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The EM Default Picture: More Nuanced Than Headlines Imply

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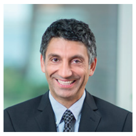

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This article was adapted from a recent podcast conversation. Listen to the full audio podcast ***here***.[1]

The coronavirus pandemic is undoubtedly creating short-term and long-term challenges for emerging markets (EMs). But not all sovereign and corporate issuers can be painted with the same broad brush, and placing too much weight on overly dire forecasts may result in missed opportunities.

1. https://www.barings.com/viewpoints/em-debt-downturns-defaults-diamonds-in-the-rough

In some ways, the challenges confronting EMs in the short to medium term are similar to those faced by their developed market (DM) counterparts. Health and wellness are front and center in this regard, as COVID-19 shows no preference for the population of Germany over that of Algeria. And no matter how you slice it, both EMs and DMs are facing financial distress in the vast majority of sectors. With locked-down businesses and stay-at-home orders still largely in effect, virtually every economy globally is feeling the pain.

But EMs are also grappling with a unique set of obstacles. For one, many rely heavily on tourism—as opposed to it being an ancillary industry in most developed market economies—for which revenue streams have all but dried up. Many also rely on remittances from their migrant populations living in foreign countries, which may be threatened by rising unemployment. Some countries also depend greatly on oil—and the decline in prices has created a tough reality for a number of EM exporters in particular. EMs are further disadvantaged by the fact that they do not have reserve currency status (i.e. their currencies, unlike the USD or EUR, are not held in significant quantities by central banks or other monetary authorities as part of foreign exchange reserves), and therefore are on the other side of 'flight to safety' trades. And finally, the financial firepower of EM central banks is quite limited relative to their DM counterparts, meaning they have less capacity to conduct 'shock and awe' monetary stimulus programs.

However, contrary to what some headlines may suggest, these challenges do not necessarily translate into an inevitable and widespread spike in defaults. EM economies are slowing as a result of the crisis, certainly, and we will unquestionably see defaults increase as a result. But not all countries and companies will be impacted to the same extent—and understanding the complex factors driving the default picture will be key to identifying the issuers that are best-positioned to withstand the current shock.

Corporates: Entering the Crisis in Good Condition, Defaults Likely Delayed Until 2021

From an EM corporate perspective, the good news is that most entered the crisis from a solid starting point—with defaults of roughly 1.5% in 2019, and balance sheets generally in good shape, with leverage ratios declining in the last few years.[2] This is in large part attributable to the fact that debt funding costs have been the lowest we've seen in decades, given the extended period of low global interest rates—which, when combined with investors' ongoing search for yield, has afforded corporate issuers broad access to capital market funding.

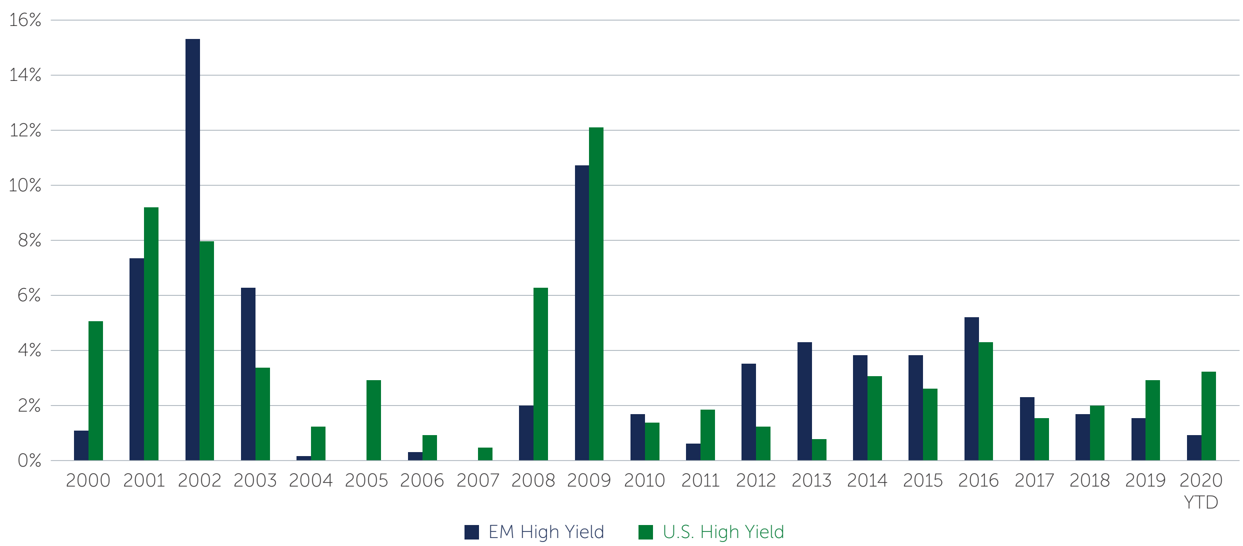
"But certainly EM corporate issuers must be destined for a large spike in defaults given the extreme weakness in oil prices this year," you might think. And you would be correct that a number of weaker corporate oil producers will certainly face challenges, despite the ability to cut capex to preserve balance sheets—but that does not nearly tell the entire story. First of all, the oil and gas sector only represents about 12.5% of the EM corporate universe.[3]

2. Source: J.P. Morgan. As of December 31, 2019.
3. Source: J.P. Morgan CEMBI. As of April 30, 2020.

So, while some oil producers will struggle, the damage should not be as widespread as some may anticipate. Second, EM oil producers may be advantaged in a lower price environment due to the fact that they tend to be the lowest cost producers globally. For instance, some Russian producers enjoy half-cycle costs (i.e. break-even costs) below $20 per barrel, and across Latin America they're close to $25 per barrel—significantly lower than many high yield DM issuers. Third, many EM corporate oil producers also have midstream and downstream operations, which tend to provide a partially offsetting natural hedge to lower upstream crude prices. Fourth and finally, many EM oil and commodity producers are also state-owned, meaning they benefit from implicit or explicit support from their sovereigns—a critical factor to consider when it comes to assessing creditworthiness in times of stress.

The other major factor to consider is the wave of credit support and liquidity measures being announced by governments around the world, where central banks are pumping money into the banking system through various measures—such as swaps, quantitative easing (QE), or a temporary waive on reserve requirements. Additionally, most EM banks are being mandated to provide debt and interest payment moratoriums to their corporate/household borrowers with varying periods. This is providing a lifeline to many corporate borrowers at such a critical time, when they're facing short-term cash crunches resulting from the crisis. India, for example, has made headlines by instituting a three-month moratorium on principal and interest payments, and then further extending it to six months. Hungarian authorities have implemented a moratorium on all loans (principal and interest) until the end of the year—and additional countries like Slovenia and Singapore have also put moratoriums in place.

FIGURE 1: EM vs. U.S. Historical Corporate Default Rates



SOURCE: J.P. Morgan. As of April 30, 2020.

Our expectation is that this credit/liquidity support will play a large role in staving off corporate defaults in 2020. That's not to say that defaults won't tick up from 2019 levels, but they should be significantly tempered by the government intervention. The timing of when the moratoriums end will depend largely on the recovery of demand in many economies. As global lockdowns are being lifted, we are starting to see the supply side (i.e. production) recover much faster than the demand side (i.e. consumption). As such, there is still a possibility that governments may need to extend the moratorium periods beyond the initial three to six months, similar to what India has done. In the medium-term, however, we anticipate that when forbearance measures get lifted, perhaps sometime in 2021—and without the continued support of governments and banks—we will likely see defaults spike by one to three percentage points, driven by weaker corporates with business models that have been significantly disrupted. We would particularly expect to see this in countries with a high percentage of dollarized corporate debt burdens or macro pressures, like Argentina and Turkey. But not all issuers in these countries will be negatively impacted given there are some strong corporates with global footprints that happen to be domiciled in these weaker countries. Likewise it's worth noting that a number of lower-rated sovereigns facing challenges at the macro level—Ecuador, Lebanon and Zambia—tend to have few or no corporate issuers on the global stage, meaning country-specific issues may have a less material impact on corporate markets more broadly.

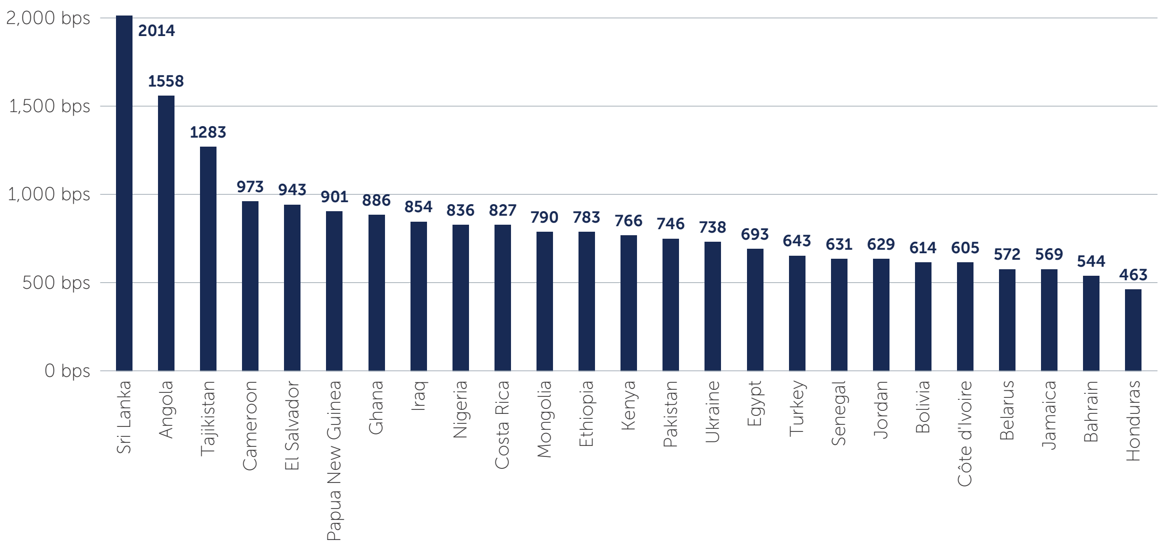
Additionally, it's likely that we could see growth in the number of 'zombie corporates' post-pandemic. In other words, many corporate borrowers may be able to pull through the crisis thanks to the forbearance measures implemented by banks—and with the lifting of lockdowns, they could see a certain level of recovery in business activities, though lower than the pre-crisis level. This 'new normal' should allow corporate borrowers to service their debt obligations, albeit with much weaker balance sheets and less efficient capital structures. In this scenario, we could see corporate default rates stay low, without the material spike that is widely expected.

Sovereigns: More Resilience Than Meets the Eye

Turning to the sovereign outlook, there are a number of EM countries that are investment grade rated—or close to investment grade rated—that have enjoyed fiscal and monetary stability and have managed their external finances prudently throughout this cycle. In many cases, the central banks of these countries have enough credibility to provide market-supporting liquidity, and allow currency depreciation, without causing inflation or capital flight. And the list is long: Mexico, Colombia, Brazil, Malaysia, Thailand, Russia and Poland, to name a few.

There is also a long list, however, of single-B rated sovereigns that don't have that same flexibility, where we see a greater risk of downgrades, or potential defaults, depending on the length and severity of the crisis. While headlines tend to exaggerate the default picture—and we realistically expect defaults to increase by about one to three percentage points over the coming year—there are some countries like Angola and Sri Lanka that were already on weak footing going into the crisis that will likely struggle.

FIGURE 2: Single-B Rated Sovereign Spreads Over Treasuries



SOURCE: J.P. Morgan EMBIGD. As of May 31, 2020.

"Overall, when looking across the entire EM sovereign universe, we believe there's more resilience than meets the eye—as well as more ability and, importantly, willingness to satisfy sovereign debt obligations."

In mid-April, the G20 announced the Debt Service Suspension Initiative (DSSI)—an eight-month sovereign debt payment suspension that can be requested by any of the 76 International Development Association (IDA) countries, along with any of the least developed countries (LDCs) that are current on their International Monetary Fund (IMF) and World Bank (WB) obligations. The DSSI allows these countries to suspend principal or interest payments on their debts to G20 members through the end of 2020.

Certainly, such support from multi-lateral lenders will help a number of weaker EMs bridge the financing gap to pull through this crisis. But it's notable that a number countries do not wish to take the support, instead focusing on managing through the crisis on their own in an effort to maintain their reputations and creditworthiness on the global stage, and hence their access to capital market funding. Honduras and El Salvador are prime examples.

Overall, when looking across the entire EM sovereign universe, we believe there's more resilience than meets the eye—as well as more ability and, importantly, willingness to satisfy sovereign debt obligations.

The Takeaway

It is inevitable that EM defaults will rise in the months and years ahead. But painting the entire universe with a broad brush oversimplifies a situation with far more nuance. Plenty of corporate and sovereign issuers will continue to thrive, and the market weakness of recent months should allow active managers to invest in those names at attractive price points. Ultimately, what it comes down to is this: sovereign and corporate selection matters, and it matters a lot. And those active managers that take a long-term view, do their homework and closely assess risk on a country-by-country and company-by-company basis stand to benefit once the global pandemic is behind us.

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