Emerging Markets Debt: A Case Against Broad EM Bearishness

By Eric Fine, Portfolio Manager, and the Active Emerging Markets Debt Team

Portfolio Manager Eric Fine and the Active Emerging Markets Debt team share several key insights on why the bearish view on EM debt may be overdone.

- **Emerging Markets (EM) are not a monolith.** Some are bad, so don't invest. Some are good, so don't throw them out. Some are really good and did well in this environment, like the Czech Republic, Thailand and Philippines. Some developed markets (DM)) bonds were crushed, like Australia, Italy and Greece. It depends, in other words, on country-specific factors, not "EM bad" or "EM good".
- **Why aren't we talking more about pricing?** There is zero reference to pricing in the bearishness, just explanations of why things went bad. There are, of course, vulnerabilities. The question, as always, is whether they are under or over-priced. If you go only by fundamentals and pick, what you view as "safe" things, you'll end up with very low risk and high duration, in our view. When any rebound comes, duration will punish those, dramatically, with no carry.
- **To counter the argument "DM equities are the best call"**, I'd say: a) that is not asset-allocation, that is trading markets and betting it all on Black 17; and b) you are betting on a V-recovery … risky bonds will do much better in a U-recovery than a V, due to the carry. A V helps risky bonds, arguably outperforming, but maybe not; however a U helps risky bonds relative to equities more clearly.
- **We believe that the bearishness doesn't sufficiently integrate the global policy responses and their speed and flexibility.** The Fed is buying investment grade (IG) paper and, as it did so, all low-beta EM rallied and high-beta EM stabilized. Swap lines with key EM countries (like Mexico, which we like) reduce the risk of U.S. dollar runs becoming self-fulfilling. They should be viewed as fairly unlimited in our opinion. The Fed is responding to every fire it sees, and quickly … much more quickly than during the global financial crisis (GFC). Moreover, the IMF, Paris Club, and G20 are stepping up … with the IMF proposing new lending facilities and the Paris Club calling for a suspension of bilateral payments (all in USD, which is in the liability numbers in a lot of the bearish reports). Here are the latest speedy reactions:

  1. The Fed's foreign exchange (FX) swap lines with Banxico and other EM central banks allow it to prevent EM runs on U.S. dollars.
  2. Bilateral creditors (wealthy sovereign lenders) are calling for suspensions of debt payments without requiring defaults.
  3. The G20 is considering essentially guaranteeing $44B in payments (including on eurobonds) for poorer and smaller countries.
  4. The IMF is increasing its balance sheet and emergency lending support. This is not a time to panic, in our opinion, it is a time to look for country-specific survivors.

- **The underlying assumption in the bearishness is that the external environment will be stressed for the foreseeable future.** That seems an extreme assumption. I wouldn't be surprised if the bears change their tune in a month or two, after a massive bounce. It seems to us like they are laying out a worst case, not a central case.

- **The bearish consensus implicitly or explicitly assumes we are in a financial crisis, like Lehman, not in a public health crisis.** This will have an obvious end, with tons of stimulus going to work when it is over. We believe we have early warning from the nascent stabilizations in China and, maybe, Italy. In our view, Fundamentals aren't the cause of this crisis. When China activity starts to rebound, and Italy has peaked and the Fed keeps anchoring IG markets and perhaps stabilizing or boosting HY indirectly (or directly, if needed), are markets really going to just sit there and wait for the "all-clear" signal? In a financial crisis, that "all-clear" is murkier. With a public health crisis, we believe it is clearer.EM economies don't have the wherewithal to just shut down their economies the way DM countries do, so we believe the growth impact may be less. Their demographics, of course, point to younger and thus possibly less vulnerable populations.
- **If China can't stimulate, the U.S. still can.** That's why a country-by-country response makes sense. China may be doing less fiscally. But the rest of world is doing more. If the U.S. initiates a $2T fiscal response and the Fed monetizes $4T in U.S. debt, we believe those U.S. dollars will get recycled globally.
- **Global Recovery Scenarios Matter**. Below is a table showing that in V- or U-shaped global recoveries, and scenarios for whether we will be wrong or right on our bottom up views – the scenarios show the strategy could possibly be up 19% if we're wrong on our bottom-up, or up 39% if we're right on our bottom-up. They are consistent with now being a possible "Sale of the Century?". Our other key takeaway whether the global recovery is as bad as L-shaped, or as good as V-shaped, the year-end returns for the strategy may possibly be up 0.6% to up 39.1%. Oil does not seem central to our performance anymore, as well, as prices reflect scorched-earth, and the exposures are fairly low, to-boot.

Exhibit 1 – Year-End Strategy Return Scenarios

Strategy Return to Year-End				
	Oil Prices			
	+ve	+ve	-ve	-ve
Global Recovery Scenario	Argentina Re-profile			
	+ve	-ve	+ve	-ve
L	6.3%	3.8%	3.4%	0.6%
U	25.5%	22.1%	22.4%	19.1%
V	39.1%	32.1%	36.5%	29.4%

Source: VanEck research.

- **We did not use the phrase "Sale of the Century" without some thought.** In a V-recovery, where we are basically right or wrong on our bottom-up views, you end up with a possible positive 29%-39%, even with our losses so far this year. U- or V-shaped recoveries help, and L-shaped hurts, but the carry is so high and current prices so distressed that even the L-scenario doesn't turn out that bad. Note that our V-, U-, or L- are about the global economy, and as we noted in other pieces, many EM economies are not trashing their economies to prevent Covid-19 health risks, whereas HY is very dependent on a US economy that is emphasizing public health over the economy. A key question for the doubters. The Covid-19 piece we wrote shows the unique Covid advantages EMs have vs DMs.
- **The L-shaped recovery looks weak.** We would say non-carrying asset-prices do worst, though that obviously depends on one's own predictions. We show how we see our bonds performing in the L-shaped scenario in the table. A V-, U-, or L-shaped recovery, which maps narrowly to credit spreads in countries where global growth is a factor, like El Salvador and Dominican Republic in USD, and Mexico, South Africa, and Indonesia in local, but it really affects everything. A V-shaped recovery assumes 80% retracement of the selloffs in spreads and EMFX. A U-shaped recovery assumes 40% retracement of the selloffs in spreads and EMFX. An L-shaped recovery assumes no retracement or further weakening in spreads and EMFX. In no scenario do we expect we get to new highs, despite global stimulus.

Thematic Country Responses to Bearish Views

- Egypt, Turkey and Brazil look bad on net international investment position. We avoided them before the selloff and avoid them now. Mexico is on that list, but we think the fact that it received FX swap lines from the Fed is a huge mitigating factor and it benefits the most from a stimulating U.S. economy and has the highest real rates in the world (other than some smaller outliers). Similarly, Egypt, South Africa, Brazil, Ukraine and Argentina have higher debt loads. We wouldn't own Egypt or Brazil, because of that, but also because Egypt has a lot of trapped portfolio flows in there (i.e., it uses capital controls policy-wise) and because Brazil's setbacks in policy mean no good news for a while and it pays low real rates to-boot. Note, though, that the high debt load is total public debt … Whatever case we'd make for Brazil (and we are not making one), it would definitely not be for its local currency public debt. But, it has more reserves ($359B) than central government debt in USD ($136B). That is a useful, specific and actionable data point. Ukraine's external debt has been a real worry for us as we considered investing, as its charts imply, but that's why we focused on an IMF deal, which just this week it is increasing the size of. The thematic point is that country-by-country is the best approach, not "I love EM" or "I hate EM"..
- I wouldn't put Argentina on any generic "EM" charts. I wouldn't have allowed that back when I was running an EM Economics Department. It is going to default, no question, precisely because its debt is too high. Very misleading, in my opinion. The question is whether it is going to stay current while it renegotiates and is the deal we get going to generate higher prices than the current "25-ish" points in the market now. We think those prices could double and its debt load would get cut in half at the same time.
- Focusing on current accounts is not really appropriate for flexible exchange rate regimes. Indonesia, South Africa, India and Turkey were part of the "fragile 5" in 2015/2016. Their currencies weakened and there wasn't inflation pass-through. In addition, it turned out to be a buying opportunity on their USD debt. I'd also note that all of them are net oil importers (even Indonesia), so terms of trade have improved.
- On China trade dependence, I think it depends on the countries. Indonesia is vulnerable, but it is doing structural reforms to make foreign direct investment (FDI) a bigger part of its external accounts. The floating exchange rate also helps. It would be a "no brainer" for an IMF program, too, if it just raised its hand. Many of the rest, though, don't have mitigating factors.
- Even on the argument about short-term liabilities versus liquid U.S. dollar assets/reserves, we use that as a test, but it needs to be taken in more detail. It's useful and Russia looks great. But it's complicated. Russia's number is defensible because it has a floating exchange rate and is not a money prison and, therefore, has little pent-up dollar demand from domestics. The most acute phase of capital flight is not when foreigners want dollars, but when domestics want dollars. Now look at Saudi and China. They look awesome. But, both have pegged exchange rates and are money prisons for domestics. That is a classic old EM problem that most have gotten away from. Many newer folks forget the "multiple uses of reserves" problem, as it hasn't characterized EM in such a long time. It is when you say: "We've got enough reserves to back up fiscal … recapitalize the banks … defend the currency." However, when you add it up, it's too much, especially defending the currency. Russia's number is legit. Saudi looks good on this metric, but that is totally superficial. Saudi is much more vulnerable than that number implies. It's an example of how "safe" stuff that is priced as "safe" might be the most dangerous stuff. China might be able to get away with it as its government is credible and doesn't deny problems. (Okay, maybe COVID-19, but not economic issues.) Anyway, we don't own China local for those reasons and more (it doesn't pay high real rates, as it is a money prison/has capital controls).

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