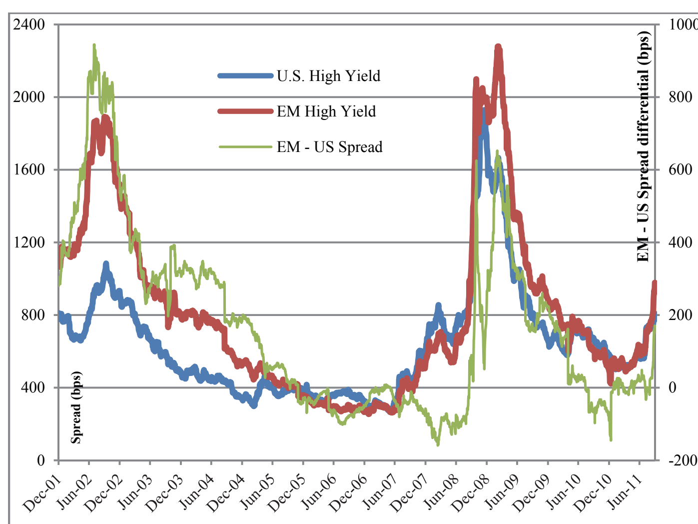
Emerging Markets High Yield Corporate Bonds Underperform U.S. High Yield Corporate Bonds Despite Stronger Credit Metrics

Robert Rauch rrauch@gramercy.com +1-203-552-1905
Carlos Gomez cgomez@gramercy.com +1-203-552-1959

September 7, 2011

Emerging markets ("EM") high yield corporate bonds have underperformed U.S. high yield corporate bonds by a wide margin in this recent market downturn. JPMorgan's CEMBI Broad Diversified High Yield Index ("CEMBI") has fallen by 13.8% over the past two months, twice the decline of 6.1% recorded by JPMorgan's Domestic High Yield Index ("Domestic"). The discount of EM high yield versus U.S. high yield has widened to 171 bps after trading flat during the earlier part of the year. The weak performance has been exacerbated by large investor outflows in recent weeks. EPFR reported that dedicated EM bond funds had an outflow of $3.2 billion during the last week of September, the largest weekly outflow since they started collecting data. The large outflow is partly a reflection of the significant amount of new investors that flocked to EM high yield in their search for yield. In a little over two years, the EM high yield bond market has grown by 51.5% to $278 billion in September 2011, according to JP Morgan estimates.

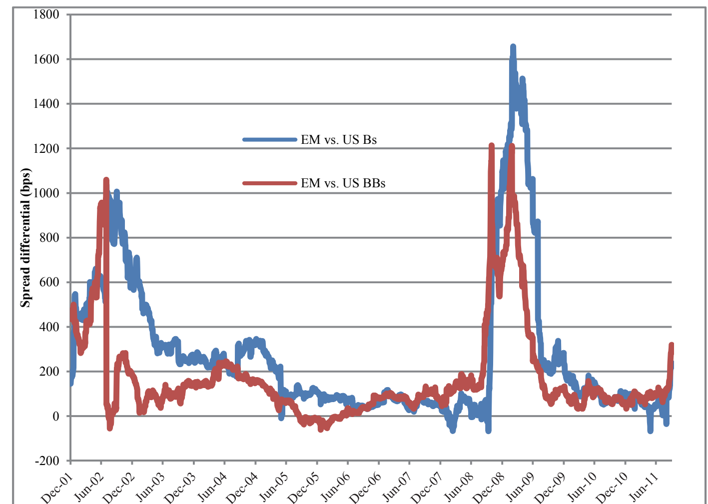
Exhibit 1: Spreads Between EM and U.S. High Yield



Note: EM High Yield (JPMorgan's CEMBI Broad Diversified High Yield Index), U.S. High Yield (JPMorgan's Domestic High Yield Index).

A closer examination of the index data (shown above) reveals that, while the CEMBI has traded at a premium to the Diversified for much of the period from 2006 until recently, a majority of this can be ascribed to the higher credit quality of the CEMBI. Disaggregating the index data by credit rating to eliminate this structural bias (e.g. higher credit quality of the CEMBI versus the Diversified), reveals that EM has not traded at a premium to the U.S. on a consistent basis since early 2008. Exhibit 2 (to the right) shows that EM BB's traded at a premium to U.S. BB's from late 2005 to mid-2006, and B's traded at a premium for a short period in early 2008.

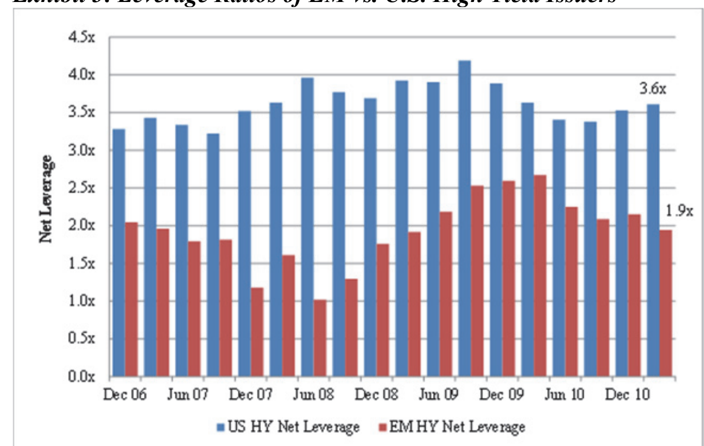
Exhibit 2: Spreads Between EM and U.S. High Yield by Credit Rating



Note: EM High Yield (JPMorgan's CEMBI Broad Diversified High Yield Index), U.S. High Yield (JPMorgan's Domestic High Yield Index).

While much of the inflows to EM high yield have been from dedicated EM investors, a significant share has come from cross-over U.S. high yield managers. JPMorgan reports that a sample of U.S. high yield accounts had 2.59% of their assets in EM as of 2Q11, an increase over the 1.82% held in 2Q10. In times of spread tightening, U.S. high yield investors tend to buy cheaper EM corporates to enhance their returns, while the opposite occurs in periods of spread widening. JPMorgan recently found that EM corporate bonds typically held by U.S. high yield accounts have underperformed the CEMBI in both spread and yield in the recent sell-off. On average, the issues more heavily owned by U.S. accounts widened 177 bps in yield and 241 bps in spread versus 61 bps and 126 bps for the CEMBI, respectively.

Exhibit 3: Leverage Ratios of EM vs. U.S. High Yield Issuers



Source: Barclays (leverage defined as net debt to EBITDA)

The weaker performance of EM high yield credits has occurred despite the fact that they enjoy stronger credit metrics than their U.S. peers. Exhibit 3 (on page 1) illustrates the net leverage metrics for non-financial corporate issuers (EM and U.S. high yield) over the past five years, showing that EM issuers are consistently less levered than their U.S. counterparts through all economic cycles – EM issuers were 1.9x net levered vs. 3.6x for the U.S. as of 1Q11. Investors have ignored the superior quality of EM corporates and consider them riskier than their U.S. counterparts. Historically, EM has traded at a 167 bps average discount, varying depending on the perception of recession risk in the market.

There are a number of reasons why investors consider EM high yield a riskier asset, but the key factors are sovereign and jurisdictional risks. Although governments in emerging economies have increasingly unregulated their economies, historically, they have been less disciplined fiscally and tend to intervene more in the economy in the form of nationalizations, currency interventions, or price controls. On a related matter, there are substantial differences in creditor rights between EM and developed economies. Most emerging markets economies continue to have highly immature bankruptcy regimes that typically favor the debtors. Further, EM corporate issuers typically have weaker corporate governance and transparency towards investors. Finally, many EM high yield issuers earn their cash flows in local currencies and their debt leverage and liquidity ratios automatically deteriorate in periods when currencies depreciate.

Notwithstanding these issues, the current underperformance of EM high yield corporate bonds provides a buying opportunity for long-term investors. Despite their higher volatility and riskiness, EM high yield corporates offer better credit quality and have outperformed U.S. high yield corporates in the past decade, with EM high yield trading through U.S. high yield spreads in 2006 to 2008 and again in 2010 to 2011. The CEMBI has returned 151.8% since December 2001, while the Domestic has returned 127.6%. The supply technicals remain favorable: last year, EM companies issued a record $69 billion in high yield bonds; while there has been $65 billion of new EM high yield issuance in 2011 YTD, most of this was in the first half of the year with only $3.9 billion of issuance in August and September. We think that EM high yield will continue to be one of the most attractive investment classes in the next several years. The attractiveness of yield is likely to continue in the near term as interest rates are likely to remain low for many years, while historical evidence indicates that high yield bonds provide superior risk adjusted returns versus equities and sovereign debt in periods of fragile economic growth. In conclusion, in addition to being stronger credits, we expect EM corporates to experience a continuous spread re-pricing in the future reflecting the ongoing improvement in EM sovereign fiscal profiles, a wider investor base, and greater transparency.

* * * * * * * * * * * * * * *

This document is for information purposes only. Under no circumstances should this document be used or considered as an offer to sell or a solicitation to buy the securities or other instruments mentioned in it. Gramercy Funds Management LLC and its affiliates ("**Gramercy**") make no representations concerning the truth or accuracy of the content or substance of this report, or of the future market value of any securities, notes, or private claims mentioned within. The information in this document has been obtained from sources believed reliable, but we do not represent that it is accurate or complete and it should not be relied upon as such. Opinions expressed herein constitute our opinion as of the date published and are subject to change without notice, and Gramercy makes no representations that it will endeavor to update its analysis upon any change of circumstances. The products mentioned in this document may not be eligible for sale in some states or countries. Gramercy and its officers, directors, or shareholders may from time to time have long or short positions in the company mentioned in this document. ©2011 Gramercy