RBC Global Asset Management

Strong fundamentals and low defaults: the EM corporate story

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"EM corporates are entering 2025 from a position of strength, with the asset class having outperformed DM peers across all ratings categories in 2024."

Despite global challenges in recent years, such as supply chain disruptions, inflationary pressures and geopolitical uncertainties, EM economies have demonstrated healthy resilience. Similarly, after an elevated default cycle in 2022 and 2023, net leverage in the EM corporate universe is close to historical lows (Chart 1), with cash-to-total debt significantly higher than developed market (DM) counterparts. Within this backdrop, we expect that spreads should continue to be driven by the underlying default outlook and default rates for the high yield component of the JP Morgan CEMBI index expected to be below both the U.S. and European high yield sectors.

Key Points

- EM corporates are entering 2025 from a position of strength, with the asset class having outperformed DM peers across all ratings categories in 2024.
- The high default rates of the post-Covid era, are now behind us, with EM corporates going through a sharp de-leveraging event as a result.
- We expect corporate defaults to be in line with U.S. markets and meaningfully lower than Europe.
- There are favourable internal dynamics with EM corporates but likely headwinds from the U.S. policy agenda.

EM corporates are entering 2025 from a position of strength, with the asset class having outperformed DM peers across all ratings categories in 2024. The high default rates of the post-Covid era, which were largely driven by the Chinese property crisis along with a steady stream of negative geopolitical events, are now behind us, with EM corporates going through a sharp de-leveraging event as a result.

We expect corporate defaults to be in line with U.S. markets and meaningfully lower than Europe

As we look ahead to 2025, our base case default forecast for the CEMBI Broad Diversified High Yield Corporate universe is estimated at 1.2%, below historical averages and slightly below the market consensus (closer to 1.7%). This is roughly in line with U.S. credit markets and meaningfully lower than European credit markets. Indeed, most of the credits we see at risk have been struggling for a while now, and hence their deterioration should hardly come as a surprise.

In terms of underlying trends, weakness in China, particularly real estate, and maturity extensions in Ukraine remain continued risks that the market is well aware of.

On the other hand, an unexpected increase in funding cost and prolonged weakness in crude oil could be non-consensus default drivers. Having said that, whilst defaults in oil & gas could pick up in 2025, we consider these potential issues more relevant with a lag, as balance sheets remain solid overall and refinancing risks are manageable.

Lastly there are a number of idiosyncratic stories in TMT with heightened default risk, should things not go according to managements' base cases.

> "The overall benign outlook for defaults should usher in a period more akin to the lower default environment of the pre-Covid era"

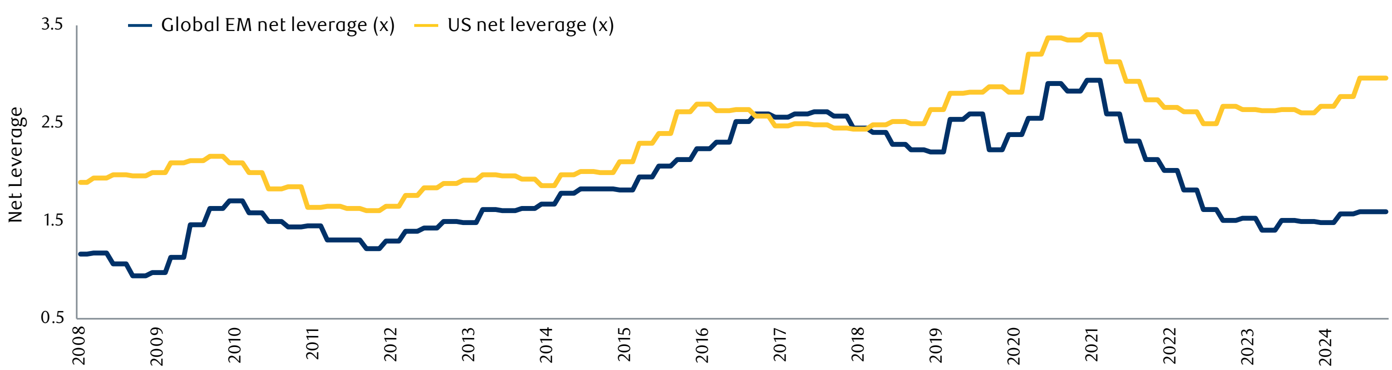
Nevertheless, the overall benign outlook for defaults should usher in a period more akin to the lower default environment of the pre-Covid era, where Sharpe ratios for the asset class were meaningfully higher and above 1 in many cases.

Favourable internal dynamics but likely headwinds from the U.S. policy agenda

While internal dynamics for the asset class remain favourable, headwinds are likely to come from the U.S. policy agenda, where the primary concerns would be trade policy and specifically tariffs. This will have both regional as well as sectoral implications and, while we won't know the true extent of Trump's ambitions on these matters until the U.S. has more fully enacted policies. However, we can make reasonable assumptions that Asia will be the region most impacted, while the question remains whether countries such as Mexico, with existing free trade agreements, will be able to mitigate the scope of any tariff actions.

Sectoral themes are more difficult to discern in EM given the varied geographies, but we do see possible downside risks to the oil price which will play a factor in portfolio positioning next year. While the external backdrop will likely provide some challenges, overall, we expect the most powerful drivers of asset class performance to be the strong fundamental backdrop, as well as yields that start the year at historically elevated levels, providing a healthy backdrop for total returns next year.

Chart 1: EM net leverage at historic lows



Source: BAML, JPMorgan as at October 2024.

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