

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

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.

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.

This document is issued in the United Kingdom (UK) by BlueBay Asset Management LLP (BlueBay), which is authorised and regulated by the UK Financial Conduct Authority (FCA), registered with the US Securities and Exchange Commission, the US Commodity Futures Trading Commission (CFTC) and is a member of the National Futures Association (NFA). This document may also be issued in the United States by BlueBay Asset Management LLC which is registered with the SEC and the NFA. Past performance is not indicative of future results. Unless otherwise stated, all data has been sourced by BlueBay. To the best of BlueBay's knowledge and belief this document is true and accurate at the date hereof. BlueBay makes no express or implied warranties or representations with respect to the information contained in this document and hereby expressly disclaim all warranties of accuracy, completeness or fitness for a particular purpose. This document is intended for "professional clients" and "eligible counterparties" (as defined by the FCA) only and should not be relied upon by any other category of customer. Except where agreed explicitly in writing, BlueBay does not provide investment or other advice and nothing in this document constitutes any advice, nor should be interpreted as such. No BlueBay Fund will be offered, except pursuant and subject to the offering memorandum and subscription materials (the "Offering Materials"). If there is an inconsistency between this document and the Offering Materials for the BlueBay Fund, the provisions in the Offering Materials shall prevail. You should read the Offering Materials carefully before investing in any BlueBay fund. This document does not constitute an offer to sell or the solicitation of an offer to purchase any security or investment product in any jurisdiction and is for information purposes only. No part of this document may be reproduced in any manner without the prior written permission of BlueBay Asset Management LLP. Copyright 2020 © BlueBay, the investment manager, advisor and global distributor of the BlueBay Funds, is a wholly-owned subsidiary of Royal Bank of Canada and the BlueBay Funds may be considered to be related and/or connected issuers to Royal Bank of Canada and its other affiliates. ® Registered trademark of Royal Bank of Canada. RBC Global Asset Management is a trademark of Royal Bank of Canada. BlueBay Asset Management LLP, registered office 77 Grosvenor Street, London W1K 3JR, partnership registered in England and Wales number OC370085. The term partner refers to a member of the LLP or a BlueBay employee with equivalent standing. Details of members of the BlueBay Group and further important terms which this message is subject to can be obtained at www.bluebay.com. All rights reserved.