Emerging Markets Debt Update

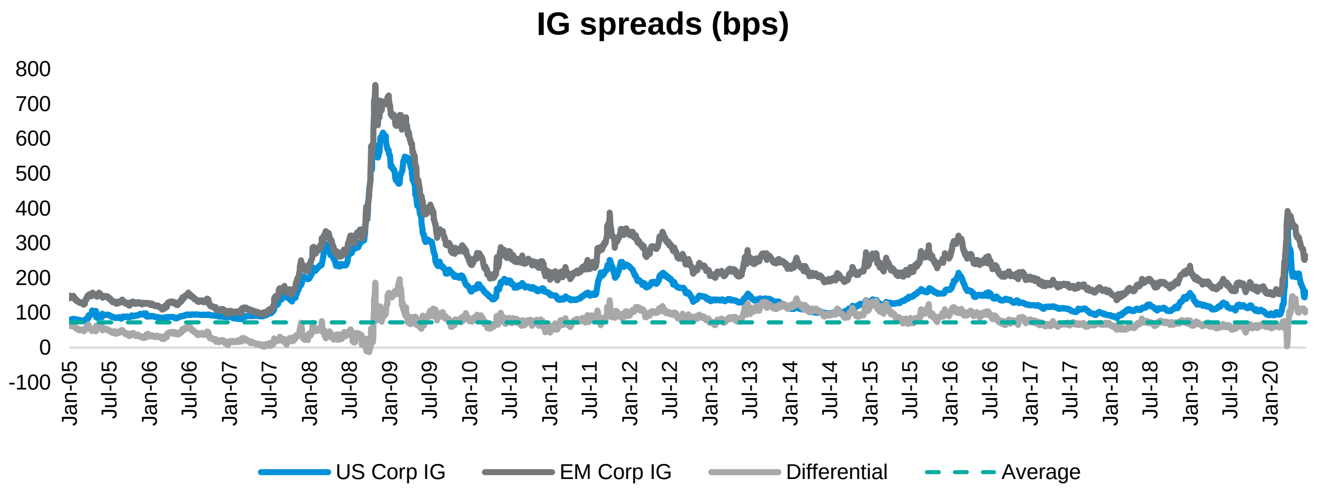
Navigating the Current Environment: Assessing Sovereign Resiliency in the Pandemic

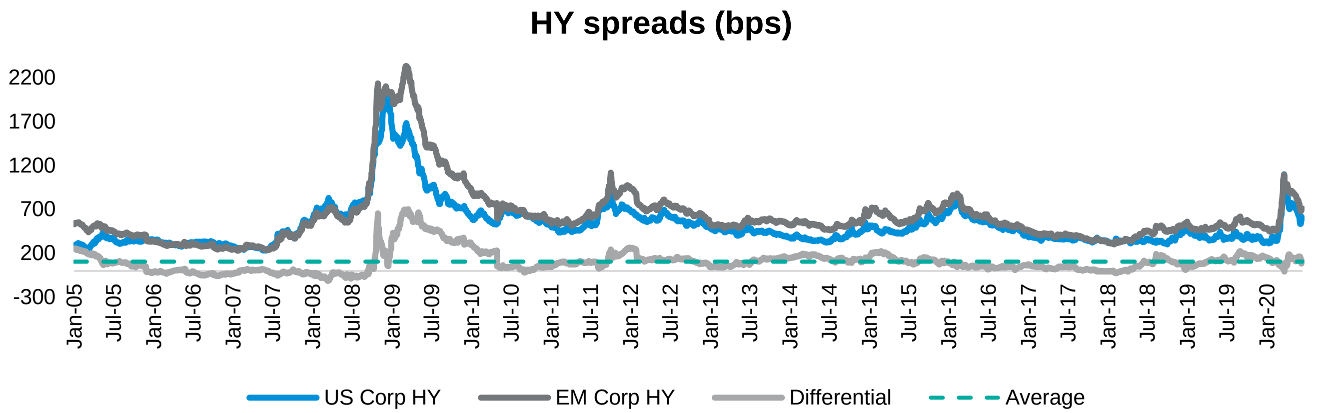
June 16, 2020

The COVID-19 (CV-19) pandemic has been an unexpected macro shock with widespread ramifications across the developed world and emerging markets. Virtually every country in the world has faced lockdowns, demand shocks, revenue declines and spending pressures. We believe this will inevitably lead to a collective deterioration of sovereign credit profiles around the globe. DM countries are generally better positioned to face the crisis, while some EM countries face bigger challenges. In this piece, we discuss two key topics:

- Our account of emerging markets fixed income performance amidst severe CV-19 market volatility
- Our resiliency assessment of EM sovereigns through the downturn, provided by MIM's sovereign research team

The last few months have been unprecedented, with emerging market debt hit hard with other global fixed income in March. Hard currency sovereign spreads (EMBI Global Diversified) and EM corporate spreads (CEMBI Broad Diversified) were 722 and 652 basis points, respectively, at the peak in March. With the announcement of stimulus packages across developed and emerging markets, liquidity fears began to gradually abate on a path to market normalization. EM stabilized and rallied with the broader market in April, but lagged DM. The market started to actively differentiate risk as more resilient credits outperformed those with less certain outlooks across the credit spectrum. Early on, the new issue market appeared only open for higher quality IG sovereigns at wide concessions (e.g. Israel, Qatar). Other IG sovereigns and a few corporates, along with select HY issuers (e.g. Paraguay, Guatemala) joined later as well. In May, EM continued to play catch up, with a strong recovery tone extending across the credit spectrum. Despite the extended rally, EM spreads seem to remain on the wider end of the historical average relative to DM.





Source: Bloomberg, JPM, MIM. US Corp: Bloomberg Barclays US Agg Corporate Avg OAS; CEMBI IG: J.P. Morgan CEMBI Broad Div High Grade Spread to Worst. US HY: Bloomberg Barclays US Corporate High Yield Average OAS; CEMBI HY: J.P. Morgan CEMBI Broad Div High Yield Spread to Worst. As of June 2020.

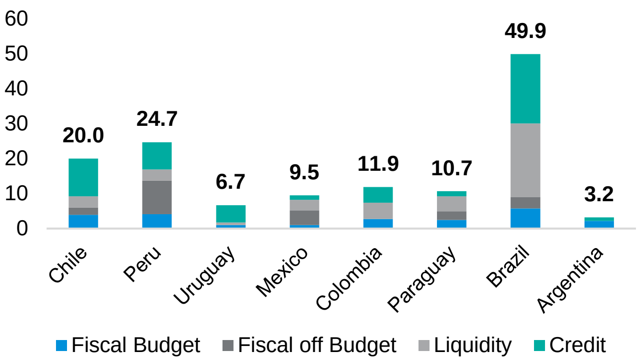
As of this writing, hard currency sovereign spreads (EMBI Global Diversified) and corporate spreads (CEMBI Broad Diversified) have compressed to 488 and 428 basis points, respectively, since the peak, driven by improved sentiment, a lift in oil prices and central bank policy actions. Local currency has also shown signs of improvement, with Indonesian rupiah and the Russian ruble rebounding strongly, among other EMFX. As we approach the second half of the year, we expect the market to continue normalizing with the global economy moving past the worst of CV-19, albeit not without bouts of volatility spurred by geopolitical flare-ups. In the current environment, EM has continued to screen cheap vs. DM credit, and we expect this to remain the case for the near-term. Credits we believe to be resilient should be better positioned. However, we will continue to leverage our resources to look for opportunities in the more dynamic names that could make the needed changes to dramatically outperform.

Sovereign Resiliency Assessment

We came into 2020 constructive on EM fundamentals. While we were cautious about late cycle dynamics, we thought the tailwinds from the U.S.-China trade accord would enable a recovery and overall good year for EM assets. However, with the arrival of CV-19, we effectively had to rip up the original 2020 playbook and re-assess the outlook for nearly every EM sovereign credit. Our team of sovereign analysts began its work in the early days of April as CV-19 cases were still rising exponentially. **The aim of this study was singular: to determine which countries would be resilient through this downturn.** As things unfolded our concerns were focused mostly on commodity exporters, as importers (such as energy consumers like Turkey and India) were of less concern. Soon thereafter it became clear that EM countries would suffer exposure to global demand more broadly, including manufacturing exporters (e.g. Romania and Mexico) and countries with large worker remittances (e.g. Pakistan and El Salvador) and tourism (e.g. Dominican Republic and Sri Lanka).

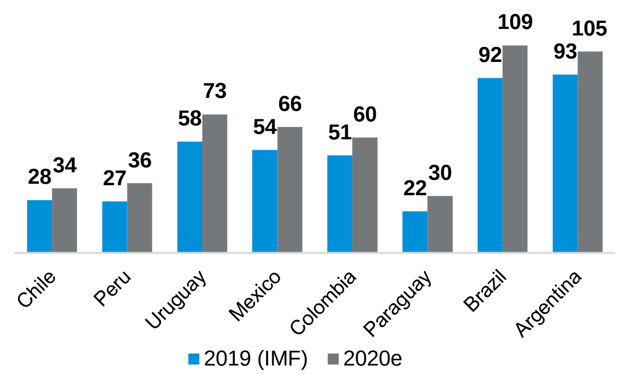
As seen in DM countries, EM policy responses since March have been far and wide. Across EM, large packages have been announced including Treasury measures with direct and indirect fiscal impact, credit lines and guarantees (from Treasury and Public Banks), and Central Bank liquidity to financial institutions. Fiscal costs are expected to be large as budgets have been revised to reflect weaker revenues and higher spending on fiscal support packages. We believe gross debt levels may rise on fiscal deficits, FX depreciation, and lower growth, elevating leverage ratios by 5 to 15 points of GDP in the near-term. Broadly speaking, this implies credit deterioration with ratings implications. Refer to examples from Latin America below:

Policy Response (% 2019 GDP)



As of June 2020
Sources: MoF, CB, MIM

Gross Government Debt (% GDP)



Source: IMF, MIM (based on IMF debt definition)

Our global sovereign research team analyzed over 60 emerging market countries where we actively invest and assigned each country to one of three buckets (**Resilient**, **Unfolding** and **Troubled**) as shown below. We define a sovereign's *resilience* as:

1) High likelihood of maintaining its current "bucket" rating (e.g. A vs BBB or BB vs B) throughout the cycle, even while allowing for some likely downward revisions within the same bucket (e.g. from BBB+ to BBB-).
2) Few concerns about resolving its 2020 financing gap by accessing domestic and/or foreign markets, using its own fiscal savings (SWF, etc.), obtaining external assistance (IMF, other international financial institution (IFI), bilateral support) or leaning more on its own Central Bank (QE, profit transfers, etc.).

In general, "resilient" credits are those that we believe have sufficient buffers to withstand the current crisis, which may include ample reserves and low external vulnerability, space to enact spending packages to re-invigorate their economies, and maintain access to the capital markets. On the other side of the spectrum, are so-called "troubled" credits. These are the countries that we believe will have a tougher time, either because they face very likely "bucket change" downgrades or because their ability to fund themselves through 2020 remains uncertain. The remainder of the credits we refer to as "unfolding." These countries are better positioned to withstand the headwinds, but not without challenges. Any missteps could put a further dent in their credit profiles, and resolution of funding gaps should be monitored closely. Below is a high-level summary of our views as of May month-end:

	RATINGS BUCKET DOWNGRADE PROBABILITY	FINANCING GAP 2020	% EMBI GD	# of Countries	COUNTRY EXAMPLES
I. Resilient	VERY LOW	NO CONCERNS	48.3%	25	Poland, Chile, Indonesia, Paraguay, Cote D'Ivoire
II. Unfolding	VARIES, HIGHER PROBABILITY OF DOWNGRADE	VARIES, LIKELY TO HAVE FUNDING GAP	38.5%	29	Saudi Arabia, Colombia, Mexico, Ukraine, Egypt
III. Troubled	HIGH FOR LOWER QUALITY NAMES, ELEVATED RISK OF DISTRESS	LIKELY TO HAVE LARGE UNRESOLVED FUNDING GAP	10.7%	10	South Africa, Angola, Sri Lanka, Ecuador

Source: MIM, JPM, 64 total countries represented in the analysis. % of EMBI GD based on notional market value.

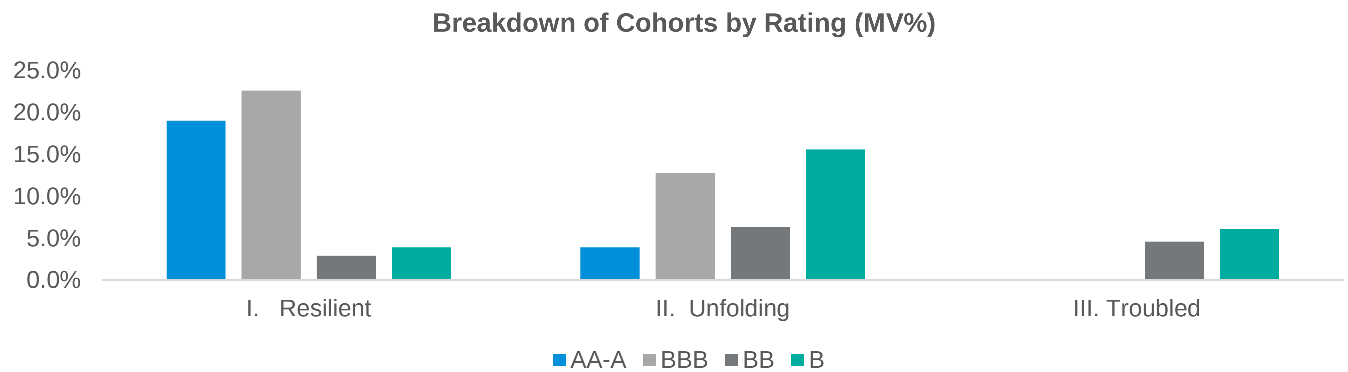
Our analysis focused heavily on announcements of external support and considered these disbursements in our assessment of funding needs. While most support will likely be delivered by the IMF to more vulnerable countries in the form of traditional programs like Stand-By Arrangements (SBAs) and Extended Fund Facility (EFFs), the new Rapid Financing Instrument (RFI) has proven to be an effective way to deploy funds quickly to countries in need. Other multilaterals and bilaterals have stepped up as well by offering cashflow relief on debt service owed to them for the next 1-2 years. Even higher quality countries have benefited from assistance from the IMF (Flexible Credit Lines or FCLs), the Federal Reserve and the ECB (via liquidity swap lines).

We are treating this as an ongoing process throughout the downcycle and may make revisions as required. For example, in our view, some of the unfolding credits will gradually become resilient over time, either because their funding scenario becomes clearer or because their credit profile stabilizes without further risk of "bucket" downgrade. Similarly, despite their severe challenges, troubled credits could manage to improve over time.

Investment Strategy Implications

We believe credit differentiation will be a critical factor in portfolio performance over the coming quarters. Therefore, we prefer to overweight the resilient names and underweight the troubled ones. We will also take positions in those "unfolding" country stories that we believe will play out positively (i.e. those that can potentially avoid downgrades and resolve financing gaps quickly and with less tension).

Drilling into our analysis further by rating category (chart below), not surprisingly, we detected a high correlation between resilience and credit rating. In other words, the more resilient credits tend to reside in the investment grade space, while the so-called troubled credits are concentrated in the lower rungs of the ratings spectrum. This highlights an important argument that starting points matter. While we believe higher quality countries are more likely to fare better than lower quality ones, we have noticed that sovereigns with existing concerns (in any rating category) are finding those concerns enhanced in the current environment (e.g. lack of fiscal consolidation in Romania and Oman, or pre-existing recessions in South Africa and Brazil).



Source: MIM, JPM

In lower quality sovereign credit, many frontier single-Bs are proving resilient thanks to IFI/bilateral support in the short term, while debt sustainability concerns increase for some countries over the medium term. For those countries already on the verge of distress, COVID-19 has exacerbated/accelerated the process, as weaker credits are pushed to restructure (e.g. Zambia, Ecuador) while the stories already in restructuring like Argentina and Lebanon could see lower recovery values.

We believe the best market opportunities will come from active positions in unfolding stories which are represented across the quality spectrum. **Getting the credit calls right on these stories could be rewarding as they "unfold" over the coming 6-12 months**. See "unfolding" story examples below:

Colombia – Chances of a downgrade to sub-IG have been increasing but could potentially be avoided if there is a clear fiscal consolidation path. Colombia has been sizing up its fiscal response to the crisis, having recently announced new measures to protect jobs (a wage subsidy) and revised its 2020 fiscal deficit target to -6.1% of GDP (vs. pre-CV-19 of -2.2%). The country recently issued $2.5bn of sovereign bonds that should complete its 2020 financing requirement, per our calculations.

Saudi Arabia – We believe fiscal and external accounts will likely deteriorate sharply due to lower oil production and prices. Our updated 2020 GDP growth forecast is -5.1%, with a budget deficit of 15.6% of GDP. Fiscal support amounts to ~1.7% of GDP but the government recently announced offsetting revenue and spending measures worth ~3.4% of GDP. Despite fiscal consolidation efforts, the sovereign might still need to use $50-100bn of SWF savings to fund the budget deficit. Ratings might not be downgraded in 2020 but could fall going forward in the absence of higher oil prices or a deeper fiscal adjustment.

Brazil – The COVID-19 crisis has caused us to revisit our previously positive outlook on the country. Despite large fiscal outlays, the economy is expected to contract by -6.5% in 2020 and rebound slowly to 3.5% in 2021.[1] We expect the nominal fiscal deficit could increase to almost 15% of GDP in 2020 from 6.8% of GDP, and the public debt could reach ~93% of GDP in 2020 from 76% in 2019. Ratings downgrades are not expected in the short-term, but risks rise overtime if temporary spending measures are extended and the agenda of structural reforms is not resumed.

Mongolia – The outbreak appears to have been relatively well contained with 148 cases (all imported) and no deaths thus far.[2] Now that Mongolia's border with China has reopened and China's recovery gathers pace, we expect Mongolia's economy to benefit from rising exports of coal and copper. The economy is expected to contract by 1%[3] this year as the second half recovery mitigates the sharp contraction of exports in Q1. While Mongolia's fiscal position could deteriorate this year, due to lower growth and a large stimulus package of 12.6% GDP, public debt still looks to be sustainable, projected to be around 77% of GDP this year.[4] Mongolia's external position warrants closer monitoring in the face of a wide current account deficit and thin FX reserves coverage. The IMF has already approved $99 million in emergency funding and we expect the Mongolian authorities to reach an agreement with the IMF for a new program after parliamentary elections are held on the 24th of June.

Ukraine – We believe the economy may contract sharply in 2020 and the budget deficit could also deteriorate. However, Ukraine recently managed to pass two key reforms to the land and banking sectors, which should give the country access to much needed IMF emergency funding as well as other multi and bilateral support. The IMF recently reached a Staff-Level agreement for a $5 billion 18-month Stand-by Arrangement for Ukraine. The EU

[1] Central Bank survey with market participants (Focus survey)

[2] Bank of Mongolia and Ministry of Finance, as of May 28th

[3] IMF

[4] IMF and MIM estimates

and World Bank have also committed funding to the Ukrainian government, which is contingent on the IMF's sign-off.

In conclusion, we have been carefully assessing the emerging market sovereign landscape and our analysis underscores that fundamentals matter more than ever in this environment. While a large number of countries appear resilient given ample reserves and tools to combat the economic challenges, sovereign leverage is set to increase for all countries. As the COVID-19 macro scenario plays out and EM country stories unfold, some have a higher likelihood of downgrade or even default; while others are more likely to retain their ratings through the cycle. These are indeed evolving stories and we believe, asset selection based on credit differentiation will be key to performance throughout this cycle.

Sources: JPM for EM spread data, Bloomberg, Barclays for DM spread data

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