

# CORPORATE VERSUS GOVERNMENT DEBT IN EMERGING MARKETS

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11/12/2013

When investors think of emerging market (EM) growth, they are often drawn to emerging market equities as their first and only stop. But with the path of interest rates now potentially “lower for longer” under a Yellen Federal Reserve, bond market investors appear to be resuming their global hunt for yield. In our view, emerging market [corporate bonds](#) may represent an attractive option for investors who believe in the emerging market story but want to participate in a lower-[volatility](#), higher-income approach than emerging market equities. **Emerging Market Corporations** When talking about EM corporate bonds, we are referring to bonds that are issued in U.S. dollars and trade at [credit spreads](#) relative to [U.S. Treasury debt](#) (just like bonds issued by U.S. companies). This market has grown in size as higher-credit-quality EM governments with more established credit histories have increasingly migrated their debt issuance to [locally denominated debt](#) due to lower funding costs and risks.<sup>1</sup> However, the market does not allow all borrowers to issue local currency debt. In our view, this has the effect of biasing the investable universe of emerging market government debt denominated in U.S. dollars to less desirable [credit risks](#). Ultimately, we believe that the risk/reward trade-off of lending to a large, multinational corporation headquartered in an emerging market country may provide a better balance between yield, [credit quality](#) and [interest rate risk](#) than [dollar-denominated debt](#) issued by EM governments. Given the robust demand from international investors for credit risk in emerging markets denominated in U.S. dollars, we believe the EM corporate asset class may continue to grow at the expense of EM government debt. In our view, this may be due to the increasing degree of familiarity investors have with these corporations. After investing in these companies’ equity for the last decade, investors have seen many of them grow to multi-billion-dollar concerns. However, in both instances (equity and debt), investors are exposed to potential [transfer risk](#). But just as in the United States, bondholders have a direct claim on assets during a credit event, whereas equity holders are lower in the capital structure and are paid last, if at all. **Why Not Government Debt?** In our view, we believe that the current compensation offered by the market for bearing transfer risk is attractively priced in the bond market. Additionally, if recent history has taught us anything, investing in government debt with a significant amount of credit risk (such as Greece) seems counterintuitive. If a government is unable to repay their debt, what recourse do creditors necessarily have? Also, generally speaking, governments derive their revenues from taxation, whereas corporations derive them through the sale of goods or services. In our opinion, the more intuitive way of profiting from emerging market growth is to be found through investments in the companies that are the actual drivers of these higher growth rates in emerging markets. In order for many of these companies to grow, they need access to capital. Emerging market corporate debt is one means of financing their growing businesses. **Evolution of the Index** Over the past 10 years, the investable universe of emerging market government debt<sup>2</sup> has changed profoundly, as measured by the [J.P. Morgan EMBI Global](#). In fact, over this 10-year period, 32 additional countries / issuers have entered the index. Today, these 32 new countries now account for approximately 20% of the overall investable universe.<sup>3</sup> Even more striking is the evolution of the largest issuers. **J.P. Morgan EMBI Global: Top 10 Issuers Then versus Now**

J.P. Morgan EMBI Global: Top 10 Issuers as of 9/30/2003

Country	Weight 9/30/2003	Weight 9/30/2013
Brazil	18.75	7.36
Mexico	18.68	11.71
Russia	15.61	9.65
Turkey	5.28	7.65
S Korea	4.71	0
Malaysia	4.21	1.35
Philippines	4.03	4.81
Colombia	3.61	2.85
Venezuela	3.14	8.38
Peru	2.14	2.06
<b>Sum of Top 10</b>	<b>80.16</b>	<b>55.82</b>

J.P. Morgan EMBI Global: Top 10 Issuers as of 9/30/2013

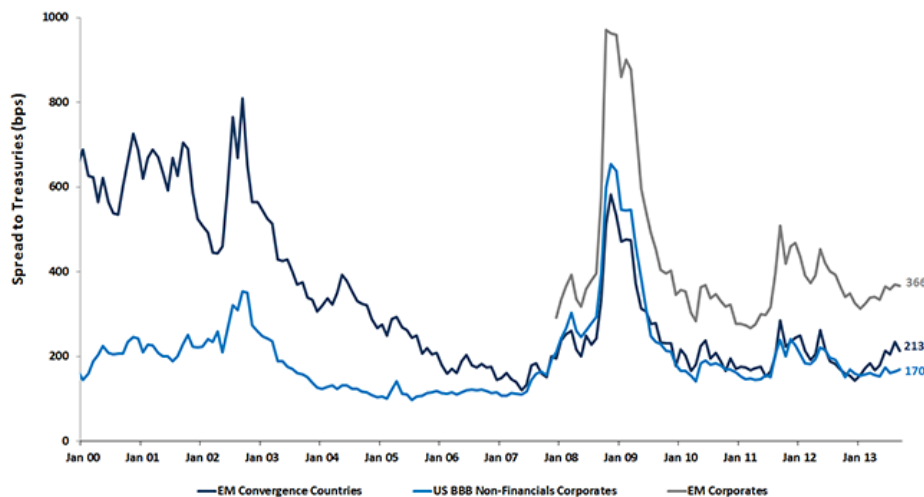
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Russia	15.61	9.65
Venezuela	3.14	8.38
Turkey	5.28	7.65
Brazil	18.75	7.36
Indonesia	0	6.84
Philippines	4.03	4.81
Colombia	3.61	2.85
Kazakhstan	0	2.75
Lebanon	1.58	2.6
<b>Sum of Top 10</b>	<b>70.68</b>	<b>64.60</b>

Subject to change. You cannot invest directly in an index.

As shown in the table above, 10 years ago, the investable universe was dominated by Brazil, Mexico and Russia. Today, the index has become much broader, but is comprised of emerging economies that have much shorter borrowing histories and lower credit ratings. In our view, although more countries are currently represented in the index, smaller, more questionable issuers have risen in prominence relative to larger economies. For example, Venezuela is now the third-largest issuer in the index. This ranks them just behind Russia, a drastically different economy and risk profile. Given the broadening of the index, returns and yields are increasingly being influenced by smaller issuers. For many investors seeking to increase exposure to emerging markets, they generally tend to think about the larger, more widely followed economies, as opposed to the smaller, less established countries. In its current form, the top 10 issuers now account for only approximately two-thirds of the weight of the index.

**Determinants of Interest Rates** Bond yields seek to compensate investors in a variety of ways. In an effort to pinpoint the potential drivers of return, we thought it might be helpful to decompose a bond's yield into its various components: 1) **Nominal Interest Rates** – Perhaps the largest contributor of yield, this portion of a bond's return seeks to compensate investors for the time value of money; it's essentially compensation for taking interest rate risk. 2) **Credit Spread** – The additional income in excess of nominal interest rates that lenders demand for the risk that they may not be paid back. 3) **Transfer Risk** – Technically, this could be a portion of the credit spread, but by identifying it separately, we are able to compare the emerging market "premium" to similarly positioned businesses headquartered in developed markets.

**Relative Credit Spreads Between U.S. Corporates, EM Corporates, & EM Government Debt**



Sources: J.P. Morgan, Bloomberg, Western Asset Management, September 30, 2013

Convergence countries spread defined as the average of Emerging Market Bond Index Plus subcomponents Brazil, Colombia, Mexico, Panama, Peru, Indonesia, Philippines, Russia, Turkey and South Africa. US BBB Non-Financials Corporates represented by the J.P. Morgan US Liquid Non-Financials Index. EM Corporates represented by the J.P. Morgan CEMBI Broad.

Past performance is not indicative of future results.

**Managing Risk** Emerging market investing is certainly not without risks. Even though emerging market corporate bonds have exhibited approximately half as much volatility as emerging market equities over the last five years, unforeseen events can and do

occur. Ultimately, we believe that at current levels, emerging market corporate bonds provide investors with enough compensation relative to emerging market government debt for the potential risks. <sup>1</sup>A principal risk is of issuing debt in a foreign currency is referred to as "original sin". This term was made famous by economist Barry Eichengreen due to the inherent asset-liability mismatch from issuing debt in a foreign currency (assets are denominated in local currency, but liabilities are denominated in a foreign currency). The thinking goes that as the country comes under economic stress, the value of the its own currency is likely to decline. As its currency declines, the country's debt burden is actually increasing in foreign currency terms at precisely the same time that it is less likely to be able to repay it. <sup>2</sup>As represented by the JPMorgan EMBI Global. <sup>3</sup>Source: J.P. Morgan, 9/30/13.

**Important Risks Related to this Article**

Investments in emerging, offshore or frontier markets are generally less liquid and less efficient than investments in developed markets and are subject to additional risks, such as risks of adverse governmental regulation and intervention or political developments.

For standardized performance and the most recent month-end performance click [here](#) NOTE, this material is intended for electronic use only. Individuals who intend to print and physically deliver to an investor must print the monthly performance report to accompany this blog.

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You cannot invest directly in an index.

## DEFINITIONS

**Corporate Bonds** : a debt security issued by a corporation.

**Volatility** : A measure of the dispersion of actual returns around a particular average level.&nbsp;

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

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

**Locally denominated debt** : Debt denominated in local currencies issued by an emerging market government.

**Credit risk** : The risk that a borrower will not meet their contractual obligations in conjunction with an investment.

**Credit quality** : A measure of a borrowers potential risk of default.

**Interest rate risk** : The risk that an investment's value will decline due to an increase in interest rates.

**Dollar-denominated debt** : Debt that is issued in U.S. dollars and must be paid in U.S. dollars. If the issuer's local currency depreciates against the U.S. dollar, it becomes more expensive for the issuer to pay off the debt; if the issuer's local currency appreciates against the U.S. dollar, the debt obligation becomes less expensive.

**Transfer risk** : The risk that a company's assets or profits are appropriated by the government.

**JP Morgan Emerging Markets Bond Index Global (EMBI Global)** : The JPMorgan Emerging Markets Bond Index Global (EMBI Global) tracks total returns for US dollar-denominated debt instruments issued by emerging market sovereign and quasi-sovereign entities including Brady bonds, loans, Eurobonds.