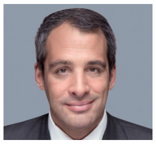
Market Insight

Emerging markets resilience in the COVID-19 pandemic

Contributors



Jean-Dominique Butikofer, CFA
Head of Emerging Market Debt

Samuel K Ayenu-Prah, CFA
Analyst, Emerging Market Debt

Fortified by boom-bust cycles

Developing countries have been going through episodes of growth volatility and financial stress since the 1980s, notably the Asian financial crisis of 1997/98 and the Global Financial Crisis of 2008/09 being the two most notorious. However, as the recognition of emerging market debt (EMD) as an investment kept increasing, these boom-bust cycles were paving the route for the asset class' growth and evolution. By navigating through previous cycles, developing countries enhanced their respective abilities to manage through such episodes, honing their experience in crafting the appropriate public policy mix, often including support from external resources, such as the International Monetary Fund (IMF) and Group of 20 (G20) countries. Furthermore, while the number of EM foreign currency (FC) debt markets keeps growing – as of June 2020 there are more than 70 investable FC countries, according to the *JPM EMBI Global Index* — numerous countries have gone through debt stress scenarios and restructuring, foreign bailouts, and contingent economic reform programs. The COVID-19 pandemic notwithstanding, Venezuela, Ecuador, Argentina, Lebanon, and Zambia were already discussing and renegotiating their debt.

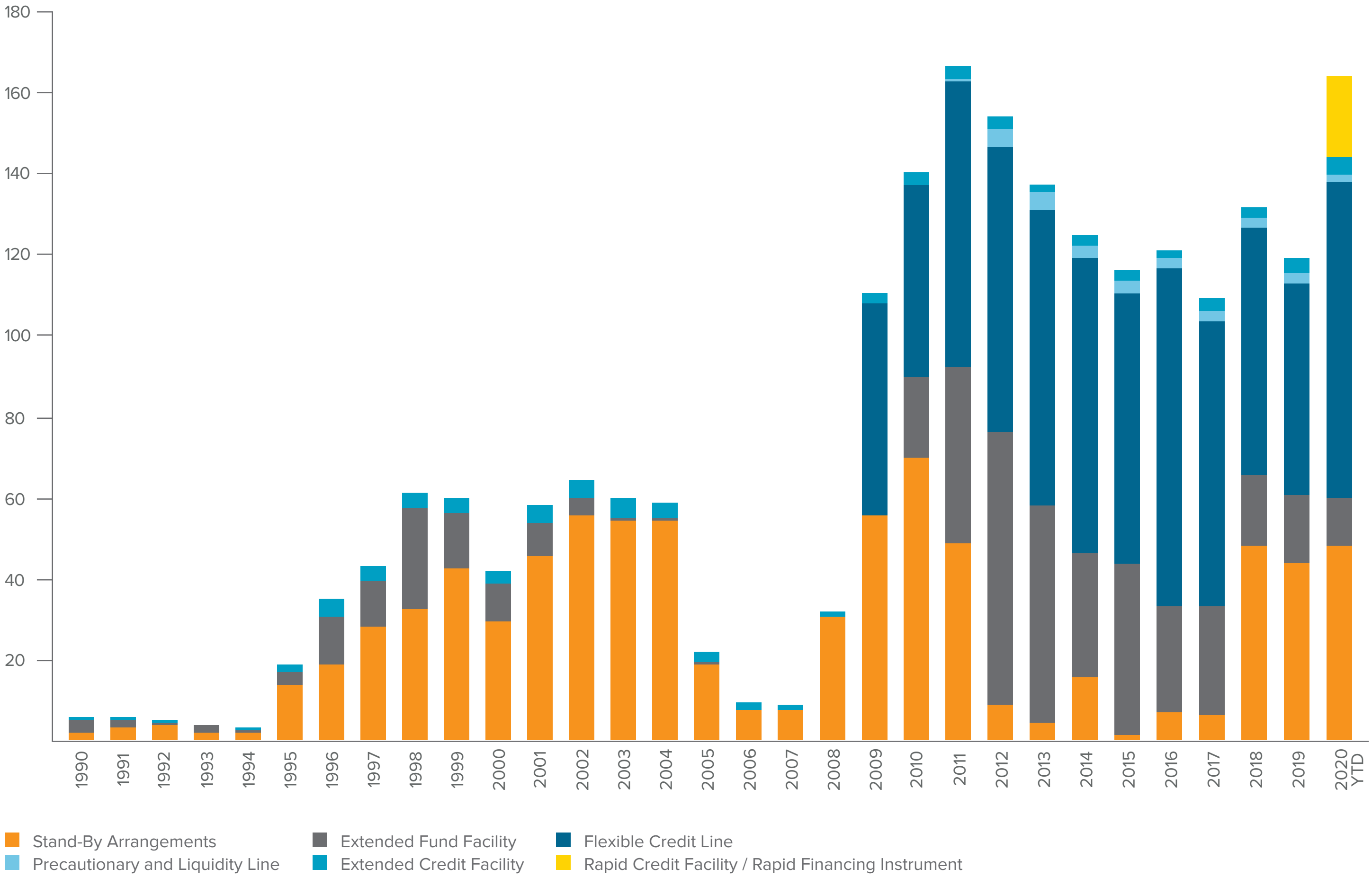
Seasoned EMD investors have witnessed repeatedly how global risk aversion and sudden capital outflows have exacerbated countries' fundamental vulnerabilities while simultaneously distorting their risk premiums to extremes. The COVID-19 pandemic, which triggered violent market price dislocations in the first quarter of 2020 and subsequent massive capital outflows, is no exception to the previous financial crisis. As the pandemic accelerated, EM growth prospects were revised significantly down, leading to growing macroeconomic imbalances, not to mention all the potential humanitarian consequences, effectively weakening the arsenal of public policy response tools and exacerbating the short-term financing and debt roll-over risks. Ratings agencies reacted as well, and downgraded many countries' ratings and outlooks. As such, the IMF and G20 nations had to intervene and ringfence a variety of EM countries.

Unprecedented and coordinated support for emerging markets

Emerging market countries with enough fiscal cushion and low levels of debt adopted broad-based domestic measures to address the global economic tumult. Taking cues from their developed market counterparts' interventionist model, these steps included fiscal and monetary policy loosening in the form of massive rate cuts, quantitative easing, and asset purchases (currencies and bonds). But it was not enough to curb the gloomy perception that – as in previous crises — emerging markets would face another round of balance-of-payments and debt crises.

The IMF and the World Bank (WB) working together with the G20 pledged to support EM countries at the "peak" of the pandemic. As such, the IMF and other international financial institutions (IFIs) decided to offer debt relief and financial support to protect EM countries from default and alleviate liquidity and roll-over risks. Importantly, not all EM countries faced the same magnitude of challenges. While the COVID-19 viral pandemic is novel, the IMF's response to crises impacting the EM world, regardless of their origin or scale, is not. For decades, the IMF has been lending to help member countries tackle balance-of-payments problems, stabilize their economies, and restore sustainable economic growth (Figure 1).

Figure 1. IMF Lending Arrangements Outstanding (in billions of SDR)



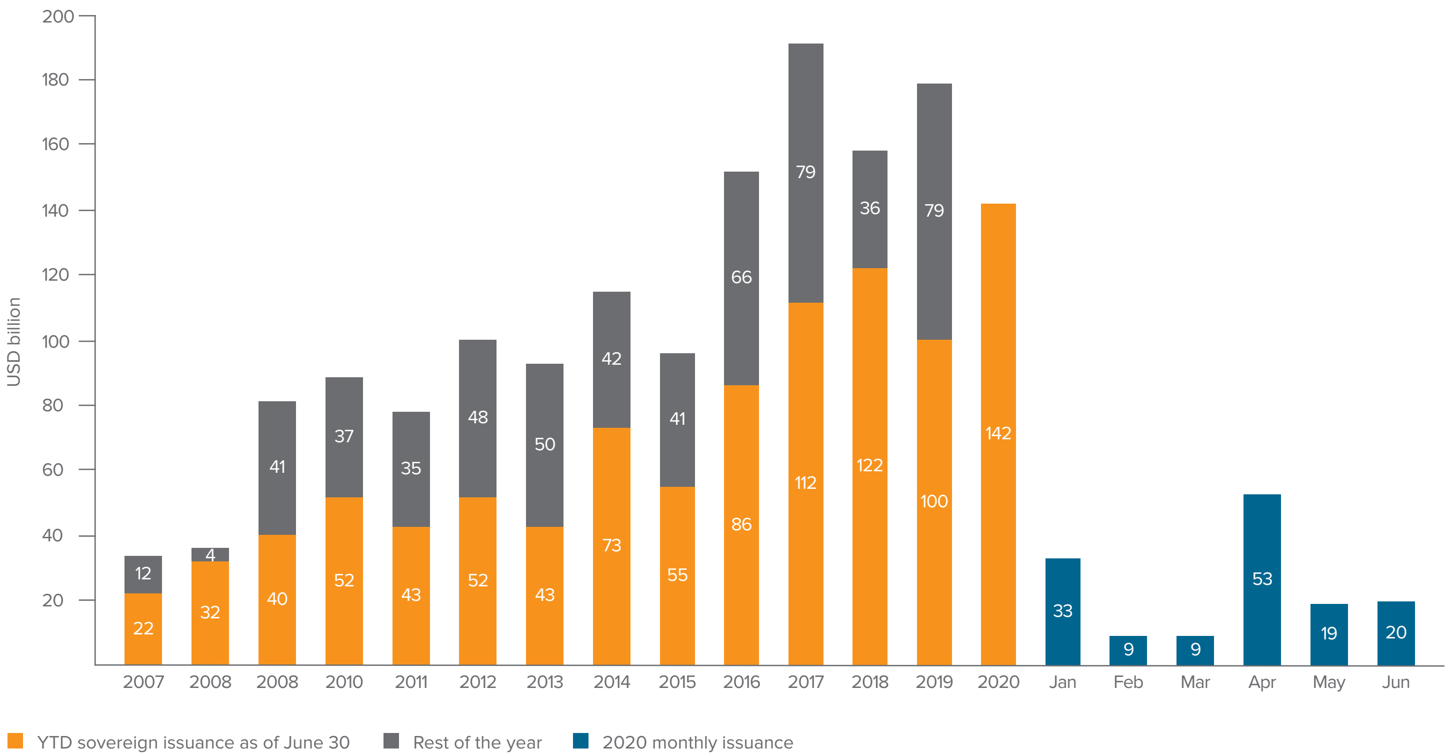
Source: IMF; https://www.imf.org/external/np/fin/tad/extarr1.aspx

During the 2008 Global Financial Crisis, IMF lending targeted effective global financial safety nets to help countries cope with adverse shocks. With high COVID-19-driven uncertainty plaguing markets as broadly as it is, official lenders increased the attention and the focus on what amounts to a small portion of the foreign currency "EMBIG" universe (publicly traded hard currency debt), i.e. the more vulnerable frontier and satellite countries, such as Nigeria, Ghana, Mongolia, Pakistan, and Honduras, among others. For these low-income countries, the G20 referred to the WB International Development Association ("IDA") list to channel their aid and financial support.

The G20, IMF and World Bank supported an initiative called the Debt Service Suspension Initiative (DSSI) for both principal and interest until December 2020. They aim to alleviate refinancing risks and give low-income countries (DSSI eligible ones) enough time to divert their financial resources to curb the effects of the pandemic. The potential unintended consequences related to forbearance for publicly traded debt have shown the practical limitations behind that initiative (selective default, limitation of market access, and increased cost of funding). Discussions between DSSI eligible countries and official bilateral and multilateral creditors will go on while private creditors will be exempt. Currently, eligible sovereign borrowers prefer to keep access to bond markets rather than pay the unintended consequences of forbearance. Beyond the IDAs (or DSSI eligible), the IMF has offered various forms of support for most of the countries in the EMBIG adding an ever-greater safety net. Out of the 74 EMBIG countries, 42 have received IMF/G20 assistance, or are in latter stages of reaching an agreement (as of June 30, 2020).

As markets started to stabilize during April, capital flows reversed, including passive funds flows, funding costs and exaggerated elevated risk premiums recovered from stressed levels. This early green light opened the door to promising sovereign debt new issuance (Figure 2).

Figure 2. EM sovereign issuance for 2020 has been robust in the face of the pandemic



Source: Bond Radar, Bloomberg, Morgan Stanley, Voya Investment Management

Road to recovery, living with COVID-19, and opportunities

As market participants were expecting the worst for EM countries, the magnitude of EM and developed markets monetary policy easing, including U.S. Federal Reserve actions, and the massive fiscal support stabilized markets and led to a rebound. These global liquidity injections, central bank interventions and massive quantitative easing led to better financing conditions for debtors and triggered a return of capital flows chasing attractive EM risk premiums. The unprecedented IFIs support and the ability of EM countries to easily access debt capital markets gave a boost to investors' confidence. EMD risk premiums have priced this new norm of sub-par growth, overall higher debt levels, and low-for-long interest rates.

While the output loss due to the pandemic will take a few years to resorb, leading and confidence indicators are showing an encouraging upward economic trajectory as the lockdowns loosen. As the world is adapting to new sanitary and social constraints related to the pandemic, we expect emerging markets, starting in the second half of 2020 - led by Asia as a whole and China in particular- to rebound strongly in 2021 and outperform developed markets.

In addition to attractive financing conditions, another EM vulnerability has also improved lately: the funding of external accounts is less severe due to improvement of current account balances and a surge in capital flows. Nevertheless, we are monitoring closely the economic prospects and growth drivers beyond the initial rebound from lockdowns, as risks related to persistent weak global trade, and possible renewed lockdowns impacting external demand and commodities, may lead to a resurgence in market volatility. Even as the epicenter of the pandemic has moved to Latin America, we feel confident that EM countries have accumulated enough experience to navigate through boom-bust environments and are prepared and supported to navigate future volatility going forward.

Nevertheless, the economic rebound will be not be equal or synchronous across EM countries. While some will adapt to the new growth models, we think that active country and blue-chip corporate credit selection within our favored countries potentially will generate expected excess returns. In our view, any period of renewed risk-premium volatility should be seen as an entry opportunity for long-term diversification into EMD.

CMMC-EMDUPDATE 071720 • IM1248952 • 212288 • WLT250004509