FRANKLIN TEMPLETON

FRANKLIN TEMPLETON FIXED INCOME GROUP

FIVE REASONS WHY INVESTORS ARE TURNING TO EMERGING MARKETS CORPORATE BONDS

REACH FOR BETTER™

KEY POINTS:

1. Emerging markets (EM) hard currency corporate bonds are a larger asset class than EM hard currency government bonds, providing large scope to diversify risk.
2. On average, EM corporate default rates have been lower than those in developed markets, highlighting their under-appreciated credit quality.
3. EM corporate bonds offer an attractive yield, high credit rating and low duration, offering a highly attractive risk/return profile.
4. EM corporate bonds deliver higher spreads than equivalent bonds in developed markets for a given level of leverage.
5. EM corporate bonds have moderate correlations to other fixed income assets and therefore provide valuable portfolio benefits alongside their attractive returns.

Hard currency emerging markets (EM) corporate bonds are an under-appreciated and under-owned area of fixed income that most investors wrongly assume are simply a higher risk alternative to EM sovereign bonds. In fact, as an asset class hard currency EM corporate bonds carry a higher credit rating – and a lower beta – than EM sovereigns: BBB versus BB+. There are two major reasons. The country weightings of EM corporate and government bond indices are very different, wrongfooting those who draw conclusions about corporate credit based on the make-up of the hard currency sovereign universe. Second, the EM corporate bond index contains numerous examples of high quality issuers, many of which have international businesses, with stronger fundamentals than their country of origin.

Fears over the currency risk of EM corporate bonds are also greatly overplayed. Since the 1997 Asia Financial Crisis, EM corporate issuers – encouraged by regulators and governments – have become more active in hedging their hard currency risk. Combined with robust earnings growth and plentiful liquidity, these factors help to explain why default rates have been comparable with developed markets. And although data quality is more variable than in some developed markets, we also see clear opportunities to deepen our credit analysis of EM corporate issuers by using Environmental, Social and Governance factors.

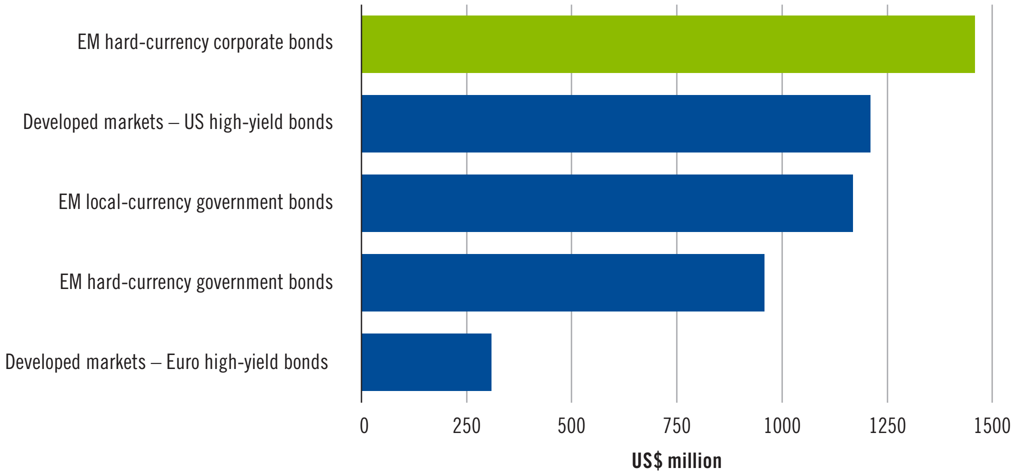
Although the growth of EM hard-currency corporate bonds into a globally significant asset class is relatively recent and therefore poorly understood, there is abundant evidence that these investments offer attractive risk, return and correlation characteristics. In the pages that follow we set out key parts of that evidence, offering five reasons why EM corporates now represent an essential element in any high-yield fixed-income portfolio.

1 | EM Hard-Currency Corporate Bonds Are a Larger Asset Class Than EM Hard-Currency Government Bonds

At around US$1.5 trillion, the hard-currency EM corporate bond index is larger than its sovereign equivalent which has a face value of almost $1.0tn.[1] Thanks to its size and depth, the EM corporate bond market offers considerable scope for portfolio diversification.

Comparisons with developed markets are also favourable; the EM corporate bond market is as big as the US-dollar and euro high-yield markets combined.

Market size aside, as at the end of 2018, there were more than 900 different issuers of EM hard-currency corporate debt, compared with about 150 hard-currency issuers of EM government and government-related debt.



Source: Bloomberg, as at 31 March 2019. EM Hard Currency Corporate Bonds – ICE BofAML EM Corporate Plus Index. US High-Yield – ICE BofAML US High Yield Index. EM Local-Currency Government – JPM GBI-EM Index. EM Hard Currency Government – JPM EMBI Index. Euro High-Yield – ICE BofAML Euro High Yield Index.

On Average, EM Corporate Default Rates Have Been Lower Than

1. EM corporate bond index: ICE BAML Emerging Markets Corporate Plus Index 'EMCB'. Hard-currency sovereign bond index: JPM Emerging Markets Bond Index 'JPM EMBI'.

2 | Those in Developed Markets

Since 2000, default rates on high-yield EM corporate bonds have been lower than those of their developed-market peers – despite many investors' belief that this asset class has lower credit quality than assets in developed markets.

Crucially, EM corporate defaults stayed well below 1% in 2018, a year marked by volatility in several emerging markets such as Mexico, Turkey and Argentina.

In addition, the International Monetary Fund (IMF) foresees that emerging markets will continue to grow between two and three times as fast as developed markets. This provides a helpful tailwind for EM corporates.

Source: Bloomberg, BAML. US High Yield – ICE BofAML US High Yield Index. Euro High Yield – ICE BofAML Euro High Yield Index.
EM Corporate High-Yield – ICE BofAML Emerging Markets Corporate Plus Index.

Attractive Yields, High Credit Ratings and Low Duration

Around 70% of bonds in the EMCB Index are investment grade, giving it a solid BBB

EM corporates – finding quality and value in the long tail of smaller issuers

Although BAML's EM Corporate Bond Plus Index ('the EMCB') is comprised of around 900 issuers, there is still a degree of concentration; the largest 20 issuers account for around 26% of the index by weight.

Many of the most indebted EM corporate bond issuers are government-owned or government-linked entities, such as **PEMEX**, **Petrobras**, **Sinopec**, and **China Development Bank**. State-owned enterprises such as these generally rely heavily on implied government support when it comes to their rating, and their cost of funding.

Our benchmark-agnostic approach focuses on the bottom-up fundamentals of companies. We consider the relative and absolute value of their bonds, regardless of their prominence in the benchmark. This methodology helps us find attractive investment opportunities outside of the largest 20, in the long tail of smaller issuers in the index, and outside it altogether.

For example:

China Mengniu is a leading manufacturer of dairy products in China with revenue of RMB 69bn in 2018, that counts France's Danone as a strategic shareholder.

MedcoEnergi is an Indonesian oil and gas company active since 1980 whose management have struck a fine balance between inorganic expansion and deleveraging the business.

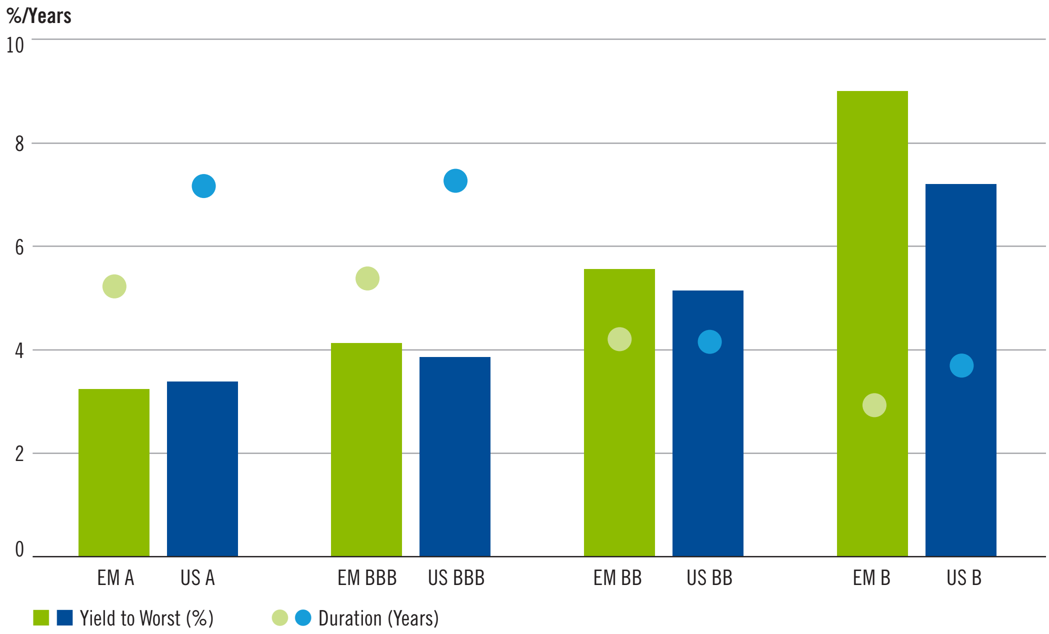
Bank of Georgia is the second largest bank in Georgia, with strong credit fundamentals and an equity listing on the London Stock Exchange.

ICTS (International Container Terminal Services) is one of the world's top five port operators but does not have a credit rating. Headquartered in Manila, the company has operations across 18 countries.

3 | rating overall, yet it offers a significant yield premium over similarly rated US credit – the EMCB had a yield to worst of 4.72% as of 31 May 2019, against 3.86% for BBB-rated US credit.

The EMCB's duration stood at 4.8 years, compared with 7.1 years for EM hard currency sovereign debt, around 7 years for US investment grade debt, and 5 years for euro investment grade debt.

Breaking down by credit rating, we note that the EM corporate market has comparative or more attractive yields in each ratings bucket compared with US credit, despite generally much lower duration.



Source: Bloomberg, as at 31 May 2019.

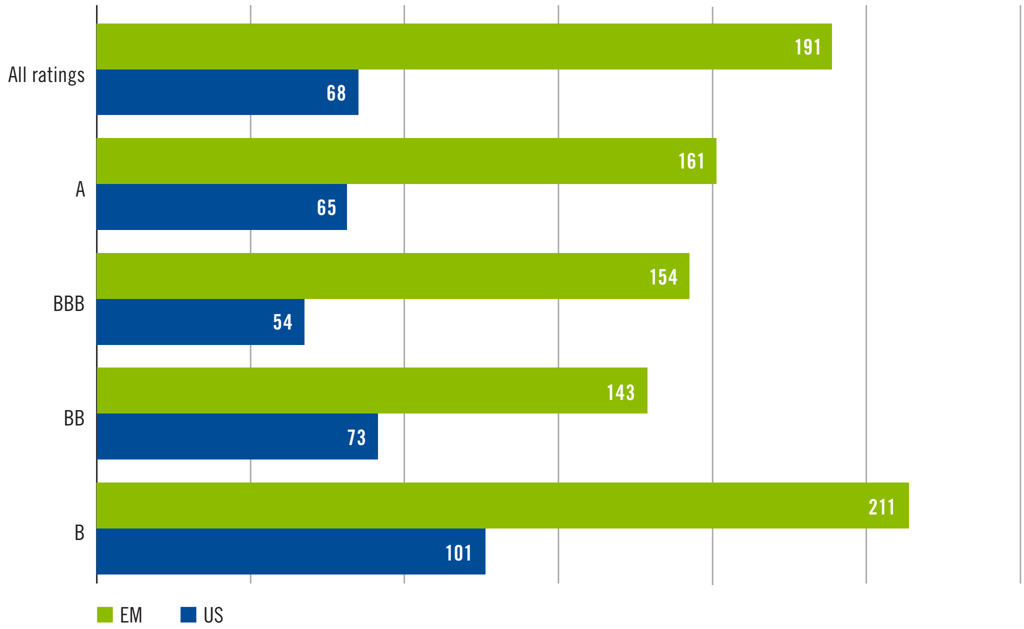
EM Corporate Bonds Deliver Higher Spreads

Within each credit rating category, EM corporate bonds offer higher spreads than developed-market corporate bonds when adjusted for their leverage, demonstrating their

4 | highly attractive balance of risk and return across the ratings spectrum.

To be precise, at 31 March, EM corporates offered 123 basis points (bps) of additional spread per turn of leverage (calculated as net debt/EBITDA) than US peers.

At the same time, it is important to note that EM corporate issuers' net leverage multiples have been trending down since the end of 2017.



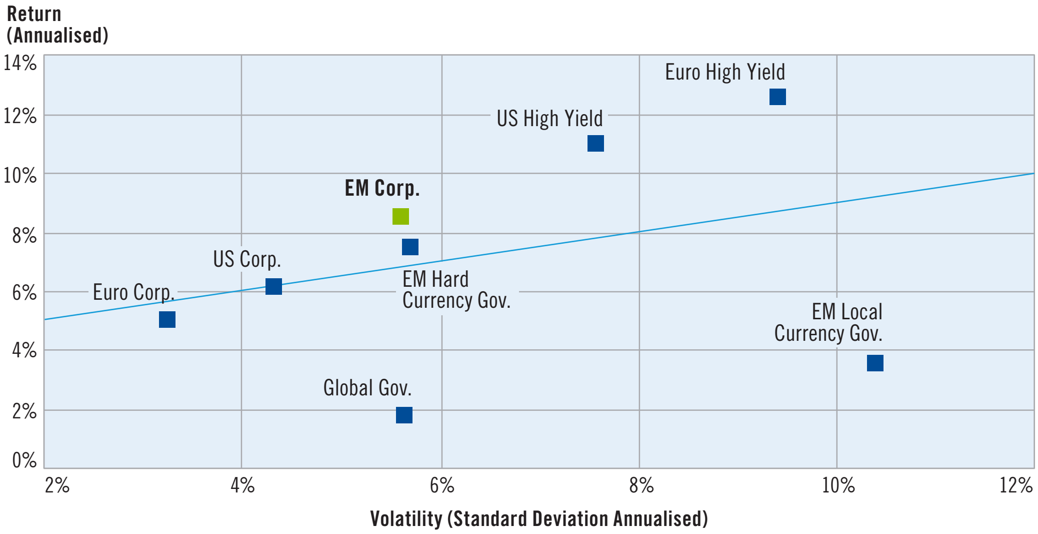
Source: BAML, Spreads as at 31 March 2019. Corporate leverage data as of 31 December 2018.

EM Corporate Bonds Are a Valuable Diversifier

The EM corporate bond market is large and contains many high-quality issuers, but those

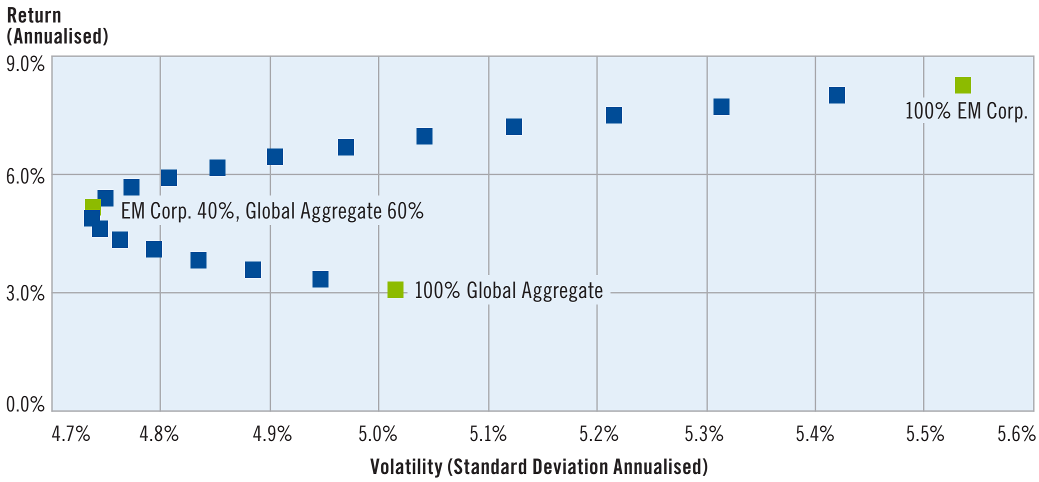
5 | are not its only attractions.

EM corporate bonds have moderate correlations to government bonds and other credit instruments globally and as a result bring valuable diversification benefits that improve the risk/return profile of many fixed-income portfolios.



Source: Bloomberg. Annualised monthly returns and standard deviation 31 December 2008–31 December 2018. Euro High Yield – ICE BofAML Euro High Yield Index (EUR). Euro Corporates – ICE BofAML Euro Corporate Index (EUR). US Corporates – ICE BofAML US Corporate Index. US High Yield – ICE BofAML US High Yield Index (USD). EM Corporate Bonds – ICE BofAML EM Corporate Plus Index (USD). EM Hard Currency Government – JP Morgan EMBI (USD) Index. EM Local Currency Government – JP Morgan GBI-EM Index (USD unhedged). Global Government – ICE BofAML Global Government Index (USD).

EM corporate bonds provide relatively high returns, with less volatility than their developed-market peers. Historically, they have offered a better risk/return profile than either US or European corporate bonds.



Source: Bloomberg, BAML Research. Annualised monthly returns and volatility 31 December 2008–31 December 2018. EM Corporate Bonds – ICE BofAML EM Corporate Plus Index (USD). Global Aggregate Bonds – ICE BofAML Global Aggregate Index (USD).

Summary

EM corporate bonds are attracting investors for good reason.

At US$1.5 trillion, EM hard-currency corporate bonds are now a larger market than EM

Some common misconceptions about EM corporates – fact or fiction?

A high-risk extension of the EM sovereign universe?

The misconception exists that EM corporate bonds are simply a higher-risk extension of EM government bonds. This is incorrect.

Firstly, government and corporate bond indices have vastly different country weightings. For example: China represents only 9% of the EM government bond index, but 28% of the EMCB. This has clear implications for the overall quality of the two asset classes.

Secondly, some corporate issuers can demonstrate stronger fundamentals and sometimes even a better rating than their primary country of risk. Examples include Braskem S.A. and Fibria Celulose S.A. in Brazil, Anadolu Efes and Coca-Cola İçecek in Turkey, Ferrexpo PLC and MHP S.A. in Ukraine, and America Movil SAB de C.V. in Mexico.

These factors contribute to the EM hard-currency corporate universe having a higher rating (BBB), and a lower beta, than the EM hard currency government bond universe (BB+).

Scope for ESG?

There is a misconception that EM corporates are a lost cause when it comes to Environmental, Social and Governance (ESG) risk factors. We strongly disagree.

Admittedly, the quality and consistency of ESG data is variable in the EM corporate world; only about 60% of issuers have an MSCI ESG rating, compared to around 80% of US corporate issuers.

At Franklin Templeton, we believe that this gap represents an opportunity. Therefore, ESG analysis can and should play a central role in EM corporate bond investing, if it incorporates proprietary analysis and engagement with management.

Proprietary analysis helps us avoid EM corporate issuers whose credit profiles are vulnerable to ESG risk factors. Our analysis also helps to add value in a positive way, either by identifying more qualitative credit strengths, or through engagement with management to improve the credit profile of the company. We've engaged in this way with a wide variety of companies, from property firms in Russia to textile firms in Indonesia.

Currency risk?

Plenty of investors fear that most EM companies will default on their hard-currency debt when local currencies depreciate. This is not the case.

We believe that this risk has diminished significantly since the 1997 Asian financial crisis when valuable lessons were learned about FX risk by companies, regulators and investors alike.

To start, more firms are now aware of currency risk and look to actively mitigate it. As a result, currency hedging has become cheaper and more prevalent than in the past. Such hedging can take a multitude of forms, from simple cash management to complex derivative strategies.

In addition, companies in several large sectors such as energy and basic resources often have a so-called "natural hedge". This stems from having revenues in hard currencies, to match the denomination of their debt.

On top of this, in the financial sector (around 20% of the EMCB) regulators are increasingly requiring EM banks to balance their foreign-exchange assets and liabilities. This reduces the probability of a currency move sparking a systemic banking crisis in the EM world.

hard-currency government bonds, and as big as the US-dollar and euro high-yield bond markets combined.

As EM companies grow and develop, we expect them to continue to recognise the benefits of funding in the international bond market. The sustained deepening of the asset class will make it even harder to ignore as an attractive investment opportunity.

Alongside this growth, the increasing variety of EM corporate issuers offers continued opportunities for investors to diversify.

EM corporates combine low default rates and better-than-expected credit ratings, with attractive yields and moderate duration. In addition, EM corporate bonds tend to offer more spread than their developed market equivalents, which underpins their compelling relative value proposition.

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Established in 1970, Franklin Templeton Fixed Income Group invests across the fixed income spectrum. Our size, global presence and depth of expertise position us to identify alpha opportunities across all major market sectors. We have managed a dedicated EM corporate bond strategy since June 1996.

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