BlueBay Asset Management

EMD: Coronavirus crisis Q&A

Polina Kurdyavko answers investors' emerging market debt questions during this time of crisis, addressing 2020 maturities, policy flexibility and liquidity concerns, alongside signs of green shoots in China.

AUTHOR
Polina Kurdyavko
Partner,
Head of Emerging Markets

PUBLISHED
April 2020

READ TIME
10 minutes

RBC Global Asset Management

How do you think EM governments will manage the fallout from the crisis? Do you think sovereign issuers have sufficient buffers to manage upcoming maturities for the rest of the year?

Looking at sovereign debt sustainability, it's important to consider liquidity. Here, there are three key points – maturities coming due; reserves available; and support from the IMF.

1. On maturities, EM sovereign debt issuers have approximately USD117bn due to mature through the course of 2020, however, a large chunk of this figure (approximately USD75bn) comes from Central & Eastern Europe (CEE) and the Middle East – notably countries that, in essence, can afford to pay. These include Poland, Hungary, Qatar and Saudi Arabia. Countries in Sub-Saharan Africa combined are due to refinance some USD10bn.

We hold a more cautious stance on this region and have been positioned underweight since the beginning of the year, reflecting our concerns around debt increases and certain governments' inability to deal with a downturn in growth. We would expect to see more pain and possible restructuring in this region. Fortunately, it remains a relatively small percentage of the overall asset class.

2. Most EM countries have ample reserves to meet their liquidity needs. Only a couple of names such as Bahrain and Ecuador have reserves below their necessary liquidity needs for the course of 2020.

3. The IMF has USD1 trillion available to support EM economies. This amounts to approximately 25% of the total EM debt stock and is notably larger than the sums held during the crises of 2008 and 1998. Interestingly, when we think about the debt stock of various emerging markets against their GDP, the number is roughly comparable to 1998 at around 10 percentage points. Therefore, we think that the EM debt stock for 2020 is manageable.

In your view, which EM countries and regions have the most policy flexibility?

Starting with the regions, Asia stands out. It is the key beneficiary of lower oil prices, as well as being the region which has tackled the coronavirus fastest. We think that China in particular has a lot of policy flexibility in terms of providing liquidity support for its domestic markets – we've already seen signs of this coming to fruition.

More broadly, it's the robust economies that jump out. In the CEE region, that's Russia, Czech Republic and the Baltic states. In the Middle East, we would highlight Israel, Saudi Arabia, Qatar, Kuwait and Abu Dhabi, alongside Chile and Peru in Latin America.

I believe alongside having the ability to support, we must also consider a country's willingness to assist – would a country choose to broaden its fiscal measures or maintain a tighter stance?

It's also worth acknowledging that the scale of support away from China is likely to be lower than in developed markets. For example, in the likes of Chile and Peru we might see 2–3 percentage points of GDP in additional support, compared to figures in the high single digits for some developed economies.

In our view, the coronavirus pandemic has only served to increase the government's willingness to provide domestic liquidity

What is funding pressure looking like for emerging market corporates?

Starting with refinancing needs, EM corporates have a total of approximately USD250bn due across 2020. However, the vast majority of this figure is due from Asia, particularly China. This is the only economy where we have already seen domestic liquidity support being issued since November 2019.

In our view, the coronavirus pandemic has only served to increase the government's willingness to provide domestic liquidity.

By way of example, today, some of the single B real estate developers are borrowing on the domestic market at levels 200bps tighter than they were prior to the outbreak. Real estate is one of the only sectors within the high yield universe that we're maintaining as a core overweight position in our portfolios.

From a business perspective, we anticipate it will be airlines that will be worst hit. But on a positive note, airlines make up the smallest percentage of the EM corporate universe, accounting for less than 0.3% at the index level.

Let's cover defaults – what are your expectations of 2020 and 2021?

As a team, we have upwardly revised our expectations following the outbreak of the virus and the correction in oil prices. We expect defaults to go from the mid-2% range up to around 4% as we move towards 2021 – this view is held against spreads which are pricing double-digit default rates.

The companies that we anticipate accounting for the bulk of our default forecast sit in the transport sector (notably airlines), alongside some utilities, although we expect these to be due to leverage issues rather than coronavirus.

Our default forecast is notably lower for two reasons:

1. EM companies have been operating in an environment of lower growth and deleveraging for at least the last five years, if not 10. Following the collapse of the oil price in 2015, we've seen most companies taking a more cautious stance regarding capital expenditure in order to bolster their cash buffers. Hence, these companies aren't entering the current downcycle with excessive leverage, which should result in lower defaults than would likely have been the case if growth expectations had been more upbeat.

2. We've seen close to 50% FX devaluation in emerging markets over the past 10 years. The key point to note is that the devaluation has been gradual. This allowed companies to adjust their debt profiles in favour of local currency and made them more cautious on projections and capex – both these factors are helping them to handle today's crisis.

There's no doubt that some EM names will face liquidity pressure, as we saw in 2008, but even when we see restructurings, we expect these to go hand-in-hand with higher recovery rates. In 1998, the average restructuring recovery price was 20c on the dollar, whereas in 2019 it was 50c.

What feedback are management teams providing regarding the economic fundamental backdrops for their companies – any signs of early green shoots?

Thanks to technological advances, we've been able to spend a great deal of time recently talking to the management teams of the companies we invest in, despite the lockdown. The feedback has been disparate depending on the sector. In utilities, we've seen capex rates fall but volumes have been relatively consistent. In telecoms – the main beneficiary of the sudden shift to new flexible working practices – we're seeing names engage with their respective governments to increase their operational scope. Industrials, metals & mining has seen some facilities shut down, which is unsurprising given the sector's cyclical nature. Lastly, oil & gas is facing lower capex provisions but the vast majority of EM names in the sector operate in the quasi-sovereign space.

BlueBay Asset Management

Regarding green shoots, China once again leads. Activity in the real estate is already back to around 90% of normal volumes, according to the companies we've spoken to.

When considering sectors, it's always wise to frame your thinking against the construction of the index.

The single-largest exposure in the index is to banks, at approximately 30%. We've been seeing relatively prudent behaviours so far as EM banks generally run fairly high capitalisation ratios and have not been extending their balance sheets in recent years (this is not to say that we won't see a rise in non-performing loans).

The second-largest sector is TMT, which is doing fairly well on the back of the uptick in telecoms and internet usage. Utilities make up around 10% and oil & gas some 13%.

So, most companies are taking a more cautious stance and reducing their activity, although few are yet to take drastic measures.

Regarding green shoots, China once again leads. Activity in the real estate is already back to around 90% of normal volumes, according to the companies we've spoken to. Restaurants and entertainment are understandably taking longer to recover, reflecting the cautious stance of the populous in the wake of the outbreak.

BlueBay
Asset Management