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An Emerging Opportunity

A growing number of investors see an attractive opportunity in high yield bond spreads. In an environment of various headwinds against equity-market multiples, the potential income offered by high yield looks like a competitive way to add portfolio risk. Estimates for defaults in the ongoing economic downturn are relatively modest due to generally strong issuer fundamentals. The case is reinforced by signs that U.S. inflation appears to be cooling off and the monetary policy outlook is stabilizing.

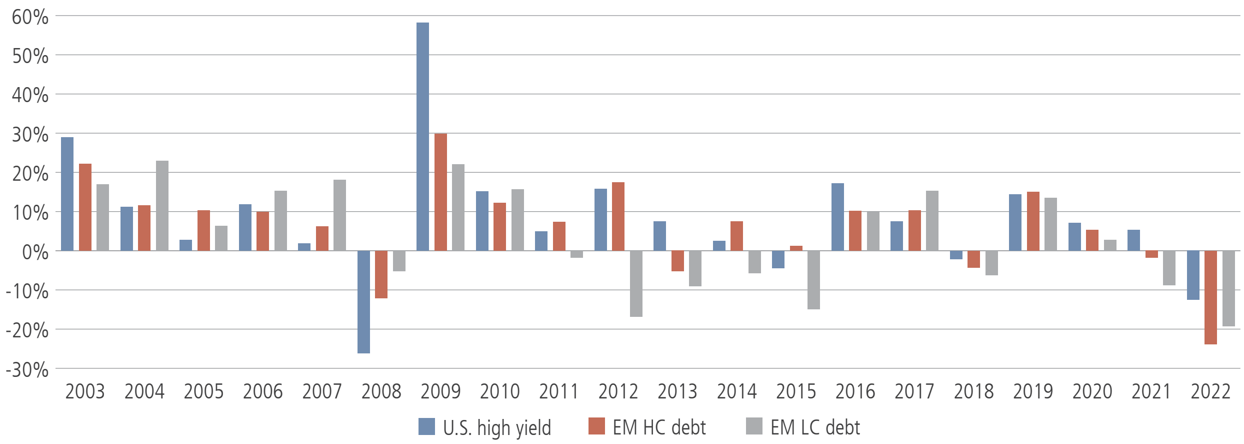
There is not the same appetite for emerging markets debt. According to JPMorgan, more than $80 billion had flowed out of these markets during 2022 to the end of October, with little sign of a slowdown. And yet we would argue that much of the case for high yield also holds for emerging markets—and historically, when high yield has performed well, emerging markets have tended to follow.

If you are one of the many investors looking positively at high yield bonds, might it be time to consider emerging markets debt, too?

As figure 1 shows, a positive year for U.S. high yield bonds is often a positive year for emerging markets hard currency sovereign bonds. Monthly returns to the two asset classes have exhibited consistently high correlation over the past 20 years. The correlation between U.S. high yield and emerging markets local currency bonds has been slightly weaker, but still high; indeed, it has been higher than the correlation between U.S. high yield and U.S. investment grade corporate bonds.

FIGURE 1. WHERE HIGH YIELD LEADS…

Calendar year total returns, 2003 – 2022



Full-period correlation of monthly returns, 2003 – 2022

	U.S. HY	U.S. IG	EMBI	EMBI IG	EMBI HY	GBI-EM
U.S. HY	1.00	0.64	0.78	0.67	0.79	0.65
U.S. IG		1.00	0.81	0.87	0.69	0.57
EMBIGD (Hard Curr)			1.00	0.94	0.97	0.80
EMBIGD IG (Hard Curr)				1.00	0.82	0.72
EMBIGD HY (Hard Curr)					1.00	0.79
GBI-EM GD (Local Curr)						1.00

Source: Bloomberg, Neuberger Berman. Data as of October 31, 2022. Indices used are Bloomberg U.S. Corporate High Yield Index (U.S. high yield), JPMorgan EMBI Global Diversified Index (EMD HC debt) and JPMorgan GBI-EM Global Diversified Index (EMD LC debt) (top); and Bloomberg U.S. Corporate High Yield Index (USHY), Bloomberg U.S. Corporate Index (US IG), JPMorgan EMBI Global Diversified Index (EMBIGD), JPMorgan EMBI Global Diversified Investment Grade Index (EMBIGD IG), JPMorgan EMBI Global Diversified High Yield Index (EMBIGD HY), JPMorgan GBI-EM Global Diversified Index (GBI-EM GD) (bottom). For illustrative purposes only. Historical trends do not imply, forecast or guarantee future results. **Past performance is no guarantee of future results.**

Technical return correlations are one thing. Fundamentals are another.

We see two pillars holding up the fundamental case for high yield over the next 12 months. The quantitative pillar notes that yields and spreads are pricing the market for recession or near-recession conditions. That might seem justified, given much of the world appears vulnerable to recession in the next year or so. But it appears to underestimate the qualitative pillar: issuers are entering this environment with stronger balance sheets than one would normally expect to see at this stage of the cycle.

We think these two pillars can also support a case for emerging markets debt.

An Attractive Starting Point

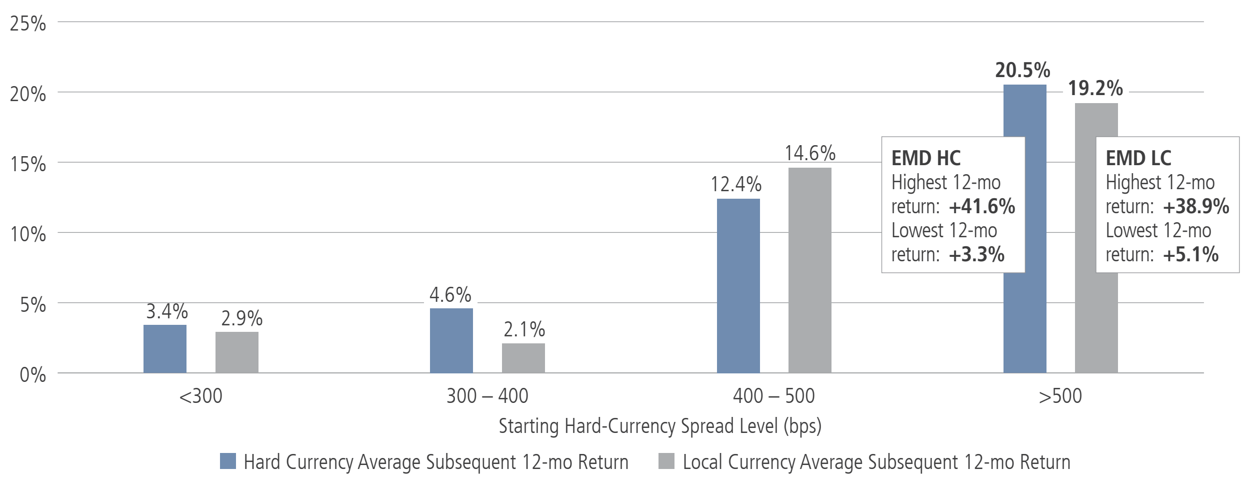
This year's sell-off in emerging markets has been unprecedented, driven by rising global rates, slowing global growth, the strengthening U.S. dollar, the war in Ukraine and growing geopolitical tensions elsewhere. The JPMorgan EMBI Global Diversified Index of hard-currency sovereign bonds was down almost 25% by the end of October, while the local-currency GBI-EM Global Diversified Index was down almost 20% and the Corporate EMBI Broad Diversified Index was down almost 19%.

This left the EMBI Global Diversified Index yielding almost 10%, with a spread of 543 basis points. At the same point at the end of October, the ICE Bank of America U.S. High Yield Index was yielding 9%, with an option-adjusted spread of 463 basis points.

The 500 basis-point threshold is meaningful for the EMBI Global Diversified Index. Over the past 15 years, setting aside a single day at the start of 2016, it has been crossed only during the Global Financial Crisis, the first few months of the COVID-19 pandemic and the war in Ukraine. Neither the Euro crisis of 2011, the commodities crash of 2014 – 15 nor the China stock market volatility of 2018 pushed spreads that high. As figure 2 suggests, spreads above 500 basis points have represented good value over the past 20 years, with strong subsequent 12-month returns, on average, and no negative outcomes—for both hard-currency and local-currency markets.

FIGURE 2. CURRENT SPREADS HAVE BEEN A GOOD STARTING POINT, HISTORICALLY

Average subsequent 12-month total returns from the given hard-currency emerging markets sovereign starting spread levels, 2003 – 2022



Source: Bloomberg, JPMorgan. Total returns to the JPMorgan EMBI Global Diversified Index (Hard Currency) and JPMorgan GBI-EM Global Diversified Index (Local Currency) in U.S. dollars, January 2003 to October 2022. Starting spread levels are end-of-month for the JPMorgan EMBI Global Diversified Index. For illustrative purposes only. Historical trends do not imply, forecast or guarantee future results. **Past performance is no guarantee of future results.**

Top-Down Outlook

Starting point isn't everything. What happens next is important. Here we turn to the qualitative pillars of our argument, one assessing the top-down environment and the other assessing bottom-up risks.

Our base scenario for the next 12 months sees developed market inflation peaking but staying elevated, central banks becoming less aggressive in their hawkishness and the 10-year U.S. Treasury yield stabilizing at around 4%. We see global growth slowing to the extent that it threatens recession in some economies. China may improve its growth rate over the lows of 2022, but we think headwinds from its real estate sector and COVID restrictions will make it hard to regain its previous trend. In geopolitics, we believe outright conflict can be contained within Ukraine. In this scenario, we believe the average EMBI Global Diversified spread over the next 12 months could be some 70 to 80 basis points lower than today's level.

Do we see local-currency markets putting in similar performance? The history explored in figures 1 and 2 suggests that it's possible. Looking forward, we believe inflation in the emerging world peaked in the third quarter of this year and that its central banks are generally further into their tightening cycles than those in the developed world (in the case of most of Latin America, most have likely finished their rate hikes). A peak and decline in the U.S. dollar could also help, with emerging markets real effective exchange rates trading cheap to their long-term average, particularly in Latin America. Among the headwinds, U.S. Treasury yields are likely to remain near current levels even if U.S. inflation cools off, and emerging currencies could struggle against slowing global growth and deteriorating current account balances.

Bottom-Up Risks

Some 7.5% of the EMBI Global Diversified Index, in terms of par value, is on track to be in default in 2022, according to our estimates. That would be the highest sovereign default rate since 2020. It goes a long way to explain why the spread in yield between the high yield and investment grade components of the Index is close to the historically wide levels it hit in 2020.

It is important to note, however, that the extreme situations in Russia, Ukraine and Sri Lanka alone account for almost 7% of the par value of the Index. (Similarly, for the JPMorgan Corporate EMBI Broad Diversified Index, the full-market 2022 estimated default rate of more than 16% falls to just 2.5% if we strip out Russian and Ukrainian issuers and China's real estate sector.)

Let's set Russia aside and assess the situation. The average recovery rate on defaulted sovereign bonds between 1983 and 2020 was 53%, according to Moody's. At current prices, bonds from various high yield countries, including Argentina, El Salvador, Ghana and Ecuador, are trading way below these levels—in the 20 to 30 cents area—suggesting that the market is pricing for them to default and inflict deep haircuts on their lenders.

Is that justified? We don't believe so. Some of the countries trading at these stressed levels are already participating in International Monetary Fund (IMF) programs—Argentina, Ecuador and Pakistan, for example. Others, such as Egypt, Ghana, Lebanon, Sri Lanka and Zambia, are discussing programs or have had them approved. Ukraine has received emergency IMF support and will begin discussions on a more formal program in the near term. We regard the IMF's involvement as a significant anchor for bondholder-friendly fiscal consolidation and reforms—a factor that appears to have been ignored in indiscriminate selling over recent months.

Conclusion

The extreme degree and speed of the tightening of financial conditions has torn through many fixed income markets during 2022. Emerging markets, which are typically quite sensitive to moves in real interest rates, have been no exception.

That has left investors with yield and spread levels that, historically, have offered favorable entry points. Moreover, we see some signs that the worst of the rates volatility could be behind us. Cooling U.S. inflation may enable the U.S. Federal Reserve to slow the rate of its rate hiking and, while it is likely that real interest rates remain relatively high for some time, the removal of some of the recent volatility could help to compress risk premia across credit markets. Yields and spreads may not come in as far as in past recoveries, many of which were accompanied by declining real rates, but investors have high income from current yields as compensation. Finally, with a lot of bad news priced in—on the Ukraine conflict, on China's COVID policy, and on the various high-yield issuers working with the IMF—we think there is a strong argument that potential upside outweighs downside risk.

That is why we believe emerging markets debt deserves a place in the opportunity set for the next 12 months, alongside other credit markets that are currently finding favor.

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