RISING TITANS: THE ALLURE OF EMERGING MARKET CORPORATES

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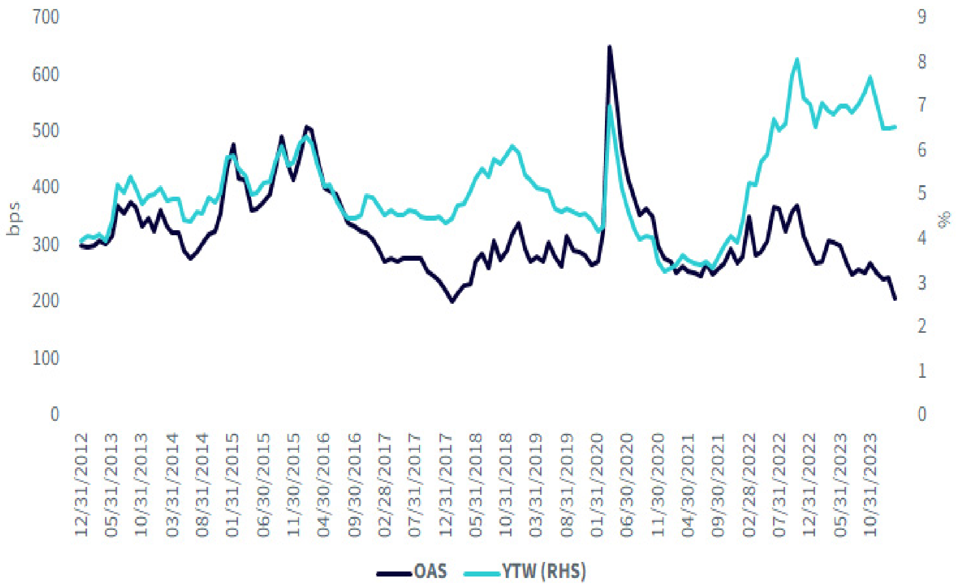
In 2023, a dominant theme for markets was the return of income in fixed income. Fast-forward to 2024, and despite a significant rally in spreads and a fall in yields during the fourth quarter, we believe this theme is still alive and well. As a matter of fact, yields of U.S. high-yield and investment-grade corporates still rest in the top quintile and decile of levels experienced over the last 10 years.

However, one segment of the market that has gone under the radar has been emerging markets debt, specifically emerging market corporates. In this piece, we will look at this sector and examine the case for including emerging market corporates' debt in investors' portfolios relative to U.S. corporate bonds and the dollar-denominated debt of emerging market sovereigns.

Attractive Yield Potential

Even after a significant rally of 444 basis points (bps) in spreads from the highs during COVID-19 (653 bps in March 2020), emerging market corporates continue to offer an attractive all-in yield. In fact, the all-in yield of 6.58% at the end of February stands in the top 10th percentile of yield offered by the sector in the past 10 years.

Emerging Market Corporates

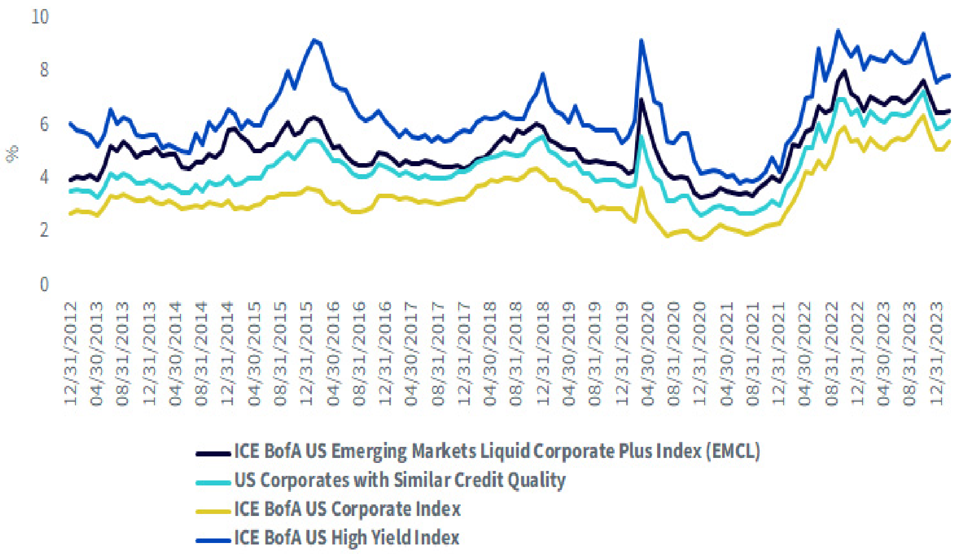


Sources: WisdomTree, ICE Data Indexes, as of 2/29/24.

For definitions of terms in the chart above, please visit the glossary.

Emerging market corporates not only offer a higher yield compared to what they have offered in the past but also compared to a portfolio of their U.S. counterparts with similar credit ratings (represented by the weighted average of the ICE corporate index and [ICE HY index](), weighted to the investment-grade/high-yield breakdown in the [EMCL Index]() (69% investment-grade and 31% high-yield as of February 29, 2024), they have consistently provided investors with higher income.

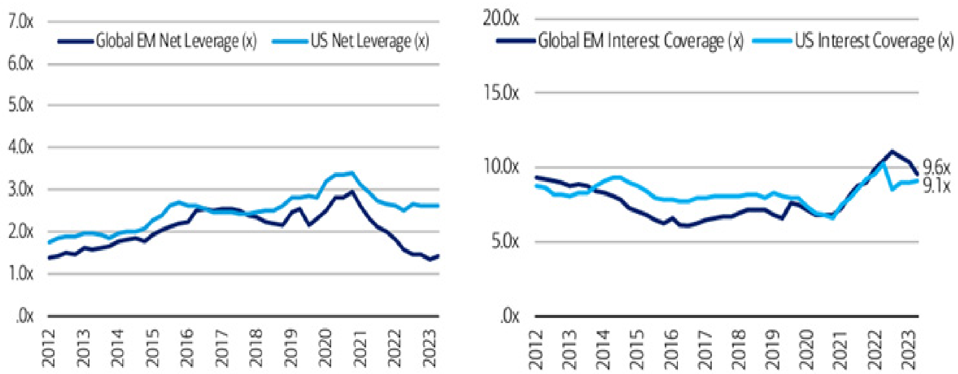
YTW



Sources: WisdomTree, ICE Data Indexes, as of 2/29/24. US Corporates with Similar Credit Quality represented by weighted average of ICE Corporate Index and ICE HY Index, weighted to IG/HY breakdown in EMCL Index.

Strong Fundamentals

One of the biggest concerns with emerging market securities, specifically corporates, and the main reason they have consistently offered higher income compared to a portfolio of U.S. corporates with a similar credit rating mixture, is their fundamentals. However, by looking under the hood, one can see emerging market corporates have improved their fundamentals. The gross and net leverage in EM corporates are some of the lowest in the past decade and also lower relative to U.S. corporates. The same can be said about their [interest coverage ratio](). Even though their IC has fallen recently, they still fare better than U.S. corporates.



Source: BofA Global Research company reports, as of 12/31/23.

Better Credit Quality and Less Interest Rate Risk Than EM USD Sovereigns

Another frequently used jibe at emerging market corporates is if an investor wants to invest in emerging markets, they can invest in "higher quality, less risky" sovereigns. However, this is another misnomer about emerging market corporates issuing in USD. The USD-Denominated Emerging Market Corporate Index has a higher allocation to investment-grade issuers than to USD-denominated EM sovereigns.

Credit Quality of ICE Emerging Market Debt Indexes – USD Corporate vs. USD

Sovereign

Corporate Sovereign			+/-
IG	68.85	64.64	4.21
AAA	0.85		0.85
AAA	13.33	9.17	4.16
AAA	24.13	19.71	4.42
BBB	30.54	35.76	-5.22

Corporate Sovereign			+/-
HY	31.14	35.36	-4.22
BB	20.72	13.01	7.71
C	7.47	17.39	-9.92
CCC and below	2.95	4.96	-2.01

EM USD Corporates and EM USD Sovereigns represented by the ICE US Emerging Markets Liquid Corporate Plus Index (EMCL) and ICE Emerging Markets External Sovereign Index (EMGB), respectively.

Looking at the country of risk of the issuers in these two indexes, the EM Corporate Index has a much higher allocation to countries with better fundamentals and a lower allocation to countries with struggling economic conditions. In many cases, the governments of the more developed emerging market countries secure most of their financing through debt denominated in their own currency.

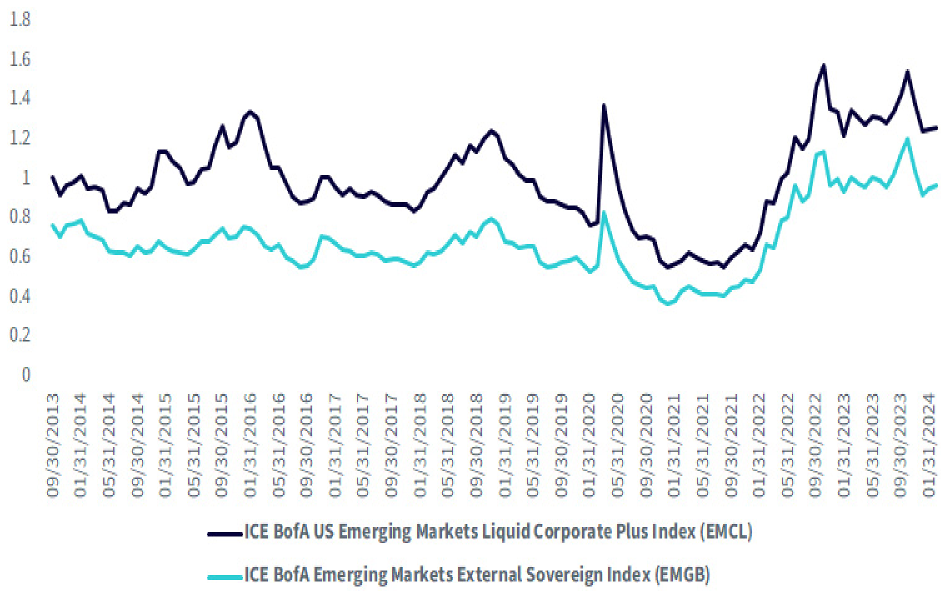
TOP 10 OW	
Country	Relative MV% (EM corps - EM Sovereigns)
China	8.73
South Korea	7.32
India	4.97
Brazil	4.57
Hong Kong	3.67
United Arab Emirates	3.34
Singapore	2.65
Malaysia	1.79
Taiwan	1.65
Chile	1.57

TOP 10 UW	
Country	Relative MV% (EM corps - EM Sovereigns)
Panama	-1.61
Dominican Republic	-2.02
Hungary	-2.26
Saudi Arabia	-2.27
Poland	-2.47
Egypt	-2.66
Indonesia	-2.77
Philippines	-3.20
Turkey	-4.25
Romania	-5.57

Sources: WisdomTree, ICE Data Indexes. Weights subject to change.

Finally, many emerging market corporations largely issue intermediate maturity debt, while EM sovereigns issue further out the curve, resulting in a consistently sharp duration difference between the two universes. (Currently, the universe for EM corporates has an average duration of 5.21 versus 6.98 for the universe of EM USD sovereigns.) Despite the duration difference, the aggregate yield sacrifice offered by EM corporates to EM is relatively modest, averaging about 27 bps over the last 10 years. Consequently, EM corporate portfolios have a significantly higher potential yield, given the amount of interest rate risk or yield per unit of duration, than EM USD sovereigns, as defined by their broad benchmarks.

Yield Per Unit of Duration



Sources: WisdomTree, ICE Data Indexes.

Selection Is the Key

As mentioned before, EM corporate fundamentals remain resilient, and financial policy remains prudent. As such, the default rate is expected to be lower as well. However, like any other segment of the market, investors need to be selective and choose issuers/regions that have better fundamentals. And that's the approach that the management team of the WisdomTree Emerging Market Corporate Bond Fund (EMCB) takes. EMCB is positioned with an over-weight (relative to the JPMorgan CEMBI Diversified Index) to Latin America and an under-weight to Africa and select countries in Asia, most notably China. China's strengthened policy response appears to have stabilized activity; however, growth is likely to slow further this year as housing and private sector confidence remain negative.

Important Risks Related to this Article

There are risks associated with investing, including the possible loss of principal. Foreign investing involves special risks, such as risk of loss from currency fluctuation or political or economic uncertainty. Investments in emerging, offshore or frontier markets are generally less liquid and less efficient than investments in developed markets and are subject to additional risks, such as risks of adverse governmental regulation and intervention or political developments. Derivative investments can be volatile, and these investments may be less liquid than other securities and more sensitive to the effects of varied economic conditions.

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You cannot invest directly in an index.

DEFINITIONS

Emerging market : Characterized by greater market access and less potential for operational risks when compared to frontier markets, which leads to a larger base of potentially eligible investors.

Basis point : 1/100th of 1 percent.

AA+ Credit Rating : The AA+ rating is issued by S&P and is similar to the Aa1 rating issued by Moody's. This rating is of high quality and falls below the AAA ranking. It comes with very low credit risk, even though long-term risks may affect these investments. The AA+ rating is considered one of the rankings for investment-grade debt.

ICE BofAML US Corporate Index(C0A0) : The ICE BofAML US Corporate Index tracks the performance of the universe of US dollar denominated investment grade corporate debt publicly issued in the US market.

ICE BofAML US High Yield Index (H0A0) : The ICE BofAML US High Yield Index tracks the performance of the universe of US dollar denominated below investment grade corporate debt publicly issued in the US market.

BofA Merrill Lynch US Emerging Markets Liquid Corporate Plus Index (EMCL) : Tracks the US dollar denominated non-government debt of EM.

Coverage ratio : Also referred to as interest coverage ratio, which compares earnings before interest and taxes to interest expense.

J.P. Morgan CEMBI Broad Diversified Core Index : Tracks the performance of US dollar-denominated bonds issued by emerging market corporate entities.