How will emerging market debt emerge from the crisis?

Key takeaways

- The impact of the recent volatility has varied greatly within emerging markets, particularly between the investment grade and higher yielding parts of the asset class. This has been reflected in the differences in yields in local and hard currency bond markets.

- Most EM countries have responded to the crisis with monetary policy, but the use of fiscal policy and virus containment measures have varied more.

- The starting point for valuations - whether that is in EM FX, EM dollar debt or the longer end of local yield curves - is currently attractive, and so at some point, we could expect strong returns from the asset class.

We’ve been through an extraordinary two months with a stark sell off in risk assets, but then we have also seen a sharp recovery. Can you talk about what you have observed over these last two months?

I have been in emerging markets (EM) for nearly 25 years and have seen several crises. I think that there are notable differences with this one. The first one is that for once, EM was not the epicentre of the crisis. Secondly, this began as a health scare, followed by an oil price shock, and now we’re facing more of an economic shock. It almost rapidly escalated into a financial crisis in March, but the unprecedented, fast and huge response from global central banks helped prevent this from happening. Thirdly, what distinguishes this crisis is that there will be an end to it, at some point, whether it’s through vaccines or immunity testing or something else, and we could see a recovery thereafter. With economically driven recessions, there is usually more ongoing uncertainty.

EM has faced a hit to global growth, falling oil prices, local virus outbreaks and lockdowns. How have these events driven EM debt markets? Did they affect EM uniformly or did we see much differentiation?

At the start of the crisis, the sell-off was very correlated, as was also the case with US credit and even US Treasuries. Very quickly, however, we saw differentiation...
between countries according to the potential impact, and we began to see an asymmetric return profile. The higher-yielding US dollar-denominated section of EM debt, and particularly those related to oil, have sold off far more than the investment grade and more diversified economies. We saw some EM credits drop around 60 points since the peak of the crisis, while some “only” dropped around 10 points, which was more in the range of US credit asset classes. The other area that was impacted was anything oil-related, so credits like Russia sold off quite sharply. There were countries that typically underperform in a crisis (because they are considered vulnerable from a funding point of view) actually holding up quite well such as Turkey. It took a while for Turkey to feel the financial and market impact of the crisis.

We have also seen a differentiation between EM local and hard currency bond markets, reflecting the quality of issuers. Local markets tend to represent the more developed issuers with higher quality within the broader asset class. In the history of the asset classes, typically the dollar index has traded at a lower yield than the local index. They have been tracking each other for the past 12 to 18 months, and now the local index is yielding significantly less (around 4.8%) than the dollar index (around 6.5%)1. However, if you take the same issuers in the local currency benchmark, re-weight them for the dollar benchmark and measure their dollar market yields, they are actually lower than the same countries’ local currency bond yields. And so, it’s not the local currency market as a whole that has held up but the higher quality, more investment grade part of the asset class.

Even within the local currency markets, there was a marked difference between returns for local currency and dollar investors. In local currency terms, local bonds were only down around 1% in March, whereas we saw double-digit losses for the dollar-denominated part of the asset class1. What damaged returns for hard currency owners of the asset class was the exchange rate, which has moved a lot more, and that’s what’s expected in a crisis.

Can you give us a flavour of how dysfunctional the markets have been over the past two months?

Several factors have combined to create a perfect storm in EM debt markets. The pandemic created fear and resulted in a correlated sell-off, followed by an oil price shock, which tends to impact EM as a commodity-related asset class. At the same time, passive exchange-traded funds (ETFs) were unwound in very large amounts, with demand for US Treasuries and dollars that couldn’t be met, all while banks and intermediaries were impacted by the practicalities of working from home, including that of the role of intermediation, which was impeded by regulations against risk-taking activities outside of an authorised environment.

The good news was that the impact these issues had on market functioning was recognised very early by the US Federal Reserve (Fed), the European Central Bank (ECB) and other central banks, including within EM. Their actions allowed the system to become “unplugged”, and slowly liquidity started draining through the system, creating a two-way flow again for the market. After two to three very difficult weeks, global central banks managed to prevent a financial crisis from

Past results are not a guarantee of future results.

1. As at 13 May 2020. Local index is the JPMorgan GBI-EM Global Diversified Index. The dollar index is JPMorgan EMBI Global Diversified. Source: Bloomberg.
developing. In terms of where we are now, liquidity is still an issue, but much less than before, and we can now trade.

What have you seen in terms of capital flows over the past couple of months?

We have seen outflows at a magnitude never seen in the asset class. In April, flows did recover somewhat as liquidity picked up with a lot of domestic and some offshore repositioning. In May, flows have so far picked up as well, some of which is likely the spill over from the Fed, creating a “circle of trust” around certain asset classes. It was also probably helped by people becoming more confident about an eventual end to the crisis with the easing of lockdowns. Whether these inflows can continue will depend on market sentiment, which in turn will depend on the path of the virus, the outlook for oil prices, Chinese growth, continued liquidity support as well as geopolitics and politics. For now, it feels as though the flows’ dynamics are looking better.

Can you talk about the spectrum of measures that have been implemented across countries? How do you expect these to evolve?

Initially there was less of a policy response from EM countries compared to developed markets (DM). Once EM authorities started to act, nearly all EM countries used monetary policy by cutting interest rates or providing liquidity. Local market yield curves have steepened as a result, given the greater uncertainty around inflation. I find that quite encouraging in terms of showing a level of feed through of policy rates and a response in the markets to likely economic outcomes. Looking ahead, there could be some more room for EM authorities to ease monetary policy, although the impact on the exchange rate and inflation will be a factor of consideration.

On the fiscal front, there have been varying degrees of government responses. I think we’ve seen a more rapid fiscal response from the more developed, higher rated EM countries and those more integrated with developed markets. But we have also started to see far more fiscal policy announcements recently, including India’s very large fiscal package announced on Wednesday (13 May).

Measures containing the virus range from total lockdowns in EM to very few restrictions in some countries. Given that EM countries’ health care systems are generally less equipped to deal with the virus, there is an ongoing discussion in EM about the trade-off between the economic impact and the ability to actually manage the virus through lockdowns.

In terms of ongoing policy, as developed markets begin to ease lockdown restrictions, expand fiscal policy and keep pushing money through the system, this is likely to encourage EM countries to be more confident about doing more themselves. Some of this may cause difficulties in the long term, especially on the fiscal front, but some is necessary, at least in the short term. One of the countries that I worry about is Brazil. Brazil has a sophisticated central bank and a deep domestic savings base, so it does have more monetary policy tools than many other EM countries, but I think its current quantitative easing might cause problems in the future. Nevertheless, one positive factor is that most EM countries came into this crisis in better shape with respect to external vulnerabilities than they have historically, and with the large drop in domestic demand, that trajectory has continued to improve in the short term. This means

that EM countries have more of a cushion than they did in the past when twin deficits were a major issue across many countries.

How do you think globalisation trends will impact EM following on from the crisis?

Many EM countries are focused on commodity provision, and the location of commodities can’t be changed. I think the investment that has occurred in Africa may continue. In terms of whether the US will bring all manufacturing onshore, I don’t think they will because of the expense and the skill set needed. On the contrary, more US manufacturers may relocate their whole production to countries such as Mexico and export from there instead of partial exports. However, one area that may become more local is food production as this crisis has highlighted the bottlenecks in the system, although I think that these trends have been happening anyway with the cost of importing food and environmental impact. Finally, it’s important to note that while a lot of EM countries are very open and integrated with the global economy, many of the larger EM economies are very domestically oriented, such as Brazil or South Africa, so the impact needs to be assessed case by case.

There has been a lot of discussion about debt relief and IFI\(^3\) involvement. What has been discussed so far, and do you think the announced relief is sufficient?

There are various programmes already in place. The World Bank’s IDA\(^4\) programme generally helps the world’s poorest countries but also includes some large and populous EM countries such as Pakistan and Nigeria. The International Monetary Fund (IMF) also has various lending facilities, including rapid credit facilities in the form of unconditional loans. The size of these loans is generally around US$500 million to US$1-3 billion in most cases, so they won’t completely solve the problems but they should potentially help. Several countries also have Stand-By Arrangements (SBA) with the IMF already in place, such as Mexico. We have recently seen Egypt apply for an IMF package, and we’re likely to see other countries follow suit. The IMF has more firepower and is looking at what else it can do, but it is not unlimited.

There has also been a lot in the press about G20 debt relief, providing near-term relief on coupon and principal payments in 2020. The G20 has asked for private sector’s participation but this is an ongoing debate. The private sector has stressed the importance for markets to remain open and use the private capital markets if they can. If countries have access to credit, then they can refinance at relatively low interest rates (despite spreads being higher than they were before the crisis), which is important for long-term structural support, ongoing market access and credibility.

Has the crisis led to a rise in EM countries defaulting on debt? Do you expect more countries to default going forward?

We currently have five EM countries in default, restructuring programmes or likely heading into one, which is unusually high. Interestingly though, four of them were already heading into a restructuring before the crisis - Lebanon,

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3. International Financial Institution
4. International Debt Association
Argentina, Zambia and Venezuela. The only restructuring triggered by the current crisis was in Ecuador.

There may well be more defaults to come, although I don’t expect it to be a 2020 problem given the liquidity provisions. Many EM countries have issued dollar debt over the past several years as a result of easy liquidity from quantitative easing, but not many countries are in a precarious situation at this stage. The countries that are getting closer to the risk of some kind of restructuring have been weak for a long time, such as Bahrain or Sri Lanka. Larger countries like Brazil also face debt challenges. In Brazil’s case though, it is more the amount of domestic rather than external debt that is the problem. If markets remain open, these countries may be able to issue longer bonds, which is better than an international financial institution (IFI) bailout or restructuring from the standpoint of markets. If market sentiment changes or the crisis deepens, one or two countries may struggle, particularly if oil prices don’t recover. For some countries that are, bilateral creditors might be an option, and we’ll be watching these geopolitical dynamics. There are also cases in which the market is pricing in a potential default or restructuring, but I expect them to be able to get through it, such as Gabon or Angola.

**EM exchange rates seem to have weakened significantly. Is this a concern for you? Do you expect that to continue or do you think we could see EM currencies strengthening from here?**

EM exchange rates have been weakening for the past few years as policymakers have used the exchange rate as a pressure valve to deal with macroeconomic headwinds. While this has been painful for dollar investors of local currency debt, it may have mitigated the risk of greater economic problems. Most EM countries have quite open economies, and they rely on trade and cheaper currencies to make them more competitive. Historically, EM currencies tended to be pegged, but they were often held too high for too long, and then when they finally broke, it was very damaging. During this crisis, nearly all the oil currencies moved very quickly in sync with oil prices when they fell, with the exception of Nigeria, which seems to be trying to work out how to slowly weaken its peg, resulting in two exchange rates operating.

In terms of value, EM exchange rates look cheap on any fundamental analysis, but that may not mean that now is the time to buy EM FX. We need to see improved global growth dynamics and more assurance around global interest rate direction. I would also expect EM exchange rates to do better when we see a recovery in commodities, which typically coincides with a weaker dollar. Once this takes place, EM exchange rates should potentially look attractive on a relative basis, particularly with the interest rate differentials. So, the value is there, but I’m not sure that the factors that are needed in place are there yet, and we may see another leg lower before we see a turnaround.

**Are you worried about the inflation in EM?**

Inflation has come down considerably in EM over the past several years, but this has been due to the same disinflationary trends that the rest of the world have experienced, rather than just EM central bank policy. Although EM central banks were very quick to cut interest rates earlier in the crisis, I expect them to raise rates more quickly than the developed world, where there’s almost a commitment now to anchor short rates. I do think that inflation will potentially
return in EM, and the question will be how contained it will be. That will be based on factors unique to each individual EM country.

**How do you see valuations of local currency and hard currency debt?**

There are higher yielding parts of the US dollar market that have sold off disproportionately and look attractive. That said, I wouldn’t load up on distressed debt as I think it’s important to have a diversified portfolio from a portfolio construction perspective, given the multiple ongoing macro and economic risks. Within local currency markets, the carry component has been relatively attractive compared to developed markets and consistent (although in the core countries this has now fallen); it’s the exchange rates that have dragged returns down for dollar investors, and at some point, I would expect currencies to start contributing to returns. It’s also important to note that there are opportunities outside of the benchmark for both local and hard currency bonds.

**What are the major drivers in the market that are shaping your views on EM debt right now?**

I would highlight three key drivers that needs to be considered carefully to invest in EM debt over the next 12 to 24 months. These drivers all have a new angle following the crisis. Firstly, Brazil is a major focus for us given its debt levels and how it’s going to manage its widening fiscal deficit and potentially problematic political situation. Given the size of the country, thinking through potential scenarios is going to be important over the next twelve months. Secondly, on a broader level, I always think about global macro drivers, whether they are geopolitical or economic. With the current US president, there has been a great deal going on with NAFTA (North American Free Trade Agreement) and Chinese-US trade tensions, driving asset class sentiment over the past few years. That will probably continue and may take a different turn as we come out of this crisis. I think that some dynamics will potentially start to shift in terms of alliances behind the US responses and Chinese responses. It will be important to watch who the providers of liquidity to the poorer countries in order to gain influence are. And thirdly, there has been a rising trend in populism, and I think that this crisis is going to bring it to a head. EM has a lot of autocratic politicians now, and this crisis is likely to exacerbate some of those socioeconomic trends that brought those people into power. Looking forward, it is worth considering whether these politicians can gain or lose power from their handling of this crisis and steering their countries through major economic damage and recession.

**Finally, what are your return expectations for the year for EM debt?**

I expect flat to positive returns in EM debt for the year as a whole, with some months of negative returns and plenty of months of positive return like April. I expect a stronger rebound to come at some point, potentially in the fourth quarter of 2020 or the first half of 2021. The starting point for valuations – whether that is in EM FX, EM dollar debt or even the longer end of local yield curves – is attractive. So, at some point, I think we’ll have very strong returns. What I’m not clear on yet is whether that comes in a short and sharp way, or a gentle grind upwards over the next 18 months. I think it’s probably more likely to be the latter.
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