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CUT OUT THE NOISE

EMERGING MARKET DEBT UPDATE

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Let's cut out the noise, the market moves, the news flow, and think of what just happened over the last two weeks: a market crash led by the global economic clampdown from the spread of the coronavirus.

What is the implication of the shut down? A hit to the income statement of households, corporates and sovereigns. Add the oil shock to the mix and we have a perfect storm for an earnings squeeze. However, should an earnings hit cause such havoc with markets breaking many records both in terms of speed and magnitude of the move across various asset classes? Only if it is permanent, impairs the balance sheet, impacts the creditworthiness of the borrower or has a significant 2nd order impact. If the economy is moving in that direction, then the world should be heading into a deleveraging deflationary depression. However, because of the Policy Put, this is not the case.

If the markets made record breaking moves these past two weeks, the global policy response has been keeping pace. We have seen the Fed and the ECB take out their Global Financial Crisis (GFC) playbook and some more. In addition, the Fed has also introduced quantitative easing to infinity, a corporate bond purchase program, corporate bond ETF purchase program and a lending program for small and medium-sized enterprises (SME). Some of which are unprecedented. Germany has also signed off on a EUR 750bn COVID package with potentially more to come.

If the policy response has been strong, why have the markets not reacted more positively, and are the asset prices reflecting the economic realities? To answer these questions we go back to our ever trusted Fundamental, Technical, Valuation (FTV) framework.

Fundamentals

The market is looking for the following :

- **Containment of the virus** – this is the catalyst for the sell-off and its containment is key to restoring economic activity. Europe is currently the epicentre before the spread of the disease accelerates into the US, suggesting some time before we see the back of this infection. Some are using the South Korea and China curve to project an end to the pandemic whilst others are considering the Italian curve. The answer is probably more nuanced given the varying policy response and country-specific qualitative factors, such as social distancing, percentage of population over 70, number of smokers, healthcare system and population density. We do, however, need to see infection rates peak out at least in one of the western countries to gain a sense of timeframe for the containment of the virus. This would provide cues to the markets and business leaders. In the background, it is worth keeping an eye on re-infection rates in China as the country goes back to the normal work routine.

- **Fiscal response** – the markets first saw large monetary policy programs announced by various Central Banks and the Trump administration reached an agreement on a USD 2trn fiscal package with the Senate Democrats and Republicans. This will have to be approved by both houses before it is signed by the President, which at this stage seems more of a formality. Fiscal stimulus is critical in this environment as we are dealing with an income shock at a mass scale, which could easily turn into a balance sheet or credit problem. It is worth noting that we are not in a GFC environment: the GFC was a financial market credit problem which translated into a real economy (income) problem. This time is the opposite – an income problem leading to a credit problem, accentuated by lack of liquidity in the financial markets.

Technicals

Technicals answer part of the question: "Are the asset prices reflecting the economic realities?" The answer being only partially as all markets – from Gold to Emerging Market (EM) Debt - broke down during the last two weeks, with severe lack of liquidity leading to extremely gappy price action and no one to take the other side of the trade.

This was particularly felt in the EM Hard Currency Eurobond market where liquidity is relatively poor. The Hard Currency Eurobond market, unlike the Local currency EM Market, lacks a buyer of last resort – no local Central bank, local Pension fund or Insurance company. It is the smaller segment in the EM Debt universe but has attracted large amounts of assets over the decade to take advantage of the perceived upside of EM exposure without taking on the currency risk. The price one pays for just being exposed to this sleeve of the asset class is the lack of liquidity, which is acutely felt at the worst possible time during the sell-offs. A Fundamentals-led price action quickly morphs into a Technical market with gappy and irrational price action.

To add insult to injury, ETFs, which by their very nature are tactical and momentum market players, also accentuate the move. This is noticeable with EM ETFs which give the perception of relative liquidity with ease of getting broad EM exposure but effectively concealing the embedded liquidity risk. These investors would have crystallised major losses in recent weeks as the main hard currency EM ETF, EMB ETF*, was down circa 24.5% vs. 17% for the EMBI Global Diversified benchmark as of 18th March 2020. This suggests the ETF was indiscriminately selling bonds at whatever price possible.

While some market commentators have questioned the effectiveness of monetary policy stimulus and liquidity measures introduced by various central banks, they have been implemented to address this very liquidity shock and ensure normal market dynamics without which the whole system will collapse under its own weight.

Valuations

To say that the price moves in the last two weeks have been sharp is an understatement. The spreads in all the EM Hard Currency indices and sub-indices (High Yield and Investment Grade) have widened by a factor of circa 2.5x and these spread levels have broken through the highs of both the 2011 or 2016 sell-offs. In the case of the EM Hard Currency Sovereign High Yield sub index, the spreads are now past 2009 levels.**

Big contributors to these moves are, of course, the energy names which have had the double whammy of a sudden economic stop and the oil price collapse due to the fall out of the OPEC+ deal. However, the indiscriminate selling, either by ETFs or forced sellers looking to raise cash, has left pockets of value across the spectrum. As an example, a AA rated sovereign long-end bond fell 45 pts, a BBB rated sovereign's (oil importer) bond in the belly of the curve was down 15 points, and then there are some short dated HY (non-energy) names paying as much as 30% for less than 1yr maturity.

*iShares USD EM Bond ETF (EMB) **Source: Mirabaud Asset Management

But can valuations fall more? Quite likely in our view. With COVID-19 still to accelerate in the US, the rest of western world looking for signs of stabilisation, the ugly corporate and sovereign numbers yet to be reported and question marks about governments putting human lives over economics, this adds to the fundamental uncertainty.

However, with each passing day we are seeing more and more policy support which gives us hope that we are moving in the right direction. At this time, it is easy to be drowned in the crescendo of noise and look at the short term but we will eventually look at the pandemic in the rear view mirror. Only this time though with pockets of extremely cheap valuations (and, of course, many minefields to navigate through), clean technicals and trillions in liquidity and easy policy conditions for the foreseeable future.

Source: Mirabaud Asset Management as of 25th March 2020.

IMPORTANT INFORMATION