Our EM outlook in a landscape transformed by COVID-19

Emerging Markets Debt Team
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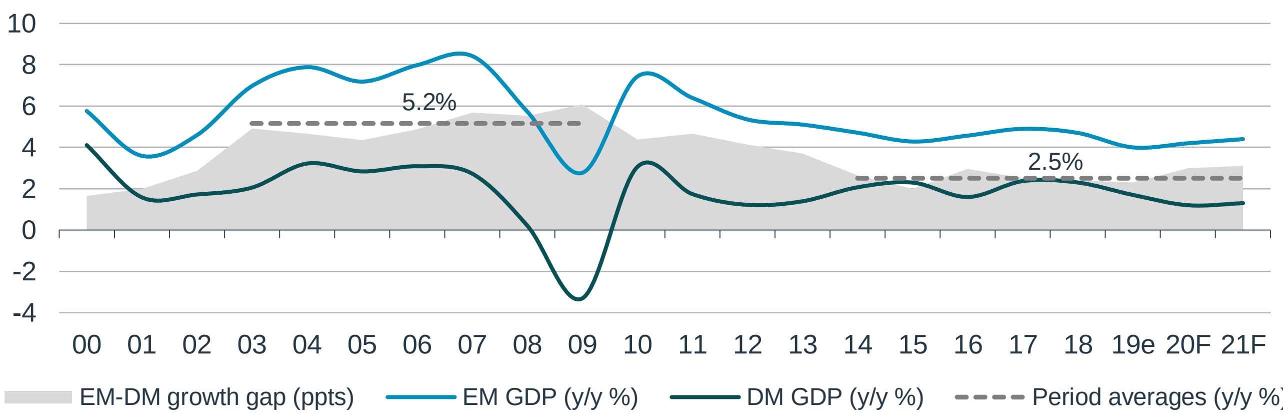
Emerging markets (EM) overall are still at an earlier stage of the coronavirus infection curve than their developed market (DM) counterparts. Considering the higher dependence of many EM economies on trade and commodities, coupled with their fragile health care systems and large “shadow” sectors, the disease-related shutdowns present significant political and economic challenges for EM policymakers. They will be forced to balance the impact of large hits to growth and fiscal accounts with public health and social repercussions. Consequently, we believe political risk will need to be closely watched heading into 2021, as voters digest their respective governments’ responses to the pandemic.

For the broad EM sphere, the economic damage from COVID-19 might turn out to be relatively mild. If so, it will be largely because EM economies, in aggregate, had higher starting levels of GDP growth relative to DM countries heading into the year (see graph below).

EM economies led entering 2020

GDP growth (%) comparisons since 2000



Sources: Haver Analytics, IMF, Morgan Stanley Research forecasts, Bloomberg. e = estimate F= forecast

In its April 2020 *World Economic Outlook*, the IMF projects developing-world GDP will contract by a relatively modest 1% this year (compared to a 6.1% decline for advanced economies), and then rebound 6.6% in 2021 (versus 4.5% growth for advanced economies). Our forecasts align with the IMF’s, showing widely divergent outcomes among individual countries. Lower-income economies, and those with limited ability to enact fiscal stimulus, are bound to suffer the most.

Against that backdrop, we believe more stimulus —and economic reforms — will be necessary globally and at the individual country level to help economies return to pre-pandemic growth rates. Additional central bank swap lines will almost certainly be required. And China, as a major bilateral creditor, will need to take a major role in providing financial lifelines.

But higher levels of stimulus and lending bring added risks. We expect government and corporate repayment capacity to be weakened as economies generate lower levels of activity and tax revenue. Moreover, with their budgets now heavily skewed toward fighting the virus, governments may struggle to address issues other than health care. Further, support for quasi-sovereigns must become part of the solution, as many still represent a drain on government balance sheets.

Given the diversity of EM countries and issuers, the current crisis creates significant, unique opportunities, despite COVID-19's devastating human and economic toll. In fact, our core belief that EM debt should not be considered a monolithic asset class has never been more applicable.

Within the EM universe, we've identified sovereign issuers with sound policy frameworks and fiscal and monetary buffers healthy enough to tolerate near-term volatility, as well as companies with strong balance sheets and liquidity positions. If debt forgiveness and multilateral funding are available, sovereigns may be able to both withstand the crisis and meet existing obligations.

Lastly, we've uncovered EM segments where we believe valuations have overshot and are inconsistent with fundamentals. Current market pricing implies a high rate of defaults that might not materialize, based on our analysis of default levels during prior crises.

Anupam Damani, CFA, leads Nuveen's 16-person Emerging Markets (EM) Debt Team, which manages over $12 billion in EM debt assets across sovereign, corporate and local-currency markets. Anupam and EM Debt team member Katherine Renfrew have been ranked among the top 20 female portfolio managers in the U.S. by Citywire Professional Buyer magazine.

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