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COVID-19 Leads to Dispersion in EM Debt

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Many emerging market (EM) countries will likely be hit harder by COVID-19 because of structural vulnerabilities and weaker institutions—in other words, their ability to contain the pandemic and their capacity to stimulate their economies. But while there is reason for concern, there is also reason for optimism.

Ability to Contain, Capacity to Stimulate

EMs' ability and willingness to contain the outbreak by enforcing social-distancing measures is an open question because of the socioeconomic fabric of emerging markets: high urban density, a large informal economic sector, and current demographics (by which I mean a younger population that is less inclined to socially distance).

Less strict lockdown regimes in combination with weaker healthcare systems may result in a disproportionally large number of COVID-19 cases and related deaths. Risks of social unrest are material in places with large informal economies.

At the same time, EMs have less capacity to respond to the pandemic through fiscal and monetary stimulus than does the developed world.

Although it varies by country, there is limited ability to enact fiscal stimulus without raising debt-sustainability concerns and massive currency devaluations.

At the same time, capital flight risk may limit central banks' freedom to deliver monetary support. This leaves the size and effectiveness of policy response an open question.

Socioeconomic Impact

As a result, the negative socioeconomic impact may be large and widespread in EMs.

The Middle East, Africa, and Latin America will likely be hit the hardest because they are less diversified commodity exporters with a weak ability to respond to the crisis.

Manufacturing-oriented economies with strong links to Western Europe and China—which have a stronger ability to manage the crisis—should be less impacted.

Credit Deterioration Expected

While we expect to see notable deterioration in credit metrics across the asset class and some pickup in defaults, we believe there are reasons for optimism.

The role of international financial institutions (IFIs) such as the International Monetary Fund (IMF) and the World Bank, development banks, and bilateral donors (such as China) should be critical in providing short-term relief.

The IMF and World Bank have lending capacity of $1 trillion. The IMF has moved very quickly in providing countries with fast and unconditional disbursement funds. It has also provided short-term funding facilities to countries without access to U.S. dollar swaps.

These measures should help contain a debt crisis in EMs. Debt-relief programs with multilateral/bilateral lenders in the form of postponing interest payments are also expected.

As a result, credit events should be limited to a handful of countries, most of them already headed in that direction. Widespread technical defaults are unlikely.

Restructuring is a time-consuming process, involves legal challenges, and creates distraction in a time when government officials should focus on crisis management.

Investment Process—Region Agnostic

When analysing the effect of the crisis on EMs, it is important to note that there are significant differences among EMs.

It is difficult to differentiate between regions, and even within regions; countries have very different levels of development, economic models, and macroeconomic buffers, which result in a different ability to respond to the crisis.

For example, Chile and Ecuador in Latin America, Russia and Ukraine in Eastern Europe, and Malaysia and Sri Lanka in Asia differ significantly.

The same happens in the oil and metal sector space. We cannot compare oil-producing countries such as Russia with Sub-Saharan economies such as Nigeria, Gabon, and Angola or copper-producing countries such as Chile and Peru with Zambia and Mongolia.

What we can say with certainty is that this is an unusual crisis because it is both global and local. It will affect export-oriented economies as badly as it affects service-driven ones. But the crisis should hit those EM countries with institutional and macroeconomic vulnerabilities the hardest.

Yet our investment process is region-agnostic. We prefer to segment our investable universe in three buckets based on different risk profiles: low-beta, middle-beta, and high-beta countries.

Our focus is on debt sustainability and the ability and willingness to service debt.

Low-Beta Countries: Positioned Well to Respond

Low-beta countries, which make up 40% of our investable universe, are relatively high-grade, low-yielding countries with low debt levels, prudent economic policies, and ample ability to implement fiscal policy.

They include the more developed emerging markets: Central and Eastern European countries such as Poland, Hungary, Russia; Chile and Peru in Latin America; and Malaysia and the Philippines in Asia.

This group of countries should have a strong ability to respond to the crisis.

Middle-Beta Countries: Story Unclear

Middle-beta countries, which make up 35% of our investable universe, include large EMs such as Brazil, Mexico, South Africa, and Turkey.

These countries have displayed persistent macroeconomic and fundamental decline over the years. They run large twin deficits, have relied on foreign capital flows, and have little fiscal space to offset the economic damage.

But here, as well, there is differentiation. Brazil and Mexico have large domestic bond markets and sufficient levels of international reserves, while South Africa and Turkey have weaker foundations (such as the ability to support the private sector).

We should see material debt-sustainability deterioration in these countries, but a credit event is extremely unlikely.

High-Beta Countries: Reasons for Concern

High-beta countries, which make up 25% of our investable universe, consist predominantly of the most vulnerable EM countries.

These include commodity-dependent countries such as Angola, Ghana, Gabon, Nigeria, and Zambia; those in sensitive parts of the world, such as Iraq and Lebanon; and those with a dysfunctional policy mix, such as

Argentina and Ecuador.

Most countries in this group will face difficulties paying interest and refinancing debt. Some of them have already stopped making interest payments or have indicated the intention to restructure, including Argentina, Lebanon, Ecuador, and Zambia.

Support from multilateral organizations is critical for high-beta countries.

Corporates: In Better Shape

The EM corporate credit sector is entering this crisis in better shape.

Over the past few years, corporates had been in a deleveraging trend while refinancing and extending maturities.

Many issuers have implemented prudent liquidity management measures such as reducing capex, suspending dividends, drawing on credit lines, curtailing operations, and improving working capital.

While cash flows will certainly be affected, we do not foresee a systemic liquidity crunch, and we anticipate default rates rising to 4% to 5%—still below previous peaks.

Positioning

In this environment, we are using a barbell strategy in our portfolios, by which I mean we are defensively positioned overall but have a small allocation to distressed, high-beta credits.

Broadly speaking, we prefer countries with diversified economic models, ample fiscal space, sufficient levels of international reserves, and strong relationship with IFIs.

Regionally, we prefer Russia and Brazil versus South Africa and Turkey (for corporates).

In the oil space, we prefer the stronger credits of Qatar and Kuwait to the weaker credits of Oman and Iraq as well as several national oil companies, but overall we remain underweight oil.

We have a small overlay in distressed credits such as Argentina and Lebanon because we estimate recovery values to be significantly above current market prices. We also have a small overweight in high-beta Ukraine because of strong multilateral support.

From a valuation perspective, we believe the asset class is very attractive. We have a bias toward increased exposure to high-beta, high-yield countries, where the average bond price is compelling.

The implied probability of default is unrealistic in our view, and there is significant price dislocation created by indiscriminate, forced selling of exchange-traded funds (ETFs). It should be corrected once market conditions normalize.

Looking Ahead

Looking beyond the short-term casualties from the crisis, there are potential long-term structural changes.

We were already seeing globalization under attack amid rising nationalism in some parts of the world. We have been seeing a rising confrontational tone from the United States regarding not only China but also Europe.

This nationalistic trend may result in more production being shifted locally in countries with large domestic markets.

This could create inefficiencies in the global economy and be detrimental to small manufacturing-oriented exporting countries, especially in Asia.

Nationalism could lead to more authoritarian regimes as well, potentially undermining democracies around the world.

We continue to monitor and assess when and how to seek to take advantage of these market inefficiencies and price dislocations.

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