedge their foreign exchange risk by earning US dollar revenues. "The paper adds that "a significant share of the remaining borrowers are state-owned enterprises." *US Dollar Debt of Emerging Market Firms*, Sasha Kofanova, Aaron Walker and Eden Hatzvi, Reserve Bank of Australia, *Bulletin*, December 2015.

The FX risk is overstated for many corporate borrowers in emerging markets. It is easy to worry about this mismatch, but far more difficult to do the sort of forensic, bottom-up balance sheet analysis that the researchers at the RBA have done. We find this across emerging market corporate debt. For example, Brazilian agribusiness JBS has 87% of its total debt denominated in US dollars but so are 84% of its revenues. The additional point the RBA researchers make about many borrowers being state-owned enterprises is also significant. In many instances this means they are likely to receive support from the sovereign.

Figure 2: 2016 EM corporate net financing needs modest



Source: JPMorgan as at 31 December 2015.

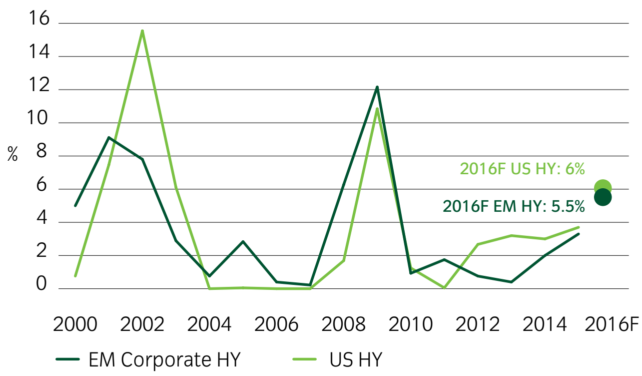
For example, many Russian companies are operating under various international sanction regimes. The US dollar funding markets are closed to them. In spite of this no Russian companies went into default in 2015 and in many cases they have conducted buybacks of their US dollar denominated bonds. Approximately 80% of issuers in the energy sector from emerging markets, companies often highly exposed to the oil price, can be considered quasi-sovereign borrowers. That contrasts with the US where most energy producers are independents.

Technical factors are also beginning to support EM corporate debt. The outflows from the asset class and poor investor sentiment have made it a difficult climate for new issuance. In the final quarter of 2015 there was negative net supply (principal repayment and bond buybacks vs. new issuance) of -$30 billion. We expect this trend to continue this year. Our estimates are that $158 billion will be returned to investors in 2016 in coupon and principal repayments. Bond buybacks are also becoming more popular due to currency volatility and could amount to $50 billion over the course of the year.

HIGH YIELD: EM AND DM ARE DIFFERENT

The high yield segment of emerging market corporate bonds is also relatively attractive when compared to developed market peers. Overall, across the cycle, the default rate is lower (3.9% vs. 4.6% for US high yield). On average, in spite of the constraint of the sovereign ceiling which means corporate ratings might not reflect true credit fundamentals, EM high yield issuers have an average rating of BB- compared to B+ for the US.[2] Twenty percent of the US high yield sector is rated CCC, compared to only 4% in EM.

Figure 3: EM HY and US HY default rates (1999-2015)



Source: JPMorgan as at December 2015.

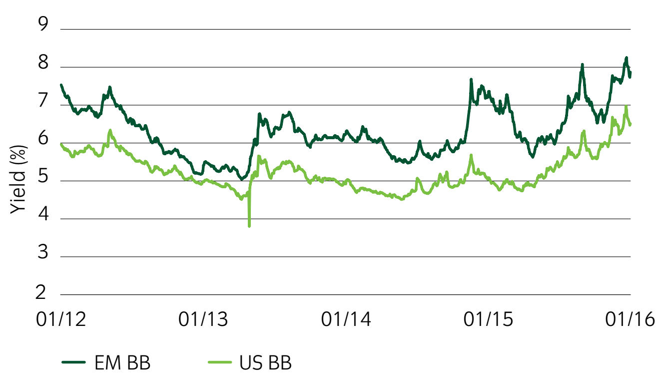
EM default rates have risen since 2011, but only modestly and they remain below their long-term average. We expect default rates for EM high yield issuers to rise to 5.5% this year versus 6% for US issuers.

INSIGHT'S VIEW

Behind the headlines emerging markets have made considerable strides in a challenging environment. We believe that both investment grade and high yield corporate EM debt are currently offering investors a more than adequate return for taking credit risk. This contrasts with large parts of the developed markets where yields remain low. EM corporates have solid credit fundamentals, strong technical support and an improving macroeconomic backdrop.

The secular case for emerging market corporate bonds is intact in spite of a difficult investment environment over the past four years. It offers a structural yield pick-up and is under-researched and therefore neither fully understood or properly valued.
But the timing of an entry into the asset class against the current investment backdrop is particularly compelling. In our view it has rarely been more propitious.

Figure 4: EM BB issuers more attractive than US peers



Source: BoA Merrill Lynch as at 31 January 2016.

[2] The sovereign ceiling rule means that a credit rating agency will not rate a private firm in any country higher than the sovereign

THE INSIGHT EDGE

Active fund management is most rewarding when fundamentals and market pricing diverge. We believe that point has been reached in emerging market corporate debt. EM high yield corporates are trading wide of their US peers at both BB and B ratings (Figure 4). But for many investors the question remains of how to access the opportunity in an optimal way?

We believe the rapid development, depth and maturity of the EM corporate debt asset class merits a standalone allocation. At $1.4 trillion the EM corporate debt universe is more than double the size of the market for investment grade sterling debt. It encompasses 64 countries and more than 900 corporate issuers, more than 60% is rated investment grade.

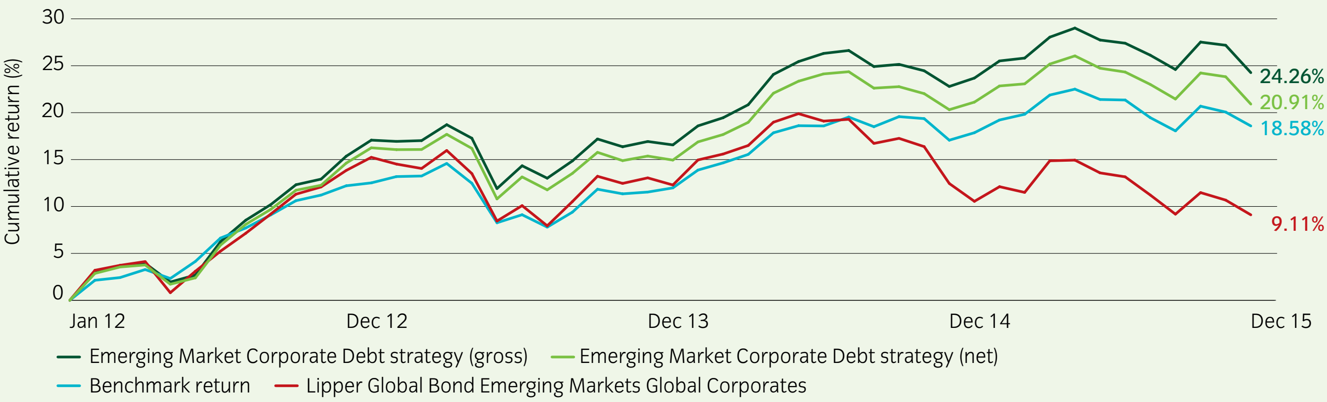
Emerging market corporate debt represents a structural opportunity enabling investors to gain access to higher returns for the same credit fundamentals. They can add new issuers and diversification to their existing bond portfolios at a time when emerging markets are gaining a dominant share of global trade and GDP.

The BNY Mellon Emerging Market Corporate Debt fund (the Fund) has been managed by the emerging market debt team at Insight Investment since inception in January 2012. This specialist team has experience of managing throughout emerging market credit cycles and crises. Insight has managed corporate debt since 2005.

The emerging market team is backed by the resources of Insight's 98-strong fixed income group which includes 42 dedicated credit analysts. These analysts operate across global sectors and therefore able to make like-for-like comparisons of credit fundamentals whilst understanding the revenue drivers of the industries individual credits operate within. This fundamental credit evaluation is overlaid with a top-down country risk assessment within a rigorous risk management framework.

The Fund has an annualised return of 4.77% since inception, compared to the 4.45% return of the JP Morgan CEMBI Broad Diversified index in US dollars. It has a top quartile ranking in its peer group of Lipper funds.

Figure 5: Emerging Market Corporate Debt strategy



Source: Insight as of 31 December 2015. Emerging Market Corporate Debt strategy (composite USC0841). Inception date: 31 January 2012. Benchmark: JP Morgan Corporate EMBI Broad Diversified index. Strategy performance shown both gross and net of annual management charge and performance fees. Includes reinvestment of dividends and other earnings. Where performance figures are shown gross of fess they do not reflect the payment of investment advisory fees and other expenses. Gross of fees returns will be reduced by the investment advisory fees and other expenses.

Past performance is no assurance of future returns. Please refer to the important disclosures at the back of this document.

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