BlueBay
Asset Management

EM debt: Our 2020 view

THE BLUEBAY EMERGING MARKETS INVESTMENT TEAM

After a positive year of returns in 2019, what are your expectations for the asset class going into 2020?

POLINA KURDYAVKO, HEAD OF EMERGING MARKETS

2019 proved to be a positive year for emerging market (EM) assets, particularly those denominated in USD. Returns were robust despite poor global growth and a number of macro risks.

Coming into 2020, the global liquidity environment looks as though it will be supportive for the asset class, encouraging investors to search for yield in EM. However, EM growth is likely to remain modest, accompanied by a slow rise in default rates from the currently low level. Gains therefore could be muted at the index level but investors would be wise to seek out sources of return, both from the long and short side.

We see three key themes driving the performance of EM risk assets in 2020:

1. **Shift from growth to stability presents potential carry trade opportunities.**
   Historically, investors were focused on growth as a key driver of EM performance. Yet some EM countries have moved away from a 'boom/bust' growth profile and towards macroeconomic stability, which provides positive risk-adjusted carry opportunities.

2. **Maturing EM credit cycle is creating increased price dislocations in liquid stressed credits.**
   As the credit cycle matures, we expect more stress in idiosyncratic credit stories given the tepid growth outlook combined with a gradual path towards global interest rate normalisation. While default rates are likely to increase towards the historical average (3.5% for corporate EM high-yield credits), we expect to see more price dislocation in liquid stressed credits, especially in some sovereigns.

3. **Domestic stimulus provides liquidity support to corporate credit.**
   This theme has been playing out in Western Europe for several years. In 2020, we expect China to provide stimulus to the domestic economy both through infrastructure spending and loose monetary policy. Sectors like Chinese real estate, in our view, will be one of the key beneficiaries of that support.

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Which risk factors do you think will prove most material in 2020?

RUSSEL MATTHEWS, SENIOR PORTFOLIO MANAGER

There are four primary risk factors we are focused on for 2020: coronavirus spreading materially beyond China; the US Federal Reserve's stance; global liquidity; and geopolitics.

1. The full impact of the COVID-19 virus is yet to be determined. We are relatively confident that the virus has passed its most dangerous phase, but the threat that it spreads materially beyond China remains. If the virus spreads more significantly into other Asian economies, or to the West, disrupting global trade and significantly altering economic behaviour in the global economy, then the medium to long-term hit to global growth could be meaningful.

2. A more hawkish stance from the US Federal Reserve would challenge our view on some of our defensive high-carry positions. If this scenario were to materialise, we would look to protect positioning by taking short EM FX positions.

3. On liquidity, we could see the environment become more challenging for EM credit given the global monetary and geopolitical backdrop. A more difficult liquidity environment might reprice hard currency spreads to incorporate a higher liquidity premium, which could impact our views on some hard currency credits.

If this scenario were to materialise, we could express a negative view through taking a short exposure in EM credit, as well as using CDS to reduce our exposure to market beta or express a negative beta view.

4. On geopolitics, material instability can never be ruled out, especially in the Middle East. If tensions escalate further in the region, which is still a tail risk, there could be profound implications for the Middle East, oil prices and potentially sentiment around the US economy. Russia could emerge as a potential winner from such a situation.

A more hawkish stance from the US Federal Reserve is likely to challenge our view on some defensive high-carry positions

Argentina – is the next stop debt restructuring?

GARY SEDGEWICK, PORTFOLIO MANAGER
GRAHAM STOCK, EM SENIOR SOVEREIGN STRATEGIST

Argentina's transformational election in 2015 promised the electorate, and investors, a new market-friendly vision for the country.

In 2019, voters reversed the direction of travel completely, effectively bringing back the old government and expunging the technocratic policymaking of the Macri administration. The August primaries foreshadowing the October election result prompted a sharp drop in bond prices, which should serve as a cautionary tale for investors looking to invest not only in Argentina but in Latin America in general from the perspective of shifting political landscapes.

That said, great volatility can bring great opportunity and Argentina is no different in this regard. The final recovery prices of the bonds are likely to be determined by three-way discussions between the government, the IMF and bondholders.

In our view, cashflow relief over the next few years should be the government's priority even while it seeks to share the burden of adjustment between the domestic population, bondholders and multilateral creditors. A fiscal adjustment will, in our view, be inevitable, whether to comply with a renegotiated IMF programme or to adapt to the absence of alternative financing sources, but the Fernandez government will hope to backload any austerity push and generate a short-term growth boost in the meantime. As a result, we expect maturity extensions and near-term coupon holidays, but do not see a need for nominal haircuts.

Additionally, in our view holders of front-end bonds are in a good position to resist being subordinated to debt falling due to the IMF in 2022 and 2023, and therefore to remain at the front of the queue.

The restructuring process is yet to get underway but with the above in mind, we favour short-dated bonds and tactically deploy downside protection via medium-term CDS instruments (where possible). Our recovery value analysis shows that the likely recovery in the short end should be in a 60-70 range with current bond prices in the low 50s. This provides potential opportunity on the upside.

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What is the significance of the PrivatBank case to the Zelensky presidency?

TIMOTHY ASH, EM SENIOR SOVEREIGN STRATEGIST

Ukraine's President Zelensky was elected on a ticket to clean up corruption, which opinion polls suggest is the top concern for the electorate and business. The travails of Ukraine therein have been revealed in the Trump impeachment hearings.

PrivatBank is important as it is the largest bank in the country and subject to a legal tussle between the Ukrainian authorities and Igor Kolomoisky, a highly controversial oligarch who backed Zelensky's election campaign. Kolomoisky is accused of fraud in the failure of the bank which resulted in its eventual nationalisation in 2016 and losses of USD5.5bn (6% of GDP at the time) suffered as a result by the state.

The Central Bank now accuses Kolomoisky of running a campaign of terror against its employees and has pleaded for support from the presidency and international financial institutions against the oligarch. Zelensky has promised a level playing field in the fight against corruption but a failure to deal fairly with Kolomoisky on the PrivatBank issue will leave him vulnerable to claims of applying selective justice, blowing a hole in his anti-corruption agenda. The issue is also key to ensuring IMF support for Ukraine and is the canary in the coal mine for investors as to whether Zelensky is a real reformer.

US support for Ukraine in the period since EuroMaydan has been critical in holding off pressure in the East from Russia. The Trump impeachment hearings have underlined that this support is to some extent dependent on Ukraine showing a willingness to fight corruption. All this has made a satisfactory resolution of the PrivatBank mission critical.

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