EM DEBT: NAVIGATING A SHIFTING MACRO BACKDROP

This piece was adapted from an interview with Ricardo Adrogué and Omotunde Lawal. The full audio podcast can be found here.*

IN THIS Q&A, BARINGS’ HEAD OF GLOBAL SOVEREIGN DEBT AND CURRENCIES, RICARDO ADROGUÉ, AND HEAD OF EMERGING MARKETS CORPORATE DEBT, OMOTUNDE LAWAL, DISCUSS POSSIBLE OUTCOMES OF THE TRADE TENSIONS WITH CHINA, VENEZUELA’S EVOLVING STATUS AS A POLITICAL HOTSPOT, AND WHY WE HAVE HIGH CONVICTION IN MEXICO.

When considering emerging markets debt as a broad universe, how would you frame the issuer types, overall market size and associated risks?

OMOTUNDE LAWAL (OL): When we speak about emerging markets debt, we’re actually talking about three distinct sub-strategies. The first is hard currency corporates; the second is hard currency sovereigns; and the third is local bonds—that is, bonds issued in the countries/local jurisdictions themselves. Whereas the local universe is roughly $7.5 trillion, the hard currency and corporate universes are roughly $1 trillion and $2.1 trillion, respectively. This compares to the U.S. investment grade universe of $5.7 trillion and the U.S. high yield universe of $1.5 trillion. From a diversification standpoint, over 70 countries are represented within the space, and issuers span the ratings spectrum from AA through CCC. So, we are talking about a very broad asset class.

RICARDO ADROGUÉ (RA): There are basically three sources of risk (and returns) here. The first is the risk of default, or credit risk—meaning the risk that a corporate or a sovereign will fail to pay back the investor that has bought its bond. The second is the risk of currency changes in the local markets. And the third is interest rate risk, which is often the least understood in the markets. If the country’s rates go up—typically influenced by the central bank, due to an overheating economy—investors lose money because their bonds go down. This is essentially the opposite of credit risk, because these bonds tend to go up when the market is softening, much like U.S. Treasuries go up when the U.S. economy softens, and that is exactly when hard currency bonds tend to suffer.

Looking at the overall economic backdrop, can you discuss the picture for emerging markets? Is there a scenario in which these regions might do well going into a recession?

RA: Despite a lowered output forecast by the IMF for 2019, economic growth numbers remain fairly positive—with advanced economies at 2%, and emerging and developed economies at 4.5%. For context, the U.S. is at 2.5% growth, while China—among the highest, alongside India—sits at 6.2%.

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Additionally, the IMF reported that risks to the growth forecast are tilted toward the downside. While headwinds to emerging markets—specifically U.S interest rates, capital outflows, falling commodity prices and trade tensions—have not gone away completely, they do appear to have receded in the last few months.

From a debt perspective, a lowered output forecast could be a positive development. A period of significantly slower growth—to the extent that the recession is not too deep in developed markets like Europe and the U.S.—would likely translate into significantly easier financial conditions from the Fed and ECB. Additionally, because emerging markets have local currencies as shock absorbers, which have been very successfully used, they have the potential to provide attractive returns as an asset class even in the event of a recession—but it would likely be very skewed towards the hard currency asset classes in that scenario.

**OL:** Also, from a corporate perspective, many issuers rely on the easing of liquidity and availability of credit—and that sometimes is one of the key drivers for spread levels and performance within the space. China is a good example of that—where, in 2018, there were much tighter credit conditions that affected spread levels. But as we begin 2019, we’re seeing some easing of those credit and liquidity conditions, and that is helping provide some spread compression within the region.

**Building on that, China and Venezuela are two countries that have dominated the headlines lately. How do you see the next couple of years playing out?**

**RA:** Regarding the trade disputes with China, the end goal of the U.S. administration is not entirely clear. If it is true political change in China, then we are in for protracted and difficult trade negotiations. If it is the trade imbalance that President Trump has pointed to, it could potentially be solved in the near future. China has given indications that it wants to ramp up buying of certain U.S. commodities, which would suggest that it is willing to do some rebalancing on the trade side—but again, it all depends on the underlying goal of the U.S. administration.

With regards to China’s economic growth prospects, there are two interpretations of what is currently happening: One is that the administration is pushing the economy along a substantial and perhaps unsustainable growth trajectory—attempting to reengage with historic levels. The other is that the economy has slowed down with the blessing of the administration. If the latter is correct, it would be a positive development—although not necessarily in the near-term for emerging markets, largely because China has high demand for products and services in emerging markets, and dampened growth would repress that. While the former scenario would be more troubling, our view leans more toward the latter—that the Chinese government does not want to push the economy past a sustainable level—and therefore does not raise concern.

**OL:** It is also important to put China’s growth in context. Any slowdown would be very gradual—and we are talking about an economy that is still growing faster than most economies at about 6%–6.5%, which is positive by any standards within emerging markets.
RA: Regarding Venezuela, as a U.S. investor, we are prevented from investing in local bonds. We approach the market as being very close to Iran and Cuba, two regimes that have defaulted some 40 or 60 years ago on their debts and never paid them back—and therefore, the recovery rate on the bonds of those countries is basically zero. If Venezuela follows the same path, the recovery rate of its bonds would likely be close to zero as well.

That said, with President Maduro and the current administration possibly on the way out, the potential for bond restructuring exists. Currently, when calculating the recovery value, we’ve found that it is not much greater than the face value of the bonds—and therefore the existing opportunity is not compelling enough for us to buy them. However, it is a situation we continue to monitor closely. While we technically cannot invest today, and would not do so given a near-term opportunity—the situation continues to evolve rapidly, and it is potentially something that could be of interest down the road. But the math has to make sense in terms of the potential recovery rates.

Thinking about your outlook for 2019, where are you seeing opportunities—in terms of both sectors and jurisdictions?

OL: On the corporate side, what drives performance is very much the fundamentals of the issuers themselves—and what we’re typically looking for when we invest is a sustainable business model and stable financial metrics. We also consider the micro/country economic backdrop, as well as the ESG considerations of the issuer, and assess whether there are any regulatory headwinds that might affect the company.

With that in mind, we are finding very good investment opportunities within idiosyncratic situations where quality companies are operating within a stressed macro backdrop. At the moment, we really like the China property space, where you can get two- or three-year duration and 8-9% yield from BB corporates, some of which are split-rated investment grade or high yield types of instruments. The same is true of Turkey—specifically within short-dated Turkish bank senior paper, where you can get 8-9% yield with short duration. Additionally, within the sovereign and hard currency sovereign spaces, we are seeing very good opportunity in places like Buenos Aires, one of the strongest provinces within Argentina, where you can again get 8-9% yield for certain instruments. So, at the headline level, certain countries look risky—but when you drill down into corporate fundamentals, the opportunities are relatively interesting and worthwhile.

RA: Mexico is potentially one of our most controversial calls today in the market. Investors often avoid it because of its leftist government—and for the same reason, they tend to favor Brazil because of its right-wing government. In our view, both present good opportunities and have good reasons for going through political transitions.

Mexico, by the definition of being leftist, does put property rights at risk—and we agree with that sentiment. That said, we think the markets are completely missing the fact that President Obrador has explicitly laid out his plans and remained steadfast in them.
First, he pledged to annul the Mexico City Airport contract, and second, he stated that as a fiscally conservative leader, he would respect monetary policy independence. In both cases, he has followed through. Despite rattling the markets, the airport cancellation was done without jeopardizing anything. We saw the same thing happen on the energy side, where he’s been very vocal on the importance of Pemex. This is a highly indebted quasi sovereign entity, in need of substantial support from the government—and we’ve seen the government come through with a capital injection and some tax break support. So, we tend to take a contrarian view on Mexico, as we’ve found its administration to be highly reliable.

What final takeaways might you offer to Barings’ clients?

**OL:** Amid the current landscape, we continue to see a variety of opportunities within emerging markets debt—including sovereign debt, local currency debt and corporate debt. For investors who may not have the time or resources to make allocation decisions between these sub-strategies, a blended strategy that seeks relative value across them can be a particularly effective way to invest in the asset class.

Another interesting opportunity for investors who are a bit more sensitive to the Fed’s actions or Treasury rate movements would be our short duration strategy. This is a very low volatility, low duration product which currently yields approximately 5.5% for just under two years of duration—and it performed quite well in 2018, which was a year of high volatility.

**RA:** Generally speaking, as we sit today, we expect 2019 to be a more favorable backdrop for emerging markets debt as an asset class relative to 2018. That said, we do expect to see a continued stream of headlines related to political elections, trade disputes and growth concerns throughout 2019. And while we’re generally more optimistic about the backdrop in 2019 relative to last year, we would stress that we are not completely out of the woods—and we believe that a strict focus on the bottom-up fundamentals of each investment is critical for success in the year ahead.
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