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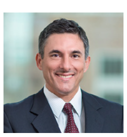
EMD: Finding Fundamental Value Through the Storm

BARINGS INSIGHTS



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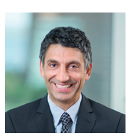

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The rapid spread of COVID-19, the precipitous fall in oil prices and the related shock to the global economy have sent markets—including EMD—into a tailspin in recent weeks. In this piece, we explore the resulting challenges and discuss opportunities beginning to emerge.

Emerging markets (EM) debt has suffered alongside the rest of the global markets in recent weeks as credit spreads have widened past levels experienced during periods of volatility in 2016 and 2018, and in some cases, to levels not witnessed since the global financial crisis.

The fall has been rapid, and perhaps unsurprisingly, commodity-producing countries and their currencies have been hardest hit, with several dropping ~20% from the end of January.

FIGURE 1: EM Debt Spreads And Yields Through Periods Of Volatility

	12/31/08	1/29/16	12/27/18	3/20/20	12/31/08	1/29/16	12/27/18	3/20/20
	Spread to worst (bps)				*Yield to worst (%)*			
Sovereign Debt								
EMBIGD	749	463	406	673	9.5	6.5	6.8	7.7
IG	520	285	217	371	7.2	4.9	5.0	4.8
HY	977	704	626	1117	12.0	8.8	9.0	12.0
AA	N/A	128	N/A	286	N/A	3.1	N/A	4.0
A	425	212	122	285	6.0	3.9	4.0	3.9
BBB	541	307	236	416	7.4	5.2	5.2	5.2
BB	787	419	336	660	10.0	6.0	6.2	7.5
B	1522	674	635	1098	17.0	8.4	9.1	11.8
C	4735	1350	3335	3849	48.6	15.2	36.0	39.0
Corporate Debt								
CEMBI	983	485	351	619	11.5	6.5	6.1	7.0
AA	607	153	106	174	N/A	3.1	3.7	2.4
A	626	206	167	269	N/A	3.1	4.1	3.6
BBB	874	353	259	423	7.4	4.4	4.6	5.1
BB	1,840	653	396	791	19.9	8.0	6.6	8.6
B	2,818	1,043	699	1,224	10.9	8.1	6.9	12.8
C	2,364	1,828	1,099	2,503	N/A	19.6	13.5	25.5
NR	646	563	519	595	N/A	7.3	7.8	6.9
Local Rates								
GBI-EMGD	N/A	N/A	N/A	N/A	7.4	6.9	6.5	5.9
5-yr USD Swap Yield	N/A	N/A	N/A	N/A	2.1	1.3	2.6	0.6
Difference (local)	N/A	N/A	N/A	N/A	5.3	5.6	3.9	5.3

SOURCES: Bloomberg, J.P. Morgan. As of March 20, 2020.

The speed and severity of the fall have impacted both the fundamental and technical picture for EM debt. Specifically, from a technical standpoint:

Outflows: The asset class has experienced severe outflows in recent weeks, with redemptions now over $17 billion year to date. In the most recent weekly data from J.P. Morgan, retail funds experienced a record outflow of -$14.6 billion through March 19. Hard currency assets were the main source, with -$10.4 billion in redemptions, as the dollar has been in particularly high demand given investors'/traders' liquidity needs vs. local currency assets (-$4.2 billion).

Liquidity: Outflows have exacerbated the currently challenged liquidity conditions. Price discovery has operated poorly in recent weeks as bid-ask spreads have widened and—based on the experience of our own trading desk—dealers have offered inconsistent pricing on the same or similar bonds. This has made it more difficult to transact, but also would suggest that investors may be unduly punished for selling in the current environment. It is also worth noting that some of the selling in the market is related to mandated de-risking, a result of regulatory risk management tools.

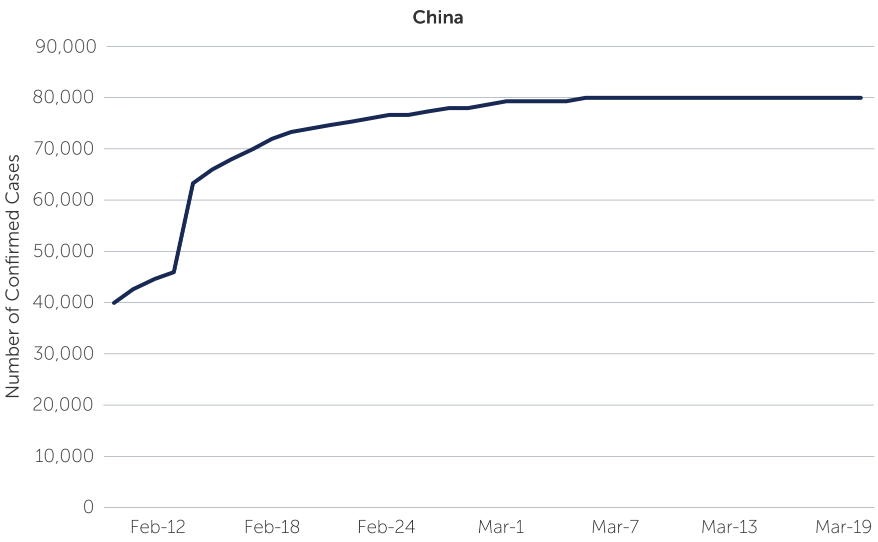
From a fundamental standpoint, the picture is more nuanced. While the world has changed drastically in just a few weeks, there are reasons to believe market prices may have overreacted.

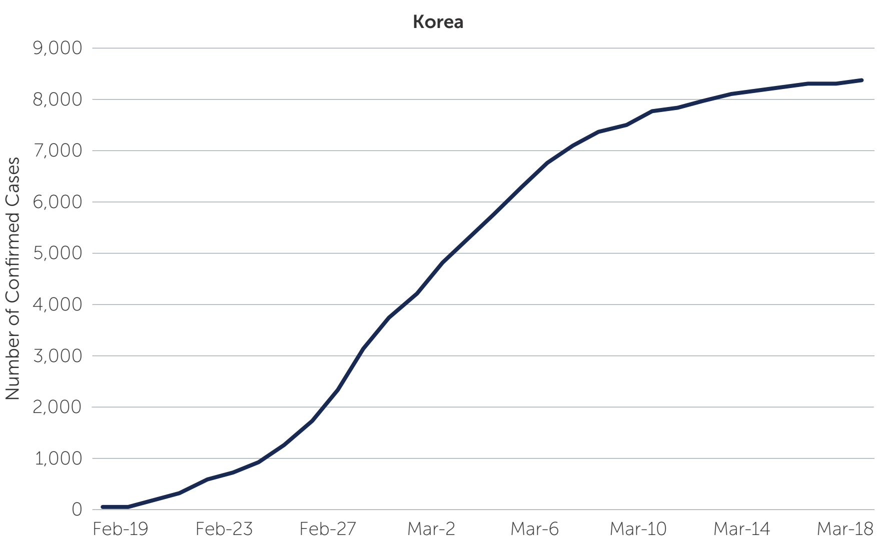
COVID-19

While this crisis should not be taken lightly—especially given the tragic toll it is taking on humanity—recent statistics, as well as our own analysis, suggest that social-distancing initiatives in China, Japan and South Korea have helped bring the spread of the virus under control in those regions. Additionally, conditions appear to have either improved materially (China) or been headed off relatively effectively (Korea and Japan).

These trends and data suggest that the pandemic could come to an end more quickly than what some (especially Westerners) may be forecasting. If it turns out to be mainly a 2020 event, with only limited economic disruption in 2021 and beyond, that would support the contention that current prices appear significantly oversold.

FIGURE 2: Total Confirmed Cases Of COVID-19





SOURCE: World Health Organization. As of March 19, 2020.

Oil Prices

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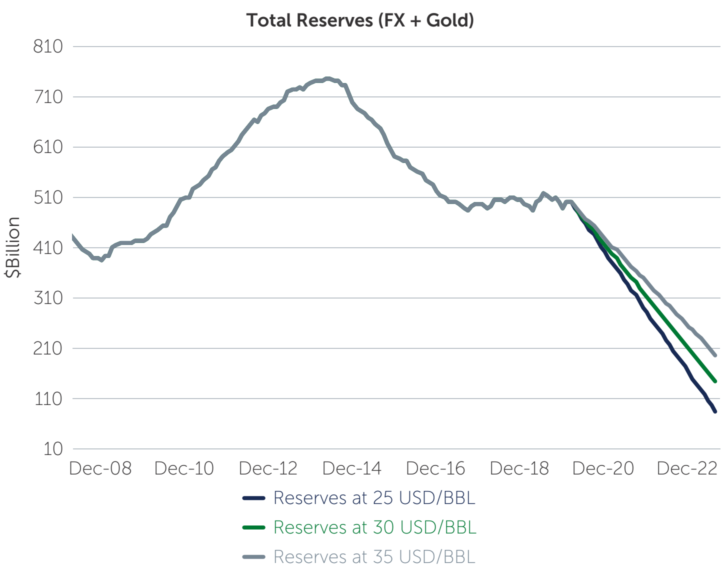
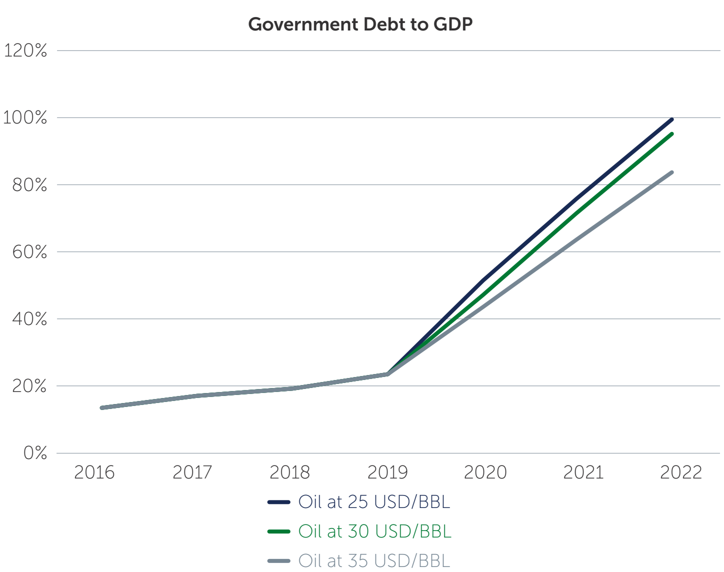
Plummeting oil prices, spurred by the Russia-Saudi Arabia price war, have weighed heavily on markets in recent weeks, impacting commodity-producing companies and countries around the world. But even here, there is reason for cautious optimism. Based on our internal analysis of Saudi Arabia's financial position, **we believe the country lacks the financial flexibility to sustain a price war at current levels over the long term**.

FIGURE 3: A Long Price War Looks Unsustainable For Saudi Arabia





SOURCE: Barings forecasts.

Saudi Arabia appears to be motivated by the prospect of gaining market share from Russia, shale producers and others. But Russia, based on our analysis, is in a position to sustain a price war for significantly longer. And shale producers, while likely to be negatively affected in the short term, have been quick to re-mobilize following past periods of weakness. Low oil prices impact Saudi Arabia's fiscal and external account in equal and very large amounts. We believe the impact on the country's fiscal balance—likely more severe than that on its current account balance—will be comparable to the impact on central bank reserves. This is predicated on the large de facto current account outflows that the country records as financial outflows.

From 2015 to 2017, Saudi Arabia waged an oil price war against shale producers that caused the country's large foreign exchange reserves—accumulated during the oil boom—to drop from ~$730 billion to ~$500 billion[1] at an average oil price over the period of ~$50/barrel.

Low oil prices impact Saudi Arabia's fiscal and external account in equal and very large amounts. Assuming oil prices at $30 and 11.5 million barrels/day production, with limited access to foreign debt markets, we expect that Saudi Arabia will cover its external deficit from FX reserves and its fiscal deficit from local borrowing. In this scenario—and accounting for the 5% expenditure consolidation announced by the Saudi government—the country's fiscal deficit would reach ~21% of GDP per year and the level of debt would reach 70% of GDP in 2021, from 23% in 2019. FX reserves would decrease by 45% to $270 billion by the end of 2021, down from $500 billion in 2019. This leaves little to no room to manage any future shocks.

Large fiscal consolidation looks unlikely from a political perspective, as Saudi Arabia, like other countries, will almost certainly face the spread of COVID-19 and the resulting economic effects. In this context, the country's people and businesses will more likely require fiscal stimulus than fiscal consolidation—in other words, it may be too socially risky for the Saudi government to deliver a large fiscal consolidation during a period of economic shock.

In summary, if oil prices remain in the $30s for a prolonged period of time, we would expect to see significant erosion of Saudi Arabia's fiscal and external buffers over a two to three-year period. In our view, this provides reason to believe the country will be motivated to stop the price war sooner rather than later.

1. Souce: SAMA (Saudi Central Bank).

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Outlook

Local Debt (Rates & Currencies)

Rates: Social distancing and other immediate policy actions in response to COVID-19 have certainly created a supply shock, which could result in higher inflation going forward. However, we believe these are temporary measures and therefore maintain a constructive view on global interest rates, and particularly EM interest rates, that have moved higher as a result of risk aversion and portfolio outflows. For these reasons, we believe interest rates across sound EM countries currently offer a very interesting investment opportunity.

Currencies: While emerging market currencies have suffered a large sell-off in recent weeks, developed market currencies (USD, JPY, EUR) have remained relatively stable. We believe this is a largely temporary phenomenon and reflective of intense risk aversion. In addition, aging populations in developed markets appear to be at higher risk from COVID-19 than EM populations, partly offsetting the weaker healthcare systems of the latter. And while commodity prices have also fallen, adversely affecting EM currencies, China's economic rebound could turn current dynamics around. For these two reasons, EM FX also offers a potentially compelling investment opportunity, in our view.

High-conviction, country-level thoughts: We came into this crisis with a preference for countries that exhibited:

1. High levels of foreign currency reserves
2. Deep local markets (financed to a significant degree by locals)
3. Credible monetary policy frameworks

We continue to believe these factors are critical to withstanding the crisis. Currently, we are stress testing our universe of countries on the basis that global GDP contracts by 10% in 2020. This may prove extreme given the fiscal efforts of global policymakers and the early positive evidence of some Asian countries' ability to slow/contain the virus, but it seems prudent at this time.

Mexico: We believe the expected shock to tourism will be offset by the drop in oil prices. As such, we believe the currency depreciation that Mexico has experienced in recent weeks appears excessive. Inflation dynamics are also contained, in our view, suggesting the sell-off in rates may be excessive. Overall, we remain constructive on both rates and the currency in Mexico.

Brazil: Brazil does not have much fiscal leeway, meaning monetary policy will be the country's main tool for addressing the fallout from COVID-19. Currently, the steepening of the Brazilian local yield curve is offering attractive investment opportunities, in our view. Moreover, the country is one of the most closed economies to global trade, suggesting a global economic slowdown may not be felt as severely.

Colombia: Colombia has shown great dexterity in dealing with severe economic shocks in the past, including the implosion of Venezuela—formerly the country's biggest trading partner—and the 2014/2015 collapse in oil prices. At the time, oil represented over 50% of the country's export earnings and 20% of government revenues. The current crisis finds Colombia in good economic health. Prior to COVID-19, it was the fastest-growing economy in Latin America, and today has a flexible exchange rate and very sound fiscal management. The oil shock is certainly a headwind for Colombia's balance of payments, but the country's fiscal position is well-guarded against fluctuations in oil prices. We therefore believe that while the local currency looks less attractive, local bonds are offering strong fundamental value.

"We believe these are temporary measures and therefore maintain a constructive view on global interest rates, and particularly EM interest rates, that have moved higher as a result of risk aversion and portfolio outflows."

Sovereign (Hard Currency) Debt

The material sell-off in recent weeks has caused the sovereign debt of many countries to trade at prices that we believe **vastly overprice default risk**.

For instance, we calculate that **Russia** has enough in foreign currency reserves to buy all of its external debt, meaning the likelihood of default is extremely remote. Yet, Russia's current external bond prices imply a 5-year, cumulative probability of default at >20%, which we think overstates the sovereign's actual chances of default by 20 times or more.

Similarly, for **Brazil**, we calculate that the country can repay two-thirds of its external debt—and all of the public sector's external debt—with its central bank foreign exchange reserves. Again, default looks like an extremely remote scenario, yet spreads on Brazil's hard currency-denominated bonds imply a 5-year, cumulative probability of default at >30%, which we think overstates Brazil's actual probability of default by a factor of 10 times or more.

Even many below investment grade countries like **El Salvador** and **Ukraine** look favorably positioned to weather the storm. In addition to exhibiting lower external and internal financial imbalances, these countries stand to benefit from lower oil prices, which could ultimately help offset adverse demand and growth shocks.

Well before the COVID-19 crisis, we modeled the countries in our portfolios to be able to withstand short to medium shocks—and we believe many countries will be able to do so. While some countries are more vulnerable than others, **we do not expect a material increase in sovereign defaults in the near-term**, especially among countries that came into the crisis with credible policy frameworks and proven capacities to adjust.

Corporate Debt

Similar to many other asset classes, the recent market sell-off has created significant dislocation in corporate debt prices, with value opportunities emerging each day. Fundamentals have been relegated to the background, as investors seek to raise liquidity for various purposes. While we remain cautious—and have focused much of our efforts on re-assessing the liquidity risk for the EM corporate issuers in our universe—we are seeing good value opportunities emerge in the low beta sectors such as utilities, food and beverage, and TMT. We acknowledge that global corporate default rates will likely trend higher for both developed and emerging markets, as the widespread collapse in global demand stifles cash flow for many industries, with intense pressure placed on working capital, cash balances, and companies' ability to sustain operations.

For EM corporate high yield bonds, the 2019 default rate (1.5%) was the lowest in at least eight years, supported by robust standalone EM fundamentals and the dovish turn by DM central banks— which helped mitigate refinancing risks for the most at-risk issuers. These robust fundamentals provide a better starting point for EM corporates relative to 2008/2009, which is a silver lining.

While some countries like China are already seeing some impact of economic deterioration on the corporate sector, EMs as a whole are still in the earlier stages of economic shutdown—so the full impact on the EM corporate universe remains unclear. Globally, access to capital for corporate issuers remains completely shut for the time being, with corporate issuers tapping their bank revolver lines where possible, cutting their capex budgets, and announcing other measures to preserve cash.

The cash flow slump accompanying much tighter financing conditions, combined with the oil price shock, will undeniably hurt creditworthiness and result in elevated default levels. But we believe the magnitude of the impact will vary by sector, with a severe but relatively short-lived economic contraction mostly affecting the weaker credits or those in the most directly exposed sectors—airlines, transportation, leisure and gaming, hotels and restaurants, and retail, for instance.

For additional context, in 2008/2009 when high yield EM corporate spread levels peaked at 2,241 basis points (bps), default rates were ~10.7%. At the current spread of 969 bps[2], the market is effectively pricing in a much higher default rate than the previously estimated 2.4% for 2020, although perhaps not quite as high as 2008/2009. Some weaker names could feel some pressure, especially with the underlying countries having to confront the COVID-19 problem more forcefully, but we do not expect to see a systemic increase in defaults.

2. As of March 20, 2020.

"We expect value opportunities to continue to emerge in the weeks and months ahead. But it is important that investors also remain vigilant during this time..."

What's Next?

We continue to closely monitor and analyze the economic consequences of COVID-19 as well as its political implications. We believe that financial markets overall may not be reflecting the latest information—and as a result, pricing in too negative of a scenario with regards to the timing of the crisis' resolution.

As we consider the months ahead, we are focusing our research efforts on several key areas to stay abreast of the latest developments and incorporate them into our analysis, including:

1. Tracking the **spread of COVID-19** and country-by-country responses in order to identify which responses work better than others and which countries' experience may be a leading indicator for others.
2. Evaluating the **internal balances** of the 90+ EM countries that we analyze to understand which have the policy credibility and financial system depth to pursue counter-cyclical policies to cushion the blow to growth and incomes.
3. Evaluating the **balance of payments** of EM countries to understand which have the exchange rate flexibility to compress imports and balance the balance of payments amid a sudden stop in capital inflows.
4. Evaluating the potential for each country to obtain **bi-lateral or multi-lateral financial support**, which in turn, will be a function of each county's policy credibility and framework.
5. Evaluating the **impact of oil prices**—including on those countries that are heavy importers of oil and benefit from lower oil prices, as well as the impact of low oil prices on energy companies compared to their estimated breakeven cost of production.
6. Evaluating the **impact of low commodity prices** on EM corporate metals & mining producers and re-assessing their cost of production measures against current commodity prices.
7. Re-evaluating our assessment of each country's **social contract** between the people and the government, to gauge any potential challenge to the political legitimacy and stability of the current regime and the risk of social and political instability.
8. Evaluating the **liquidity of the EM corporates** we are invested in over a 12-month time horizon to identify any potential vulnerability.

We expect value opportunities to continue to emerge in the weeks and months ahead. But it is important that investors also remain vigilant during this time, as headlines will likely remain very negative, markets will face continued liquidity challenges, and there remains much uncertainty on the path to ultimate recovery.

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