

PLAYING DEFENSE IN EMERGING MARKET FIXED INCOME

Bradley Krom — Head of U.S. Research
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When looking around the global fixed income landscape, investors searching for income potential have essentially two choices: [non-investment grade debt](#) or emerging markets (EM). While high yield flows continues to dominate the headlines, emerging markets have generally flown under the radar in recent months. In this discussion, we focus on how investors may be able to best position against a change in Federal Reserve (Fed) policy while maintaining income potential from investments in emerging markets. As we will show, emerging market corporate debt¹ remains an underutilized tool in many investor portfolios, particularly when confronted with the prospect [rising U.S. interest rates](#). While U.S. interest rates have fallen so far this year, many investors continue to debate an eventual normalization of Fed policy. In a [previous blog post](#) we highlighted how [U.S. Treasuries](#) and [investment-grade fixed income](#) fared during the “taper tantrum” compared to the actual commencement of [tapering](#). In a classic “sell the rumor, buy the fact” scenario, rates rose in advance of any change in policy, only to decline after the Fed actually started to scale back purchases. As we show in the table below, when comparing both variants of U.S. dollar-denominated fixed income in emerging markets, we can contrast the various drivers of return over both periods.

	Total Returns		Spread Returns		Treasury Returns	
	EM Sovereigns	EM Corporates	EM Sovereigns	EM Corporates	EM Sovereigns	EM Corporates
Taper Tantrum	-6.08%	-2.81%	-2.28%	-0.26%	-3.89%	-2.56%
Actual Tapering	9.87%	6.98%	5.03%	3.95%	4.60%	2.92%
Cumulative Period	3.19%	3.98%	2.64%	3.68%	0.53%	0.29%

EM Sovereigns proxied by the JPMorgan EMBI Global. EM Corporates proxied by the JPMorgan CEMBI Broad Index. Taper Tantrum: 5/22/13–12/17/13. Actual Tapering: 12/18/13–8/31/14. Source: J.P. Morgan, as of 8/31/14. Past performance is not indicative of future results. You cannot invest directly in an index.

For definitions of indexes in the chart, please visit our [glossary](#). During the “taper tantrum,” many investors were initially caught off guard by the implications of Fed chairman Ben Bernanke’s comments. As the market grappled with this potential shift in policy, [U.S. Treasury yields](#) rose. At the same time, rising interest rates caused many investors to reduce their exposure to emerging markets. Investors reasoned that with rates in the U.S. heading higher, opportunities in emerging markets appeared less attractive by comparison. As investors sold, [credit spreads widened](#). Interestingly, even though the investable universe for EM corporate debt is now significantly larger than the market for [sovereign debt](#) denominated in U.S. dollars (\$806 billion versus \$671 billion)², EM sovereigns have tended to have a much higher percentage allocation in global investors’ portfolios. According to J.P. Morgan, assets benchmarked against EM sovereign debt are nearly five times as large as EM corporate debt (\$296 billion versus \$64 billion)³. In our view, EM sovereigns represent a much more crowded trade than EM corporates. As a result, they may be more sensitive to changes in capital flows into and out of emerging markets. This can be clearly evidenced by EM sovereign spread returns when outflows accelerated from EM debt in the second half of 2013. Even with higher levels of income, the returns from credit cost investors more than 2%. Looking at the other driver of total returns, EM corporate bonds experienced less pain during the sell-off due to their shorter duration compared to EM sovereigns (5.44 years versus 7.23 years)⁴. Since the actual tapering of asset purchases began December 18, EM sovereign bonds have outperformed EM corporate bonds. However, this performance gap can largely be explained by its previous period of significant underperformance. When looking over the entire period, EM corporate bonds experienced less drawdown and greater total returns. In an environment where investors are concerned about [rising U.S. rates](#), investors should consider a shift from EM sovereigns to EM corporates. As we have mentioned [previously](#), we believe emerging market corporate bonds represent a more attractive alternative to EM sovereign debt on account of wider credit spreads, lighter investor positioning and lower sensitivity to interest rate risk. While the timing and future path of U.S. interest rates remains far from certain, EM corporate bonds could represent a more defensive

alternative to other emerging market fixed income options. ¹As proxied by the J.P. Morgan CEMBI Broad. ²Source: J.P. Morgan, as of 8/31/14. ³Source: J.P. Morgan, June 2014. ⁴Source: J.P. Morgan, as of 8/31/14.

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You cannot invest directly in an index.

DEFINITIONS

Non-investment grade debt : Sometimes referred to as “junk bonds,” these securities have a higher risk of default than investment-grade securities.

Interest rates : The rate at which interest is paid by a borrower for the use of money.

U.S. Treasury Bond : a debt security issued by the United States government.

Investment Grade : A rating given to a municipal or corporate bond. It is a relatively favorable rating by either Moody's or Standard & Poor's indicating a higher chance an issuer performs interest and principal obligations as promised by the terms of the debt issuance.

Tapering : A shift in monetary policy by which the Federal Reserve would begin decreasing the amount of bonds it purchases.

Treasury yield : The return on investment, expressed as a percentage, on the debt obligations of the U.S. government.

Credit spread : The portion of a bond's yield that compensates investors for taking credit risk.

Widen : an increase in the amount of compensation bond holders require to lend to risky borrowers. When spreads widen, the market is implying that borrowers pose greater risk to lenders.

Sovereign Debt : Bonds issued by a national government in a foreign currency, in order to finance the issuing country's growth.