

Mining emerging market fundamentals for hidden gems

▶ **With home interest rates at all-time lows, the higher yields of emerging market bonds may be hard to resist. But they obviously carry risks. A deep dive into the fundamentals of emerging economies reveals surprising differences and unexpected strengths – and may allow managers to spot opportunities while mitigating risk**

Emerging markets (EM) ended the first half of 2020 on a note of confidence, even as the Covid-19 pandemic accelerated in parts of Latin America and elsewhere. Central bank support in the developing world, as well as in the US and Europe, put a floor under risk assets. That said, returns on EM debt were uneven: investment-grade sovereigns are up, and Asia and China fared best of all because of effective measures to contain the coronavirus. High-yield bonds, by contrast, underperformed safer assets.

Investors remain understandably cautious, but vulnerability to the pandemic and to oil and other commodity prices varies significantly from country to country. A bottom-up analysis of the economic fundamentals of each country can reveal surprising strengths and opportunities for investors.

For example, some oil-exporting economies are highly vulnerable to fluctuations in international oil prices. Other countries, such as the Dominican Republic, are oil-importing nations, which benefit from low prices, although

the Dominican Republic is sensitive to tourism, which has been severely disrupted by the pandemic.

Some countries are tied at the hip to China's recovery, whereas others would benefit more from a US rebound. Some, such as Russia and Iraq, entered the pandemic with strong fundamentals – modest debt-to-GDP ratios, for example – while other countries have less fiscal leeway. We expect close to half of the countries in the J.P. Morgan EMBI Global Diversified Index to need debt restructuring as a result of the global recession.

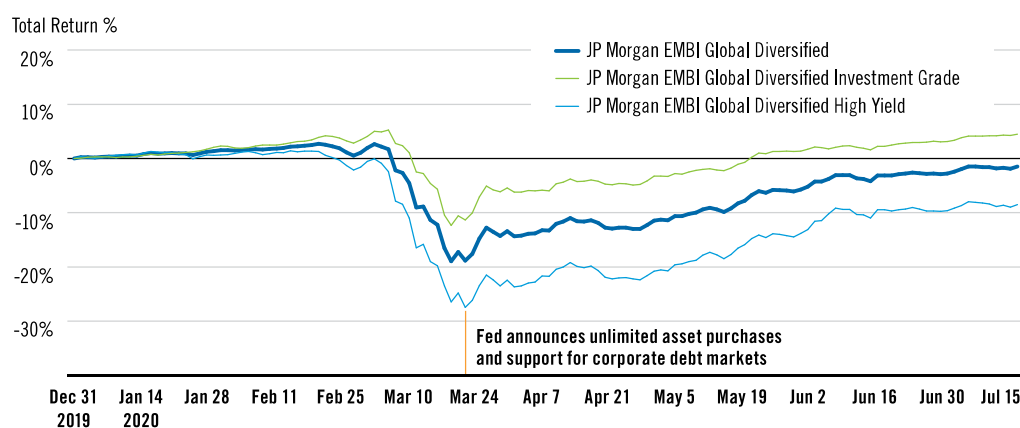
Debt relief: Good or bad?

Creditors, including the IMF, World Bank and Paris Club have been quick to help countries fund their emergency responses with additional credit lines and debt freezes, sometimes called 'standstills'. These have averted solvency crises in a number of distressed economies.

EM SOVEREIGN BONDS REBOUND FROM MARCH LOWS

Exhibit 1: Investment-grade hard currency EMD outperformed high yield.

December 31, 2019–
July 15, 2020



Sources: Franklin Templeton Capital Market Insights Group, JP Morgan, Macrobond. Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses or sales charges. **Past performance is not an indicator or a guarantee of future results.** Important data provider notices and terms available at www.franklintempletondatasources.com.

But it is important to monitor debt-relief proposals that could trigger a ratings downgrade or shut emerging economies out of publicly traded markets. Sixteen emerging-market finance ministers wrote a joint op-ed in *Jeune Afrique*¹, a Francophone publication, warning that G20 debt relief programme² should not interrupt repayments on publicly-traded bonds.

The other key actor to watch is China. Its role as a global creditor now surpasses the IMF and other multilateral lenders such as the World Bank, with an estimated \$1 trillion in direct loans and trade credits, mostly to commodity-driven economies in Africa, East Asia and Latin America. Since the onset of the pandemic, China has suspended debt repayments for 77 emerging economies and announced \$2 billion in assistance to countries impacted by Covid-19.

For many of these countries, a successful recovery is highly dependent on their relationship with China. In addition to being a key creditor, China is often the main trading partner and biggest market for the commodities of the developing world.

In China's orbit

China's success in containing Covid-19 is good news for commodity-exporting countries. Its oil consumption is back to pre-pandemic levels, as is the country's demand for industrial commodities such

as iron ore to feed its steel mills.

For EM investors, understanding China's growing influence in emerging markets is vital. Take Angola, Africa's second-largest oil exporter. It was hit hard by the collapse in oil, as over 60 per cent of state revenue and 90 per cent of Angola's exports are petroleum based.

On the heels of plunging oil prices and a ratings downgrade in late March, Angola's bond prices signalled a debt restructuring was imminent. Nervous investors headed for the exit. But a closer look revealed no need for panic. The key lay in Angola's relationship with China – its chief export partner as well as biggest creditor. China imports the majority of Angola's oil. It also holds most of Angola's short-term debt. President João Lourenço announced³ in June that he had successfully negotiated a three-year debt moratorium on the \$22 billion Angola owes China, potentially saving \$4.5 billion in debt servicing costs. Bond markets responded favourably.

Low debt allows Iraq to weather storm

Not every oil exporter was against the wall when oil prices crashed earlier this year. As OPEC's second-biggest oil producer, Iraq entered this year's oil shock on a better financial footing than many oil-exporting peers, including Angola. Iraq has kept its debt burdens low by relying on investments from foreign oil companies to boost

production of its hydrocarbon reserves, rather than borrowing money to accomplish the same aims on its own. As a result, Iraq spent less than 3 per cent of state revenues on servicing its foreign debt last year⁴. Production, meanwhile, reached a record-setting 4.8 million barrels per day last year⁵, marking a major milestone after 15 years of conflict.

Iraq's Achilles' heel is not debt, but the government's vast public payroll and state pensions, which current oil revenues do not cover. So whereas Angola turned to China for debt relief, it is likely that Iraq will turn to both the US and the IMF for budgetary support.

As the global economy looks forward to Covid-19 vaccines, we are confident that emerging market assets will continue their upward trajectory as economies and consumers gradually return to business as usual. We think a selective approach that evaluates bonds country-by-country remains the best.

Find out more: www.franklintempleton.co.uk/em-debt

Written by Franklin Templeton Fixed Income Group

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¹ "Aucun pays ne doit avoir à choisir entre sauver des vies et rembourser des dettes," *Jeune Afrique*, May 2020.

² G20's Debt Service Suspension Initiative

³ Frey, A. "Angola/Mozambique: China debt relief helps Fitch Ratings," Club of Mozambique, June 2020

⁴ Iraq Staff Report. International Monetary Fund. July 2019.

⁵ Iraq Staff Report. International Monetary Fund. July 2019.

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