# EM Corporate Strategy

# Would you like some Fed cuts with those steaming credit spreads?

29 March 2023

EM Corporate Strategy
Global

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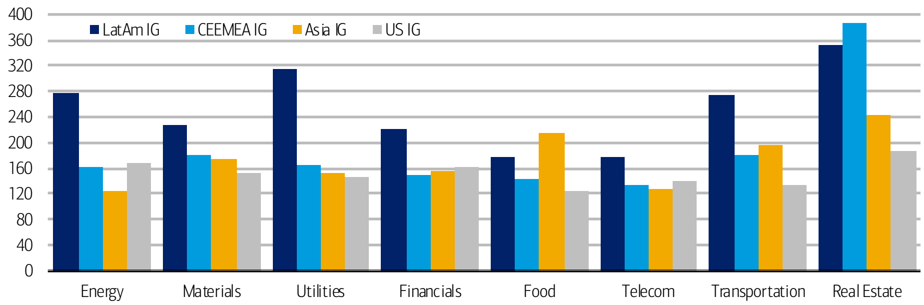
## Macro regime-shift favors credit quality. Latam IG's cheap

In March, following US bank failures, markets added financial system stability concerns to a list of forward-looking headwinds. In response, EM Corporate credit spreads widened mostly in Latam (+39bps IG/ +88bps HY) and CEEMEA (+37bps IG/ +63bps HY) as USD rates fell significantly (-59bps MTD for the 5yr tenor).

Looking forward, we expect the further tightening of lending standards and credit conditions. With credit tight and rates remaining high in the near term, more cracks may appear in rate-sensitive corners of the financial system, making a Fed pivot and the easing of global dollar liquidity conditions more likely.

If that risk materializes, we expect a repeat of the current dynamic of higher spreads and lower USD rates. In such an environment, we favor EM IG, that has longer duration, attractive yields, and lower spread sensitivity to stress compared to EM HY. Across regions, Latam IG has the widest spreads relative to US IG.

**Exhibit 1: IG OAS levels by sector and region with US shown for comparison (3/27)**
Latam IG is wide to regional peers, while Asia IG spreads tighter to US in Energy, Financials, Telecom

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## HY more sensitive to volatility, IG more sensitive to rates

HY spreads have a higher beta to macro volatility. We find that HY spreads tend to increase 2x to 3x more than IG spreads in periods of stress in Latam and CEEMEA. Asia has a weaker correlation due to the high volatility of HY Property. On the other hand, EM IG corporates have a higher beta to treasuries vs HY due to their longer duration. As a result, we would expect IG to overperform HY in a higher spread, lower rate environment.

## EM Corporate return outlook resilient to mild shocks

We estimate the sensitivity of EM Corporate returns for the EMCB index to different credit spread and US treasury levels. We find that even in mild crisis-like scenarios, returns remain positive or slightly negative in the low single digits. The resilience of returns is afforded by the high carry and because further cuts are likely if the worst scenarios materialize.

**Anne Milne**
Research Analyst
BofAS
+1 646 855 4096
anne.milne@bofa.com

**Jason Amoratis**
Research Analyst
BofAS
+1 646 556 0831
jason.amoratis@bofa.com

**GEMS Corporate Credit Rsch**
BofAS
+1 646 855 4096

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US Credit Market Strategist: Taking stock of the sell-off 17 March

See common abbreviations on pg.9

## Macro regime shifts after recent bank failures

Despite the move higher in spreads since the recent bank failures, our return outlook for EM Corporate credit in 2023E remains positive because the high carry and a softer rates outlook cushions index returns.

That said, the recent bank failures add banking system stability to the already lengthy list of downside risks for global corporate credit. We believe this anxiety will be sticky and that we are shifting towards an environment of higher credit spreads, lower rates, and challenged liquidity. On one hand, fresh risks are added to the outlook:

- **Global banks are now structurally more susceptible to shifts in market confidence**, as recent bank failures will remain salient for depositors and investors. As a result, banks are likely to tighten lending to de-risk and bolster their liquidity and capital. As of January's Senior Loan Officer Opinion Survey, US banks were already tightening their lending standards.
- **Shaken confidence in AT1 will raise medium-term cost of bank capital**. The CS merger deal upended the perceived seniority of CoCo notes. Uncertainty makes AT1 capital more expensive, barring a hard clarification of the framework by regulators and/or additional creditor protection features that we wouldn't expect soon. Further, this reduces economic incentives to call existing notes which can exacerbate confidence in the asset class.
- **Tighter bank credit will have knock-on effects** on corporates and consumers, increasing the likelihood of a US recession. Our forecast is for a mild recession later this year. A US recession would affect EM through reduced global demand, lower commodity prices, and higher credit spreads. Cyclicals, including commodity producers—highly represented in EM—may be challenged.
- **Supply is likely to slow**. Corporate bond supply, that only reopened in January for EM, is likely to remain constricted in the near term due to high uncertainty. While lower net supply is a technical positive, it's negative for spreads as issuers may lose access to a source of financing.

On the other hand, there are mitigating positives:

- **Low EM bank-run risk.** EM banks in our universe are large, have strong capital cushions, are systemically important, and have sticky deposits due to high market concentration and high retail share of deposits. However, the AT1 market may be smaller and may be limited to best-in-class banks going forward.
- **New Fed liquidity undoes the effects of QT.** The Fed measures effectively undid five months of QT, increasing its balance sheet and providing about $392bn of liquidity into the system (as of Mar. 22nd). This is a technical positive.
- **CB Dollar liquidity swaps likely if there's more stress**. The Fed increased the frequency of standing dollar liquidity swap lines to foreign CBs from weekly to daily. These lines were important in reducing dollar liquidity stress in global funding markets during 2020, according to a study by the NY Fed. None of the standing lines are to EM CBs, but in 2020 they were extended to the CBs of Mexico, Brazil, Korea, and Singapore. We think it's likely that Fed will follow the 2020 playbook and use this tool to ease global dollar liquidity if needed.

### More credit events likely until financial conditions significantly ease

It is likely that additional events or surprises may roil the markets as Financials go through a deleveraging process and corporate profitability is challenged. In this environment we like IG and high quality HY and seek tactical opportunities to enter during market turbulence. In the rest of the report, we analyze the recent market reaction as a template for future turbulence, show which segments look cheap, assess sensitivities to spreads and USD rates and examine how far spreads went historically.

## MTD performance: IG, Asia overperformed

Despite market uncertainty, the broad EM Corporate index is up +0.6% MTD in March. This positive return masks a significant move higher in spreads coupled with a significant move lower in rates. If we break the returns down by rating grade and duration, IG and, specifically, longer duration IG overperformed.

**Exhibit 2: Global EM corporate total returns by effective duration and rating**
Long duration EM IG corporates overperformed MTD (3/27)

| | Effective Duration (Years) | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| **Rating** | **1** | **2** | **3** | **4** | **5** | **6** | **7** | **8** | **9** | **10+** |
| AA | 1.1% | 1.8% | 2.1% | 2.3% | 2.5% | 2.4% | 2.9% | 2.9% | 0.6% | 1.0% |
| A | 1.0% | 1.6% | 2.2% | 2.0% | 2.1% | 3.1% | 2.6% | 2.9% | 3.8% | 1.3% |
| BBB | 0.7% | 0.5% | 0.5% | 0.7% | 0.4% | 0.3% | 1.0% | 0.6% | 0.6% | 0.5% |
| BB | -1.6% | -1.1% | -1.0% | -0.9% | -1.0% | -1.4% | -0.6% | -2.5% | -2.9% | 1.9% |
| B | -0.3% | -0.7% | -0.9% | -3.5% | -0.9% | -0.6% | | | | -4.2% |
| CCC | -0.8% | -1.1% | -2.0% | -2.5% | | -8.5% | | -8.0% | | 1.4% |

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When we look at MTD returns by region and rating, we see that Asia IG overperformed MTD relative to other regions and HY. Asia IG has lower duration than CEEMEA and Latam, and the relative overperformance came from Asia spreads staying steady instead of widening.

**Exhibit 3: MTD total returns by region and rating**
Broad trend was a rotation towards Asia and IG

| | LatAm | CEEMEA | Asia |
|---|---|---|---|
| AA | | 1.5% | 2.3% |
| A | 1.7% | 1.4% | 2.0% |
| BBB | 0.2% | 0.2% | 0.8% |
| BB | -0.8% | 0.1% | -3.4% |
| B | -3.9% | 0.8% | -2.2% |
| CCC | -1.2% | -0.7% | -5.1% |

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### Tight EM spreads at the index level hide significant regional variation

When we compare to US, Asia IG spreads remain tight, while the relative spreads of the other two regions returned to more fair levels after the recent volatility. Latam and CEEMEA IG widened about 40bps MTD on 3/27, as US IG widened 20bps. Asia IG relatively overperformed, and widened vs US through March. As a result, we find that Asia IG spreads now fair vs US, given the almost 3-year difference in duration.

**Exhibit 4: EM Corps vs. US. Duration, Yield, OAS, MTD OAS change (3/27)**
Asia IG was relatively isolated from market volatility in March

| Region | Eff. Duration | Yield | OAS | MTD OAS Change |
|---|---|---|---|---|
| Investment Grade | | | | |
| Latam IG | 7.2 | 6.1% | 238 | 41 |
| CEEMEA IG | 6.0 | 5.3% | 183 | 38 |
| Asia/Pacific IG | 4.4 | 5.4% | 158 | 20 |
| US IG | 7.3 | 5.3% | 144 | 20 |
| High Yield | | | | |
| Latam HY | 4.5 | 9.9% | 633 | 94 |
| CEEMEA HY | 3.0 | 9.2% | 566 | 65 |
| Asia/Pacific HY | 2.4 | 13.1% | 941 | 257 |
| US HY | 3.9 | 8.7% | 499 | 96 |

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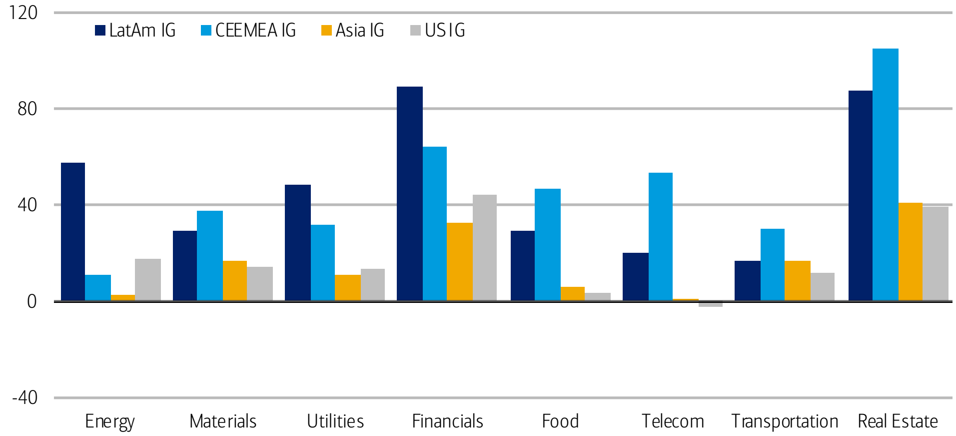
## IG OAS widened MTD in LatAm and CEEMEA

IG spread widening has been significant. MTD, IG spreads widened +41bps in LatAm. A monthly move of this size or larger has been observed in 12 out of 135 months since 2012. In CEEMEA, IG spreads widened +38bps, a move seen only in 8/135 months since 2012. Asia IG spreads were up +20bps, a move observed 7/135 months since 2012.

**Exhibit 5: IG Regional OAS by sector vs. US (3/27)**
Financials and Real Estate IG spreads were most pressured. Asia IG was a positive outlier with less-affected spreads.

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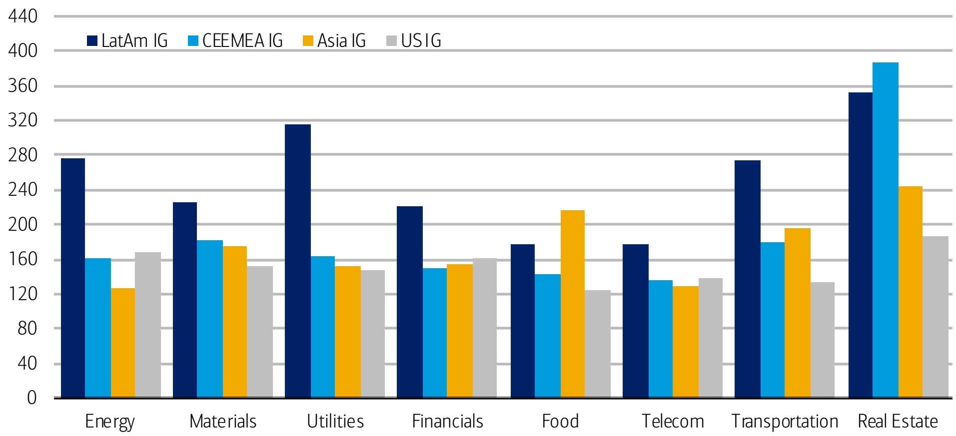
### Latam IG looks relatively cheaper

Taking stock, after these sizeable spread moves, in most major sectors for EM Corporates, Latam IG spreads are currently meaningfully cheaper relative to the US, CEEMEA IG spreads are generally at similar levels vs US IG outside of Real Estate, while Asia spreads are tighter than US IG in the Energy, Financials and Telecom sectors.

**Exhibit 6: IG OAS levels by sector and region with US shown for comparison (3/27)**
Latam IG is wide to regional peers, while Asia IG spreads tighter to US in Energy, Financials, Telecom

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Wider spreads in Latam are pricing in challenges to the political and regulatory operating environment for corporates. As economic conditions worsen (high interest rates, sticky inflation, challenged growth) governments may tap into the resources of Quasi corporates to pursue political goals. Additionally, changes to fuel subsidies, utility tariffs, or increased taxation are some examples of the risks faced by Latam corporates. Despite those challenges, we find current Latam IG levels overall relatively attractive.

## High carry and rates dynamic provide cushion

We calculate the 2023YE Total Return for EM Corporates under different rates and spreads assumptions to understand impact to index returns. We are not revising our spread targets and default rates outlook at this point.

Our current TRR projection is +8.3% for the full year of 2023. This is based on our projected 2023YE spread targets, default rate forecast, and BofA house treasury yields forecast (340bps for 5yr treasuries and 325bps for 10yr by 2023YE).

**Exhibit 7: 2023E TRR forecast based on expected spreads, rates (house forecast), and default rates**

Our current 2023YE spread targets would lead to tighter spreads in Latam IG (-38bps) and HY (-124bps)

| As of 27 Mar 2023 | EM Corporates | | | IG | | | HY | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | EMCB Total* | IG | HY* | LatAm IG | EMEA IG | Asia IG | LatAm HY | EMEA HY | Asia HY* | Chinese HY ppty** |
| Current Spread (bps) | 289 | 167 | 620 | 240 | 183 | 159 | 650 | 569 | 620 | 3,087 |
| YE23 Target (bps) | 278 | 180 | 542 | 215 | 189 | 170 | 539 | 510 | 600 | |
| Difference (bps) | -11 | 13 | -78 | -25 | 6 | 11 | -111 | -59 | -20 | |
| Duration (yrs) | 4.8 | 5.2 | 3.9 | 7.2 | 5.9 | 4.4 | 4.7 | 3.1 | 2.7 | 2.2 |
| YTW (%) | 6.8 | 5.7 | 9.6 | 6.1 | 5.4 | 5.4 | 10.2 | 9.4 | 10.1 | 34.7 |
| Price ($) | 89.7 | 90.5 | 87.4 | 90 | 91 | 92 | 84 | 91 | 88 | 88.1 |
| Face Value (US$bn) | 1,537 | 1,117 | 420 | 165 | 229 | 735 | 215 | 124 | 80 | 27 |
| Default Rate (% mkt weight)* | 0.0 | 0.0 | 4.7 | 0.0 | 0.0 | 0.0 | 3.7 | 6.7 | 3.9 | 42.9 |
| Total Returns YTD | 1.8 | 2.2 | 0.7 | 0.9 | 1.6 | 2.6 | -0.9 | 2.5 | 1.9 | |
| Total Return from as-of-date to 2023YE (%) F | 6.4 | 5.4 | 9.0 | 8.5 | 5.3 | 4.7 | 12.3 | 5.9 | 6.3 | |
| Total Return, 2023 (%) F | 8.3 | 7.7 | 9.8 | 9.5 | 7.0 | 7.5 | 11.3 | 8.6 | 8.3 | 8.0 |

* Excluding Chinese HY property

**China HY property: returns projection via a bespoke methodology, given the high number of defaults that exit the index

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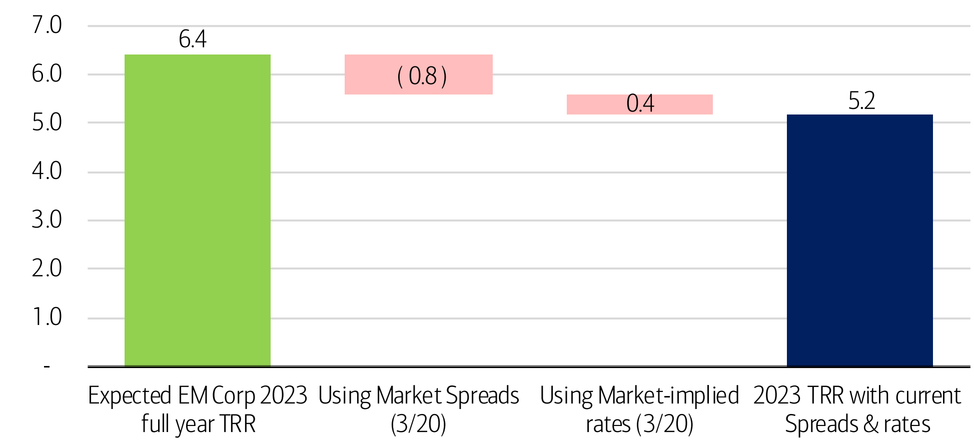
### Return forecast is relatively insensitive to mild spreads and rates shocks

High carry tends to resilient returns given mild spread tightening. Case in point, despite the recent volatility, if we plug in the current market implied spreads and treasury forwards the expected TRR for 2023 only falls to +7.1% from +8.3%, or to +5.2% from +6.4% for the remainder of the year.

**Exhibit 8: Sensitivity analysis - How our estimated TRR from 3/27 to 2023YE would change given current market spreads and USD rates**

TRR is relatively robust to mild spread widening as returns are driven by carry

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## Returns resilient vs. mild historical stress levels

One of the dynamics we observed in March is that DM systemic stability fears pushed spreads higher, but also pushed treasury rates lower, as the Fed would be more likely to ease to stabilize the banking system and US economy. If more things break over the course of the year, we expect a repeat of the same: spreads higher, rates lower.

We explore the sensitivity of returns to a range of scenarios, without making a forecast or assertion as to the likelihood of the scenario. In the following table, each row represents a flat treasury rate scenario. Each column represents a shock to EM IG and HY credit spreads. We assume that HY spreads are 2x as sensitive as IG spreads. We keep the default rate constant because the effect defaults tend to lag credit stress can be thought to be captured through higher credit spreads.

**Exhibit 9: EM Corp est. returns from 3/27 to 2023YE for a range of spreads and rate scenarios**
USD Rate cuts allow more room for EM spread tightening before returns turn negative

**Sensitivity of EM Corporate returns from 3/27 to the end of the year**

| IG spreads chg from current: | -50 | 0 | +50 | +100 | +150 | +200 | +250 | +300 | +350 |
|---|---|---|---|---|---|---|---|---|---|
| HY spreads chg from current: | -100 | 0 | +100 | +200 | +300 | +400 | +500 | +600 | +700 |
| Treasuries (flat curve bps) | | | | | | | | | |
| 500 | 0.8 | (2.1) | (5.0) | (7.9) | (10.8) | (13.7) | (16.6) | (19.6) | (22.5) |
| 450 | 3.2 | 0.3 | (2.6) | (5.5) | (8.4) | (11.3) | (14.2) | (17.2) | (20.1) |
| 400 | 5.6 | 2.7 | (0.2) | (3.1) | (6.0) | (8.9) | (11.8) | (14.7) | (17.7) |
| 350 | 8.0 | 5.1 | 2.2 | (0.7) | (3.6) | (6.5) | (9.4) | (12.3) | (15.3) |
| 300 | 10.4 | 7.5 | 4.6 | 1.7 | (1.2) | (4.1) | (7.0) | (9.9) | (12.8) |
| 250 | 12.8 | 9.9 | 7.0 | 4.1 | 1.2 | (1.7) | (4.6) | (7.5) | (10.4) |
| 200 | 15.3 | 12.3 | 9.4 | 6.5 | 3.6 | 0.7 | (2.2) | (5.1) | (8.0) |

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*The box represents scenarios with more acute US-originating macro stress. These scenarios are not a forecast.

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To provide context for the sensitivity analysis, in the next two sections we explore how high EM spreads went historically in past periods of stress and the tight correlation between of EM IG spreads and EM HY spreads.

### In past crises ex-GFC, IG OAS reached 300-400bps (or +150-200bps from today)

We examine historical spread levels for IG by region. In most crises, barring severely adverse scenarios such as the GFC and the initial response to the pandemic shock, IG spreads max at or below 400bps for Latam and CEEMEA IG, and 300bps for Asia IG. That would be around +150 to +200bps from current levels

**Exhibit 10: LatAm IG OAS**
LatAm IG spreads in past crises maxed around 400bps, if we exclude a brief 2020 spread spike and the GFC when spreads exceeded 600bps

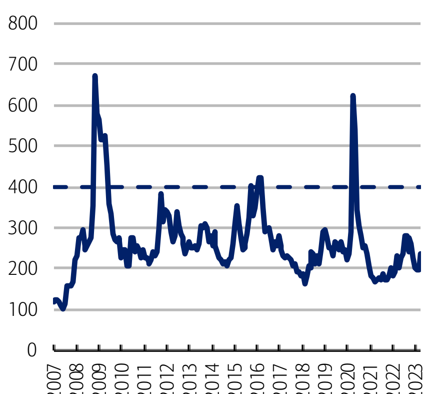


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**Exhibit 11: CEEMEA IG OAS**
CEEMEA IG OAS in past crises maxed at about 400bps if we exclude the GFC

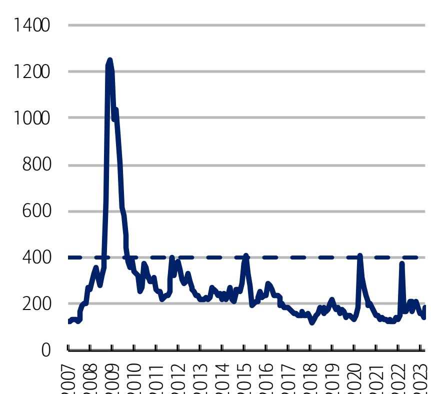


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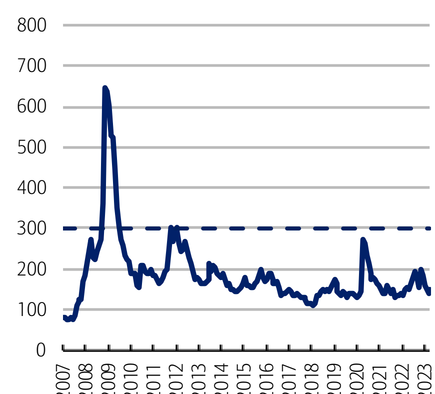
**Exhibit 12: Asia/Pacific IG OAS**
Asia/Pacific IG OAS in past crises maxed at about 400bps if we exclude the GFC

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Please note that the composition of the underlying EM IG universe has changed since the GFC, due to ( a ) the Russian and Venezuelan corporates exclusions, ( b ) that was replaced by issuance from Asian and GCC IG issuer and ( c ) the benefits of fifteen years of economic growth and deepening of local capital markets to the maturity and capital access of EM IG corporates.

### HY spreads can reach distressed levels at times of crisis with defaults lagging

EM HY spreads have reached distressed levels in past crises in all three regions. HY spreads during crises need to be viewed in conjunction with default rates, as defaulted issuers exit the index providing relief to spreads for the wrong reasons.

**Exhibit 13: LatAm HY historical OAS**
LatAm HY spreads reached distressed levels in past crises

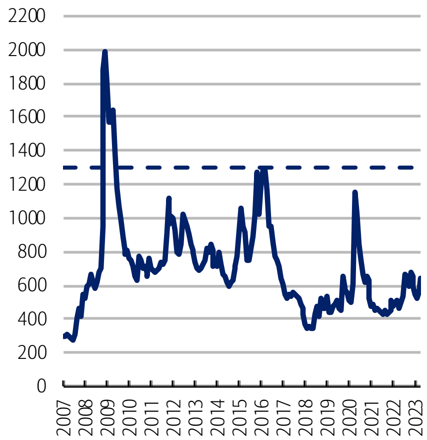


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**Exhibit 14: CEEMEA HY historical OAS**
CEEMEA HY spreads reached distressed levels in past crises

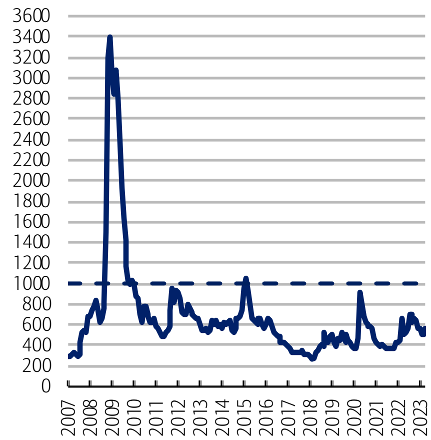


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**Exhibit 15: Asia/Pacific HY historical OAS**
Asia HY spreads have been driven by the HY Chinese property crisis since 2021


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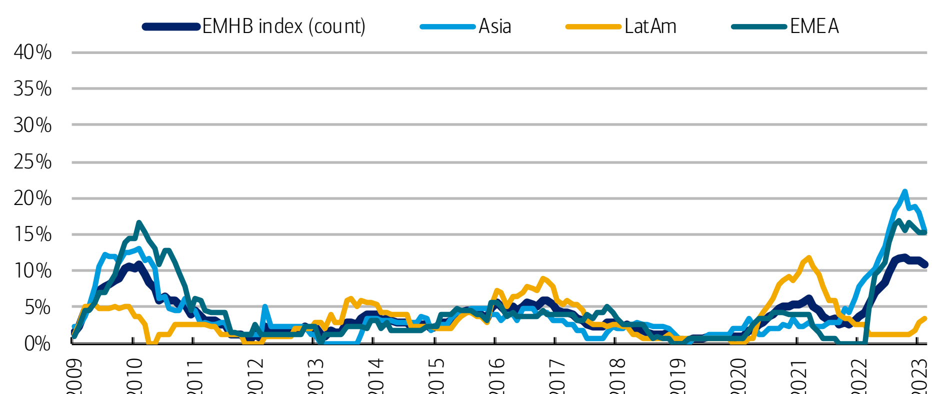
**Exhibit 16: EM HY count-based Last Twelve Month Default rate by region**
LTM Defaults often peak with a lag of about 12 months from the peak in spreads as credit stress takes time to eat into corporate Balance Sheet and liquidity buffers




**Source:** BofA Global Research, ICE Data Indices LLC.
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**Latam, CEEMEA HY spreads change 2-3x more than IG with high correlation**

We calculated the relation between OAS changes between IG and HY by region over rolling 3-month periods. We calculate changes in spreads stripping out rebalancing effects at the index level, that tend to underestimate spread increases for HY as distressed assets drop in market weight.

**Exhibit 17: CEEMEA 3m OAS change: IG vs HY since 2010 ex Russia**

CEEMEA HY spreads changed ~2.4x IG spread change since 2010

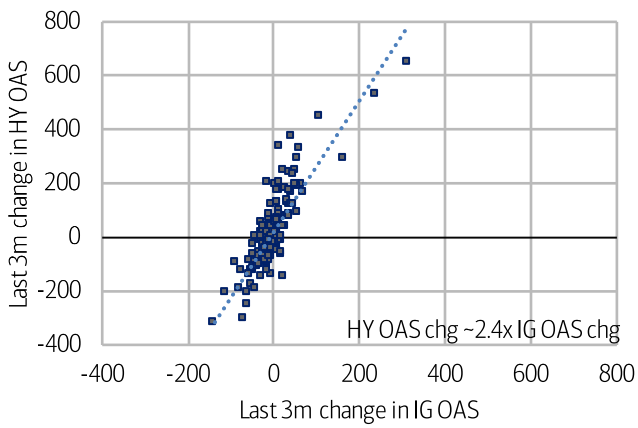


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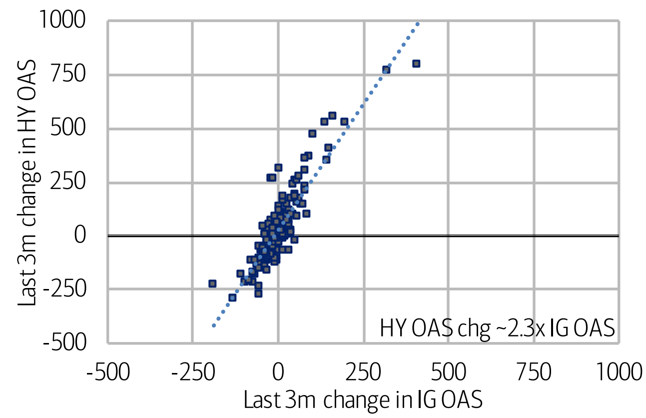
**Exhibit 18: LatAm 3m IG OAS change: IG vs HY**

LatAm HY spreads changed ~2.3x IG spread change since 2010

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We find that:

- In CEEMEA, HY spreads tend to increase at 2.3x IG spreads with a strong correlation since 2010. We exclude Russia from this analysis, as the exclusion of mostly IG Russian bonds in 2023 would distort historical correlations.
- In Latam, HY spreads tend to increase at 2.4x IG spreads with a strong correlation since 2010.
- In Asia, there is not a strong correlation between IG and HY spreads, as the HY spreads are largely affected by the volatile Chinese HY sector.
- In periods of extreme stress, such as the GFC, we would expect HY spreads beta to IG spreads to be higher, as HY is more sensitive to extreme stress

**Common abbreviations**

| | |
|---|---|
| AT1 | Additional Capital Tier 1 |
| AT2 | Additional Capital Tier 2 |
| CB | central banks |
| CEEMEA | Central Eastern Europe, Middle East, Africa |
| chg | Change (simple difference) |
| CoCos | Contingent Convertibles |
| EM | Emerging Markets |
| Fed | The Federal Reserve |
| GFC | Global Financial Crisis |
| HY | High Yield |
| IG | Investment Grade |
| LatAm | Latin America |
| LTM | Last Twelve Months |
| MTD | Month to Date |
| NY | New York |
| OAS | Option Adjusted Spread |
| US | United States |
| USD | United States Dollar |
| TRR | Total Rate of Return |
| DM | Developed Markets |
| GCC | Gulf Cooperation Council |
| QT | Quantitative Tightening |

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# Research Analysts

**Jason Amoratis**
Research Analyst
BofAS
jason.amoratis@bofa.com

**Anne Milne**
Research Analyst
BofAS
anne.milne@bofa.com

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