Weekly Update
April 3, 2020

Invesco Fixed Income

Emerging markets are supported by central bank actions and valuations

Global markets have reacted to the coronavirus pandemic by building in a risk premium to reflect the deterioration in underlying growth and solvency assumptions. Emerging markets (EM), in particular, have built in a risk premium based on funding stresses that have become evident in US dollar markets.

The initial reaction to the global economic "sudden stop" was to build in a risk premium commensurate with the information available at the time. Risk aversion resulted in the strengthening of funding currencies, such as the euro and yen, relatively stable EM rates and some weakening in EM credit. As the scope of the crisis became evident, starting in Italy and then ripping through Europe and the US, funding pressures in the US dollar market emerged, first in the US Treasury market, then in European government bonds, followed by US money markets and ultimately every aspect of financial markets. Because US dollar assets are the largest component of global markets, this pressure inevitably showed up in foreign exchange markets, where it became very difficult to borrow US dollars in the forward market. The seizing up of the currency markets had a dramatic impact on EM currencies and rates.

The effect on currencies was clear cut. The US dollar strengthened as investors seeking to meet contractual obligations bought US dollars instead of borrowing them. The second order effect was on EM rates, where the lack of US dollar funding led to reductions in received positions, particularly in the long end of some markets such as Brazil and Indonesia. The credit component of EM risk was negatively impacted by both these factors and exacerbated by the sharp fall in oil prices, as the price war erupted between Russia and Saudi Arabia. Oil prices also hurt currencies of countries with heavy oil dependence.

EM policy response

The EM policy response to the turmoil has been primarily monetary, and to a more limited extent, fiscal. Most EM countries did not come into this crisis with much fiscal room. However, in an environment where the US Federal Reserve (Fed) cut interest rates to zero and is engaging in a significant amount of quantitative easing (QE), they do have significant monetary room. EM countries have reacted with a mix of measures, even those countries with little fiscal room, such as Brazil. Brazil's central bank has reduced interest rates and the government is making cash distributions to lower income wage earners along with other fiscal measures, and local governments have enacted measures to provide credit to small and medium-sized enterprises. In India and Indonesia, support is coming from the central banks in the form of lower interest rates or increased market purchases of bonds and an increase in the fiscal deficit by a few percentage points through direct cash transfers and subsidies. In China, which has the greatest policy room, measures have been more focused on businesses, providing them subsidies and financing, and through increases in state and local government spending.

Given the restrictions on EM fiscal policy, there have been some constraints, but each country has taken significant actions to help alleviate the economic stress caused by the pandemic. The following table highlights key policy responses in various countries. The final backstop for emerging market countries will likely come from the International Monetary Fund (IMF), which has around USD1 trillion of available lending capacity and is seeking to expand that over time.

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Table 1: Overview of EM policy responses

Country	Policy Rate change (% pts, during Feb. and March 2020)	Fiscal loosening (% of GDP)	Spending front loading	Tax cut/deferrals	Wage subsidy/paid leave	Cash transfers	Market Support	Bank measures	QE
Argentina	-12.00	0.9	x	x	x				
Brazil	-0.75	1.4	x	x	x	x			
Chile	-1.25	4.7	x	x	x		x		
China	-0.20	0.3	x	x		x	x	x	x
Colombia	-0.50	0.1		x		x	x		x
Czech Rep	-1.00	2.8		x	x		x		x
Egypt	-3.00	2	x				x	x	
Hungary	0.00	0.3					x	x	
India	-0.75	1	x	x		x			
Indonesia	-0.50	2.5	x	x	x		x	x	
Israel	0.00	5.6		x	x				
Malaysia	-0.25	16		x		x			
Mexico	-0.75			x				x	
Poland	-0.50	10			x				
Philippines	-0.75	0.3	x	x			x	x	x
Romania	-0.50	1.5		x	x		x	x	
Russia	-0.25	1.1	x	x	x	x	x	p	
S. Arabia	-1.25	2.3		x			x		
S, Africa	-1.00						x		x
S. Korea	-0.50	1.1		x	x	x			
Thailand	-0.50	3.3		x	x		x	x	
Turkey	-1.50	1.5	x	x	x	x			
UAE	-1.25	1.1		x				x	
Ukraine	-1.00	2.2		p			x	x	

Source: Bloomberg LP, BNP Paribas. Rate data as of April 2, 2020. Policy measure data as of March 3, 2020. P=planned.

Potential opportunities arise from market dislocation

Market dislocations inevitably create potential opportunities. We would classify opportunities as three types: those that will likely benefit from central bank action in specific countries, those that will likely benefit from central bank actions globally and those that will likely benefit from asset prices having fallen to very low levels.

We see the first type of opportunity in EM interest rates in those countries where the central banks are likely to continue reducing rates. We would expect most central banks to fall into this category. While it is difficult to assign a magnitude to future rate cuts, we believe the most monetary room is in Mexico, Russia and India, with less room in Colombia, Brazil, South Africa, Indonesia and Malaysia. We believe a subset of rate opportunities exists in countries where the yield curves have steepened dramatically as a result of funding stresses in the US dollar market. We believe such yield curve opportunities exist in India, Brazil, South Africa and Indonesia, where there is a desire on the part of the central banks to reduce long-term borrowing costs and ease financial conditions that have tightened dramatically.

The second set of opportunities in EM will likely come from developed market central bank actions. With the repricing of growth and solvency assumptions, the US dollar and other developed market currencies have risen sharply versus EM currencies. EM currencies have, on average, declined by 14% in the past year; the higher beta currencies have declined by nearly 30%.[1]

The response from developed market central banks to the crisis has been very large. As mentioned above, the Fed has cut rates to zero and is engaging in massive QE. From March 13 to April 1, the Fed purchased USD888 billion in securities and that total is likely to exceed USD1 trillion by April 3.[2] Including other recently announced Fed facilities, we expect the Fed balance sheet to expand anywhere from USD2 trillion to USD4 trillion. The European Central Bank (ECB) has joined in with its QE, which is expected to approach USD1 trillion to USD1.5 trillion. These long-term injections will likely help global liquidity conditions and lead to the depreciation of the US dollar when the current period of risk aversion ends. It is a bit early to pinpoint the currencies that will likely outperform the most, as we need greater clarity on oil prices.

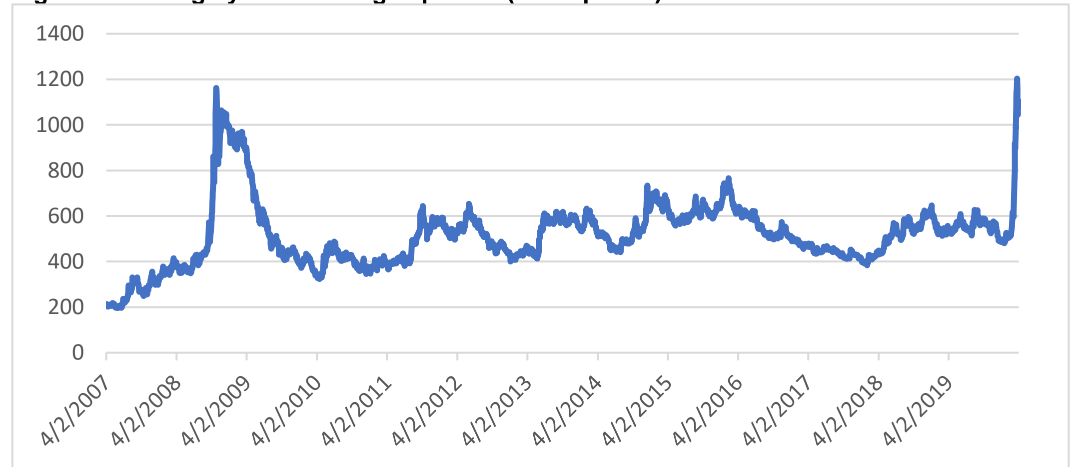
We expect the third set of opportunities to relate to assets whose prices have fallen the most. These will likely relate primarily to credit. Credit in EM countries will likely face additional headwinds related to the depreciation of EM currencies, increased liabilities and the commodity price shock. As these shocks recede over time, we believe significant value can be extracted from those markets (as highlighted below in “Sector focus: EM credit”). The catalyst for releasing that value will likely depend on the first two opportunities being realized.

Invesco Global Fixed Income outlook
The current selloff in EM markets has two primary causes: a medium-term reassessment of growth and risk, and short-term funding pressures. We expect the drawdown in interest rate and currency markets due to funding pressures to reverse fully and provide significant additional gains as rates fall to new lows in EMs. With developed market rates at, or near, zero, we believe EM rates still have significant room to fall. We expect growth and risk concerns to dissipate over a time period of between 18 months to two years. Given that we believed EM assets offered attractive opportunities prior to the pandemic, we think the recent moves by the Fed have removed some longer-term headwinds for EM assets and we remain very constructive over the next two years.

Sector focus: EM credit

There is no doubt that the current COVID-19 pandemic and its related effects, including the collapse in oil prices, are having a significant negative impact on emerging market (EM) economies. Also, most EM countries, with the exception of China, have fewer resources than their developed market counterparts to mitigate this impact. These concerns have weighed heavily on financial assets in the EM sovereign and corporate credit sphere. This is especially true for high yield EM countries, where signs of strain are widespread and have caused EM sovereign high yield spreads to widen beyond the highs of the 2008/2009 global financial crisis.

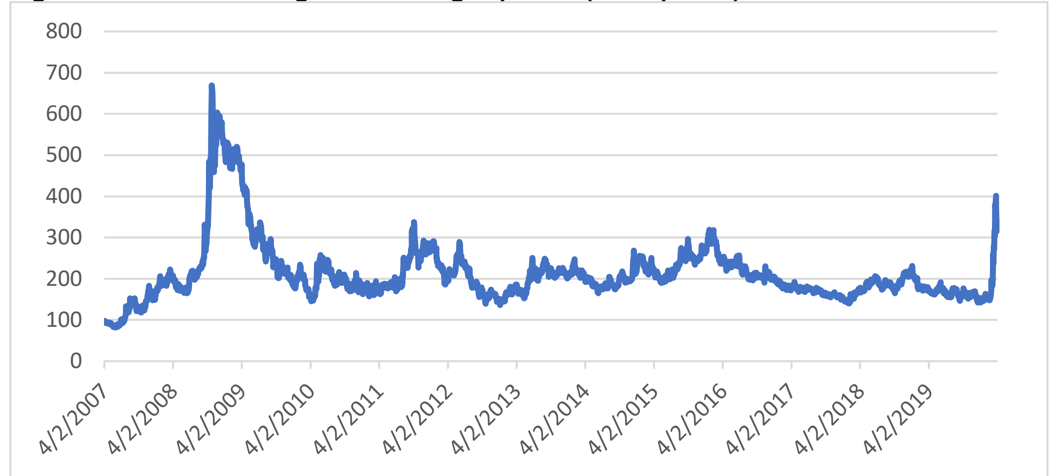
Figure 1: EM high yield sovereign spreads (basis points)



Source: JP Morgan, JP Morgan Emerging Market High Yield Bond Index, data from April 2, 2007 to March 31, 2020.

Investment grade EM credit spreads have also widened sharply but remain well below the 2008/2009 spike.

Figure 2: EM investment grade sovereign spreads (basis points)



Source: JP Morgan, JP Morgan Emerging Market Investment Grade Bond Index, data from April 2, 2007 to March 31, 2020.

Over the past few decades, EM spread widening of this magnitude - sovereign and corporate - has typically proved to be a good buying opportunity. Even taking the 2008/2009 period as an example, investors would have generated strong returns over the subsequent 12 months - approximately 25% for investment grade and 70% for high yield (Figures 1 and 2). Based on this history, and the recent greater spread movement of high yield versus investment grade, we might conclude that now is a good entry point for EM high yield. For patient investors with a high risk tolerance, this may be the right conclusion, as the high yield market appears to be pricing in a very bearish scenario that we believe is unlikely to materialize.

Investment grade EM credit potentially more attractive on risk-adjusted basis

However, for more conservative investors, investment grade emerging market credit may offer a more compelling opportunity on a risk-adjusted basis. While the economic impact of the current crisis is likely to be severe among all economies, we believe investment grade EM countries and companies are well positioned to weather this prospect. Most investment grade EM issuers remain in a sound financial position, often with better credit metrics than their developed market peers. This provides them with a broader set of options with which to mitigate the pressures of the current crisis compared to high yield EM issuers.

EM countries and companies also play vital roles in the global economy. As such, the developed world is highly incentivized to provide some level of support. We are already seeing this play out with Fed programs that offer EM countries access to US dollars and the availability of IMF emergency funding. Considering this, we do not see meaningful default risk under conservative scenarios within the investment grade EM space. We could see some major investment grade issuers like Mexico or Colombia migrate to high yield, but that is the main risk, in our view, not default.

That is not to say that EM credit does not carry more risk than developed markets, especially in periods of crisis. EM credit certainly carries more risk, given that many EM countries face greater political and economic volatility. In addition, there is no equivalent, broadly, in EM, to the Fed or ECB that can step in and buoy the market by directly buying assets. However, looking at historical data in the EM investment grade space, additional investment risk is primarily related to asset price volatility rather than default risk. Taking that into account, and considering the spread differential between EM and developed market investment grade bonds, we believe investors are being compensated for incremental EM risk. As Figure 3 shows, spread differentials between investment grade EM and US corporates are at their widest levels in the past four years.

The world is still working its way through the current crisis and uncertainty remains extremely high. However, financial markets appear to be pricing in a fairly bearish scenario. As such, we believe this may be a good time to consider adding EM risk, especially in the more resilient parts of the market, such as investment grade EM credit.

Figure 3: EM and US investment grade corporates spread differential (basis points)

Source: JP Morgan, JP Morgan Emerging Market Investment Grade Corporate Bond Index and JP Morgan US Investment Grade Corporate Bond Index, data from March 31, 2015 to March 31, 2020.

1 Source: Bloomberg LP, April 3, 2019 to April 2, 2020.
2 Source: Morgan Stanley Research based on https://www.newyorkfed.org/markets/pomo/operations, data as of April 1, 2020.

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