William Blair

EMERGING MARKETS DEBT

Investment Management
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EM Corporate Debt Themes in an Evolving World

Amid evolving global dynamics, we believe emerging market (EM) corporate debt offers compelling opportunities. The diversity of the asset class offers investors a wide spectrum on which to effectuate their views. But investors should navigate with caution. As we begin 2025, we believe the following themes will have the most impact on the asset class: negative net supply, U.S. policies, crude oil, the trajectory of interest rates and impact on financing costs, and improved default rates.

January 2025

Portfolio Manager
Luis Olguin, CFA

EM Corporate Debt Themes in an Evolving World

In 2024, EM corporate credit performance was strong, with index returns surpassing 7.6%. The asset class significantly outperformed EM and developed market (DM) credit in all rating categories except CCCs.

For 2025, while we believe return dispersion from the diverse opportunity set will offer ample investable opportunities, we highlight five themes that we believe will have a notable impact on EM corporate debt returns: negative net supply, U.S. policies, crude oil, the trajectory of interest rates and impact on financing costs, and improved default rates.

Negative Net Supply

In the 2010s, one of the defining characteristics of the EM corporate universe was growth. The asset class grew from 269 issuers to a peak of 845 issuers, while the debt market cap grew from $300 billion to $1.4 trillion ($2.2 trillion if 100% government-owned quasi corporates are included).

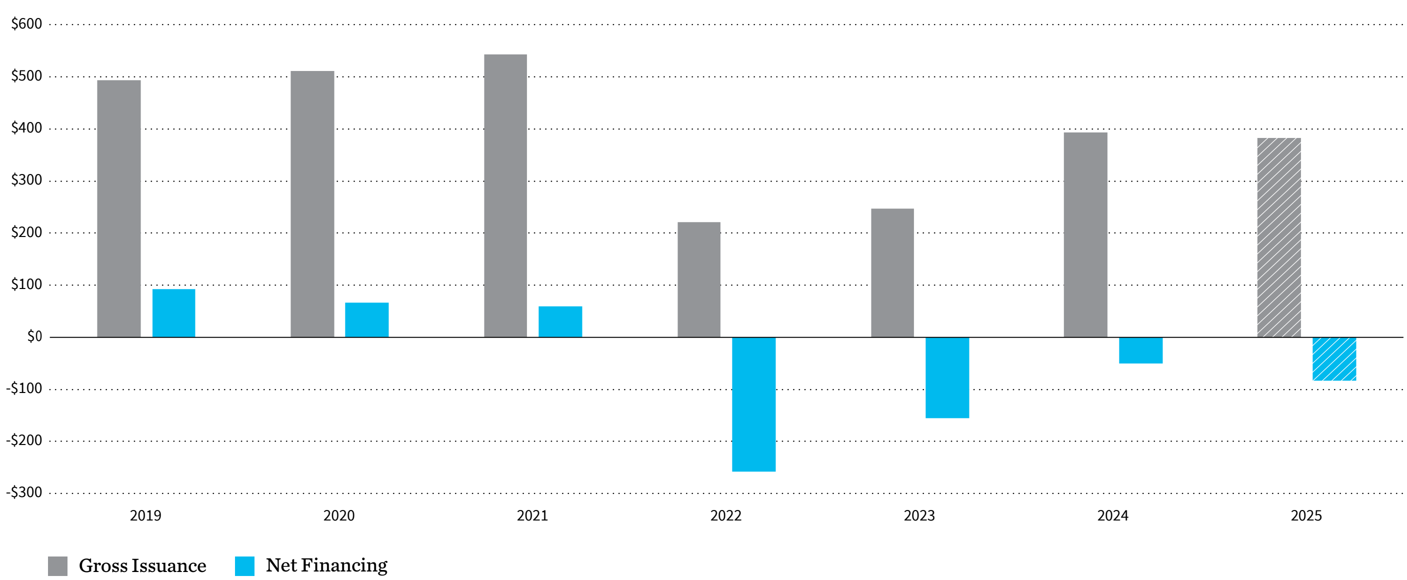
This growth was global but buoyed by Asia, particularly China. Gross issuance peaked in 2021, while net financing (which includes gross issuance less coupons, amortizations, tenders, and buybacks) was still positive, suggesting inflows into the asset class were required to cover funding needs.

Net financing became significantly negative in 2022 and 2023. This was mostly due to gross issuance falling over 50% from its peak. While issuance rose in 2024 and is expected to be stable in 2025, net financing continues to be negative, although much less so, with issuance in Asia

> "We view gross issuance expectations in 2025 as adequate while still supportive of healthy absorption from internally generated cash flows."
>
> **Luis Olguin, CFA**

EXHIBIT 1

Gross Issuance and Net Financing From 2019 to 2025 (in Billions)



Sources: J.P. Morgan Emerging Market Corporate Strategy and William Blair, as of December 2024.

still significantly depressed. Local debt financing and private credit markets have given issuers additional sources of capital.

New issuance is the bloodline of the asset class. It regularly offers a new issue premium, introduces debut issuers into the index, and gives investment managers concrete opportunities to reassess relative value and portfolio exposures.

In our view, the change in new issue activity had two major effects. First, it added to lower trading liquidity as portfolios become more stable. Second, it led to technical rallies as market participants looked for bonds during demand surges. A healthy new issuance market is primordial for the overall functioning and pricing of corporate credit.

Overall, we view gross issuance expectations in 2025 as adequate while still supportive of healthy absorption from internally generated cash flows. Continued but not massive negative net financing should be helpful for the asset class.

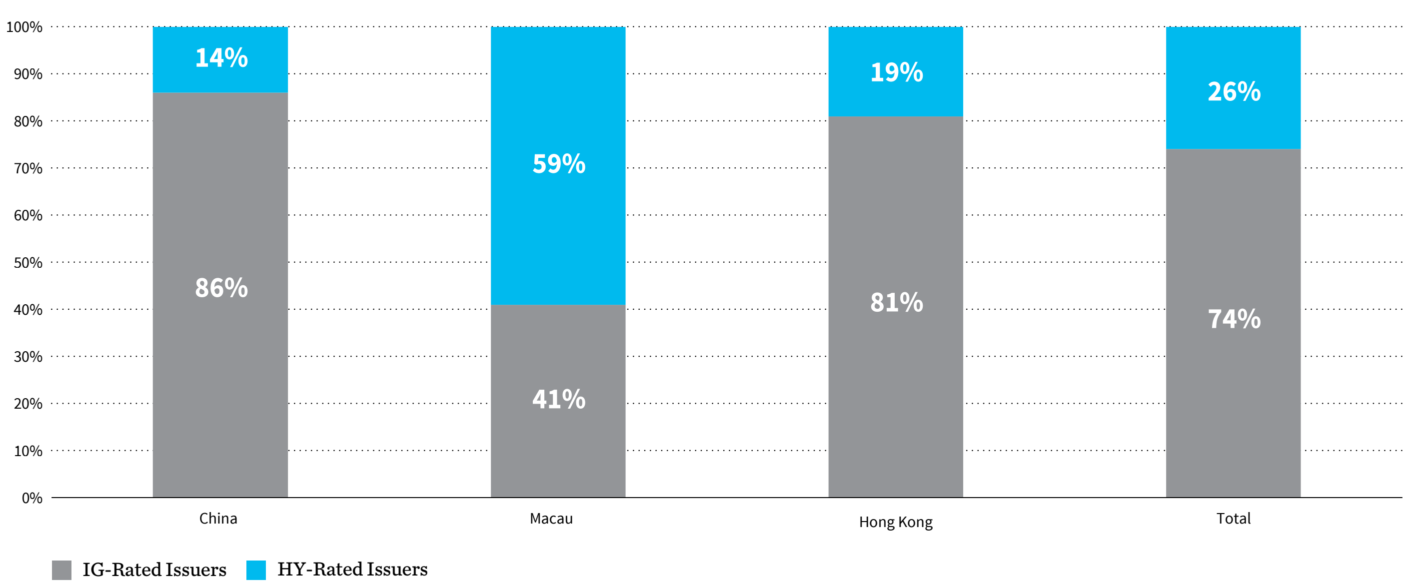
U.S. Policies

With the Trump 2.0 administration taking control, we can only surmise what recent rhetoric will become policy and their effects on our universe. Our EM debt team outlook, "Emerging Markets Debt in an Evolving World," highlights potential risks such as trade policy (in particular tariffs toward China) and a softer outlook for EM currencies. We focus our analysis on these two risks to EM corporates and acknowledge that they are not exhaustive or linear.

Examining the J.P. Morgan Corporate Emerging Markets Bond Index (CEMBI) Broad Diversified gives us a better assessment of the impact of tariffs on China to our universe. We define Greater China to currently include 181 issuers throughout China, Hong Kong, and Macau. These issuers account for approximately 15% of the index, of which almost three-fourths carry investment grade (IG) ratings. While tariffs will affect the overall perception of China, it is crucial to understand the sector and credit risk profile of our universe as well as the fact that many issuers are domestically focused and thus less directly exposed.

EXHIBIT 2

Ratings Breakdown Across Greater China



Sources: J.P. Morgan CEMBI Broad Diversified and William Blair, as of December 31, 2024.

"Our bottom-up analysis seeks to uncover individual issuer dynamics and shows enough flexibility for the majority of issuers."

Luis Olguin, CFA

More than 40% of the Greater China universe debt market cap is in financials, of which close to 80% are IG-rated, suggesting stronger capitalizations and systemic importance.

The second largest sector exposure is consumer, of which the overwhelming majority is tied to Macau gaming issuers. We see the transmission from tariffs to gaming activity as less direct but do acknowledge the ties to gross domestic product (GDP). Credit quality has improved for gaming issuers due to resilient demand and continued deleveraging.

The third major sector in Greater China is technology, media, and telecommunications (TMT), of which 98% is IG-rated. The sector is concentrated in large internet commerce issuers with significant capacity to absorb volatility due to their domestic focus and diversified revenue streams. Although direct tariffs would most likely reprice spreads, they are unlikely to significantly damage their credit profile.

The lowest-rated sector continues to be real estate, but it is still about 55% IG-rated. With remaining issuers having already survived a significant downcycle, we view their outlook as more dependent on government policies toward the sector than external trade dynamics. But we also acknowledge their ties to internal growth and financing conditions. Second-order effects of slower GDP growth to the region and commodity demand could also be notable but are likely to be offset by strong policy reactions.

The November 2024 U.S. election has heightened volatility across most currency pairs as initial weakness in DM currencies has now spread into EM currencies. When analyzing the risks of weaker currencies to the asset class, we view it through an index and bottom-up approach.

Out of the 63 countries in the corporate index, our internal analysis suggests 53 countries have some sort of peg (72% of the index weight), of which 17 have rigid pegs (27% of the index). Only 10 currencies are floating, with the vast majority likely to have central bank intervention in periods of major volatility.

In addition, commodity sectors (such as oil and gas and metals and mining) account for 17% of the index, with top lines tied to dollar revenues. Thus, the currency depreciation effect to our universe can be less direct than headlines.

In this case, top-down analysis is incomplete as every issuer could have different currency exposure than its country or sector would imply. Our in-depth, bottom-up analysis aims to reveal the true nature of this risk at the issuer level. Although our investment focus is U.S. dollar bonds, our issuers can and will have local currency denominated debt, particularly as local debt markets have gotten deeper.

> "Our in-depth, bottom-up analysis aims to reveal the true nature of the risk of currency mismatch."
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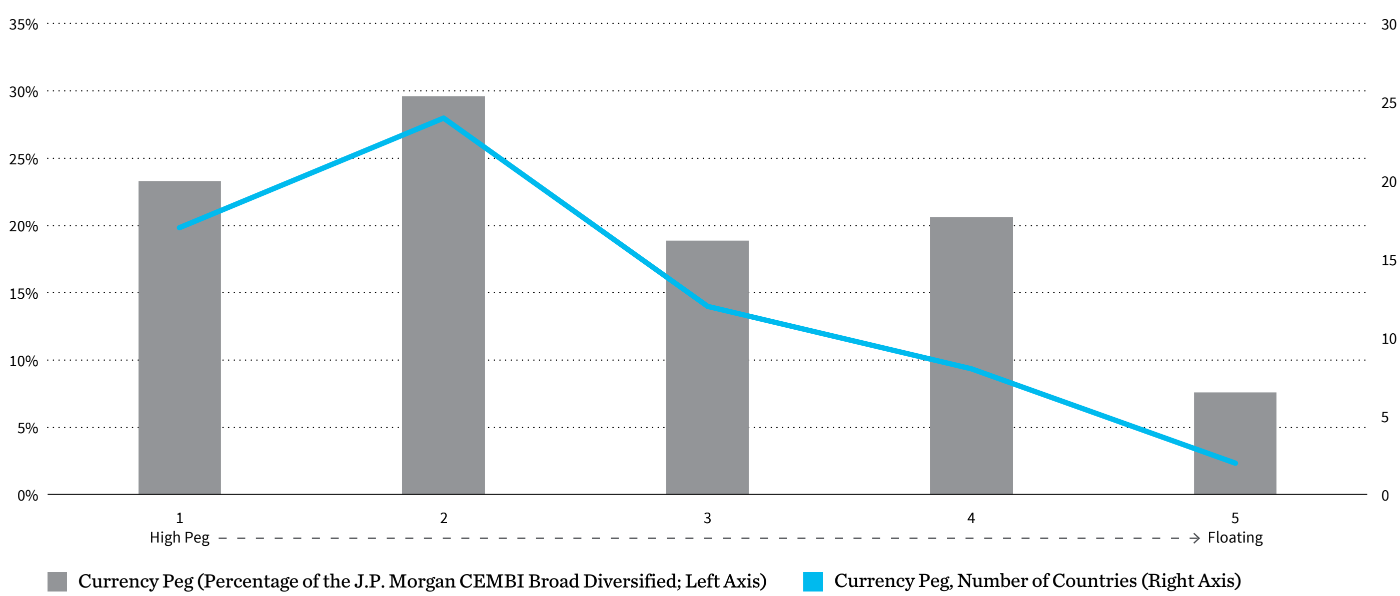
> **Luis Olguin, CFA**

In most cases, management teams are cognizant of currency mismatch risk and manage it through derivatives or internally through matching dollar cash flows with dollar debt. Timing mismatches can occur or be miscommunicated so thorough analysis is essential.

EXHIBIT 3

Currency Peg Analysis



Sources: J.P. Morgan CEMBI Broad Diversified and William Blair, as of November 28, 2024. 1 refers to high peg and 5 refers to floating.

EM Corporate Debt Themes in an Evolving World (continued)

Oil

Crude markets continue to be driven by demand uncertainty, increasing supply, and geopolitics.

Regarding demand, while India and the Middle East are becoming bigger consumers, it is still primarily China and the United States that determine balances. For 2025, global demand growth is forecast to be approximately 1 million barrels per day, which is somewhat under historical averages.

Although China accounts for 15% of total world demand, growth is expected to be tepid as fuel consumption continues to be affected by economic overhangs and electric vehicle (EV) penetration.

The United States accounts for about 20% of global demand, yet demand growth and oil intensity has flatlined for years. New policies in the United States could lead to volatility in oil markets and potentially consumption growth.

When looking at supply, production that is not part of the Organization of the Petroleum Exporting Companies (OPEC) is expected to grow, particularly in Brazil, Guyana, Canada, and the United States. But questions remain about how much and how quickly U.S. producers can react to more supportive government policies, though governmental support for higher production will certainly be there.

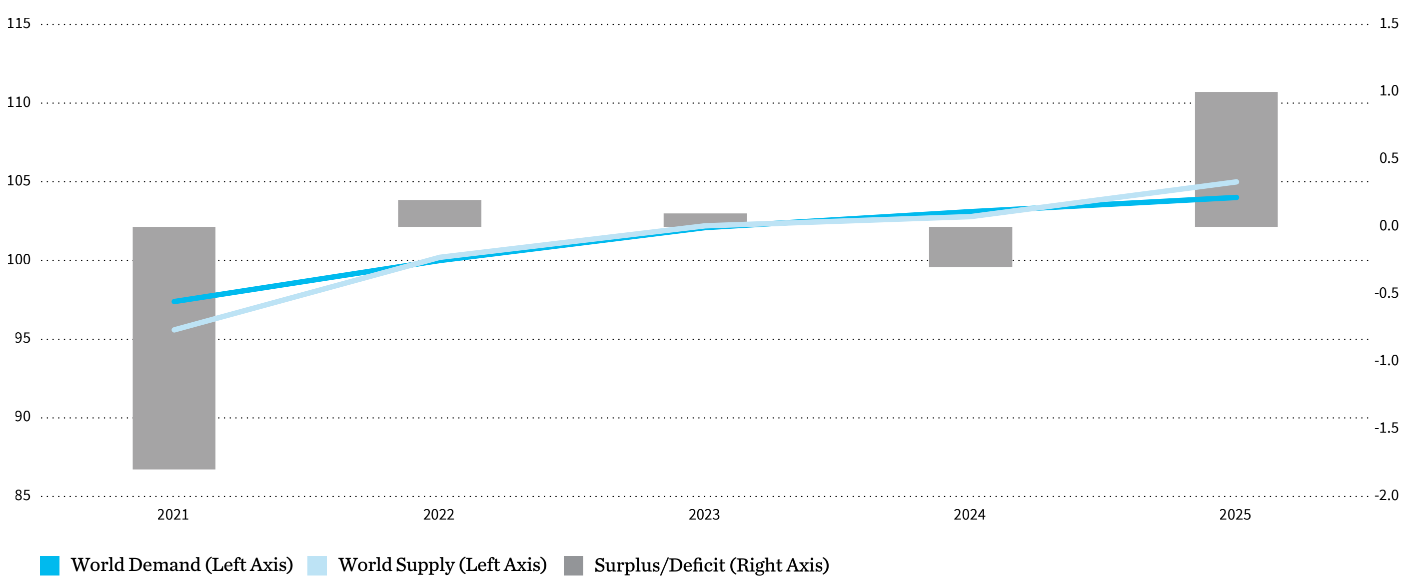
OPEC members continue to constrain their output, and the eventual release of barrels will likely bring major uncertainty for oil markets in 2025; it could lead to an oversupplied market if not met by demand fortitude.

But OPEC is also trying to balance varying factors in its decision: losing market share and thus market control; high domestic financing needs; and the effects of the energy transition.

In addition, geopolitics will likely continue to add volatility to markets. The conflicts in the Middle East and Ukraine, as well as new U.S. policies toward Iran and Russia, could quickly go from headlines to actual effects on constraining supply.

EXHIBIT 4

Global Oil Supply and Demand From 2021 to 2025 (in Million Barrels Per Day)



Sources: International Energy Agency and William Blair, as of December 2024.

Current market forecasts expect lower crude oil prices in 2025. While lower prices will affect higher cost producers in our universe, we note that the vast majority of the sector has cost structures well below price forecasts, suggesting lower fundamental risks.

The oil and gas sector is also diverse and includes integrated issuers, pipelines, pure-play exploration and production (E&P), and oil field services companies. Capital expenditures (capex) have been rising but can be flexible, allowing companies to generate free cash flow even with lower oil prices.

Interest Rates and Financing Costs

Higher interest rates affect corporate issuers through higher financing costs for new debt, leading to lower free cash flow generation and thus less financial flexibility. The diversity and dynamism of the asset class adds nuances to analysis, so we take several approaches to assess the risk.

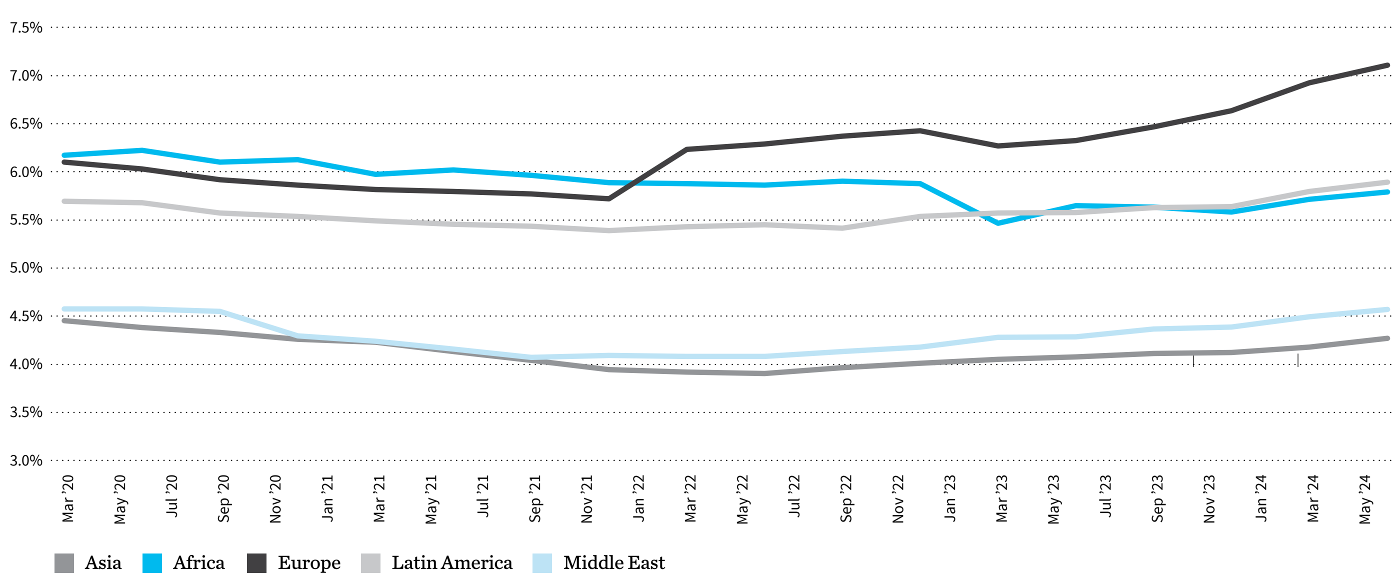
> "Every issuer will be affected differently, react differently, and have different capacities to absorb higher rates."
>
> **Luis Olguin, CFA**

When looking at the trajectory of coupons in our index, issuers pay higher coupons across regions, with the simple average coupon up over 40 basis points (bps) since 2021. But every region is showing higher increases as Asia drags down the average due to now-defaulted higher coupon China Real Estate bonds exiting the index.

Average index coupons also include historically lower rates, so we take two approaches to discern trends.

EXHIBIT 5

Index Average Coupon by Region



Sources: J.P. Morgan CEMBI Broad Diversified and William Blair, as of November 22, 2024. A direct investment in an unmanaged index is not possible.

First, we use our internal new-issue database for analysis. While this data is not exhaustive, we do believe it is representative, and shows a clear trend of higher coupons in IG and high yield (HY), even as IG durations have shortened and HY durations remained in a range.

We also looked at the current index by vintage (year of issuance). This analysis shows an average increase in coupons for the 2020 to 2024 vintages of 140 bps in IG and 250+ bps in BBs and Bs. Lower-rated issuers will be more affected by this increase in coupons, which could be a factor in the next cycle of credit stress.

In this context, it is important to highlight that issuers don't necessarily roll into new debt every year, with many having locked in lower interest rates in the past.

> "We also believe there is no particular sector or country at risk of credit stress but do note the idiosyncratic nature of defaults. A benign outlook for defaults in 2025 is positive for the corporate investment environment."
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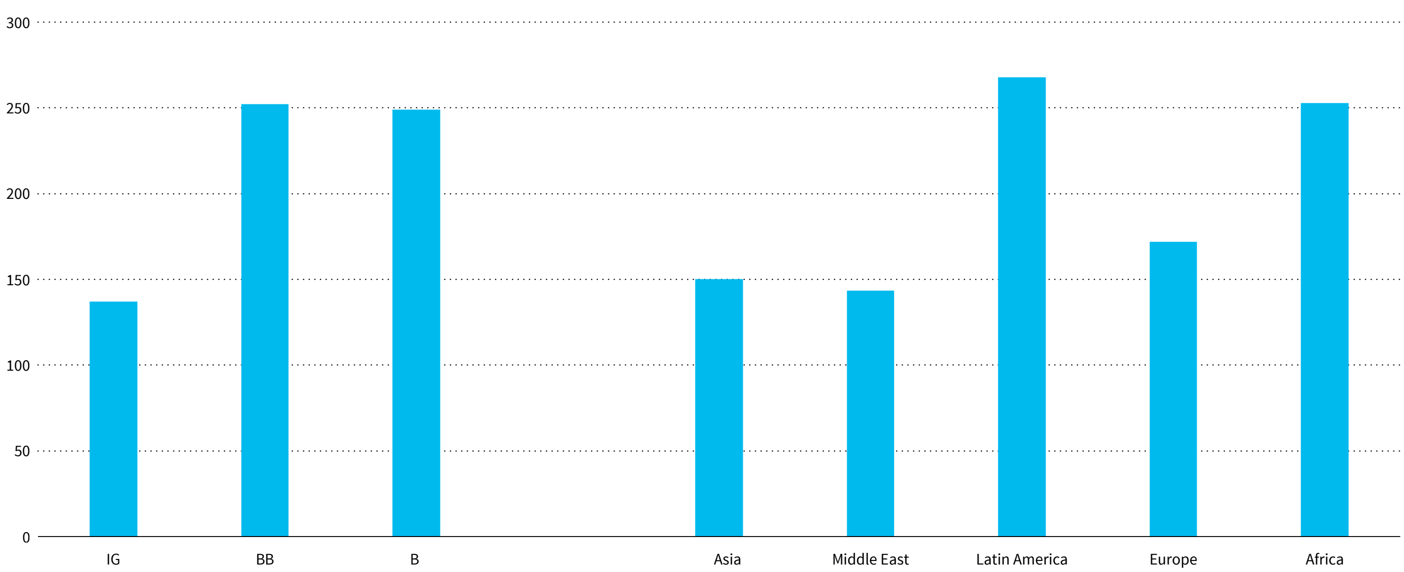
> **Luis Olguin, CFA**

Because of that, we look at upcoming maturities and current yields to get a sense of potential future increases in coupons. The index level maturity profile appears very stable, with approximately 5% maturing in 2025 and 10% to 15% maturing per year over the next five years, which is in line with historical averages.

EXHIBIT 6

Current Index Coupons by Vintage Over the Last Five Years (in bps)



Sources: J.P. Morgan CEMBI Broad Diversified and William Blair, as of November 22, 2024.

Our analysis of current coupons relative to yields suggest coupons could be poised to rise by almost 200 bps if issuers were to refinance bonds, with shorter maturity vintages potentially rising more.

It is too simplistic to make an overarching assessment as to the effects of higher coupons to financial flexibility. Every issuer will be affected differently, react differently, and have different capacities to absorb higher rates. Our bottom-up analysis seeks to uncover individual issuer dynamics and shows enough flexibility for the majority of issuers.

Default Rates

The long-term default rate for the HY component of our universe is 3.6%,[1] resulting in under 1.5% for the index. Defaults have had two major default peaks since index inception, although the mid-2010s saw relatively elevated defaults relative to DM credit.

1 Source: J.P. Morgan. CEMBI default rates are par weighted and based on bond stock at prior year-end. Note: Long-term average since 2002. 2024 level is as of September 2024.

The last default peak was tied to COVID-related stress, causing defaults and distressed exchanges to soar as well as policies intended to limit leverage in the Chinese real estate sector uncovered unstainable business models instead; the conflict between Russia and Ukraine led to limited access to capital markets; and capital controls in Argentina caused issuers to reprofile their debt.

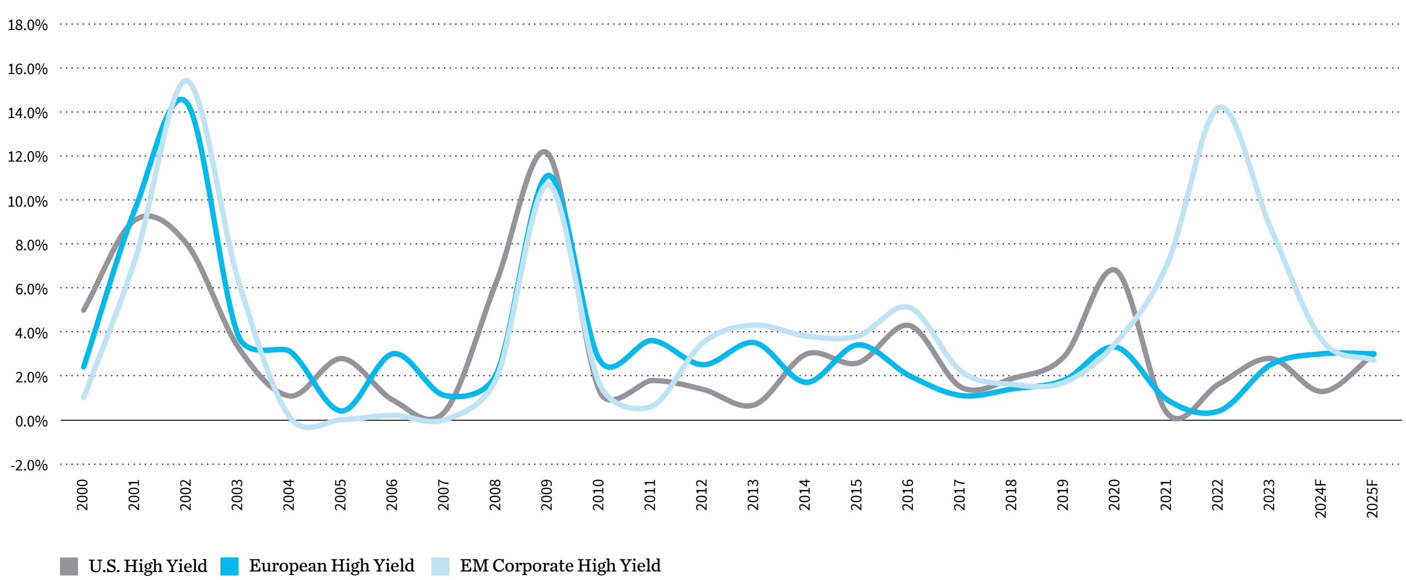
Default rates in other regions such as the Middle East have remained contained. Default cycles typically mean revert as problem issuers restructure or liquidate and exit the index.

We believe we could be in a period where defaults are confined, as issuers continue to be able to address near-term maturities and have expanded financing options through local and private credit markets.

We also believe there is no particular sector or country at risk of credit stress but do note the idiosyncratic nature of defaults. A benign outlook for defaults in 2025 is positive for the corporate investment environment.

EXHIBIT 7

Corporate Default Rate History



Sources: J.P. Morgan High Yield Strategy, J.P. Morgan European Strategy, J.P. Morgan Emerging Market Corporate Strategy, Moody's, and William Blair, as of September 2024. Past performance is not indicative of future returns. A direct investment in an unmanaged index is not possible.

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