Muzinich & Co

Light my fire

In our latest roundup of key themes in emerging-market debt, we explore how credit investors can potentially benefit from growing global energy consumption and demand for copper.

Key takeaways

- **Oil consumption and investment:** Oil is likely to remain a key energy source, potentially making investments in oil-related credit issuers attractive.
- **Copper demand and supply:** A supply-demand imbalance could lead to higher copper prices, increasing the appeal of copper-related companies**.**
- **Opportunities in EM:** There are opportunities to gain exposure to oil and copper through emerging markets, particularly in Latin America and Asia.

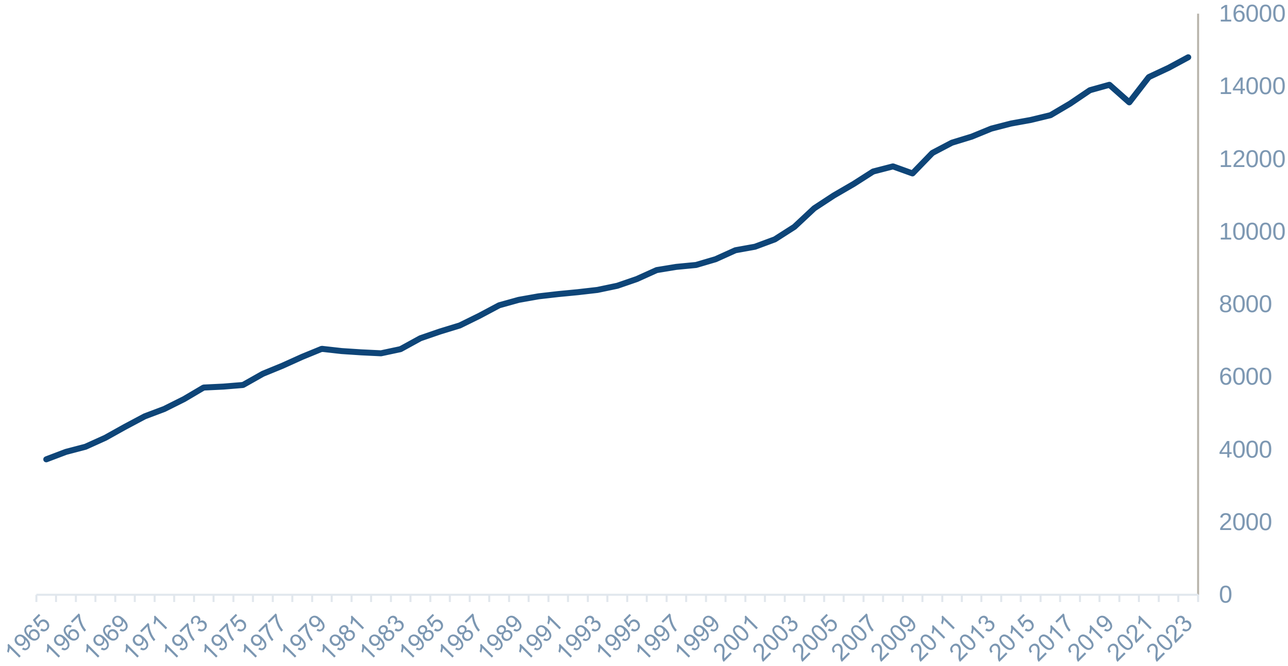
Warren Hyland
Portfolio Manager

The big story

Global energy consumption has been on a remarkable growth journey, a trend that looks set to continue on the back of rising populations and increasing average living standards.

With two energy carriers – oil and copper – key to the increase in current and future consumption and decarbonisation, how can investors access and benefit from this systemically-important global megatrend?

Figure 1: Global oil consumption (million barrels)



Source: BP Statistical Review - Global Total Energy Consumption, as of December 31, 2023. Latest available data used. For illustrative purposes only.

Oil: The key to mobility and modernity?

The world remains dependent on oil, consuming over 100 million barrels a day.[1] The average barrel is processed into multiple products (Figure 2). Without it, there would be no aviation industry, asphalt, plastic or key consumer goods like synthetic fibres used for medical applications such as intravenous bags and syringes.

Figure 2: What does a barrel of oil become?

Gasolene	43%
Diesel	27%
Jet fuel	6%
Bunkering fuel (shipping)	5%
Asphalt	4%
Other fuels	5%
Other (waxes, plastics, etc)	10%

Source: Visual Capitalist, as of September 14, 2021 - What's made from a barrel of oil? Latest available data used. For illustrative purposes only.

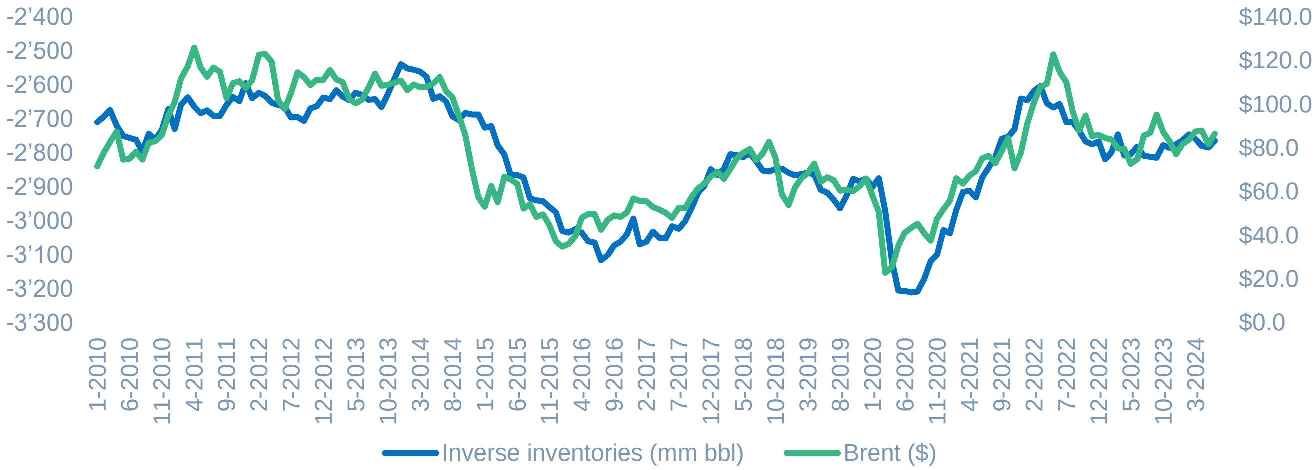
Due to the nature of oil wells, production rates fall over time - estimated to be around 8% a year.[2] While there are concerns over demand, with a news headline about peak oil consumption every few months, oil is unlikely to run out any time soon.[3]

Historically, inventory levels have been highly correlated with crude oil prices (Figure 3). Currently, there is a c.2.75-billion-barrel stockpile, equating to 2 months' consumption.[4]

Predictions of near-term demand vary. Goldman Sachs estimates modest draws of 100 thousand barrels of oil a day for the next 12 months,[5] HSBC an average draw of 600 thousand barrels per day over 2024 and 2025,[6] while some of the more aggressive forecasters like Standard Chartered call for even higher inventory draws of over a million barrels a day over the next 12 months.[7]

Usually, if inventories decline, prices increase. However, given OPEC+'s ongoing role of co-ordination and monitoring, it is difficult to find a scenario where inventories significantly increase and prices fall, which could make an allocation into oil-related credit issuers appealing.

Figure 3: Oil price (RHS) and inventories (LHS) highly correlated



Source: US Energy Information Administration Short-Term Energy Outlook, July 2024. For illustrative purposes only. Reference to $ is USD

1. Statista, as of 22 May 2024
2, 3. International Energy Agency, World Energy Outlook 2023, as of October 2023. Latest data available used.
4. US Energy Information Administration Short-Term Energy Outlook, July 2024.
5. Goldman Sachs, Global Supply and Demand Table, April 2024
6. HSBC Global Research, as of June 3, 2024. "Oil markets – OPEC+ roadmap leaves unanswered questions."
7. Standard Chartered, Commodity Roadmap, June 2024

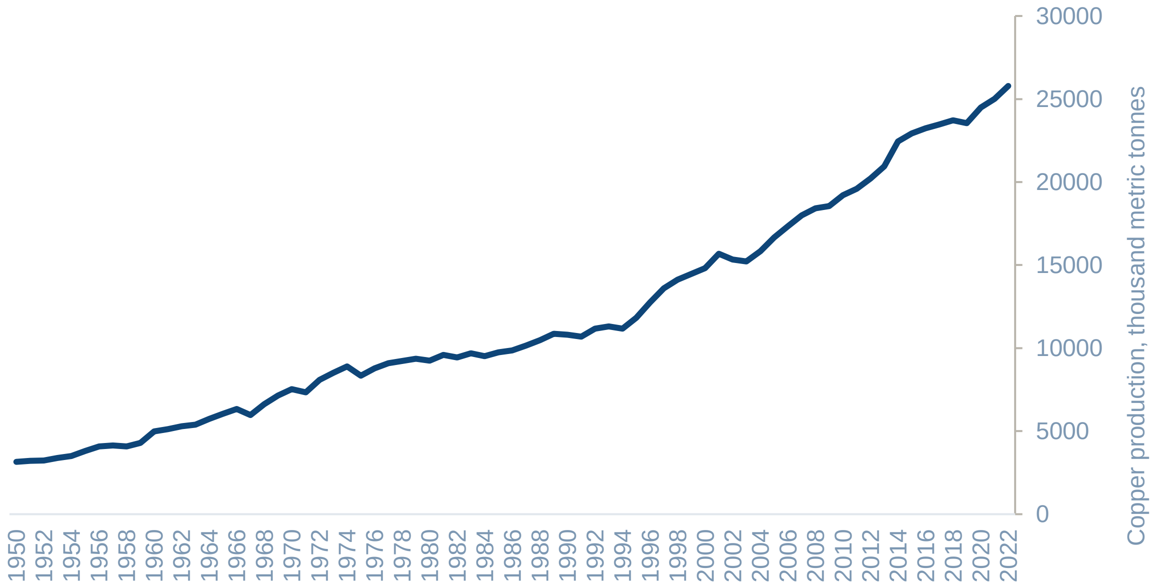
Copper: The key to net zero?

Today, 50% of the demand for copper comes from construction and infrastructure applications, with the rest from equipment manufacturing and other industrial uses.[8] In its 'Sustainable Development Scenario', the International Energy Agency (IEA) estimates world demand could hit 33.4 metric tonnes (mt) per year by 2040, nearly 40% higher than it was in 2020.[9]

This is predicted to be primarily driven by the installation of more renewable energy sources, grid investments, battery storage and electric vehicles (EVs). Passenger EVs can consume up to 3.5 times more copper than a traditional petroleum-powered one.[10] Solar panels and wind farms, meanwhile, need 7-10 times more copper per megawatt of electricity production capacity relative to fossil-fuel based systems.[11]

The demand picture stands in stark contrast with supply. It can take 4-12 years to develop a new copper deposit.[12] It is also becoming more difficult to extract copper; the copper grade – the ratio between copper extracted to the earth processed to extract the copper – has dropped from 2.3% in 1913 to less than 1% today.[13]

Figure 4: Growth in copper production



Source: La Commission Chilena del Cobre, as of December 31, 2022. Latest available data used. For illustrative purposes only.

Estimates of future demand vary, depending on the view forecasters take on the pace of grid investments. However, the uniting thread is the market will likely be in deficit for some time.[14] A telling forecast is the IEA's 25-50% gap between copper supply and demand in 2035.[15]

The market is already feeling the impact of the supply shortage. Global inventory levels were estimated to be at 2 weeks' worth of consumption at the beginning of 2024, with an annual deficit of 1-3%.[16] While a 1-3% deficit might not seem catastrophic, it would be enough to run inventory levels down to zero within 2 years.

In any commodity market, a combination of low inventories and deficits results in price increases. It is difficult to say why copper would be any different, making a good case for corporate issuers linked to the commodity.

Copper bottomed

For investors looking to gain exposure to oil or copper, an allocation to emerging markets may be a viable option. For example, it is possible to take indirect commodity exposure via an allocation into local currency or sovereign debt. Chile, the world's largest copper producer since 1990 with close to 50% of the exports from copper-related products, is a good example.[17] Both the currency and sovereign are directly linked to the value of copper.

8. International Energy Agency, as of 3rd May 2021. Total copper demand by sector and scenario, 2020-2024. Latest available data used.
9. International Energy Agency, World Energy Outlook 2023, as of October 2023. Latest data available used.
10. Bloomberg, BNEF Transition Metals Outlook 2023
11, 13. Material World - A substantial story of our past and future, Ed Conway, 2023
12. University of Arizona, Superfund Research Center, as of 2024. Copper mining and processing: Lifecyle of a mine.
14. JP Morgan, 25th June 2024, Metals Weekly: Copper – deferred not derailed.
15. International Energy Agency Critical Minerals Outlook 2024
16. Bank of America, as of April 2024
17. Nasdaq, 'Top 10 Copper Producers by Country, as of March 4, 2024

However, we believe it is more efficient to take direct exposure via the commodity producer. This allows an investor to tailor their exposure to underlying risk parameters such as duration, credit ratings, capital structure and sovereign risk (i.e. only invest in a company where the sovereign is deemed investible).

As shown in Figure 5, energy represents 19.6% of the emerging market corporate universe, with metals and mining comprising nearly 7%. Outstanding securities total US$240 billion, making it one of the most liquid sectors within the asset class.[18] The largest sub-sector is integrated energy – companies involved across the whole supply chain, from exploration to refining, distribution and marketing, through oil, gas and renewables.

Figure 5: Energy sector breakdown

Face Value	US$240bn				
Region		**Rating**		**Sub-sector**	
Countries	25	IG	11.26%	Energy - Exploration & Production	2.83%
Asia	5.5%	HY	8.32%	Gas Distribution	2.56%
Middle East and Africa	5.22%	AA	2.76%	Integrated Energy	11.79%
Latin America	7.46%	A	4.71%	Oil Field Equipment & Services	0.24%
Eastern Europe	1.42%	BBB	3.79%	Oil Refining & Marketing	2.17%
		BB	6.30%		
		B	1.18%		
		CCC	0.84%		
Maturities out to:	2070				

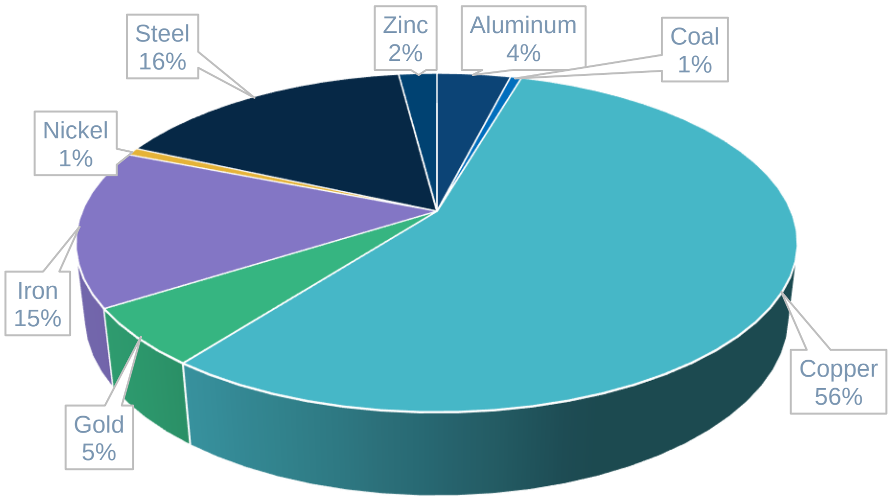
Source: ICE Index Platform, ICE BofA Emerging Market Corporate Liquid Index, as of 28th July 2024. For illustrative purpose only.

Integrated energy companies are strategically important to their country of origin and the majority are partially or fully government owned. We believe this sub-sector might be an attractive way to gain medium-level risk exposure to the oil sector with opportunities available globally and across the ratings spectrum.

For investors looking for maximum sector beta, exploration & production (E&P) could be an option, with opportunities in high-yield frontier and Latin American E&P specialists. Low-beta exposure can be accessed via the gas distribution sub-sector, where contracts are commonly fixed with ship-or-pay minimum volume commitments. This allows investors medium-term access to the sector, with less sensitivity to day-to-day volatility.

Within metals and mining, copper is the largest sub-sector,[19] representing 56% (Figure 6), and is highly skewed to investment grade (75%) as management tend to run conservative and bond-friendly balance sheets. Latin America is the largest region (66%), with opportunities in Chile, Mexico and Brazil. In Asia, Indonesia stands out as a potential source of exposure.

Figure 6: Emerging market metals & mining



Source: ICE Index Platform, ICE BofA Emerging Market Corporate Liquid Index, as of July 31, 2024. For illustrative purpose only.

18, 19. ICE Index Platform, ICE BofA Emerging Market Corporate Liquid Index, as of 30th July 2024.

The month in credit

July was positive for all credit markets and EM corporates were no exception, with the ICE BofA Emerging Market Corporate Liquid index gaining 1.4%, aided by the performance of Asian high yield and its property sector.[20] Greater determination by Chinese policymakers to support regional growth set a positive tone.

Another positive theme was the continued recovery of distressed credits in the Latin American telecoms sector, in-line with the reopening of the region's high-yield primary market.[21]

Within Latin America more broadly, central banks and governments maintained their focus on economic recovery and stability. In Argentina, the government continued to exhibit fiscal discipline, posting a sixth consecutive monthly surplus and launching an asset regularisation regime to attract c.US$100 billion to boost reserves.[22]

In Mexico, higher rates started to bite into economic growth with GDP growing only 0.2% quarter-on-quarter.[23] In a coordinated move, the US and Mexico joined forces to counteract moves by China to circumvent US tariffs on steel and aluminum.

In Brazil, headline inflation accelerated in July, although remained below the ceiling of the target band. The rise was partly due to base effects, but underlying measures also rose and remain consistent with inflation between the target centre and ceiling.[24] As a result, we believe the central bank will likely leave the benchmark interest rate at 10.5% for a second consecutive meeting.

In contrast, Chile saw a contraction in core inflation and cut interest rates to 5.5%, while also being reaffirmed with an 'A' rating and stable outlook by Fitch Ratings.

We also saw positive ratings news in Turkey as Moody's upgraded its sovereign rating from B3 to B1 – the first upgrade in over a decade, while maintaining a positive outlook.[25] As the country's credibility and effective monetary policies gain traction, macroeconomic stability and stronger institutions may in turn help the country's underlying credit strengths, such as its diversified and competitive economy and comparatively strong fiscal and debt metrics.

Ukrainian credit outperformed after a favourable sovereign debt exchange was announced with bondholders. This was a surprise as the sovereign made a significant improvement in its original proposal, raising recovery rates from 25 cents to 35-40 cents on the dollar, terms which have been blessed by the International Monetary Fund.[26]

Meanwhile, Thailand held investment discussions around the ambitious Southern Land Bridge project.[27] The project aims to link the Gulf of Thailand and Andaman Sea to shorten sea transportation times and capture transshipment volumes from ports in Malaysia and Singapore.

We also witnessed the possibility of a rise in unorthodox policies, with the prospect of Indonesia increasing its debt-to-GDP ratio to 50% from the current 39% raised by the country's president-elect. This contrasts with the outgoing administration's conservative stance and could increase the budget deficit beyond the current allowance.[28]

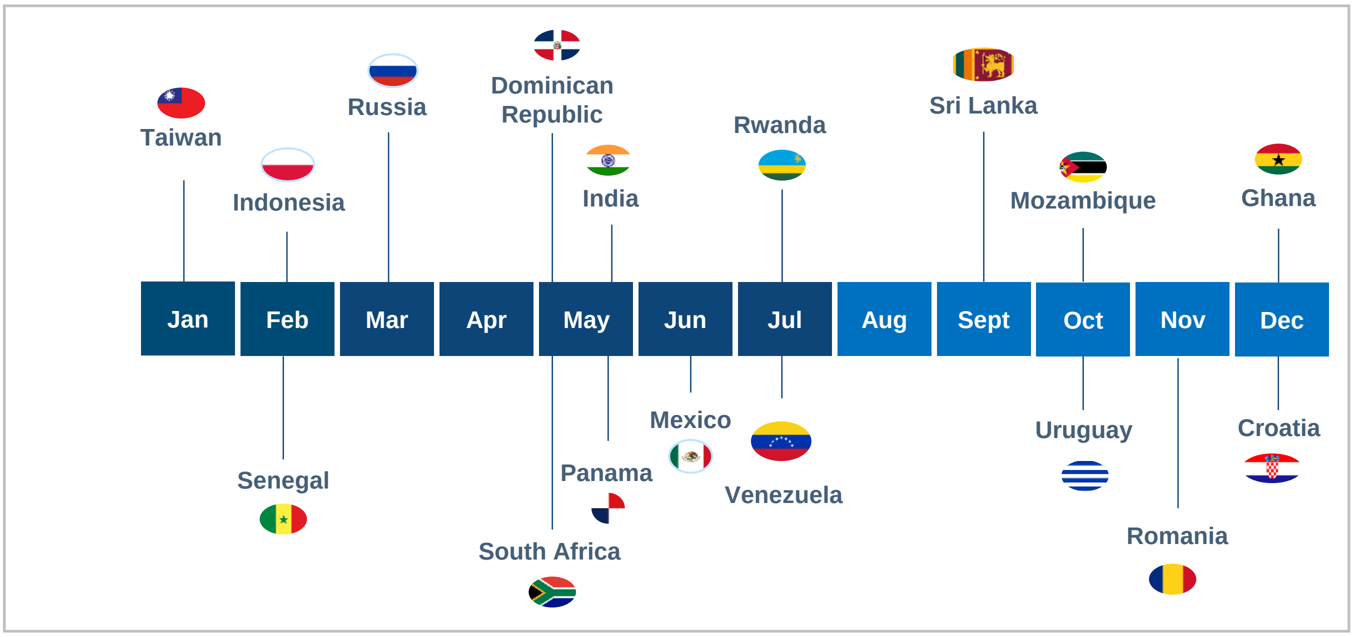
The primary market continued to gather steam, with July's issuance of US$13.5 billion, taking the year-to-date total to US$242 billion, ahead of forecasts. Quasi-sovereigns were the month's most prolific issuers, contributing 42% of supply, mostly from Asia. There was also significant issuance by utilities, with approximately 50% of year-to-date supply coming in July.[29]

Overall, fundamentals appeared to improve. JP Morgan lowered its full-year default forecast for the emerging market high-yield market from 4% to 3.6%, driven by an improving picture in Latin America and Europe.[30]

20. ICE BofA Index Platform, as of July 31, 2022 – This index tracks the performance of US dollar (USD) denominated emerging markets non-sovereign debt publicly issued in the major domestic and Eurobond markets.
21. Asharq Al-Aswat, as of July 30, 2024. "China's leaders vow to step up policy support for economy".
22. Reuters, July 16, 2024. "Argentina posts six months of fiscal, financial surpluses"
23. Bloomberg, as of July 30, 2024. "Mexico's Economic Growth Undershoots Forecasts as Woes Mount"
24. Trading Economics, as of July 10, 2024.
25. The National, as of July 20, 2024 – "Turkey receives first ratings upgrade from Moody's in a decade on improved governance'
26. Bloomberg, as of July 22, 2024 - "Ukraine, Key bondholders reach deal on US$20bn overhaul"
27. The Nation, as of June 1, 2024. "Land bridge project draws interest from over 100 companies: ministry"
28. Financial Times, as of July 10, 2024 "Indonesia's president elect plans sharp rise in debt"
29. JP Morgan, Global Credit Research, as of July 26, 2024 - EM corporate weekly monitor
30. JP Morgan, Global Credit Research, as of 8th July 2024 – EM corporate default monitor

EM election calendar

A bumper year for elections in emerging markets with more than half of the world's population due to go to the polls.



Source: Muzinich & Co as of August 2024. For illustrative purposes only.

Credit

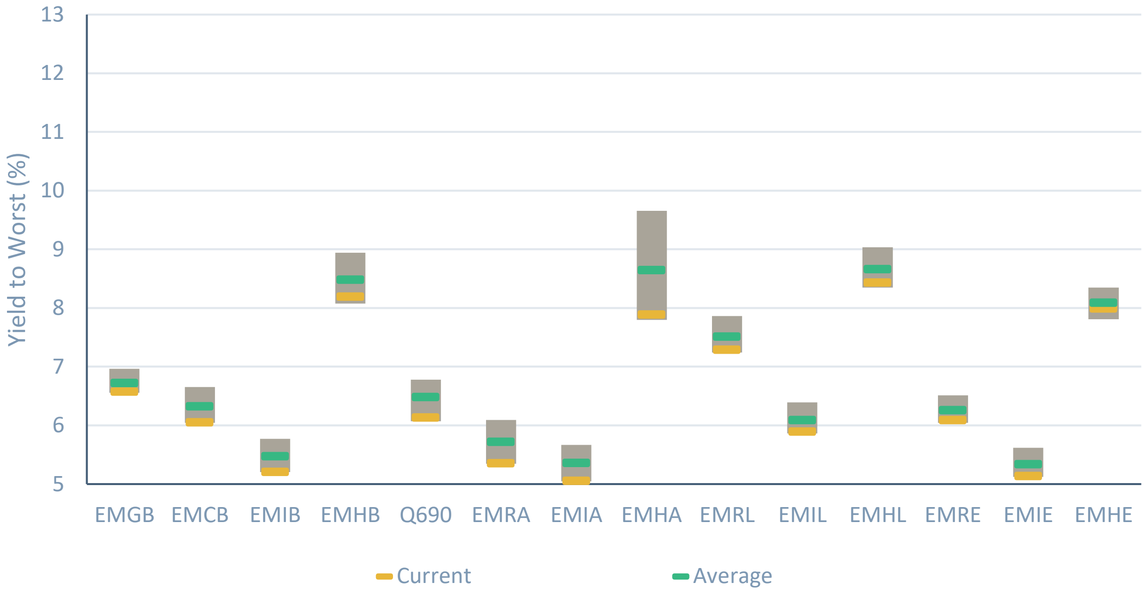
	YTW	STW	ΔYTW	ΔSTW	July Total Return
Emerging Market Sovereigns (EMGB)	6.57	271	-0.22	9	1.81%
EM Corporates (EMCB)	6.05	199	-0.30	7	1.66%
EM Investment Grade Corporate (EMIB)	5.20	114	-0.27	10	1.63%
EM High Yield Corporate (EMHB)	8.19	414	-0.32	5	1.74%
EM Corporates – Short Duration (Q690)	6.13	183	-0.30	13	1.16%
Asia Corporates (EMRA)	5.35	120	-0.37	1	1.71%
Asia Corporates Investment Grade (EMIA)	5.05	91	-0.33	6	1.70%
Asia Corporates High Yield (EMHA)	7.88	367	-0.71	-29	1.73%
LatAm Corporates (EMRL)	7.29	318	-0.24	12	1.82%
LatAm Corporates Investment Grade (EMIL)	5.89	174	-0.20	13	1.73%
LatAm Corporates High Yield (EMHL)	8.43	435	-0.27	11	1.88%
EMEA Corporates (EMRE)	6.08	221	-0.21	11	1.44%
EMEA Corporates Investment Grade (EMIE)	5.13	127	-0.19	13	1.40%
EMEA Corporates High Yield (EMHE)	7.98	408	-0.17	14	1.50%

	1y	2y	3y	4y	5y
Emerging Market Sovereigns (EMGB)	8.63%	6.86%	-2.33%	-0.83%	-0.17%
EM Corporates (EMCB)	8.88%	6.05%	-1.57%	-0.11%	1.07%
EM Investment Grade Corporate (EMIB)	7.04%	4.25%	-1.69%	-0.65%	0.79%
EM High Yield Corporate (EMHB)	13.88%	11.03%	-1.02%	1.20%	1.69%
EM Corporates – Short Duration (Q690)	8.48%	6.69%	-1.20%	0.28%	0.54%
Asia Corporates (EMRA)	8.20%	5.11%	-1.37%	-0.74%	0.84%
Asia Corporates Investment Grade (EMIA)	7.44%	4.31%	-0.15%	0.27%	1.79%
Asia Corporates High Yield (EMHA)	14.76%	11.56%	-7.74%	-6.05%	-3.91%
LatAm Corporates (EMRL)	10.27%	7.77%	0.73%	2.80%	2.81%
LatAm Corporates Investment Grade (EMIL)	6.03%	5.06%	-1.58%	0.07%	0.95%
LatAm Corporates High Yield (EMHL)	13.87%	10.04%	2.64%	5.05%	3.88%
EMEA Corporates (EMRE)	8.79%	6.40%	-4.45%	-1.74%	-0.17%
EMEA Corporates Investment Grade (EMIE)	6.42%	3.36%	-6.60%	-4.12%	-2.04%
EMEA Corporates High Yield (EMHE)	13.44%	12.24%	-0.45%	2.41%	3.06%

Past performance is not a reliable indicator of current or future results.

Source: ICE data platform. as of 31st July 2024. EMGB - ICE BofA Emerging Markets External Sovereign Index EMCB - ICE BofA Emerging Markets Corporate Plus Index, EMIB - ICE BofA High Grade Emerging Markets Corporate Plus Index, EMHB - ICE BofA High Yield Emerging Markets Corporate Plus Index, Q690 - ICE BofA Custom Emerging Markets Short Duration Index, EMRA - ICE BofA Asia Emerging Markets Corporate Plus Index, EMIA - ICE BofA High Grade Asia Emerging Markets Corporate Plus Index, EMHA - ICE BofA High Yield Asia Emerging Markets Corporate Plus Index , EMRL - ICE BofA Latin America Emerging Markets Corporate Plus Index, EMIL - The ICE BofA High Grade Latin America Emerging Markets Corporate Index, EMHL - ICE BofA High Yield Latin America Emerging Markets Corporate Plus, EMRE - ICE BofA EMEA Emerging Markets Corporate Plus Index, EMIE - ICE BofA High Grade EMEA Emerging Markets Corporate Plus Index, EMHE - ICE BofA High Yield EMEA Emerging Markets Corporate Plus Index,. Index performance is for illustrative purposes only. You cannot invest directly in the index. Indices selected provide best proxy for highlighting performance of emerging market corporate bonds. For illustrative purposes only.

Yield to Worst



Source: ICE data platform. as of 31st July 2024. EMGB - ICE BofA Emerging Markets External Sovereign Index EMCB - ICE BofA Emerging Markets Corporate Plus Index, EMIB - ICE BofA High Grade Emerging Markets Corporate Plus Index, EMHB - ICE BofA High Yield Emerging Markets Corporate Plus Index, Q690 - ICE BofA Custom Emerging Markets Short Duration Index, EMRA - ICE BofA Asia Emerging Markets Corporate Plus Index, EMIA - ICE BofA High Grade Asia Emerging Markets Corporate Plus Index, EMHA - ICE BofA High Yield Asia Emerging Markets Corporate Plus Index , EMRL - ICE BofA Latin America Emerging Markets Corporate Plus Index, EMIL - The ICE BofA High Grade Latin America Emerging Markets Corporate Index, EMHL - ICE BofA High Yield Latin America Emerging Markets Corporate Plus, EMRE - ICE BofA EMEA Emerging Markets Corporate Plus Index, EMIE - ICE BofA High Grade EMEA Emerging Markets Corporate Plus Index, EMHE - ICE BofA High Yield EMEA Emerging Markets Corporate Plus Index,. Index performance is for illustrative purposes only. You cannot invest directly in the index. Indices selected provide best proxy for highlighting performance of emerging market corporate bonds. For illustrative purposes only.

Index descriptions

EMGB - ICE BofA Emerging Markets External Sovereign Index tracks the performance of US dollar and euro denominated emerging markets sovereign debt publicly issued in the major domestic and eurobond markets. Qualifying securities must have risk exposure to countries other than members of the FX-G10, all Western European countries and territories of the US and Western European countries.

EMCB - ICE BofA Emerging Markets Corporate Plus Index tracks the performance of the US dollar and euro denominated emerging markets non-sovereign debt publicly issued in the major domestic and eurobond markets. Qualifying issuers must have risk exposure to countries other than members of the FX G10, all Western European countries, and territories of the US and Western European countries.

EMIB - ICE BofA High Grade Emerging Markets Corporate Plus Index is a subset of the ICE BofA ML Emerging Markets Corporate Plus Index (EMCB) including all securities rated AAA through BBB3, inclusive.

EMHB - ICE BofA High Yield Emerging Markets Corporate Plus Index is a subset of the ICE BofA ML Emerging Markets Corporate Plus Index (EMCB) including all securities rated BB1 or lower.

Q690 - ICE BofA Custom Emerging Markets Short Duration Index tracks the performance of short-term US dollar and euro denominated emerging markets non-sovereign debt publicly issued in the major domestic and eurobond markets.

EMRA - ICE BofA Asia Emerging Markets Corporate Plus Index is the subset of the ICE BofAML Emerging Markets Corporate Plus Index, which includes only securities issued by countries associated with the region of Asia, excluding Kazakhstan, Kyrgyzstan, Tajikistan, Turkmenistan, and Uzbekistan.

EMHA – The ICE BofA High Yield Asia Emerging Markets Corporate Plus Index is a subset of ICE BofA Emerging Markets Corporate Plus Index including all securities rated BB1 and lower with a country of risk within the Asia region.

EMIA - The ICE BofA High Grade Asia Emerging Markets Corporate Plus Index is a subset of ICE BofA Emerging Markets Corporate Plus Index including all securities rated BBB3 and higher with a country of risk within the Asia region.

EMRL - ICE BofA Latin America Emerging Markets Corporate Plus Index is a subset of The ICE BofA Emerging Markets Corporate Plus Index including all securities issued by countries associated with the geographical region of Latin America.

EMIL - The ICE BofA High Grade Latin America Emerging Markets Corporate Index is a subset of ICE BofA Emerging Markets Corporate Plus Index including all securities rated BBB3 and higher with a country of risk within the Latin America region.

EMHL - ICE BofA High Yield Latin America Emerging Markets Corporate Plus is a subset of ICE BofA Emerging Markets Corporate Plus Index including all securities rated sub-investment grade based on the average of Moody's, S&P and Fitch, and with a country of risk associated with the geographical region of Latin America.

EMRE - ICE BofA EMEA Emerging Markets Corporate Plus Index is a subset of The ICE BofA Emerging Markets Corporate Plus Index including all securities issued by countries associated with the geographical region of Europe, the Middle East and Africa including Kazakhstan, Kyrgyzstan, Tajikistan, Turkmenistan and Uzbekistan.

EMIE - ICE BofA High Grade EMEA Emerging Markets Corporate Plus Index is a subset of ICE BofA Emerging Markets Corporate Plus Index including all securities rated BBB3 and higher with a country of risk within the Europe, Middle East and Africa regions**.**

EMHE - ICE BofA High Yield EMEA Emerging Markets Corporate Plus Index is a subset of ICE BofA Emerging Markets Corporate Plus Index including all securities rated BBB3 and higher with a country of risk within the Europe, Middle East and Africa regions.

The MSCI EM Index is a free-float weighted equity index that captures large and mid cap representation across emerging market countries. The index covers approximately 85% of the free float-adjusted market capitalisation in each country.

LDMP - ICE BofA Local Debt Markets Plus Index is designed to track the performance of emerging markets sovereign debt publicly issued and denominated in the issuer's own currency.

J0A0 - The ICE BofA ML US Cash Pay High Yield Index tracks the performance of US dollar denominated below investment grade corporate debt, currently in a coupon paying period that is publicly issued in the US domestic market.

C0A0 - The ICE BofA ML US Corporate Index tracks the performance of US dollar denominated investment grade corporate debt publicly issued in the US domestic market.

HE00 - The ICE BofA ML Euro High Yield Index tracks the performance of EUR dominated below investment grade corporate debt publicly issued in the euro domestic or eurobond markets.

ER00 – The ICE BofA ML Euro Corporate Index tracks the performance of EUR denominated investment grade corporate debt publicly issued in the eurobond or Euro member domestic markets.

CLCURFGB Index – Global Copper Refined Total Production - Yearly. This sector contains the copper production data for Chile, release by COCHILCO.

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