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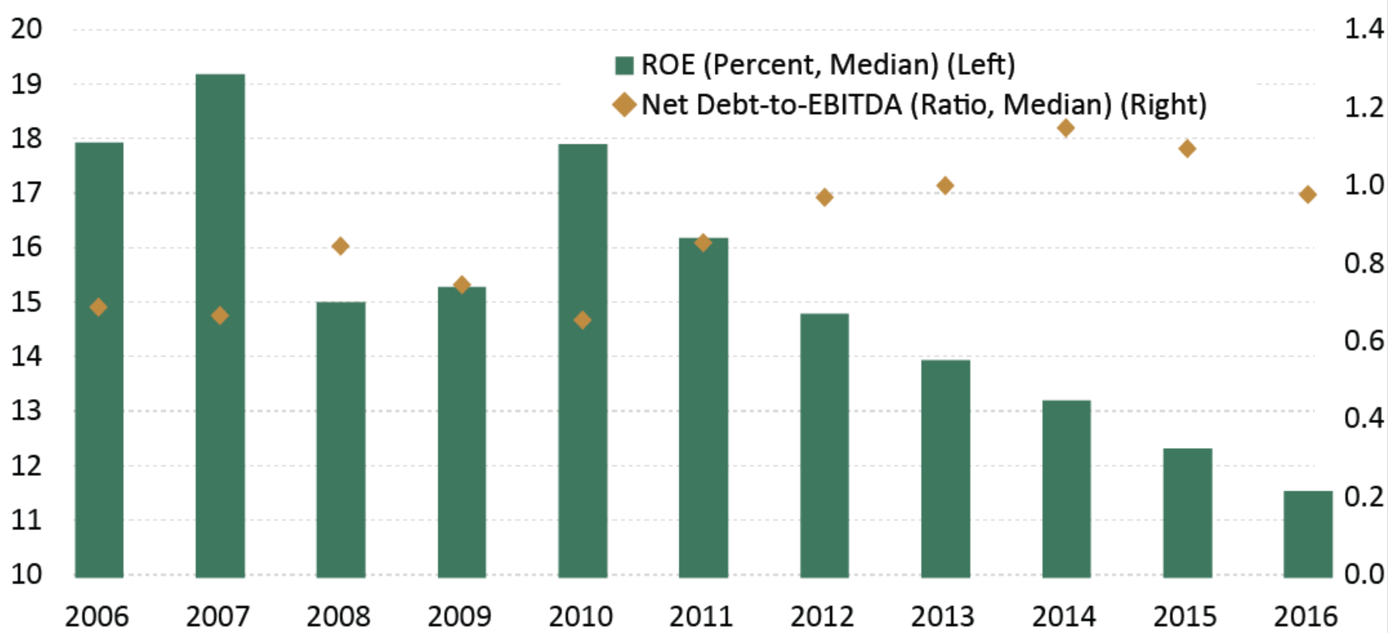
# Obstacles Make Way for Opportunities in Emerging Markets

**We believe emerging market opportunities in credit markets are finally becoming more evident. Returns on equity have collapsed over the last several years, and debt relative to earnings before interest, taxes, depreciation, and amortization (EBITDA) appears to have peaked as operating margins have diminished and leverage has ceased to increase (see Chart 1). The focus now is on balance sheet management and earnings stabilization—an environment typically positive for credit investors.**

**Chart 1: Return on Equity and Net Debt-to-EBITDA* in Emerging Markets** *As of 6/30/2016*

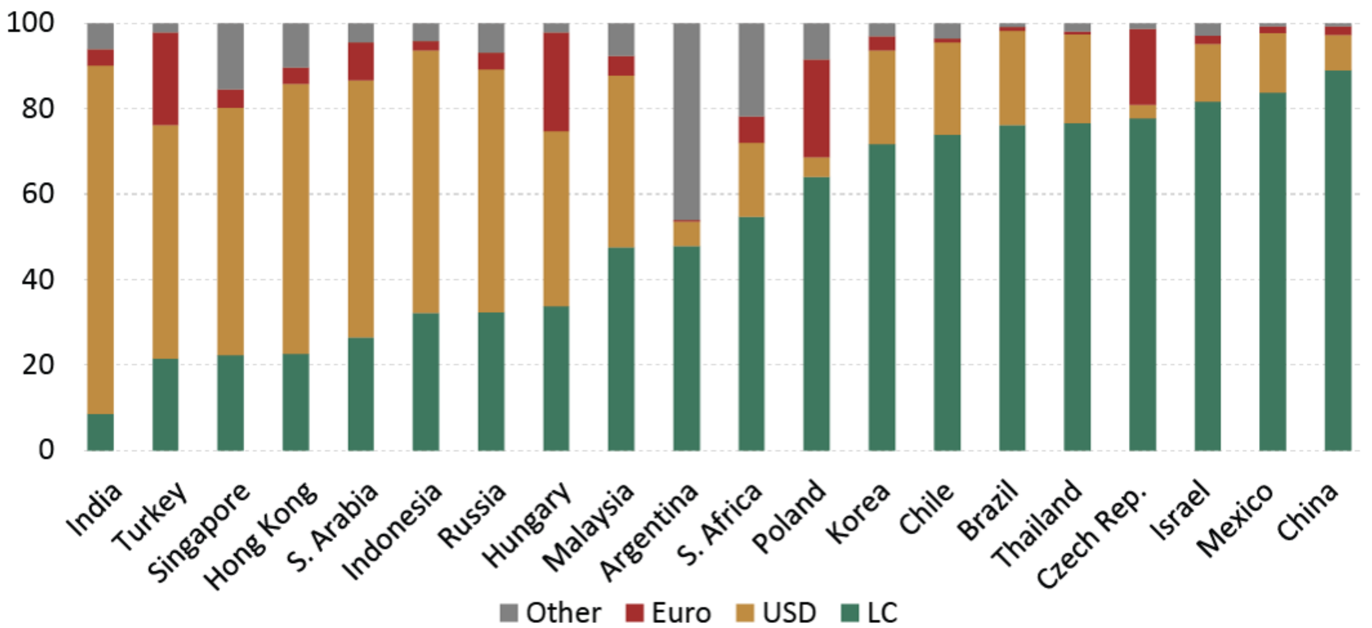



**Excludes financials*

*Source: Bloomberg (© 2016, Bloomberg Finance LP), MSCI, Institute of International Finance*

**Most major emerging markets—with the exception of those that generate U.S. dollar (USD)-based revenue—have issued their debt in local currency, avoiding the currency mismatch which caused so many challenges historically (see Chart 2).**

**Chart 2: Currency Breakdown of Financial Corporate Debt** *Percent, Q1 2016*

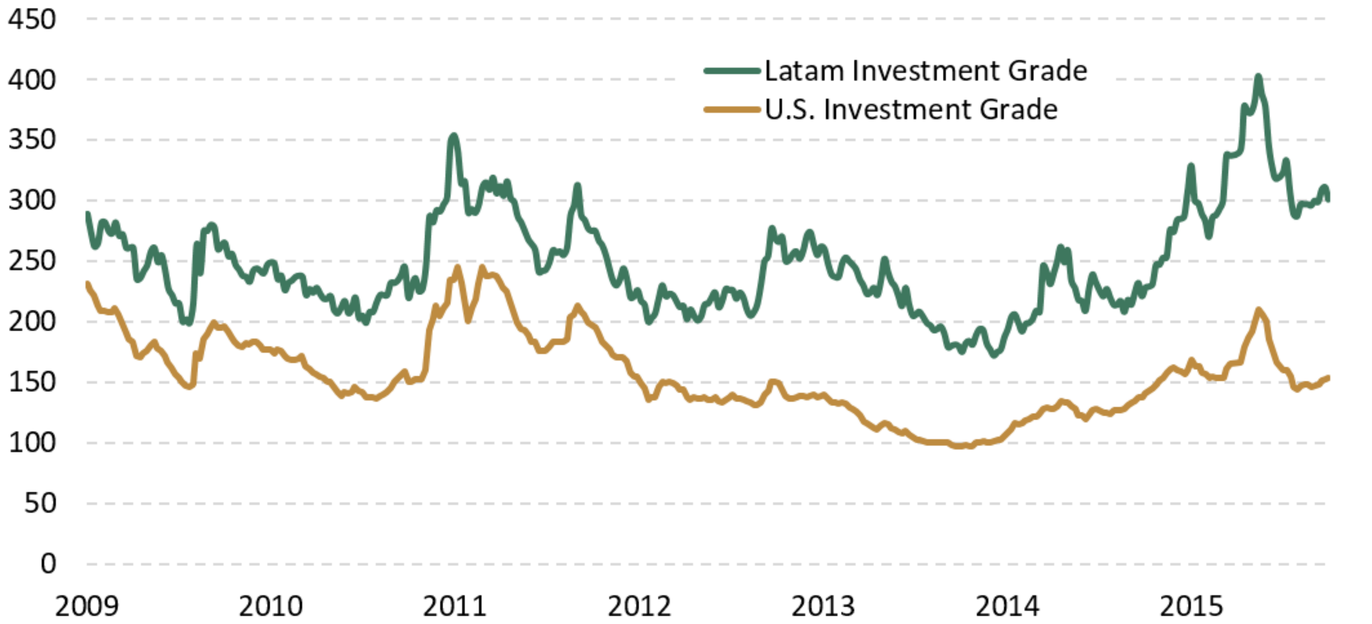



*Source: BIS, Harver, Institute of International Finance estimates*

**Current conditions point to opportunities in USD-denominated emerging market corporate and sovereign debt. Furthermore, local currency debt may also offer attractive prospects in developing markets that are most compelling due to currency adjustments.**

**After monitoring emerging market credit markets for some time, we recently began buying select quasi-sovereign and corporate bonds in certain Latin American (Latam) countries. Latam investment grade yields, from a relative valuation standpoint, currently are nearly double U.S. investment grade (see Chart 3), an attractive entry point on a historical basis. Latam high yield also compares favorably to U.S. high yield (see Chart 4).**

**Chart 3: Latam Investment Grade Bonds at Attractive Levels Relative to U.S. Investment Grade** *Option Adjusted Spread, Basis Points, As of 6/30/2016*




*Source: Bank of America Merrill Lynch*

**Chart 4: Latam High Yield Compares Favorably to U.S. High Yield**
*Option Adjusted Spread, Basis Points, As of 6/30/2016*

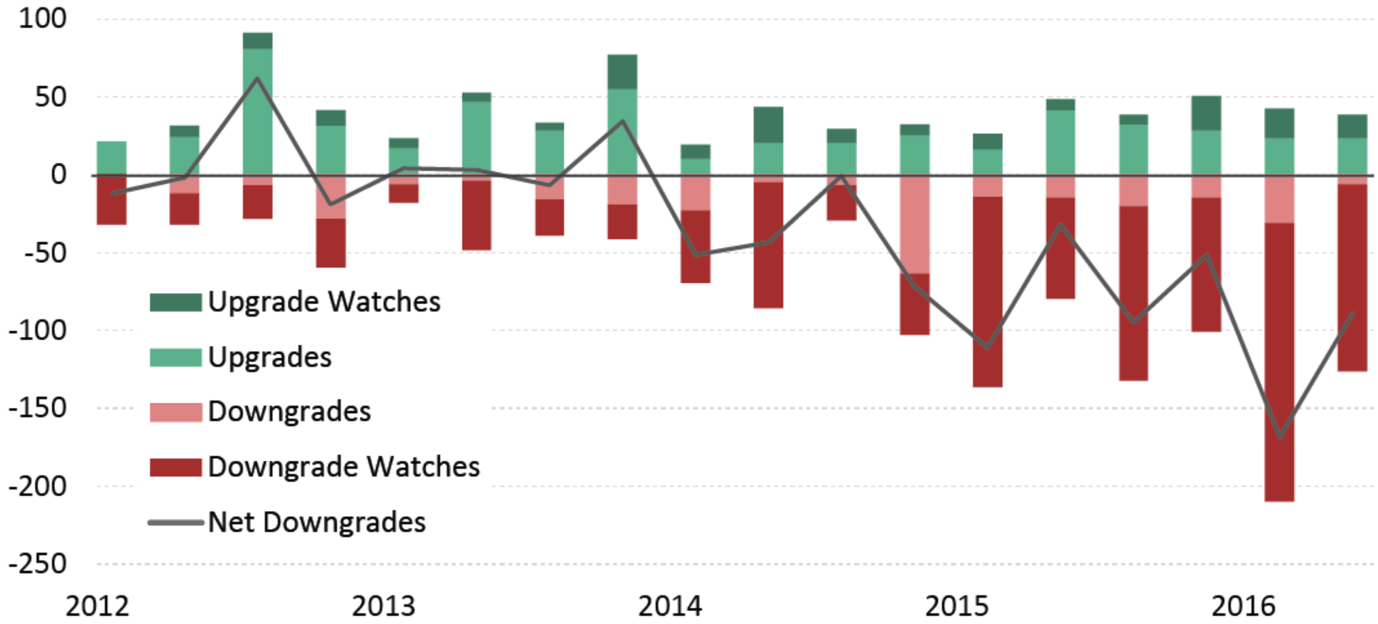

*Source: Bank of America Merrill Lynch*

**Credit ratings for emerging markets as a whole have also bottomed (see Chart 5), signaling, in our opinion, a potential turnaround. More specifically, emerging market corporate and sovereign rating downgrades reached**

their zenith in late 2015 into early 2016 and have since pulled back (see Charts 6 and 7).

**Chart 5: Emerging Market Credit Ratings Have Bottomed***

*Number, S&P Ratings on Corp. and Government Securities, As of 6/30/2016*

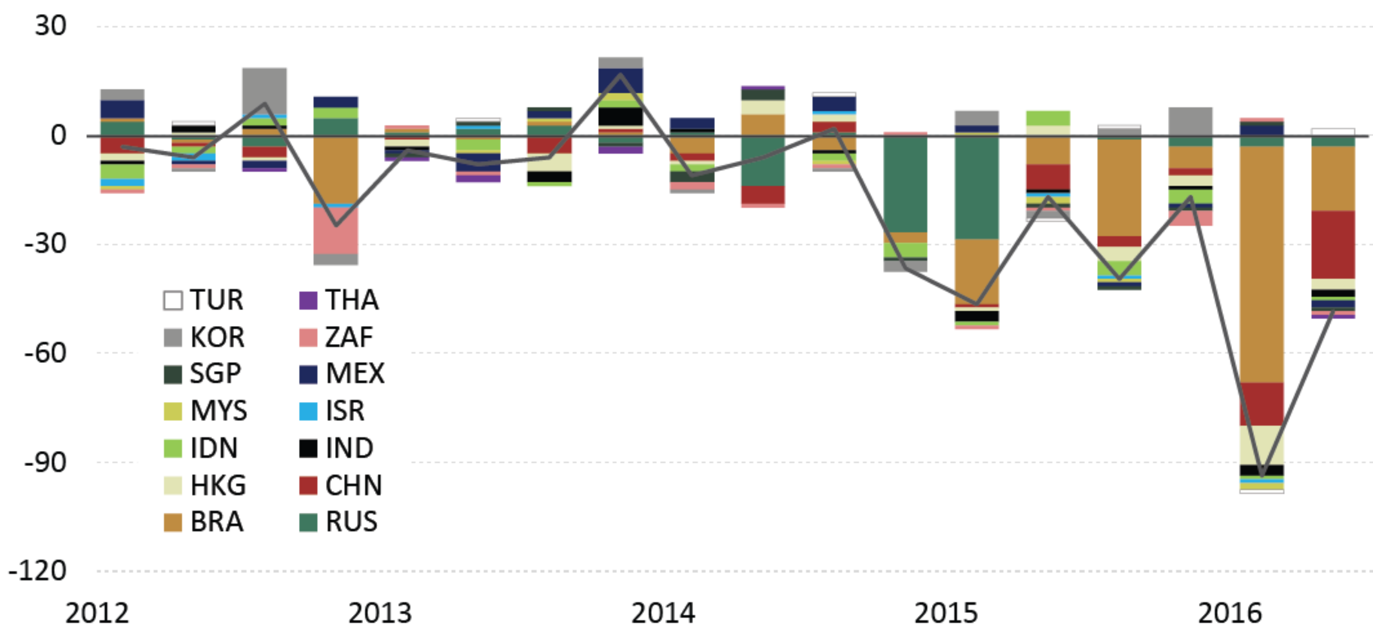



**EM14 excludes Argentina, Czech Republic, Hungary, Poland, Chile and Saudi Arabia from our EM 20 sample.*

*Source: Bloomberg (© 2016, Bloomberg Finance LP), Institute of International Finance*

**Chart 6: Non-Financial Corporate Credit Ratings Show Net Upgrades**

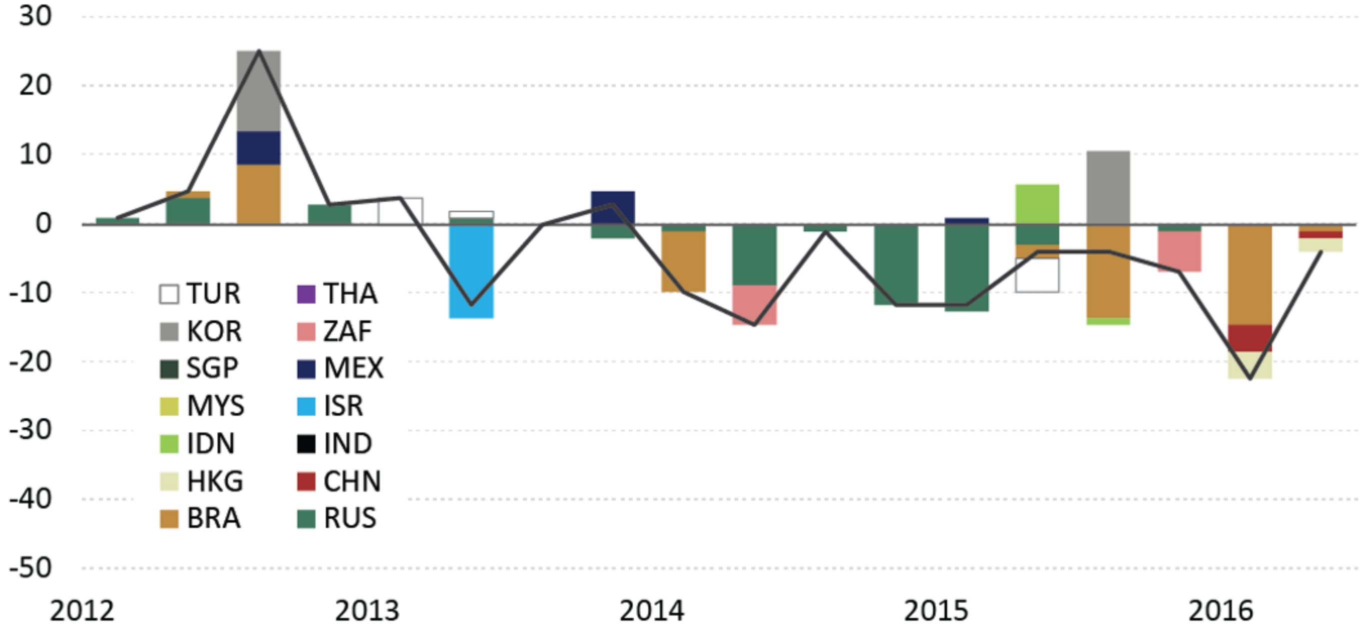
*Number, Upgrades Minus Downgrades Including Rating Watches, As of 6/30/2016*




*Source: Bloomberg (© 2016, Bloomberg Finance LP), S&P, Institute of International Finance*

**Chart 7: Net Upgrades Also Seen in Government and Public Sector Credit Ratings**

*Number, Upgrades Minus Downgrades Including Rating Watches, As of 6/30/2016*




*Source: Bloomberg (© 2016, Bloomberg Finance LP), S&P, Institute of International Finance*

# Conclusion

**The rout in commodity prices, particularly for oil, has been another obstacle for commodity-linked emerging markets that is now showing signs of improvement. Recent oil price stability—prices above USD $35 per barrel—should lend further support for emerging market opportunities. With commodity prices, spread valuations, and credit ratings stability currently in better alignment, we anticipate that opportunities in hard currency emerging market corporates are now appropriate.**

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