

# Emerging Market Dollar Debt Suggests a Regime Change is Coming

In what has been quite a challenging year for emerging markets (EMs), nearly all asset classes have struggled. In prior posts, my colleagues have made the case for the valuation opportunity in [local rates](#) as well as [non-USD currencies](#). In this post we'll focus on the information currently embedded in dollar-denominated bonds. Broadly speaking, rates and currencies reflect relative business cycles, domestic inflation dynamics, and global competitiveness trends. Emerging market dollar debt (EMD) is simply a reflection of issuers' willingness and ability to pay. When looking at the asset class, a few things to stand out:

## 1. The potential return is still worth the extra “headaches”

Given the currency denomination, EMD lends itself to a cleaner “apples-to-apples” comparison with other fixed income markets. Although valuations are tight or mid-range relative to its own history, EMD continues to offer a higher yield than developed market peers. For instance, despite all the hubbub about Italian debt, the valuation anomaly is nowhere near that of 2011 when BTPs traded like a true EM (See [Chart 1](#)).

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### Chart 1: Italian 10 Year No Longer Trades Wide to EMBI

As of 10/4/2018



Source: Bloomberg (© 2018, Bloomberg Finance LP)

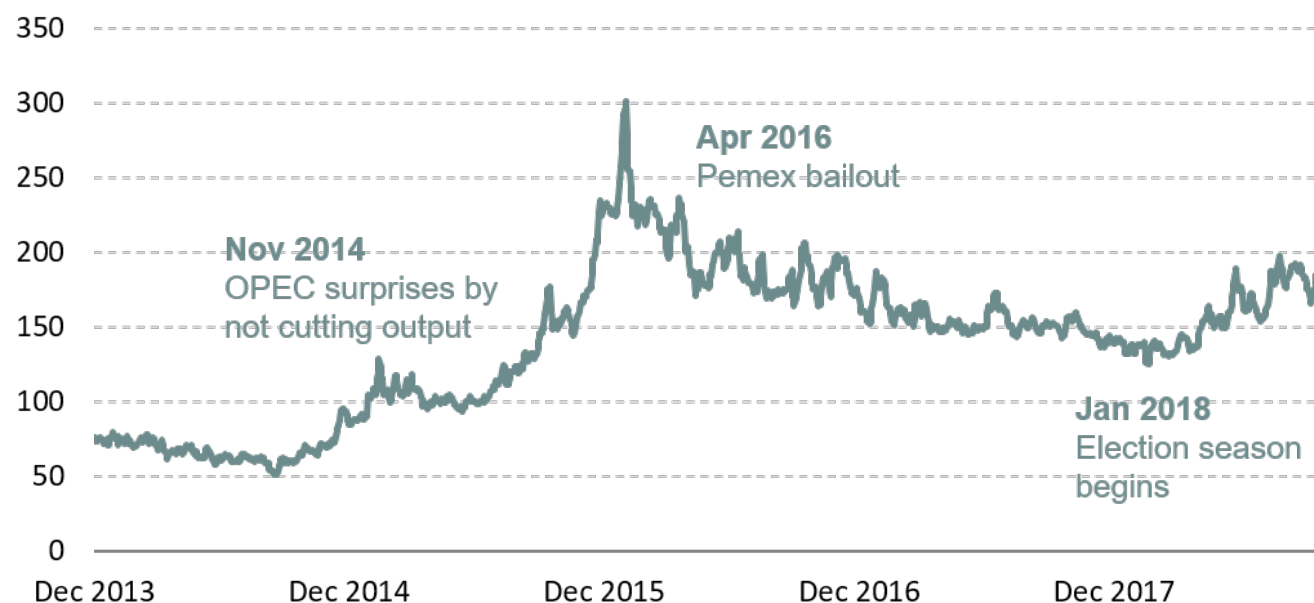
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## 2. Regime change is coming in some markets

The electoral calendar year in EMs has been quite busy, particularly in Latin America. Certain dollar bonds are pricing the potential for regime change ahead. In Mexico, the president elect won handily after softening his populist rhetoric of past campaigns. However, he remains critical of recent energy market reforms, which has contributed to a widening in the spread between the dollar bonds of Pemex, the state-owned oil company, and, the sovereign (see [Chart 2](#)). In Argentina, the elections of 2019 will offer a choice between a continuation of the pro-market government which has so far failed in its stated economic goals and a return to the populism of years' past. This potential shift has led the market to demand a significant premium pickup between dollar bonds maturing before and after the elections, as shown in [Chart 3](#).

## Chart 2: Pemex Spread to Sovereign Widening Again

Yield to Maturity, 2044 Bonds, As of 10/4/2018



Source: Bloomberg (© 2018, Bloomberg Finance LP)

## Chart 3: Argentina 2021 Bonds Trade Wide to the 2019s Given Political Risk

As of 10/4/2018



Source: Bloomberg (© 2018, Bloomberg Finance LP)

## 3. The weak spot is corporate, not sovereign

# balance sheets

Over the last two decades, EM sovereigns have endeavored to avoid generating the economic imbalances of prior cycles. Overall debt levels are lower, the bulk of debt is fixed rate, denominated in local currency, and cash balances have been built up in central banks' vaults. However, the same cannot be said of EM corporate issuers, where vulnerabilities have started to appear. For example, the Turkish sovereign has exceptionally low debt levels at 26.7% of gross domestic product (GDP), but Turkish bank bonds maturing over the next 12 months yield over 10%—suggesting some market expectation of distress. There is also a currency flow impact from corporate debt where issuers that have domestic currency revenues, but dollar liabilities, need to hedge their exposure. Initial currency moves generated by economic fundamentals can overshoot as corporates rush to hedge their dollar liabilities. This, we suspect, is playing out in Indonesia.

## 4. Some debut issuers will become debut defaulters

Over the last decade, low rates and quantitative easing in developed markets have allowed a lot of sovereigns to come to market for the first time in their history—keep in mind, we currently are not invested in these first-time issuers. Ability to pay can be quantified, but can deteriorate in economic downturns. Willingness to pay relies in large part on history so it's unclear how some of these countries will respond when under duress. It's safe to say that multilateral institutions like the International Monetary Fund (IMF) will be called on more frequently over coming years.

There is a lot of disagreement in the market when it comes to the future of EM; this is creating price anomalies in dollar debt that are starting to look appealing. Uncertainty will always be high in EM and the next few years will be pivotal, but we think opportunities abound.

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