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INVESTMENT NOTE **25 MARCH 2014**

EM high yield approaching crisis valuations

Emerging market debt was the place not to be in 2013. But the sector's rapid growth, increasing contribution to performance dispersion within major benchmarks and low valuations warrant investors' attention, says Jon Brager, Senior Analyst at Hermes Credit.

EM impact is increasing

Since 2008, the notional share of the Merrill Lynch Global High Yield Index claimed by emerging markets (EM) grew from 8.5% to 14.1%. While impressive, it's not the full story: recognising that bonds with longer duration or a higher spread – or both – will exert a greater impact on the index's return, we calculate that EM grew to 22.5% during this period, compared with 21.5% for Western Europe and 55.4% for North America.

Mass outflows on taper talk

The market began to weaken even before the US Federal Reserve mentioned "tapering" and the five-year reach-for-yield trade unwound, triggering mass capital outflows. In the past year, EM spreads widened by nearly 70bps as those in developed markets (DM) tightened by 90bps on an absolute basis. The sector lost 0.28% as DM returned 8.41%. Outflows from the four largest EM bond ETFs indicate the extent of investors' withdrawal: since January 2013, the net asset values of each fell by 45%.

Valuations approaching extreme levels

Absolute spreads of 686bps indicate that EM high-yield valuations are approaching extreme levels and a hawkish Fed could further depress the market in the short-to-medium term. DM spreads, in contrast, remain very tight. The ratio of EM spreads to DM spreads, cancels any difference between the betas of the two markets, illustrates the difference in valuations. This ratio was steady at 1.2 for all of 2012 and early 2013 but continued EM underperformance has driven it wider to 1.75, a level last seen during the 1997 Asia crisis and 2001 Argentina default.

Issuers profiting from currency weakness

For benchmark-oriented investors, the risk of being underweight EM increases with every additional basis point of underperformance. However, our analysis shows that these undervaluations are driven primarily by historically tight DM credit spreads combined with a rise in EM sovereign risk premiums. With the exception of Latin America, EM corporate credit spreads narrowed in the past year. Essentially, any macro bet on EM is now a gamble that country risk premiums will normalise. We prefer to selectively invest rather than buy beta. Specifically, we focus on high-quality global issuers with business models that benefit from local currency weakness.

Identifying valuation anomalies

Such companies are usually exporters of dollar-denominated products or have substantial operations in emerging markets. Cemex, a Mexico City-based producer of cement and building products, has a $15.9bn market capitalisation, operates worldwide and is benefiting from strong cement demand from Latin America and Asia and the US housing recovery. It plans to reduce net leverage from 5.5x to 3.0x, which will help tighten spreads. Its bonds currently trade 200bps wider than those of competitors Lafarge and Heidelbergcement – which, we think, is partly due to its EM domicile.

-ENDS-

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Notes to Editors:

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