Investment Insights | Invesco Fixed Income

EM investment grade debt: An attractive alternative for insurers

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Overview

We believe emerging market (EM) investment grade hard currency debt is an attractive option for insurers. The asset class offers:

- Compelling long-term value potential, underpinned by better growth prospects for EM economies compared to advanced economies
- Historically strong fundamentals and improved credit quality due to the growth in A and AA rated assets
- A large and diverse investment universe that supports portfolio diversification
- Favorable regulatory capital treatment

EM investment grade hard currency debt is an attractive option for insurers, in our view, as it is an increasingly broad and mature asset class that offers attractive return potential and potential diversification benefits. While the last three years have been a tumultuous period for EM due to a series of rare and highly disruptive events, recent history indicates that the asset class can deliver attractive risk-adjusted returns over the long term. From 2010-2019, EM investment grade debt produced higher returns than US investment grade debt, with only modestly more risk (Figure 1). We believe the asset class is set up to perform similarly well in comparison to US credit coming out of this recent period of crisis.

Figure 1: EM performance, 10-year period from 2010-2019

	Duration	Annualized returns	Volatility	Sharp ratio
EM sovereign investment grade	9.37	6.35%	7.37%	0.86
EM corporate investment grade	5.48	5.71%	6.46%	0.88
US investment grade	8.68	5.59%	5.89%	0.95

Source: Invesco, JP Morgan EMBI Global Diversified Investment Grade Index, JP Morgan Corporate Broad EMBI Diversified High Grade Index, Bloomberg US Corporate Total Return Value Unhedged USD Index. Data as of March 30, 2023. **Past performance is not a guarantee of future results.**

EM's post-GFC evolution

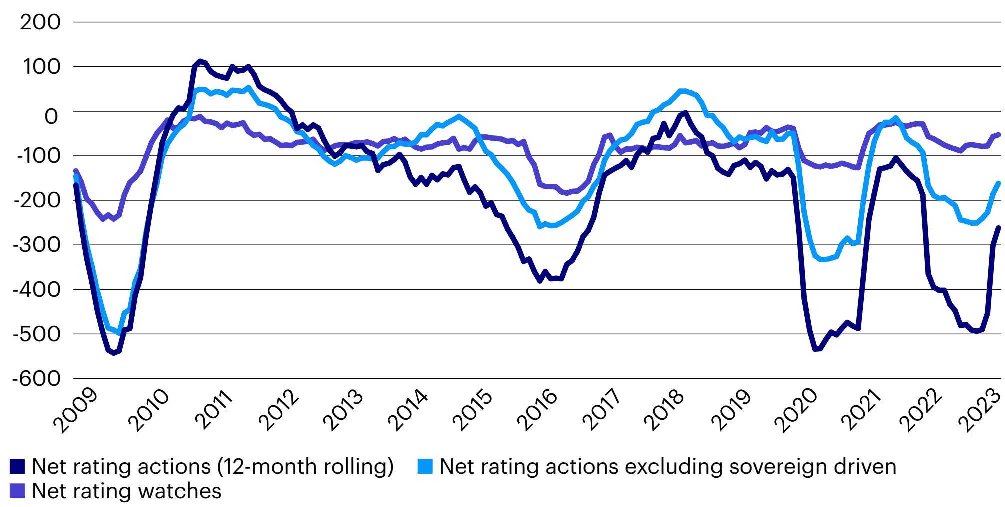
EM economies solidly outperformed developed market (DM) economies during the 2008-2009 global financial crisis (GFC). Like all risk assets at the time, EM valuations, especially in credit, were depressed. Attractive valuations and relatively better fundamentals set the stage for very attractive returns, which garnered the attention of investors and drove strong investment flows into the asset class. Sentiment remained tempered, however, among higher quality, longer-term institutional investors, who maintained concerns about the relative newness of the asset class, its level of risk and limited breadth.

In our view, those concerns have been addressed over past ten-plus years. The asset class has grown several fold over that period to over USD4 trillion of bond stock, representing more than 130 countries and over 1,000 distinct issuers, with more than half the market now rated investment grade. The EM market is currently larger than the US high yield or commercial mortgage-backed securities market and much more diverse.

EM in the post-pandemic landscape

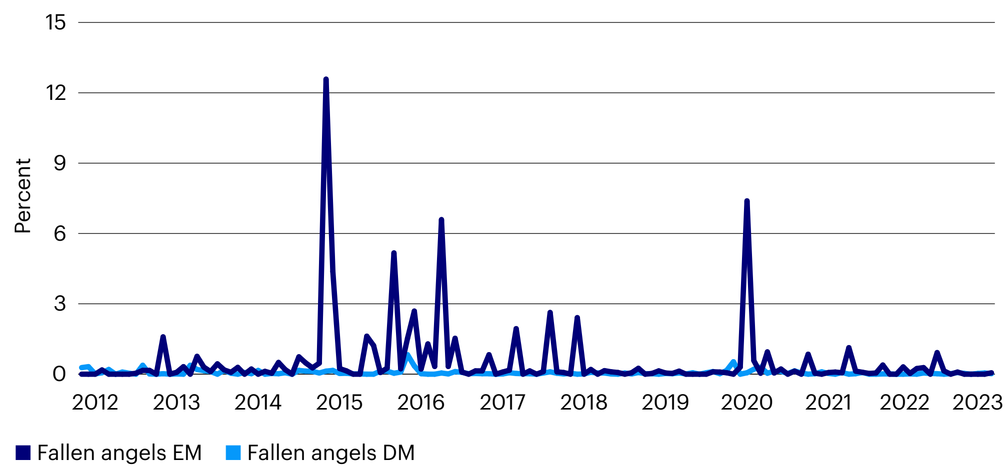
The past few years have been extremely challenging for EM due to a series of unprecedented events; the pandemic, a crisis in the Chinese real estate sector, Russia's invasion of Ukraine, record DM inflation and a sharp rise in US interest rates hit EM hard in terms of economic fundamentals. As a result, we saw an elevated level of ratings downgrades from 2020 to 2022 (Figures 2 and 3).

Figure 2: EM net rating actions (upgrades minus downgrades)



Source: Bank of America. Data from Jan. 31, 2009 to April 30, 2023.

Figure 3: Fallen angels in EM versus DM (per month/% of par)



Source: Bank of America. Data from Feb. 28, 2012 to April 30, 2023. Based on JPM EMBI and COAO ICE BofAML US Corporate Indices. Fallen angels are issuers whose credit ratings have been downgraded to high yield from investment grade.

The ratings shakeout has left the investment grade segment of EM in a stronger position, as the weaker issuers have dropped to high yield. And despite this period of turbulence, returns on EM investment grade credit have held up well compared to US investment grade corporates (Figure 4).

Figure 4 – EM returns and volatility, 2020 - present

	Duration	Annualized returns	Volatility	Sharp ratio
EM sovereign investment grade	8.82	-3.82%	10.01%	-0.11
EM corporate investment grade	5.31	-1.80%	5.77%	-0.15
US investment grade	8.18	-1.63%	9.89%	-0.09

Source: Invesco, JP Morgan EMBI Global Diversified Investment Grade Index, JP Morgan Corporate Broad EMBI Diversified High Grade Index, Bloomberg US Corporate Total Return Value Unhedged USD Index. Data as of March 30, 2023. **Past performance is not a guarantee of future results.**

Fixed income assets and returns have certainly suffered over the past three years, and EM has been hit especially hard by the broad upheaval in the global economy. But we believe recent events have been unique and are unlikely to be repeated for at least the next decade. Additionally, fixed income yields, especially in EM, are the most attractive they have been in almost 15 years.[1] Accordingly, we expect the next decade to be more similar to the 2009–2019 period than to the past three years.

Greatly improved credit quality across EM investment grade universe

Credit quality has greatly improved across both the sovereign and corporate segments of the EM investment grade universe, making it much more suitable and attractive for insurers.

The improved quality is due to the expansion of the A and AA rating buckets of the asset class and the heavy downgrade cycle we have experienced over the last three years, which has pushed marginal investment grade issuers into high yield. An example is Colombia, which was downgraded to high yield after a prolonged period of deficits and rising debt levels. Similarly, the Mexican oil and gas company, Pemex, was downgraded to high yield after years of posting credit metrics consistent with a single-B or lower rated credit. Most large, private Chinese real estate companies have also been downgraded to high yield, removing some of the most opaque and levered constituents of the corporate investment grade universe. On the positive side, we have seen an expansion of the A and AA rating categories, driven by governments and companies in the Middle East, Asia and Latin America.

The improvement in the asset class's average credit quality is most dramatic in the sovereign and quasi-sovereign space where the percentage of the market rated A or higher has more than doubled since 2017, to just over 50% (Figure 5).

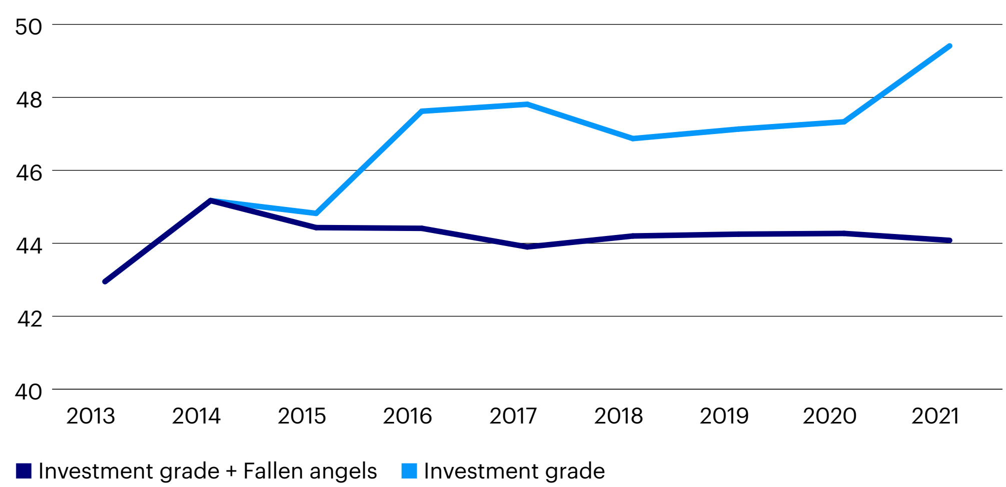
Figure 5: EM investment grade sovereign bond index - breakdown by rating

	March 17	March 19	March 21	March 23
AA	6.0%	3.8%	14.3%	16.1%
A	17.8%	23.7%	29.2%	33.9%
BBB	76.2%	72.5%	56.5%	49.9%

Source: Bank of America. JP Morgan EMBI Global Diversified Investment Grade Index. Data as of March 30, 2023. **Past performance is not a guarantee of future results.**

This ratings dynamic has corresponded with meaningful improvement in political stability rankings among investment grade governments, as measured by the World Bank Worldwide Governance Indicators (WGI).[2] This measure is a good proxy for the generally improved credit quality of constituent countries, in our view, as it suggests more stable, financially sound entities. Sovereign credit metrics, such as debt-to-GDP ratios and fiscal deficits, are not as meaningful on their own, in our view.

Figure 6: WGI political stability rankings – Investment grade countries



Source: World Bank. Data from Jan. 1, 2013 to Jan. 1, 2021. The WGI provides a ranking of 215 countries and territories based on six dimensions of governance, including political stability, government effectiveness, and control of corruption.

In the corporate space, we have also seen improvement in average credit quality, though not as dramatic as in the sovereign space. Since 2017, the proportion of the corporate credit market rated A or higher has increased from 38% to 47% (Figure 7).

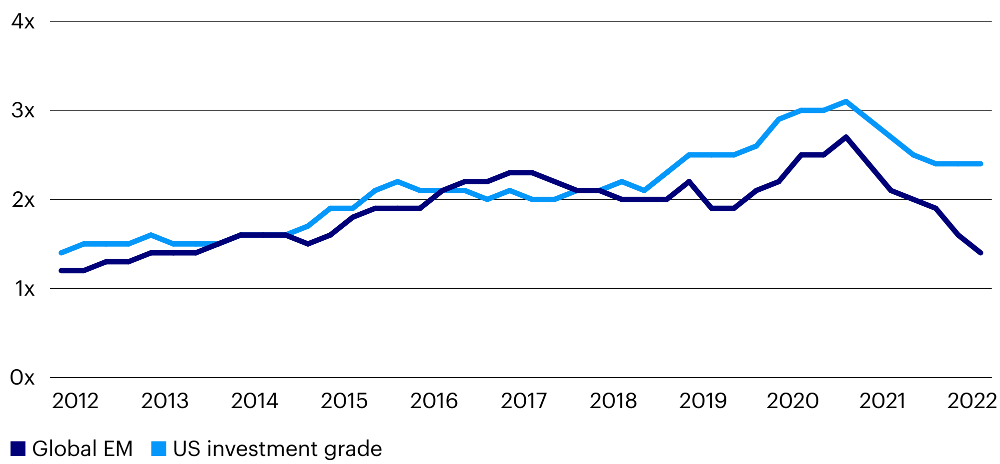
Figure 7: EM investment grade corporate bond index – Breakdown by rating

	March 17	March 19	March 21	March 23
AAA	0.1%	0.0%	0.1%	0.1%
AA	4.3%	2.4%	4.4%	7.4%
A	33.9%	37.0%	38.7%	39.8%
BBB	61.6%	60.6%	56.7%	52.7%

Source: Bank of America. JP Morgan Corporate Broad EMBI Diversified High Grade Index. Data as of March 30, 2023.
Past performance is not a guarantee of future results.

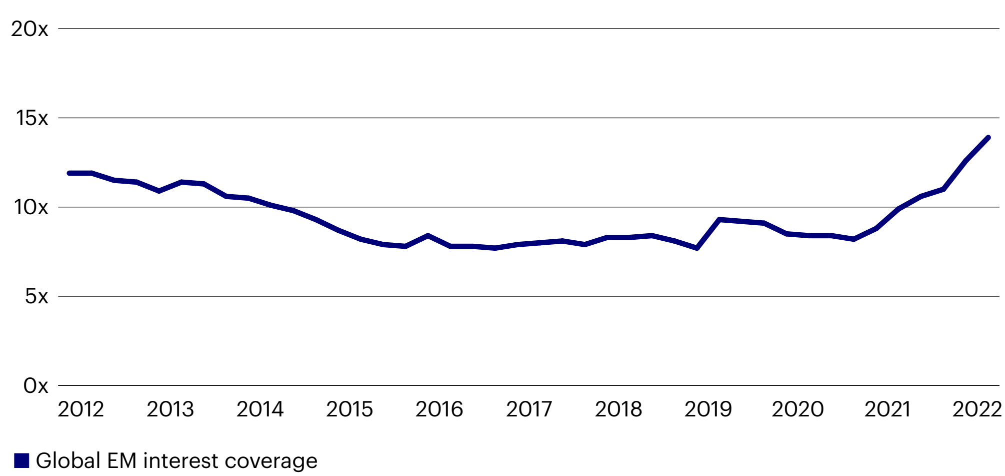
Credit metrics for EM investment grade corporates have also shown significant improvement. Net leverage on average is around one time, the lowest it has been in a decade, and well below that in the US investment grade credit market (Figure 8). Interest coverage ratios are also much improved (Figure 9).

Figure 8: EM vs DM corporate comparison - net leverage



Source: Bank of America Global Research. Data from March 31, 2012 to Dec. 31, 2022.

Figure 9: EM investment grade interest coverage



Source: Bank of America. Data from March 31, 2012 to Dec. 31, 2022.

The EM investment grade credit universe has improved in terms of both average credit rating and credit fundamentals. In our view, this dynamic is especially attractive for insurers and other high-quality oriented investors, as the ability to deploy capital in the asset class in a prudent and productive manner is greater compared to five or six years ago.

Compelling long-term return opportunity

In addition to improved credit fundamentals, the second pillar of EM debt's value proposition is its compelling level of expected returns relative to traditional alternatives.

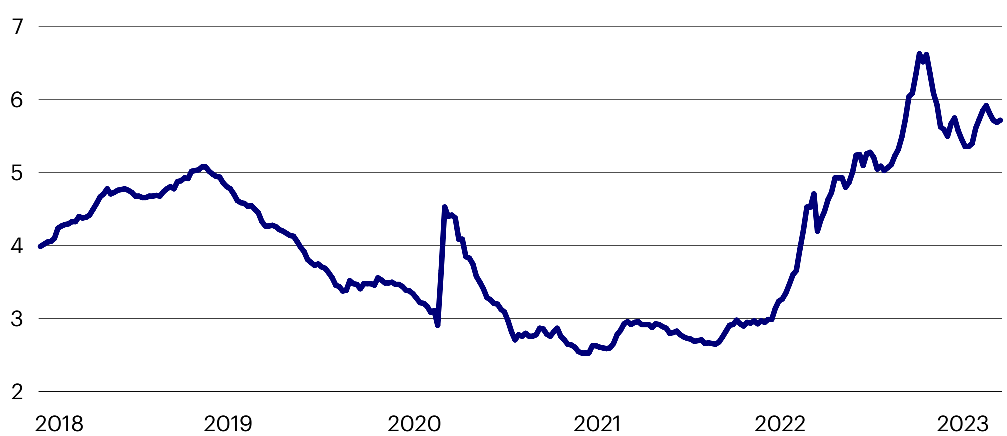
EM investment grade bond spreads are not currently elevated, but neither are high quality bond spreads broadly. Nevertheless, we find EM compelling based on its decade-high yields and attractive relative value versus DM.

As shown in Figures 10 and 11, aside from periods of market crisis, EM investment grade sovereign and corporate yields are the highest they have been in the past five years. Elevated yields and a stronger overall credit profile should drive strong returns over the long term.

Figure 10: EM investment grade sovereign yield-to-worst (%)

Source: JP Morgan. Data as of March 30, 2023.

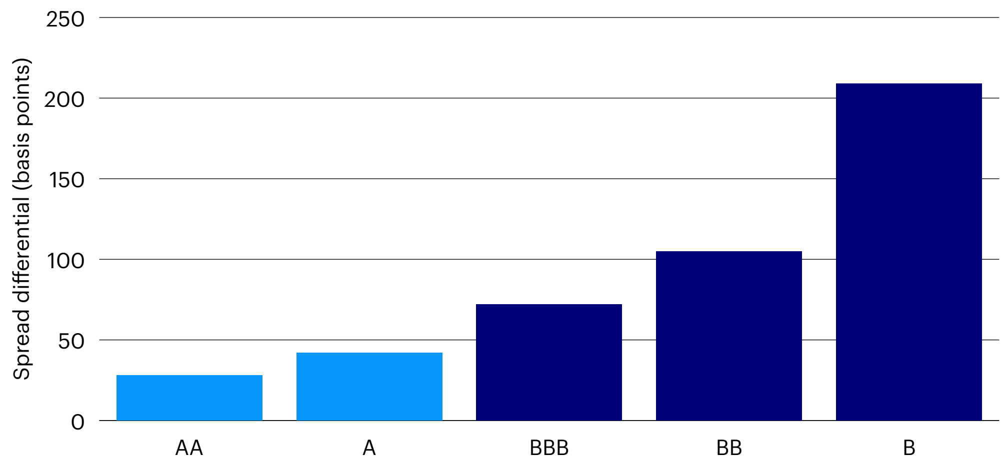
Figure 11: EM investment grade corporate yield-to-worst (%)



Source: JP Morgan. Data as of March 30, 2023.

In addition, EM's relative value versus DM looks attractive, in our view, especially considering the improved credit profile of EM investment grade. As Figure 12 shows, EM debt has consistently offered an attractive spread pick-up versus comparably rated credit over time. While the spread pick-up in the investment grade space is less than in high yield, even a modest difference in spread can make a significant difference in terms of total returns over time.

Figure 12: Average EM credit spread differential vs US credit - Past five years



Source: Bloomberg L.P. JPM EMBI Global Diversified Investment Grade Index. JPM Corporate Broad EMBI Diversified High Grade Index. Bloomberg US Corporate Index. Data as of March 30, 2023.

While aggregate average spread differentials highlight the relative value of the EM asset class, there are limitations, as credit ratings do not tell the whole story. Rather, we find that issuer comparisons are best when illustrating the value offered by the asset class. Figure 13 provides examples of EM and DM companies with comparable operations and credit profiles. These examples show that EM companies generally offer even more attractive yield and spread pick-up versus comparably rated DM companies than when compared based on aggregate ratings alone.

Figure 13: Sector comparisons of EM vs DM

	Bottlers		Home Improvement		Supermarkets	
USD Figures	**EM**	**DM**	**EM**	**DM**	**EM**	**DM**
Net Revenue	3,118	43,004	16,331	157,403	16,331	148,258
EBITDA Margin	12.7	28.3	10.5	17.2	10.5	4.8
Net Leverage	2.33	2.38	3.06	1.76	3.06	2.74
Sr Rating	**BBB/A-**	**A1/A+**	**Baa3/BBB**	**A2/A**	**Baa3/BBB**	**Baa1/BBB**
Maturity	2032	2032	2027	2027	2027	2027
Issue Size	600MM	2MM	974.789MM	750MM	974.789MM	600MM
OAS	174	53	171	28	171	77
	+121 bps		**+143 bps**		**+94 bps**	
YTW	5.45%	4.10%	5.74%	4.05%	5.74%	4.53%
	+1.35%		**+1.69%**		**+1.21%**	

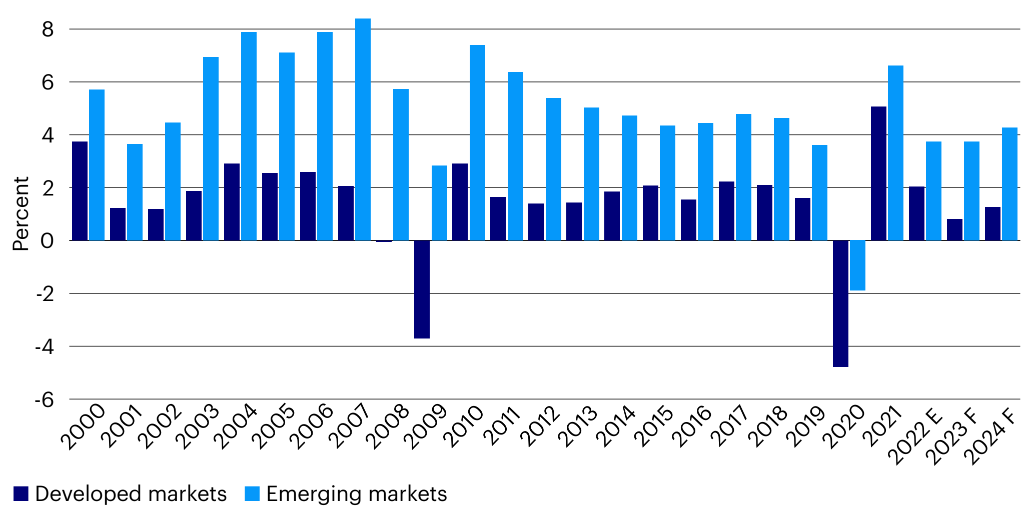
	Protein		TMT		Telecom Towers	
USD Figures	**EM**	**DM**	**EM**	**DM**	**EM**	**DM**
Net Revenue	956	53,282	2,922	120,741	455	10,711
EBITDA Margin	11.0	8.6	50.2	14.7	91.0	64.7
Net Leverage	0.33	1.66	2.00	8.14	7.03	6.50
Sr Rating	**Baa3/BBB-**	**Baa2/BBB+**	**BBB-/BBB**	**Baa2/BBB**	**Baa3/BBB-**	**Baa3/BBB+**
Maturity	2052	2048	2026	2026	2032	2033
Issue Size	900MM	1.5MM	561.815MM	1.75MM	1MM	800MM
OAS	285	171	164	-22	310	163
	+114 bps		**+186 bps**		**+147 bps**	
YTW	6.69%	5.60%	5.89%	5.22%	6.84%	5.25%
	+1.09%		**+0.69%**		**+1.58%**	

Source: Bloomberg L.P. Data as of March 30, 2023.

Economic growth trends support the EM value proposition

Despite an expected slowdown in DM, EM growth is expected to remain strong in the coming year. We expect EM GDP growth to reach 4% or higher in 2023, compared to expectations of tepid growth and an increasing risk of recession in DMs.

Figure 14: EM vs DM GDP growth

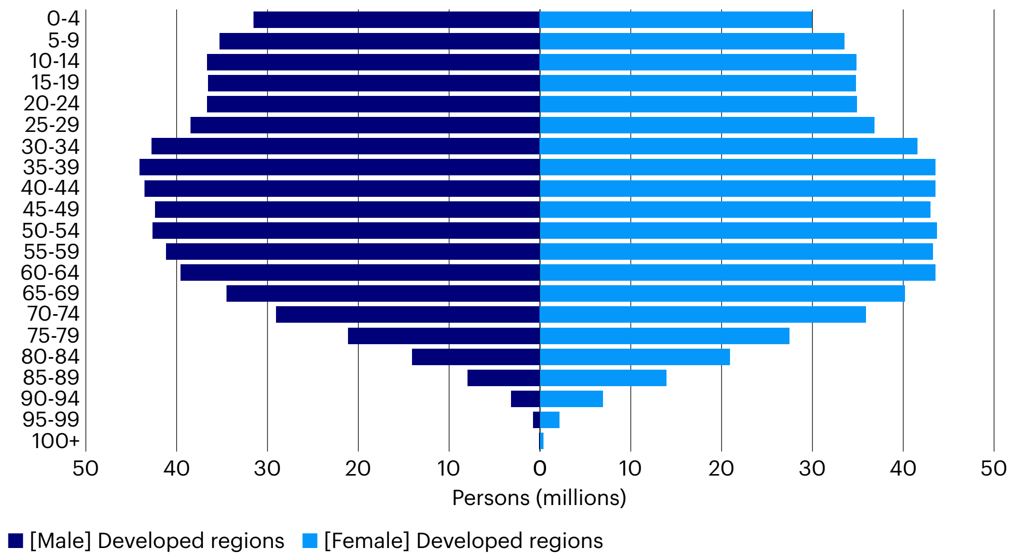


Source: BofA. Data as of March 30, 2023.

Taking a longer-term view, the prospect for EM growth to outpace more advanced economies for a prolonged period is strong, in our view. Currently, EM economies account for 40% of global GDP, but 85% of the world's population. In addition, as Figure 15 shows, the age distribution in EM is skewed younger, which is favorable from a growth perspective.[3] The DM world faces a large and growing older population and a shrinking younger, working age population. These are powerful demographic trends with major economic implications for the next two decades. If current EM growth differentials hold, EM will account for more than 50% of global GDP in the next 20 years, up from 40% today, according to the World Bank.[4]

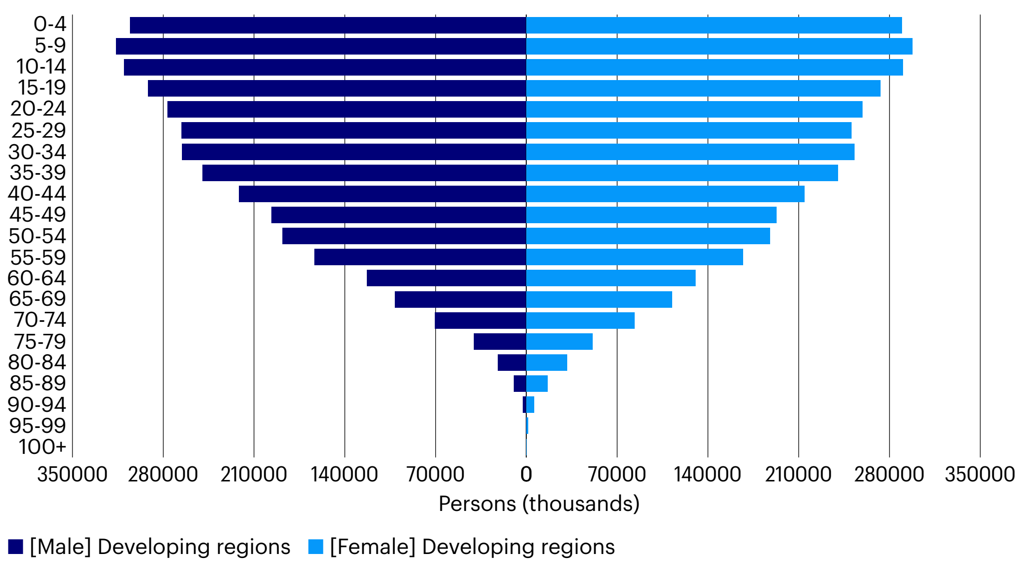
Figure 15: Age distribution of EM vs DM

Developed regions (DM)



Source: World Bank. Data as of March 30, 2023.

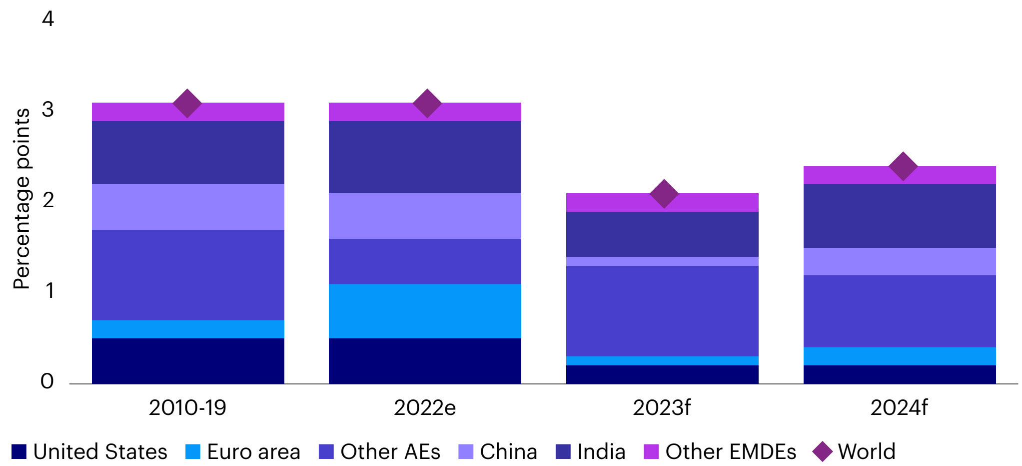
Developing regions (EM)



Source: World Bank. Data as of March 30, 2023.

This trend has already become evident in the diminishing contributions of the US and Europe to global growth compared to the developing world (Figure 16).

Figure 16: Contributions to global growth



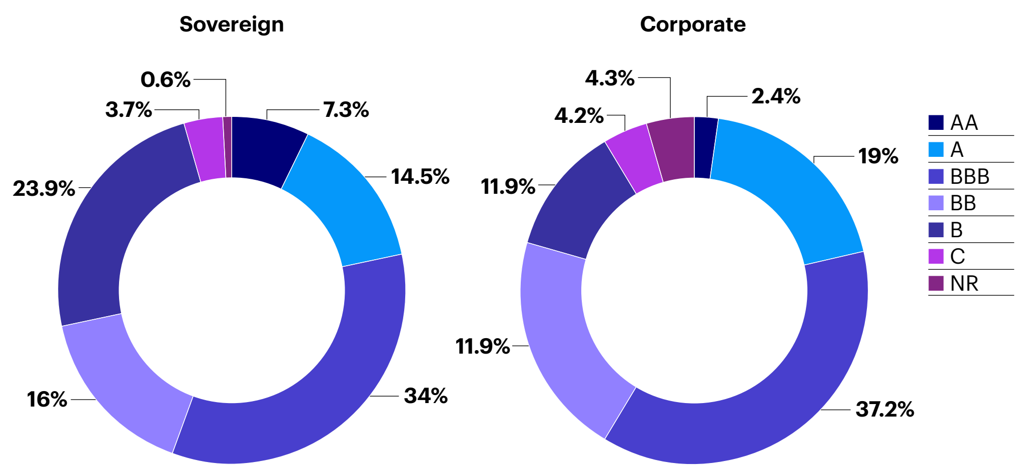
Source: World Bank. Data as of March 30, 2023.

Note: AEs = advanced economies; EMDEs = emerging market and developing economies. Aggregate growth rates and GDP per capita calculated using real US dollar GDP weights at average 2010-19 prices and market exchange rates. Data for 2023 and 2024 are forecasts.

Diversification benefits and broad investment opportunity

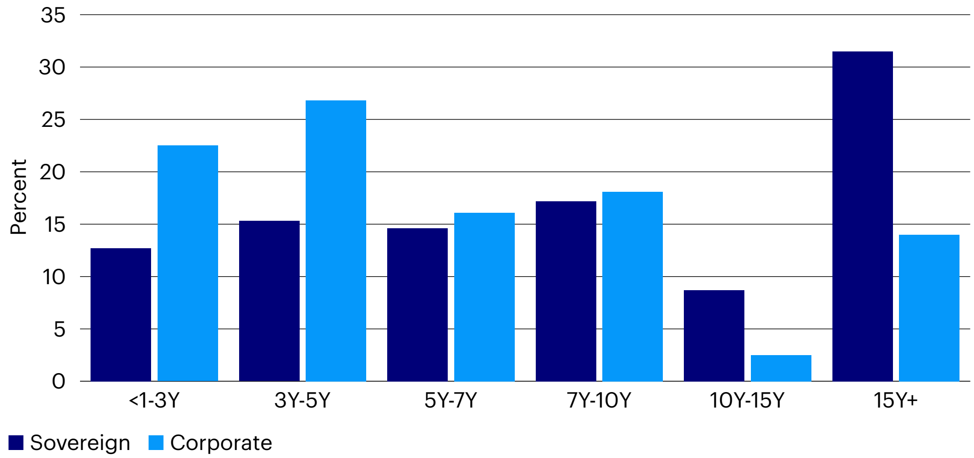
Beyond the primary consideration of attractive risk-adjusted returns, EM debt also offers diversification benefits. In the past, a justifiable view held that EM hard currency debt was a narrow, highly correlated asset class. That is no longer the case. As figures 17 and 18 show, the market is quite broad in terms credit quality and maturity profile, which reflects the strong growth in market size over the past decade of more than six times for corporates and three times for sovereigns.

Figure 17: EM credit rating profile - % of EM indices



Source: JP Morgan. Data as of March 30, 2023. Percentages of JPM EMBI Global Diversified Investment Grade Index and JPM Corporate Broad EMBI Diversified High Grade Index.

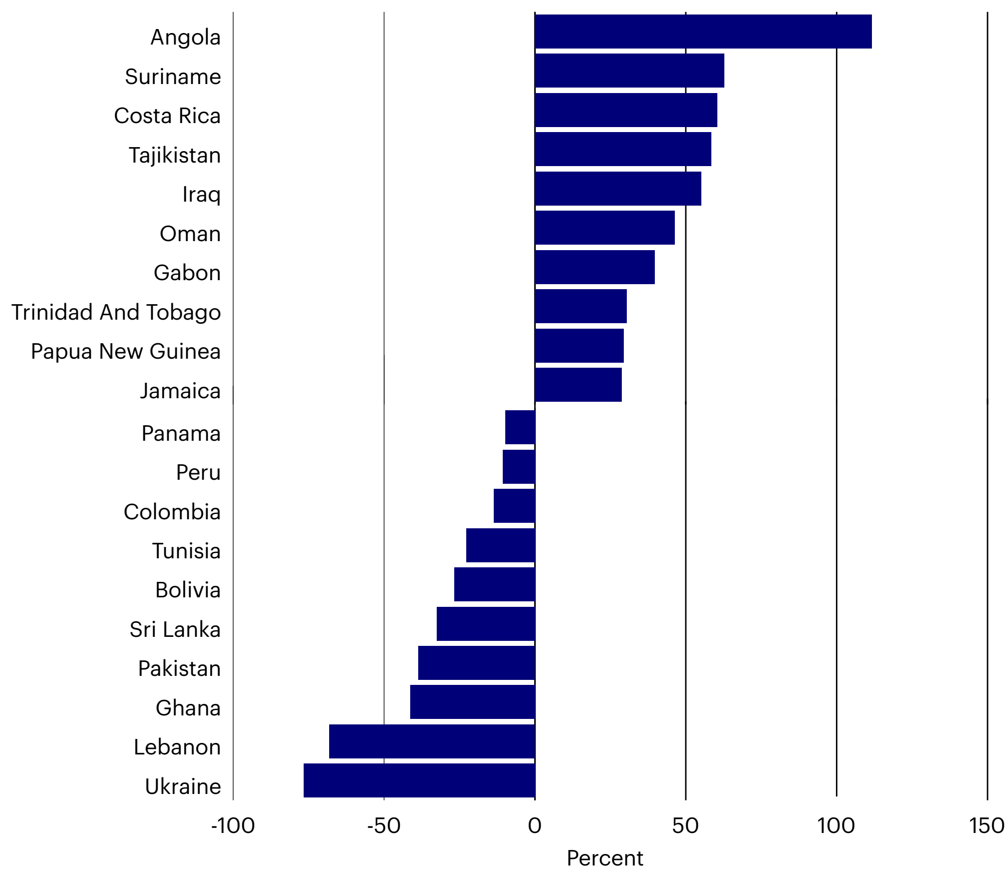
Figure 18: EM credit maturity profile - % of EM indices



Source: JP Morgan. Data as of March 30, 2023. Percent of JPM EMBI Global Diversified Investment Grade Index and JPM Corporate Broad EMBI Diversified High Grade Index.

Additionally, EM has displayed a significant dispersion of returns by region, country and individual issuer, especially during periods of stress. Global EM and DM hard currency bonds are somewhat correlated based on major macro drivers, such as US rate moves. However, in the same way that returns can diverge between EM and DM credits, absent broad macro drivers, the same is true within EM. Over the past three years, returns within EM have ranged from deeply negative to sharply positive. Even within the investment grade universe, the dispersion of returns has been high, with the best performing country up over 100% and the worst performing country down more than 50% (Figure 19).

Figure 19: EMBI top-10 and bottom-10 three-year total returns (%)



Source: JP Morgan. EMBI is Emerging Markets Bond Index. Data as of March 30, 2023. **Past performance is not a guarantee of future results.**

This dispersion is not surprising, given the varied economic impact of shocks, such as the pandemic, and then rising global interest rates. It highlights the diversification benefits of the asset class, especially in the context of credit risk. The trajectories of the economic fundamentals in China, Peru, Qatar and Malaysia, for example, are vastly different from each other and those in the US. At any given time, these countries are at different points in their economic cycles, providing potential diversification against fundamental credit risk, as any negative shock will likely affect each economy differently. This was true in the 2008/2009 financial crisis, when EM economies fared better than DM economies, and again during the 2020 pandemic, when the impact and rate of recovery has varied significantly.

Currency considerations – Cross currency swaps

The EM credit asset class comprises a sizeable debt stock denominated in euros, though most of the market is denominated in US dollars. This can create some uncertainty for European institutions, whose base currency is euros or pounds. Foreign exchange hedging in such situations has typically been done using currency forwards on a one-to-six month basis. While relatively simple to implement, such a strategy leaves longer-term investors subject to fluctuations in hedging costs. Over the past three years, for example, costs have fluctuated from 1.8% to 3.2% and back to 1.9%.[5] Such movements can significantly impact returns and may be problematic for investors seeking certainty over the life of their portfolios. By using a slightly more complex hedging strategy that makes use of cross currency swaps, insurers may be better able to match hedges to the duration of their portfolios. We find this is a more efficient approach to managing foreign exchange risk than simple hedges using currency forwards.

Regulatory capital treatment

European insurance regulation is straightforward in its treatment of all fixed income assets, regardless of their origin. Under the Standard Formula of Solvency II, the capital charge is captured under the spread risk, as with other bonds. There is no specific treatment for EM debt.

Standard formula considerations

If hedged into local currency, an EM bond consumes no more capital than a domestic bond with an equivalent rating.

For the bonds and loans of central banks and governments denominated in their own currencies, specific favorable shocks apply (Article 180.3). Compared to corporate bonds, these shocks are more favorable.

Matching adjustment considerations

EM debt that is completely swapped back into sterling (using cross currency swaps) is eligible for a matching adjustment.[6]

Conclusion

EM investment grade debt is a large, diverse asset class that offers attractive value and will likely make up an increasingly large share of the global fixed income universe. As such, we believe an allocation to the asset class warrants serious consideration by insurers. At Invesco, we have extensive experience investing in EM debt and working with institutional clients to provide access to the asset class via tailored solutions that meet their exact requirements.

1. Source: JP Morgan. Data as of March 30, 2023.
2. Source: World Bank. The WGI provides a ranking of 215 countries and territories based on six dimensions of governance, including political stability, government effectiveness, and control of corruption.
3. Source: World Bank. Data as of March 30, 2023.
4. Source: World Bank, Global Economic Outlook. Data as of March 30, 2023.
5. Source: Bloomberg L.P. Data as of March 30, 2023.
6. The "matching adjustment" allows insurers to discount the valuation of their long-term liabilities under Solvency II at a more favorable discount rate than the usual risk free rate where certain eligibility criteria are met, thereby reducing the assets required to be held against those liabilities.

Investment risks

The value of investments and any income will fluctuate (this may partly be the result of exchange rate fluctuations) and investors may not get back the full amount invested.

Fixed-income investments are subject to credit risk of the issuer and the effects of changing interest rates. Interest rate risk refers to the risk that bond prices generally fall as interest rates rise and vice versa. An issuer may be unable to meet interest and/or principal payments, thereby causing its instruments to decrease in value and lowering the issuer's credit rating.

The risks of investing in securities of foreign issuers, including emerging market issuers, can include fluctuations in foreign currencies, political and economic instability, and foreign taxation issues.

The performance of an investment concentrated in issuers of a certain region or country is expected to be closely tied to conditions within that region and to be more volatile than more geographically diversified investments.

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