Taking Stock of Emerging Markets

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Setting the scene

Emerging Markets have experienced **massive outflows** following the outbreak of the COVID-19 pandemic in addition to spending **US$240bn** of their foreign-exchange reserves.

- **Investors have broadly sold EM equity** exchange-traded products (ETPs) with only one week of inflows since **February 23rd** resulting in outflows of **$20.7bn over the period.** Investors did turn to **single country ETPs** in March – especially to those exposed to **Asian countries** amid broad EM equity outflows – but this trend has largely reversed itself since.
- In fixed income, **EMD has been a laggard** in terms of flows versus other spread assets, such as IG and HY, both of which have continuous inflows since **March 22nd.** While selling out of EMD ETPs has slowed from a record **$8.5bn** of outflows in **March** to be relatively flat in April with inflows of **$133m** (due to buying in hard currency and selling out of local currency netting out), **we are yet to see investors meaningfully return to the exposure in May.**

Source: BlackRock and Markit, as of 8 May 2020

In this piece, we discuss with some of our lead EM portfolio managers:

Opportunities

Risks

Current Outlook

Potential Triggers for Changes in our Views

Sources of Financial Support EMs can Leverage

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Filip Vurdelja
Official Institutions Group

Filip Vurdelja: What is your outlook on EM?

Stephen Andrews: In our economic transition to a post-COVID-19 world, we will likely see a return to a low growth and low return environment. Liquidity should remain elevated following the staggering scale of monetary and fiscal support. In this environment, EM should offer better growth and returns which should be attractive to investors. We believe valuations are now very attractive with Price-to-Book ratio signaling a good entry point with historically good returns over the next 5 years. Currencies have adjusted and large scale stimulus should put a cap on the dollar – a clear positive for the asset class. EM offers more diversification benefits as correlation with DM markets are coming down. So far most EM/Frontier countries have shown less COVID-19 impact than initially predicted and may get through this better than DM.

Gerardo Rodriguez: We see three phases to the market adjustment to the crisis: a market freefall first, followed by markets trying to find a bottom with increased dispersion, and lastly, a recovery. We see the EM world as currently in phase two – a fertile one for active investors. The current crisis has accelerated many longstanding trends. This includes DM's performance vs. EM – and similar trends in momentum vs. value, tech vs. energy and the U.S. versus the rest of the world.

Amer Bisat, PhD.: We divide EMs into three broad groups; 1) high-quality issuers that can weather the storm; 2) a large, problematic middle that is easing at the expense of their currencies; 3) countries that we believe cannot handle the shock and may default.

Pablo Goldberg: This shock is all about growth and its impact on the fiscal accounts. On average, EM's 2020 growth is 5 percentage points below where we thought it would be as recently as in January, accounting for a rebound in H2. We see three channels of transmission: drop in export volumes and tourism, domestic lockdowns, and capital flows. A sudden stop of capital forces countries to seek extraordinary sources of financing: multilateral and bilateral creditors and central bank monetization. For the weakest balance sheets, the former might come with a request for private sector debt restructuring, while the latter could lead to inflation and further currency weakness.

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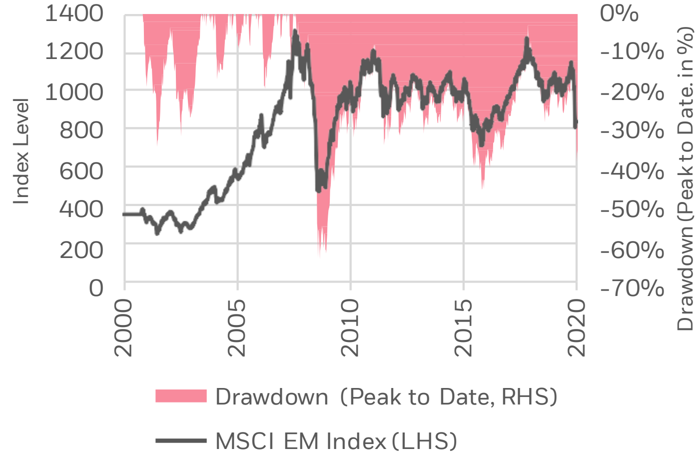
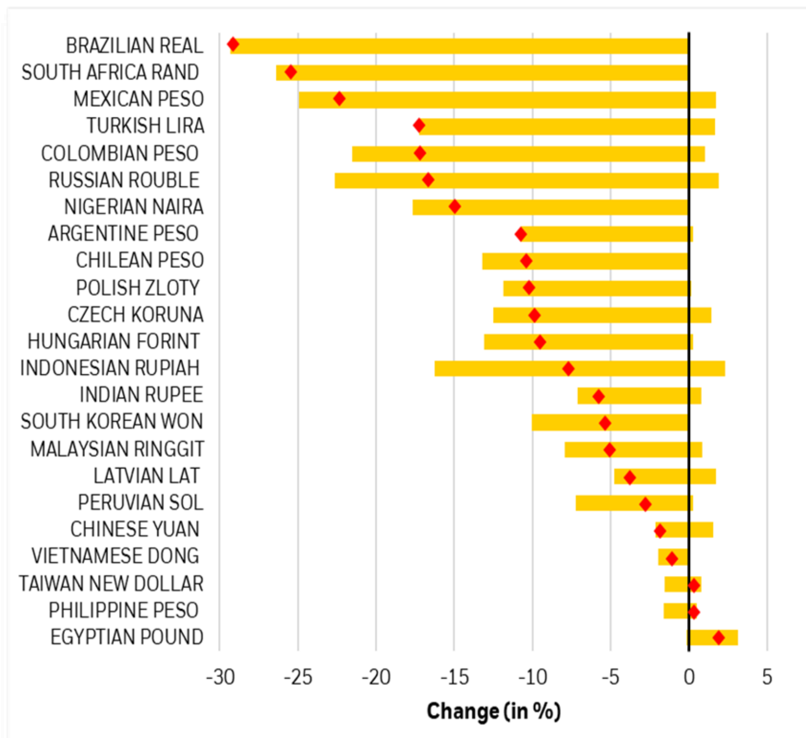
EM Got Beat Up

In 2020 EM experienced a -34% drawdown, and is now down -38% from its last true peak in 2007.



Indexes are unmanaged and do not account for fees. It is not possible to invest directly in an index. Source: The figures shown relate to past performance. Past performance is not a reliable indicator of future results and should not be the sole factor of consideration when selecting a product or strategy. BlackRock, Bloomberg, as at end March 2020.

EM FX movements indicate a wide range of differentiation.



Indicates YTD performance as of May 6th, 2020. The bars represent the year-to-date range of percentage change in each currency versus the U.S. dollar.

Source: Refintiv Datastream and BlackRock Investment Institute, as of May 6th, 2020.

F.V: Where do you see opportunities?

S.A: Carry countries, specifically India and Indonesia as well as materials and energy. China has been very resilient (service industry is fully open, consumer side is recovering; the focus is now on demand) but geopolitical tensions and a reliance on exports make EM ex-China also relevant. In China we see opportunities in sectors which we view as long term winners (such as e- commerce, online education and food delivery), sectors immune to the current crisis (agriculture and healthcare) as well as sectors which are poised to benefit from the policy spending (for example, construction material companies). We are also overweight brokerages due to the policy focus on increasing visibility of the financial markets in the country.

G.R: The team has been incorporating in portfolios several new COVID-19 related tactical insights. These include: betting with countries' perceived strength for policy response (e.g. long South East Asia vs. LatAm); extending text scraping of online job postings from DM to EM to pick winning industries (e.g. long healthcare and software; short insurance and energy); and seeking out EM firms with relatively high revenue exposure to countries further along the virus recovery curve such as Japan, China and South Korea.

A.B: The high-quality group (1) includes Chile, Peru, Czech Republic, South Korea and Taiwan. These issuers are in the zip code of U.S. investment grade credit. As the Federal Reserve supports IG credit, they are likely next in line for yield-hungry buyers. We are happy to buy many such EM issuers.

P.G: In the long term, we are also more comfortable with countries that, despite other issues, are behaving more responsibly and are abstaining from spending which they cannot afford.

F.V: Where are you reducing risk?

S.A: We are reducing exposure to overly defensive names in the telecommunication and healthcare sectors which have done very well (but will not benefit as much from a market bounce back/normalization). We also have been decreasing exposure to supply chains in North Asia.

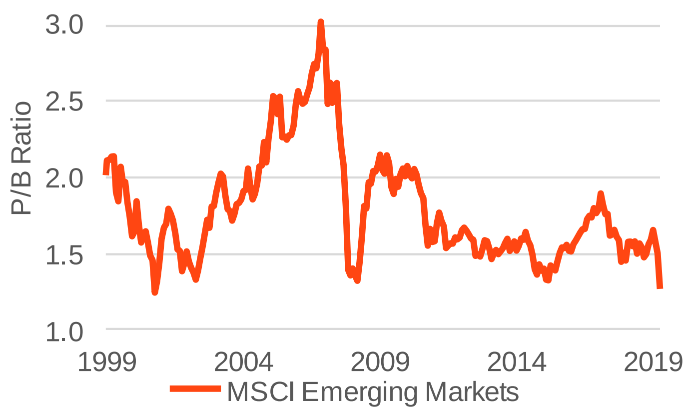
G.R: Slower-moving quant signals work poorly in inflection points. We introduced a policy of no over weights on hard-hit sectors such as leisure and no underweights on biotech, pharma and life sciences. We have scaled back risk-taking – and only now edging it higher again in Asia as the situation normalizes. Another risk management safeguard is a focus on thematic initiatives such as "anti-crowding" and "anti-leverage." This means keeping close tabs on hedge funds positioning– and betting against them as a defense against the risk of another round of portfolio deleveraging.

A.B: The second group of countries (the problematic middle) has made a calculated decision to ease aggressively – both fiscally and monetary – even though their weak balance sheets can ill afford it. They are using currency depreciations as the economic relief valve. Markets may eventually punish these countries – many of which have spent years building up credibility on fiscal probity and inflation fighting. This group worries us most. It includes key constituents of EMD benchmarks. The risk is further currency implosions that force central banks to raise rates. We are likely to see a wave of debt restructurings and defaults in the third group. This scenario is already playing out in some countries (for example, in LatAm). The official institution sector will assist many countries (please refer to page 3 where we discuss financial support). Such support is often conditional on a sustainable debt trajectory.

P.G: We continue to be focused on credits with better balance sheets that could have a faster "escape velocity" from the current growth slump. These names are IG countries with a better financial transmission channel that would allow credit to flow faster into the corporate sector and households. It will take a good reopening of economies for us to turn more risk on.

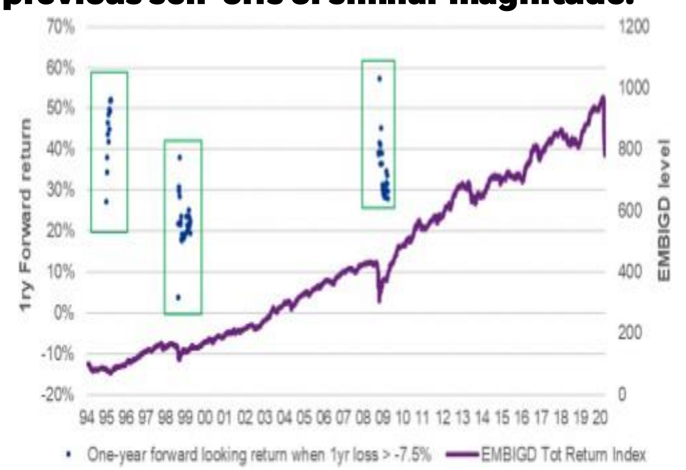
Valuations Are Cheap

Price-to-Book value of 1.3x has historically been a very good entry point.



Source: Bloomberg, MSCI, as at end March 2020. The figures shown relate to past performance. Past performance is not a reliable indicator of future results and should not be the sole factor of consideration when selecting a product or strategy

Hard currency IG valuations are attractive. EM sovereigns performed well after previous sell-offs of similar magnitude.



Indexes are unmanaged and do not account for fees. It is not possible to invest directly in an index Source: BlackRock chart on JP Morgan EMBIGD index, as of 3 April 2020. Past performance is not indicative of future performance.

F.V: What development outside of EM excluding China would make you reconsider your outlook to the upside or the downside?

S.A: Several potential scenarios might skew the risks to the downside: new credit issues emerging which the Fed struggles to control, rapid (and hard to contain) infections rates within EM, and a recovery in the West which is more aggressive and leading to better growth in DM (relative to EM).

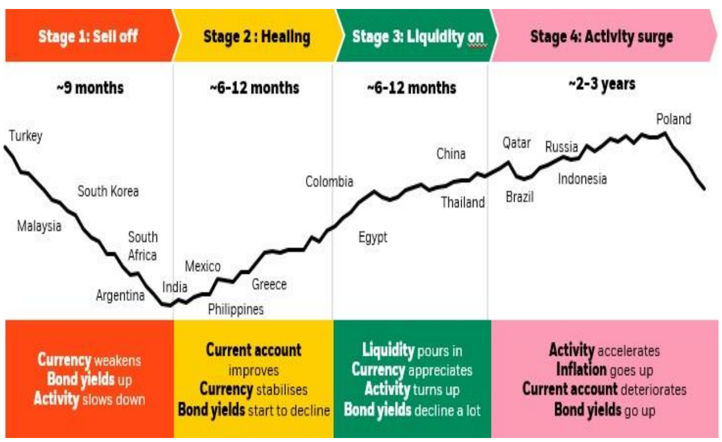
G.R: We are watching closely how the health care systems resist the virus shock in EM economies and what the market reaction is to the first round of fiscal and monetary policy responses. We are also concerned regarding the possibility of having a second wave of contagion later in the year.

A.B: There are three external dynamics that we would focus on and believe will have an important bearing on EM asset prices. First, and most importantly, DM growth. A faster recovery in the DM would quickly translate into a better EM backdrop. Second, a recovery in commodity prices—especially the energy complex—would be very beneficial to EM asset prices. Finally, we keep a close eye on global liquidity which we believe eventually finds its way to EM assets.

P.G: A successful reopening of economies would be the best news for EM, particularly if they come accompanied with resumption of global trade and tourism flows. On the downside, a resurgence of contagion would make markets retest their lows.

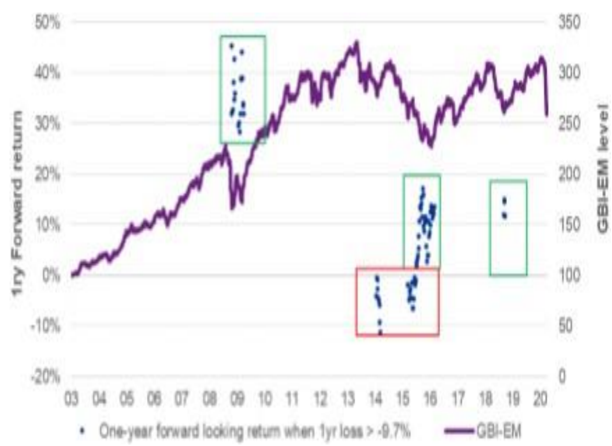
Prospects Are Mixed

Tracking the direction of travel matters.



Source: BlackRock as of March 31st, 2020. For illustrative purposes only., not meant to depict actual data. Country placement is not indicative where the countries are in their actual economic cycles.

Local EM tends to lead recovery but the return is depended on FX outlook.



Indexes are unmanaged and do not account for fees. It is not possible to invest directly in an index Source: Source: BlackRock chart on JP Morgan GBI-EM index, as of 3 April 2020. Past performance is not indicative of future performance.

F.V: What are the sources of financial support from the official community that EM can tap to make up for private capital outflows at a time of enhanced spending needs?

Isabelle Mateos y Lago: The international community has organized very quickly to mobilize resources for EM.

At the poorer end of the spectrum, following a plea from the leaders of the IMF and the World Bank, endorsed by the G20, 76 countries can benefit, upon request, from debt service suspension from official creditors through year end, with private sector creditors encouraged to do the same and indeed working on delivering it.

So far there has been insufficiently broad support for a general allocation of the IMF's Special Drawing Rights (SDR), but the door remains open to doing one at a later stage should the liquidity situation of EM get worse. SDRs augment recipient countries' international reserves without creating additional debt, and are allocated proportionally to countries' share of IMF quotas. They are particularly helpful to countries with limited FX reserves. The last general allocation of SDRs took place in 2009 in response to the GFC.

I.M.L: The IMF has also doubled the amounts it can deploy as unconditional emergency assistance to $100bn and has $700bn available to support its member countries, i.e, many times what was needed following the Global Financial Crisis (GFC). More than 100 countries have now applied for assistance from the IMF and more may yet to do so. Under its own policies, the IMF cannot lend to countries whose public debt is deemed unsustainable without private sector involvement (i.e, some form of restructuring). Given the large increases in public debt expected to be needed in most countries, these considerations may come into focus in countries with currently elevated debt levels.

At the other end of the spectrum, EMs with very strong fundamentals can benefit from a new IMF short term liquidity line. Similarly as during the GFC, a handful of EM countries with strong external positions have been granted access by the Fed to a bilateral swap line of up to $60bn each. Additionally, the Fed has created a new repo line that allows any central bank to exchange US Treasuries for cash, thereby not adding to reserves but alleviating the need to sell USD reserves to obtain liquidity. Finally, some EMs that are part of regional arrangements, e.g. ASEAN+3, have access to additional bilateral liquidity lines, the first tranches of which can be drawn without conditionality. All in all, this global FX safety net is quite substantial, more so than during the GFC, as are in many cases, EM own FX reserves buffers. The availability of FX liquidity buffers, however, does not by itself alleviate concerns around debt sustainability where they exist and may have been made worse by FX depreciation.

Conversation took place between May 4-8, 2020

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