The US-EM high yield default rate differential widens to 2%

By Jan Dehn

Emerging Markets (EM) Corporate high yield bonds trades at 184bps wider than US Corporate high yield in spite of much lower default rates. Ecuador's President Moreno entered into talks with the opposition to review a controversial cut in fuel subsidies following two weeks of protests. A no confidence vote in the Romanian government may pave the way for positive fiscal developments. Brazil sets out on the long road to making its currency convertible. South Africa's fiscal balance worsens. Nigeria's economic policies are heading in the wrong direction. Indian growth slows and RBI takes action. The global backdrop delivers three positive and one negative development. The Fed begins to buy bonds in what appear to be an attempt to facilitate greater government spending.

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	11.6	–	1.54%
MSCI EM Small Cap	10.8	–	0.50%
MSCI Frontier	9.1	–	0.62%
MSCI Asia	12.3	–	1.58%
Shanghai Composite	10.7	–	1.42%
Hong Kong Hang Seng	7.9	–	2.27%
MSCI EMEA	9.1	–	1.73%
MSCI Latam	12.3	–	0.41%
GBI-EM-GD	5.17%	–	0.27%
ELMI+	4.77%	–	0.41%
EM FX spot	–	–	0.22%
EMBI GD	5.19%	340 bps	-0.34%
EMBI GD IG	3.53%	172 bps	-0.70%
EMBI GD HY	7.42%	566 bps	0.08%
CEMBI BD	5.11%	342 bps	-0.08%
CEMBI BD IG	3.67%	198 bps	-0.33%
CEMBI BD Non-IG	7.19%	549 bps	0.28%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	16.3	–	0.66%
1-3yr UST	1.60%	–	-0.34%
3-5yr UST	1.56%	–	-0.90%
7-10yr UST	1.73%	–	-1.77%
10yr+ UST	2.20%	–	-3.60%
10yr+ Germany	-0.47%	–	-2.71%
10yr+ Japan	-0.18%	–	-0.62%
US HY	5.79%	390 bps	0.31%
European HY	3.92%	431 bps	0.27%
Barclays Ag	1.37%	-36 bps	-0.83%
VIX Index*	15.58	–	-1.46%
DXY Index*	98.44	–	-0.52%
EURUSD	1.1025	–	0.48%
USDJPY	108.24	–	0.91%
CRY Index*	176.04	–	2.54%
Brent	59.7	–	2.35%
Gold spot	1488	–	-0.37%

Note: Additional benchmark performance data is provided at the end of this document. *See last page for index definitions.

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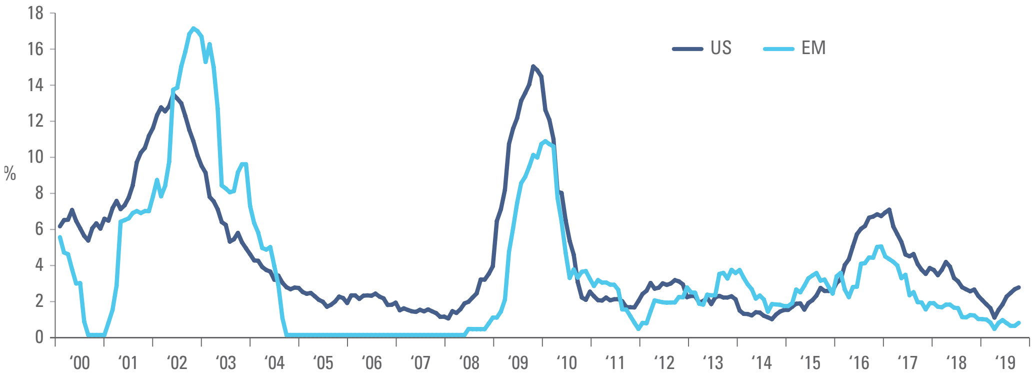
The default rate for EM corporate high yield (HY) bonds fell to 0.7% in September 2019, according to an update from Bank of America Merrill Lynch. This compares to 1.1% a year ago with a long-term average default rate of 3.4% (Figure 1). By contrast, the default rate for US HY corporates has increased to 2.7% from 2.5% from a year ago with a long-term average default rate to 4.4%. It is likely that the worsening performance of US HY corporates reflects the policy environment in the US with respect to trade, the halving of US growth rates over the past 12 months and lower energy prices.

Fig 1: **Default rates**



Source: Ashmore, BAML. Data as at September 2019.

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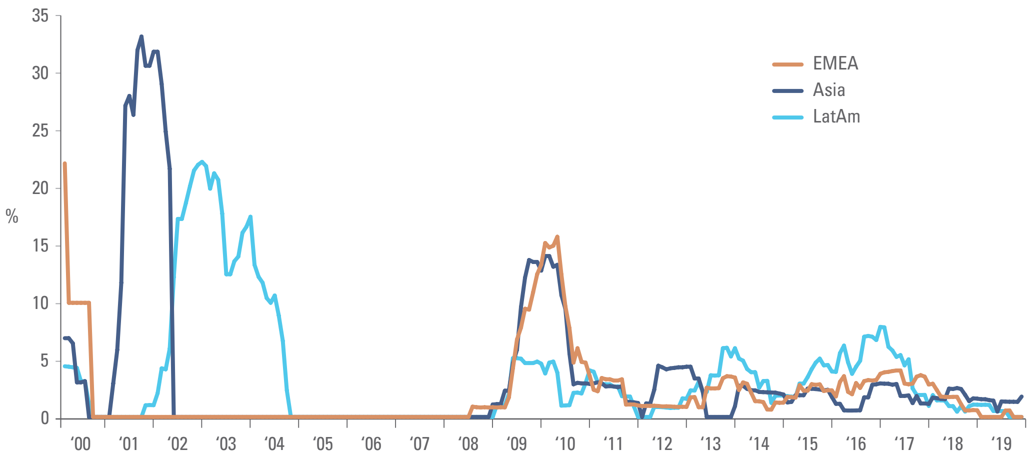
By contrast, EM HY corporates saw a broad-based decline in default rates (Figure 2). Eastern European and Latin American HY corporates have not recorded any defaults in the last three months and have seen default rates generally decline since late 2016. Asian HY corporates default are at slightly higher rates, but far below their 3.4% long-term average.

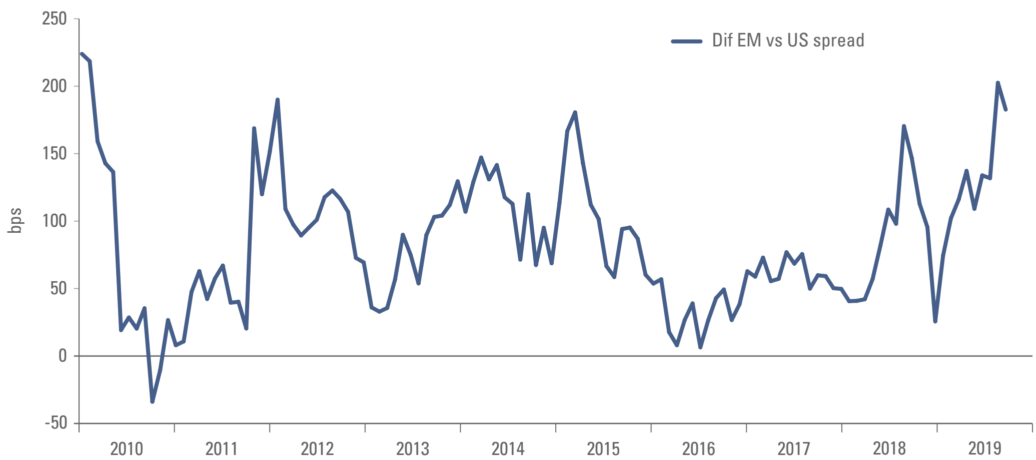
Fig 2: **Default rates by EM region**



Source: Ashmore, BAML. Data as at September 2019.

Interestingly, current valuations don't reflect the much lower levels of EM HY corporate default rates – a full 2% below those of US HY corporates. EM HY bonds traded at 557bps over US Treasuries, 184bps wider than US HY corporates at 373bps, at the end of September. This is the widest spread differential since late 2009 (Figure 3).

Fig 3: **Spread on EM HY corporate bonds less US HY corporate bonds spread**



Source: Ashmore, BAML. Data as at September 2019.

How often does EM HY trade at such wide spreads to US HY corporates when the default rate differential so strongly favours EM? Based on monthly data for the past 17 years (ie since records began), EM HY traded tighter than current spreads versus US HY bonds more than 86% of the time when default rate differentials were around 2% in favour of EM. Indeed, the modal spread for EM HY versus US HY when the default rate differential has been in the range from 1.75% to 2.25% in favour of EM HY is only around 50bps as shown in Figure 4. There have only been six occasions in the past 17 years, when EM HY has traded wider than today, given the current default rate differential.[1]

[1] To arrive at these numbers, we first identified all the months in which EM HY default rates were between 1.75% and 2.25% below the default rate for US HY. Next, we identified the spread versus US HY corporates in those months. We found that EM spreads were narrower than today more than 86% of those times.

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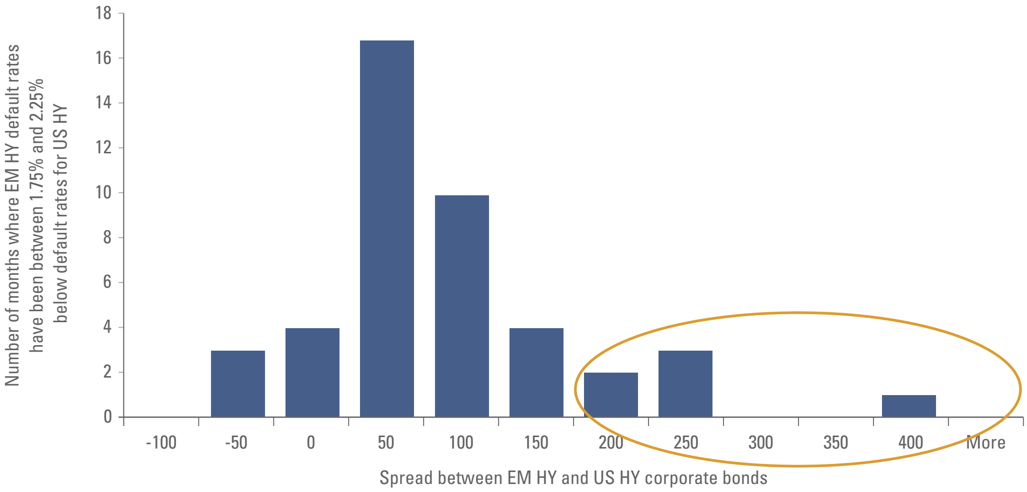
Fig 4: **How often have EM HY bonds traded at different spreads with a favourable default rate differential versus US HY corporates in the current range from 1.75% and 2.25%?**



Source: Ashmore, BAML. Data as at September 2019.

Lower default rates indicates a safer investment. Wider credit spreads indicate investors are being paid more. In other words, EM HY corporates are a safer and more attractive investment than US HY corporates at current valuations and default rates, and we believe that the outlook is likely to remain the same or going to improve. EM economies have faced major headwinds, such as a halving of commodity prices, the Taper Tantrum, a 50% Dollar rally, China's slowdown, trade wars, and the entire Fed hiking cycle. By contrast, US HY corporates have been sheltered by low rates, plentiful liquidity and a demand for US credit from investors from all over the world in the past ten years. However, this has led to more levered US HY corporates which trade with tighter spreads despite US protectionism and an approaching recession. In this context, we believe that investors can both increase returns and reduce risks by shifting their HY exposure from the US to EM.

- Ecuador: President Moreno has agreed to review controversial fuel subsidy cuts implemented on 1 October following two weeks of protests. CONAIE, the main indigenous group opposed to the subsidy cut, has halted protests. The two sides are likely to move towards a new agreement, which curtails subsidies, possibly over a longer time frame, while granting greater protection to vulnerable groups.

- Romania: The PSD-led government lost a confidence vote. A new government will now be formed within 45 days or fresh elections will be called. This is good news. The PSD-led government has approved a 40% increase in pensions, which would severely worsen the fiscal outlook. This law now has a chance of being overturned. Core inflation on yoy basis declined to 3.5% in September from 3.9% yoy in August.

- Brazil: The government presented a set of legal reforms designed to pave the way for BRL to eventually become a convertible currency. The reforms, which will simplify and modernise Brazil's bureaucratic and cumbersome currency regime, would also significantly lower the cost of doing business in Brazil. Brazil, like many other large EM countries, could see their currencies emerge as global reserve currencies over the coming years, which would be of enormous benefit in terms of stability and lower transactions costs. To achieve this, EM countries face two major obstacles. First, the need to overcome resistance from existing issuers of reserve currencies, who are likely to defend their turf against newcomers. Second, they need to get their own house in order, which is exactly what Brazil is currently doing. In other Brazilian news, headline CPI inflation turned negative in September (-0.04% mom), which brought CPI inflation down to 2.89% on yoy basis.

- South Africa: The latest fiscal revenue numbers are troubling. Combined with rising expenditures, the South African fiscal balance is now on track for a deficit in excess of 6.0% of GDP compared to the government's initial estimate of 4.3% of GDP. The bailout of the loss-making energy giant, ESKOM is a significant part of the negative surprise on the fiscal burden. The roadmap for reforming ESKOM is scheduled for publication around the end of October.

- Nigeria: The government's decision to close the country for food imports in order to create better prices for local producers appears to have led to a large increase in inflation. Furthermore, the latest data suggests that the central bank may have begun to finance the Federal Government. If so, Nigeria's policies are not dissimilar to those implemented in Argentina during the government of Cristina Kirchner, which resulted in significant inflation and economic deterioration.

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- **India:** Industrial production was down 1.1% on a yoy basis in August. This was worse than expected (+1.7% yoy). The Indian economy tumbled after the recent election due to fiscal contraction, weakness in housing and banking sector problems. In response, the Reserve Bank of India cut the policy rate by 25bps to 5.15% with an easing bias.

- **Poland:** As of this morning, the vote count in the parliamentary election shows that the governing Law and Justice Party has secured more than 49% of the votes. The main opposition party Civic Coalition received 22% of the vote. The other opposition parties received fewer votes. The Law and Justice Party received 37.6% of the vote in 2015. Based on the partial vote count, the Law and Justice Party should receive a comfortable majority of seat in parliament. We do not expect significant changes in policy.

Snippets:

- **Argentina:** Presidential candidate Alberto Fernandez stated last week that his administration aims to appoint a credible Finance Minister and that Vice-Presidential candidate Cristina Kirchner will have 'zero' influence on policy. This is consistent with our view.[2]
- **China:** The September Caixin PMI moderated to 51.3 from 52.1 in August. Exports were 3.2% lower in September than in the same month of 2019. Imports were also down on a yoy basis (-8.5%).
- **Colombia:** CPI inflation on a yoy basis edged higher to 3.82% in September from 3.75% yoy in August.
- **Costa Rica:** The primary deficit for the year to September has declined to 1.4% of GDP from 1.9% a year ago due to stronger revenues following a recently approved VAT reform.
- **Czech Republic:** At 2.7% yoy, the CPI inflation rate in September was lower than expected (2.9% yoy).
- **Hungary:** CPI inflation declined to 2.8% on a yoy basis in September from 3.1% yoy in August. Prime Minister Viktor Orban suffered his first electoral defeat since taking office in 2010 as pro-European centre-left Gergely Karacsony won the mayoral election in Budapest.
- **Malaysia:** The government presented the 2020 Budget with a fiscal deficit of 3.2% of GDP, embedding a contraction in expenditure of 2.4% of GDP relative to 2019.
- **Mexico:** CPI inflation declined further on a yoy basis in September to 3.0% compared to 3.2% in August and 4.8% yoy at the end of last year. Gross fixed investment was slightly better than expected in July.
- **Peru:** President Martin Vizcarra's approval rating soared from 52% to 82% due to his tough stance on corruption. Vizcarra suspended the Parliament one month ago, when its leaders tried to block legislation aimed at eradicating corruption in politics. In other news, the central bank left the policy rate unchanged at 2.5%.
- **Philippines:** The trade deficit narrowed to USD 2.4bn in August from USD 3.4bn in July. The consensus expectation was for a deficit of USD 3.6bn.
- **Russia:** The current account surplus narrowed to 5.8% of GDP in Q3 2019 from 6.7% of GDP in Q2 2019 on the back of a decline on oil prices.
- **Serbia:** CPI inflation on a yoy basis moderated to 1.1% in September from 1.3% yoy in August.
- **Singapore:** The Monetary Authority of Singapore eased FX policy slightly based on its expectation that the output gap will remain negative going into 2020.
- **Slovakia:** The yoy rate of growth of industrial production slumped -8.1% in August after rising at a rate of 2.8% yoy in July. The central bank left the policy rate unchanged at 2.5%.
- **Slovenia:** Industrial production was 0.8% higher in August on a yoy basis following a strong rate of expansion in July (5.0% yoy).
- **Sri Lanka:** The government has approved a major Singaporean foreign direct investment of USD 20bn into a refinery project in Hambantota.
- **Taiwan:** Exports slumped in September on a yoy basis (-4.6% yoy versus +2.6% yoy in August).
- **Tunisia:** Tunisians voted overwhelmingly voted in favour of a reformist candidate in the president election at the weekend. Law professor Kais Saied, who favours a continuation of the revolution of 2011, won a landslide victory, according to exit polls.
- **Turkey:** The current account surplus increased from USD 1.1bn in July to USD 2.6bn in August.
- **Vietnam:** Moody's placed Vietnam's credit rating (Ba3) under review for downgrade citing institutional weaknesses. The review is likely to be completed within three months.

[2] See *'Argentina Q&A'*, The Emerging View, 23 August 2019.

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Global backdrop

The US Federal Reserve has resumed asset purchases to alleviate the liquidity problems facing primary dealers. The tightness of liquidity conditions is the result of the rising US fiscal deficit, which is expanding the supply of Treasuries concomitant with the Fed halting its Quantitative Easing (QE) programme. The Fed insists the asset purchases are not QE, since their aim is not to lower term rates. We agree. The aim is clearly to facilitate greater fiscal spending.

In addition to Fed asset purchases, the global backdrop improved on three fronts and worsened on two fronts.

In the first positive development, UK Prime Minister (PM) Boris Johnson seems to have stumbled upon a formula that may break the deadlock in negotiations over the UK's departure from the European Union (EU). The agreement's details are unknown, but it is believed to 'sit' somewhere between the terms proposed by former Prime Minister Theresa May, and a pure 'no deal Brexit'. Both these extremes have been rejected by the UK Parliament. It remains highly uncertain if the new deal will be approved. PM Johnson will meet with EU representatives Thursday in a summit aimed at sealing the initial terms of the 'divorce' settlement. From Thursday, the UK parliament will have two weeks to deliberate. Estimates from leading UK fiscal think tanks put the likely damage to UK growth at 7% of GDP in addition to a GBP 50bn fiscal cost over ten years. Regardless of the eye-watering costs for UK citizens, an agreement would remove a large source of uncertainty from the global backdrop ('no-deal Brexit'), which should be viewed as good news from the perspective of EM investors.

The second positive development was the agreement to suspend planned tariff hikes on China by US President Donald Trump after the two sides struck a mini trade deal, which is almost identical to a deal, which was on the table two years ago. At the time, Trump hoped he could achieve a better deal by rejecting the proposal and escalating his aggression against China. Two years later, the escalation has so weakened the US economy that Trump has been forced back to the original proposal. It is safe to say that the economic costs of Trump's trade war have so far vastly exceeded any so-called benefits. Nevertheless, the short term détente should be welcomed by all.

Thirdly, it is clearly positive that South Korea and Japan now appear to be moving towards a truce in their recent trade spat. South Korea's Prime Minister Lee Nak-yon is scheduled to travel to Japan this week for the Emperor's enthronement ceremony. He will visit Japan for three days. Business ties, which have been under strain in recent months, will be discussed. An agreement would support companies, which have been suffering from Trump's trade crusade against China. South Korean exports were -11.7% lower in September than in the same month of 2018 (yoy), a small improvement from August (-13.8% yoy).

On the negative side of the global risk ledger, the decision by Trump to withdraw US forces from areas controlled by Kurds in Northern Syria has led to a significant rise in broader geopolitical risk. The withdrawal of US troops created an immediate power vacuum, which was exploited immediately by Turkey, which invaded the area on the pretext of creating a safety zone to reintegrate Syrian refugees. Tensions are now escalating across the region. The Kurds, under attack by the powerful Turkish army, warned they may retaliate against the US by releasing thousands of ISIS prisoners under their control. Turkey threatens to allow Syrian refugees into Europe, should the US or the EU intervene on their operation. Meanwhile, the Syrian Government, supported by Russia is allegedly coming to the aid of the Kurds. Other interested parties may be drawn into the conflict as well, increasing broader geopolitical risks.

Secondly, in her first speech as head of the IMF Kristalina Georgieva pointed to a "synchronized slowdown" in global growth. She said that GDP growth is decelerating in 90% of the world's countries as a consequence of misguided trade policies. Specifically, the IMF estimates that global growth will take a USD 700bn hit (0.8% of global GDP) in 2020 as a direct or indirect consequence of Trump's ill-advised trade war. However, she also noted that around 40 EM economies are forecast to grow faster than 5% this year, which is now preventing the global economy for submerging. Mrs Georgieva cautioned against further monetary policy easing in countries with negative rates as prolonged low rates have negative unintended consequences. She called for expansionary fiscal policy in countries, such as Germany, Netherlands and South Korea to boost potential growth alongside structural reforms to boost productivity. As models to be followed in order to enhance productivity, she mentioned childcare reform in Chile, anti-corruption measures in Ghana and cutting of red tape in Jamaica.

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Ashmore

Benchmark performance

Emerging Markets	Month to date	Quarter to date	Year to date	1 year	3 years	5 years
MSCI EM	1.12%	1.12%	7.33%	9.06%	6.64%	3.26%
MSCI EM Small Cap	0.42%	0.42%	2.45%	4.82%	1.81%	0.45%
MSCI Frontier	-0.16%	-0.16%	10.47%	10.06%	6.93%	-0.96%
MSCI Asia	0.96%	0.96%	6.91%	9.31%	6.95%	4.96%
Shanghai Composite	2.36%	2.36%	22.13%	17.94%	1.29%	6.81%
Hong Kong Hang Seng	2.48%	2.48%	7.14%	7.50%	6.20%	4.16%
MSCI EMEA	0.95%	0.95%	6.64%	10.55%	5.41%	0.23%
MSCI Latam	1.37%	1.37%	8.00%	4.87%	6.24%	-0.29%
GBI EM GD	1.70%	1.70%	9.69%	13.58%	4.03%	0.69%
ELMI+	1.04%	1.04%	2.47%	4.61%	2.34%	-0.02%
EM FX Spot	1.21%	1.21%	-1.31%	-1.33%	-3.03%	-6.23%
EMBI GD	0.06%	0.06%	13.05%	13.43%	4.88%	5.63%
EMBI GD IG	0.03%	0.03%	15.25%	16.22%	5.44%	5.47%
EMBI GD HY	0.10%	0.10%	10.79%	10.58%	4.29%	5.69%
CEMBI BD	0.28%	0.28%	10.95%	11.45%	5.20%	5.18%
CEMBI BD IG	0.09%	0.09%	11.63%	12.59%	4.87%	4.73%
CEMBI BD Non-IG	0.55%	0.55%	9.98%	9.87%	5.80%	5.84%

Global Backdrop	Month to date	Quarter to date	Year to date	1 year	3 years	5 years
S&P 500	-0.14%	-0.14%	20.38%	11.12%	13.86%	11.53%
1-3yr UST	0.08%	0.08%	3.15%	4.49%	1.61%	1.28%
3-5yr UST	-0.05%	-0.05%	5.13%	7.74%	1.99%	2.08%
7-10yr UST	-0.43%	-0.43%	9.37%	13.97%	2.62%	3.26%
10yr+ UST	-1.58%	-1.58%	17.87%	24.91%	4.60%	5.69%
10yr+ Germany	-2.65%	-2.65%	14.08%	18.93%	4.24%	6.75%
10yr+ Japan	-0.59%	-0.59%	5.55%	8.66%	1.83%	4.66%
US HY	-0.17%	-0.17%	11.21%	7.29%	5.83%	5.38%
European HY	-0.36%	-0.36%	8.31%	4.45%	3.96%	4.38%
Barclays Ag	-0.08%	-0.08%	6.23%	8.03%	2.22%	1.82%
VIX Index*	-4.06%	-4.06%	-38.71%	-26.89%	-3.35%	-31.64%
DXY Index*	-0.94%	-0.94%	2.36%	3.38%	0.43%	14.71%
CRY Index*	1.21%	1.21%	3.67%	-11.07%	-7.09%	-35.73%
EURUSD	1.15%	1.15%	-3.87%	-4.78%	0.48%	-12.90%
USDJPY	0.15%	0.15%	-1.33%	-3.16%	3.91%	1.11%
Brent	-1.74%	-1.74%	11.00%	-25.75%	14.96%	-29.77%
Gold spot	1.06%	1.06%	16.03%	21.24%	18.90%	20.69%

*VIX Index = Chicago Board Options Exchange SPX Volatility Index. *DXY Index = The Dollar Index. *CRY Index = Thomson Reuters / CoreCommodity CRM Commodity Index.

Source: Bloomberg, JP Morgan, Barclays, Merrill Lynch, Chicago Board Options Exchange, Thomson Reuters, MSCI, total returns.
Figures for more than one year are annualised other than in the case of currencies, commodities and the VIX, DXY and CRY which are shown as percentage change.

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