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The COVID-19/Oil/US stock market triple shock: impact on Emerging Markets

By Jan Dehn

Introduction

An unprecedented triple shock from the US stock market crash, COVID-19 and falling oil prices has dislocated asset prices and impaired liquidity across all markets. The turbulent nature of this correction and the uncertain impact on people's daily personal and professional routines is understandably unnerving to many investors. But we believe it helps to put things into historical context. In this research piece, we discuss past financial shocks, health scares and oil price collapses, and analyse the markets' immediate and subsequent reaction.

While every market shock is unique, we believe we can draw some parallels that can assist investors in navigating this latest shock, protect their portfolio, and ultimately take advantage of opportunities created by market dislocation.

Even though this triple shock is unparalleled, we believe the basic principles for how to manage investments in this crisis are no different from other crises. Only those in urgent need for liquidity should contemplate any action until liquidity conditions have normalised.

In our opinion, Emerging Markets (EM) prices have already moved into clear buying territory, but buyers too should exercise discipline by setting clear buy levels and aiming to re-enter in a staggered fashion through a 'three-bullet' strategy.

Experience from past financial shocks, health scares and oil price collapses shows that EM equities and high yield segments of EM fixed income perform particularly well in the aftermath of all three types of shocks. In our opinion, re-entry to investment grade asset classes, including local currency, can be considered, but is less time sensitive.

Local market investments now look particularly interesting for those with a less positive view on the US business cycle and the Dollar.

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An unprecedented global triple shock

Global markets have been pushed into extreme dislocations by a triple shock comprising a US stock market crash, a pandemic triggered by the spread of the COVID-19 coronavirus to Western economies, and a collapse in oil prices due to a price war between Russia and Saudi Arabia.

On one hand, each of these three types of shocks is familiar to Emerging Markets investors. Since inception of the main EM benchmark indices in the early 1990s, there have been no fewer than eighteen major global financial market shocks, six significant worldwide health scares, and ten outsized oil price collapses (Figure 1).

Fig 1: **Financial shocks, health scares and oil collapses since the early 1990s**

Date	Global market shocks	Global health crises	Oil price collapses	Cause of shock
April 1994	•			Fed hikes
October 1997	•			Asian crisis
August 1998	•			Russian crisis
October 2000	•			Fear of slowing US economy
September 2001	•			9/11
July 2002	•			Fear of slowing US economy
February 2003		•		SARS
June 2006	•			Hike triggers recession fears
August 2007	•			BNP Paribas gates
August 2008			•	Global recession fears
September 2008	•			Lehman
June 2009		•		H1N1
May 2010	•		•	Greece
Mar 2011	•			Japan earthquake
June 2011			•	Recession fears
August 2011	•			US debt ceiling and Eurozone crisis
May 2011			•	Dollar rally
September 2012		•		MERS
May 2013			•	Taper tantrum
February 2014		•		Ebola
October 2014	•		•	Rate hike fears
February 2015		•		Zika
August 2015	•		•	Fed hike fears
January 2016			•	Trump election
June 2016	•			Brexit
February 2018	•			US inflation fears
November 2018			•	US recession fears
December 2018	•			US recession fear/equity plunge
February 2020	•	•	•	Coronavirus, recession fears, Saudi-Russia oil price war

Source: Ashmore, WHO, Bloomberg. Note: VIX and oil shocks defined as 10 point moves away from 60-day moving average.

On the other hand, this is the first time that the three types of shocks have occurred at exactly the same time. Moreover, the global backdrop is different from past crises in the sense that asset prices in developed markets are extremely elevated after years of Quantitative Easing (QE) policies, while policy-makers in those countries now have fewer options to offset any negative economic fallout. These unique features have undoubtedly exaggerated the recent market turmoil and impaired liquidity even beyond what is normally the case in market dislocations.

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An unprecedented global triple shock

Managing EM through a global triple shock

Despite the unprecedented nature of the on-going triple shock, the basic principles for how to manage investments in this crisis are no different from other crises. Instead, the triple shock has impacted the size of the opportunities, which may be greater than normal, and the breadth of the opportunity set, which may be wider than usual. Investors should therefore prepare to be more tactical and more open-minded than usual as conditions can change at short notice and opportunities may emerge in surprising places.

Liquidity conditions remain extremely impaired in all markets, EM as well as developed. This suggests that, for now, investors should bide their time. Only those desperate for liquidity should contemplate any action until trading conditions have normalised. The alternative approach of trying to execute large transactions in the current illiquid conditions will almost certainly ensure abysmal execution, regardless of whether investors are buying or selling.

There are good grounds for expecting liquidity conditions to gradually improve. The prospects of slower economic growth and some credit stresses are already triggering additional monetary easing and promises of additional fiscal support in developed economies. Importantly, central banks in Europe and the United States have already taken significant steps to improve market liquidity. As liquidity gradually normalises, investors can re-engage at less irrational prices.

If the ultimate decision is to sell, it is better to wait until liquidity has returned and then to stagger sales over longer periods to ensure the best possible execution at better prices. On the other hand, for those minded to buy it is encouraging that EM prices have already moved into clear buying territory. Buyers too should exercise discipline, however, by setting clear buy levels and aiming to re-enter in a staggered fashion through a 'three-bullet' strategy. By staggering entry, investors can be sure to get risk on board, while it offers genuine value, in sizes commensurate with market liquidity. At the same time, they keep alive the option to buy more at lower prices if there are further dislocations to come.

The rest of this report analyses how the three types of shocks currently impacting EM have affected markets in the past and identifies specific opportunities that arise from each type of shock. The conclusion pulls this analysis together into a succinct set of investment ideas.

The US equity shock

The US stock market crash has been unusually rapid and severe. In addition to sharply reducing risk appetite, the crash has dramatically impaired liquidity conditions world-wide, not just in EM. Global liquidity has, to all intents and purposes, been rendered paralysed.

The paralysis in market liquidity has in turn contributed to massive re-pricing of assets across all markets. In the main EM asset classes, the drawdowns over just two weeks have already exceeded the average drawdowns in the past eleven most severe crashes in the S&P 500 index since 1993 (Figure 2).[1]

Fig 2: **EM assets have already moved into value territory**

	S&P 500	MSCI EM	EMBI GD	EMBI IG	EMBI HY	CEMBI BD	GBI-EM GD
Drawdown in the last 11 +15% S&P 500 crashes	-24.0%	-24.1%	-4.8%	-0.9%	-7.0%	-3.1%	-6.2%
Drawdown in the current sell-off	-26.7%	-20.0%	-11.1%	-5.5%	-17.6%	-5.7%	-10.4%
This drawdown compared to past S&P 500 sell-offs	1.1x	0.8x	2.3x	6x	2.5x	1.8x	1.7x

Source: Ashmore, Bloomberg. From Index Inception up to and including 12 March 2020.

Specifically, EM sovereign Dollar-denominated bonds have sold off between 2.3 and 6 times *more* than average in large US stock market crashes. The drawdown in EM sovereign high yield bonds has been particularly severe; the 18% drawdown so far matches that seen in the most severe US stock market crash in modern times, namely the 2008/2009 Sub-prime and Banking Crises. EM corporate bonds have sold off between 1.7 and 2.5 times *more* than in past US stock market crashes, while the pullback in EM equities is now already within a fifth of the maximum drawdown seen in past US equity market routs.

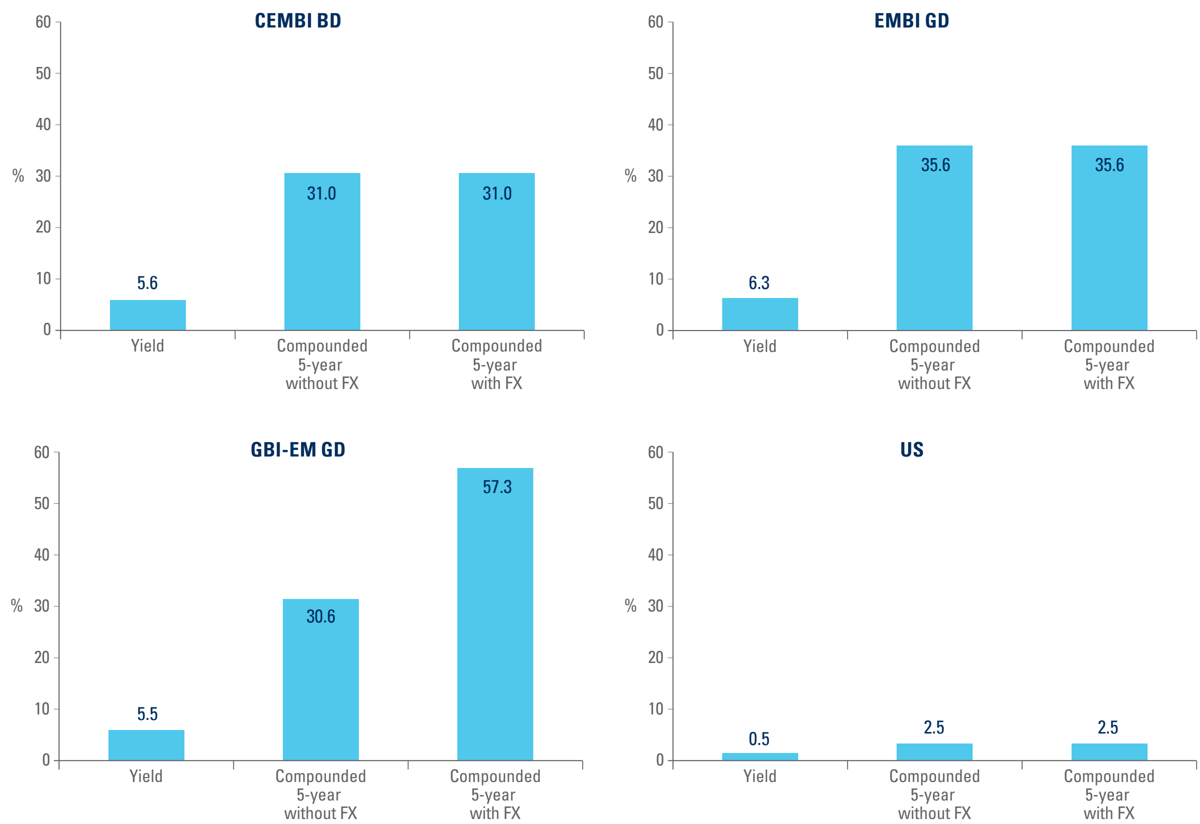
[1] These sell-offs all exceeded 15% from peak to trough.

The US equity shock

The re-pricing of EM fixed income has already enhanced the carry in EM bonds relative to owning bonds in developed countries. For illustration, consider Figure 3, which shows yields to maturity and 5-year compounded returns (assuming only coupon clipping) for the three main segments of EM fixed income as well as US government bonds. At current valuations, EM Dollar-denominated sovereign and corporate bonds will respectively deliver compounded returns between 31% and 36% over the next five years compared to less than 3% for US Treasuries. Of course, at the current dislocated levels of EM spreads there are good grounds for expecting some spread compression, which could result in even greater return differentials in the coming years. For example, the current spread of EM external debt over US Treasuries is 528bps.[2] When this spread returns to 'normal' levels around 300bps then investors can expect to make a capital gain of more than 20%, given duration of about nine years.

To the extent that the US stock market crash proves a harbinger for a long-overdue recession in the US economy, then this shock may also mark a turning point in global currency markets as Dollar strength has been closely linked to the formidable rally in US equities over the past decade. Dollar weakness has followed major US equity market corrections, including the Dotcom Bubble collapse and 2008/2009. EM currencies, which are currently 20% cheap to the Dollar, have done well in such environments. A repeat in this crisis could therefore push the total return in EM local bond markets to more than 50% over five years, based solely on the cheapness of EM currencies and coupon clipping in bonds.

Fig 3: **Yields to maturity and implied 5-year returns solely from coupon clipping: EM fixed income versus US Treasuries**



Source: Ashmore, Bloomberg.

EM equities have already cheapened significantly to the point, where they now price in a risk premium of 20% with respect to US equities. Price to book is just 1.3x and the P/E ratio is just 11.4x, both below long-term averages. In the past, it has paid off to be nimble in shocks as EM equities often bottomed out ahead of US equities (this happened in both 2008 and 2016, for example). EM equities have also delivered particularly strong excess returns to investors, who have put money to work during the height of dislocations. Figure 4 illustrates this point. The table shows returns by asset class in the 12 months following sharp spikes in the VIX index (a proxy for large financial market dislocations) as well as excess returns arising from investments timed specifically to coincide with financial crises, relative to long-term average returns.[3] While all EM asset classes deliver strong returns in the 12 months after shocks, the timing-specific 'alpha' for equities is particularly large at 380bps for broad equities and 490bps for small cap equities.

[2] As of close of business on 13 March 2020.
[3] Global market routs are measured as spikes in the VIX index in excess of 10 points above the 60-day moving average.

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The US equity shock

Fig 4: **Asset class returns and excess returns from timing investments to coincide with global market shocks – by EM asset class**

	Global market shocks	
	Asset class return 12 months after shock	Excess return from timing investment to coincide with shock versus long-term average return
Fixed income	**11.2%**	**2.9%**
External debt	11.1%	2.2%
High yield	*12.2%*	*2.2%*
Corporate debt	9.7%	2.5%
High yield	*14.2%*	*5.4%*
Local currency	8.6%	2.0%
Equities	**6.6%**	**4.3%**
Broad	6.2%	3.8%
Small cap	7.1%	4.9%

Source: Ashmore, Bloomberg.

Beyond the immediate opportunity created by market dislocations, a weakening Dollar environment over the next few years should prove conducive to inflows to EM countries. This would relieve the severe finance limitations that constrain investment and growth in most EM countries, thereby stimulating domestic demand in particular.[4] Herein lies an important additional source of potential upside for EM equities, since domestic demand makes up three quarters of the gross domestic product across EM. Domestic demand is therefore critical to the earnings outlook, which in turn drives stock prices. In a lower Dollar environment, EM equities would therefore do even better than local bonds over a number of years, in our view.

The COVID-19 shock

The spread of the COVID-19 coronavirus pandemic to Western Europe and the United States has been a big factor in the current sell-off and increased the complexity involved in making investment decisions. At a minimum, the health scare has increased the scale of the likely economic fallout and introduced unfamiliar market dynamics, which affect how and where to 'trade' this crisis.

Still, there have been no fewer than five global health crises in addition to COVID-19 since the early 1990s, namely MERS, SARS, Ebola, Zika and H1N1. Experience from trading these past health crises offers some guidance for how markets are likely to behave in the aftermath of the current crisis. Granted, COVID-19 is a larger pandemic with global reach. It is also the first global health crisis to coincide with a major US stock market crash and a collapse in oil prices. However, this should not alter the fundamental principle for how to invest. If so, what insights have the past health crises provided with respect to EM investments in the context of the on-going COVID-19 pandemic?

First, past health crises have created particularly large mispricings in EM equities and to a lesser extent in high yield (HY) fixed income (Figure 5). Equity market returns in the 12 months after shocks have therefore been very high and the excess returns to timing investments, that is, returns to investments undertaken during the crises themselves, relative to long-term returns – have also been very high indeed. In broad EM equities, post-crisis returns have exceeded 13%, while the excess return from timed investments have been a sizeable 10.8%. For EM small cap equities, the numbers are even more impressive at 17% and 15%, respectively.

4 As of end-2018, financial markets were 3.6 larger than GDP in developed countries, but only 0.9 times GDP in EM. In other words, there is four times more money chasing returns in developed countries than in EM, relative to the size of the underlying economy.

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The COVID-19 shock

Fig 5: **Asset class returns and excess returns from timing investments to coincide with global health shocks – by EM asset class**

	Global health crises	
	Asset class return 12 months after shock	Excess return from timing investment to coincide with shock versus long-term average return
Fixed income	**8.4%**	**0.1%**
External debt	8.3%	-0.7%
High yield	*10.7%*	*0.7%*
Corporate debt	8.1%	0.9%
High yield	*12.8%*	*3.9%*
Local currency	2.0%	-4.6%
Equities	**15.2%**	**12.9%**
Broad	13.2%	10.8%
Small cap	17.2%	15.0%

Source: Ashmore, Bloomberg, WHO.

As noted above, health scares have also introduced significant mispricing in the HY segments of EM fixed income. The 'beta' for EM sovereign HY bonds in the aftermath of health scares is nearly 11% with an additional timing-related excess return 70bps. The beta in corporate HY bonds is just shy of 13% with an additional 3.9% alpha from timing investments to coincide with health scares.

On the other hand, allocations to investment grade EM bonds – comprising of local currency bonds and the investment grade segments of the Dollar-denominated sovereign and corporate bond markets – have not delivered great timing-related alpha in post-crisis periods. As such, they appear to trade more like conventional risk hedges that make sense during the height of panics, but underperform higher yielding securities in their aftermath. US government bonds behave the same way; they underperform their own long-term average return by 1.7% over the 12 months after the health scares.

There is still considerable uncertainty about how the COVID-19 outbreak will unfold. However, if this outbreak were to evolve broadly in line with previous infectious virus outbreaks, it would suggest that COVID-19 will spread to most countries with the extent of the spread constrained by humidity and temperature. We believe the outbreak would likely have a very high half-life and the economic fallout will be proportional to infection rates. If we were to assume a half-life of 75% and infection rates of 50% in developed economies and ranging from 25% to 40% in EM countries, one would have to estimate:[5]

- Global growth to contract to 2.2% this year compared to IMF's forecast of 3.4% from October 2019.
- Most of the pandemic to be over by the end of 2020 and by the end of 2021 there will be very little evidence of the pandemic.

The growth impact of COVID-19 is likely to be more severe in developed economies, because developed economies have lower growth rates to begin with.We expect EM's contribution to global growth in 2020 to increase to 85% from 80% due to COVID-19. The contribution of developed economies to global growth looks set to decline by a quarter from 20% to 15%. Within EM, Eastern Europe's contribution to global growth declines, while Asia's contribution remains largely unchanged. Latin America, the Middle East and sub-Saharan Africa should contribute more by virtue of higher overall growth rates and lower infection rates.

Though early days, so far the data has been consistent with these assumptions. China and South Korea appear to be the first countries to emerge from the crisis. They are the two largest EM equity markets comprising 48% of the MSCI EM. They employed the most proactive containment and policy responses globally. Real time data has been improving on a sequential basis lately, underpinned by huge liquidity stimulus and monetary/fiscal support. Policy stimulus is often a leading indicator for macroeconomic trajectories in these command economies. This bodes well for equities in both countries, assuming the required attention is paid to industry and firm specific factors.

[5] These characteristics are based on the behaviour observed in past outbreaks.
For more details, see the discussion in the coronavirus section of *'It is here again – the VIX spike!'* Market Commentary, 28 February 2020.

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The oil shock

Oil prices are down about 50% this year, peak to trough. The sharp decline was triggered by a price war between Saudi Arabia and Russia, coupled with fears of a massive hit to global consumption and hence growth and demand for commodities. As always, the duration of the oil shock matters at least as much as magnitude of the price decline. Our view is that the price war is irrational and likely to be reversed relatively soon. Unlike price wars in retail, price wars in oil markets do not push nations into non-existence. Oil production is therefore not likely to decline. The main question is therefore how long it will take for Russia and Saudi Arabia to recognise their costly mistake and find a formula to end the spat without losing face.

Figure 6 shows how EM asset classes have reacted in the aftermath of major oil price collapses of which there have been ten since the early 1990s.[6] Similar to the pattern observed after global market shocks, post-shock returns have generally been very strong in fixed income, especially in HY segments, while timing-related excess returns, that is, the excess returns from timing investments to coincide specifically with the shocks themselves, relative to long-term returns, have been four times greater in equities in than in fixed income. The reward to actively timing investments is particularly high in EM small caps, which comprises many non-oil companies.

Fig 6: **Asset class returns and excess returns from timing investments to coincide with global oil price collapses – by EM asset class**

	Oil price collapses	
	Asset class return 12 months after shock	Excess return from timing investment to coincide with shock versus long-term average return
Fixed income	**8.6%**	**0.4%**
External debt	9.4%	0.4%
High yield	*10.7%*	*0.7%*
Corporate debt	7.6%	1.1%
High yield	*9.9%*	*1.0%*
Local currency	5.4%	-1.2%
Equities	**4.0%**	**1.6%**
Broad	3.2%	0.8%
Small cap	4.8%	2.5%

Source: Ashmore, Bloomberg.

What is the sensitivity of EM fundamentals to negative oil shocks?

Dependence on oil exports tends to be very concentrated in particular countries, while most EM countries import oil and hence benefit from lower oil prices. For EM as a whole, net energy exports only make up about 2% of GDP.

In Asia, net energy exports are -3% of GDP, meaning that Asia is a net importer of oil and benefits from lower oil prices. In Eastern Europe and Latin America, net energy exports are negative in most countries, albeit positive and very high in a small number of countries (e.g. Russia, Venezuela). For Eastern Europe as a whole, overall energy export dependence is only 1% of GDP, or half of the EM average, while in Latin America the average energy export dependence is 0% of GDP. Africa's net energy export dependence is in line with the EM average of 2% of GDP. The only region of EM where net energy export dependence is very high is the Middle East with 13% of GDP. However, Middle East countries are among the best placed to handle a downturn in prices due to high reserves and mostly low debt burdens, although there are some exceptions, such as Oman.

[6] We define shocks as drops in the WTI price of oil of USD 10 per barrel in excess of the 60-day moving average.

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Conclusion

An unprecedented triple shock comprising a US stock market crash, a worldwide health pandemic, and a collapse in oil prices has engulfed global financial markets. The triple shock has compounded price dislocations and heavily impaired market liquidity across all markets. The complexity of investing has increased, but the basic principles of how to invest have not changed.

Active management can deliver significant alpha in the aftermath of global macro shocks with managers who have a proven track record and the relevant skills to navigate difficult market conditions.

Based on our experience of managing investments in EM during crises, we believe that investors should only attempt to scale into markets as market liquidity improves, regardless of whether they intend to buy or sell. Selling into extremely stressed illiquid markets is always a bad idea and particularly in this triple shock environment. Better to do nothing now (if buying is not on the radar) and sell into recovery later with better execution at more rational prices.

We believe that investors can take advantage of the enormous price dislocations, which have emerged across various EM asset classes. Due to impaired liquidity conditions and plenty of residual uncertainty, the way to approach investing is to follow a 'three-bullet'strategy, which balances the desirability of getting risk on board at attractive prices with the high value of the option to wait for more information and buying more later, if prices fall further.

In our opinion, investors may want to aim to scale into EM equities and HY segments of the EM fixed income first. Experience from past shocks shows that these two segments of EM perform best in the aftermath of each of the three types of shocks that are currently underway. Investments in investment grade sovereign and corporate credit as well as local currency should also be contemplated, but they are less time sensitive. Local market investments are now becoming particularly attractive for those with a medium term outlook, which encompasses a less bullish view of the US business cycle and hence the Dollar.

Contact

Head office

Ashmore Investment Management Limited
61 Aldwych, London
WC2B 4AE
T: +44 (0)20 3077 6000
@AshmoreEM
www.ashmoregroup.com

Bogota
T: +57 1 316 2070

Dubai
T: +971 440 195 86

Dublin
T: +353 1588 1300

Jakarta
T: +6221 2953 9000

Mumbai
T: +9122 6269 0000

New York
T: +1 212 661 0061

Riyadh
T: +966 11 483 9100

Singapore
T: +65 6580 8288

Tokyo
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