

Stress testing EM Sovereign external debt

By Gustavo Medeiros

The coronavirus outbreak was an unprecedented shock to the global economy, which experienced the fastest and deepest recession outside times of war. The global economy is also likely to experience the fastest rebound on record in 2020, thanks to the combination of large monetary and fiscal policy expansions worldwide and healthier banking systems.

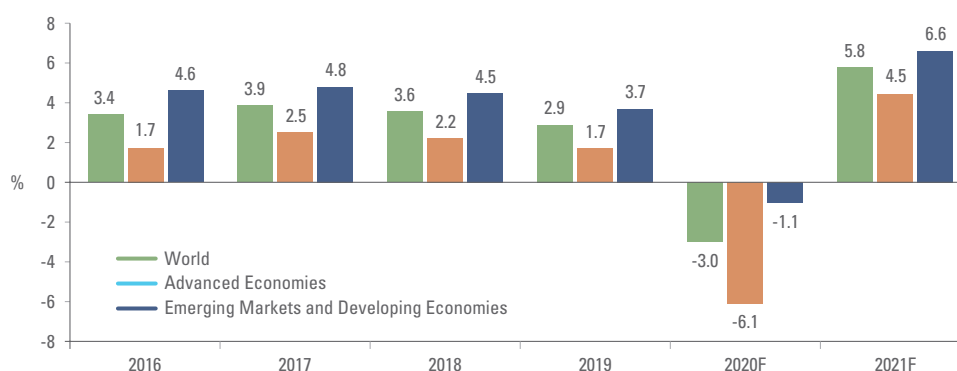
However, an economic bounce from very low levels and a rapid resurgence in asset prices does not mean that all is well. Despite generally better policy management of the coronavirus downturn compared to previous major recessions, the episode is likely to accelerate already widening income and wealth inequalities. Higher inequality will have negative implications not just for the economies of developed countries, but also their financial markets. Against this backdrop, it seems sensible to rotate exposure into Emerging Markets (EM). EM sovereign debt valuations remain extremely attractive.

This report stress tests EM external debt using extremely negative assumptions and still finds that returns going forward are likely to be significantly better than the returns on offer in developed bonds markets, given the valuations and the broader economic backdrop in developed economies.

How deep is the coronavirus recession?

The ongoing recession triggered by the coronavirus outbreak is the deepest experienced over the last century, at least in peacetime. The recession has been caused primarily by sudden-stops in economic activity as governments ordered population to stay home in order to limit the spread of the virus ('lockdowns'). As per Figure 1, the IMF estimates that the world economy will contract by 3.0% in 2020, mostly due to a deep 6.1% contraction in developed markets (DMs).

Fig 1: IMF GDP forecasts



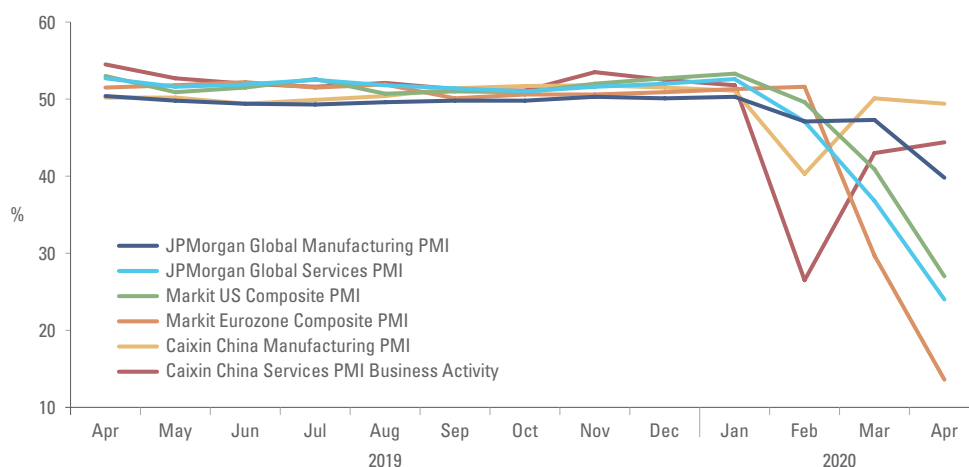
Source: IMF WEO, Ashmore. Data as at April 2020.

China was the first country hit by coronavirus, but also the first country to successfully manage the outbreak and stabilise its economy. Therefore, China may provide an indication of what should be expected in the rest of the world. China's Purchasing Managers Index (PMI) survey (Figure 2) shows services declining further and faster than manufacturing before rebounding. Production has generally ramped up ahead of consumption, so if this pattern is repeated in other countries it implies that global inventory levels will increase. This may feed into deflationary pressures across supply chains in similar fashion to what was initially observed in the oil market recently. We therefore expect inflation rates to remain at very low levels for the remainder of 2020.

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Fig 2: Global PMIs: China first in, first out (FIFO)



Source: Markit, JP Morgan, Bloomberg, Ashmore. Data as at April 2020.

How is the coronavirus recession different from other recessions?

So far, the coronavirus-induced recession has been distinct from past recessions in several respects. First, previous deep recessions had their inception within the financial system, mostly due to the exhaustion of the long-term leverage cycle. As debts increased, interest payments eventually rose faster than earnings, thus eroding companies' and individuals' ability to service debt. As individuals and companies started to default on their debts, credit conditions tightened creating a negative feedback loop which led to yet further defaults. In contrast, the coronavirus recession has not originated from within the financial system, which is relatively healthy thanks to the recapitalisation of banks in the US after the 2008/2009 crisis and strongly supportive liquidity backstops provided by the European Central Bank (ECB) in Europe starting around 2012.

Second, policymakers across the globe have been extremely quick to react, enacting gargantuan fiscal expansions in a matter of weeks, while central banks have simultaneously injected liquidity and bought large amounts of government bonds. The large expansion of central bank balance sheets has enabled the public sector to temporarily fill the demand gap left by declining private sector demand. Unemployment insurance, loans, and aid for small and medium companies as well as support packages to large industries, such as airlines, have in effect been funded by asset purchases from central banks. This stands in sharp contrast with the policy reaction in 2008, when the US government did not immediately support homeowners going into foreclosure and was also reluctant to recapitalise the banking system for fear of moral hazard issues.

These differences in the policy reaction function compared to previous deep recessions have had two important implications. One is that banks can now be part of the solution, say, by providing loans to small and medium companies (provided governments support the loans via partial or full guarantees). The other is that better coordination between monetary and fiscal authorities means that cash can reach the most needy segments of the population, who, on account of their higher marginal propensities to spend, can help smooth the impact on the economy. As a result, the immediate economic rebound should be faster than many anticipate.

What will be the main impact on society and markets?

In our 2020 outlook pre-coronavirus,¹ we argued that inequality is a major emerging theme, which is likely to have serious ramifications for markets over the coming decade. As Figure 3 indicates, income inequality in the US has reached levels not seen since the 1920s. In fact, the root cause of the 2008 mortgage crisis was inequality. As the share of pre-tax net labour income earned by the bottom 50% of US adults declined from 20% in 1979 to 13.5% in 2006, the average household could only continue to own houses, cars, and engage in ample consumption by increasing borrowing. To enable this to happen, politicians created incentives for banks to lend ever larger amounts of money to individuals with ever worsening capacity to service debt. The result is that most household debt is now owed by medium and lower income families.

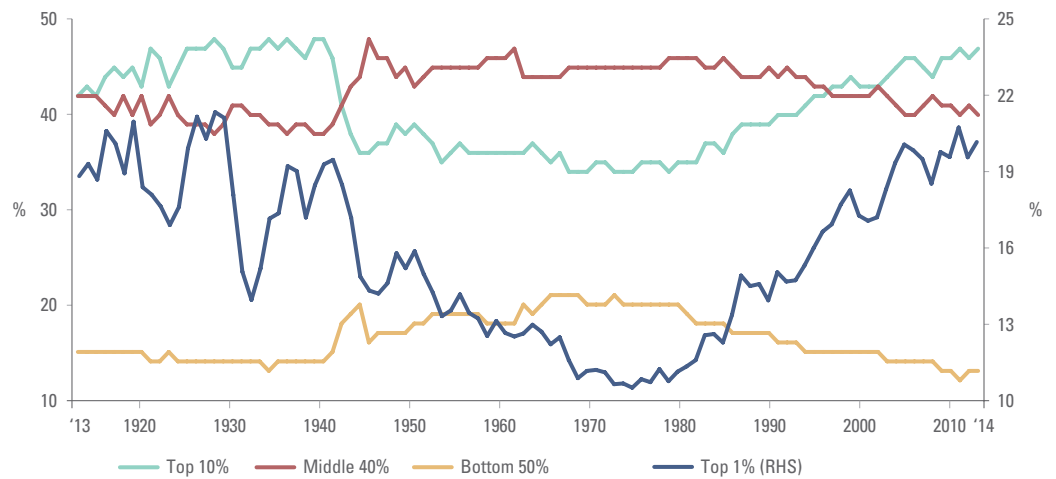
¹ See: *The 2020-2024 EM fixed income outlook*, The Emerging View, 20 December 2019.

As figure 4 demonstrates, the bottom 50% of Americans have 0% of the total wealth. Low-income families are also facing an extremely uncertain situation as more than 40m US adults are now without jobs. And to make matters worse, the coronavirus recession is likely to accelerate previous trends of job losses to automation (e.g. driverless automobiles, expanded use of robots in manufacturing), and a preference to online services rather than high street services. These trends are likely to increase discontent among voters and increase demands for social benefits. Social transfers can of course have a net positive impact on the economy in the midst of recession, but they pose a serious risk to the public finances, trend growth, productivity, and even inflation if they are made permanent. Which begs the question: which politician today has the political will to reverse state support in the current political climate and elevated unemployment rates?

Inequality is also behind the recent rise of far-right politics, including trade protectionism and other 'lose-lose' nationalistic policies. Much of this socio-political erosion has so far largely been ignored by financial market participants as the liquidity expansions from central banks have continued to push up asset prices. Ironically, asset price inflation is itself exacerbating inequality and thus increasing the appeal of populist policies.

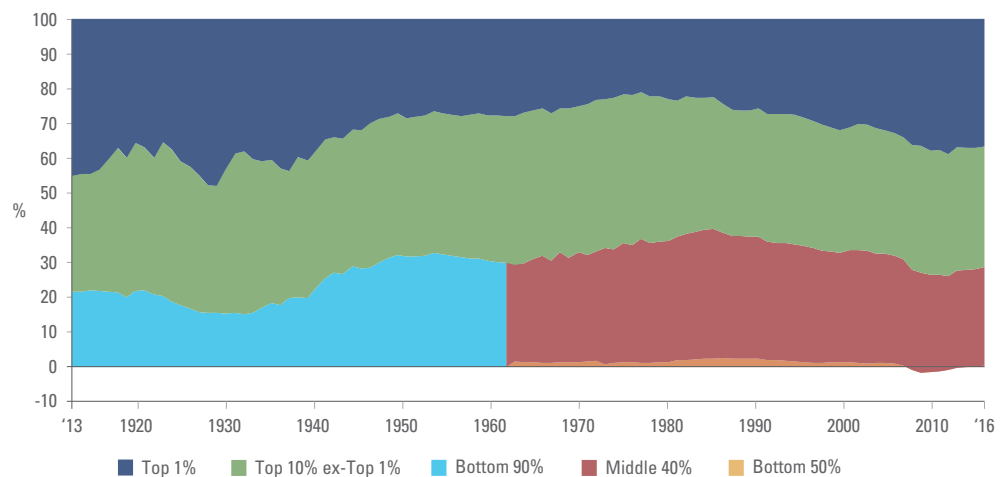
The bottom 50% of Americans have 0% of the total wealth. Low-income families are also facing an extremely uncertain situation as more than 40m US adults are now without jobs

Fig 3: US share of pre-tax national income



Source: wid.world/data, Ashmore.

Fig 4: US share of net personal wealth



Source: wid.world/data, Ashmore.

The increase in demand for social benefits in the context of already elevated levels of public indebtedness will inevitably lead to more pressure for higher taxation, in our view. Policies to raise taxes on wealthy individuals, large corporations, and technology companies are already favoured by the majority of Democratic Party voters and could become a reality, a necessity even, after the coronavirus crisis subsides. A comprehensive tax reform aimed at closing tax loopholes for big corporations and to introduce taxation for technology companies based on their revenue rather than profits seems very likely, in our view.

The debate over wealth transfers itself, let alone the implementation of such policies, is likely to have a significant negative market impact. This is particularly the case in developed economies (DM), where the bulk of the debt has been accumulated in recent years and where the largest tax increases should therefore be expected.

What is the impact of coronavirus on EM?

As discussed in a recent publication, we have been expecting the impact of coronavirus on populations in EM to be less than that in DMs, including fewer cases and deaths per million.² So far, the data supports this view. The number of cases in EM is much smaller than in DM, both in absolute terms and as a percentage of the population. As demonstrated on Figure 5, deaths per million people, which is less impacted by differences in capacity to test than cases, are far lower in EM than in DM. Several factors explain the lowest virus incidence in EM, including younger populations, lower urbanisation levels, smaller service sectors, warmer climates, and widespread BCG vaccinations. Yet, the short term economic impact in EM has been significant due to the imposition of the same type of social distancing rules as in DMs and the disruption to global supply chains.

Fig 5: **Coronavirus deaths and cases by population: EM vs DM**

EM/DM	Deaths	Cases	Population	Cases (per million)	Deaths (per million)	Mortality (%)
EM	89,226	2,435,627	6,750,688,760	361	13	3.7%
SSA*	10,527	246,106	1,202,675,870	205	9	4.3%
DM	262,555	3,118,520	977,765,020	3,189	269	8.4%
Total	351,781	5,554,147	7,728,453,780	719	46	6.3%

Source: WHO, Worldometer, Ashmore. Data as at 28 May 2020. SSA – Sub-Saharan Africa.

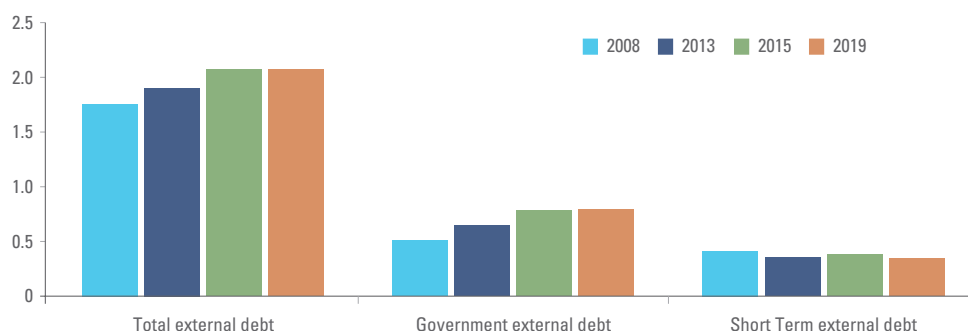
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How resilient are EM external accounts and how large is EM debt?

Many analysts have expressed concern that the coronavirus shock poses a serious threat to EM's external balances. However, this does not appear to be borne out in the data. In fact, external borrowing by EM countries has been relatively modest in the lead up to the coronavirus outbreak, especially when placed in the context of the level of central bank foreign exchange (FX) reserves and the size of EM economies, perhaps with only a few exceptions.

Most of the expansion in external debt issuance in EM in recent years has been in longer-term instruments. The ratio of short-dated EM external debt to FX reserves has actually declined from 0.42 in 2008 to 0.35 in 2019 as per the third set of columns in Figure 6.³ The ratio of government total external debt to FX reserves has increased from 0.52 in 2008 to 0.81 today (middle set of columns), but EM countries still have more FX reserves than their entire stock of outstanding external debt. The ratio of total external debt (including corporate debt) to FX reserves was 2.11x in 2019, which is the same level as in 2015 and only slightly greater than in 2008 (1.79x). Figure 6 covers all the countries that report debt metrics to the World Bank. We deliberately excluded China, Singapore, and Hong Kong from the sample to reduce the distortion from their better ratios and larger economies.

Fig 6: **EM external debt (ED) to central bank reserves: Weighted by nominal GDP**



Source: Haver, World Bank, Ashmore. Data as at December 2019. *EM External Debt to Central Bank reserves ex-China, Hong Kong and Singapore.

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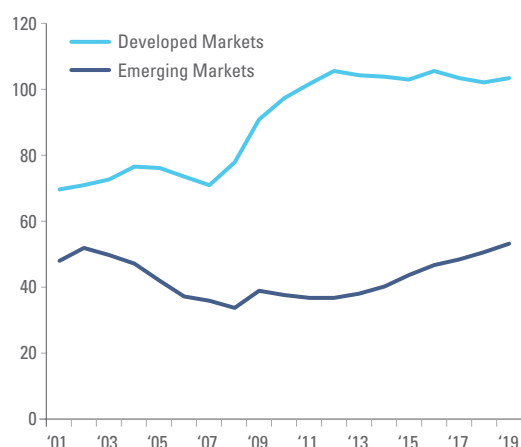
² See: *'Status update: Coronavirus and EM fixed income in 2020 and beyond'*, Market Commentary, 29 April 2020.

³ Sample size in 2019: Total ED/Reserves: 42 countries. Government ED: 36 countries. Short term ED: 44 countries.

When compared to the size of their economies, EM debt has only increased at very modest pace in both absolute terms and relative to DMs. As Figure 7 shows, the ratio of government debt to GDP increased from 34% in 2008 to 53% in 2019. In comparison, DM debt surged from 78% to 103%. The coronavirus shock is demanding a large fiscal response across the world, leading to a rise in debt/GDP. However, we believe that DMs are likely to experience the worst deterioration due to their worse starting points and to the likelihood that they assume more debt than EM countries. Besides, many EM economies now have the option to fund their liabilities in their local markets and if needed with their own central banks acting as buyers of last resort.

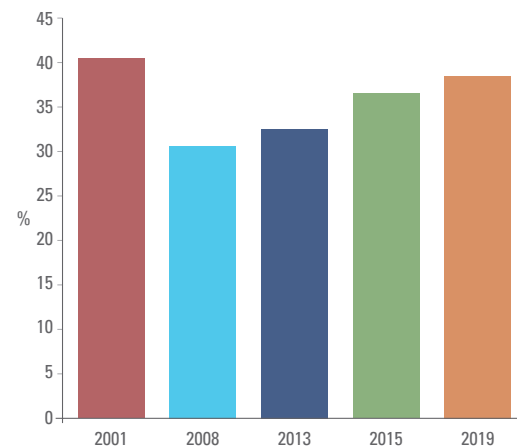
External debt to GDP has increased modestly in EM as shown in Figure 8 with much of the contribution due to a few countries with large domestic bond markets. The ratio of total external debt (including corporate debt) to GDP has increased from 31% in 2008 to 39% in 2019.⁴ The main contributors to the increase were Mexico, Brazil, Turkey, South Africa and Czech Republic. Brazil and the Czech Republic do not have an external debt problems because their FX reserves are large enough to cover almost their entire stock of outstanding external debt. Mexico has a large USD 61bn IMF stand-by facility, which, if included in the reserves calculation is enough to repay more than half of the country's outstanding external debt. South Africa has a policy of holding minimal reserves, but the majority of its external debt is held by large corporations that either have export revenues in Dollars or hedge their currency exposure.

Fig 7: EM vs DM Government Debt/GDP



Source: IMF WEO, Ashmore. Data as at December 2019.
All countries aggregated by Purchasing Power Parity GDP.

Fig 8: EM External Debt to GDP



Source: Harver, Ashmore. Data as at Q4 2019.
*Excluding Hong Kong, China and Singapore.

Is there value in EM hard currency debt?

EM Dollar-denominated sovereign debt is still trading at some of the widest spreads over US Treasury bonds since 2008. The knee jerk reaction of investors to the coronavirus shock pushed the spread for the JP Morgan Emerging Market Bond Index Global Diversified Index (EMBI GD) from 300bps in February 2020 to 721bps at the widest point in March 2020. Bonds are now trading around 520bps. Since 2004, EMBI GD spreads have only been above this level for a brief period between October 2008 and May 2009. The yield to maturity at the current spread is just below 6.0%.

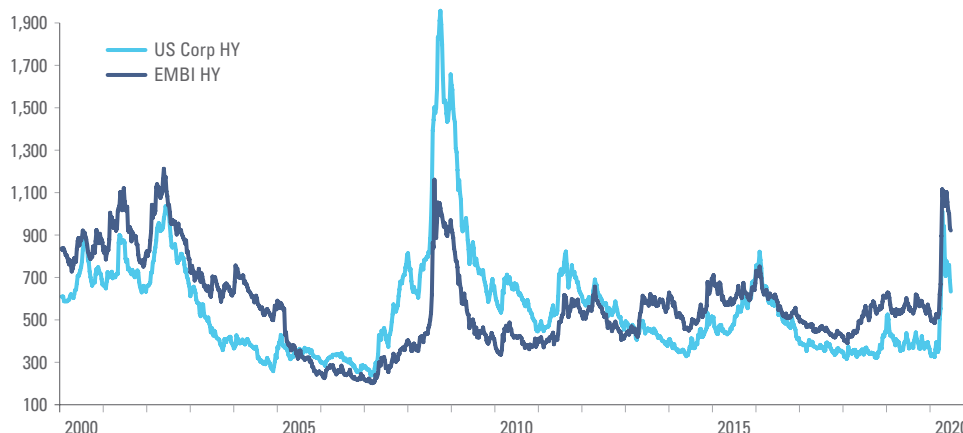
These valuations are already attracting buyers. EM outflows have subsided since the fiscal and monetary policy bazookas were put into action in developed countries. Most EM sovereign debt markets have re-opened with a record USD 72bn in Eurobonds issuance in April, mostly from investment grade issuers. In May, demand for high yield (HY) issuers also began to recover. The re-establishment of market access is crucial as it allows EM sovereigns to temporarily increase their fiscal deficits to smooth the economic impact of the coronavirus shock.

In spite of the recent signs of a recovery in EM debt markets, valuations remain distorted, particularly in the HY space. Figure 9 shows that EM sovereign HY bonds currently trade 238bps wider than US corporate HY bonds, which is the widest spread differential since 2004. Indeed, since its inception in 1998, the EMBI GD has only traded wider than current levels relative to US HY bonds 12.5% of the time. One important reason for the divergence in valuations is technical; the Fed is buying US HY bonds, whereas the main buyer base in EM external debt is long-term institutional investors, who move relatively slowly. This means yields remain very attractive, providing a buying opportunity.

Since its inception in 1998, the EMBI GD has only traded wider than current levels relative to US HY bonds 12.5% of the time

⁴ Sample in 2019 = 53 countries.

Fig 9a: **EMBI GD vs US HY Spread over US Treasury**



Source: Bloomberg, Barclays, JP Morgan, Ashmore. Data as at 26 May 2020.

Stress testing external debt

Some investors have expressed concern about the risk of debt distress and restructurings after the ongoing coronavirus shock. We do not believe this should deter investors from buying into the opportunity. After all, most EM countries will be able to circumvent the distress in bond markets by temporarily tapping into funding from international financial institutions (IFIs) and local markets. The handful of countries that are in trouble – including Argentina, Ecuador, Lebanon, Zambia, and Venezuela – are already well into the process of restructuring their debts, which is largely priced. For example, Argentinian bonds currently trade at 32-42 cents (c), Ecuador at 38-45c, Zambia at 48c, and Lebanon at 17-20c. Venezuelan bonds currently have a zero weight in the EMBI GD and bonds trade in a 4-12c range. We believe that recovery values on these bonds are likely to be higher than currently priced, implying a significant upside to current values.

To demonstrate the value in the EM external debt market today, we have stress tested the EMBI GD using what we believe to be a quite severe scenario. We impose 65% haircuts on the principal and coupons payments for the countries above (Venezuela is not included as it has a 0% index weight). We also assume that all the bonds of the countries, which traded at spreads from 750bps to 1,500bps over Treasuries at the widest point in March of this year will follow the same path as the troubled credits and restructure their debts with a 31% haircut on both principal and coupon pay-outs (31% is the average haircut for sovereign debt over the last 200 years). This second group of countries comprises 19 sovereigns as well as the Mexican quasi-sovereign oil giant, Petroleos de Mexico (Pemex). In other words, our stress test comprises more than a quarter of all the outstanding bonds in the EMBI GD. For simplicity, we've assumed a 3-year maturity extension for the first group of countries and a 1-year extension for the second group.

The effect of the stress test is to reduce the yield to maturity of the EMBI GD by 2.19%. Thus, based on the 5.99% index yield as of 26 May 2020, the yield to maturity (after applying the stress test) declines to 3.80%. Even in this extreme situation, the total return is clearly much larger than anything available in the DM sovereign space. As shown in Figure 10, EM external debt would return 33.8% without any haircuts, and 20.5% in the stress test scenario, which far exceeds the compounded return of 10 year Treasury bonds (3.5%).

Fig 10: **5yr compounded returns of ED (including stress-test) vs 10yr UST**

	EM ED	EM ED: Stress-test	10yr UST
Yield	5.99%	3.80%	0.70%
5yr TR	33.8%	20.5%	3.5%

Source: JP Morgan, Ashmore. Data as at 26 May 2020.

In reality, however, we think our stress test scenario is far too conservative. We believe the vast majority of EM countries in the index will avoid default, and the ones that do default will likely pay a higher recovery value than we have implied in the exercise.

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