

The Time is Now: Seizing the Opportunity in Emerging Market Investment Grade Credit

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Executive Summary

Income is back... for the first time in a decade investors can generate better bond returns without relying heavily on spread or duration gains. The investment grade sector of Emerging Market Debt offers a compelling opportunity to construct a portfolio of higher-quality bonds with attractive all-in yields, creating a buffer against potential headwinds.

5.5% Investment Grade Yield! Looking forward, the attractive yield alone may be the primary driver of returns with additional upside potential for longer-duration assets like EM IG with the Federal Reserve maintaining a bias toward further policy easing.

Paid premium for the same credit rating. Despite sharing the same average credit rating as US IG, EM IG currently offers nearly 100 basis points of additional spread compensation (Figure 2). This EM IG spread premium stands in the 70th percentile of cheapness, with spreads more than 40bps wider than historical averages.

High level of all-in yields, resilience to U.S. Treasury volatility, and strong credit fundamentals make a persuasive investment case for Emerging Market Investment Grade (EM IG) credit.

Investors Get Paid for Quality

Today, the high level of yield offered by EM IG allows investors to remain conservative from a credit perspective while being able to generate better bond returns solely from income. For much of the decade prior to the 2022 Federal Reserve hiking cycle, a low-rate environment forced investors to pursue higher yields by moving further down the credit spectrum. That dynamic has changed.

This shift has restored a key feature of fixed income: earning attractive income without relying heavily on spread or duration gains. This creates a valuable margin of safety against potential negative returns. This becomes especially important in today's environment of unpredictable United States policies towards emerging markets, including a focus on anti-globalization and protectionism, and a transactional approach favoring those countries willing to 'make a deal'. In this environment, we like quality. Countries with strong external accounts and fiscal discipline should have a stronger negotiating position vis-à-vis the United States.

Despite these risks, the higher quality and attractive yield offered by EM IG builds an asymmetric return profile as seen in the table below – if Treasury yields and credit spreads remain unchanged, investors still can achieve a 5.5% return over the next 12 months. Additional upside return potential comes if the Fed maintains a bias toward further easing, where longer-duration assets like EM IG would benefit from price appreciation.

Figure 1.
Investment Grade Credit Spread and UST Yield Change

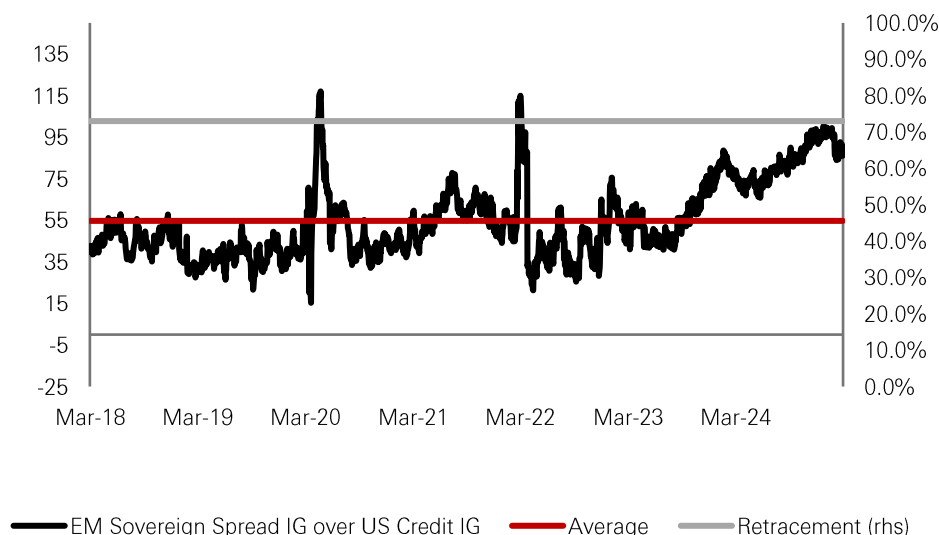
		IG Credit Spread Chg						
		+50	+25	+10	0	-10	-25	-50
UST Yield Chg	-1%	7.9%	9.2%	9.9%	10.4%	10.9%	11.6%	12.8%
	-0.75%	6.7%	7.9%	8.7%	9.2%	9.6%	10.4%	11.6%
	-0.50%	5.5%	6.7%	7.4%	7.9%	8.4%	9.2%	10.4%
	-0.25%	4.3%	5.5%	6.2%	6.7%	7.2%	7.9%	9.2%
	0%	3.0%	4.3%	5.0%	5.5%	6.0%	6.7%	7.9%
	+0.25%	1.8%	3.0%	3.8%	4.3%	4.8%	5.5%	6.7%
	+0.50%	0.6%	1.8%	2.6%	3.0%	3.5%	4.3%	5.5%
	+0.75%	-0.6%	0.6%	1.3%	1.8%	2.3%	3.0%	4.3%
	+1%	-1.8%	-0.6%	0.1%	0.6%	1.1%	1.8%	3.0%

Source: JP Morgan, as of 10 March 2025.

Premium for EM

Despite sharing the same average credit rating as US IG, EM IG currently offers nearly 100 basis points of additional spread compensation (Figure 2). This EM IG spread premium stands in the 70th percentile of cheapness, with spreads more than 40bps wider than historical averages.

Figure 2.
EM IG Credit Spreads Cheap to DM IG



Source: JP Morgan, Bloomberg, as of 06 March 2025.

Structural inefficiencies driven by a bias towards U.S. credit and an under-allocation to emerging markets are the root cause for the persistent spread differential. Since 2012, US Investment Grade debt funds have experienced large massive inflows while Emerging Market hard currency debt flows remain barely in positive territory (Figure 3). As a result, EM has a much cleaner technical position whereas the crowded positioning in US IG markets makes it more vulnerable to indiscriminate sell-offs.

Figure 3.
Divergent Fund Flow Story

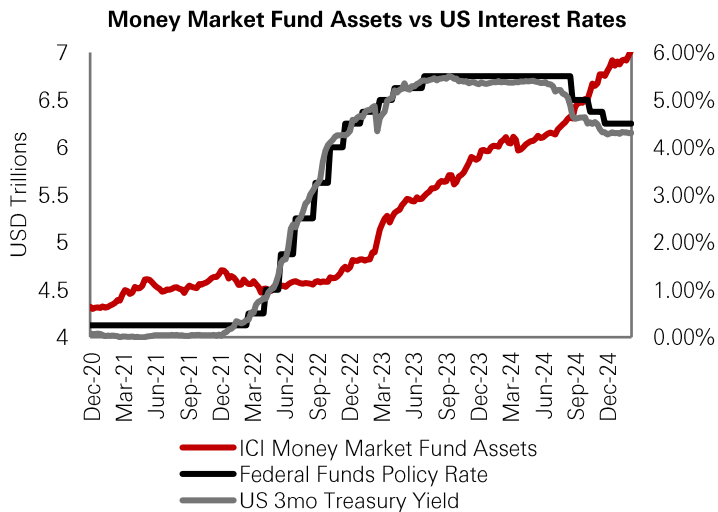


Source: BAML, as of 31 December 2024.

A Shifting Landscape Creates Opportunity in Fixed Income

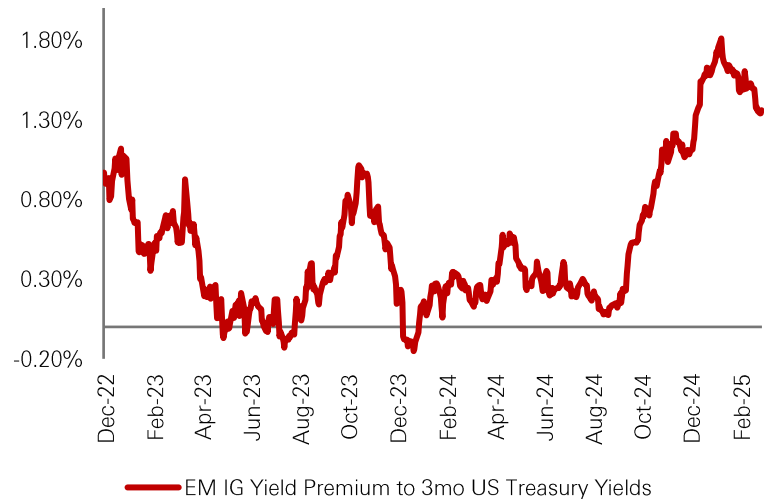
Demand for EM IG may experience a pickup in flows as yields in the front-end of the US Treasury yield curve decline and steepens overall (Figure 4). With the Fed having already cut rates by 100 basis points and signaling further easing, investors will likely seek higher-yielding alternatives without venturing too far down the credit spectrum. EM IG credit stands as a compelling solution, now offering attractive all-in yields compared to historical premiums over Money Market Funds (MMFs) (Figure 5).

Figure 4.
Money Market Assets Surge with Fed Rate Hikes



Source: ICI, Federal Reserve, Bloomberg, as of 05 March 2025.

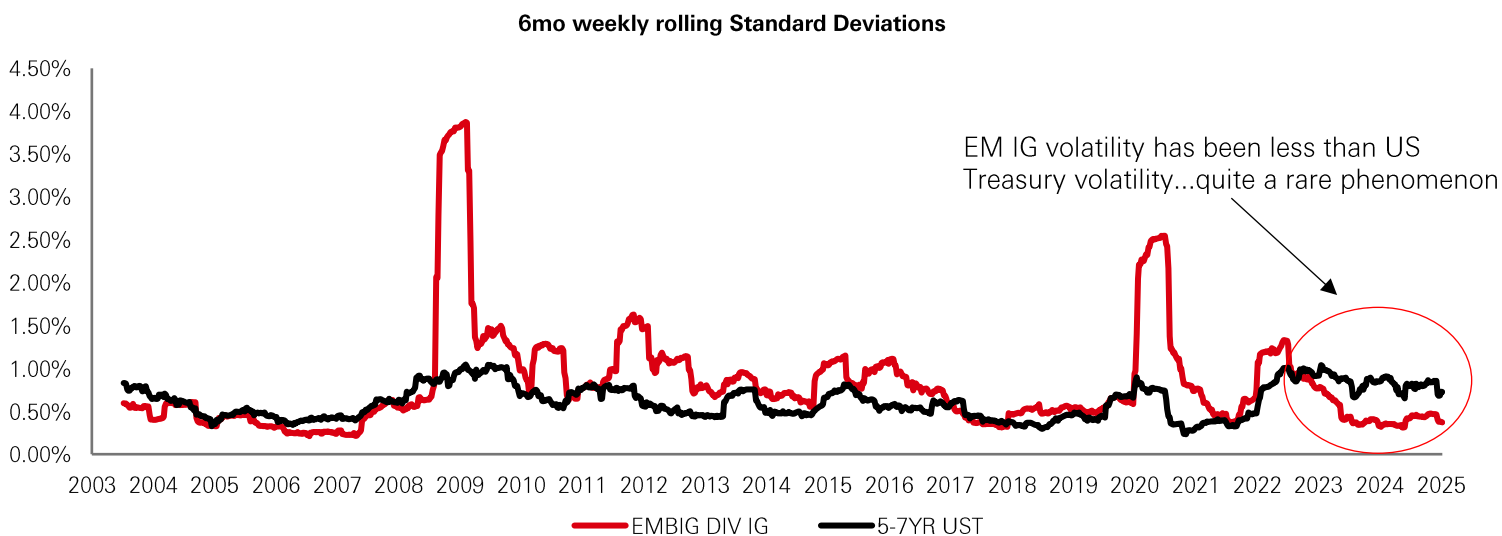
Figure 5.
Yield is Back in Favor for EM IG



Source: Federal Reserve, Bloomberg, as of 05 March 2025.

One potential risk to the earned income potential for EM IG is a spike in market volatility. However, in the recent pickup in U.S. rate volatility, EM IG spreads have remained resilient. Today's EM IG spread volatility is lower than that of the underlying reference duration of the U.S. Treasury benchmark (Figure 6). This provides an extra layer of protection to EM IG investors.

Figure 6.
Treasury Volatility has Surpassed EM IG Credit Spreads Volatility

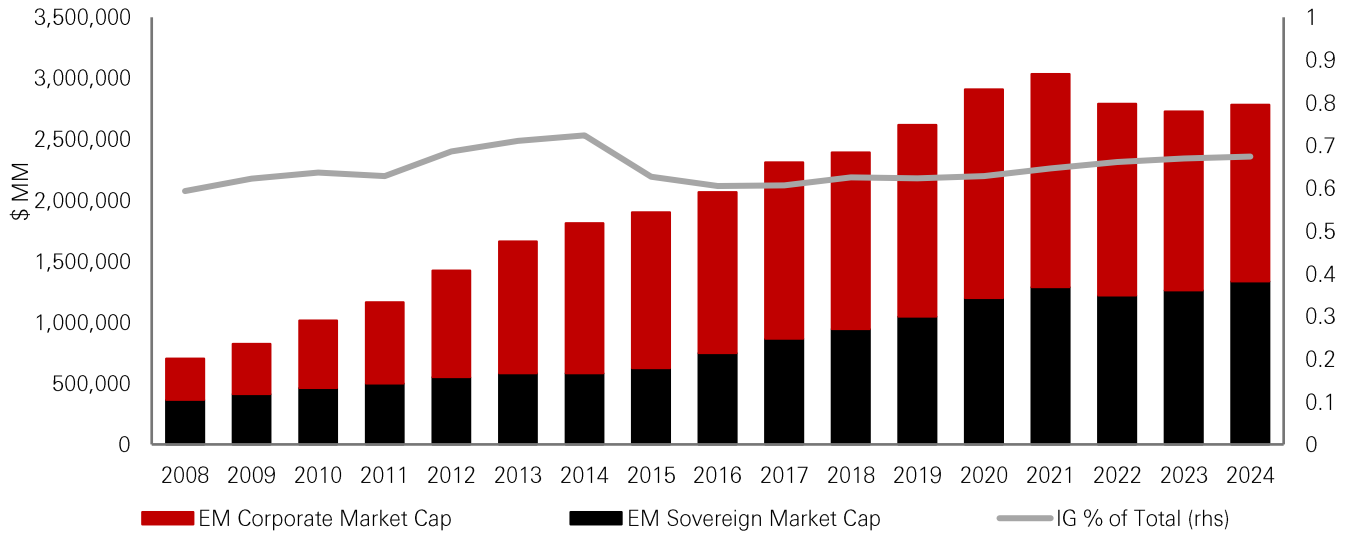


Source: Bloomberg, JP Morgan, as of 07 March 2025.

Investment Grade Shining Bright

The Emerging Market dollar debt universe has nearly quadrupled in market capitalization since 2008. Today, the Investment Grade portion of the universe represents nearly half of the total index constituents and 70% of the market capitalization (Figure 7).

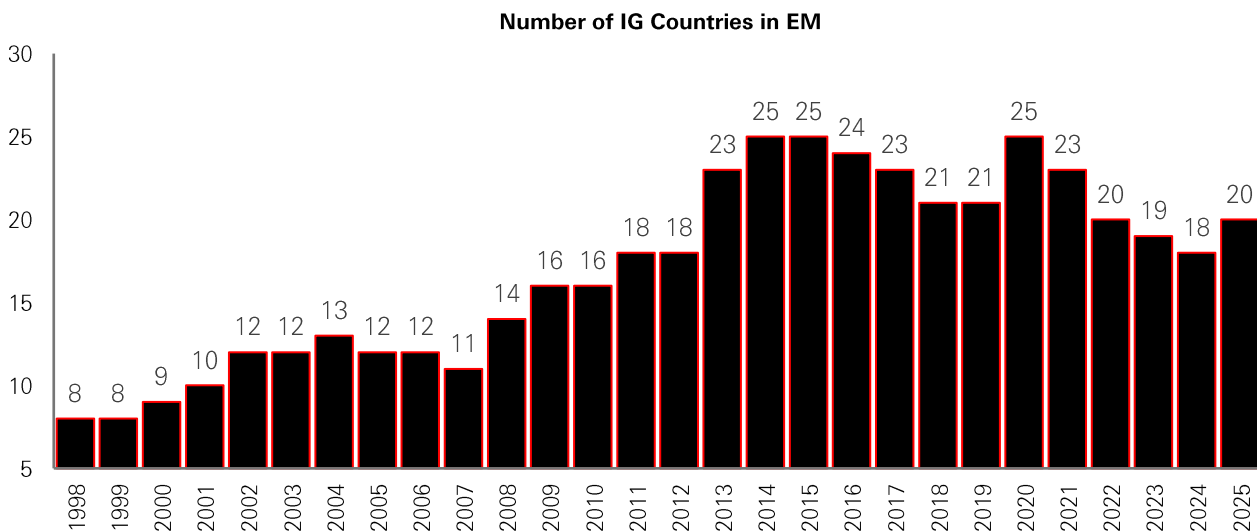
Figure 7.
Explosive Growth in Emerging Market Assets



Source: BAML, as of 31 December 2024.

Within the Emerging Market sovereign debt universe, the composition of the higher quality segment of the universe has grown in the number of country constituents (Figure 8) and has improved in credit rating representation (Figure 9).

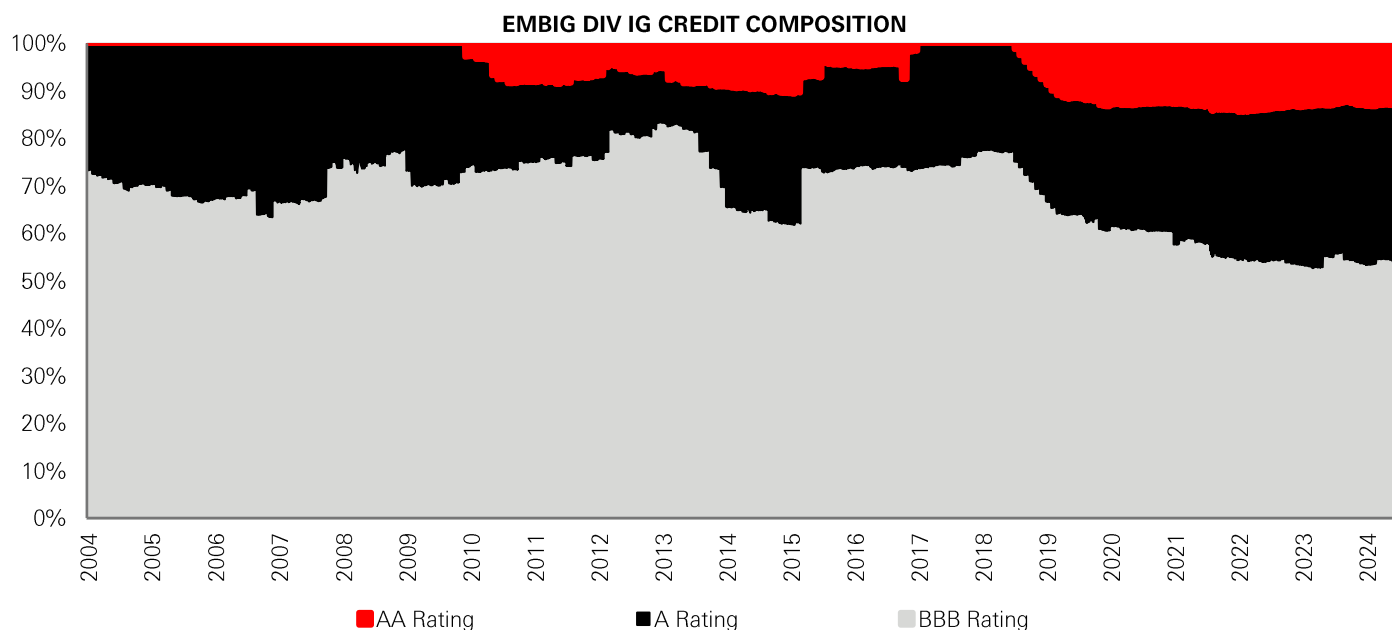
Figure 8.
EM IG Universe has Grown in Opportunity Set



Source: JP Morgan, as of 31 January 2025.

Investment Grade Shining Bright

Figure 9.
Improving Credit Rating Trends for EM IG

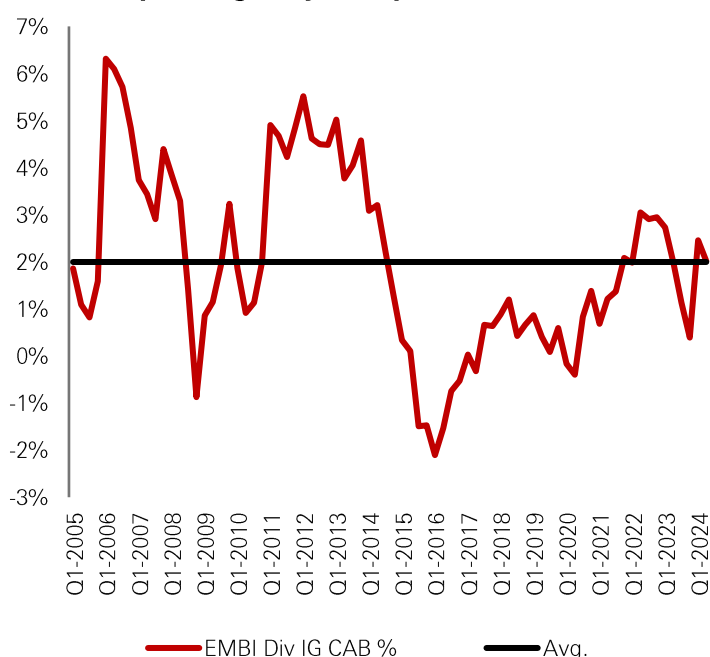


Source: JP Morgan, as of 21 February 2025.

The improvement in credit quality has been a result of EM governments committing to strong fiscal discipline, implementing reforms to restore economic stability and stabilizing debt burdens.

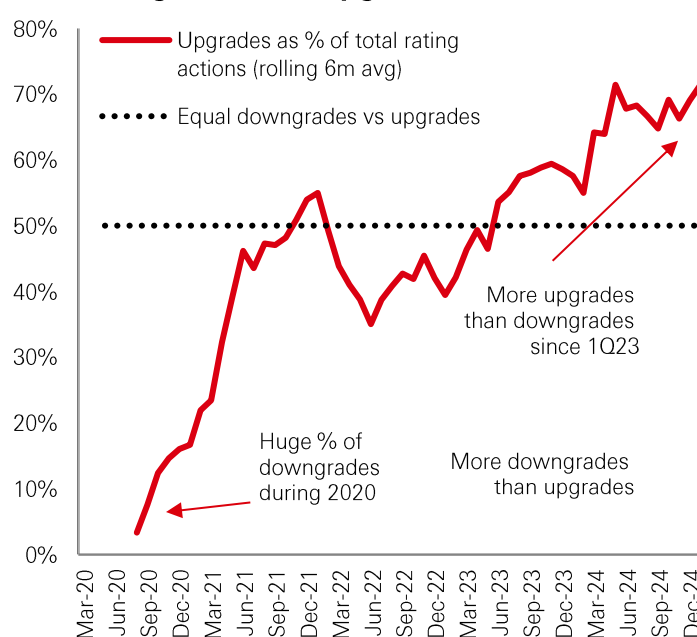
As the trend of strong fundamentals with improving current account balances continues (Figure 10), additional rising star candidates should gain Investment Grade status (Figure 11). In addition to the positive trait of stronger underlying fundamentals in the asset class, EM IG investors can also benefit from this wider opportunity set in terms of diversification and liquidity.

Figure 10.
Fundamentals for EM IG
on an Improving Trajectory



Source: JP Morgan, Haver, as of 31 September 2024.

Figure 11.
EM Ratings Migration
Pointing Towards Upgrades*



Source: BofA Global Research, Bloomberg, as of 31 January 2025.

* Suriname, Belize, Ecuador and Argentina were upgraded after restructurings of debt.

Source: HSBC Asset Management. Diversification does not ensure a profit or protect against loss. The views expressed above were held at the time of preparation and are subject to change without notice. Any forecast, projection or target where provided is indicative only and is not guaranteed in any way.

Investment Grade Shining Bright

Table 1.

Countries	Yield to Maturity (%)	Examples
Saudi Arabia	5.40	Indonesia ♦ Track record of fiscal discipline and strong growth ♦ Ongoing commitment to business-friendly reforms and deepening integration of trade supply chains with global economy
Indonesia	5.38	
China	5.08	
United Arab Emirates	5.39	
Qatar	5.16	
Chile	5.70	Bulgaria ♦ Strong external position with stable levels of import coverage and current account deficits covered by FDI ♦ Potential euro adoption to drive further integration with European Economy
Mexico	7.55	
Philippines	5.28	
Poland	5.45	
Hungary	5.73	
Romania	6.77	Chile ♦ Robust fiscal prudence, maintaining debt levels that are solidly aligned with IG-rated country averages ♦ Upcoming elections likely to lead to a return to business-friendly policies
Panama	7.26	
Peru	6.01	
Uruguay	5.42	
Malaysia	5.20	
India	5.04	UAE ♦ Strong and improving external position driven by low breakeven oil price ♦ Low debt levels against sizeable FX reserves
Kazakhstan	5.40	
Kuwait	4.39	
Bulgaria	5.31	
Latvia	5.23	

Source: JP Morgan, HSBC Asset Management, as of 28 February 2025.

The level of yield is not guaranteed and may rise or fall in the future.

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Conclusion: Now Is the Time to Invest

Investors have an unprecedented opportunity to capitalize on the EM IG asset classes growth potential. Since its inception in 1998, the EM IG universe has undergone a remarkable transformation, fueled by shifting global economic power, market evolution, and structural improvements within emerging economies.

As the EM IG universe continues to evolve and mature, it presents a unique opportunity for forward-thinking investors. The combination of attractive yields, resilient spreads, improving credit fundamentals, and increasing investor recognition makes now the ideal time to gain exposure to this dynamic asset class.

The opportunity is clear. The time to invest is now.

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