Eaton Vance

Fundamentals return to the forefront in emerging-market debt

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- Volatility related to the COVID-19 outbreak and dramatic oil price decline in Q1 2020 precipitated a large sell-off in risk assets, including significant outflows from emerging-market (EM) debt funds.
- With technical headwinds having begun to abate after the intense volatility of March 2020, we believe that fundamentals are returning to the forefront as a key performance driver in EM debt.
- In our view, EM interest rates appear attractively valued when analysed against developed markets and on an inflation-adjusted basis, though we have become more neutral in our outlook for currencies.
- We remain neutral on EM sovereign credit, a sector offering historically compelling valuations, but where many issuers are confronting a challenging macro environment.
- Looking ahead, we believe that the quality of research and analysis as well as the ability to access markets will be key for managers to achieve investment success at this critical time for EMD.

In this Q&A, Michael Cirami, CFA, portfolio manager and co-director of global income, Marshall Stocker, Ph.D., CFA, portfolio manager and director of country research, and Brad Godfrey, CFA, Director of Alternative Asset Allocation Strategies, discuss the recent market downturn and outlook for emerging-market debt ahead.

Can you please provide a brief review of performance in the first quarter?

The first quarter was obviously a difficult period for risk assets. The situation for emerging-market debt (EMD) was no different, with net outflows from EMD funds in the quarter totalling US$29 billion. In Exhibit A, we show our proprietary attribution for the underlying risk factors that drove performance on EMD indexes in the quarter.

On the hard-currency side, we can see sovereign and corporate credit spreads were the hardest hit areas, an outcome consistent with what we would normally expect in a "liquidity crunch." Spreads widened significantly, costing the J.P. Morgan Emerging Markets Bond Index (EMBI) Global Diversified 21.78% and 7.45% on the J.P. Morgan Corporate Emerging Markets Bond Index (CEMBI) Broad Diversified. Adding the additional 9.50% incurred by spread widening for corporate bonds onto the relevant sovereign spread performance, which is how we analyse the sector, aggregate spread widening cost the CEMBI nearly 17.0%. The large fall in US Treasury yields was positive for hard-currency EMD, helping to partially offset declines elsewhere. Across the board, total declines on the EMBI and CEMBI registered 13.38% and 10.17%, respectively.

In local-currency EMD, foreign exchange (FX) acted as the principal detractor to the J.P. Morgan Government Bond Index - Emerging Markets (GBI-EM) Global Diversified, with a 13.90% decline. The FX fall accounted for most of the overall 15.21% decline on the GBI-EM in the quarter. The rush to the US dollar and other reserve currencies precipitated the fall. Notably, however, the EUR:USD exchange rate had a muted impact on index performance. For Eastern European issuers, we view the EUR:USD rate as an embedded risk factor for currencies linked to the US dollar.

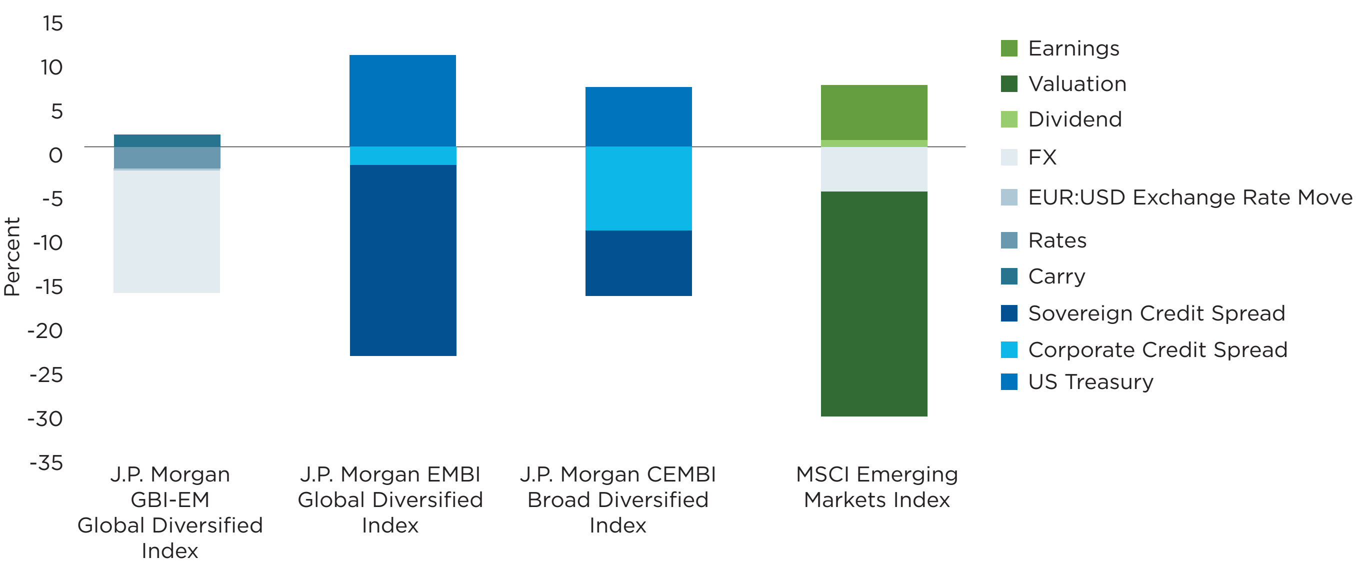
Broadly speaking, how are you thinking about the current situation and what the outlook may be like ahead?

We are thinking about market developments in terms of phases. The first phase, as everyone knows, began in early to mid-March when financial market dislocations and volatility picked up quite strongly in response to the dual shocks of the COVID-19 pandemic and the dramatic fall in the oil price. As the sell-off in risk assets intensified, EMD was also buffeted by a technical headwind from large outflows from the asset class.

While the first phase appears to have concluded, there's a critical element to the story that has been somewhat layered into the background, which is that the March 2020 sell-off was the first test of the financial system since the global financial crisis. While the causes are different, so, too, is the "plumbing" in the markets and the ways that investors traded amid the volatility. In the first phase, we estimate that say 75% of price action was being driving by market dislocations and 25% by country fundamentals. Now

Exhibit A

Emerging-market Q1 2020 performance review



Sources: J.P. Morgan, Eaton Vance calculations. Corporate Credit Spread and Sovereign Credit Spread return attributions are modelled by decomposing the overall spread return to its two components: the sovereign spread and the corporate spread over the sovereign. It is not possible to invest directly in an index. Data provided is for informational use only. **Past performance is not a reliable indicator of future results.**

that we are entering the second phase, the situation has somewhat reversed, with 75% of price action driven by fundamentals and only 25% by the technicals and overhang from the first phase.

While we may continue to see sharp moves on a short-term basis, we believe that ultimately, fundamentals will be the primary driver of asset prices ahead. Our research has shown that historically, economic policy at the country level has mattered most to asset performance over the long term and specifically in times of stress.[1] That is to say that countries with a high level of economic freedom, where you have more rule of law, simpler business procedures, strong institutions and sound monetary policy have historically enjoyed better asset returns.

Are emerging markets more vulnerable to the COVID-19 pandemic than their developed-market peers?

It's well known that emerging markets, like most other countries, are not particularly well prepared to handle a pandemic-driven health care crisis. For emerging markets in particular, there are three aspects that, in our view, are not widely appreciated at this point. Firstly, the data do not support the warm-weather burnout thesis. On the one hand, a number of the 130 countries we follow are equatorial, have warm weather and haven't reported many cases. On the other, it's early in the process and many of these countries are simply less connected to the global economy and international travel, which has delayed the onset of higher infection rates. Egypt, for instance, is now seeing an upturn in infection rates.

The second aspect concerns social-distancing policies. Despite national leaders in some countries, such as Belarus and Brazil, having advocated more of a business-as-usual approach, we know that individuals and local government leaders have taken their own steps to reduce mobility. This fact is borne out by falls in mobility data, which suggests that even in the absence of a coordinated national response, social distancing is happening to some degree in these countries.

Thirdly, in emerging markets and beyond, we do not really have an orthodox policy response for the supply-side shock of a pandemic. We're certainly seeing aggressive fiscal and monetary responses, but we're also seeing other novel policy elsewhere. Some policies will prove to be effective and others less so. For example, we are monitoring forbearance policies closely right now. In response to the crisis, some countries are discussing up to 12 months of forbearance on consumer loans, but with little clarity on how the loans will start to perform in the future and who will hold that liability. In this sense, we see a lot of policy adventurism afoot at the moment that needs to be monitored very closely.

How have the dual shocks played out in terms of credit quality across the EMD universe?

As expected, we've seen signs of deterioration. While we usually focus little on the ratings agencies, their actions have been swift and noticeable. For instance, we saw ratings downgrades in March for both South Africa and Oman, two countries with which we've long had concerns. As for defaults, certain countries were already headed in this direction before COVID-19. Argentina is a well-known example, as is Lebanon. Elsewhere, Ecuador has announced plans to restructure short-term liabilities, while Zambia has hired restructuring advisors and Seychelles, a country on few people's radar, has indicated that they'd like to open negotiations with creditors. Distressed trading in Angolan, Tajikistani and Sri Lankan bonds suggests these countries may also face the prospect of default.

Ultimately, policy will come to matter more for individual country performance as we touched upon already. Emerging markets have adopted the more unorthodox policies of their developed-markets peers, with many central banks cutting rates aggressively into this crisis as well as a handful even implementing QE. Unfortunately, emerging markets tend to have weaker institutions, which could, in turn, create new problems. In Hungary and Slovenia, for example, we know that the steps taken to combat COVID-19 have not been very democracy-friendly.

More generally, the COVID-19 policies we've seen mark the first time emerging markets have responded to a crisis with fiscal and monetary policy easing. An open question is how sustainable this will be. Right now, our verdict is that it will be sustainable for some, but not for all. In terms of central bank policy, the authorities will have monetary firepower for as long as they have the confidence of markets. In this respect, the broader COVID-19 policy responses will probably matter most, as they will underpin investor views on a given market. That being said, the situation remains highly uncertain for many countries. Economic forecasts are being regularly revised down and are at best only estimates. We've been having many conversations with policymakers and they will often be the first to admit that it's difficult to have solid forecasts at this time.

You mentioned economic forecasts. Do you expect a significant decline in the economic health of EM economies?

Many emerging-markets countries are dependent on oil, tourism and remittances or some combinations thereof. To provide context around how significant some of these adjustments will be, consider that in Turkey credit card purchases by foreigners are down 90%. Across emerging markets, our working assumption at present is that economic output will decline between 2% and 7%

[1] "Emerging-market debt: Determinants of sovereign bond quality and returns," Marshall Stocker, Eaton Vance, September 2019.

from the previous baseline. That's just a starting point. The numbers could be better or worse by country. In terms of budget deficits, our starting assumption based on early analysis and conversations with policymakers is that these will be around 5% wider.

Overall, we expect a sharp contraction followed by a slow rebound. The IMF has said there may be as much as US$1 trillion in funds available to support countries, but that would be loans not grants. Understandably, there's a long line of countries that have requested assistance. Nigeria just applied for US$3.4 billion from the IMF, which comes in addition to US$2.5 billion from the World Bank and US$1.5 from the African Development Bank. These are the types of figures we're seeing, which are reasonably large and we expect to see a lot more requests of this type ahead.

Is there a framework you use for analysing countries with respect to COVID-19 and economic outcomes?

Given that this is a supply-side shock, we're paying particular attention to the balance of payments, which will be important for a country's ability to respond to external challenges. The technical aspects of national health care systems also matter. For instance, what is a country's health care capacity in terms of number of beds and doctors per capita? Certain emerging markets have greater capacity than others, which may also come to matter for political stability.

We're also looking at certain ESG dimensions that become more prominent when a country is confronted by a large negative externality, such as COVID-19. On the social side, levels of trust and solidarity in a society may influence attitudes toward social distancing, which, in turn, may determine rates of infection and, thus, the magnitude of the economic impact. Governance is also important in this respect. Are authorities enforcing or neglecting social-distancing measures? What amount of political capital do leaders have and how are they spending it? Again, there are countries that are both stronger and weaker on the question of governance, which we think could come to matter as to how events related to COVID-19 play out in these markets.

How will COVID-19 impact the US-China relationship?

The relationship was already worsening prior to the pandemic, but is unfortunately deteriorating further now. One way to characterise the schism is as a struggle between the champions of transparency in the West on the one hand and then, on the other hand, China's approach to providing financial resources to other emerging markets. We already know, for example, that bilateral lending from China has long been opaque. In our view, it appears likely that we'll see even more of these types of deals ahead. China has plentiful resources that other countries need, not least of which are its ventilators and medical testing kits.

At the same time, the West and the US, in particular, have been commandeering these resources from emerging markets, with masks taken by the US in Bangkok, as an example. China is offering medical resources, but there appears to be a lack of transparency here and reports indicate that some devices have been defective. That's not surprising, given that we saw the same lack of transparency from China with respect to the virus itself. We didn't find out about COVID-19 in China early enough and still do not know how many cases there were in the country.

Going forward, we believe this will be the trade-off when it comes to China in the sphere of EMD. In early April, for example, Nigeria simply came out and said that it will not default on eurobonds, while offering little more information. It's likely, however, that it will ask China to restructure its bilateral debt, which China may be willing to do, if recent news reports are to be believed.

As we look forward, where do you see the most compelling opportunities in EMD?

In Exhibit B, we show our outlook and where we see value by the different investible risk factors in EMD. On interest rates, we raised our outlook to an overweight. We believe that interest rates appear fairly compelling when compared to developed markets and adjusted for inflation as well as within the context of easing central bank policies. It's worth noting that the markets with more robust and attractive interest-rate curves tend to be on the more developed side of the EMD space, rather than being among the higher-yielding, lower-quality names.

On currencies, we've reduced our conviction from an overweight to neutral. While it's tempting to look at the large sell-off in many countries as an attractive entry point, we do not want to underestimate how significant the shock has been to emerging markets. When we go country by country, it seems to us that a lot of the sell-off has been justified, with currencies appearing fairly valued at this point. That said, there is a decent amount of differentiation for EM currencies as a whole.

We maintain a neutral view on sovereign credit. While we believe that valuations appear attractive on a historic basis and see scope for possible improvement as clarity surrounding the recovery improves, many issuers will be confronted by a challenging financial and economic environment in the short term.

Lastly, we upgraded corporate credit to a moderate overweight. While it's a tough economic environment, EM corporate credit is a rich universe and a lot of the issuers are national champions and important companies with access to capital markets and financing. In fact, we think these companies may be a little better prepared to deal with sudden stops in business than their counterparts in the developed-market world.

Overall, we maintain a neutral stance on EMD. For many countries, it's going to be challenging and the price declines alone are not enough to compensate for this.

Exhibit B

Emerging-market outlook

	Underweight	Moderate Underweight	Neutral	Moderate Overweight	Overweight	Summary
Currency			◆			Reduced to neutral. While FX sell-off has been significant, economic and financial challenges loom large.
Local Interest Rates					◆	Moved to overweight; higher yields, combined with lower policy rates in EM and DM, create attractive environment for high-quality countries.
Sovereign Credit			◆			Market sell-off has led to some countries offering attractive valuations, but economic uncertainty remains.
Corporate Credit				◆		Upgrade to moderate overweight.
EM Equities			◆			Maintain at neutral.

Source: Eaton Vance. Data provided is for informational use only and should not be considered investment advice.

We want to see greater understanding and clarity of policy responses beyond what has been rolled out to stabilise markets. Of course, we also need greater clarity on matters related to COVID-19, which, in part, means a pathway and a timeline to a vaccine.

What are the main variables you are looking at to decide to either remain cautious or increase risk in portfolios?

Our views of the EMD universe are really formed on a country-by-country and risk factor-by-risk factor basis. When we identify an investment that looks compelling, we take on more risk and when we do not, we become more defensive. Clearly, through the first phase of the volatility, we became more averse to risk. On balance, we still remain defensive, but now that fundamentals are starting to matter more in the second phase, we have been finding opportunities at the margin and reintroducing some risk in our portfolio positioning.

Clearly, with fundamentals coming back to the fore, the quality of research and fundamental analysis will matter more than ever for investment success in this asset class. In this respect, we believe that our deep expertise, approach to research and our ability to access markets through our dedicated trading and operational infrastructure give us an edge over competitors at this particularly critical time for managing emerging-market debt.

Index Definitions

JP Morgan Government Bond Index – Emerging Markets (GBI-EM) Global Diversified is an unmanaged index of local-currency bonds with maturities of more than one year issued by emerging-market governments. Inception date for index is 31/12/2012. Unless otherwise stated, index returns do not reflect the effect of any applicable sales charges, commissions, expenses, taxes or leverage, as applicable. It is not possible to invest directly in an index. Historical performance of the index illustrates market trends and does not represent the past or future performance of a portfolio.

JP Morgan Emerging Markets Bond Index (EMBI) Global Diversified is an unmanaged index of USD-denominated bonds with maturities of more than one year issued by emerging-market governments. Unless otherwise stated, index returns do not reflect the effect of any applicable sales charges, commissions, expenses, taxes or leverage, as applicable. It is not possible to invest directly in an index. Historical performance of the index illustrates market trends and does not represent the past or future performance of a portfolio.

JP Morgan Corporate Emerging Markets Bond Index (CEMBI) Broad Diversified is an unmanaged index of USD-denominated emerging-market corporate bonds. Unless otherwise stated, index returns do not reflect the effect of any applicable sales charges, commissions, expenses, taxes or leverage, as applicable. It is not possible to invest directly in an index. Historical performance of the index illustrates market trends and does not represent the past or future performance of a portfolio.

Morgan Stanley Capital International (MSCI) Emerging Markets Index is an unmanaged index of emerging markets common stocks.

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Important Additional Information and Disclosures

Sources: Eaton Vance, JP Morgan. All information as of April 28, 2020, unless otherwise specified.

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