MyStratWeekly

Market views and strategy

Ostrum ASSET MANAGEMENT

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N° 008 // 1st February 2021

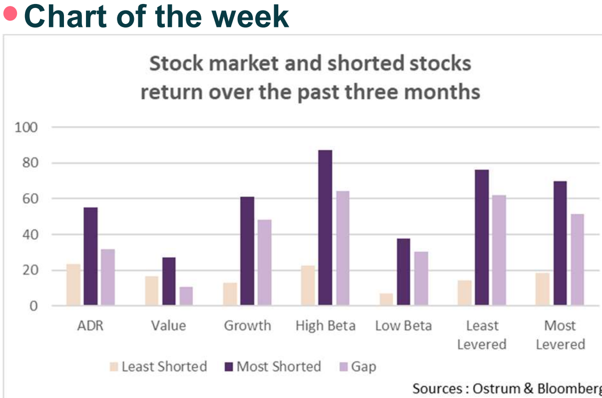
Topic of the week: Emerging Countries Debt; Changing

- **Emerging countries have shown resilience compared to previous crises. Despite an unprecedented economic crash, EMBIGD spreads have reacted less than in the past.**
- **However, some countries, particularly in Africa, are concerning. A major change is the emergence of China as a major creditor.**
- **Giving the IMF more flexibility to increase its credibility in the face of a more serious crisis would be a step in the right direction.**

Market review: Margin call

- **Equities drop, speculation sparks high volatility in US markets**
- **Fed kept policy unchanged**
- **Knot hints at ECB's intervention on the euro**
- **High yield erases 2021 gains**

Chart of the week



The return of market volatility is also linked to the intervention of investors who take positions opposite to short sales. The result is paradoxical, and totally unusual, the values most affected by short selling are those that rebounded best.

A conclusion valid for all market segments.

One may doubt the sustainability of this movement, the fundamentals will eventually act as a reminder force.

Figure of the week

239

Source : Ostrum AM

Tuesday, February 2 is the 239th consecutive listing day where the VIX is above 20. This is the second longest series recorded.
The culprit: the Covid effect, since February 2020.

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Topic of the week

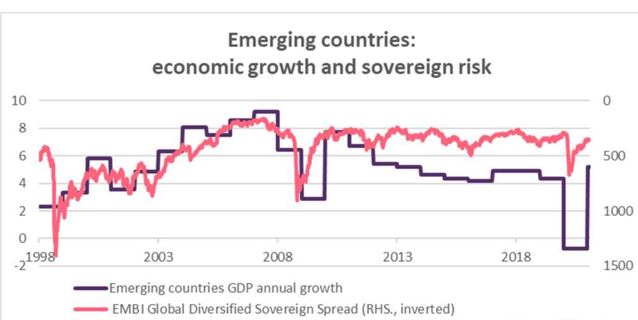
Emerging Countries Debt; Changing

Emerging countries have of course suffered from the pandemic but have shown interesting resilience. The reaction of the international community is one reason. On the other hand, the most indebted countries of Africa are worrying, and here too we must take into account a new element, the emergence of China as a major creditor. It seems to us that an evolution of the IMF, especially with a broader financial base, would be needed to deal with future crises.

Health crisis and resilience

Emerging countries have been impacted by the economic impacts of Covid-19 even before the virus infects their populations. Shrinking world trade, falling commodity prices, declining tourism and a sharp decline in remittances from migrant workers were the main channels of transmission of the pandemic on the economic activity of these countries. The consequences were dramatic and unprecedented, a 0.8% decrease in GDP of emerging countries in 2020 while in 2009, at the worst of the previous crisis, it was still growing by 2.9%. The consequences were also financial. Massive outflows of capital from emerging markets have led to higher dollar financing costs for these countries.

Despite this, the rate response was unusually low. Admittedly EMBIGD more than doubled from less than 300 in early 2020 to 721 on March 23. But the reaction is much less violent than it was in 2009 (almost 1,000) or, of course, in 1998 (a higher one without proportion to what we have just experienced at 1,405). It is strange that the loss of growth has been incomparably greater. There is therefore a resilience of emerging countries compared to previous crises.



Source : Ostrum & Bloomberg

How can this resilience be explained? On the one hand, emerging countries have benefited from external assistance earlier in the cycle. Central banks in emerging countries called on the Fed to receive funding in dollars. The US Central Bank had reactivated its swap lines with the other central banks it had set up during the 2008 financial crisis.

On the other hand, the management of the epidemic has led to urgent financing needs, which has convinced some central banks in emerging countries to implement unorthodox monetary policies such as financial asset purchase programs (called “QE”). Even if the volumes purchased may seem timid compared to what has been done by the BoJ, the ECB or the Fed, this is an important novelty. The goal was to finance themselves at a lower cost or on a larger scale. This resulted in a significant reduction in domestic interest rates.

Emerging countries have also appealed to the International Monetary Fund to release funds and help overcome this crisis. More than 90 countries requested emergency assistance from the IMF ($102 billion) and resources from the World Bank ($160 billion and $80 billion for development banks), illustrating the magnitude and severity of the shock on emerging countries.

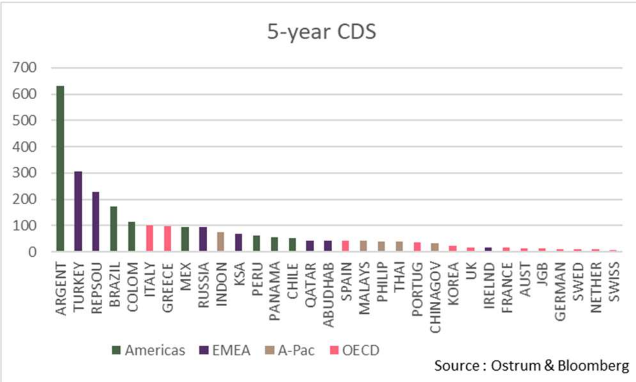
Other solutions were also provided, particularly for the poorest countries that were hit hard by the pandemic. These already heavily indebted countries have significantly increased their public spending to cope with the epidemic, raising fears about the sustainability of their debts.

Despite an unprecedented economic crisis, the rate response is much less severe than in 2009 or 1998.

With this in mind, in April 2020, the G20 launched the Debt Service Suspen-sion Initiative (DSSI), which allows the 73 poorest countries that request it to suspend interest payments.

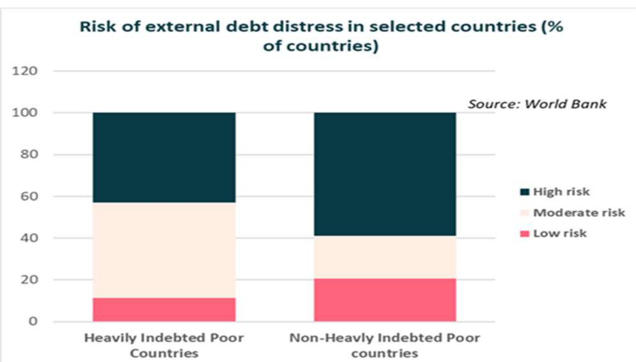
The mobilization of the international financial community has thus largely contributed to avoiding a financial crisis in emerging countries. The historically low global interest rate environment is also likely to mitigate risks.

This resulted in a rapid reduction in risk premiums on EM sovereign debt in the financial markets, for instance the above-mentioned EMBIGD spread which went from 721bp at the peak of the crisis on 23 March 2020 to 351bp at the end of 2020, close to its historical median levels. Similarly, the risk of default measured by the CDS shows that some of the emerging countries are trading below the level of Greece or Italy, many of the countries of South East Asia trading below Spain.



Fragilities persist in Africa

However, care must be taken on these aggregates. Several States in the “frontier economies” are already in default of payment on their debt, while others, particularly very poor countries such as Sub-Saharan Africa, are exposed to a high risk of over-indebtedness.



Of the 46 countries that have applied to the ISSD, 31 are African countries, more than two-thirds of them, in order to ease the repayment of their debts! This shows that fragilities persist.

Africa was not severely affected by the health crisis, but by its economic consequences. The fall in commodity prices, including oil, tourism, world trade and remittances by migrant workers has rapidly worsened its economic outlook, putting pressure on heavily indebted poor countries.

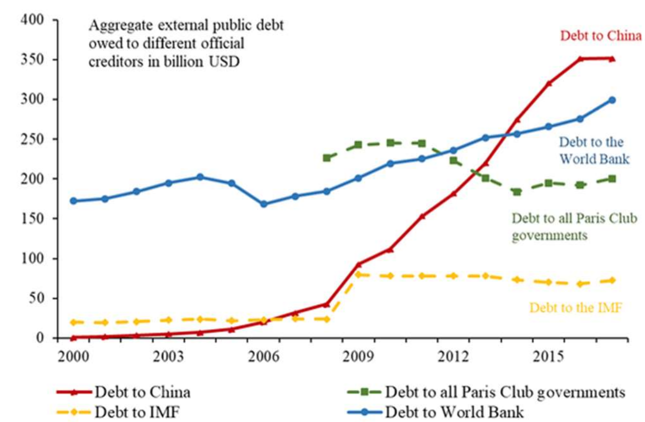
In October 2020, Zambia declared that it could not pay the $42.5 million in interest on its dollar debt and that it was about to default on its $12 billion external debt, the equivalent of half of its GDP! Angola too has been hit hard by the fall in oil prices, putting pressure on its public finances. Gabon and Ghana are also at risk.

The health crisis has led to urgent spending and other financing needs to deal with the disastrous economic and social consequences. African countries are facing a dilemma: helping their most vulnerable population or paying off their debts? China has the answer.

China comes to muddy the waters

This is another important shift in the financing of emerging countries. The health crisis has highlighted the ”hidden” and very significant indebtedness of emerging countries vis-à-vis China. Chinese banks and financial institutions have provided billions of dollars in loans to countries in financial difficulty for the Belt and Road Initiative project.

Unfortunately, the information on the subject is limited and incomplete. The “China’s overseas lending” report by S. Horn, C. Reinhart and C. Trebesch, published in Kiel Institute for the World Economy, is an excellent source that we use below. Chinese official lending now trumps that by other major official creditor nations. Developing and emerging countries are now much more indebted to China than to all other major creditor governments combined: 106 countries in developing and emerging market sovereigns owe 370 billion USD to China compared to 246 billion USD in debt owed to the group of 22 Paris Club member governments.



The majority of financing is guaranteed by commodities (oil), or by public infrastructure. Two Chinese state-owned banks, China Development Bank and Exim Bank alone account for 77% of loans. Africa is the region that has benefited the most from Chinese loans because of its wealth of raw materials. Between 2000 and 2018, Chinese banks granted $148 billion to African countries and state-owned enterprises.

The problem is that these Chinese loans are opaque. Basic information, such as the interest rate of the loan, is known only in rare cases. Moreover, these loans are not listed in the standard databases such as the World Bank and the IMF, because China is not a member of the OECD, or of the Paris Club and is therefore not obliged to publicly publish the terms of its loans. Similarly, Chinese state banks largely fall under their radar screens of rating agencies such as Moody’s or Standard & Poor’s or data providers such as Bloomberg

Hence, a "hidden debt" problem, which means that borrowers and international financial institutions have an incomplete picture of what the world owes to China and under what conditions.

The "China's overseas lending" report estimates at $200 billion (2016) the amount of these "hidden" loans. This represents 6% of the GDP of the 50 countries most exposed to China, particularly the very poor countries of Sub-Saharan Africa, it also represents 15% of the amount of debt of these countries. It leads to an underestimation of the debt and to the underestimation of the associated risks.

In the case of Africa, China holds 62% of its official bilateral debt, according to the China Africa Research Initiative, John Hopkins, "Chinese Loans and Africa's Debt Problem 2020", published in July 2020. Also according to this study, Chinese loans exceed 25% of the debt stock in 7 African countries that are at risk or already in over-indebtedness: Djibouti (57%), Angola (49%), Republic of Congo (45%), Cameroon (32%), Ethiopia (32%), Kenya (27%), and Zambia (26%).

62% of Africa's official bilateral debt is held by China.

China has deferred interest and principal payments under the Debt Service Suspension Initiative (DSSI). For example, in the case of Zambia, China Dévelopment Bank deferred interest and principal payments by 6 months until April 2021. EximBank has suspended all payments from its $110 million loan portfolio.

Angola also reached an agreement in September with three of its major creditors, including China Development Bank, to which it owes $14.5 billion, and EximBank ($5 billion), for debt relief of $6.2 billion over the next three years.

These initiatives by China are giving relief to African countries that are over-indebted. These countries thus have some room for maneuver to help the most vulnerable population that has been hit hard by the health crisis and its economic consequences.

Is international reform necessary?

The Debt Service Suspension Initiative (DSSI) initiated by the G20 in April 2020 also encouraged private sector lenders to participate in debt restructuring negotiations.

This is particularly important because Chinese state-owned banks are considered private sector institutions by their government and were not involved in the negotiations. Without knowing what countries already owe and under what conditions, other private creditors cannot make informed loan decisions. They will also be reluctant to participate in restructurings unless they know the terms and conditions granted to other creditors.

The World Bank and the IMF are also pressuring China to cancel its debt to the poorest countries, but China is reluctant. The Chinese authorities prefer to defer repayments or to make partial cancellations of repayments. Most of the lending to emerging countries has been through the Belt and Road Initiative, a long-term project.

A simple solution to the solvency problem of over-indebted countries would be the issuance of special drawing rights (SDRs) by the IMF. This would allow these countries to rely on another reserve currency to fight the epidemic by having complementary international reserves.

In 2008, the IMF issued $270 billion in Special Drawing Rights (SDRs) to double its strike force. At the peak of the pandemic, the IMF had estimated the needs for emerging countries at $2.5 trillion, while its lending capacity is $1 trillion.

To remedy this, the International Monetary Fund wanted to increase the circulation of SDRs by $500 billion, but this proposal was blocked by the Trump administration (the United States are the main shareholders of the IMF) because it constitutes a new front in the war of influence between the United States and China.

Will the new tenant of the White House change the American position vis-à-vis these countries?

While Africa is the riskiest region, other middle-income countries such as Brazil also have significant financing needs (Fiscal Monitor, IMF, April 2020). This reflects the strong impact of the pandemic on emerging countries including the BRIC countries. The global debt stock has also grown, and the IMF will therefore need more resources to deal with future crises. Giving the IMF more room to maneuver in order to increase its credibility in the face of a more serious crisis would therefore be a step in the right direction.

Conclusion

The pandemic has been a violent economic and financial shock for emerging countries. It also highlighted several structural changes in the debt of these countries. The mobilization of the international financial community is one element that has prevented a more serious financial crisis. Although some countries have suffered greatly, the resilience of emerging countries as a whole contrasts with previous crises.

However, fragilities persist, particularly in Africa. The health crisis has put pressure on already over-indebted African countries, highlighting another structural change with China's "hidden" debt. The opacity of Chinese loans makes it difficult to negotiate debt restructuring with private creditors.

The Debt Services Suspension Initiative (ISDD) has enabled over-indebted poor countries to make room for maneuvers; China has carried out several debt repayment deferrals The extraordinarily low interest rate environment is likely to mitigate the risks associated with emerging-market debt. In the medium term, however, a greater financial base for the IMF seems desirable in order to be able to have instruments of adequate size. The Trump administration had opposed going in this direction, the new administration gives hope.

Zouhoure Bousbih

Emerging countries financial needs

	Maturing Debt	Budget deficit	Gross financing needs	Maturing debt	Budget deficit	Gross financing needs	GDP (2019)
	% GDP			USD billions			
Brazil	9.2%	9.4%	18.5%	169	172	341	1 841
India	3.6%	7.4%	11.0%	101	208	309	2 800
Mexico	7.4%	4.2%	11.6%	88	50	139	1 200
Turkey	5.1%	7.5%	12.6%	38	55	93	740
Indonesia	2.9%	5.0%	7.9%	32	56	89	1 126
Poland	5.1%	6.7%	11.8%	31	41	71	605
Thailand	5.2%	3.5%	8.7%	27	18	45	520
Malaysia	6.6%	4.2%	10.8%	24	16	40	370
Hungary	14.0%	3.0%	17.0%	24	5	29	170
Russia	1.3%	4.8%	6.1%	23	85	107	1 750
Philippines	4.9%	3.4%	8.3%	18	12	29	355
Ukraine	9.4%	8.2%	17.6%	13	11	25	140
Romania	3.8%	8.9%	12.7%	10	22	32	250
Colombia	1.6%	2.5%	4.1%	6	9	15	370
Peru	2.0%	7.1%	9.1%	4	16	20	220
TOTAL	**4.9%**	**6.2%**	**11.1%**	**608**	**776**	**1 384**	**12 457**

Source: IMF, Fiscal monitor April 2020

Market review

Margin call

Sharp decline in equities and extreme volatility in the US despite solid earnings publications and better-than-expected growth. Fed left monetary policy unchanged.

The casino is open. The hunt for shorts also. The GameStop story, microcap turned into the largest Russell 2000 capitalization for a time, has been picked up by prominent political leaders. Current speculation in the stock market allowed by online trading platforms does raise the question of the functioning of financial markets and their alleged efficiency. Individual investors are indeed able to collude and force Wall Street out of short positions, as hedge funds run short positions sometimes worth more than the marketable amount. Massive buying of short-dated call options forces a sharp run-up in prices as market makers seek to hedge their books. The gamma effect, which is exponential on short expiries, amplified volatility to absurd levels. Market option volumes exceed that on underlying securities.

Financial history is mired with speculative bubbles. The beauty contest is often irrational. Associated systemic and economic risks are indeed a matter of public policy. Be assured: GameStop is only the tip of the iceberg. Growth stocks that are most shorted on NYSE doubled last year. US technology stocks making losses quadrupled in 2020 after years of sideways trading. Excess financial are obvious. Margins and collateral requirements may be raised as net margin debt has rebounded from their March 2020. CCPs have already initiated changes. In Europe, whilst the possibility to short stocks is better regulated, the weekly outperformance of European REITs appears traceable to investment funds buying back their shorts out of fear of a speculative run-up in stock prices.

Against this backdrop, Jerome Powell's response during the post-FOMC press conference on current market volatility is appalling. Financial stability is a prerequisite for transmission of monetary policy to the real economy et the Fed does have authority to raise margin requirements. Fed Chair Powell even questioned the influence of monetary policy on asset prices… at least officially. On economic grounds, GDP growth came in at 4% annualized in the fourth quarter, thanks to business investment (R&D 8.2%, equipment 24%) and residential investment. Household consumption declined in November and December due to pandemic-related restrictions resulted in excess savings (savings rate rose to 13.7% of disposable income). Inflation picked up at year-end. Central bankers can no longer ignore risks associated with housing risks after the 2008 debacle. Residential housing prices increased more than 9% from a year ago but the Federal Reserve is still unwilling to alter purchases of mortgage-backed securities (set at $40b a month currently).

Monthly Treasury bond purchases stay unchanged at $80b although future adjustments are likely in keeping with the government borrowing needs. The expected increase in bond supply from March (about $675b in the second quarter in net terms) may spur steepening bets all the more so that incoming CPI publications may fuel the reflation trade. The US Treasury's issuance strategy may change in response to strong demand for TIPS (breakeven inflation rates at 2.15%). A rise in TIPS auction sizes is a possibility.

In the euro area, the economic situation was less bad than anticipated in the fourth quarter. France GDP came in at -1.3%, whilst Spain (+0.4%) and Germany (+0.1%) posted modest growth. Last week's surprise pertains to inflation. German prices rose 1.4%m in January. Besides the expiration of the July VAT cut and a new CO2 tax, changes in sector weightings of the HICP played a role in the price spurt. Euro area HICP ex Tobacco gauge will not show its familiar seasonal drop in January, which will accrue to linker holders. Two-year inflation swaps are trading at 2019 highs.

Furthermore, Klaas Knot alluded to the possibility of ECB intervention on the euro. These comments may foreshadow an interest rate cut. As regards Bunds, yields oscillate within a tight range between -0,56% and -0,50%. EU issuance offering a premium have been well received by markets. Slovenia placed a 60-year security. The Italian political situation is improving. Conte may remain prime minister and the risk of early elections is diminishing. The spread on 10-year Italian BTPs reverted to 115bp despite soft demand at last week's auctions. Lastly, the BoE will likely keep policy unchanged pushing back against calls for a rate cut.

Credit markets suffered somewhat from weaker equity markets last week. Financials' primary issuance remain light relative to last year but corporate borrowers from the non-financial sector continue to tap the primary market. The earnings season is beginning in Europe which will reduce corporate bond issuance flows. European investment grade bonds trade at 95bp spreads vs. Bunds (+5bp). High yield had a rough week. Speculative-grade spreads rose by 21bp last week wiping 2021 performance in the wake of CDS indices. The earnings season has begun in the US. About 80% of corporate earnings publications have beaten consensus estimates so far, but stock prices have failed to reflect increased profitably especially among the large US technology names.

Axel Botte
Global strategist

Main market indicators

G4 Government Bonds	01-Feb-21	-1wk (bp)	-1m (bp)	YTD (bp)
EUR Bunds 2y	-0.73 %	+0	-3	-3
EUR Bunds 10y	-0.51%	+4	+6	+6
EUR Bunds 2s10s	21 bp	+4	+8	+8
USD Treasuries 2y	0.11 %	-1	-1	-1
USD Treasuries 10y	1.08 %	+5	+17	+17
USD Treasuries 2s10s	97 bp	+6	+18	+18
GBP Gilt 10y	0.33 %	+7	+13	+13
JPY JGB 10y	0.06 %	+1	+4	+4
€ Sovereign Spreads (10y)	01-Feb-21	-1wk (bp)	-1m (bp)	YTD (bp)
France	23 bp	0	+0	+0
Italy	113 bp	-10	+1	+1
Spain	61 bp	-2	-1	-1
Inflation Break-evens (10y)	01-Feb-21	-1wk (bp)	-1m (bp)	YTD (bp)
EUR OATi (9y)	96 bp	+5	+10	-
USD TIPS	211 bp	+3	+12	+12
GBP Gilt Index-Linked	312 bp	+8	+12	+12
EUR Credit Indices	01-Feb-21	-1wk (bp)	-1m (bp)	YTD (bp)
EUR Corporate Credit OAS	93 bp	+3	+2	+1
EUR Agencies OAS	41 bp	+1	+0	+0
EUR Securitized - Covered OAS	32 bp	+0	-1	0
EUR Pan-European High Yield OAS	352 bp	+11	-6	-6
EUR/USD CDS Indices 5y	01-Feb-21	-1wk (bp)	-1m (bp)	YTD (bp)
iTraxx IG	51 bp	+0	+3	+3
iTraxx Crossover	265 bp	+2	+24	+24
CDX IG	55 bp	+3	+4	+5
CDX High Yield	313 bp	+4	+19	+20
Emerging Markets	01-Feb-21	-1wk (bp)	-1m (bp)	YTD (bp)
JPM EMBI Global Div. Spread	352 bp	-4	-2	+0
Currencies	01-Feb-21	-1wk (%)	-1m (%)	YTD (%)
EUR/USD	$1.209	-0.49	-1.06	-1.15
GBP/USD	$1.371	+0.28	+0.26	+0.42
USD/JPY	¥104.92	-1.08	-1.64	-1.54
Commodity Futures	01-Feb-21	-1wk ($)	-1m ($)	YTD ($)
Crude Brent	$55.8	$0.1	$4.0	$4.0
Gold	$1 865.1	$6.8	-$33.6	-$29.3
Equity Market Indices	01-Feb-21	-1wk (%)	-1m (%)	YTD (%)
S&P 500	3 714	-3.31	-1.11	-1.11
EuroStoxx 50	3 539	-0.39	-0.37	-0.37
CAC 40	5 476	0.06	-1.36	-1.36
Nikkei 225	28 091	-2.54	2.36	2.36
Shanghai Composite	3 505	-3.28	0.93	0.93
VIX - Implied Volatility Index	30.97	33.55	36.13	36.13

Source: Bloomberg, Ostrum Asset Management

Additional notes

Ostrum Asset Management

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