A shift in EM fixed income strategies

Evolving economic factors have increased the appeal of EM sovereign debt over EM corporate bonds.

By *Mauro Favini*

In August 2022, a difficult year for emerging markets (EM) and risk assets, we made the case for EM corporate debt, citing strong fundamentals and attractive valuations. However, we now believe that the outperformance of EM corporates over EM sovereign credit has ended.

EM corporates have outperformed their sovereign counterparts since 2022, supported by greater spread compression and a shorter duration profile.

We are entering a new macroeconomic regime of slower growth due to tariffs and other uncertainties, while EM corporate valuations have reached very tight levels. We explore the potential benefits of investing in EM sovereign debt relative to EM corporate bonds.

EM sovereign debt offers higher spreads and longer duration than EM corporates

EM sovereigns offer a unique combination of higher spreads and longer duration relative to EM corporates, with an attractive all-in yield of 7.78% and a duration of 6.6 years[1] – giving EM sovereigns an edge during market stress and risk-off sentiment. EM corporates offer a lower all-in yield of 6.77% and a shorter duration of 4.2 years[1], with less spread compression potential.

When interest rates rose, the shorter duration profile of EM corporates benefitted investors. We believe this tailwind has passed, and we now prefer longer-duration assets like EM sovereigns.

Fundamentals shift?

Before the Global Financial Crisis, the private sector was highly leveraged, making financial markets vulnerable. Amid the economic turmoil, the public sector intervened to stabilise economies via quantitative easing and extensive bailouts. Financial repression was revived as governments implemented strategies to stimulate the private sector. Since 2008, central banks and governments implementing measures to foster corporate investment and economic recovery.

This improved the overall quality of corporate balance sheets over the past decade. However, there is the potential for structural change as the pendulum swings from strong corporate balance sheets to stronger sovereign balance sheets.

Since the end of the Covid-19 pandemic, EM sovereign fundamentals have been improving, with upgrades outpacing downgrades among EM sovereign issuers at a rate of 2:1 in 2024[2] – the highest ratio in ten years.

Looking at EM corporates, while balance sheets remain healthy, optimism has likely peaked. Sectors such as energy, industrials, automotives and chemicals have been deteriorating due to the economic slowdown in Europe and overcapacity in China, which is adding leverage and putting pressure on prices.

The new tariffs implemented by the US administration have only added to these challenges, raising the critical question: will EM firms absorb the extra costs of the tariffs, or will they pass them along to consumers through higher prices?

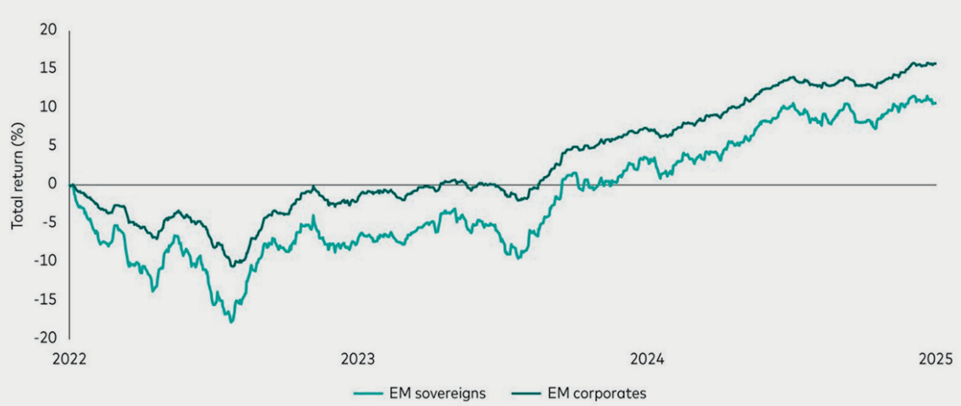
Recent data from the US suggest consumer confidence is waning – making it difficult for companies to pass along the costs of tariffs through higher prices, potentially putting pressure on EM firms' profit margins and leading to a deterioration in EM corporate balance sheets.

EM corporates look relatively expensive

Currently, EM corporate spreads are at historically tight levels – while EM sovereign debt spreads are priced closer to their long-term averages.

As EM corporate valuations have compressed at a faster rate than their sovereign counterparts, the spread

FIGURE 1: TOTAL RETURN FOR EM CORPORATE BONDS COMPARED WITH EM SOVEREIGN DEBT



Source: Bloomberg, for the period 1 January 2022 to 31 March 2025. Indices used: EM sovereigns: J.P. Morgan EMBI Global Diversified Index; EM corporates: J.P. Morgan CEMBI Global Diversified Index.

> ‘EM sovereigns offer a unique combination of higher spreads and longer duration relative to EM corporates.’

differential between the asset classes has increased over the last 15 years – leading to sovereign debt looking more attractively priced, on a relative – value basis, in the current market.

Sovereigns offer a better liquidity profile

While the liquidity profiles of EM sovereigns can vary widely, EM corporates do not usually benefit from the same level of liquidity as EM sovereigns.

EM sovereign issuers typically have well-developed bond yield curves with large issues at varying maturity points. A typical EM sovereign issuer has six bonds outstanding, with an average issuance size of approximately $ 1.2 billion. Meanwhile, the average EM corporate issuer has two bond issues outstanding, with an average issuance size of approximately $ 600 million.

In the event of a sell-off, EM corporates can face greater liquidity challenges than EM sovereigns. At current valuations, we do not believe that investors are being fully compensated for the additional liquidity risk of EM corporates.

Different default dynamics

Both EM sovereigns and EM corporate issuers might be subject to periods of distress leading to large drawdowns and, sometimes, defaults. Although we do not anticipate an increase in defaults, it is worth highlighting the differences in default dynamics and recovery rates between the two asset classes.

EM sovereign defaults tend to be slower and more predictable, often due to prolonged economic mismanagement, and EM sovereign issuers usually have access to multilateral aid and additional time to work out a solution with their creditors. Corporate defaults, however, can be sudden, triggered by company-specific risks like fraud or governance issues.

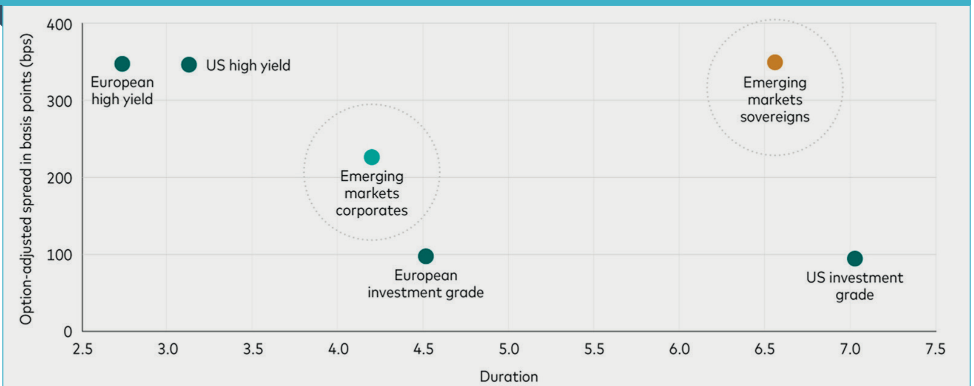
Since 2008, EM sovereigns that have entered default had higher recovery rates (56%) versus EM corporates (34%), primarily due to multilateral support and more standardised resolution processes, whereas corporate defaults involved more legal complexities.

An attractive long-term opportunity

Given the current macroeconomic environment of slower growth and tight EM corporate valuations, we believe a broad exposure to EM sovereigns offers investors a better chance of long-term investment success, providing better valuations, higher liquidity and improving fundamentals when compared with EM corporates. ■

1 Source: Vanguard and Bloomberg. Yield and duration calculations are per 31 March 2025.
2 Source: Vanguard and Bloomberg, as per 31 December 2024.

FIGURE 2: OPTION-ADJUSTED SPREADS AND DURATIONS FOR VARIOUS TYPES OF DEBT



Source: Bloomberg, per 19 March 2025. Indices used: US high yield: ICE BAML US High Yield Index; European high yield: ICE BAML European High Yield Index; European investment grade: Bloomberg Euro Aggregate Corporates Index in EUR; US investment grade: Bloomberg Global Aggregate Corporates US Dollar Index; EM hard currency sovereigns: J.P. Morgan EMBI Global Diversified Index; EM corporates: J.P. Morgan CEMBI Global Diversified Index.

Mauro Favini

Portfolio Manager, Vanguard Fixed Income Group

SUMMARY

An uncertain macro-economic backdrop characterised by slower growth due to tariffs and other uncertainties, along with very tight EM corporate debt valuations, have increased the appeal of EM sovereign debt over EM corporate bonds.

EM sovereigns offer a combination of higher spreads and longer durations than EM corporates, which offer improved downside mitigation in periods of market stress and risk-off sentiment.

EM sovereign bonds have better liquidity profiles and higher default recovery rates than EM corporates.

PHOTO: ARCHIVE VANGUARD