Janus Henderson INVESTORS

DEMYSTIFYING EMERGING MARKETS DEBT HARD CURRENCY

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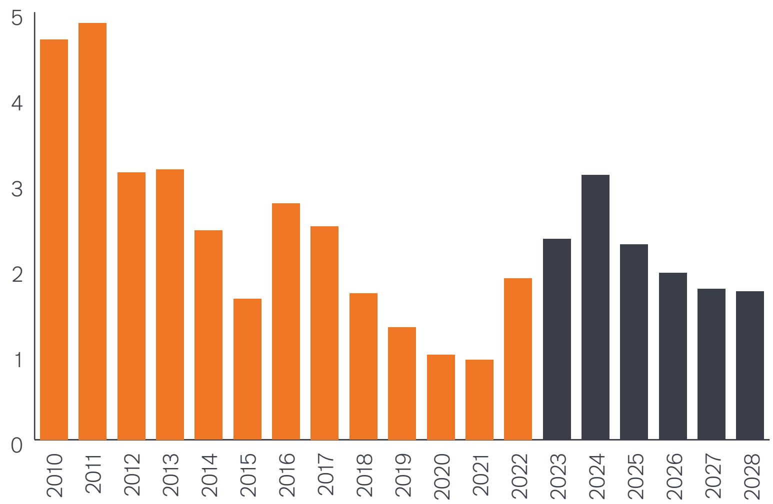
A decoupling story

Post-COVID inflationary pressures have laid the groundwork for a possible decoupling in global monetary policy. Although each central bank reacted differently to the pandemic, the common policy reaction has been to tighten monetary policy to tame rising prices. Slowing growth indicates we may well be nearing the end of this tightening cycle. Since emerging market (EM) economies were relatively more proactive in policy tightening, we believe they could lead developed market (DM) peers in easing, as seen in Angola and Costa Rica.

Policy-driven headwinds are more significant for DMs than EMs, where the feedthrough of monetary policy to the economy is greater given higher indebtedness. Stronger commodity prices are also more favourable for some EMs, which can benefit from the China rebound as intra-EM trade has flourished. Emerging markets growth is expected to decouple from the rest of the world including the US (Figure 1). Growing three times as fast as DMs, these economies are expected to account for nearly 80% of global growth over 2023 and 2024[1]. Structural growth drivers such as technological innovation and an expanding working age population help underpin this. After all, 86% of the global population resides in EM and developing economies[2].

Figure 1: GDP growth rate difference between EM and the US



Source: Macrobond, IMF, Janus Henderson, as at 7 March 2023. **There is no guarantee that past trends will continue, or forecasts will be realised.**

KEY TAKEAWAYS

- Emerging markets debt hard currency (EMD HC) offers unrivalled scale, compelling diversification and attractive return potential.
- Myths pervade the emerging markets debt asset class which detach perception from reality around defaults, leverage to the developed market cycle and ESG risks.
- In the sovereign space, the unique nature of borrowers mitigates default risk, while the broad issuer base allows investors to tap into diversification potential and gain from ESG upgrades driven by policy improvements.

[1] Source: IMF World Economic outlook, April 2023. Gross domestic output in percent change (constant prices).
[2] Source: IMF World Economic outlook, April 2023.

A broad and liquid universe

This begs the question that since EMs are the powerhouse of the global economy, driving economic output and population growth, is it even possible to avoid being exposed to them through investment portfolios? We would argue that investors already have indirect exposure to EMs, and which can benefit from a direct exposure to the asset class. The EMD HC universe is an asset class where the opportunity set is the broadest in terms of global coverage. The sovereign bond universe has grown from 55 countries to 69 countries over a decade, eclipsing the country breadth in EM corporate bond and local universe (Figure 2).

Nearly doubling in size over the past decade, the EMD HC universe has grown to be comparable in market cap to the US high yield sector. 414 issues are in listings over a billion dollars, which compares to 247 in the US high yield sector and 29 and 294 in EM corporate bonds and local markets respectively. Also representative of the large liquid universe, the average EM sovereign issuer is around twice the size of US HY and EM corporate issuers. Factoring in issues that are also denominated in euros further expands this opportunity set.

Figure 2: Emerging markets debt versus other debt asset classes over the last decade

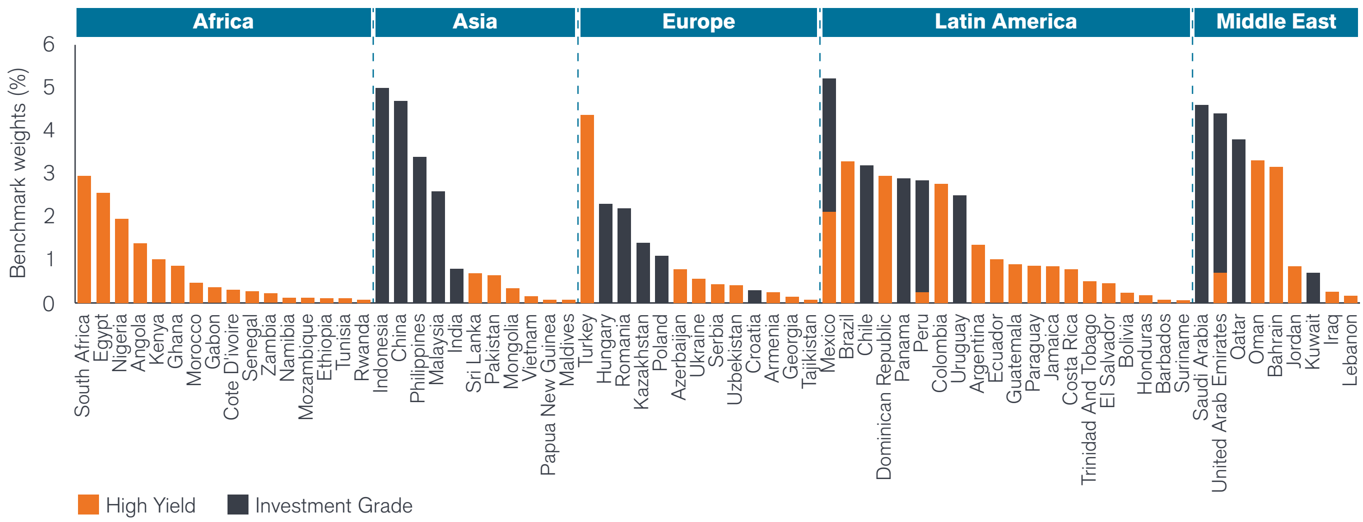
	Countries		Market Cap ($/€mn)		Market Cap Listings > $1bn		Number of issues > $1bn		Average issuer size ($mn)
Index	Feb-23	Jan-13	Feb-23	Jan-13	Feb-23	Jan-13	Feb-23	Jan-13	Feb-23
Dollar-denominated EMD HC	**69**	**55**	**1,104,723**	**579,214**	**787,176**	**511,111**	**414**	**232**	**1,171**
Euro-denominated EMD HC	35	14	217,980	67,857	108,491	55,148	79	32	890
EMD corporate credit	45	34	294,177	186,908	38,811	38,849	29	31	398
Local currency EMD	20	15	1,310,847	962,158	1,293,633	957,907	294	165	4,109
US high yield	**22**	**23**	**1,209,210**	**1,281,119**	**376,313**	**447,449**	**247**	**298**	**626**

Source: JP Morgan as at 28 February 2023. Indices shown are the JP Morgan EMBI Global Index (dollar-denominated EMD HC); JP Morgan EMBI Global Index (euro-denominated EMD HC); JP Morgan CEMBI Index (EMD corporate credit); JP Morgan GBI-EM Global Diversified Index (local currency EMD); and ICE BofA US High Yield Index.

Different countries, diverse return drivers

Amid pervasive uncertainty, the merits of diversification feel most valuable and warranted for investors. The broad EMD HC country universe is evenly balanced between investment grade and high yield and spans all regions globally – from poor Sub-Saharan Africa to middle income countries and the rich Middle East. No country measures much more than 5% unlike other EM indices where China dominates (Figure 3). This variation that characterises the asset class enables effective diversification through offering access to different growth drivers as well as risk characteristics. Such drivers can be structural and so can offer more long-lasting diversification, as opposed to say more short-term cyclical drivers.

Figure 3: A broad country universe maximises stock selection potential



Source: Janus Henderson Investors, JP Morgan, as at 31 December 2022.
Note: Index used is the JP Morgan EMBI Global Diversified Index.

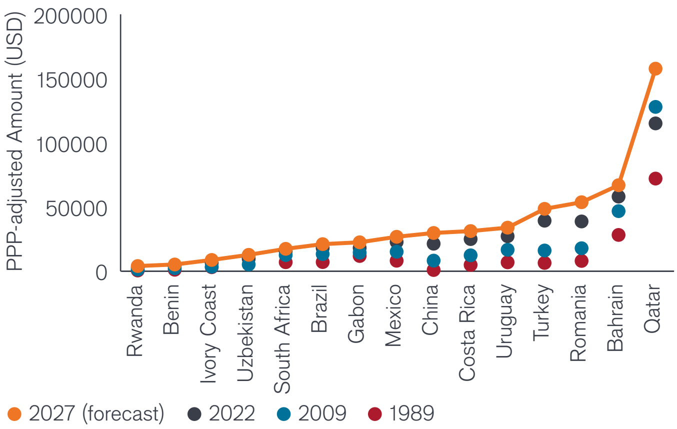
Economic development never rests

Where differentiation in fundamentals can aid with risk diversification is for example: investment grade versus high yield; high income to middle income; and commodity exporters versus importers. We can further divide the universe into two further sub-groups, comprising of economies in the process of transitioning from one group to the next. The three buckets are:

- **Factor-driven economies** – a low development group, such as commodity exporters, that benefit from cheap labour and ample natural resources.
- **Efficiency-driven economies** – as wages rise, productivity improves through better processes and technology, which matures education as well goods and domestic, financial and labour markets.
- **Innovation-driven economies** – high wages need to be sustained through sophisticated production and innovation to advance these further, culminating in high income countries. Some of the most advanced EMs are in the transition phase from efficiency-driven economies to innovation-driven economies, such as Brazil and China.

As economic development never rests, this creates an opportunity to participate in improvement, which often can underpin a rating upgrade story for a sovereign. While the pace of development can vary, it is often upward, as seen in China and Turkey evolving into middle income economies (Figure 4). However, there are outliers such as Qatar where GDP per capita (purchasing power parity) in real terms jumped but then retraced, as can happen in commodity export-driven countries. This exemplifies how the array of countries in different stages of economic development can bring diversification to portfolios.

Figure 4: Economic development varies across EM

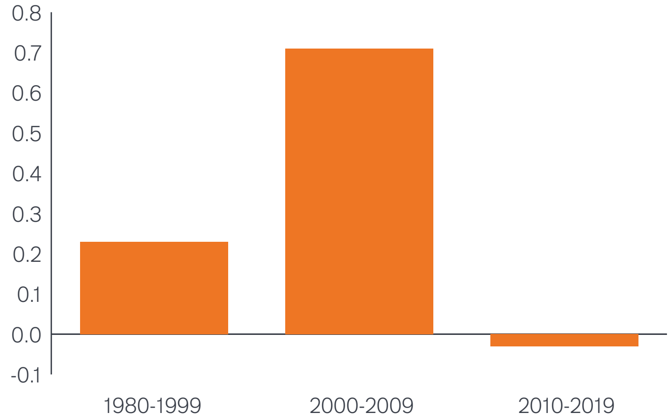


Source: Macrobond, IMF, as at 12 April 2023. PPP = purchasing power parity. **There is no guarantee that past trends will continue, or forecasts will be realised.**

Myth: EM is just levered DM

Another misconception is around the inextricability of the EM and DM cycle, which in the context of slower global growth and higher borrowing costs fuels default fears. As discussed earlier, the differential between EM and US GDP growth is set to increase in 2023 and 2024[3] as EM outpaces the US (particularly given the China rebound), while correlation of growth has waned (Figure 5). From 2010 to 2019, as evidence of this decoupling, correlation was negative before the onset of Covid.

Figure 5: Correlation between annual US and EM real GDP growth has fallen



Source: Tellimer Research, IMF WEO, 31 December 2019.

There may not be as close a relationship as assumed between the US monetary cycle and the performance of the EMD HC. According to our analysis[4] on post GFC cycles:

- Nearly 60% of the time the US Fed Funds rate was positively correlated with EMBIGD spreads, meaning 40% of the time tighter US monetary policy accompanied EM spreads tightening – contrary to perceptions. The main differentiator is often related to the relative growth dynamics between the US and the rest of the world.
- 60% of the time when US Treasury yields rose, spreads were positively correlated and widened.
- 80% of the time when the dollar strengthened, spreads were positively correlated and widened.

US Treasury yields therefore have less predictive power than perceived. The dollar is a much better indicator of how the global market environment is for EM. Again however, looking at global growth dynamics, it is more likely that it is not the dollar in itself that impacts spreads, but the influence from the same underlying growth dynamics that support spread tightening in EMBIGD (better fundamentals outside of the US). Therefore, tightening financial conditions globally is not predictive of EM spread widening if EM fundamentals are improving relative to US fundamentals, as seen in 2016 and 2017 when EMBIGD spreads tightened despite the US Federal Reserve tightening policy.

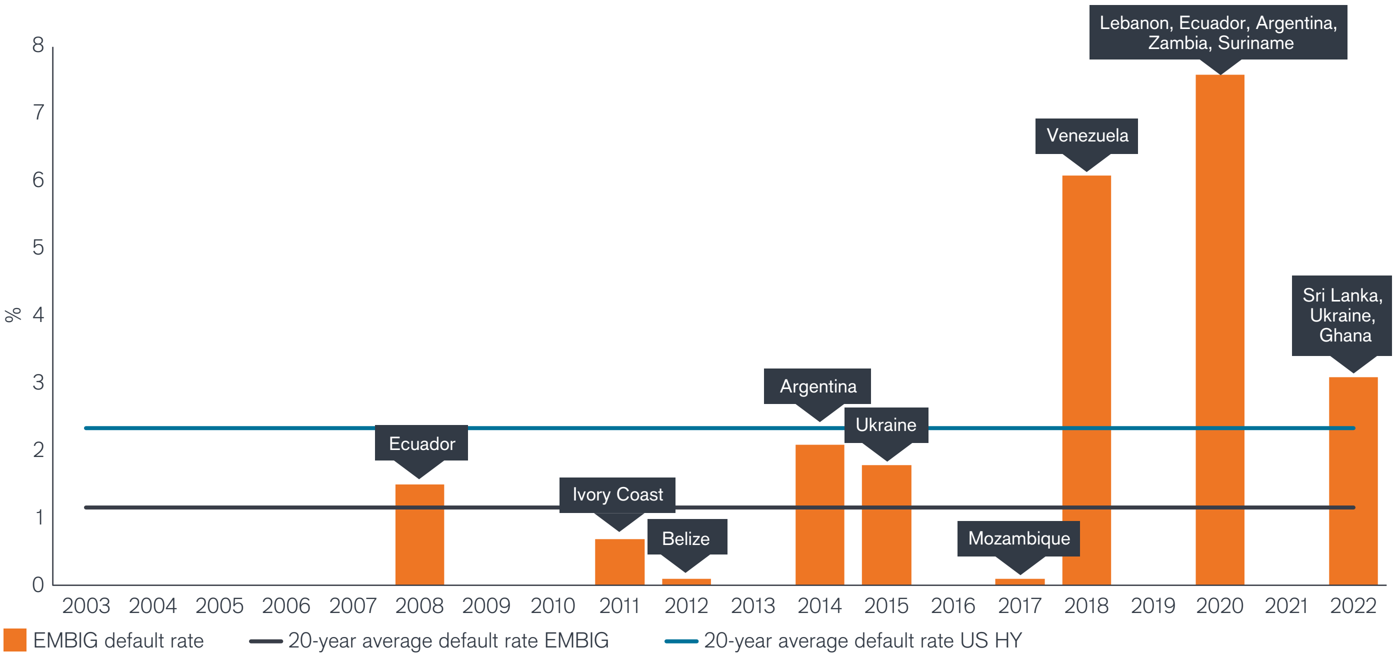
[3] Source: Macrobond, IMF, Janus Henderson, as at 7 March 2023. **There is no guarantee that past trends will continue, or forecasts will be realised.**

[4] Source: Janus Henderson Investors, as at 31 December 2022. Spreads of the JP Morgan EMBIGD. 1 January 2011-31 December 2022.

Myth: Default risk is high

EMs have also progressed by upgrading policy frameworks, where most bigger EM countries have comparable frameworks to DMs. Positive development is encouraged through the greater involvement of institutions such as the International Monetary Fund (IMF). Post the 1980s, sovereign defaults tend to be sporadic and reach quicker resolutions through partnership with such institutions. According to Morgan Stanley, 20 out of the 26 restructurings since 1999[5] involved partnership with the IMF – with a programme nearly always agreed *ahead* of the debt restructuring closing and a return to the bond market tends to form part of such programmes. Over the past nearly two decades, the EMD HC average default rate is c.1% pa (Figure 6), with average recovery rate of more than 50%[6], though individual recovery rates vary between countries. This compares to an average default rate of just over 2% in the US HY space over the same period.

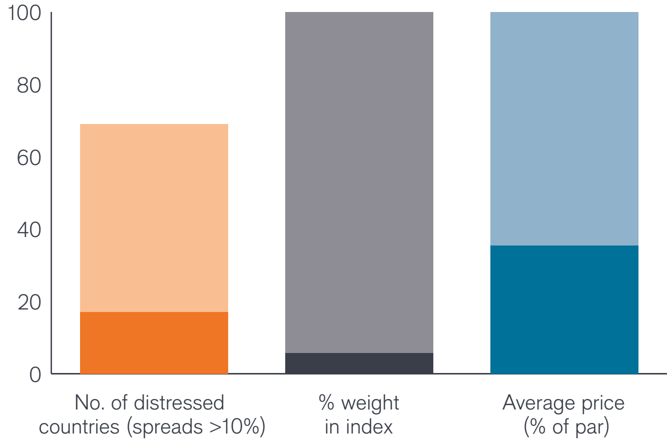
Figure 6: Sovereign defaults are few and far between



Source: JP Morgan, 1 January 2003 to 31 December 2022. US High Yield and EMBIG default rate notionally weighted. Note: Although Ukraine is not being treated as a defaulted issuer in the EMBIG, we are factoring it into the rate due to the restructuring, as credit default swaps were triggered.

Despite this, the market perception of defaults is disconnected with historical reality. According to Morgan Stanley research, with even conservative estimates of recovery rates (at 40% and 25%), the market implied probability of default is higher than history across the ratings spectrum[7]. In reality, the number of distressed countries equate to around 6% of the index, while the prices of distressed countries (35% of par) trade well below recent recovery rates (Figure 7). Overall, perception of EM doesn't fully factor in the policy improvements and structural reform over the last two decades.

Figure 7: The prices of distressed issuers trade well below recovery rates



Source: Janus Henderson Investors, as at 31 March 2023. Note: Index used is the JP Morgan EMBI Global Diversified Index.

[5] Source: Morgan Stanley, 4 October 2022.

[6] The recovery rate is the amount, expressed as a percentage, recovered from a loan when the borrower is unable to settle the full outstanding amount. Recovery rates based on Morgan Stanley calculations, 4 October 2022.

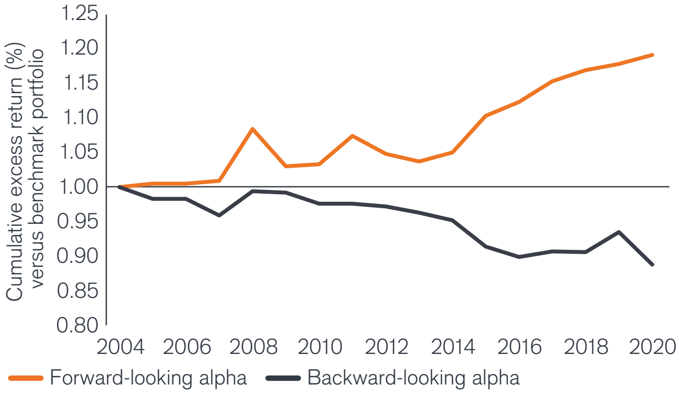
[7] Source: S&P, Fitch, Moody's, Bloomberg, Morgan Stanley Research, 3 March 2023.

Myth: EM exposes you unduly to ESG risk

This pivotal role of policy explains why governance is key to sovereign credit risk with ratings highly correlated with different governance measures. The most important World Bank governance indicators are, in our view, the rule of law[8], political stability, and regulatory quality. The way we evaluate ESG risk on both a quantitative and qualitative basis therefore helps mitigate the ESG risk associated with investing with a strict adherence to materiality. According to our analysis[9], regulatory quality, income level (GDP per capita) and public debt stock (debt-to-GDP) are among the top factors driving the variation between different countries' sovereign credit ratings. Two governance indicators – political stability and the rule of the law – also account for a country's variation in ratings over time.

As with all ESG data though, it is backward-looking and often comes with a lag. A study we have done involves looking at excess returns of a backward-looking portfolio (weighted to countries that have improved regulatory quality in the past) and forward-looking portfolio (tilted to countries assuming perfect foresight on improvement in regulatory quality in the future) versus an equally weighted benchmark. It shows a forward-looking approach delivers strong alpha and even a passive approach would be better than a backward-looking approach (Figure 8). While of course it is impossible to have perfect foresight, if you can reliably forecast current and future trends in governance, you can consistently unlock alpha. That is why for us we are relentlessly trying to catch up on emerging governance trends across the country universe through on-the-ground research and quantitative input.

Figure 8: A forward-looking approach to ESG essential to alpha creation



Source: Janus Henderson Investors, as at 31 January 2022. **Past performance does not predict future returns.**

Methodology

The portfolios are as follows:

- **Benchmark** – an equally weighted portfolio of 25 countries (4% weight each) included in the EMBIGD which have been part of the index for the entire period between end-2004 to now. We calculate the annual spread return using JP Morgan spread return indices for each country.
- **Backward-looking portfolio** – invests ONLY in countries that have seen a stronger improvement in their World Bank 'Regulatory Quality' index than the benchmark average from t-4 to t-2.
- **Forward-looking portfolio** – invests ONLY in countries that have seen a stronger improvement in their World Bank 'Regulatory Quality' index than the benchmark average from t-1 to t+1 (assumes perfect foresight).

Looking past pre-conceptions

Some pre-conceptions surround the EMD asset class that are an overhang from the past and overlook the maturing of EM economies in improving policy quality in governance and fundamentals that define EM potential and resilience. As we enter a more challenging part of the global growth cycle, the EMD HC diverse universe offers investors the opportunity to capture diversification as well as compelling growth as EMs decouple from DMs and policy tightening reverses. More attractive yields have also emerged, highlighting the income opportunity. That said, there is a lot of dispersion in this heterogenous universe. An active approach can help distil the opportunities and balance the risk and reward on offer to generate steady alpha over the long term.

[8] Rule of law captures perceptions of the extent to which agents have confidence in and abide by the rules of society, and in particular the quality of contract enforcement, property rights, the police, and the courts, as well as the likelihood of crime and violence (World Bank).

[9] Source: Janus Henderson Investors, 31 December 2022.

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Important information

Emerging market investments have historically been subject to significant gains and/or losses. As such, returns may be subject to volatility.

High-yield or "junk" bonds involve a greater risk of default and price volatility and can experience sudden and sharp price swings.

U.S. Treasury securities are direct debt obligations issued by the U.S. Government. With government bonds, the investor is a creditor of the government. Treasury Bills and U.S. Government Bonds are guaranteed by the full faith and credit of the United States government, are generally considered to be free of credit risk and typically carry lower yields than other securities.

Credit Spread is the difference in yield between securities with similar maturity but different credit quality. Widening spreads generally indicate deteriorating creditworthiness of corporate borrowers, and narrowing indicate improving.

J.P.Morgan Emerging Markets Bond Index Global (EMBI Global) tracks total returns for traded external debt instruments in the emerging markets

Alpha compares risk-adjusted performance relative to an index. Positive alpha means outperformance on a risk-adjusted basis.

ICE BofA US High Yield Index tracks the performance of US dollar denominated below investment grade rated corporate debt publicly issued in the US domestic market.

GC-0423-122909 04-30-24 200-99-122909 04-23