Emerging Markets: Opportunities with Corporate Bonds

Paul Severin

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In an interview with Péter Varga, Senior Fund Manager Erste Asset Management, I am discussing the chances and risks with investments in emerging markets corporate bonds. Many Investors feel unsettled by the weak performance of the emerging markets. Why is this the case?

Péter Varga: For many emerging economies their business model has become unviable due to the decline in commodity prices. Large economies like Russia, South Africa, and Brazil are hugely dependent on commodities; they have not diversified enough and are now facing a backlash. The rating agencies downgraded both Russia and Brazil to junk status (BB) last year.

Is the dependence on commodities a common denominator for all emerging economies?

No, not generally. Turkey for example benefits from low commodity prices. The aforementioned dependence on the commodity cycle does exist though in comparison with the developed economies, which is why the price decline is relevant. That being said, many countries have devalued their local currencies to the same extent, i.e. they have pretty much balanced their books. For local currency investors, this has eaten into their performance. Our fund invests exclusively in hard-currency bonds, is hedged against the euro, and is therefore not affected.

Péter Varga,
Lead Manager Emerging Markets Corporates
Erste Asset Management

How important are politics?

At the moment unfortunately, overly important. Some examples: Russia is battling sanctions due to the Ukraine conflict, Brazil and China are faced with allegations of corruption, and in the Arabic world we can see religious tensions. Political uncertainty comes with direct ramifications for the behaviour of international investors.

How important is the interest rate policy of the US Fed for you?

The spreads relative to US Treasury bonds are currently very high, also historically speaking. The underlying investment universe of ESPA BOND EMERGING MARKETS CORPORATE had recorded a yield of 8% as of 31 December 2015, which was in excess of the return on high-yield corporate bonds from the USA (7.5%). From my point of view, the spread is high enough to offset further, moderate interest rate hikes. I am very relaxed about this topic.

There is a strong focus on China. What do you expect?

China to me is a black swan in 2016. The biggest economy in the world is expected to incur a drastic decline in economic growth. This will result in global ramifications. The Achilles heel of China is its high level of debt of the private economy and of local governments, i.e. of districts, towns, and municipalities. Many companies are kept on life support by banks. I believe that the default ratios officially stated in the banks' balance sheets are overly optimistic by a long shot.

The Chinese government is trying to countersteer the falling export dynamics with stimulus measures and a controlled devaluation of the currency. The economic set-up is to be made more sustainable, with domestic consumption and the domestic construction sector gaining in importance.

Are emerging markets bonds less liquid than bonds from developed countries?

I find it difficult to comprehend this argument. Many times a temporary situation of (il)liquidity of a bond is mixed up with the general liquidity situation. There is no doubt that negative company news like in the case of Petrobras will have a significant effect. It may take the market a few days to find a new equilibrium price. Until then, panic prevails. I wonder if the situation was that different in the case of Volkswagen or Glencore, or is a lack of liquidity really a topic that is specific to emerging

markets? I take a different view.

Have emerging markets corporate bonds established themselves as asset class?

Ten years ago, the volume of emerging markets corporate bonds amounted to USD 300bn; today, this figure has increased to USD 1.5bn. This asset class is therefore of significant relevance.

In terms of clients, we can still see a mixed picture. Some clients take a rather conservative or negative stance vis-à-vis emerging markets bonds. Family offices and private asset managers, on the other hand, hold a remarkably constructive opinion, which has surprised me. Some large-scale investors had already taken positions in other emerging markets asset classes, such as equities or local currency bonds, and therefore had no leeway to invest in emerging market corporate bonds anymore. I have noticed that an increasing number of investors include emerging markets corporate bonds in their strategic considerations. But overall, there is upward potential.

Why should an investor buy corporate bonds from emerging markets issuers?

The companies are currently acting in favour of bondholders. Strong balance sheets are on top of the agenda of the CFOs due to imminent refinancing and the difficult market environment. Dividends or share buybacks are currently not under consideration. This means that bondholder value trumps shareholder value. In other words, emerging markets exposure in corporate bonds currently makes more sense than in equities.

What sort of opportunities can you see in terms of countries?

Latin America is interesting. Brazil used to be “everybody’s darling” for a long time, but has now turned into an underperformer. Investors have also pulled out of Columbia due to political problems and corruption affairs. If the situation were to stabilise, it could lure investors back quite quickly.

Many global investors are running a significant overweight on Asia. Therefore valuations in those markets are less attractive and the potential for disappointment is sizeable. To many market participants, Russia is not investable, and the markets are cautious when it comes to Brazil.

The aforementioned further devaluation of the renminbi remains the main risk. The decline of the exchange rate was causing significant turbulences in 2015.

What do you expect for 2016?

The risk is not normally distributed. There are risks looming in 2016 that are not properly captured by the standard deviation and can thus not be easily modelled. Volatility remains high. The good news is that a substantial amount of risk has already been priced in, including some defaults due to the decline in commodity prices. We will try to buy on weakness. I expect a performance of about +2-4% for 2016, conservatively speaking. We should be able to match a large part of the coupon rate. In case of substantial fundamental changes on the commodity markets or in the political arena, we might see the currently high spreads narrow, which would come with positive repercussions.

The fund manager:

Péter Varga, CFA
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Péter Varga has been with ERSTE-SPARINVEST KAG since 2005. He is responsible for emerging markets corporate bonds. Before joining our company, he was in charge of convertible bond and corporate bond funds and the management of two total-return funds with Union Investment (Frankfurt/Main). He holds a degree in finance and company valuation from Corvinius University, Budapest, and has been CFA since 2004. In addition, he has published numerous texts in capital structure theory and finance.

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Paul Severin has worked at Erste Asset Management since April 2008. Until 2012 he was responsible for the company’s product management; he has directed communications and PR activities since April 2012. From 1992 to 2008, he was director of equity fund management and deputy director for institutional funds at Pioneer Investments Austria in Vienna.

His career in the securities business began in 1992 at Constantia Privatbank as a portfolio manager and analyst. He worked as primary analyst at Creditanstalt Investmentbank in Vienna from 1994 to 1999.

He studied international business at Innsbruck University and Marquette University in Milwaukee, WI, USA. Before his university studies, he worked at Dornbirner Sparkasse in letters of credit and export financing.

Paul Severin is a member of the board at ÖVFA (Austrian Association for Financial Analysis and Asset Management) and a CEFA charter holder.