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EM fixed income: Selective opportunities in a continuing adverse environment

Introducing the Emerging Markets Credit Ranking Model

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- After a challenging 2018, emerging market bonds have made a come-back in the first two months of the year.
- Fed's move to a dovish stance and relative progress in US-China trade talks have pushed investments into emerging market bonds, especially with valuations looking attractive post last year's sell-off.
- The recent rally in emerging market bonds resembles a lot like the one witnessed during 2016 period which was characterized by a similar backdrop- Fed pause and China stimulus. However, we remain cautious as this time we have reasons to believe that it will be different.
- China will face limitations in stimulating the economy given its already high debt levels while Fed's pause may not last long as US growth is stronger now compared to 2016.
- However, short-term rally in EM dollar sovereign bond market remains a possibility as change in Fed's stance to relieve pressure on US financial conditions.
- In addition to our *selective overweight on GCC bonds*, we have increased preference on ***Russia*** and ***Brazil sovereign dollar*** bonds based on our "***EM credit ranking model***". Within GCC, we have increased preference for high-quality sovereigns like ***Saudi Arabia*** and ***UAE*** and expect Oman bonds to come under pressure.
- We also believe that the recent outperformance of EM local-currency bonds will fade as markets will start pricing in the possibility of Fed hike in the latter half of the year while valuations are already tight against EM sovereign dollar bonds. Within EM local currency, *we maintain our tactical overweight only on short-dated Indian local currency government bonds.*
- Valuations in EM corporate and quasi-sovereign bond market are also not attractive versus the EM sovereign dollar bonds, with the latter to remain under pressure due to higher refinancing needs.
- Within EM corporate bonds, lower rated bonds are not attractive and EM investment grade bonds should outperform the EM junk bonds.

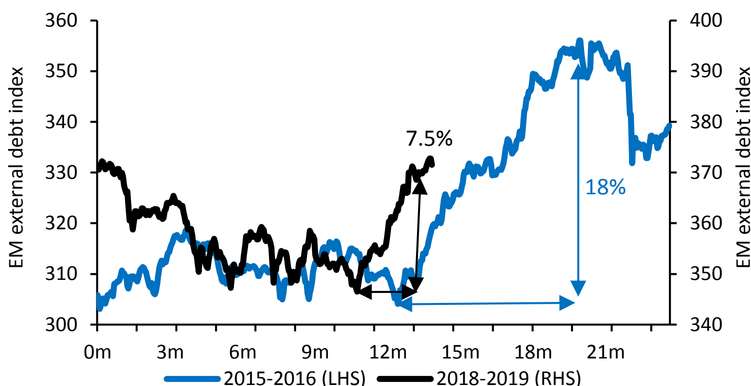
Introducing the EM credit ranking model based on the economic fundamentals

There has been an increasing demand for emerging market bonds recently, with the change in Fed's stance to a "patient" and dovish bias, marginal de-escalation of US-China trade tensions and reports of rising China stimulus in January. Amidst the recent optimism, we still maintain a cautious stance on emerging market bonds as the current positive dynamics could change in the second half of the year, especially with the Fed unlikely to remain on a pause mode for a long period of time. At the same time, we expect the emerging market bonds to rally in the short-term.

In order to better evaluate the valuations of emerging market sovereign dollar bonds, we have devised our own ***EM credit ranking model*** which ranks a selected number of 22 emerging economies based on their current fundamentals and compares them with their respective CDS levels. Based on the conclusions from the model and further analysing the domestic risks in each economy, we believe that valuations in ***Russia*** and ***Brazil*** sovereign dollar market are increasingly attractive. Hence, in addition to our selective overweight on GCC bonds, we have increased our preference for Russia and Brazil sovereign dollar bonds. Within the GCC bond market, we are now selectively overweight only on the high-quality sovereigns and reduced our preference for Oman sovereign dollar bonds.

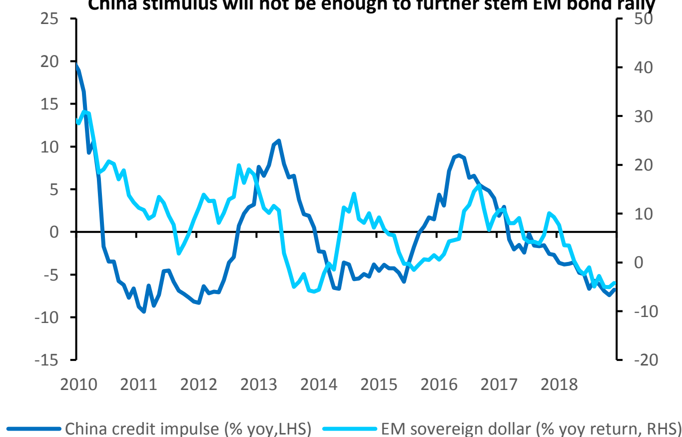
Be cautious- recent rally is not a déjà vu

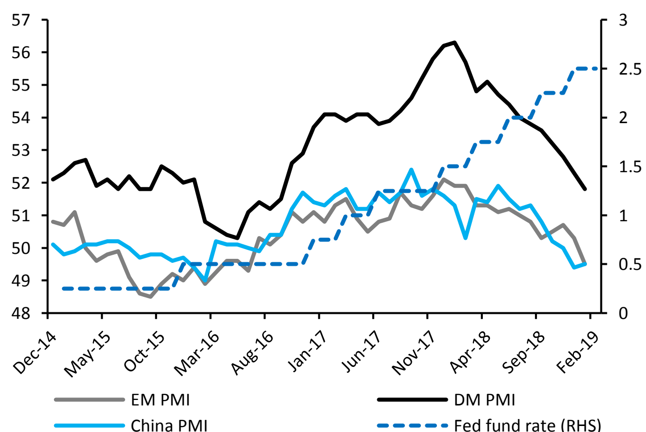
Emerging market bonds have made a come-back in the first two months of the year, after suffering for most part of 2018. Global growth slowdown concerns and increased market expectations of a possible Fed pause has fuelled investments into emerging market debt, especially with valuations looking attractive post last year's sell-off. The current market dynamics- possibility of a Fed freeze and China slowdown risks along with geopolitical tensions remaining at the forefront- may remind us of the 2015-2016 period. Similar to 2018 sell-off, emerging market bonds came under extreme pressure in 2015 in anticipation of the beginning of the Fed tightening phase and concerns on China hard landing. However in 2016, China stimulus and Fed going on a prolonged pause had sparked a sustained rally in emerging market bonds. We believe that this time may be different for the reasons outlined below.



Source: Bloomberg, ADCB

Firstly, China slowdown risks will remain a cause of concern. The current economic situation in China looks quite similar to what we witnessed in 2015-2016. In the beginning of 2016, slowdown in China's growth had become a major worry for the global markets and triggered increased volatility in the emerging markets. The annual growth rate in 2015 dropped to 6.9%, which was the lowest recorded in 25-year then. However, Chinese economy escaped a hard landing and growth bounced back in 2016 as the Chinese government unleashed a massive stimulus which ultimately translated into stronger economic activity. Fast forwarding to today, similar to what markets witnessed in the beginning of 2016, 2019 started with reports of slowest growth recorded in 2018 in almost 28-years. Similarly, just recently, there have been reports of increase in credit growth in January with Chinese banks responding to the PBOC's liquidity easing measures and increased new lending. However, the pick-up in credit impulse may not necessarily translate into better growth. We have our doubts that it will have a sustained and powerful impact on the domestic economic activity given the backdrop of elevated debt levels and absence of any stimulus in the property market. In addition, January's jump in credit growth may have been stronger than anticipated, but is not surprising as historically the Chinese government tends to inject liquidity ahead of the lunar New Year holidays. As such, it is important to wait and watch whether the pick-up in credit growth is further confirmed by future data points.



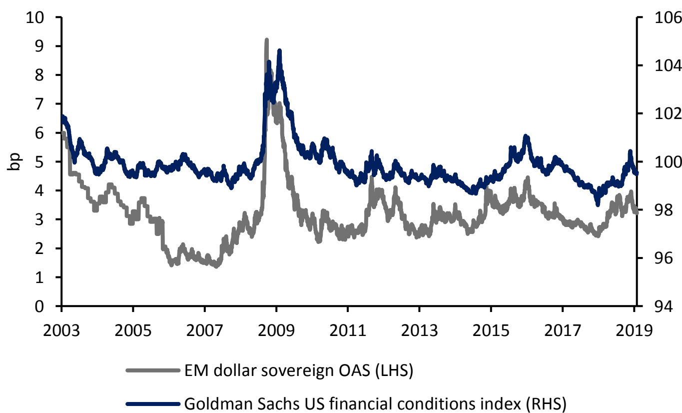


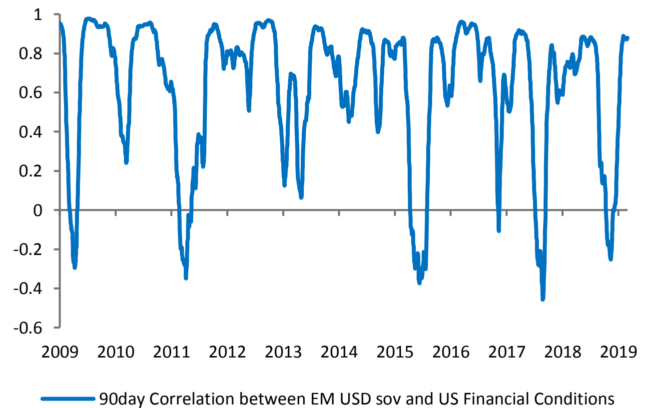
Source: Bloomberg, ADCB

Secondly, there has been a "dovish" switch in Federal Reserve's policy stance since the beginning of the year. The Fed has now been advocating a "patient" approach in raising policy rates in light of tightening financial conditions towards the end of last year and also acknowledging the rising economic risks from other parts of the world. The Fed has also signalled that it may be considering to put an end to the balance sheet reduction by end of this year. This year's Fed freeze signal is also reminiscent of early 2016. Back then, after raising rates for the first time in December 2015, then Fed chair Janet Yellen had acknowledged slowdown concerns in China and emerging markets and its possible impact on US growth, forcing the Fed to remain on a pause mode until December 2016. However, the current scenario varies when compared to 2016- US economy has been growing at a stronger and better rate on the back of fiscal stimulus. GDP is trending above 3% while in 2016, it was trending below 2%. Once financial conditions start easing with the Fed's current pause mode and there is evidence of higher wages fuelling price pressures in the economy, then the central bank could even raise policy rates in the second half of the year. A swing in expectations with regards to the Fed re-hawkish mode is likely to be a source of increased volatility in emerging market bonds.

Short-term rallies are possible

At the same time, we are not ruling out the possibility of short-term rallies in emerging market sovereign dollar bonds. The combination of reports of China credit impulse (if sustained), Fed pause and de-escalation of trade tensions should provide relief to emerging market assets. Separately, US financial conditions have been a significant driver of the performance of the emerging market bonds. Historically, emerging market spreads and Goldman Sachs US financial conditions index have exhibited a positive correlation with one another. However, in 2018, this correlation had turned negative as emerging market bond spreads continued to widen even though US financial conditions remained accommodative. Currency crisis in weak emerging economies was the main catalyst for the widening of the spreads with the sell-off aggravated by the strong dollar backdrop in August 2018. However, the correlation has now moved back to the positive territory. US financial conditions are likely to ease with the Fed's "patient" approach in raising rates and this should push EM bond spreads lower.





Source: Bloomberg, ADCB

Introducing the Emerging market Credit Ranking Model

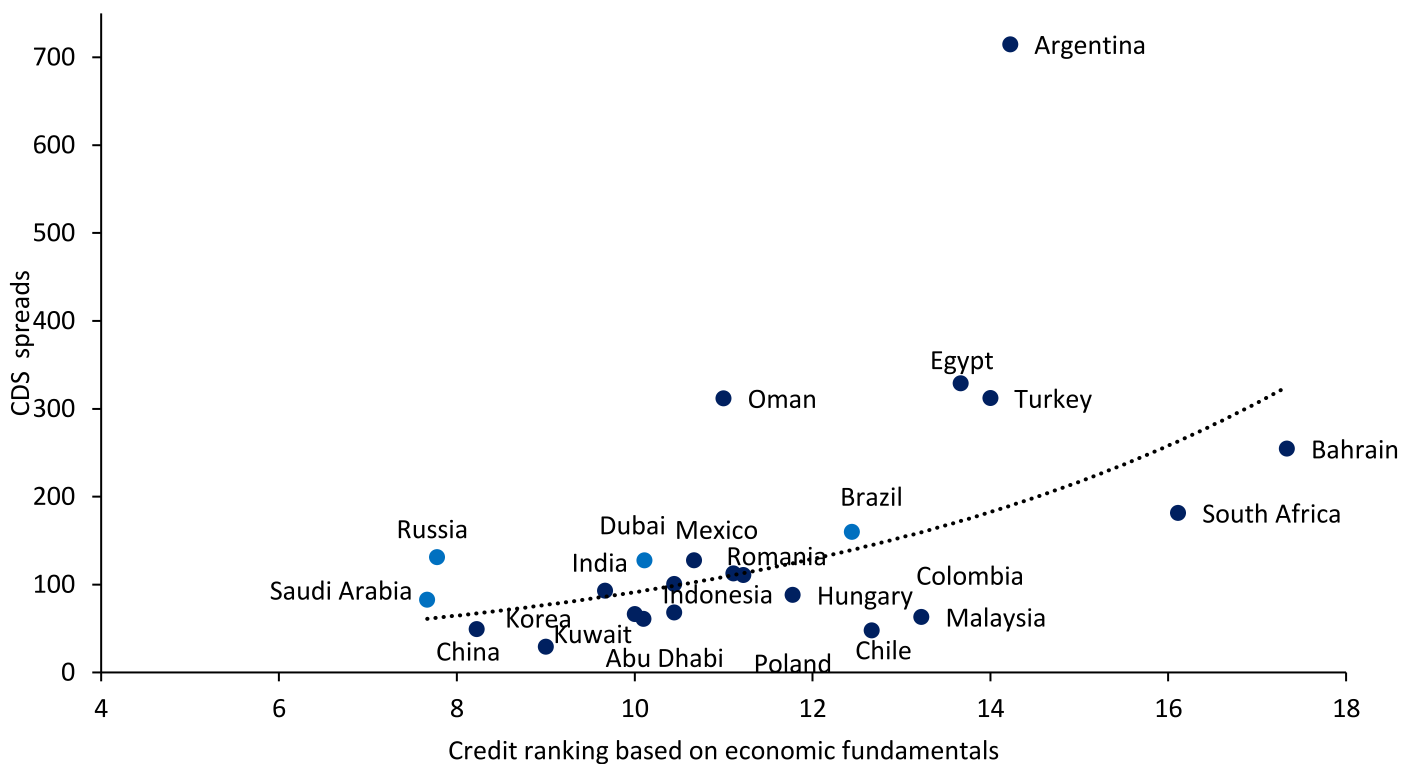
Overall, *we maintain our underweight stance on emerging market hard currency bonds*. However, we would like to highlight some opportunities which appear attractive in the dollar sovereign bond market space on a country level. In order to analyse the dollar bond market valuations, we have previously relied on the sovereign credit ratings of various emerging economies and juxtaposed them against their respective credit default swap (CDS) spreads. However, sovereign credit ratings do not immediately reflect the country's current fundamentals and at the same time, spreads often tend to price in the positive/negative rating change beforehand. As a result, we have devised our own ***credit ranking model*** that incorporates some of the important macro-economic drivers. We have also limited our analysis only to include 22 emerging economies across the globe. All countries are ranked based on macro-economic indicators- which together well capture the overall macroeconomic strength of the countries, looking at the domestic setting as well as the external positioning of the emerging economies. A lower ranking implies a better sovereign outlook.

The chart below compares our credit ranking versus the CDS spread levels. This helps in identifying the rich/cheap valuations of the emerging bond markets. Emerging bond markets above the blue line are trading cheap versus their respective credit

ranking. Given the Fed uncertainty and global growth slowdown risks, we stress that it's crucial to stick to emerging economics which exhibit strong fundamentals and positive reform momentum in the coming years.

Russia favoured on having most attractive valuations

Valuations are looking most attractive in Argentina, Egypt, Oman, and Russia. Since the credit ranking model does not incorporate domestic and geopolitical risks, it is important to evaluate these countries on an individual basis. Out of this group, we favour **Russia**. Credit spreads are not only trading cheap versus the country's fundamentals, but Russia continues to remain better placed in terms of its external positioning given its low foreign debt. During times of increased external risks and stronger dollar bias, Russia bonds should relatively be less vulnerable. On the other hand, **Argentina** is trading extremely cheap versus the emerging market peers but political risks are likely to remain dominant with the presidential elections in October 2019. **Oman** is also looking attractive post the rating downgrade led sell-off in December. While they fall within our overall preference for GCC bonds, we believe that the Oman bonds are likely to remain under pressure given the rising fiscal concerns and also unlike Bahrain, prospects of any financial aid from its GCC peers look dim given the country's political orientation. In addition, Oman bonds were already included in the JP Morgan bond index and inclusion of other GCC bonds this year will ultimately reduce its overall weighting in the index. In **Egypt**, in addition to the cheap valuations, the credit momentum looks optimistic as two out of three credit rating agencies have positive outlook-which means there is possibility of a credit rating upgrade in next 12-24 months. However, CDS spreads are largely pricing in the positive credit outlook and now trading at BB rating levels.



Source: Bloomberg, ADCB

Brazil, Saudi Arabia and Dubai are also attractive

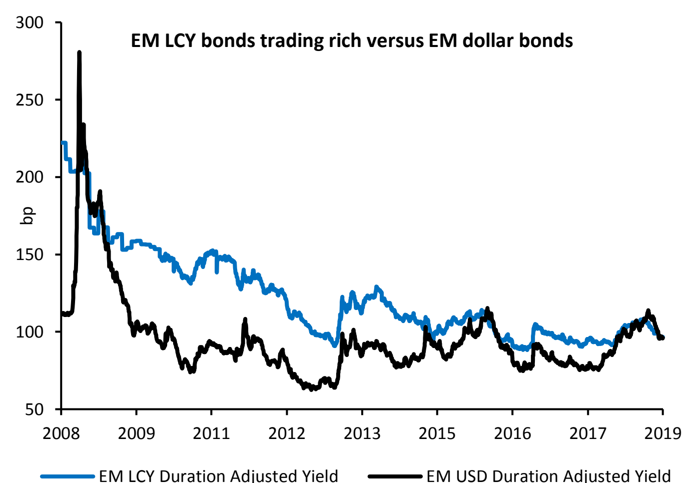
Credit spreads in Brazil, Mexico, Saudi Arabia and Dubai are also trading cheap compared to their peers and also versus their credit ranking. We retain our selective preference for *GCC sovereign bonds*, particularly the high-quality bonds which includes Saudi Arabia and Dubai. Inclusion of the GCC bonds in the JP Morgan bond index is likely to attract index-related inflows and hence should prove supportive for the bond spreads. In addition, **Brazil** bonds spreads are also trading at attractive levels even after the spreads have tightened, in expectations of the passage of the social security reform. President Bolsonaro has already submitted his proposals for the social security reform to the Congress, which remains crucial in reducing the country's debt level. We could see volatility in the short-term as the social security reform proposal will be challenged at the Congress. However, in the event that the reform is passed, it should raise the possibility of sovereign rating upgrade and should ultimately lead to spread tightening.

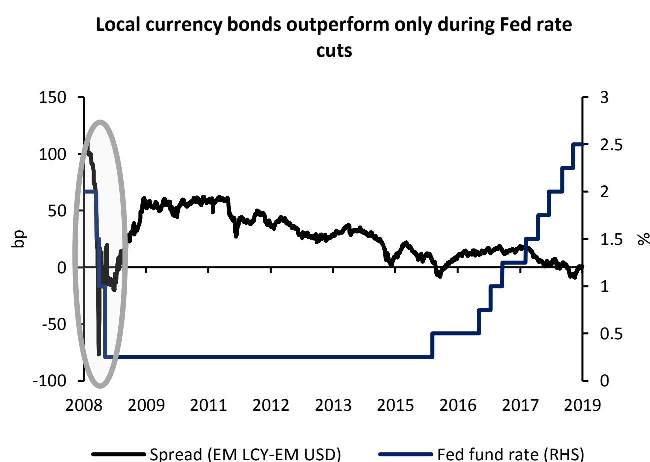
Elsewhere, **Mexico** spreads have widened on fiscal concerns related to credit deterioration of the state-owned oil company Pemex. The government's support package has also been underwhelming and any kind of support from the government may not prove enough to improve the situation. As such, Pemex concerns are likely to weigh on the economic growth.

EM dollar sovereign bonds to outperform the local-currency counterpart

In 2018, emerging market bonds across the board suffered on account of strong dollar bias, trade tensions, Fed hawkishness and tight US liquidity conditions. Majority of the EM central banks were forced to switch to tighter monetary policy, tracking the Fed rate hikes and also to combat inflation pressures aggravated by the currency weakness and higher oil prices. As a result, it was not surprising that the EM local-currency bonds underperformed more than their dollar counterpart in 2018. However, since the beginning of the New Year, EM local currency bonds have been performing well, receiving boost from the change in Fed's stance. With the Fed likely to be in pause mode for next few months, there is still potential for short-term rallies in the local currency bond markets, particularly the countries where inflation pressures are likely to remain subdued this year. However, currency volatility remains a risk if the greenback continues to appreciate. Separately, valuations in the local currency bond space are not very strong either. As shown in the chart below, EM local currency bonds have historically traded at a spread over the dollar counterpart. However, recently, the duration-adjusted yield have declined even below the EM dollar bond spreads. In addition to rich valuations, Fed is a crucial driver for the local-currency bond performance. Historical precedents indicate that the local-currency bonds have outperformed the dollar bonds during periods of Fed rate cuts. However, we believe that the Fed's patient approach will not ultimately lead to Fed easing policy rates.

Within EM local currency bond market, *we maintain our tactical preference for short-duration India local currency government bonds*. Short-dated India government bonds have rallied so far this year, boosted by the surprise RBI rate cut. With growth disappointing, increased political uncertainty ahead of the elections and inflation pressures remaining subdued, we expect that the Indian central bank will maintain a dovish stance in the coming months.



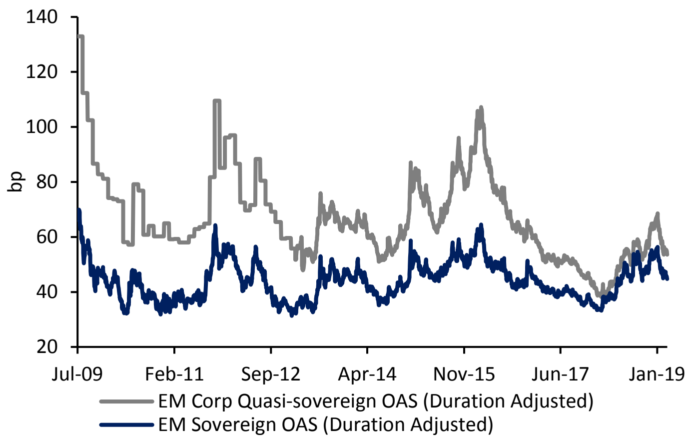


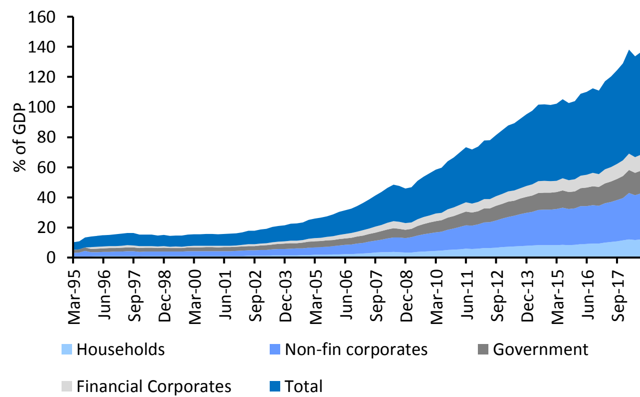
Source: Bloomberg, ADCB

EM corporate: Not very attractive valuations versus EM Sovereigns

EM corporate and quasi-sovereign bond spreads have also significantly tightened with the Fed's dovish turn and ease in US-China trade tensions benefitting the entire asset class. However, looking at the valuations, EM corporates and quasi-sovereign spreads are trading tight compared to the sovereign counterpart, only 10bp above the EM sovereign. In fact, EM corporate duration-adjusted yields have dropped even below their long-term average, trading at above around 25bp higher than their sovereign counterpart, not offering enough additional risk premium.

In addition to rising global debt levels in emerging markets, its concerning that there has been increased reliance on non-bank financing which has rapidly been growing since the financial crisis. Non-bank corporate leverage as an aggregate for emerging markets has more than tripled to 30% of overall GDP from 9.5% in 2008. Of course, China comprises a large portion of the increase in non-financial corporate leverage. As such, EM corporates will come under more pressure especially if China completely loses its focus from de-leveraging the economy. Spreads could remain volatile especially with the upcoming refinancing needs in the EM corporate bond market. According to recent IIF data, an aggregate of USD1.8trn worth of non-financial corporate debt is due to mature by 2020.

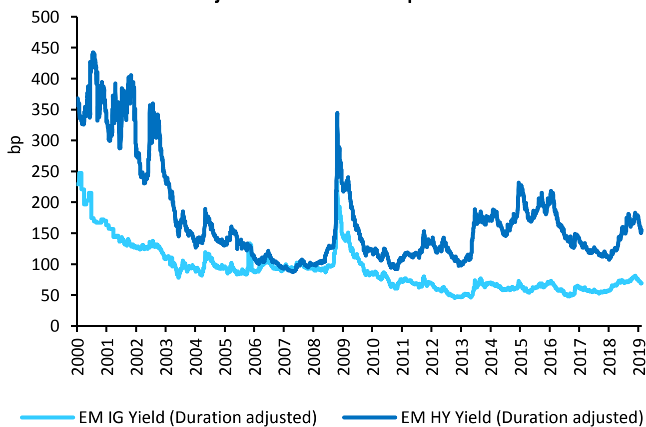


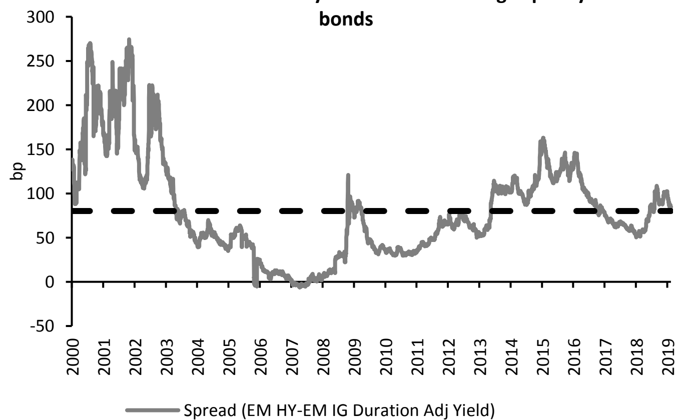


Source: Bloomberg, ADCB

EM Corporate: Quality remains key

With the Fed's dovish stance, many market participants may be keen on moving down the quality of the corporate bonds, mainly to fetch higher yields. Hence, search for yield could further fuel preference for low-rated EM junk bonds. While EM high yield bonds provide an attractive carry over their US counterpart, valuations when compared to better quality EM corporate bonds do not look impressive. After adjusting for duration, EM high yields bonds are trading at around 80bp above the EM investment grade bonds, hovering around their long-term average. Hence, quality remains key over higher yield in selecting EM corporate papers.





Source: Bloomberg, ADCB

Sources

All information in this report has been obtained from the following sources except where indicated otherwise:

1. Bloomberg
2. Wall Street Journal
3. RTTNews
4. Reuters
5. Gulfbase
6. Zawya

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