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EM DEBT FOR INSURERS: FINDING THE RIGHT ALLOCATION

Emerging-market (EM) debt's strong returns over the past two years have attracted significant flows. While recent volatility has tempered that broad enthusiasm, investors interested in a strategic allocation to EM are still actively exploring the space. However, to properly evaluate EM opportunities, it is important for insurers to consider the cost of capital, as well as the risks.

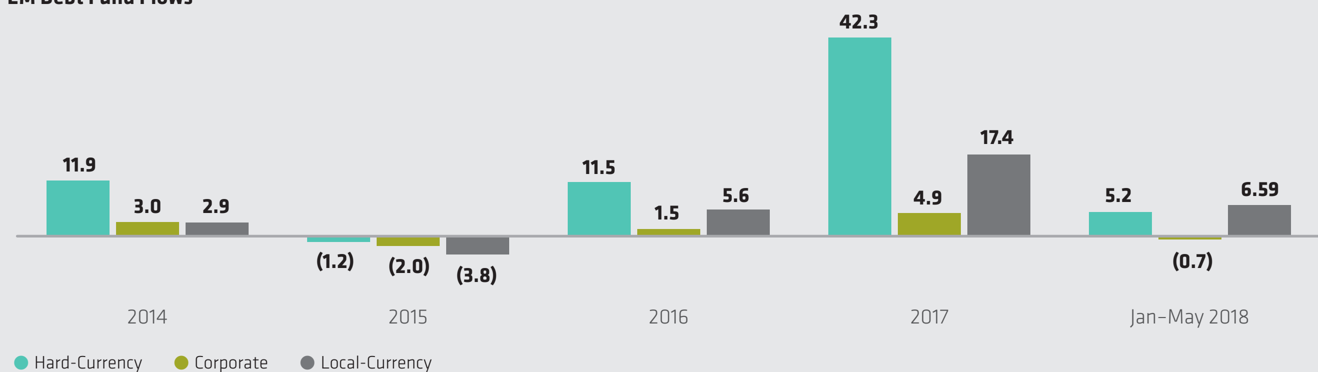
RECENT MARKET TURBULENCE HAS IMPACTED EM FLOWS

A rallying US dollar and tightening global financial conditions have put pressure on EM debt. Moreover, negative headlines regarding idiosyncratic risk (e.g., in Argentina and Turkey) have arisen, and uncertainty surrounding trade sanctions—particularly between the US and China—continues to loom.

EM debt asset flows have moderated from the robust levels seen in 2016 and 2017, which saw inflows of $18.6 billion and $64.6 billion, respectively. These inflows spanned market segments, with hard-currency sovereigns, corporates and local-currency debt all benefiting (*Display 1*). Although the recent volatility has slowed EM fund flows, and has even led some investors to reduce their weightings, we expect that flows will start to increase again when markets inevitably stabilize—particularly given the better valuations now available.

DISPLAY 1: FLOWS INTO EM CONTINUE TO BE POSITIVE

EM Debt Fund Flows



As of May 31, 2018
Source: Morningstar

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Over the past few years, many different types of investors—including insurers—have sought to build a more strategic allocation to EM debt. The recent burst of volatility has not derailed that trend, but instead has created opportunities to invest at more attractive levels.

EM country- and company-specific fundamentals remain solid, and EM debt continues to offer a range of opportunities for investors searching for yield in an environment of still-low interest rates and compressed credit spreads. Insurers, in particular, have resumed their activity in this space, with interest picking up steadily since its low point in 2013, when a spike in market volatility during the taper tantrum curtailed investment.

While some investors may be agnostic about individual EM debt segments, focusing primarily on absolute returns, insurance investors generally take a more granular approach. They tend to invest more selectively in specific subsectors of the market, as dictated by asset-allocation plans, risk appetite, applicable regulations and capital charges.

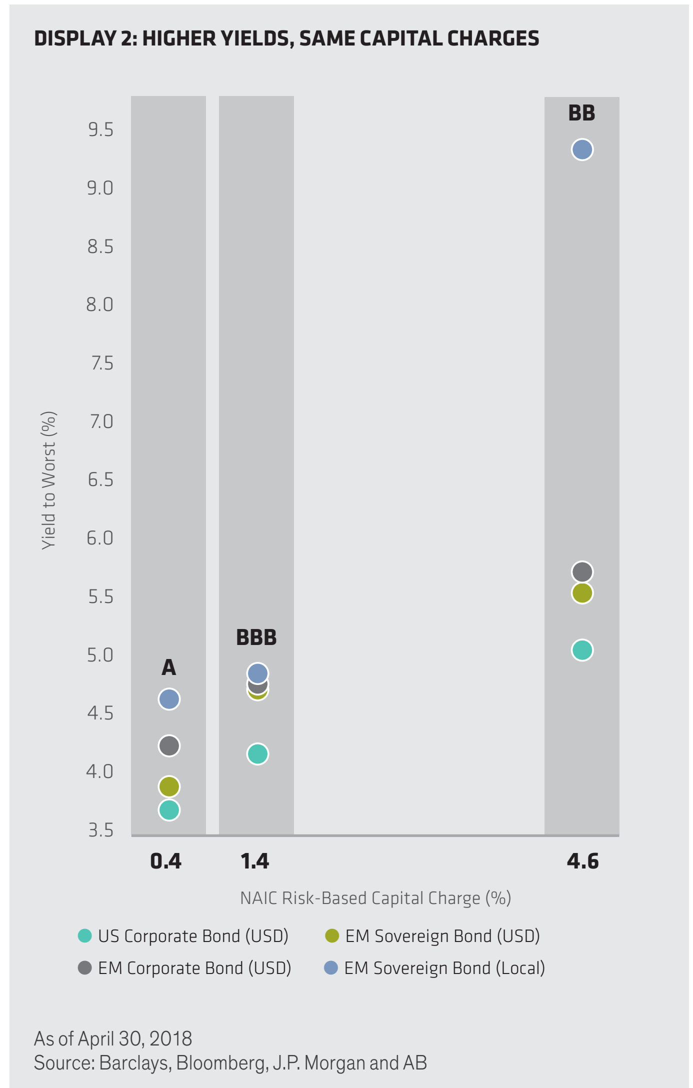
EM HARD-CURRENCY DEBT: CHARGES SIMILAR TO DEVELOPED CORPORATES, BUT CONSIDER THE VOLATILITY

For insurers with liabilities denominated in the US dollar, investing in hard-currency debt (US-dollar denominated, for simplicity's sake) is a natural extension of their corporate-bond allocation. As such, hard-currency debt may be a significant part of their allocation.

For insurers in the US, under the National Association of Insurance Commissioners (NAIC) Risk-Based Capital (RBC) framework, the required capital charge for an EM hard-currency bond—either sovereign or corporate—is the same as the capital charge for a developed-market corporate bond with the same rating. There is no explicit country or region input into the formula for calculating the capital charge. Additionally, as is the case with US credit, the NAIC's ratings designation for a particular issue is typically derived from the ratings assigned by nationally recognized statistical rating organizations.

For example, *Display 2* shows that for each of four A-rated bonds (EM local-currency sovereign, EM corporate, EM hard-currency sovereign and US corporate), the NAIC RBC's capital charges are identical—in this case, 0.4%. The same holds true for ratings adjusted down the credit-quality spectrum, as well.

DISPLAY 2: HIGHER YIELDS, SAME CAPITAL CHARGES



As of April 30, 2018
Source: Barclays, Bloomberg, J.P. Morgan and AB

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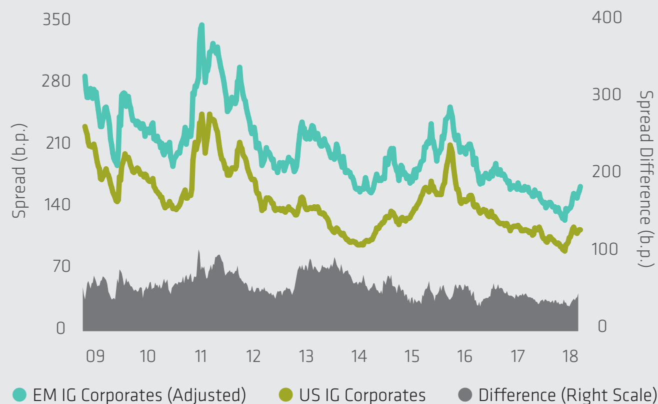
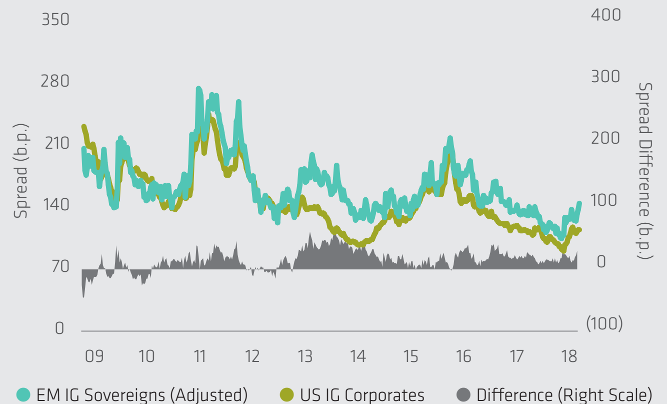
DISPLAY 3: EM INVESTMENT-GRADE (IG) CORPORATES AND SOVEREIGNS OFFER RELATIVE VALUE

Spreads and Spread Difference

EM IG Corporates vs. US IG Corporates



EM IG Sovereigns vs. US IG Corporates



Historical analysis for illustrative purposes only.
Through May 18, 2018
Spreads are adjusted prior to June 30, 2017.
Source: Bank of America Merrill Lynch and AB

Display 2 also illustrates that EM debt bonds typically offer higher yields than do similarly rated US corporate bonds. In the example's A-rated bonds, the EM hard-currency sovereign bond trades 20 basis points (b.p.) higher than the US corporate bond, while the EM local-currency bond trades 95 b.p. higher. For the BB-rated bonds, the difference is significantly greater. Compared with the US corporate bond, the yield on the hard-currency sovereign is about 50 b.p. higher, but the yield on the local-currency sovereign bond is roughly 430 b.p. higher, offering almost twice the yield.

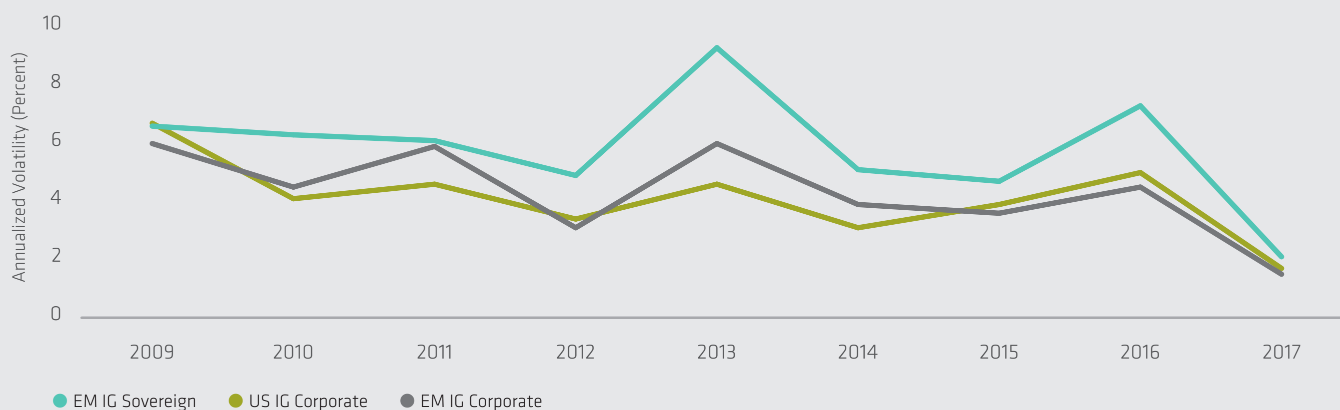
For insurers that hold liabilities in another currency—such as the euro, pound sterling or yen—investing in EM hard-currency debt is also a natural extension of their credit allocation. However, these insurers now have to account for the currency-hedging cost, too, just as they would when investing in US corporate bonds.

When currency-hedging costs are elevated, as is the case today for European and Japanese investors, the extra yield spread that can be found in EM investment-grade debt versus US investment-grade corporate bonds with the same rating and maturity (*Display 3*) may help overcome that added cost.

While the yield pickup for investment-grade EM hard-currency debt over US investment-grade credit is attractive because the capital charges for the two asset classes are similar, it is also pragmatic to consider the relative volatility of EM spreads versus US investment-grade spreads.

DISPLAY 4: SOME EM ASSETS ARE LESS VOLATILE THAN US ASSETS

Volatility of EM Investment-Grade Market



Historical and current analyses do not guarantee future results.

Through December 31, 2017

EM IG sovereign is represented by J.P. Morgan EMBI Global Diversified, US IG corporate is represented by J.P. Morgan US Liquid, and EM IG corporate is represented by CEMBI Broad.

Source: J.P. Morgan and AB

Although the volatility measures of both have decreased significantly since the global financial crisis, it is fair to say that EM debt spreads generally remain more volatile than US corporate spreads for bonds of equivalent ratings and maturities. However, as can be seen in *Display 4*, some parts of EM debt—namely EM investment-grade corporates—do exhibit volatility similar to that of developed-market debt.

When investing in EM debt, insurers must be comfortable that their solvency and balance sheets can withstand this higher volatility. They can address this issue by adopting careful guidelines designed to restrain them from investing in more volatile sectors and by utilizing research-based security selection that avoids issuers with large downside potential. This could include removing higher-beta holdings or avoiding names that are more at risk of a downgrade to below-investment-grade status (even if they may offer attractive yields).

EM LOCAL-CURRENCY DEBT: COST CONSIDERATIONS

Insurance companies also should not overlook the potential of EM local-currency debt. This sector does make currency risk a consideration, as it may result in an additional capital charge under certain regulatory regimes. However, in the right environment it can offer attractive return potential.

For NAIC-regulated insurers, currency risk carries no explicit capital-charge rate. Under NAIC RBC, a US dollar–denominated BBB-rated bond has the same capital charge as a bond of the same rating issued in South African rand—even though the underlying economic, credit and interest-rate environments may be quite different.

For US-domiciled insurers, EM local-currency debt investments can still have greater internal complexities—and potentially more

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volatile financial results. Also, systematically hedging the currency risk of local-currency bonds is very likely to be expensive, with the future cost of hedging more unpredictable than for hard-currency hedging. As a result, insurers investing in local EM debt may prefer to simply bear the currency risk.

The overall implication for insurance investors: the expected returns from EM local-currency debt need to compensate for the complications from currency risk. Positioning in this market segment becomes less about substituting for corporate bond exposure, and more about finding an alternative to other riskier and more capital-intensive investments, such as equities or hedge funds.

HIGH YIELD: THERE IS POTENTIAL, BUT ADJUST FOR COST OF CAPITAL AND CREDIT RISK

High-yield EM debt can also hold appeal for insurers with room in their risk budget, though it can be accompanied by additional costs and risks that must be taken into consideration.

In accordance with local regulations, high-yield bonds are either significantly more expensive than investment-grade bonds from a capital point of view, or they are simply inadmissible. In the US and Europe, high-yield bonds are admissible, and it is important for insurers there to account for the cost of capital when comparing the relative value of investment-grade and high-yield EM debt.

Where appropriate, insurers should consider adding higher-rated high-yield bonds because of the potential for price gains if the issuers' fundamentals improve. For example, a BB-rated issuer with strengthening fundamentals could be on the verge of an upgrade to investment-grade status. The bond could see substantial price appreciation before the official rating upgrade takes place. A portfolio that ignores higher-rated high-yield issuers will miss out on these opportunities.

However, insurance companies should also be aware of the risk of mark-to-market volatility, as well as credit impairment (or default) risk.

Examples include the decline of crude-oil prices in 2015 and 2016, and the downgrade of Brazil's sovereign debt to below-investment-grade status after a corruption scandal in 2015. The oil-price decline put tremendous pressure on oil and gas companies (many domiciled in EM countries), with even investment-grade names defaulting. The downward pressure resulting from Brazil's downgrade bled through to Brazilian corporates.

Both cases illustrate how exogenous factors can impact EM debt sectors—particularly high yield, with its inherently higher level of risk—which can then be unfairly punished by nervous investors. Deep active research is needed to evaluate the macro environment and understand businesses from the bottom up is up, determining which issuers are truly at risk and which are indiscriminately selling off along with the overall market. The judicious use of stress-testing will also help provide insight into which companies are best equipped to survive.

Although negative headlines can have an outsize impact on high-yield EM debt, they also provide opportunities for investors that have done strong fundamental credit research. Just as investment-grade EM hard-currency debt offers a viable substitute for developed-market investment-grade credit, high-yield EM debt is worth insurers' consideration relative to US high yield.

THE BIG PICTURE

Overall, EM debt has performed well over the past few years, attracting sizeable inflows. Even though elevated volatility is a likelihood in the near term, the market is backstopped by the robust global-growth story and positive commodity-price trends. Moreover, fundamentals across many EM countries remain sound. There are wide-ranging opportunities in this market for discerning investors looking to increase return and add income potential to their portfolios.

When exploring the various segments of this market, insurance companies should consider that the capital charges for many EM debt sectors are not much different from the charges for US bonds with the same credit rating. In addition, the more capital-intensive segments may be worth a closer look, especially relative to other investments in insurers' total asset allocation.

Insurers should also be cognizant of the risks associated with these markets and the potential impact on their financial metrics. While the recent market volatility is a useful reminder of the importance of selectivity, it also presents opportunities. For those who know where and how to search, there will be attractive entry points on the horizon.

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