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TALKING HEADS PODCAST

By **Daniel Morris,** Chief Market Strategist I **Alaa Bushehri,** Head of EM Corporate Debt

UPTURN BECKONS FOR EMERGING MARKET CORPORATE BONDS

Daniel Marris: Hello and welcome to the BNP Paribas Asset Management Talking Heads podcast. In this episode, we'll be discussing emerging market corporate debt. I'm Daniel Morris, chief market strategist, and I'm delighted to be joined by Alaa Bushehri, head of EM Corporate Debt. Welcome, Alaa. Happy New Year. Happy New Year to all of our listeners. Thanks for joining me.

Alaa Bushehri: Thank you for having me. And happy New Year to you.

Daniel Morris: When we think about emerging market assets, the first thing that comes to mind is volatility. 2022 was maybe not the most volatile year, but it's up there. We think of everything that happened: rising US interest rates and a strong US dollar, which generally isn't the best environment for emerging market assets. We think about the huge changes, the volatility that we've seen in China, which has had a big impact on emerging market assets and the Ukraine war, and particularly the impact that had on commodity prices, which again has had different impacts on different emerging markets depending on whether they're commodity exporters or not. So before we go to your outlook for 2023, could I ask you for a quick recap on what were the key factors for 2022, at least as far as emerging market corporate debt was concerned?

Alaa Bushehri: For 2022, I would summarise it as a very much challenging year. We ended up with a negative return for the year at -17%. It was a function of both macro and idiosyncratic events. I will start off with China, which you mentioned. The zero-Covid policy there created a slowdown across all sectors and affected the wider Asia region and global trends, more specifically on supply. China real estate was the event. We saw record defaults there. The sector was the largest bond issuer out of Asia, not just out of China, and very much a big part of the benchmark. And when we saw a tightening in policy there, which therefore led to defaults, we saw record defaults there. However, we do now see that trend turning around. It was our expectation that we would see easing and we do see the country now moving away from its zero-Covid policy. This has translated into positive sentiment. We also see easing policy across the real estate sector and supportive measures to help recovery there. So in conclusion, it was a very challenging year, but we do hold an optimistic view and expect improved performance for this year.

Daniel Morris: Well, we certainly all hope it will be better in 2023. You know, history tends to show that after you have a bad year, we should then have a good year. To go into more detail, what are your expectations for 2023? And, as always, what are some of the risks you foresee?

Alaa Bushehri: For 2023, we are expecting total returns to be in double-digit territory and for it to be led by the opening of China and the reversal of tight policies there. Again, from both a macro and micro point of view, the outlook faces uncertainties. These are around the themes of inflation, recession risks, rates, geopolitics and the risk of credits events, whether that is a single name or a sector or a region. We place a very low probability with regards to the risk of a credit event. But we are in EM corporates and that is an aspect that we always have to be on the outlook for.

Daniel Morris: You are looking for opportunities to overweight one sector or area versus another, so taking relative value positions as opposed to absolute positions, credit versus sovereigns, how does EM credit look versus US credit? How do you see valuations and fundamentals now?

Alaa Bushehri: On EM corporates versus sovereigns, the relationship has changed quite a lot and it's very interesting. If you are, for example, looking with a fresh pair of eyes at relative value, what it looks like now does look different from a couple of years ago. Since not necessarily all EM countries have corporates that are issuing, the index constituents in terms of regions and countries are very different or are becoming more different. Traditionally, you had emerging markets sovereigns that had quasi names. That's state-owned companies who issue bonds on the back of the sovereign yield curve such as Bank of China or Petronas of Malaysia or Petrobras of Brazil. They are either state-owned companies directly or if they are listed, as in the case of Petrobras. They have a very strong link to the government and government policies affect their business model. So that link is very clear. Over the years, we've seen corporates grow in terms of diversification. We see that at a benchmark level. So the EM corporates benchmark is now shorter in duration by approximately two years, but it's better in terms of ratings: it's investment-grade. EM sovereign are high-yield. Having said that, if we look at relative value, we ended 2022 with corporates slightly outperforming. You have to look at it from a bottom-up perspective to really understand where those moves have come from. So, when you look at EM corporates versus EM sovereigns, or EM corporates versus US credits, even in the IG and the high yield sector, what we found is that we really need to understand the moves from a bottom-up perspective. Having looked at that, we're heading into 2023 with an overweight in high-yield, but that is very much from a bottom-up approach, also focusing on recovery and situational plays. I would narrow it down to China, Indonesia, Macau and India, and a little bit of South Korea, but that's more sector specific. So in Asia, we hold an overweight in the high-yield sector, but also in Latin America and some opportunities in Europe. In terms of the fundamentals, they have remained quite resilient. This is a function of the balance sheet optimisation that started to take place starting in 2015 when we had a downturn in oil. A lot of EM corporates are linked to the sector and they needed to look at their financial health and optimise it. Those efforts led to where they were during the lockdown, where they found their fundamentals to be much stronger. Fast forward to now, it has put them in a position where they were able to navigate tough markets last year. So they are quite resilient and despite the headwinds, we saw only very marginal weakening. We expect them to continue with that discipline.

Daniel Morris: I'm sure you've got your list of big opportunities. What are your highest convictions right now?

Alaa Bushehri: Our preference is in Asia. We continue to be constructive on China real estate and our view started to play out, more specifically on 11 November when the policymaker communicated with the financial sector on what we perceive to be a more targeted and focused plan to deliver projects. We see a turnaround for the sector. There have been quite a few positive developments which have been reflected in the price moves over the last couple of weeks. The trajectory of the sector has moved towards a positive trend in line with our expectations. While we are yet to see a few of our very specific targets or expectations play out, we do expect this positive trend to continue. Away from China and China real estate, we are constructive across Asia high-yields. We do like Indonesian commodities and Indian renewables. Macau stands to benefit from the China reopening. We also like Asian subordinated bank debt, which has been the focus since the fourth quarter of last year. We expect them to call the subordinated debt as the call dates come due.

Daniel Morris: Alaa, thank you very much for joining me.

Alaa Bushehri: Thank you for having me.