NEUBERGER | BERMAN

KAAN NAZLI
Senior Economist and Portfolio Manager—Emerging Markets Debt

GLORIA LAM
Senior Credit Analyst—Emerging Markets Debt

GORKY URQUIETA
Global Co-Head of Emerging Markets Debt

Vulnerability to Default in Emerging Markets

The COVID-19 outbreak and consequent market dislocation has put significant pressure on emerging market debt. Some of the specific features of this crisis, such as the impact on oil prices, travel restrictions, the decline in tourism and lower remittances, have deprived many countries of much needed hard-currency receipts and pushed the sovereign default rate to levels not seen since 2001. How are these pressures translating into actual and expected default rates in emerging markets, for both sovereigns and their respective corporate issuers?

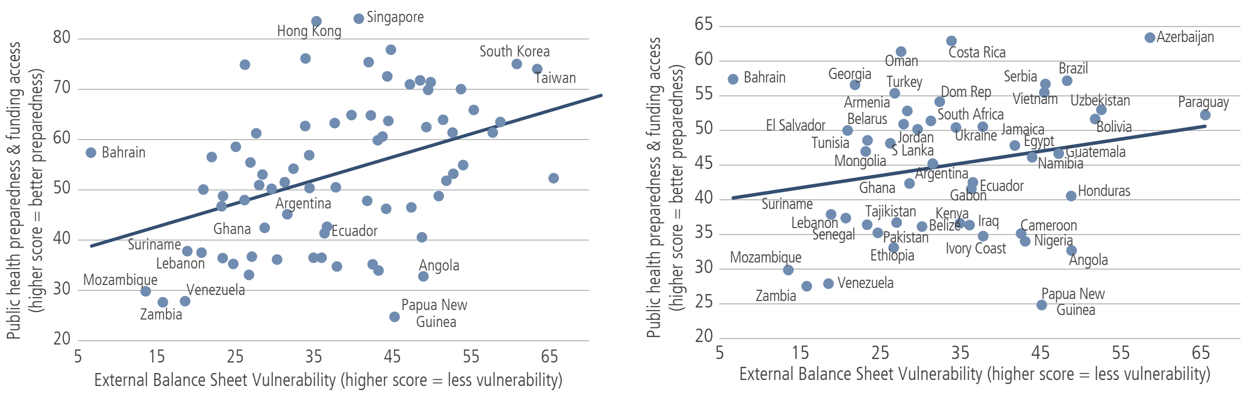
Let's begin by looking at sovereign issuers.

Worryingly, when we plot our proprietary country scores for external balance sheet vulnerability (the burden of hard-currency debt that requires hard-currency receipts for repayment) against our scores for public-health preparedness, we see a significant correlation. That correlation persists, albeit less sharply, even when we select a high yield-only universe (figure 1).

FIGURE 1. FINANCIAL AND PUBLIC-HEALTH VULNERABILITY IS CORRELATED

JPM Emerging Markets Bond Index Global (EMBIG)

JPM EMBIG High Yield Only



Source: Neuberger Berman. As of July 2020.

On the plus side, the policy responses from developed and emerging markets have been swift and unprecedented.

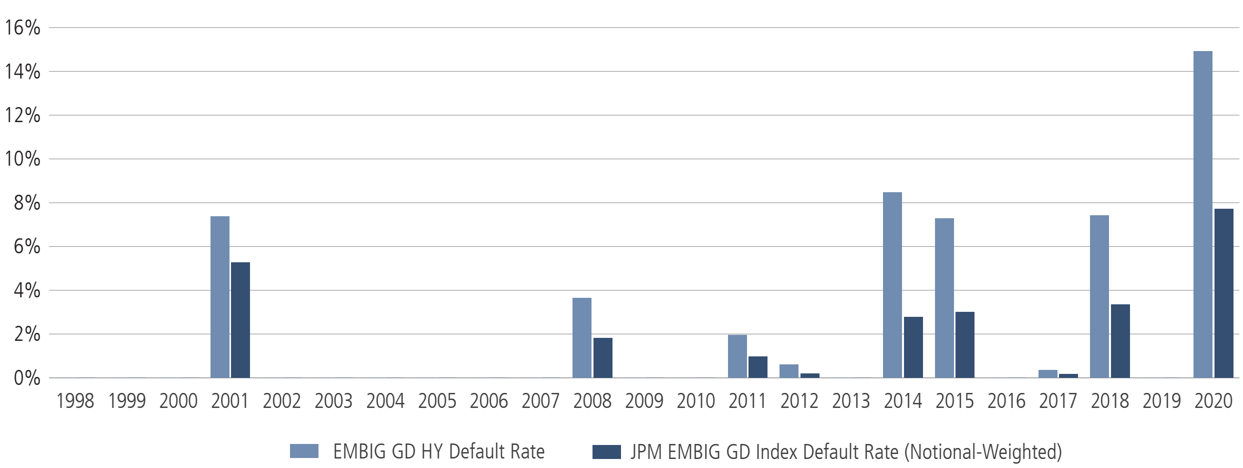
A significant amount of multilateral crisis support has been made available. Support from the International Monetary Fund (IMF) and World Bank is already at almost $60bn. In addition, the Paris Club and G20 have provided liquidity support by suspending bilateral debt payments for the least-developed nations. Domestically, policy rates are at all-time lows in many emerging countries. Some sovereigns, for example Kenya, are still engaged in talks for payment relief, mainly with Chinese entities. Others, such as Ghana, Ivory Coast and Angola—which received a three-year debt moratorium from Chinese entities that will enable it to restore its IMF-backed program—covered their additional financing needs quickly and efficiently.

Net Effect

The net effect has been to push default rates up to levels not seen since 2001 (figure 2). Two of the three defaults that have occurred so far, by Argentina and Lebanon, had nothing to do with COVID-19 and were effectively announced already, and at 7.8% defaults are still the exception rather than the rule in emerging markets.

FIGURE 2. THE SOVEREIGN DEFAULT RATE IS AT ITS HIGHEST SINCE 2001

JPMorgan EMBIG Global Diversified Index default rate (notional-weighted, full index and high-yield only)



Source: JPMorgan, Neuberger Berman calculations. As of July 2020.

Nonetheless, the global COVID-19 lockdown was the proverbial reversal of the tide that reveals who has been swimming naked—the sovereigns who had a plan to "muddle through" in normal times and now face severe financial pain. We put Ecuador, which is the third country to have already defaulted, in this camp; and see Zambia (which has appointed a financial advisor), Belize and Suriname as likely to miss payments in the coming months.

As the main challenge for the rest of the year in emerging markets is likely to remain the fallout from COVID-19, we expect more concern and discussion around rising defaults. We think that the final rate for 2020 is likely to settle below 8.5% (and below 16% for the high yield universe). We struggle to model a much higher default rate than that, given the local adjustments and the international support we have so far seen.

Deleveraging

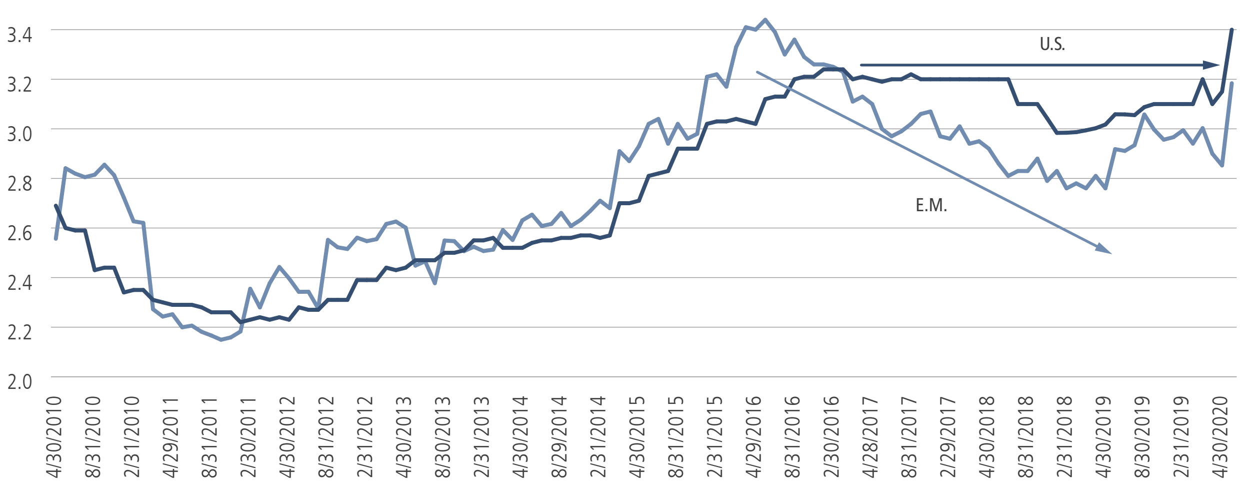
Historically, defaults among emerging market corporate issuers have not necessarily been driven by sovereign defaults.

Based on bottom-up estimates by our emerging markets corporate analysts, we think that the high yield default rate could increase to 4.6% in 2020, versus 1.5% in 2019. That level remains manageable versus previous market downturns, such as 2009 in the aftermath of the financial crisis, when the default rate reached 10.5%, or the end of the commodity super cycle in 2016, when it hit 5.1%.

Why is that the case? Between 2016 and 2019, emerging markets corporate issuers have been deleveraging (figure 3), which will help provide a buffer to earnings and the balance-sheet impact from the operational disruption of COVID-19. In addition, bold and rapid monetary and fiscal interventions across major economies in both the emerging and developed markets has buoyed liquidity and stabilized sentiment in corporate bond markets. Current market stress remains well below the levels we saw during the 2008 global financial crisis: as of mid-July, only 6.7% of emerging markets corporate high yield bonds were trading below 70 cents on the dollar, down from 17.6% in late-March and significantly lower than the 58.8% that were under similar stress in 2008.

FIGURE 3. BUILDING A BUFFER SINCE 2016

Corporate leverage, U.S. vs. emerging markets, 2010 – 2020



Source: FactSet. Data as of May 31, 2020.

So far, defaults here have been driven by jumbo issuers in Latin America and commercial State-owned Enterprises in China. We observe some concentration in the transport sector, with four airlines in emerging markets under restructuring or bankruptcy process so far this year, but other defaults have been largely idiosyncratic.

Looking Ahead

Looking ahead, our relatively benign full-year 2020 default rate forecast of 4.6% is informed by the active asset and liability management that we see companies undertaking, combined with an ongoing recovery in commodities prices. Many emerging markets high yield corporates are now seasoned issuers, with much larger operating scale in their home markets and more diversified funding channels than back in 2008.

By region, we see some encouraging signs from Asia,[1] where many issuers extended their debt maturities last year, and a number of stressed credits improved their liquidity position via corporate actions and capital raising over the last two months. By contrast, a number of stressed issuers in CEEMEA have major maturities beginning in 2022, but a strong rebound in oil prices since April has also alleviated pressure on high yield corporates in this region. In Latin America, where defaults are expected to be higher, corporates have alleviated some liquidity pressures by drawing down credit lines in anticipation of difficult operating conditions—further stress depends on the severity and duration of COVID-19-induced disruption.

FIGURE 4. EMERGING MARKETS HIGH YIELD CORPORATE BOND DEFAULTS

Realized defaults in 2020 and Neuberger Berman's estimates for the full year

	2020 Default Rate to June 10, 2020	NB FY2020 Default Estimate
Asia	1.7%	3.6%
CEEMEA	1.5%	3.2%
Latam	4.3%	7.6%
Total EM	**2.4%**	**4.6%**

Source: Neuberger Berman estimates based on par value of defaulted bonds.

Based on this assessment of default risk, and with credit spreads still at elevated levels despite the recent rebound, we feel comfortable maintaining exposure to sovereign and corporate names whose prices adequately reflect the risk. We believe they offer value in anticipation of a continued market recovery.

[1] See Sean Jutahkiti and Prashant Singh, "Asia Credit remains Firmly Investment Grade" (July 2020), at https://www.nb.com/en/gb/insights/asian-credit-remains-firmly-investment-grade.

Neuberger Berman
1290 Avenue of the Americas
New York, NY 10104-0001

www.nb.com