

Update on emerging markets credit

Market Insights by Jacopo Turolla, Senior Portfolio Manager, AZ Life Azimut's life insurance company in Ireland

Emerging Markets were not spared by the Covid-19 and the ensuing global recession will have a strong impact on their economies both on the external and on the internal side. On the external side, it will hit harder those countries that rely on tourism or on the sale of commodities to earn revenues in hard currency (i.e. in dollars) while on the internal side it will impact two types of countries; those that couldn't stop the spread of the virus (such as Brazil) and those that imposed stricter lockdowns (ex. South Africa)

Emerging Markets authorities reacted actively with a strong fiscal stimulus and interest rate cuts by the central banks. This kind of response is unusual for Emerging Markets: in the past during crises central banks have often resorted to rate hikes in order to limit the fall in their currency and slow down outflows of capital. But many EM countries are now different: firstly they now have less need for capital inflows as the average current account deficit has shrunk compared to the past; secondly global inflation pressures have subsided leaving more space for central banks' action.

How do we expect EM countries' fundamentals to evolve and how do we take this into consideration in our investment process?

The currency weakness and a higher deficit will lead to higher debt ratios and in this scenario the selection should focus on issuers with solid balance sheets. We focus on a set of ratios to select the countries that we should be overweight: debt on GDP, share of foreign currency denominated debt, share of multilateral debt and last but not least short term external debt coverage.

Half of EM issuers have a debt lower than 45%, which is low by international standards, and although many of these virtuous countries are investment grade, there are as many that still offer a high yield, like Honduras, Paraguay and Azerbaijan in the BB rating bucket and Benin in the single B bucket.

A large share of debt in local currency is a credit positive, because in general it is rare for a country to default on the debt denominated in a currency that it can print, therefore countries like Egypt, Morocco and Mexico with only around 20% of debt denominated in dollars or euros will suffer less from a depreciation in their currencies. A high share of multilateral or bilateral debt can also be considered a credit positive and it can help a country overcome the current crises more swiftly. Multilateral creditors usually charge a lower interest rate compared to private debt and usually it's easier to obtain debt relief when your debt is owed to International Financial Institutions like the IMF or to a partner country, like China in many South East Asian and African countries. Belarus, Cameroon and Georgia are the example of countries with more than 50% of their debt owed to these kind of creditors.

Lastly, countries with short term low refinancing needs compared to their cash and foreign currency revenues have a lower probability of defaulting while on the opposite side countries with high refinancing needs and low reserves are at risk of a restructuring. Mexico, Russia, India, Colombia, and Philippines belong to the first group while Mozambique, Ecuador, Senegal, and Gabon are part of the second one.

The chart below divides countries on two aforementioned ratios.

Are there any risks arising from the G20 plan on debt relief for Emerging Countries?

The 20 largest economies have pushed forward a proposal for giving some debt relief to the least developed countries and as part of the plan, private creditors were asked to take part in the restructuring of the debt. The news of a potential restructuring put some pressure on prices initially but after a few weeks the details of the plan and the rejection of the involvement of Eurobonds both by creditors and most Emerging countries brought some relief. Even for those countries where creditors might eventually agree to a debt relief, talks are just focusing on a rescheduling of 2020 coupons, and no real loss should be imposed on the bonds.

Should we expect an increase in debt defaults?

Since the beginning of the year, three countries have either defaulted or announced that they would like to restructure their debt: Argentina, Lebanon and Zambia. There is a risk that in the coming months we might see more defaults, especially from those countries that arrived to the current crisis with highly leveraged balance sheets. The good news is that the average spread paid on emerging market bonds is already pricing this risk: a spread over Treasury between 500 and 600 basis points can cushion against an increase in the default rate up to 10% yearly in the next 12-18 months. This means that even if 5% of the issuers were to default each year the performance of a basket of EM bonds would still be positive all else equal.

Which countries are we overweight our portfolios? Which ones should we avoid?

After taking into consideration all the ratios that we discussed above, we have grouped the countries in virtuous and weak ones. Some Caribbean countries like Honduras, Guatemala, and Dominican Republic emerge as some of the better places to withstand the current crisis, as they all have low debt ratios and their economies could quickly rebound once the US economy starts recovering. In the higher risk bucket, we would pick Benin, as the country not only has some of the best debt ratios in Sub-Saharan Africa, but it also enjoys a reform oriented President and a strong growth potential. Another country we like is Egypt, even though the country suffers from high debt ratios and was severely hit on the tourism side from Covid-19; we believe the authorities have the commitment to set the country once again on the fiscal consolidation path.

We are on the other side avoiding all those countries that even before the spread of Covid19 that didn't show any commitment to keep their balance sheets in order and suffered from a poor fiscal track record in the last years. We already mentioned some of these countries above, but we would also add Sri Lanka and Suriname to the list of the countries that we should avoid.

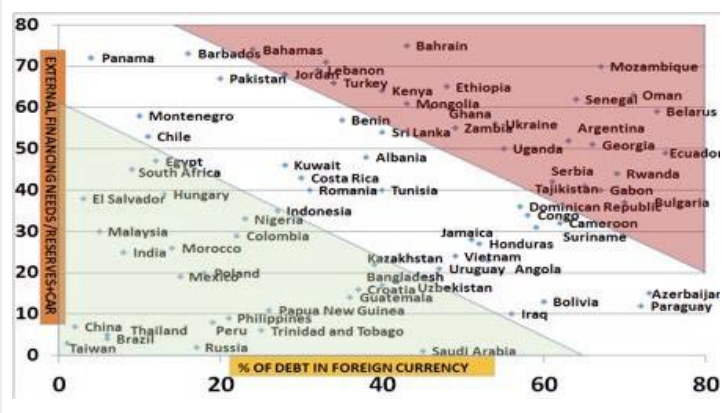
What do we think about EM Credit valuation from a historical and relative perspective?

The average spread of emerging market Sovereign bonds in dollars over Treasury bonds is around 500 basis points excluding Argentina. The historical average of this measure has been 300 basis points in the past 15 years and 400 in the past 23 years and whenever the spread has traded higher than its average, this has predicted strong returns in the next few years. Sometimes EM Sovereign credit is compared to US corporate bonds in order to gauge the relative valuation of the market. At present an average of Sovereign EM BBs yields around 50 basis points higher than an average of US corporate BBs, another indication of the good valuation of the asset class.



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