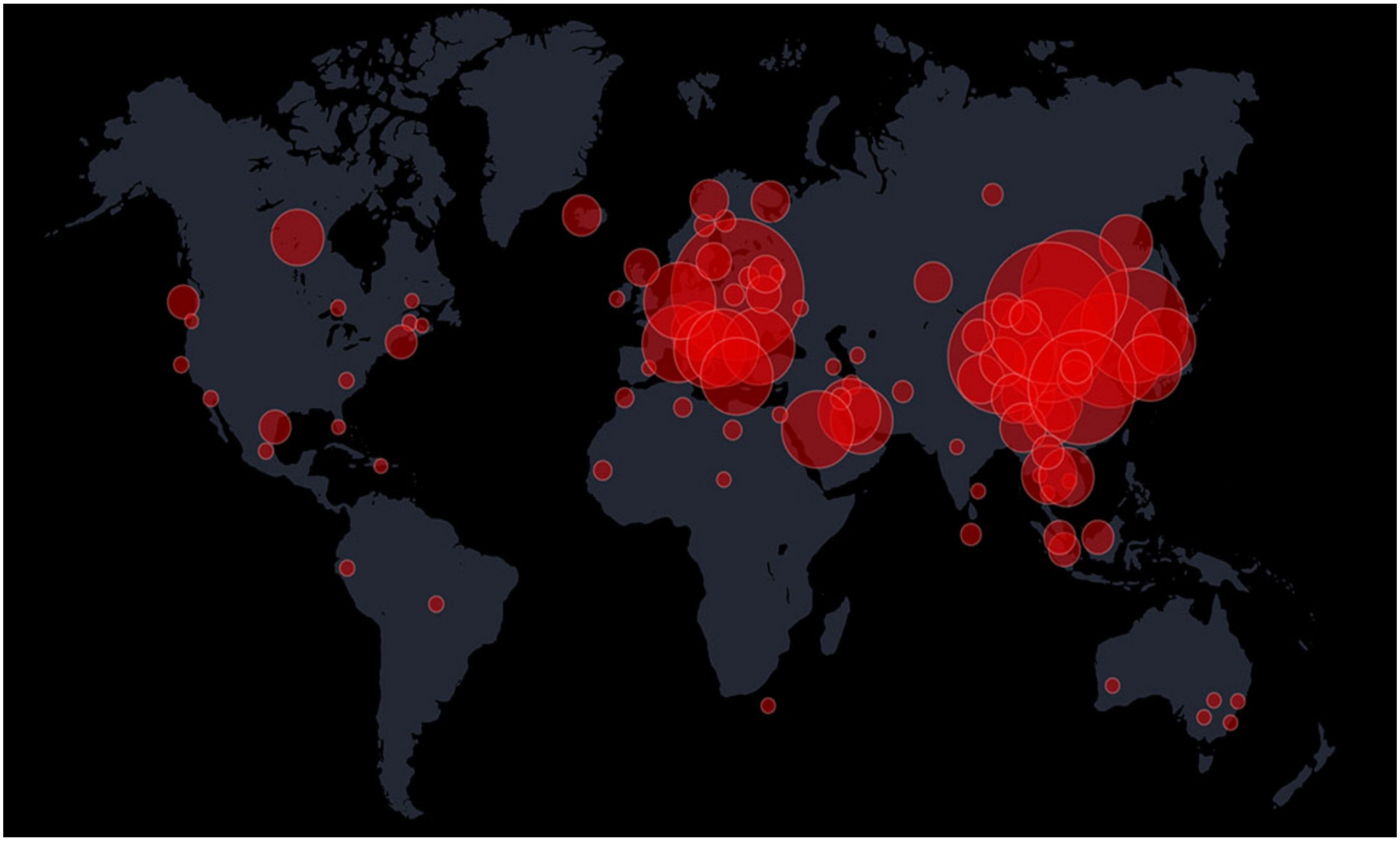
Global Asset Management

BlueBay Asset Management

Portfolio Manager Perspectives
BlueBay Emerging Market Debt Update
Weekly Update

March 5, 2020



Spreading wider

With the coronavirus continuing to spread across countries as disparate as Nigeria and Brazil, fear gripped markets once again: global equities fell, led by Wall Street, while EM currencies suffered and spreads widened in EM fixed income.

Summary

Any complacent investors at the start of last week were dramatically jolted out of this mindset by a sharp sell-off in global equities as coronavirus fears gripped financial markets. The S&P was down over 11%, while Europe and emerging markets (EMs) were not far behind. Meanwhile, core rates rallied, with US 10-year yields ending the week more than 30 basis points (bps) tighter, at 1.15%.

In commodities, oil prices were the underperformer as global demand fears drove prices down by 11–13% on the week, leaving them down more than 20% on a year-to-date basis. Metals prices also suffered, with even gold trading down this week – although we believe this was likely only a matter of investors taking contribution on a trade that was actually 'in the money'. In our opinion, the larger down moves in other metals prices were more reflective of the growth concerns that drove risk assets this week.

In EM fixed income, hard-currency markets outperformed local markets. Within hard currency, investment grade was around 30–45bps wider on spread but total returns were only down between 20bps and 1% (with corporates outperforming sovereigns) because of the support from the US Treasury rally. High yield was a different story, as growth fears drove spreads 70–100bps wider (again, corporates outperforming sovereigns) and total returns were down

around 3%. In local markets, total returns were down more than 3% as foreign-exchange (FX) markets once again suffered. We finally began to see some contagion in EM rates markets also, but we feel the primary driver here was FX weakness.

Market review

- Just as China had seemingly contained the coronavirus, it began to spread across many other parts of the world, including within EMs. South Korean cases moved past the 2,000 mark, while countries as far apart as Nigeria and Brazil also reported cases.
- China reported manufacturing purchasing managers' index (PMI) numbers that were down 14 points, to 35, and non-manufacturing PMIs that were down 24 points, to just below 30. These numbers were far worse than most were expecting. On the manufacturing side, all major components of output fell sharply, as did new orders and export orders. On the non-manufacturing side, services and construction took a large hit as people stayed away from transport systems and remained at home. China continues to push for workers to return to factories in an attempt to stabilise growth after a sharp drop-off in activity over the last month.
- Lebanon is approaching decision time on its USD1.2 billion eurobond maturity, which is due to be repaid 9 March. Investors are still none the wiser as to whether these bonds will ultimately be redeemed at par. With prices hovering in the high-50s, we feel the move will be dramatic either way.
- In Argentina, the government hired an information agent to begin identifying bondholders, suggesting that an initial debt restructuring offer may be shown to investors over the next couple of weeks.

Market outlook

In our opinion, for many, the speed and shock of the moves last week will have brought back memories of 2008. Moves at the start of this week have been no less volatile, as markets wrestle with the trade-off between a severely impaired growth outlook set against another round of monetary and fiscal easing, which we believe governments and central banks will increasingly provide to help soften the blow.

On Tuesday (3 March), the US Federal Reserve (Fed) delivered a 50bps inter-meeting interest-rate cut and left the door open for more as it stated it will 'act as appropriate to support the economy'. Expectations are that at least a further two 25bps interest-rate cuts will follow before mid-year (likely in the next two Fed meetings), which we feel will go most of the way to validating market pricing of the Fed.

We believe that other central banks are extremely likely to follow the Fed, with markets pricing cumulative rate cuts until year-end of around 19bps for the European Central Bank, 32bps for the Bank of England, 67bps for the Bank of Canada, 32bps for the Reserve Bank of Australia and 12bps for the Bank of Japan. In EMs, the major central banks are also likely to follow with a further round of rate cuts, in our opinion, despite the recent bout of FX weakness, given that inflation remains well anchored and that real rates, compared to history, are relatively wide versus developed markets.

We believe short-term market moves are going to be volatile and hard to predict, but below we offer our opinion over the medium term:

- There will need to be a major fiscal response to contend with the broken supply chains resulting from the coronavirus. There will be more healthcare and infrastructure spending along with more micro-level fiscal support to affected individuals and companies. There will also be more state bailouts (like the recent case of a Chinese conglomerate), and more mergers and acquisitions activity. We would also expect there to be some regulatory forbearance to help the most impacted industries.
- The level of support offered to the most impacted sectors – such as transport, consumption and commodities – will have a direct correlation to how well the high-yield default rate is contained in credit markets. For oil companies, the OPEC meeting on Thursday (5 March) will be key in terms of providing some near-term support to prices. As noted in prior commentaries, oil credits become much more sensitive to further moves in oil at these levels.
- In the developed world, the Fed is the central bank with the most room to cut interest rates and, as the interest-rate differential narrows versus the rest of the world, it is reasonable to expect some US dollar weakness. Most likely, this will also feed through to EMs, where some of the higher-yielding currencies will benefit, although we would view this opportunity as tactical at this point.
- The structural opportunity likely resides in EM rates markets, where EM real rates stand closer to 3%, versus developed markets, which are running negative real rates. By historical comparison, we feel there is plenty of room for this gap to narrow.

Index Review – Weekly Market Snapshot as of 02/28/2020

	Total return			Spread / yield change (bps)				
	Weekly	MTD	YTD	Weekly	MTD	YTD	Spread (bps)	Yield (%)
Hard Currency Sovereign	-2.10%	-0.97%	0.54%	65	59	83	373	4.98
Hard Currency Corporate	-1.02%	-0.03%	1.42%	46	36	49	339	4.47
Local Currency Corporate	-1.97%	-1.91%	-2.66%	-3	-1	4	142	5.74
Local Currency Sovereign	-3.18%	-3.41%	-4.65%	4	-5	-27		4.95

Source: Bloomberg, JPMorgan

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