THOUGHTS FROM THE FRONTIER

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GlobalEvolution

GLOBAL EVOLUTION THOUGHTS FROM THE FRONTIER

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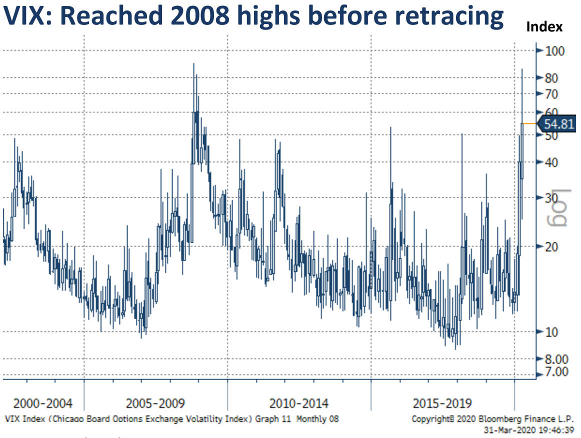
A contagious market response to policy

The scary feature of the COVID-19 pandemic is not so much its mortality rate but its contagiousness. Just as contagious has been the response of financial markets to the socio-economic measures taken to flatten the viral tsunami. Although our Frontier Market (FM) sovereign debt portfolio enjoyed some isolation relative to other pure hard currency (HC) indices such as JP Morgan´s NEXGEM FM sovereign debt index, the financial market risk contagion still aggressively bled into our universe.

Financial markets hate economic shocks and uncertainty and the socio-economic health policy response to the COVID-19 pandemic has delivered both in abundance. The VIX index, which measures the volatility of the futures prices in the S&P 500 Index and arguably remains the major barometer of global risk sentiment, revisited levels last seen during the 2008 financial crisis. During periods of market panic, the risk logic becomes very blunt: the more fragile the economic structure of the household, company or sovereign, the more vulnerable they are to the economic shock from the COVID-19 policy response.

VIX: Reached 2008 highs before retracing



Source: Bloomberg

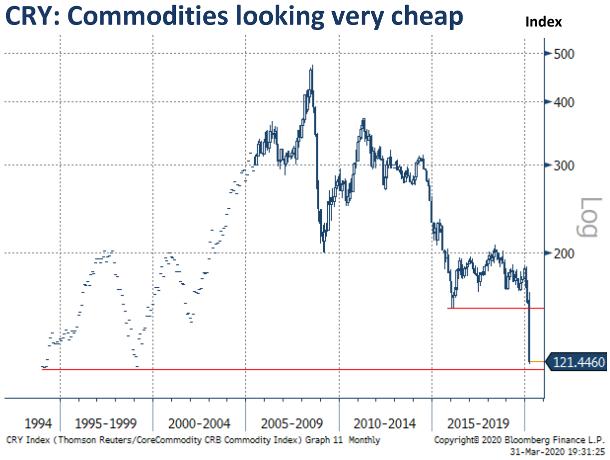
Working in conjunction with the credit risk channel in a self-fulfilling loop is liquidity risk. As market liquidity dries up, the more stretched individuals, companies or sovereigns face increasing tough allocation pressures.

A downward shock in commodity prices

In common with other periods of risk aversion derived from downward shocks to global GDP, the COVID-19 panic has also influenced FM sovereign debt via the commodity price channel.

Of course, the average commodity price levels came from a more subdued level relative to the elevated prices seen during the 2008 financial crisis, mitigating the repricing somewhat. Even commodity prices during the crisis of 2014/2015 look quite elevated relative to the oversold levels that we see presently, and the key Commodity Research Bureau Index (CRY) is now back to levels last seen in the 1990s.

CRY: Commodities looking very cheap



Source: Bloomberg

As is often the case, perhaps the most extreme commodity price contagion has come from oil. Prices been undermined not only by the extreme reduction in demand but also by a counterintuitive surge in supply, as Russia and Saudi Arabia decided to rip up the OPEC-Plus supply arrangements.

Brent oil front-month prices in free fall

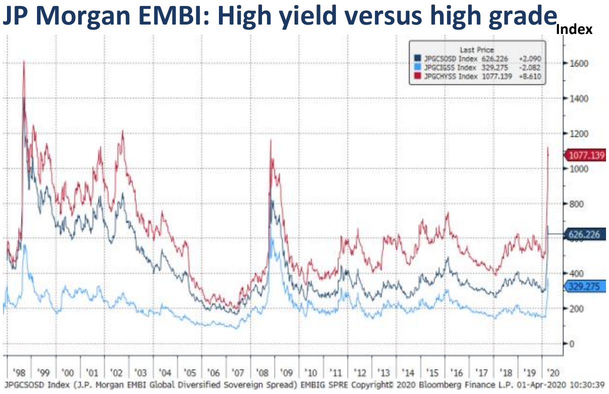
Source: Bloomberg

Hard currency contagion

The dominance of local currency (LC) positions in our FM sovereign debt portfolio (around two-thirds of exposure) going into the COVID-19 market panic provided us with some isolation from the worst of the downward price pressure. Yet as is often the case in period of extreme global risk aversion and stress, the portfolio picks up most contagion from hard currency (HC) positions.

Indeed, market panic means FM HC bonds traded more on fear and flow than fundamentals. Market stress is clearly being magnified by regulatory changes that limit the abilities of banks to intermediate the market, which is especially critical amid large passive-mandate and ETFs flows with real-money investors also facing redemptions.

JP Morgan EMBI: High yield versus high grade



Source: Bloomberg

Unlike during the 2008 financial crisis when high-yield and high-grade EM HC sovereign debt both sold off aggressively, the spread widening in investment grade sovereign bonds has been relatively modest with the COVID-19 panic.

The indiscriminate selling of riskier assets is seldom based on fundamentals. With the huge uncertainty around the longevity of the socio-economic measures needed to flatten the COVID-19 pandemic curve, it is of course difficult to build appropriate scenarios against which fundamentals can be gauged.

Historically such uncertainty almost always creates huge value. It appears to us that many HC sovereign bonds are oversold and offer significant longer-term value once markets are able to build a core scenario with any certainty.

In order to take advantage of opportunities to buy cheap HC bonds while also helping manage potential redemptions, we have been rotating out of less favored LC position and building cash. We are particularly focused on switching into HC positions and out of LC where the HC bond yield is now higher, a situation that is historically extremely rare unless restructuring is imminent.

Coordinated global liquidity provision

Of course, timing a rebound amid the uncertain short-term outlook is tricky. But we are gaining confidence that the coordinated monetary and fiscal liquidity stimulus from global policy makers will stimulate a rally every bit as sharp as the selloff. In fact, we suspect it may even be more acute than the 2008/2009 rebound as policy makers appear to have learned the importance of frontloading financial stimulus in order to minimize second-order economic affects.

Importantly, there is a group of G10 countries that appear able to print money (utilize quantitative easing) in order to provide their governments with the resources needed to mitigate the economic effects from their COVID-19 social healthcare policies. It is a policy not available to most of the globe´s central banks. The G10 countries are looking at ways of utilizing their hard currency benefits in order to improve liquidity for other economies in order to firm up the whole system.

As of 6 April 2020, the U.S. Federal Reserve (the Fed) will allow other central banks to use US government bond holdings as collateral for short-term USD borrowing for an initial period of six months. The repo operation augments the already expanded swap line operations the Fed already has with certain central banks. The move further cements the role of the USD as the effective global reserve currency.

Another critical initiative for improving global liquidity comes from the International Monetary Fund (IMF), who on 4 March 2020 announced a rapid disbursing of the USD 50 billion Emergency Financing Facilities. Importantly, the assistance is available without the need for a full program to be in place. Moreover, of the total, some USD 10 billion is available at zero interest for 10 years to the poorest members via the so-called Rapid Credit Facility established in 2009. The new facility is designed to augment existing arrangements that can also be increased or extended. Greater clarity on how IMF funding will be utilized will likely be provided during the IMF´s online spring meetings in mid-April.

The availability of IMF funds for many FM sovereigns where pricing has temporarily closed HC market access will prove a huge variable driving bond prices moving forward. It appears to us it is a variable being underpriced by the market at present.

A constructive core scenario

Developing a core scenario on when the socio-economic policies designed to flatten the COVID-19 pandemic curve will be eased is key to any asset allocation strategy. While it is currently very difficult to apply meaningful probabilities to such scenarios, we believe the economic shock will be shorter than anticipated by many, with Q2 2020 seeing the beginning of normal socio-economic relations in most of the OECD countries and Q3 seeing a broad normalization of activity. Our view assumes that ample global liquidity will almost certainly remain in place for an extended period.

Such a core scenario has very important consequences for two other central credit variables: tourist receipts and commodity prices. Under our core scenario, the impact on the northern hemisphere summer tourist season will not be as negative as many seem to fear.

Second, once the market anticipates a demand rebound, we expect commodity prices to increase aggressively from what can only be described as extremely oversold levels. Of course, the oil market also needs to assume that the supply surplus derived from Russia-Saudi Arabia standoff can also be resolved. We believe that a solution will be found in the coming months, resulting in pushing oil back up to an average of nearer USD 40 per barrel for 2020.

Although it is extremely difficult to call the turnaround in market sentiment, history generally teaches us that markets hit by fear and panic reveal extraordinary value. This is particularly true in FMs, which already suffer from information asymmetries relative to more developed markets and can become even further mispriced during periods of market dislocation and stress.

Taking advantage of mispricing

So how does our assets allocation attempt to take advantage of our reasonably constructive core scenario amid the widespread apparent mispricing relative to fundamentals?

Basically, we will continue to rotate out of LC instruments that have performed relatively well into those assets that offer more capital appreciation in a rebound. Although this will mainly be a switch into HC instruments, there are also a few opportunities where an unwarranted backup in LC yields may cause us to rotate into higher duration LC instruments. Egypt and Ukraine are the most obvious examples.

Of these it is probably Ukraine´s bonds that offer the most potential price appreciation, not least because they have been the hardest hit with seemingly the least fundamental justification. When looking for countries that will outperform in the present environment, oil importers with limited exposure to tourism and amble access to official concessional financing should do well. Ukraine appears to score well. Add a strong structural adjustment story and low inflation (a 2.4% annual rate in February 2020) and we see the potential for LC Ukrainian yields to compress back to around the 10% level where they were trading prior to the market panic, when they subsequently gapped to over 20% due to the lack of local institutional demand and market capacity.

Fragile but not distressed

Ukraine HC bonds also look reasonably attractive having also sold off in an exaggerated fashion. In fact, they sit within a select group of countries that the market considers fragile enough to demand double-digit USD yields but not yet pricing in an inevitable restructuring haircut. These include Ghana, Rwanda, Nigeria, Mozambique, Iraq, Oman, Dominican Republic, El Salvador, Costa Rica, Pakistan, Sri Lanka, Tajikistan and Mongolia.

Let's start with the oil-reliant sovereigns. We sold our LC position in Nigeria and most of our HC positions in Iraq and believe that both may offer HC value once we get more clarity on when oil prices will rebound. Nigeria may also offer LC value again once the authorities allow dollar/Nigerian naira to find a new clearing level.

Ghana, which we do not consider heavily oil-reliant, clearly offers HC value but also offers decent LC value which we continue to hold. Rwanda HC also appears to offer significant value and we intend to add where possible. We feel similarly about Mongolia, Mozambique and El Salvador.

Like Ukraine, Pakistan is an oil importer with limited exposure to tourism and healthy access to official concessional financing. As HC bonds are trading at similar low double-digit yields to our LC holding, we are looking at switching some of the position.

We have been gradually unwinding our LC positions in Sri Lanka for some time due to the deteriorating post-election policy environment. Although hugely elevated, Sri Lanka´s HC yields look likely to head into even more deeply distressed territory amid political uncertainty, fiscal policy deterioration and economic shock from the loss of tourism.

Deeply distressed

Indeed, Sri Lanka may join the next category of sovereigns whose bond prices have become deeply distressed in expectation of debt restructuring. The bonds of some of these sovereigns, like Argentina and Lebanon, were pricing restructuring before the COVID-19 market panic. Some, like Angola, Ecuador, Zambia and Suriname, entered the category during the crisis.

Along with Ukraine, it was positions in Angola, Ecuador and Zambia that contributed the bulk of the portfolio´s negative return in 2020's first quarter, more specifically in March. Our positions reflected a belief that each sovereign had embarked on policy measures which were improving creditworthiness, each in cooperation with the IMF: via formal programs in Angola and Ecuador and in the expectation of a formal program in Zambia. While some form of maturity extension or debt reprofiling may well take place in each country under an IMF-orchestrated COVID-19 emergency-inspired burden-sharing across all creditors, we do not see this as a done deal or being anywhere near as deep as the market is presently pricing. Not least, we do not share the implied view that commodity, and especially oil, prices will remain at extremely low historical levels for an extended period.

Angola

Angola is in a much better place than it was when oil prices last had a USD 30 per barrel handle in 2015.

Since then the nation has embarked on an IMF structural adjustment program including major FX market reforms that moved dollar/Angolan kwanza (AOA) from 100 to 541, leaving the currency extremely competitive and hugely boosting the AOA fiscal revenue from oil production.

Prior to the recent collapse in oil prices Angola was running a broadly balanced fiscal position and a current account (CA) surplus. The government´s revenue growth target of 12% and expenditure target of 10% are also very conservative given likely nominal GDP growth of over 20%. There will also be expenditure reduction from lower subsidies (amid plans to remove them completely going forward) and a potential postponement of capital spending and additional financing of USD 2 billion from the USD 5 billion FSDEA, Angola's sovereign wealth fund.

The CA surplus of around USD 5 billion in 2019 is likely to turn into a minor deficit in 2020 (based on oil production of 1.4 million barrels per day and an average price of USD 40 per barrel) once the savings from IOC income repatriations, and lower fuel and other imports are taken into account. The National Bank of Angola had gross FX reserves of USD 16.85 billion at the end of February 2020. At present there is no formal request to open discussions with commercial creditors.

Ecuador

In Ecuador, discussion with creditors is imminent after the government announced it would utilize the 30-day grace period for the upcoming coupon payments on three bonds worth circa USD 200 million. But in a clear demonstration of good will to creditors, the government did meet its March 2020 repayment. We suspect that any discussion with commercial creditors will happen in unison with official creditors and associated with an emergency COVID-19 financing package coordinated by the IMF.

Zambia

In Zambia, a formal advertisement for a sovereign debt advisor sent HC bond prices from moderately distressed to heavily distressed. It is no coincidence that this occurred at the same time the government formally applied for IMF financial assistance, as any IMF funding will be premised on the government showing that its debt profile is at least on the way to being longer-term sustainable. We do not believe Zambia finances are in terrible shape because the heavy fiscal deficits are not derived from current spending but rather excessive capital spending, which is in now being rationalized, including a freeze on any new projects. Although we see value in the HC bonds here, we arguably see better value in the LC bonds that we have held for some time. Importantly, if Zambia can finally achieve an IMF program it will likely prove the catalyst to stabilize a currency which already looks cheap, and finally deliver substantive LC bond yield compression.

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