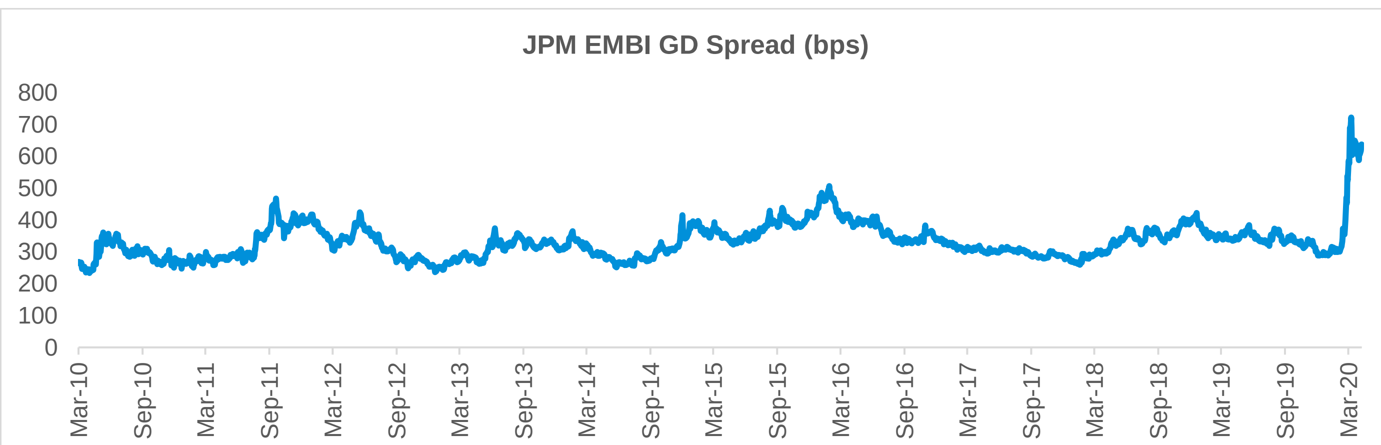
Emerging Markets Debt Update

April 24, 2020

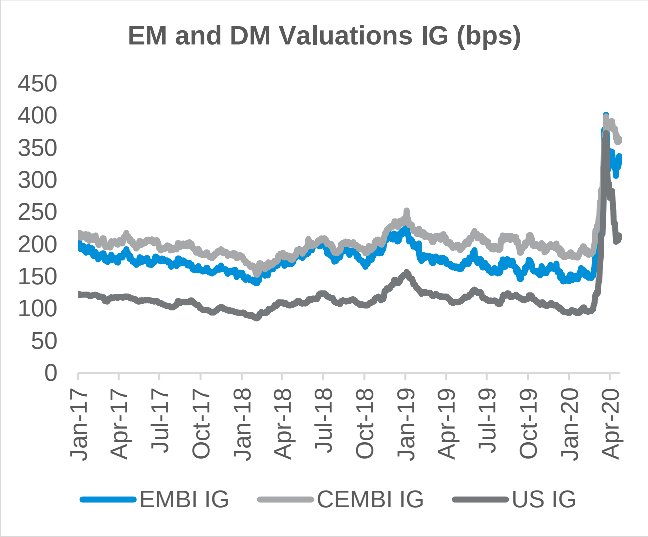
The past few months have been a trying time for the global economy and the markets, as they have been hit with multiple shocks, on the growth and commodities fronts. The severity of the Covid-19 demand shock has been compounded by the OPEC-related supply shock for many countries across developed and emerging markets. Policy makers have reacted with dramatic monetary and fiscal measures attempting to build a bridge between the global economy that existed pre-pandemic and the economy that will exist afterwards. Trying to minimize the damage to the broad economy seems to be the key attribute of the policy responses thus far. However, from our perspective the length of the needed bridge and the economy that exists when this is behind us is not entirely clear. With this amount of uncertainty, we are relying on our investment process to assess vulnerabilities and potential resilience across the sovereign and corporate credit landscape. Our global research teams have been analyzing economic growth expectations and conducting liquidity analysis on an ever-changing landscape of emerging market credit during this unprecedented time. That analysis seeks to identify the vulnerabilities as well as the potential levers sovereigns have to weather the storm, through monetary or fiscal channels, reserve buffers, and access to multilaterals, among other avenues.

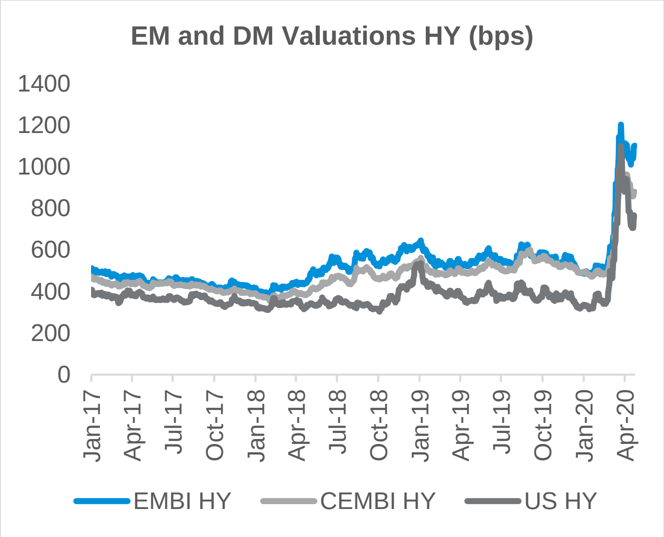
Market reaction has been severe: EM markets have continued to be stressed in terms of liquidity, across the credit spectrum. Hard currency sovereigns EMBI spreads were wider by 337 basis points over Q1 ending at 627 bps (254 basis points wider for the month of March), underscoring the extreme volatility. At the time of writing, spreads are at 637 bps.



Sources: Bloomberg, As of 4/23//2020

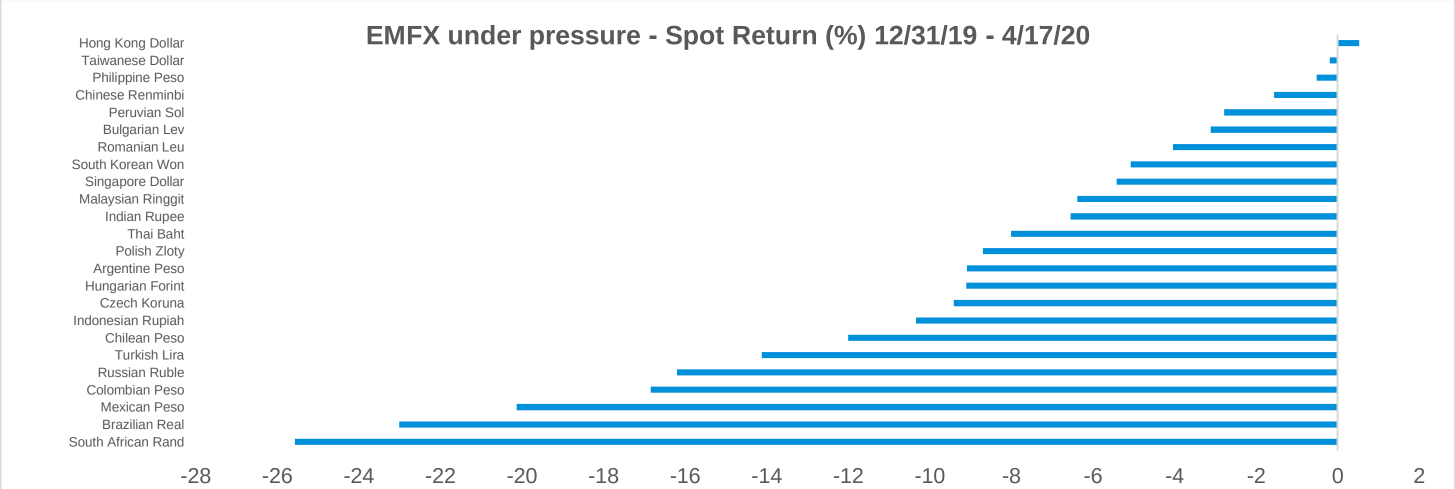
The spread moves have revealed a notable bifurcation between EM investment-grade, and high yield, with HY spreads more than three times wider. This past quarter, EM high yield sovereigns widened over 590 basis points while EM high grade sovereigns by 188 basis points, ending Q1 at 1078 bps and 328 bps, respectively. The widening has been especially notable in high yield credit given greater uncertainty around funding sources and concerns around restructuring. Below reveals the magnitude of the recent spread moves in EM IG vs. US IG and EM HY vs. US HY credit, which reveals a more pronounced tightening for US vs. EM credit.





Sources: Bloomberg, As of 4/23/2020

Spreads of oil exporters and sovereigns reliant on tourism have been pressured in this environment. By market capitalization, oil exporters account for ~36% of the EMBI GD, with inclusion of GCC credits (vs. 23% in 2015), making the Index more sensitive to oil prices.[1] Local currency (GBI-EM) had a poor first quarter, with many emerging market currencies significantly weaker vs. the dollar. EMFX has been under pressure, as the demand for dollars, together with the plunge in oil prices, sent currencies into a tailspin, especially those of commodities' producers. Some of the worst performing currencies YTD are Brazilian real and South African rand (see chart below). Local currency yields for a number of countries rose sharply, with South Africa local yields ballooning to 12.6% during the period.

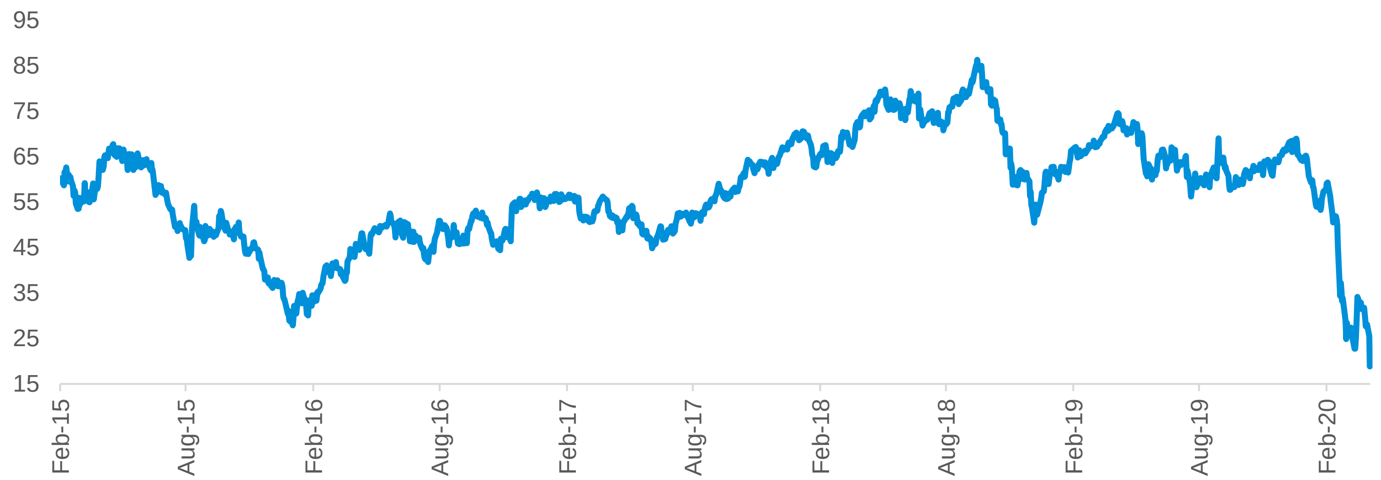


Sources: Bloomberg, As of 4/17/2020

[1] Source: JPM, Crude Reality: Quantifying the impact of the oil price shock on J.P. Morgan Emerging Market Bond Indices. As of March 2020.

One area that we are keenly focused on is oil prices, with Brent crude falling below $20s/bbl (chart below) having been in the high $60s earlier in the year, with the price drop intensified by the Russia-Saudi spat. The historic OPEC+ deal to cut production by 9.7 million barrels a day provided some fleeting respite for the market, before oil prices continued to fall. However, the question still remains whether the cuts will be enough to keep prices from sliding further against a backdrop of lackluster demand for energy.

Oil prices dropped significantly during the period (Brent Crude price/bbl)



Sources: Bloomberg, As of 4/21/2020

What does this mean for EM? Given the challenged backdrop, we can try and identify the likely winners and losers in a prolonged environment of low oil prices. Simply said, net oil exporting credits seem more likely to suffer while net oil importers seem more likely to benefit. This dynamic is complicated by the fact that CV-19 is threatening global demand overall, impacting both oil exporters and everyone else.

Oil exporters: GCC countries are oil rich, but also oil dependent. Saudi Arabia, UAE, Kuwait, Qatar are all Investment Grade rated and have significant buffers to help withstand lower prices. However, they also have high fiscal oil break-evens, which could erode their buffers over time and motivate them to keep an active presence in the new issue market. Oman and Bahrain are substantially more vulnerable to sustained low oil prices.

Russia is a sizeable energy player but also has significant buffers on the credit side. It has become less of a target for U.S. sanctions over the past year. Kazakhstan and Azerbaijan will also face headwinds but do have some buffers of their own.

In Africa, oil-dependent countries include Angola, Gabon and Nigeria, all of which become more vulnerable in this environment, and have seen ratings downgrades.

Within LatAm, Mexico and Colombia have traditionally been known as oil plays, but the relevance of oil in the economy has declined over time. Mexico is in fact a net oil importer and the government hedges the oil price of the barrels it exports. Brazil's oil production has been rising but is not an abundant factor in the overall economy. We feel Ecuador faces the biggest risk in the region with tight liquidity concerns existing even before prices plummeted, as the government noted it would use a grace period to delay interest payments, instead using the funds to fight the epidemic.

Downgrades have started to come in and more are likely to follow. On March 26th, Mexico was downgraded one notch to BBB by S&P given the prospects of lower growth. Moody´s followed and downgraded Mexico to Baa1 and kept the negative outlook. Fitch downgraded Colombia to BBB-, keeping the negative outlook. The decision to downgrade was based on expected weaker credit metrics driven by the double shock of oil prices and CV-19.

Non-energy players: The arrival of lower oil prices is tantamount to a well-timed fiscal stimulus given the impact CV-19 is likely to have on the global economy. China, as the world's largest oil importer, should be one of the biggest single beneficiaries. Other oil importers likely to benefit include Central and Eastern European countries, Central American and Caribbean countries, Turkey, India, South Africa, Ukraine and South Korea among others. However some of these countries' valuations have been punished, such as Carribean and Asian countries heavily reliant on tourism revenues. For example, international tourism receipts comprise 13.7% of GDP for Thailand, and 9% for Dominican Republic.[2] Many EM countries have large remittance flows that will also suffer during this downturn.

Navigating the current environment: Our analysts are continuously evaluating countries under coverage, assessing their ability to respond to the current market environment. Deficit spending may exceed certain thresholds, and it is not improbable that some countries may have to restructure, despite the high likelihood of support from the IMF and other multinational institutions. And hence, this assessment of vulnerability across economic, fiscal and external dimensions is critical.

Having said that, there are countries that have implemented reforms pre-crisis, and that entered this challenging period with some defense mechanisms. A number of countries have departed from the typical EM playbook of raising rates to defend FX, with Chile, Peru, Mexico, Brazil, Turkey, South Africa, among others cutting rates to address the shock to their economies. Away from monetary measures, a range of fiscal responses were announced, from short-term tax deferments to emergency spending to help the population affected by the virus. While there has been a dearth of issuance last month, a few sovereign and corporate issuers have managed to come to market and we expect that trend to continue as a response to funding needs and to provide a cushion to their balance sheets.

Given the growth of external vulnerabilities and liquidity pressures, there has been a lot of discussion lately around IMF's role as the lender of the last resort for emerging market countries. Last month, the IMF announced that "it stands ready to support vulnerable countries with different lending facilities, including through rapid-disbursing emergency financing, which could amount up to $50 billion for low-income and emerging markets." Most recently, it doubled the access to its emergency facilities to meet the expected demand of about $100 billion in financing. IMF's current total resources "translate into a capacity for lending or "firepower" of about SDR 715 billion (around US$ 1 trillion)."[3] Already the IMF has started disbursing funds, with Ghana one of the recent recipients of a $1 billion loan. IMF also announced that its executive board had approved a new short-term liquidity line to assist member countries that have strong fundamentals, providing a backstop to these countries. However, increased IMF assistance raises the question of potential burden-sharing implications among a country's private sector creditors.

Looking forward, each of the countries' reaction function to the shocks may be influenced by multiple factors, from credit-specific to exogenous and will hinge on the speed at which the health of the global economy regenerates once we are fully across the bridge of uncertainty. As we think about opportunities in the market, we are careful about the type of risk we are adding, focusing on higher quality credit. The situation remains fluid, amid heightened volatility, which we expect to persist in the near-term, and as such continue to monitor developments closely.

Sources: MIM, Bloomberg, Barclays, JPM

[2] BofA Global Research.

[3] IMF; https://www.imf.org/en/About/FAQ/50-billion-rapid-disbursing-emergency-financing-facilities

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