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Emerging Market Debt

Something Old, Something New

- US elections jitters are starting for EM after an agitated yet overall constructive summer.
- A Trump win is generally seen as bad for EM, as it would bring about trade protectionism, lead to USD appreciation, a potential currency war with Asia and higher US rates that would hurt frontier markets. A Harris win would be better as it would help avoid all of the above.
- We might sometimes forget that a Trump presidency is not a new outcome for markets, and that Harris also offers a relevant playbook after being a VP in the current administration.
- In this piece we investigate whether the first Trump presidency in particular offers a useful guide as to what to expect from Emerging Market Debt (EMD) should he win another term.

Magda Branet, CFA
Head of Emerging Market Debt

Is it 2016 again?

Similarities with the pre-2016 elections are striking when we look at EM today.

In November 2015, **Ukraine** had just completed its debt restructuring following the first Russian invasion of 2014 and the subsequent sovereign default. In August of this year, Ukraine restructured its sovereign debt again, after a 2-year moratorium on external debt payments.

In 2016, **Argentina** was having a “moment” with the Macri reformist government in place promising a break from the past. Today we are witnessing another attempt at a turnaround, with the Milai administration having embarked in an aggressive fiscal stabilization program.

China was struggling with low growth, overcapacity and deflation fears, with the property market in the doldrums.

Brazil was experiencing a fiscal and political crisis. Dilma Roussef’s administration pushed the budget deficit to double digits (it peaked at -10.2% of GDP in 2015) and eventually faced impeachment. Today Lula’s honeymoon with markets (after his re-election in October 2022) seems to be over, with the 2024 projected budget deficit at -10% of GDP again.

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EMD during Trump 1.0 - more fear than harm

Overall, the first Trump Presidency turned out to see buoyant returns from EMD, with hard currency and local currency debt posting similarly high returns of +23% between Jan 2017 (Trump inauguration) and Jan 2021 (Biden inauguration) [1].

EMD hard currency spreads stood at 340 bps for sovereigns and 330 bps for corporates in September 2016, as US elections were getting close. On Trump announced (and unexpected) victory, there was an immediate 40bps widening of spreads for sovereigns, while EM corporates a more illiquid and less reactive asset class, did not move.

EM spreads consequently proceeded to rally, to 268bps for sovereigns and 247bps for corporates, until the end of 2017. **In all, EMD returned +9% for the combined sovereign and corporates asset classes in the first year of the US administration.**

Argentina, a darling of the market by then (after re-accessing debt markets following Macri's election in 2015 and the clearance of the conflict with bond holdouts), **outperformed and delivered +15%. Ukraine, still riding on post-restructuring enthusiasm, was up 17%.**

2018 saw the start of tentative policy tightening from the Fed. This led to a widening of EM spreads, with the countries most exposed to external financing risks (Turkey and Argentina) cracking under the pressure of tighter financial conditions, Argentina eventually defaulted on its debt in October 2019, after Macri lost his re-election bid, and Turkey experienced a balance of payments crisis with the TRY losing 30% in one day in August 2018.

In sum, the first year of Trump, stars aligned as EMs benefitted from a few idiosyncratic stories (Ukraine, Argentina), easy US monetary and fiscal policies, and synchronised growth rebound. Starting in 2018, Trump's reflationary policies led to a tightening of monetary policy, which hit the most fragile EMs (Turkey, who ran a high current account deficit (CAD), and some frontier markets like Argentina and Ecuador).

Are we going to (trade) war again?

The start of the trade wars between China and the US can probably be traced to March 2018, when President Trump tweeted about his intention to impose tariffs. Steel and aluminium were the first products targeted, and 4 rounds of tariffs ensued in all, as well as sanctions on Chinese tech (Huawei and ZTE) and military companies, followed by export controls on a number of key products and sectors.

The CNY had been under pressure going into US elections, depreciating 6% in the 12 months preceding Trump's inauguration. However, between the start and the end of the Trump Presidency, the CNY slightly appreciated (by cca 4%). **A 14% depreciation occurred after March 2018, and was consequently reversed.** Interesting to note that today, at 7.13, the USDCNY is hovering around the peak it reached during Trump 1.0 (7.17 was reached in September 2019 and May 2020 in the midst of the pandemic).

[1] Source: Bloomberg, JPM Indices. It also applies to other market data in this article, unless otherwise stated.

In spite of being a popular short with investors, as witnessed by various surveys, **the CNY has remained eerily stable this year**. An imminent CNY devaluation seems to be preceded by a widening of the CNH-CNY spread, reflecting short speculative positions on the CNH from offshore investors. This occurred for instance in August 2015, when a steep devaluation of 2.7% of CNY followed. This spread has remained wide this year, as CNY shorts have become a consensus trade. However, in the recent bout of currency volatility, the CNY followed the JPY and appreciated swiftly, and the CNY/CNH spreads converged to 0 - a sign that speculative shorts have been cleared in the episode.

Betting on CNY depreciation and buying USD has not been proprietary to foreign investors only. If we measure the difference between the cumulative Chinese trade balances (showing large surpluses) and conversions of USD into CNY by exporters, one can notice that much of China's surpluses have been stored in USD (some estimates put holdings of USD by corporates and households at 300-600bn).

Dollarization increased in recent years across Asia, given the high interest rate differential between the US and the region. Chinese 10y government bond yields trade around 1.7% inside 10y UST yields (the spread went as high as 2.4%). Hedging Asian currencies into USD is carry positive, due to negative interest rate differentials versus the US: 3m annualized hedging costs via forwards stand at -2.6% for the THB, -2.5% for the KRW and -2% for the MYR.

This means that Asia FX is already oversold and the risk of a re-conversion of USD into local currencies, should material CNY weakness fail to materialize, especially as US rates head lower (making the shorting less attractive from a carry point of view), is worth noting.

This could limit CNY depreciation pressure, even as tariff fears mount.

What can happen to Ukraine?

As mentioned above, when Donald Trump first took office, **Ukraine had completed its restructuring of external debt the year before in August 2015, issuing new bonds in November 2015.**

In August 2024, Ukraine reached an agreement with bondholders and sent out a proposal of restructuring of those very obligations, and new instruments have been trading since the end of the month.

The 2015 restructuring was relatively straightforward: **it contained a 20% haircut on principal, no payments until 2019 and a 4-year maturity extension.** The 2024 restructuring proposal is slightly more complex, encompassing the exchange of old instruments for 2 types of bonds, a classic Bond A with step up coupons and a bond B with a contingent payment schedule, whereby principal can be increased depending on certain conditions being met on the level and the growth rate of Ukraine GDP by 2029.

The principal haircut is slightly higher than in the first restructuring, between 37% and 25% (depending on whether the optionality of Bond B is met). External debt payments over the next 4 years are, in IMF terms, "token", allowing significant cash flow relief for Ukraine,

At the time of the first restructuring, **the economic and political situation of Ukraine was dire, but not dis-similar to today's.** Part of Ukraine's territory was occupied, and in spite of the Minsk agreements of 2014/2015, a complete cease fire had not been achieved. The conflict appeared "frozen" although flare ups would be recurrent. Ukraine's GDP had fallen dramatically following the invasion, registering a 50%

y/y contraction in USD terms in 2015, partially explained by the local currency's debasement (the hryvnia lost half of its value from 10UAH/USD in 2014 to 22UAH/USD in 2015). At the exit, Ukraine had a debt-to-GDP ratio of 90% and had secured an IMF support package of USD17.5bn.

Today, Ukraine has secured a similar amount of IMF support, with a 4-year EFF (Extended Fund Facility) totalling USD15.6bn, of which the latest USD 2.2bn tranche was released in May 2024. GDP seems to have fallen by less than during 2014/2015, (-20% in USD terms) especially thanks to the relative stability of the hryvnia, which "only" lost 45% since the start of the invasion.

The most important parameter in determining the value of the Ukraine bonds going forward is the exit yield - i.e. the yield at which the new instruments will trade once issued. **After the 2015 restructuring, the new bonds, carrying coupons of 7 ¾ %, traded relatively well after being issued and settled at a yield of around 8%,** hovering between 8% and 10% between November 2015 until February 2022, when Russia invaded Ukraine and yields skyrocketed to the 40%-60% area.

How will the exit yield vary in a Trump versus Harris scenario?

Trump has repeatedly said he would end the Ukraine war in "days" and threatened to cut support not only for the Ukraine conflict but for NATO in general. Since the 2014 invasion of Ukraine, the US have provided USD58.2bn in military support, of which the vast majority (USD55.4 bn) since February 2022[2]. Should support be cut completely, one would assume Ukraine would find itself in a very similar situation to the one of the first invasion, which had been fought off with much less Western military assistance. This would be without counting on Europe increasing its aid as the gap between committed and allocated aid to Ukraine is high.

With a similar debt-to-GDP ratio as in 2015, a similar amount of IMF assistance, and committed assistance from Europe still in place, Ukraine bonds could follow a similar pattern to the first restructuring outcome- ie trade with spreads between 800-1000bps, resulting in yields in the 12-14% area. This would translate, based on our calculations, in bond prices in the mid to high 50s area.

We admit there is significant uncertainty as to how the market would react in case support was dramatically reduced- with an initial hit on sentiment probable. However, we stick to the view that servicing of the bonds is secure under the IMF program and another restructuring, barring an unforeseen worsening of the war in the next 4 years.

Argentina – Milei v Macri – Is this time different?

Back in November 2015, outsider businessman turned politician, Mauricio Macri was elected on a platform vowing economic and political change after a decade of 'Kichnerismo' rule. Within one year of his presidency and by the time Trump got elected, Macri had lifted capital controls, floated the currency, and issued a record bond deal after inking a multibillion settlement with hold-out creditors from the previous restructuring.

Today, the beleaguered South American nation is grappling with another episode of high inflation, economic recession, and risk of debt default. Profligate government spending, financed by money

[2] Source: US department of state website- https://www.state.gov/u-s-security-cooperation-with-ukraine/, August 2024.

creation, is the root cause of Argentina's economic malaise according to President Javier Milei. An economist political outsider turned senator in 2022 and president in 2023, Milei was elected on a mandate to stabilize the economy, which was at the brink of hyperinflation, with rising poverty levels amidst a web of price and capital controls. To reverse the secular economic decline and avoid another debt default, Milei has pledged to undertake a massive fiscal adjustment – and is already doing so – unlike his predecessors.

Both Macri in 2015 and Milei last year inherited challenging situations. Arguably, Milie's inheritance was even worse than Macri's – triple digit vs. double digit inflation, double digit (in billions) vs. single digit negative international reserves, double digit vs. single digit twin deficits (incl. Central Bank deficit). Despite optimism, worldwide interest, and initial success, the Macri experiment failed as fiscal dominance prevailed leading to renewed imposition of capital controls, higher levels of inflation than inherited, and an eventual debt restructuring.

Conclusion: history likely to repeat itself?

In spite of certain challenges that the asset class overall and certain EM countries in particular were facing in 2016, post the US presidential elections EMD performed well. Buoyant equity markets, decent global growth and some idiosyncratic turnaround stories helped returns in the year following Trump's inauguration.

This time around, we think EM debt can repeat these behaviours, regardless of the US election result. We still see upside in EM HY, particular frontier markets, with Ukraine and Argentina being favourite trades. Trade wars and protectionism could bring about a strong USD, but de-dollarization as US interest rates are cut can act as a powerful counterbalance.

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