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Neuberger Berman Emerging Markets Equity Team

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Market Context

The weekend's shocking Saudi announcement that its national oil company, Aramco, would both pump more oil and offer price discounts to a broad set of buyers led oil price to drop to USD 30 (WTI) per barrel. This news came on the back of oil prices falling from above January's USD 60/ barrel to the USD 40 last week, on fears that demand would fall due to slowing global economic activity as individual countries try to contain the coronavirus. The OPEC oil cartel, whose production is led by Saudi Arabia was looking to cut production though Russia, a significant producer, disagreed with the proposal.

Monday's broad equity market sell off was led by the Energy sector, as well as currencies in oil-driven markets. Russia's stock market index was closed, but its currency, the Ruble, fell 8.5% on Monday, adding to previous losses, to leave the currency down over 17% on a year-to-date basis. Consumer-driven economies where Energy makes up a large part of the equity markets also fell; for example, Brazil, home to the state-champion oil name, Petrobras, also retreated over 12%, again hurt by its currency falling 2.6% on the day.

More broadly, a slow economic back drop, which had already led to more supportive central bank monetary policy, now has to contend with falling consumer demand due to the COVID-19 outbreak, and an Energy sector whose revenues are likely to fall dramatically, if the flooding of the oil markets is sustained over the coming months. These twin exogenous shocks pair a greater supply of oil matched against falling demand due to the COVID-19 outbreak that may lead to an exercise by markets to find the new equilibrium price which might take some time.

Among these two major oil suppliers, Saudi government needs oil to be priced between USD 70-80 to balance their budget, while Russia's budgeted figure is around USD 50. Both governments have sovereign wealth funds they can tap to fund fiscal deficits in the short-term, though Saudi Arabia would seem to be in a weaker position from its rising debt levels, recent listing of Saudi Aramco and its pegged currency to the USD. The floating Ruble is important to highlight as it acts as a hedge for the Russian oil producers, reducing the breakeven price as the currency depreciates. The team hopes that the geopolitical tensions do not escalate and discipline comes back into the oil market.

Looking across EME, smaller caps may also get hit harder by a risk-off trade impacting the lesser liquid names. Over time though, we believe Asian market are likely to be net beneficiaries as they are oil importers; although given the subsidy regimes in certain countries, lower oil prices will mostly benefit governments, not the consumer. Some sectors that would traditionally benefit in the short-term are currently negatively impacted by the COVID-19 outbreak (e.g., airlines). Also, China will take time to re-start their economy when COVID-19 containment is achieved. So we believe the broader economic benefits of the lower oil price will likely not be immediately felt.

Investment Implications

Within our EME portfolios we have an underweight bias towards Energy and seek to avoid direct exposure to the Gulf countries, but have an overweight stance on Russia. The team is reviewing positions to evaluate each company's resilience given current market conditions (both the COVID-19 outbreak and oil sensitivity).

The severity of both the COVID-19 disruption, and now this oil price retreat, speaks to the lack of earnings visibility for the remainder of 2020, with the uncertainty also likely contributing to the volatility in equity markets. Early March's US Federal reserve's interest cut serves as a further reminder of the potential ensuing negative economic impact this uncertainty is causing. But it also highlights the greater monetary flexibility that emerging markets have at their disposal to stimulate their respective domestic economies, though the currency volatility may delay the immediate rate cuts. The lower oil price could also offer respite to the many EM energy importers, like China and India.

Given this backdrop, the team, with its focus on domestic businesses, are evaluating a variety of consumer names across the EME space that have sold off during the retreat, some of which are more insulated both from the COVID-19 impact and oil-linked segments of the economy. The team have focused on Chinese consumer names, where the team believes demand could rebound over the medium-term, and evaluating names in other regions, as well with an emphasis on the cash flow generation of the businesses. Due to the volatility in the market we remained disciplined on our trading activity with specific price limits on trades. The team will continue to avail of individual stock opportunities being offered during the market selloff, but do not anticipate wholesale changes to portfolios.