Prepared for professional clients only – April 2012

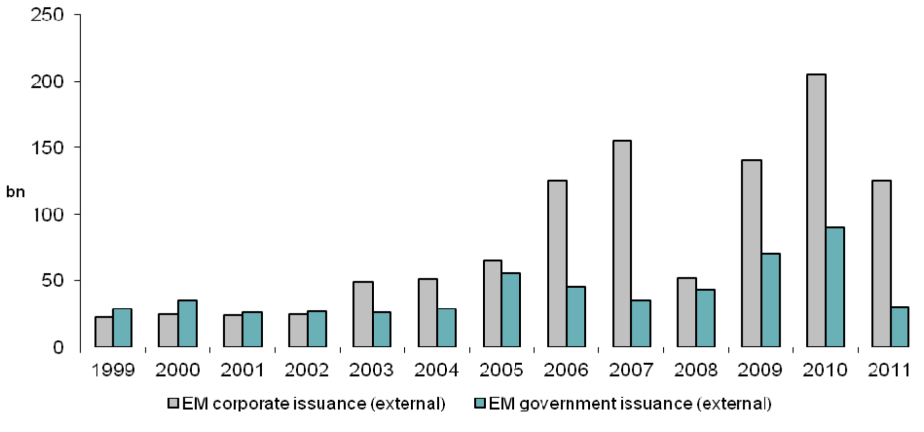
Viewpoint

Emerging market corporate debt comes of age

In an environment of low interest rates across most developed economies, fixed income investors seeking a higher level of return have tended to turn to the government bond markets of emerging economies. While US dollar- and local currency-denominated emerging market debt have come to be considered as prominent asset classes in their own right, the market for emerging market corporate debt has remained under the radar of many fixed income investors.

We believe that the emerging market corporate debt market has now matured into an accessible and attractive investment opportunity for those investors that can manage the risks appropriately.

The market for emerging market corporate bonds has in the past been viewed as insufficiently large, liquid and diverse to make feasible an investment strategy dedicated to investing solely in the bonds issued by companies in emerging economies. However, as GDP growth has gone hand in hand with expanding corporate activity in emerging economies, the number of companies from different sectors turning to the debt markets for financing has increased significantly. Over the past decade, the market for US dollar-denominated (external) emerging market corporate bonds has grown to over US$1 trillion in size; as illustrated in the chart below, levels of issuance have been higher than in the external emerging market sovereign debt market in each year since 2003.



Source: BIS, Bank of America Merrill Lynch Research, 31 January 2012.

Managed by

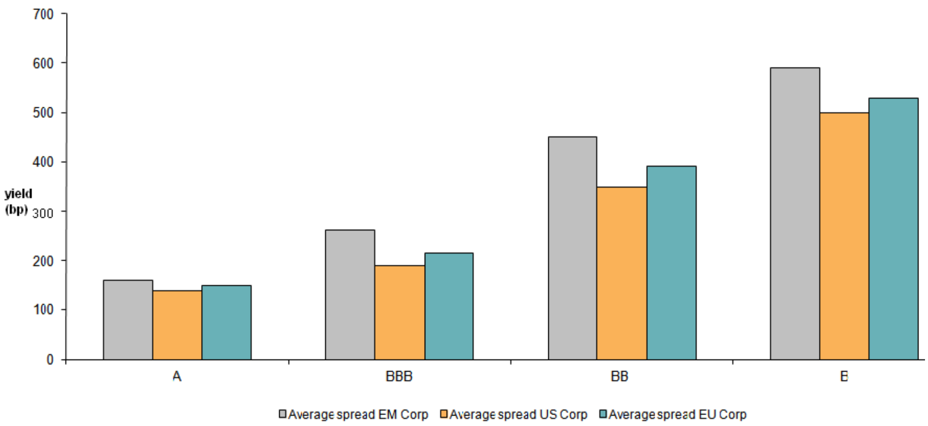
Insight INVESTMENT

BNY MELLON

"We believe that there is a premium that can be captured by identifying emerging market corporate issuers that are of similar or better quality than their peers in developed markets, and which boast a compelling risk/reward profile."

Both developed and emerging economies have seen a shift in the lending function away from banks to capital markets. With deleveraging banks limited in their capacity to lend, companies are becoming increasingly reliant on issuance in the bond market for financing their longer-term expansion plans. As many issuers try to access capital markets simultaneously, companies, particularly in emerging economies, need to issue bonds paying an attractive coupon to ensure that they are taken up by investors. For this reason, and on account of the perceived risks associated with investing in emerging economies, emerging market corporate bonds pay coupons that are, on average, significantly higher than those paid by their similarly-rated developed market counterparts.

The following chart shows the average spreads over US Treasuries of bonds issued by emerging market, US and European corporates with investment grade (A and BBB) and sub-investment grade (BB and B) credit ratings. Regardless of the credit rating, emerging market corporates offer a higher yield, on average, than US and European corporates.



Source: Bank of America Merrill Lynch, 31 December 2011.

It is interesting to note that many emerging market issuers, both investment grade and high yield, have stronger credit fundamentals than similarly-rated issuers in developed economies. The emerging market corporate sector as a whole has witnessed significant improvements in governance and regulation; there has been widespread adoption of international accounting policies, the entrenchment of local bankruptcy laws and greater transparency. Corporate issuers have benefited from strong economic growth, with many receiving credit rating upgrades. Indeed, many of the world's leading companies are now domiciled in emerging economies; for instance, the global oil industry has evolved from being dominated by a handful of producers from developed economies to now include companies such as Gazprom (Russia), Petrobras (Brazil) and Saudi Aramco (Saudi Arabia).

We believe that there is a premium that can be captured by identifying emerging market corporate issuers that are of similar or better quality than their peers in developed markets, but priced more cheaply, making for a compelling risk/reward profile.

Proceed with caution

With the rapid growth in the number, type and quality of issuers, the emerging market corporate debt universe has become increasingly diverse. It has developed into a truly global market, spanning Africa, Asia, Central and Eastern Europe, Latin America and the Middle East, as represented by the JP Morgan Corporate Emerging Markets Bond Index (CEMBI Broad Diversified). While banks have historically been dominant in the realm of emerging market corporate bond issuance, issuers from the industrials, oil and telecoms sectors now account for a 19%, 14% and 12% share, respectively, of total issuance. (Source: JP Morgan Global Index Research, February 2012).

Emerging market companies operate within a wide range of macroeconomic, political and legal environments, and their mixed fortunes are to a great extent influenced by the domestic conditions in which they are embedded. Not all emerging countries have deep and liquid capital, currency and swaps markets, along with a local investor base; we are wary of the risks involved in investing in the corporate bond markets of these countries. An assessment of the country-level environment in which a company operates is at the top of our hierarchy of considerations taken into account when making an investment decision.

"Although many emerging market corporate bonds have a standard covenant comparable to those of US corporate bonds, it is nevertheless crucial to have a thorough understanding of local bankruptcy laws, pay-back arrangements and creditor rights."

Our focus is on issuers with more than US$300 million of outstanding debt, to ensure good liquidity (in our view, it is likely that small issues will underperform in bear markets). Although many emerging market corporate bonds have a standard covenant comparable to those of US corporate bonds, it is nevertheless crucial to have a thorough understanding of local bankruptcy laws, pay-back arrangements and creditor rights. Only if the emerging market corporate offers a risk/reward advantage, compared with a similar issuer in a developed country, would we invest.

An asset class taking shape

The current environment of low interest rates across most developed economies has proven favourable for the emerging market corporate bond market, with increasing inflows in to the asset class boosting liquidity conditions and encouraging local subscription. As emerging market corporate issuers continue to see their credit ratings improve, we expect demand for local currency-denominated (domestic) emerging market bonds to rise, as the dynamics of the maturing asset class play out further.

We remain cognisant, however, of the potential volatility of an asset class that is only beginning to capture the attention of fixed income investors. Investing in emerging credit markets entails risks, but so does investing in developed credit markets, as the (lack of) liquidity of the past few years would testify. In our view, for those investors that can manage the risks appropriately, the increasingly accessible and diverse emerging market corporate debt market provides attractive investment opportunities.

BNY メロン・アセット・マネジメント・ジャパン株式会社
BNY Mellon Asset Management Japan Limited

金融商品取引業者：関東財務局長（金商）第 406 号
〔加入協会〕社団法人　投資信託協会
　　　　　　社団法人　日本証券投資顧問業協会