Emerging Market Yields

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April 18th 2019

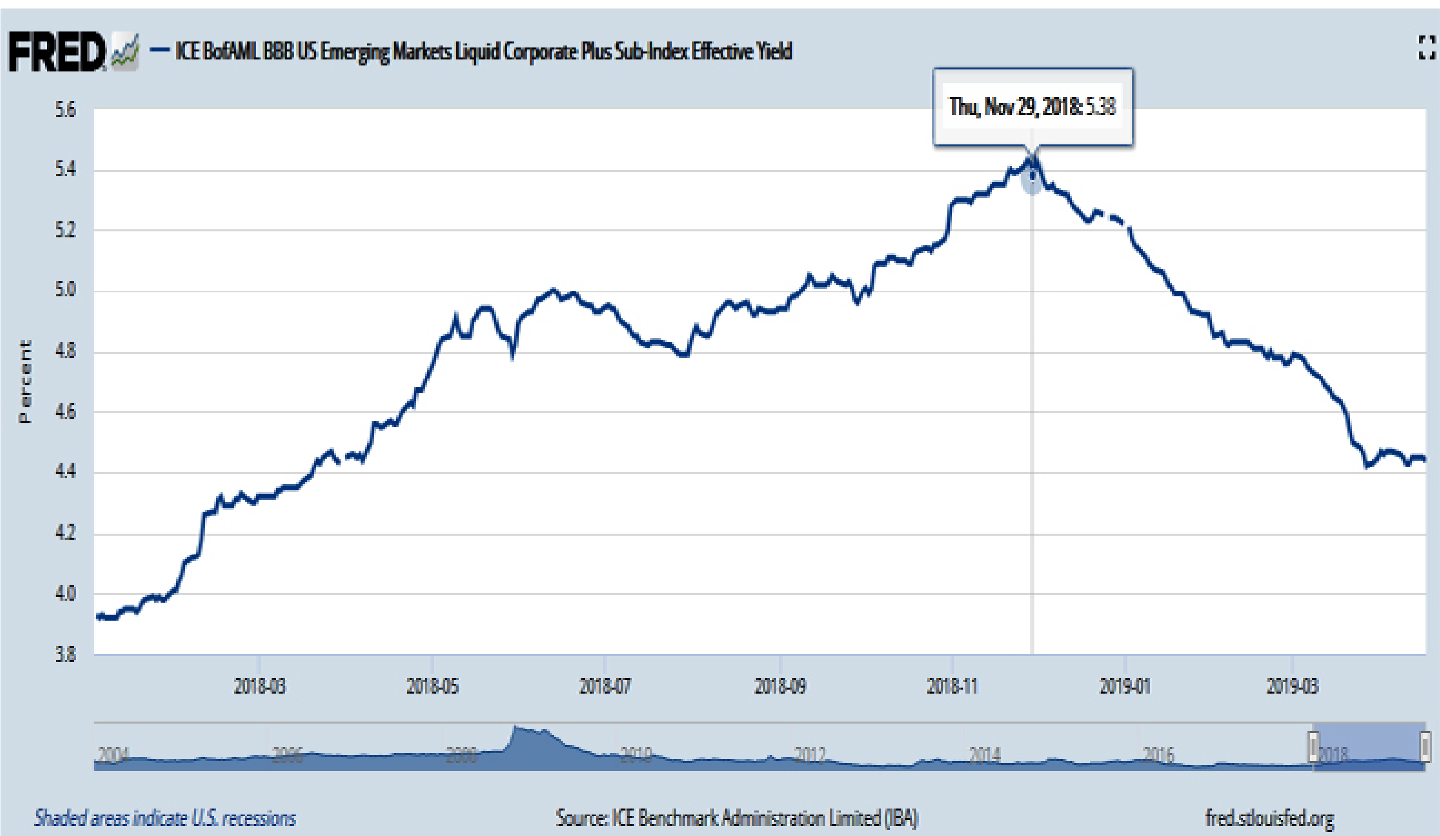
Yields on high grade and high yield emerging market bonds rose significantly last year to levels not seen in 5 years. Performance has been strong in Q1 2019, with yields falling by 100bps in BBB credits.

High Yield

The BofAML High Yield Emerging Markets Corporate Index effective yield had risen from a near all-time low of 5.3% at the end of January 2018, to a high of over 8% in December, due to a combination of rising rates and 250 bps wider credit spreads. Subsequently to the December peak, the sub-investment grade bond yields have recovered significantly to below 7%. These swings have resulted in increased bond price volatility over the past 18 months with high correlation to price performance of global equities.

Investment Grade

2018 saw a steady widening of spreads, pushing yields on the BBB EM Corporate Index from 3.8% to a high of 5.4% in November. This increase in EM yields came on the back of a smooth period of tightening over the prior 2 years, which saw outperformance of EM bond portfolios in funds. This stellar performance attracted significant inflows to funds investing in these markets, further driving the tightening of spreads. The BofAML High Yield EM Index spread declined by over 600bps, from 10% in early 2016 to a low of 3.15% in January 2018.



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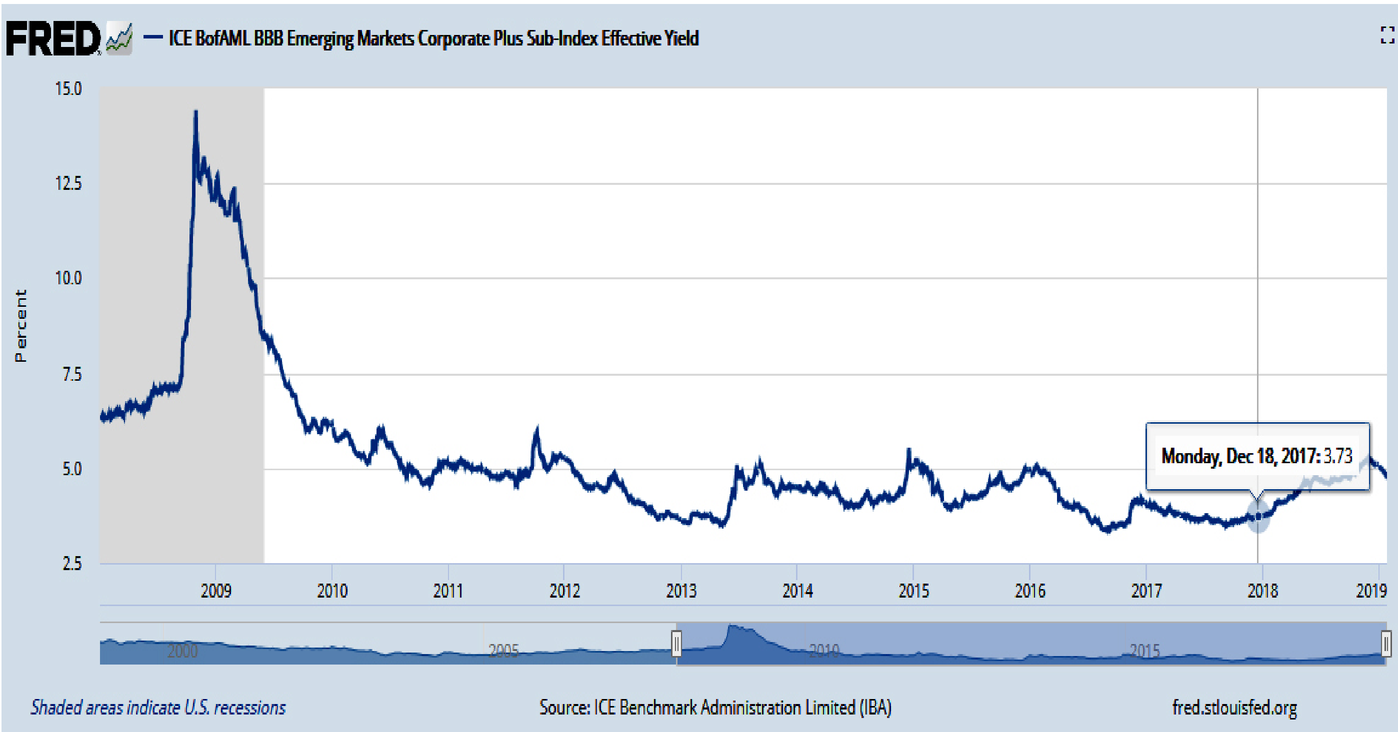
Taken in a wider time frame, this index yield ranged from 5% to 10% in the post-Financial crisis period of 2010 to 2017.



Investor sentiment can significantly drive fund flows, which can amplify changes in credit spreads. Credit spread changes can then affect investor sentiment, in a feedback loop. This loop drives spreads tighter in bull markets, but can lead to wider spreads and illiquidity if sentiment turns and funds are forced to liquidate bonds to meet redemptions. This sentiment may be shifting as the US dollar rises and investors take note of recent underperformance of EM bond investments.

2019 Outlook

Moody's highlighted the 3 following factors to affect credit spreads in 2019:

- ***Global growth will decelerate across both advanced and emerging markets in 2019. While growth in advanced countries will still be solid, emerging market prospects will diverge***

- ***The 2019 sovereign outlook is still stable, but credit risks will build. The window for addressing credit challenges, including high debt levels, is closing as the risk of tail events is rising.***

- ***Rising risks stem from further escalation of trade tensions, sharper-than-expected financial market adjustment to monetary policy normalization, a faster-than-expected slowdown in China and an escalation of political tensions***

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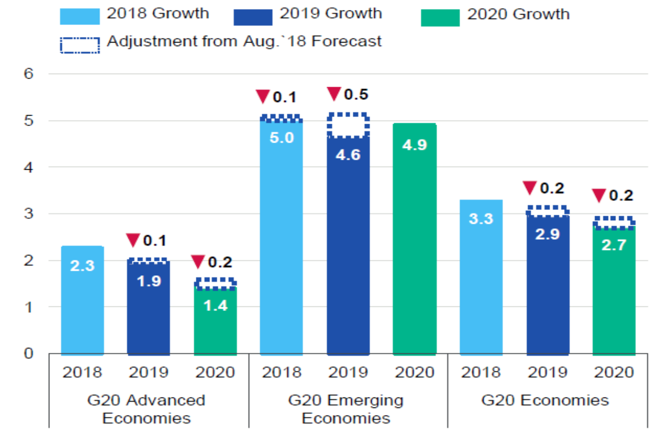
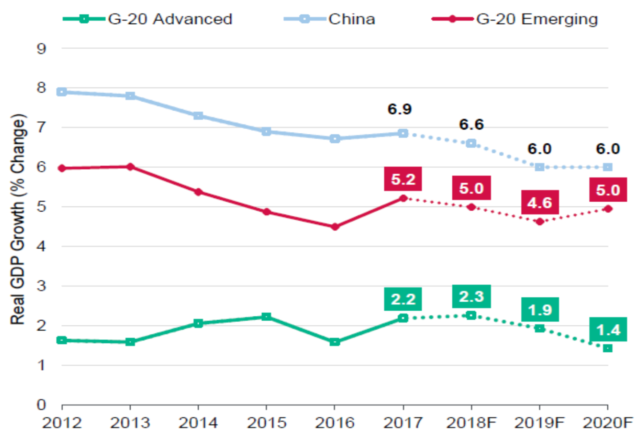
Economic growth will decelerate over 2019-20

- Global economic growth has passed the peak
- Slowdown in G-20 advanced economies driven primarily by weaker US growth
- Slowing of economic activity in China and contractions in Turkey and Argentina will pull down aggregate G-20 emerging markets growth in 2019

Global growth will decelerate in 2019



Slowdown in G-20 advanced economies driven primarily by weaker US growth



Source: Moody's Investors Service

EMERGING MARKET CREDIT SPREADS

Figure 8. Emerging Market Median OAS

Emerging Market	Median Spreads				Bond Counts			
Duration	A	Baa	Ba	B	A	Baa	Ba	B
>=1 and <3	78	121	286	506	84	113	51	60
>=3 and <5	96	146	300	588	55	132	72	69
>=5 and <7	114	198	316	494	54	91	38	31
>=7	139	233	322	545	95	157	31	29
Emerging Market Sovereign	**Median Spreads**				**Bond Counts**			
Duration	A	Baa	Ba	B	A	Baa	Ba	B
>=1 and <3	54	64	261	336	18	19	17	14
>=3 and <5	81	101	205	411	11	27	20	24
>=5 and <7	78	133	298	474	19	23	26	24
>=7	132	211	322	541	55	73	27	28
Emerging Market Corporate	**Median Spreads**				**Bond Counts**			
Duration	A	Baa	Ba	B	A	Baa	Ba	B
>=1 and <3	89	135	295	525	66	94	34	46

Source: Moody's Weekly Market Outlook 11 April 2019

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Potential Outcomes

- **Spread stabilization**

Scenario: The slow global expansion plods along, with no significant disruptions in commodity markets or geopolitics. Bubbling issues in Argentina, Brazil, Mexico and other EM markets fade, and investors remain committed to the sector. Spreads remain close to current levels, and there is little further change in the risk-free rate. Investment Choice***: Stay fully invested in EM to take advantage of the higher yields.***

- **Spreads decline to historic January 2018 lows**

Scenario: Global economic growth picks up with outperformance by EM economies. Current issues fade, and tensions in the geopolitical climate ease. Risk free interest rates hold steady or decline. Investment Choice: ***Extend duration and take additional credit risk to capture cap gains in longer, lower credit bonds.***

- **Spreads widen to 10-year averages over the next 2 years**

Scenario: Global growth is weak, with underperformance by EM economies. Inflows to EM funds decline, but investors remain confident and attracted by 7-9% yields. The risk-free rate is stable. Investment Choice: ***Shorten duration and improve credit quality. This will reduce yields but will protect against falling prices***.

- **Spreads widen dramatically**

Scenario: Global economic or geopolitical issues lead to investor fear and a flight to quality.
Investment Choice: ***Go to cash or short-term treasuries, to be prepared to take advantage of volatile, illiquid markets.***

Conclusion

Investors in EM bonds should review portfolios to ensure that their duration and credit profiles properly match their objectives and constraints. Spreads have widened, making yields more attractive across the sector as the risk-free longer rates have moved lower. However, there is still potential price downside should economic growth weaken, or international political events develop negatively. Selective security choice remains the key to market outperformance.

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