Emerging market investment grade debt for insurers
Capturing yields while maintaining quality, capital requirements and an integrated ESG approach

For professional investors and qualified clients/sophisticated investors only.

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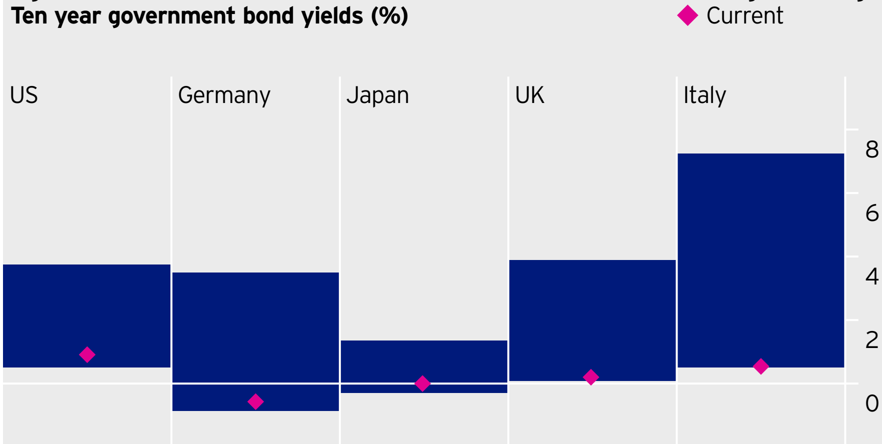
Reasons to consider emerging markets credit

- Attractive Long Term Returns
- Broad and Diverse Universe
- Regulatory Capital Treatment
- Robust Economic Outlook

Introduction

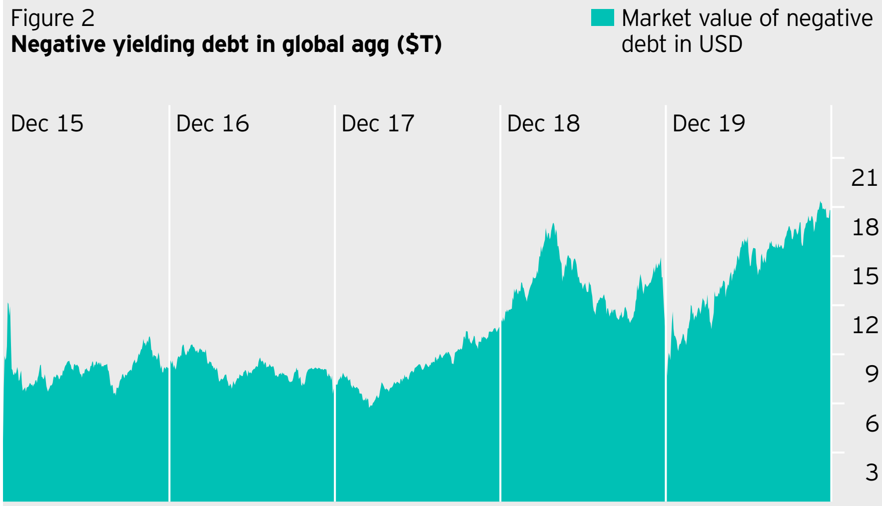
Since the global financial crisis, we continue to live in an increasingly low yield world. There has been hope that highly accommodative rates across the major developed economies would eventually drive a meaningful acceleration in global GDP and a normalised rate environment. However, that has not happened (Figure 1). Instead, after seeing short term European rates hold in negative territory for several years (Figure 2) and US rates at historical lows, we saw global rates driven even lower by the COVID-19 pandemic which caused the most highly synchronised contraction in global GDP in modern history. While uncertainty remains high, we do think it is reasonable to expect that this environment of extremely low interest rates is here to stay for at least the next few years. In this paper, we explain why investing in emerging markets investment grade debt could offer a potential source of diversification for insurers who are looking for attractive long term returns, a broad and diverse universe, the regulatory capital treatment and a robust economic outlook. In addition, we also consider the reasons why considering this asset class could be a great opportunity for investors to drive change while integrating ESG considerations into their portfolio.

Figure 1
Ten year government bond yields (%)



Source: Bloomberg, as 31 December 2010 to 31 December 2020.

Figure 2
Negative yielding debt in global agg ($T)



Source: Bloomberg, Barclays, as of 31 December 2020.

As a result of this low rate environment, high quality-oriented insurance fixed income investors looking for reasonable yields are now left having to go very far out the duration curve to bonds with maturities of 30 years or longer or look beyond traditional developed market investment grade bonds. In our view, emerging market investment grade hard currency debt is an attractive option for such investors for a number of reasons.

Firstly, and most importantly, the asset class offers compelling long-term value. As we will show, emerging market hard currency debt offers an attractive spread premium over similarly rated developed market debt that is primarily a function of volatility, not credit risk. As a result, long term asset class returns are quite strong on a comparable basis, providing attractive compensation in our view for that higher volatility. Secondly, this is a broad and diverse asset class with over $3.5 trillion of hard currency bonds spanning more than 70 countries with very different characteristics. Such breadth and depth provide diversification benefits and attractive investment opportunities in our view. Consider, for instance how different the economies of China, Saudi Arabia and Peru are from each other. It is also important to note for insurance clients that emerging market hard currency investment grade bonds get the same regulatory capital treatment by rating category as developed market bonds.

Taking all of this into consideration, we find investment grade emerging market debt to be very compelling for high quality oriented insurers with a longer term focus as they are able to benefit from the additional spread and yield offered by the asset class while looking past the sometimes higher volatility. In addition, this focus on the higher quality segment of the emerging market debt space allows investors to fully avoid the occasional severe volatility and default risk (Argentina and Lebanon for example) that can be found in the very low quality segment of the market. This lower quality segment certainly garners a lot of media attention, but the reality is that this is a small part of the market and investors are able to potentially generate superior risk-adjusted returns and often better total returns by avoiding this segment of the market.

Attractive relative value versus developed market debt

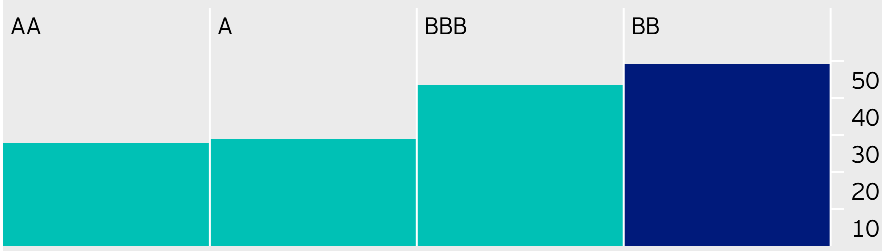
As Figure 3 shows below, emerging market debt has consistently offered an attractive spread pick up on comparable quality over time. While the spread pick up in the investment grade space is certainly less than high yield, even this modest difference in spread can make a big difference in terms of total returns over time.

Over the past 10 years, even taking into account the impact from the 2020 pandemic, annualised returns for emerging market investment grade debt look very favorable in comparison to developed markets. Over this period, returns have averaged 6.52% and 5.84% (Figure 5) for investment grade emerging market sovereign and corporate debt, respectively. This compares favorably to the 4.49% average return for US investment grade debt (Figure 5).

Volatility has been higher for emerging market debt but in our view investors are well compensated for that volatility.

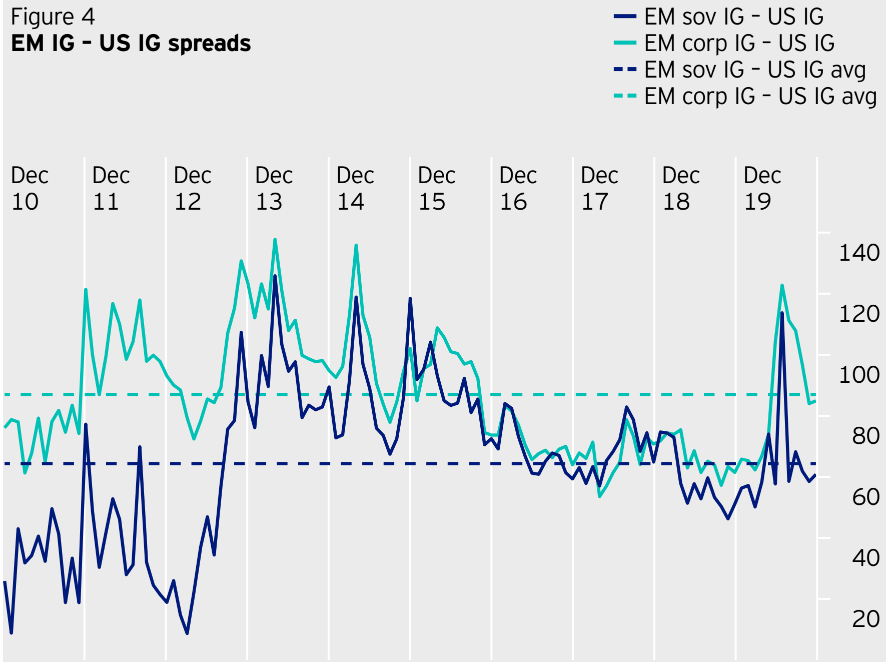
While our view is that emerging market investment grade debt should be a consistent core allocation for insurers rather than a tactical allocation given the attractive long-term value. It is worth noting that relative value and future returns coming out of periods of crisis tend to be quite favorable on a lagged basis as emerging investment grade debt spread tightening typically lags that of US investment grade debt, especially as it relates to emerging market corporate debt. As Figure 4 shows relative spread differentials between emerging market and US investment grade corporate bonds have only just recently begun to compress and remain at quite elevated levels, well above historic averages. While emerging market investment grade sovereign spread differentials have compressed from their peak, they have only come back to longer term averages and are well wide of their historic tights. As such, we do find the present conditions to be quite compelling for investment into emerging market investment grade debt.

Figure 3
Average EM vs US spread premium (OAS bps)



Source: Barclays, as of 31 December 2020. (5 year avg).

Figure 4
EM IG – US IG spreads



Source: JP Morgan, as of 31 December 2020.

A comparison of volatility adjusted returns

While we believe a long-term orientation is best for emerging market credit, bouts of volatility in any asset class can test an investor's resolve. As such, volatility does warrant consideration especially as it is an area where emerging market does not compare as favorably to developed markets. Generally, on a like for like basis emerging market credit is more volatile. If you take a typical 10 year USD BBB emerging market sovereign or corporate bond it will exhibit more volatility than the typical US corporate 10 year USD BBB bond. However, you do get compensated well for that higher volatility, especially in the emerging market corporate space.

The data in Figure 5 looks at total returns and volatility for the past 10 years comparing emerging market IG credit (USD bonds only) to US investment grade credit (USD bonds only). Firstly, if you compare emerging market sovereign IG and US Corp IG, you see that while you do have higher volatility for a broadly similar duration profile, annualised returns are almost 75bp higher over the past 10 years. When looking at the corporate space, the comparison is also quite favorable with EM IG Corporates a Sharpe ratio of 0.90 over the past 10 years versus 0.98 for US IG and with a 7bp annualized return pick up. Overall, the data shows that emerging market hard currency debt offers a comparable risk adjusted returns profile to US investment grade and higher total potential returns.

While US IG Sharpe ratio compares somewhat favorably to EM IG, duration for US IG is materially longer than its emerging market counterpart. Given the higher degree of interest rate risk and lower credit spreads in developed market debt, we believe there is scope for superior total and risk adjusted returns for emerging markets in an environment of steady to rising rates.

Figure 5
Comparative Sharpe Ratios Global Investment Grade Credit

	Duration	Annualized returns	Volatility	Sharpe ratio
EM Sov IG	8.29	6.52%	7.36%	0.89
EM Corp IG	5.09	5.84%	6.45%	0.90
US Corp IG	8.84	5.77%	5.91%	0.98
US IG	6.22	4.49%	3.19%	1.41

Source: Bloomberg, JP Morgan, Barclays, as of 31 December 2020. (10 year average).

Credit risk: emerging market vs developed market

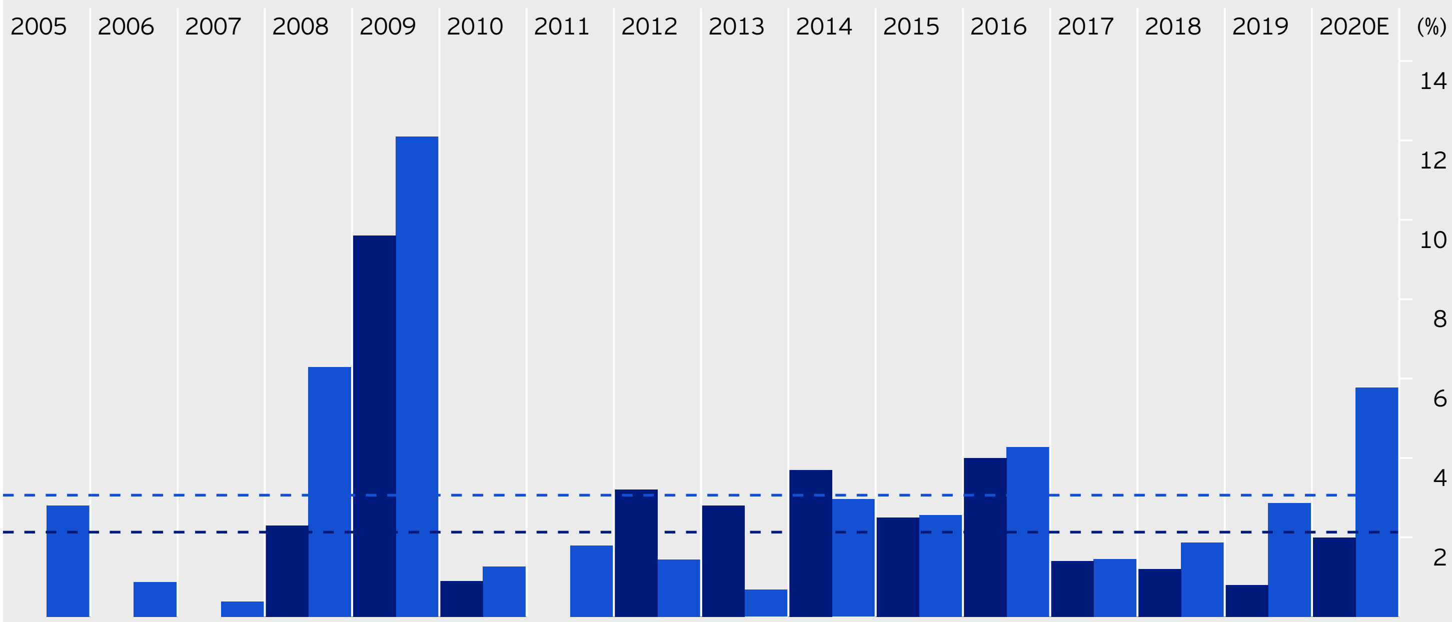
The most common objection from insurers as it relates to emerging market credit is that it is much ‘riskier’, even in the investment grade space, than developed market credit. When addressing this concern, it is important to define specifically what is meant by ‘riskier’, as that is a very broad term. Here we are going to focus on what we view as the two main types of risk in the public credit space – price or spread volatility and credit/default risk.

While volatility is certainly a concern for all investors, for insurers with a long-term orientation, default risk is the key risk when investing in hard currency bonds, emerging market or developed markets. Given some of the prominent and overstated headlines that we see in the emerging market space there is a perception that default risk is higher in the emerging market space.

It is certainly true that many emerging market economies are more volatile from an economic or political standpoint. However, the rating agencies consider the economic and political volatility of a given country as part of the consideration when assigning both sovereign and corporate ratings for emerging market issuers.

As such, when you look at the default data on a comparable quality basis, the default rates in the emerging market space in aggregate are not materially different from developed market credit (Figure 6).

Figure 6
EM & DM Corporate High Yield Default Rates



Source: JP Morgan, Invesco, as of 31 December 2020.

When considering credit risk in the emerging market space it is also important to note that similar to developed markets there is really no incidence of default of IG rated bonds in any given year. There are bonds that are downgraded from IG to HY and then ultimately default over a multi-year period but this occurs in developed markets as well. Secondly, when you look at the high yield segment of the market, you see roughly similar corporate default rates among high yield issuers. This data illustrates quite clearly that the rating agencies do a reasonable job of adjusting for the relevant country dynamics when it comes to emerging market hard currency debt ratings.

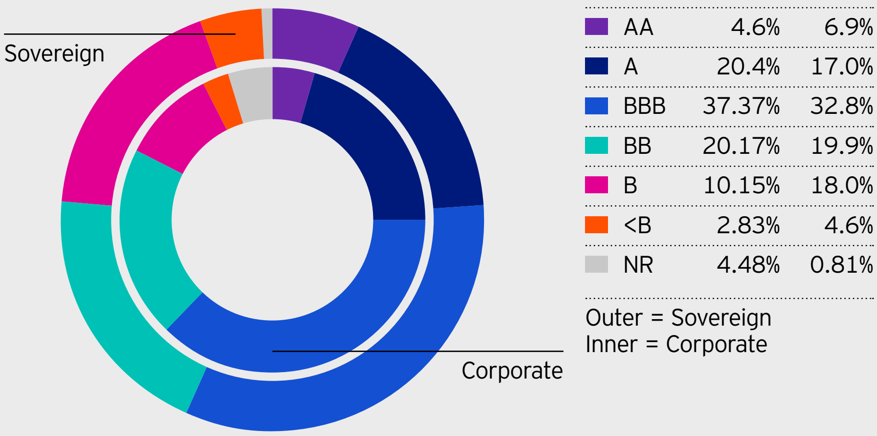
Volatility – rather than default risk – is a key driver of the additional credit spread premium in EMs

After examining both the volatility and credit risk characteristics for emerging market hard currency debt as compared with developed market debt it is our view that the persistent spread premium in emerging market is driven by a combination of higher asset class volatility and perhaps a lack of familiarity with the market rather than true credit risk. As the return data in Figure 5 highlights this is a market characteristic that long term oriented investors can take advantage of.

Diversification Benefits and Broad Investment Opportunity

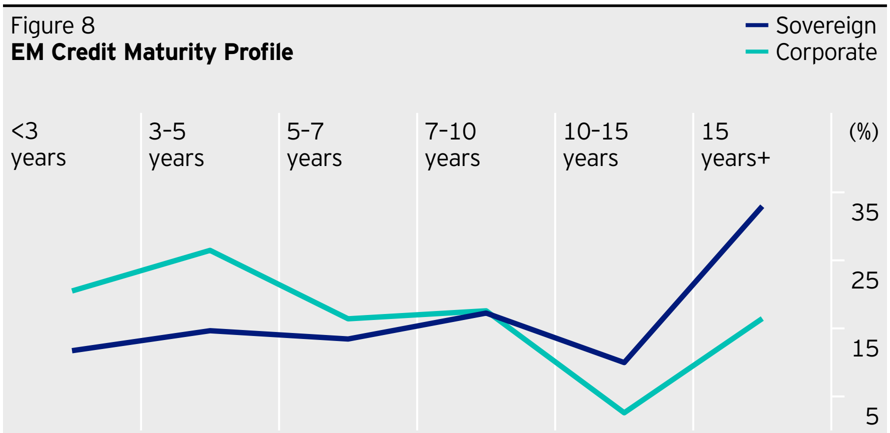
It is worth noting the broad opportunity set and potential diversification benefits of investing in emerging market fixed income. A decade or two ago emerging market hard currency debt was a much narrower asset class with a higher degree of correlation amongst constituent issuers. Whether you owned Mexican sovereign bonds or a Chinese corporate bond there was a tendency for the prices of these securities to move in tandem. Today, that is no longer the case as Figures 7 and 8 illustrate. Since the GFC the EM debt market has grown substantially. This is a function of the higher growth and interest rates in emerging economies, improving fundamentals and greater connectivity with the global financial system. Over this time period the number of sovereign issuers included in the most common benchmark index has doubled and the market value of sovereign and corporate indices have grown 5-8x. The opportunity set today is quite broad in terms of credit quality and maturity range with over $3.5 trillion in total bond stock spread across 74 countries (Figure 9).

Figure 7
EM Credit Rating Profile



Source: JP Morgan, Bloomberg, as of 31 December 2020.

Figure 8
EM Credit Maturity Profile



Source: JP Morgan, Bloomberg, as of 31 December 2020.

Figure 9
Market size, composition and growth of EM

Market Size

- >$2 Trillion of Index Eligible Bonds
- Sovereign - $1.33 Trillion
- Corporates - $1.25 Trillion

Market Composition

- 74 countries
- 713 corporate issuers
- 90 quasi-sovereign issuers
- 54% of Sov / Quasi-sov rated IG
- 58% of Corporates rated IG

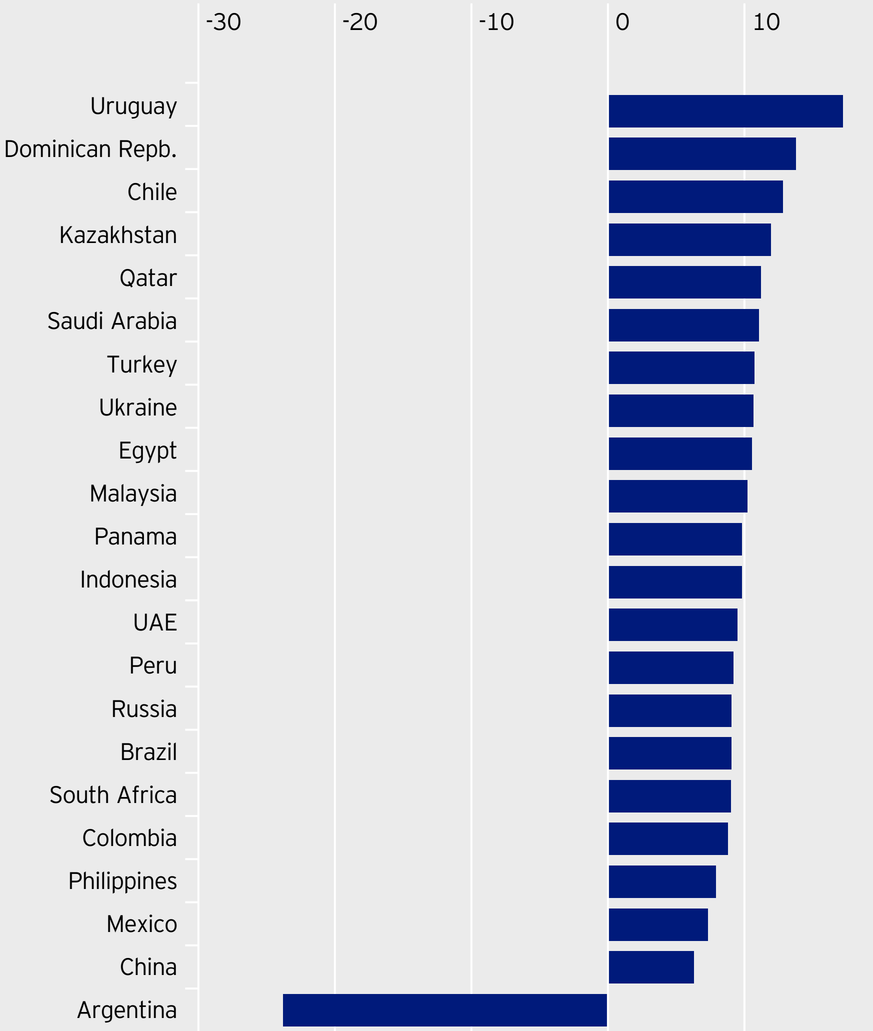
Market Growth (past decade)

- Corporate hard currency - 6x
- Sovereign debt - 3x

Source: JP Morgan, Bloomberg, as of 31 December 2020.

The less homogenous nature of these economies is observable in the greater dispersion of returns by country, sector and individual issuer, which is often particularly evident during periods of market or economic stress. In 2020 returns across emerging market range from deeply negative to sharply positive with the best performing of the large constituent countries up almost 14% and the worst performing country down almost 23% (Figure 10). Even within the investment grade universe dispersion of returns can be high.
The very large majority of hard currency EM debt is issued in US dollars and therefore is priced on a spread to the US treasury curve. In 2020 the dramatic move lower in US rates was a primary driver of returns across dollar denominated fixed income in both developed and emerging markets. This also increased historical correlations amongst asset classes. However, the variance in credit spread premium amongst this more heterogeneous mix of emerging economies provided a continued source of diversification as well as opportunities for managers to express their investment views using the expansive opportunity set afforded by the asset class in its modern form.

Figure 10
EM Sovereign Debt Returns FY2020 by Country



Source: JP Morgan, as of 31 December 2020.

This dispersion of returns is not surprising given the varied economic impact we have seen even with a shock as broad and uniform as from the pandemic. This highlights the diversification benefits of the asset class, especially in the context of credit risk. Think about how different in terms of economic fundamentals and drivers China, Peru, Qatar and Malaysia are from each other as well as from the US. At any given point in time such countries are at different points in the economic cycle. This dynamic, in our view, provides diversification against fundamental credit risk, as typically any given negative shock will affect the various countries across emerging markets quite differently. We saw examples of this in the 2008/2009 financial crisis, where emerging market economies fared much better than developed market economies. And again, in the 2020 pandemic where China has recovered much more quickly than the US and the bulk of Latin America.

Currency Considerations – Cross Currency Swaps

The emerging market credit asset class does have a sizeable amount of debt stock in Euros, however, the vast majority of the market is US dollar denominated. This can leave some uncertainty for European institutions with a base currency of Euros or Sterling that will need to hedge. Typically, foreign exchange hedging in such situations has been done using currency forwards on a one to six month basis. While simple to implement, such a strategy leaves longer-term investors subject to fluctuations in hedging costs. Over the past three years for example we have seen those costs fluctuate from 1.8% to 3.2% and then back down to 1.9%. Such movements can have a large impact on returns and are problematic for investors who are looking for certainty over the life of their portfolio. By using a slightly more complex hedging strategy that makes use of cross currency swaps insurers are able to match the hedge to the duration of the portfolio. We find this to be a much more robust approach to managing foreign exchange risk in such portfolios than simple hedges using currency forwards because it protects against potential rising hedging costs.

Regulatory Capital Treatment

The European insurance regulation is straightforward in its treatment of all fixed income assets, regardless of their origin. Under the Standard Formula of Solvency II, the capital charge is captured under the spread risk, the same as for other bonds.

There is no specific treatment for emerging market debt.

Standard formula considerations
If hedged into local currency, an emerging market bond will consume no more capital than a domestic issue with an equivalent rating.

For bonds and loans of central banks and states of countries and denominated in their own currency, specific favorable shocks apply (Article 180.3). In comparison to corporate bonds, these shocks are much more favorable.

Matching adjustment considerations
Emerging market debt which is completely swapped back into Euros (using cross currency swaps) are eligible for matching adjustment.

Inclusion of emerging market debt can increase the efficiency of portfolios under Solvency II

There are two key reasons why emerging market debt is attractive under Solvency II:

1. Extra yield compared to an equivalent rated developed market bond leading to a higher capital efficiency
2. Additional diversification of the Portfolio: Inclusion of emerging market debt increases the efficiency from both economic and regulatory perspective as shown in Figures 11 and 13

EMD inclusion improves the efficient frontier since insurers can obtain higher expected yields for the same level of risk.

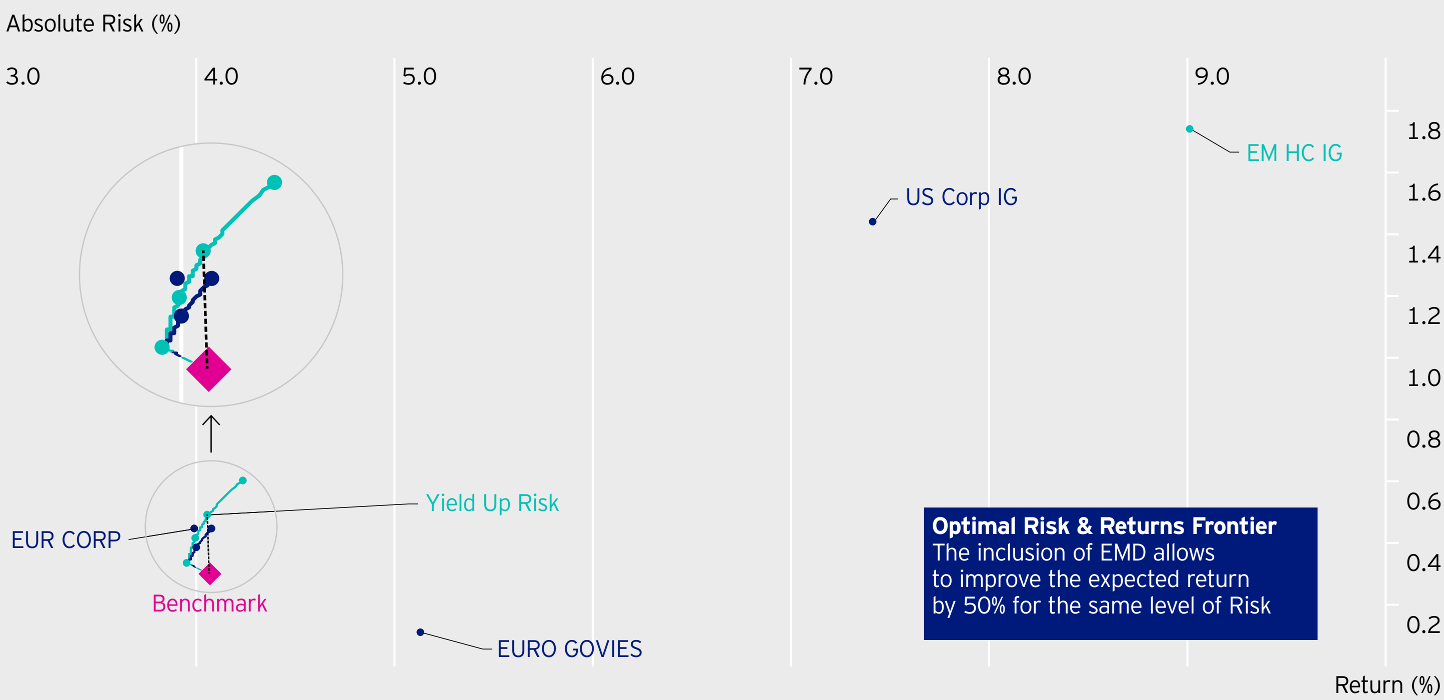
In our example below, we have compared two universes, one with emerging market debt (hedged in Euros) as an alternative to the US Fixed Income and one using only US Fixed Income (hedged in Euros) as a diversification play.

The benchmark is made of the domestic fixed income (50% Government Bonds and 50% Corporate Bonds).

The integration of emerging market debt leads to higher efficiency in the portfolios versus the simple integration of US Fixed income.

The sample portfolios below offer a higher expected yield for a lower level of risk and capital requirements compared to the benchmark.

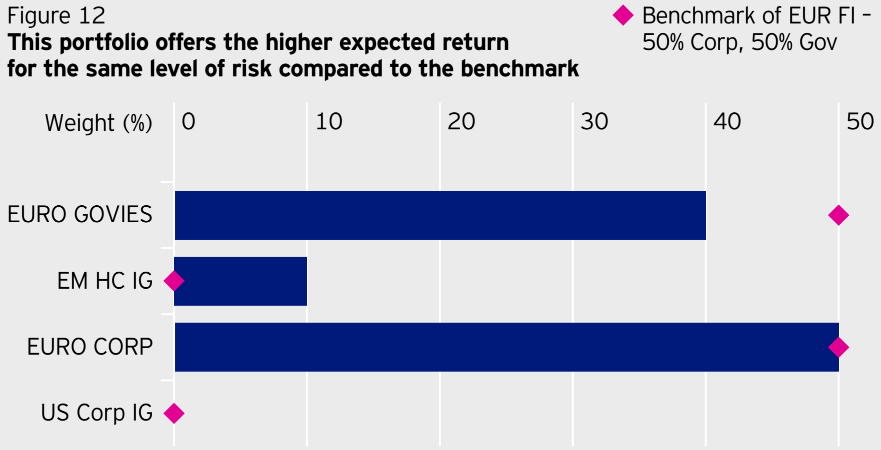
Figure 11
Portfolio optimisation using volatility as a risk measure



Source: Vision; as at 31 January 2021. Hedged Yields in EUR.[1]

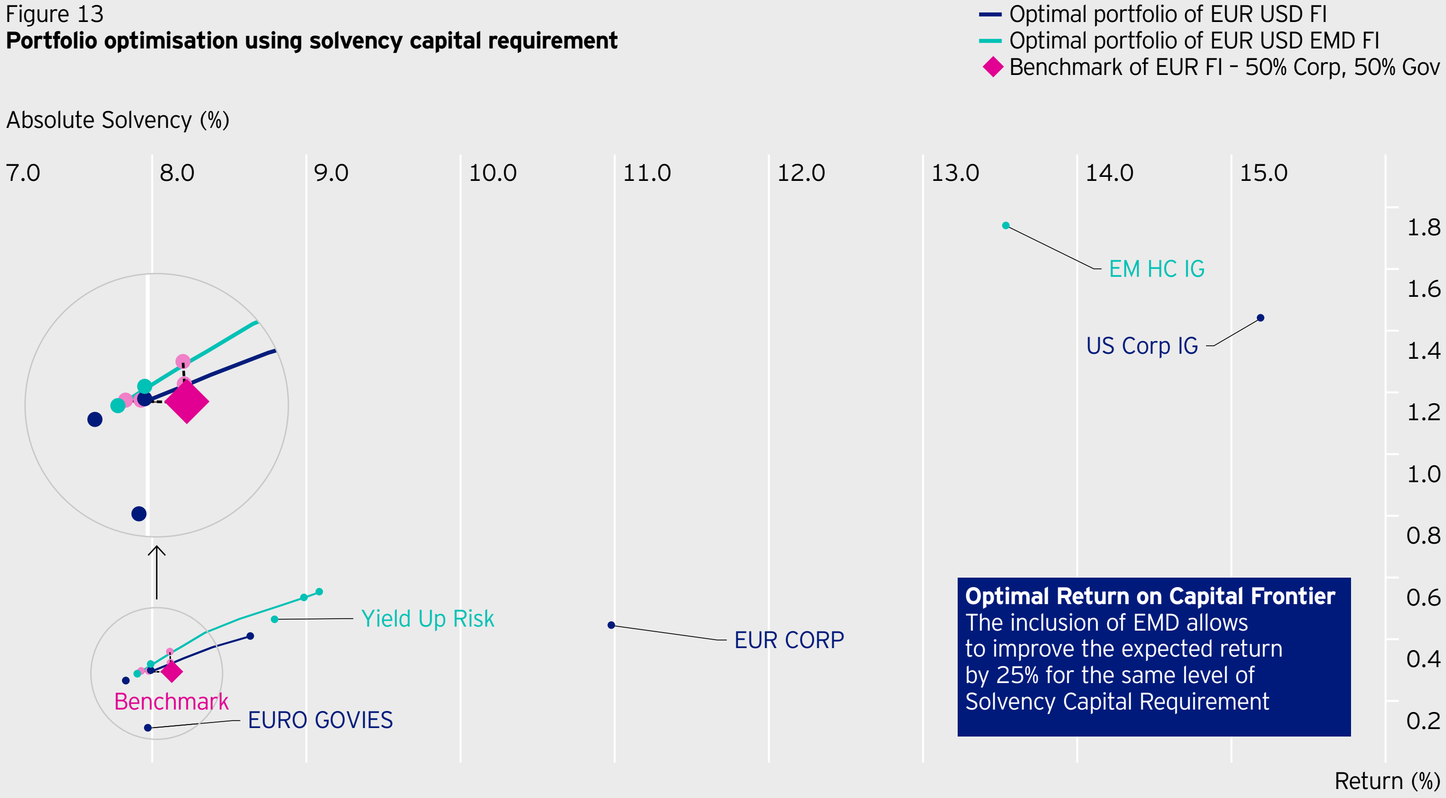
[1] The Foreign Exchange impact is modelled considering the International Fischer Effect where the foreign returns are adjusted by the 10 years governmental bonds yields differential between countries. This fx hedging is used to reduce the uncertainty of those expected returns.

Figure 12
This portfolio offers the higher expected return for the same level of risk compared to the benchmark



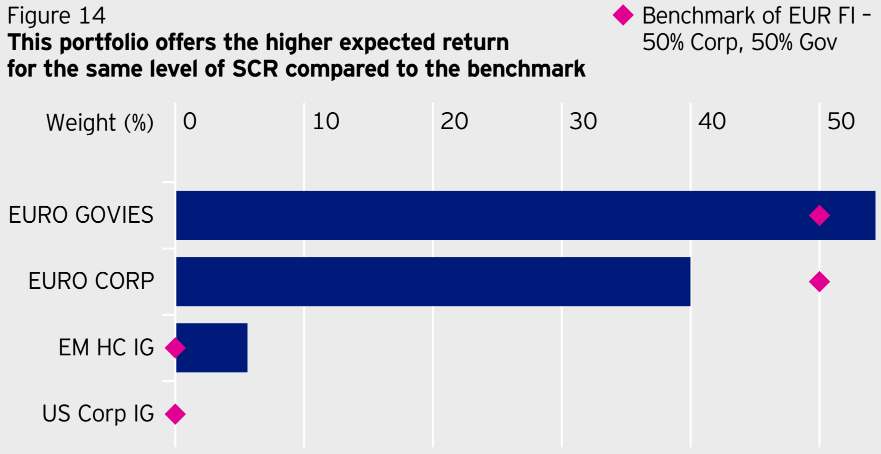
Source: Vision; as at 31 January 2021. Hedged Yields in EUR.[1]

Figure 13
Portfolio optimisation using solvency capital requirement



Source: Vision; as at 31 January 2021. Hedged Yields in EUR.[1]

Figure 14
This portfolio offers the higher expected return for the same level of SCR compared to the benchmark



Source: Vision; as at 30 November 2020. Hedged Yields in EUR.[1]

ESG and emerging markets

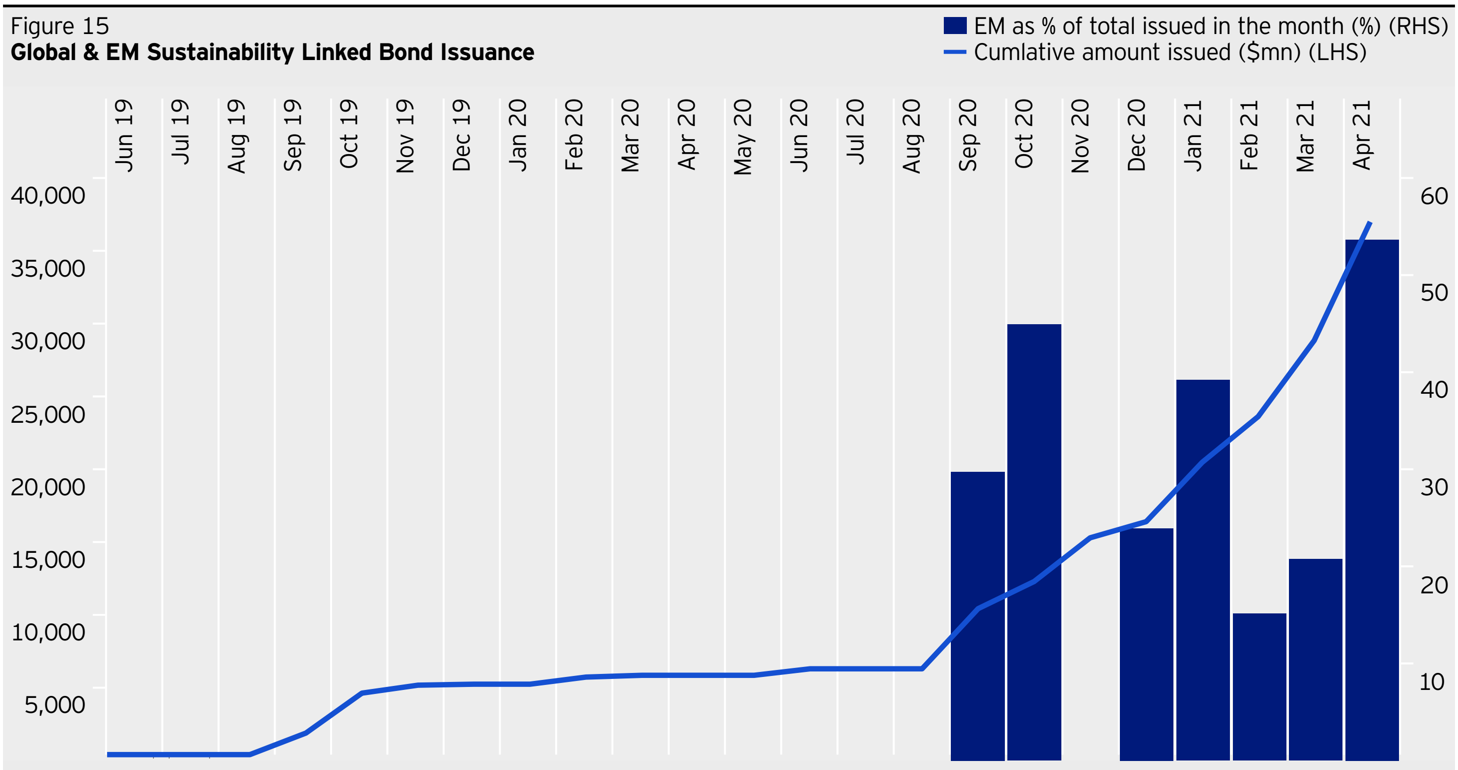
ESG factors are rapidly becoming a primary consideration for many investors not just in Europe but across the world. Increased interest from retail and institutional investors, and regulatory changes in key markets across the globe are all changing the way capital is allocated to companies and countries. ESG investing is an essential part of addressing the risks facing society in the long term and we recognize the importance of our role in supporting the necessary changes that will help improve the quality of life for people all over the globe. There is also growing evidence that suggests ESG factors, when integrated into investment analysis and portfolio construction, not only ensure the full consideration of risk and opportunities but may offer investors potential long-term performance advantages in asset classes such as emerging market credit.

We believe that emerging markets present an excellent opportunity for investors to drive change while participating in an asset class with strong investment potential. In fact, the investment rationale for allocating to EM overlaps a great deal with the reasons to focus on EM with an ESG lens. Over 80% of the world's population lives in emerging markets (EMs) and more than half of global GDP is generated in EMs. Population and GDP growth in EMs outstrips develop markets. The growth of these markets represents a significant investment opportunity, while how these markets develop will dramatically impact the goals of sustainable investing.

Focusing on EM might seem counter-intuitive to many ESG investors at first blush. EMs overall tend to score worse on corruption and transparency indices, tend to have less developed institutions and social equality, and many are producers and exporters of commodities with negative environmental impacts. But it is for this very reason that ESG oriented investing in emerging market credit affords investors a greater opportunity to support and drive positive change than in developed markets. For example, EMs have immature energy infrastructures but also have some of the world's best resources for renewable energy. Onshore wind in Brazil or solar in India and Africa are examples of opportunities to democratize energy in an environmentally sustainable way for growing populations.

We also believe that taking ESG factors into consideration can positively impact performance outcomes. ESG analysis is an essential part of the process for investing in emerging market debt as this can identify material financial risks and opportunities that traditional credit analysis may miss. When evaluating emerging market investments, a robust understanding of issuer fundamentals and macro factors are critical. Taking ESG factors into consideration is a natural extension of that robust analysis, which contributes to a transparent comprehensive assessment of issuers. We have found that issuers that operate in a more sustainable manner and actively engage with investors on ESG topics are often better managed and more transparent. Empirically, this increases the likelihood of positive investment outcomes and mitigates the likelihood of negative surprises which are commonly related to an ESG deficiency.

Figure 15
Global & EM Sustainability Linked Bond Issuance

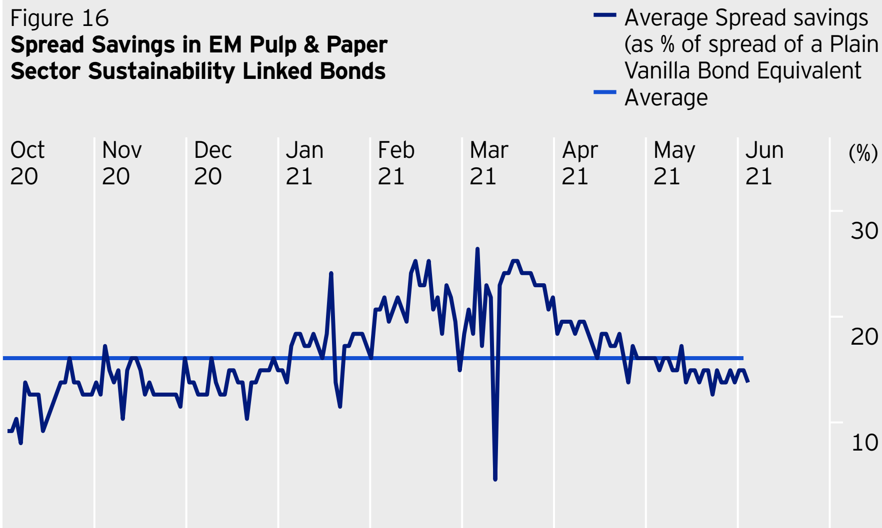


Invesco, Bloomberg, April 2021.

While EM issuers currently lag DM on ESG factors, EM issuers are increasingly willing to engage with fixed income investors. EM issuers tend to be more focused on debt investors as compared to their DM counterparts as debt is often a more important part of their capital structures. If EM issuers can broaden their investor base and lower their cost of capital by engaging ESG investors, they have good incentive to do so. We have seen evidence of this in the rise of sustainability linked bonds from emerging market issuers (Figured 15) and the commensurate lower spreads versus peers (Figure 16).

ESG investing for fixed income is still in a formative phase. While regulations and standards are evolving, ESG investing is inherently a bespoke strategy tailored to each investor's objectives. Emerging market credit is an area to strongly consider if your goals are to make impactful change without limiting returns potential.

Figure 16
Spread Savings in EM Pulp & Paper Sector Sustainability Linked Bonds



Source: Invesco, Bloomberg, May 7, 2021.

Summary

In today's very low yield environment insurers need to cast an increasingly broad net to find compelling investment opportunities and maximise potential risk-adjusted returns. Given the compelling opportunity set offered by emerging market credit we believe it warrants serious consideration within fixed income portfolios. In our view, whether due to misconceptions about the riskiness of the asset class or a lack of familiarity, too many institutions are under allocated to an asset class with attractive returns both in total and on a risk adjusted basis, which is larger than US high yield and whose constituent countries account for more than 50% of global GDP.

As we have shown, emerging market credit, especially investment grade credit, has a host of characteristics that make it an attractive investment opportunity with adequate breadth and depth to meet a range of investment requirements. Moreover, we expect ESG to grow exponentially in the next few years, reshaping the landscape of the global financial industry and offering great potential opportunities in emerging markets. For these reasons, we believe insurers should give emerging market credit serious consideration as part of their investment allocation. Invesco Insurance Solutions partner with insurers to integrate this exposure across their portfolios and design a highly customised solution which ultimately can improve the capital generation of the insurer. In this framework, emerging market debt improves the Solvency ratio and the capital generation potential of the portfolio.

Investment Risk

The value of investments and any income will fluctuate (this may partly be the result of exchange rate fluctuations) and investors may not get back the full amount invested.

Debt instruments are exposed to credit risk which is the ability of the borrower to repay the interest and capital on the redemption date.

Changes in interest rates will result in fluctuations in value.

When investing in less developed countries, you should be prepared to accept significantly large fluctuations in value.

Investments in debt instruments which are of lower credit quality may result in large fluctuations in value.

Investing in distressed securities carry a significant risk of capital loss.

Whilst the fund manager considers ESG aspects they are not bound by any specific ESG criteria and have the flexibility to invest across the ESG spectrum from best to worst in class.

Important information

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ID4640/2021