Sale of the Century?

By Eric Fine, Portfolio Manager, and the Active Emerging Markets Debt Team

COVID-19, and the reaction to it, are creating unprecedented uncertainty, volatility, economic downside and asset price weakness. The risks to personal health compound what is significantly a psychological phenomenon on all those fronts. Against this, there has been an also-unprecedented policy response, led by what is implicitly a commitment by the Fed to buy unlimited amounts and types of assets. This commitment transcends borders due to the resumption of FX swaps with other central banks. We frame that commitment from monetary authorities as bridging the gap between today's uncertainty and the eventual economic traction that will maintain from also-unprecedented fiscal stimuli. There's gas being put in the tank and even though the car can't be driven for a while, monetary support is providing a garage. Below are more detailed thoughts from the active EM debt team on the following: 'What' the Fed's done so far; 'Why' many EM countries should weather this storm; 'Which' EM countries represent the best opportunities in our view; and 'When' this "Sale of the Century" will gain purchase.

'What' has Been Done?

We'll start briefly with 'What' has happened so far, the most important of which is an implicit unlimited-in-time-and-size commitment by the Fed to buy risky assets. Though the Fed hasn't yet had to make such a broad commitment, we think it's implicit. A brief description of how the Fed got here underlines why we think so—why we think they've crossed the line to M-Infinity. By the way, we wrote about the inevitability of such a response in a piece called "**M-Infinity**" in 2012. Our point in referring to this piece is to emphasize that the Fed implicitly crossed this line a decade ago, in our opinion, so the speed and flexibility of their current reaction should be viewed as enduring. Please read that piece if you want to see the roots of this implicit asset purchase commitment.

On to the current crisis. The Fed's initial reaction to the coronavirus crisis was an immediate repeat of its prior reaction—emergency rate cuts and open-ended quantitative easing (QE) using U.S. Treasuries and agency mortgage-backed securities (MBS) as its targeted assets. Though mortgages weren't the epicenter of the current crisis as they were during the 2008 Global Financial Crisis (GFC), they are still important. We believe, the unique fact about the U.S. economy is the centrality of housing (as of 2018, 65% of households were owner-occupied, housing represented 25% of household net worth and 15% of GDP was housing-related). That'll be important for the economic future to which the Fed is building bridges. After that initial Fed move, though, markets immediately continued their selloffs, particularly credit markets. This led to the Fed's next action to include commercial paper (CP) purchases via a Treasury-blessed structure. Markets eventually resumed their selloffs, with credit markets becoming the more obvious problem child. That's when the Fed crossed the line—or in our thinking, made more explicit what was theretofore implicit— and said investment grade (IG) corporate paper would also be put on its balance sheet.

We are not saying that all credit markets are finally stabilized, only that the implicit commitment to do so has been made increasingly explicit—the time to prepare for such stabilization is now. High Yield (HY) markets haven't yet reacted as positively as IG markets and the HY market is critical. Fed buying has been concentrated on front-ends, so long-ends have reacted less, so far. Collateralized mortgage backed securities (CMBS) have not yet been included for approved buying as they were under Term Asset-Backed Securities Loan Facility (TALF) during the GFC (only Agency CMBS have). Greatly complicating the situation is the Fed's desire to get not just Treasury blessing for its actions (as required), but increasingly political (i.e., Congressional) blessing. In particular, the Fed asked for Congressional support for $425B of capitalization for the Exchange Stabilization Fund (ESF), the headlined $2T Treasury fund to backstop Fed "13.3" lending (we're referring to the clause that allows direct Fed support for the private sector). This is not necessary, legally, in our view. But it may be reasonable, given the longer-term risks such moves entail. These moves profoundly upend prior concepts of U.S. capitalism and the relationship between government and private actors. Also, how does one exit? Our answers are that this is not a useful focus right now, other than in helping explain the Fed's desire not to be an independent (word choice intentional) actor in responding to the crisis. It also means Congress is likely to have a big say in how Fed lending flows to households and businesses. Our key points are that the commitment to support asset prices is there, even though there may be more bumps on the road for asset prices not specifically targeted.

A brief summary of the U.S. fiscal response shows how large it is. The current stimulus is sized at 9.7% of GDP in 2020. The 2019 deficit was 4.7%, so the increase and impulse is significant. This is in line with the fiscal deficit of 2009, which stood at 10.1%. The financing context, of course, is that the central bank's QE, and thus financing, is open-ended, to include not just whatever deficit spending isn't absorbed by the market, but also all the risk assets we described above. Our view is that, if the Fed needs to move out the risk curve to buy riskier assets, it will. That was the point of referring to our older piece—this is not really "out of the blue" from a theoretical standpoint, in our opinion.

Below are some bullet points that summarize Fed actions as they stand now, not to detract from our key point that we think they are implicitly open-ended, however volatile the path to that open-endedness is:

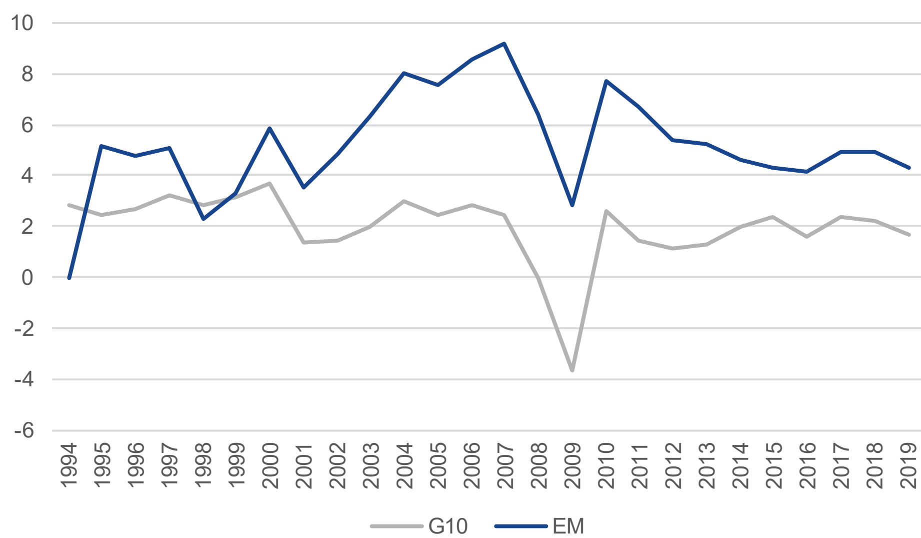
- 50bps inter-meeting rate cut followed by a 100bps emergency rate cut.
- QE program (initially $500B of Treasuries and $200B of agency MBS, then open-ended in terms of its size).
- Lowering of the discount rate on primary credit and extension of the lending term at the discount window to 90 days.
- Large repo operations at extended terms.
- Re-establishment of Primary Dealer Credit Facility.
- Re-introduction of Commercial Paper Funding Facility (subsequently expanding the range of securities that can be purchased via this facility).
- Establishment of a Money Market Mutual Fund Liquidity Facility, which was subsequently expanded to include state and municipal money markets.
- Establishes swap lines with major central banks (nine more in addition to the original five—European Central Bank (ECB), Bank of England (BoE), People's Bank of China (PBoC), Bank of Japan (BoJ) and Swiss National Bank (SNB)).
- Establishment of two facilities to provide credit to large firms—Primary Market Corporate Credit Facility and Secondary Market Corporate Credit Facility.
- Establishment of Term Asset-Backed Securities Loan Facility to broaden the range of assets for asset-backed securities (ABS) issuance.

'Why' will EM Acquit Themselves Again?

We expect EM to eventually acquit themselves, as they did following the GFC—their initial conditions are similar and many EM countries will be healthy receptacles for the global monetary and fiscal tide. EM economies had toughened themselves up prior to the GFC. We believe, They'd already been through so many tests, they arrived at a solid and, in our view, extreme conclusion—the so-called "Washington consensus" following the last major spate of their crises in the late 1990s. It basically involved becoming a lot like the developed markets (as the DM used to be) in key respects. Limits on debts and deficits were key. Independent central banks that focused on targeting inflation and protecting their currencies and now-built-up domestic financial systems became the norm. This was crucial because a necessary element of these reforms was addressing the "original sin" problem (as it's called in the literature). That is, undeveloped domestic financial systems that led to dependence on USD-denominated debt. Whenever their local currencies weakened, their ability to repay weakened and their currencies weakened further—a vicious cycle ensued leading to defaults that many still (wrongly) think define EMs.

EM's strengths led to economic acquittal following the GFC. China became a part of the positive recovery narrative, using its capacity to leverage as a global growth engine. Many EM countries maintained positive growth during the GFC, with Poland, for example, not even entering recession. Exhibit A below shows the growth patterns of EM vs DM, with EM growth still suffering acutely in the bad old days of 1990-2000, compared to the good new days of EM in 2000-2010.

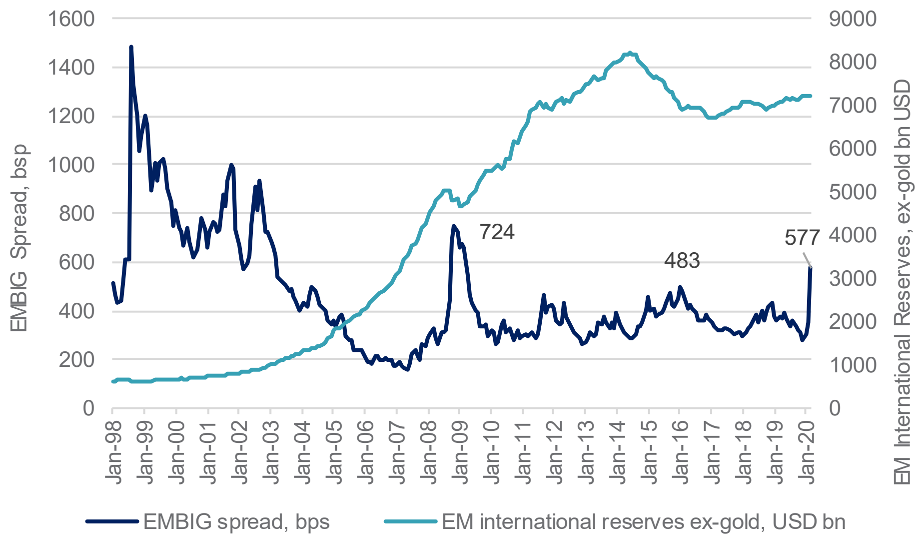
Exhibit A – EM Growth Stayed Positive in GFC
Real GDP Growth in EM and DM, %



Source: Bloomberg LP

EM's strengths led to market acquittal following the GFC, particularly of USD-denominated sovereign debt, which will offer the first clear buying opportunity in the current crisis. EM local currency suffered, but it did its job as the shock absorber that prevented vicious cycles and generated good buying opportunities, albeit ones that were basically tactical, not strategic. EM hard currency sovereign debt spreads, however, offered strategic buying opportunities. Spreads widened sharply and briefly along with all risk assets, but never substantially broke previous cycle spread lows and went on to set new lows for the post-GFC cycle. Volatility also declined compared to the pre-GFC period. Exhibit B shows the J.P. Morgan Emerging Bond EMBIG spreads during the pre-GFC and post-GFC periods, showing that that little spike in spreads in 2009 was a short-lived incredible buying opportunity. We think the same is the case now. The chart-enamored will notice that lower peak spreads ensued post-GFC compared to pre-GFC and so far in this crisis that is happening again (i.e., the post-GFC spread spike wasn't higher than the most recent spike in the pre-GFC period and the current spike isn't higher than the highest spike in the post-GFC period). Remember new record-low spreads followed the GFC acquittal—it is not a stretch to think that that will be the outcome again, because what risky debt will be out there other than EM debt, following the latest Fed policy experiment?

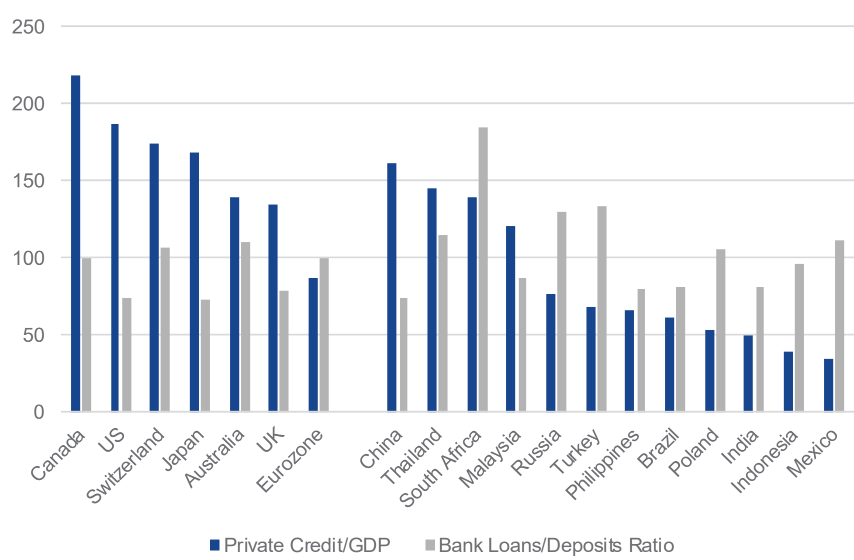
Exhibit B – EM Sovereign Spreads Saw New Era Post-GFC
EM Reserve and Sovereign Spreads



Source: Bloomberg LP

The initial economic conditions in EM remain pretty robust, in our view. Below we compare EM and DM on the metrics of government debt, private credit (as leverage proxies), real policy rates (as central bank currency-defense proxies) and banking sector common-equity-to-assets (as banking sector health proxies). Of course, in our investment process, we use a wider set of variables: we'll get into more detail for the EM debt aficionados soon. Right now, we are only making a general point. Overall, leverage is lower in EM, with China in range with the DM countries. Overall, though, EM financial systems require more of what is essentially offshore or wholesale financing, as represented by their worse-than-DM loan/deposit ratios. Still, even on that metric they are in line, not worse. More on that later, as it's a legitimate risk best addressed country by country, with Fed FX swap lines another key mitigant. High real policy rates are a further support for the pro-EM argument and we show that chart in a later section. **On many measures—leverage, central bank currency defense and banking system health—EM is arguably superior to DM.**

Exhibit C – EM Leverage, Central Banks, Banking Systems vs. DM
Leverage and Banking Systems in EM and DM



Source: Moody's, IMF

Even many local currency markets acquitted themselves post-GFC, meaning that many of those will offer potentially great buying opportunities in the current crisis. In our view, the best—what we call the "graduates"—are names such as the Czech Republic, South Korea, Thailand and the Philippines. Here, we don't see buying opportunities as they were so well-behaved in this crisis they played a defensive role (actually, we've been selling them to take advantage of the "Sale of the Century"). Their interest rates rallied and their currencies were not especially weak—akin to the definition of a DM "risk-free" bond (a theoretical bond that repays interest and principal with aboslute certainty), in fact.

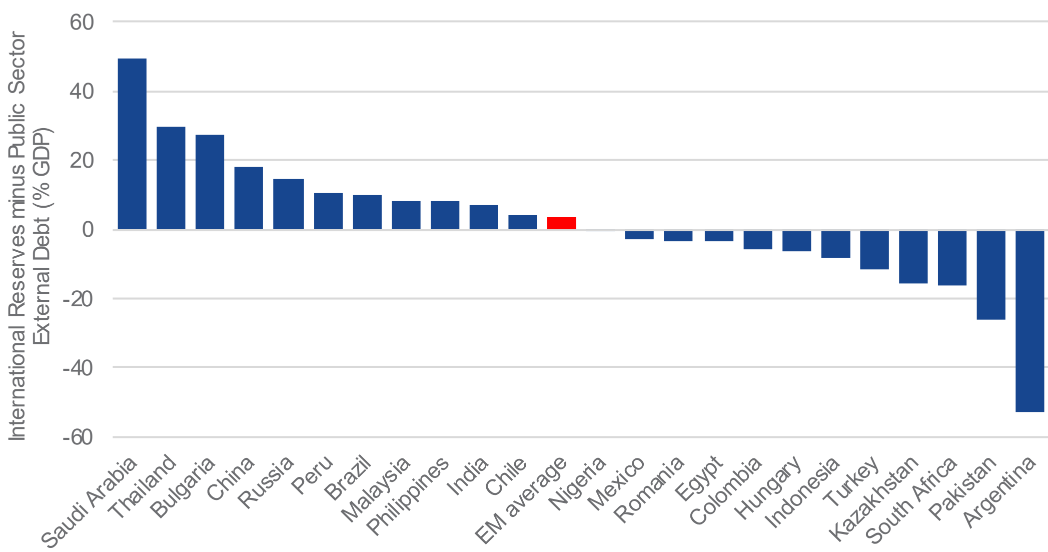
Many "students" in local currency represented great buying opportunities after the GFC. This was due to a key Fed innovation we noted above—FX swaps with other central banks. These swaps represent an unlimited-in-time-and-size (in our view, though technically it is just implied) forward sale of USD from the Fed (the precise terms are secret as far as we can tell). The receiving central bank provides the USD in their local economies where it sees USD are needed, whether to financials or non-financials. The result is that USD shortages don't become self-fulfilling crises. They were offered in the GFC and we awaited their re-advent in the current crisis to get more confident about buying opportunities in EM local currency. As noted above, the Fed offered them in its current crisis response. The EM central banks that received them this time are Mexico, Brazil, South Korea and Singapore. We are not saying any central bank that got them has a local currency market we're keen on investing in, as we are still speaking in generalities, not yet getting into our detailed list of "Sale of the Century" assets.

Our point is that many of these local currency markets are priced purely as shock absorbers, which is too narrow a role based on our discussion above.

'Which' EM Bonds are in the "Sale of the Century"?

As a general, introductory point, we see a great number of buying opportunities in USD-denominated sovereign/quasi-sovereign debt and in local currency-denominated debt, though corporates will be more complicated. USD sovereign/quasi-sovereign debt benefits from liquidity. It also benefits from many sovereigns being net creditors in USD. Brazil, Russia and China fit that bill, for example. (Please see Exhibit D below for a full list.) Debt management offices obviously use this strength credibly when markets are too oversold, so this is a practical strength, not a theoretical one.

Exhibit D: Net Sovereign USD Creditors
Net Public Sector Creditor Status, 2019



Source: VanEck Research; Moody's; Bloomberg LP

Local currency markets benefit from liquidity. They also benefit from many central banks maintaining high real policy rates. In addition, many of these central banks are confident enough in their own fundamentals that they are doing their own versions of QE—buying local debt on their balance sheet and issuing local currency money liabilities against it. (For what it's worth, we think the definition of QE has not yet been globalized, focusing on the asset-side definition and not the liability-side definition, so we welcome a discussion there.) The list currently includes—Chile, Czech Republic, Israel, South Africa, Colombia, the Philippines, Poland and Romania, definition-contingent, of course. Many have healthy domestic financial systems that provide a buyer base for local debt.

Corporate debt suffers from illiquidity. Luckily, much of that illiquidity is already manifest in lower prices and, also luckily, we didn't own significant amounts of corporates going into the crisis. Unluckily for us, however, what little corporate debt we had was energy-related, so it suffered dramatically for now. Corporate debt in EM also doesn't have a natural buyer of last resort, as corporate debt in the U.S. and Europe now has. As a result, we will be more selective in this sector and won't focus too much on it in the more detailed framework and list of opportunities that will follow.

The key metrics that guide us in determining which EM debt asset prices represent a "Sale of the Century" obviously start with our investment process, but must also involve "tests" that capture the unique risks of the current crisis. Our investment process starts with a comparison of fundamental risks (16 variables in particular, that capture solvency, flow and structural fundamentals) to the premium paid by the bonds (the credit spread for USD debt, the real interest rate for local currency debt). The process then allows "tests". (Please reach out if you want a more detailed description.)

'Which' Issuers, in Detail?

Below is a table summarizing the key USD and local currency bonds that we see as unique buys, and their representative prices, carry and yield to maturity.

Exhibit E – Our Favorite Bonds

USD Bonds			
Issuer	Price	Carry	YTM
Argentina 2021 (Caa2/CCC-/CC)	28.00	91%	210%
El Salvador 2035 (B3/B-/B-)	85.25	8.60%	9.40%
Angola 2049 (B3/B-/B-)	56.00	15.40%	16.40%
Gabon 2031 (Caa1/B)	64.50	10.10%	13.20%
Dominican Republic 2049 (Ba3/BB-/BB-)	88.375	7.10%	7.40%
Ukraine 2032 (Caa1/B/B)	88.75	8.30%	8.90%

Local Currency Bonds			
Issuer	Price	Carry	YTM
Indonesia 2035 (Baa2/BBB/BBB)	91.75	7.9%	8.4%
Mexico 2047 (Rating/Rating)	99.5	7.90%	8.10
South Africa 2026 (Baa3/BB/BB+)	100.38	10.10%	10.30%
Uruguay 2028 (Baa2/BBB/BBB-)	75.32	11.20%	13.70%
Dominican Republic 2026 (Ba3/BB-/BB-)	94.00	10%	11.10%
Ukraine 17% 2022 (Caa1/B/B)	92.25	17.20%	22.90%

Moving on to an explanation of why we see these bonds as so attractive, we should reiterate that all of these bonds are at the top of the list of cheap bonds generated by the core (Step 1) of our investment process. As such, they provide high spreads (for USD bonds) or real yields (for local currency) bonds, relative to their normalized fundamentals (16 of them). Those fundamentals are subjected to a cross-section regression to optimize their weights, according to the best fit with the USD bond market, or the local currency bond market, thus reflecting market preferences in real time. We also judge that they pass key "tests" generated by the current environment (Step 2).

USD Bonds

- **Argentina USD bonds.** We believe, Argentina's bond prices will be determined mostly by ongoing debt negotiations with creditors and less by market vicissitudes. In crises, correlations tend to equal 1, which has happened in Argentina in recent days. It resisted the overall market trend until last week's (final?) panic. Nonetheless, that correlation and beta are priced, in our view, and the normal uncorrelated elements are no longer priced. The IMF recently "guided" Argentina to a harsher-than-expected initial restructuring offer. But, despite this, we reckon the present value of a harsh offer (which should arguably be accepted) should result in prices of 50 cents on the dollar. Current prices of bonds we like are 26-30 cents. Moreover, the IMF repeated its recommendation that Argentina stay current on its bonds and pursue a voluntary restructuring, so the bonds are carrying while we track the outcome. Also please note that the decline in USD reserves has been stopped as a result of functioning capital controls (which may be bad for some asset prices, but not for USD bonds). Finally, we'd note that the bulk of USD obligations coming due this year are local-law bonds, not the foreign-law (U.S./U.K.) bonds that we favor.

- **El Salvador USD bonds.** El Salvador was also hit for weeks of the crisis, and got a final wallop as all asset price correlations approached 1. Still, we think its bottom-up fundamentals will re-assert. Newly-elected President Nayib Bukele was inaugurated in the middle of 2019 as a center-right candidate who can fairly be called populist. His main obstacle in implementing reformist policies that would support the creditworthiness of the sovereign was the Legislative Assembly. This tension was overcome when he sent the army into the Assembly. Whatever one thinks about that move beyond its economic implications, it ended the impasse. In addition, this move was more of a bid to launch congressional elections for his party, which currently has no representation as his party is a newcomer. It seems to have worked as his popularity is at record highs, despite his policy promises of reform.

- **Angola USD bonds.** These bonds have exceptionally good upside/downside, in our view. Although clearly oil-dependent, the country benefits from an IMF funding program, which it achieved by implementing very tough reforms. We think it is extremely unlikely (and fairly unprecedented) for the IMF to allow a country to default when it is adhering to one of its programs. As a result, the oil price collapse and its impact on Angola's creditworthiness is likely to be viewed as a shock beyond the government's control and to which the IMF must react with forbearance, in our opinion. At current prices, we also think that the country is now fairly uncorrelated—if anything, it over-reflects the price decline and under-reflects the reform commitment and support of the IMF. The country, further, benefits from a newly-elected reformer with orthodox policy views and an anti-corruption agenda that enjoys popular support.

- **Dominican Republic USD bonds.** The Dominican Republic arguably benefits in some ways from the economic crisis, as an oil importer. Fuels account for approximately 20% of imports. Against this, though, is the sharp decline in tourism, which accounts for just under 40% of exports. Our thinking, in summary form, is as follows. We see the oil price collapse as more of a supply shock than a demand shock and thus a more enduring feature of the current environment. The COVID-19 crisis, on the other hand, doesn't strike us a permanent and we expect an eventual resolution. The fact of stable and orthodox policy in the Dominican Republic, coupled with good relations with the U.S. and IMF (should they be needed), make us comfortable with this economic tension.

- **Ukraine USD bonds.** Ukraine strikes us as very uncorrelated in the current environment. Its popular new President Volodymyr Zelensky invested his political capital in radical pro-market reforms. These include the basics such as fiscal austerity and central bank independence. But they also include extreme measures such as land reform (allowing the purchase and sale thereof, even by non-residents). Such reforms historically generate secular growth upside. Also we believe, boosting the economy is a de facto rapprochement with Russia, restarting economic activity in the east of the country (this is not much publicized so as not to annoy the IMF's biggest shareholders). In our opinion, the country was rewarded with an IMF program that provides both credibility and market access (when markets reopen), as well as funding.

Local Currency Bonds

- **Indonesia local currency bonds.** Although Indonesia is one of the GBI-EM's major components, at 9.28%, we see it as having secularly improving characteristics and view it as a likely "graduate" in EM. It is arguably the last "Asian Latin", that is, following the path of the others (led by Korea decades ago and tailed by the Philippines) who pursued orthodox reforms year-after-year and were rewarded by stronger domestic financial systems, higher ratings and low and anchored inflation (a key condition for stable local debt issuance). Its current account deficit was 2.7% of GDP in 2019 and it's fiscal deficit was 2.2%, both sustainable. USD reserves at the central bank are approaching record highs at $130.4B in February 2020, compared to $100.2B in November 2015, whereas inflation is approaching record lows (at 2.98% year-on-year in February 2020, down from 8.36% year-on-year in December 2014). This is all based on a strongly reformist government that enjoys popular and business sector support (this last is now convinced of the upside from reform, whereas before it preferred its privileges). Recently, Indonesia announced it is scrapping its fiscal rule temporarily in response to COVID-19 and it could see a deficit of 5%. Its historical austerity should keep this from feeding adverse expectations, we believe. The central bank believes, too, and has inaugurated regular buybacks of local currency and USD government debt to provide liquidity.

- **Mexico local currency bonds.** Mexico is also a GBI-EM stalwart, but we see it as one of the most orthodox, policy-wise and as having been overly sold as a "hedge" due to its correlation with risk markets and extremely deep liquidity. Basically, it has been massively oversold, both the currency and the bonds. Mexico benefits from among the highest real yields in the world at 2.7%. In our opinion, Mexico also benefits most from any U.S. economic rebound that we expect to ensue once the crisis is over and fiscal stimulus and pent-up demand gain purchase. The bulk of Mexican trade is with the U.S. (approximately 50% of imports and 80% of exports).

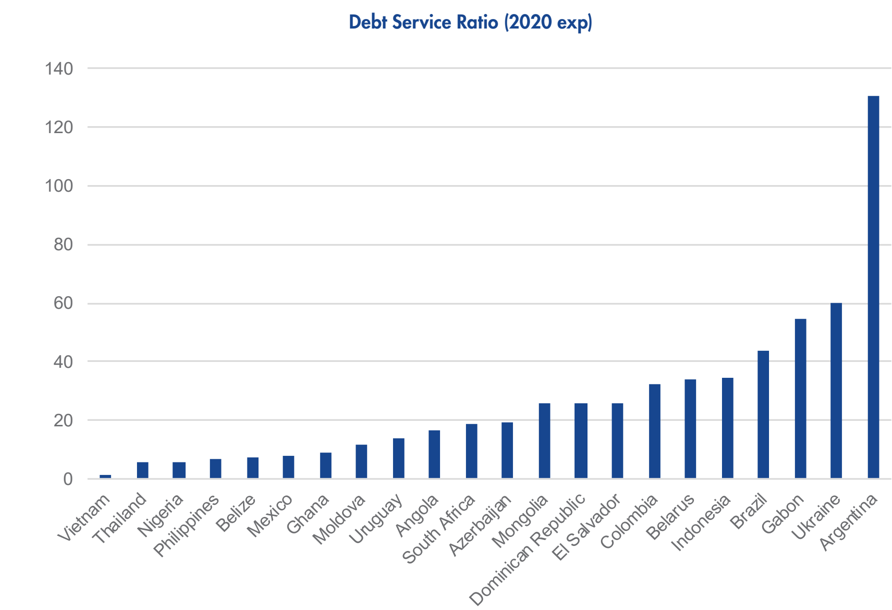
- **South Africa local currency bonds.** Another GBI-EM stalwart (at 7.52% of the GBI-EM), South Africa benefits most from the V-shaped global economic recovery we expect. Merchandise trade is 55-60% of GDP. Real interest rates have been maintained at high levels by the legitimately respected central bank (the SARB). South Africa is also an oil importer (petroleum and petroleum oils account for approximately 16% of imports), strengthening the country's external accounts/terms-of-trade, as well as anchoring inflation (where fuel and electricity account for 8.4% of the consumption basket). We do have some worries here. The country could get downgraded by Moody's to below investment grade this week, which would result in its eventual exclusion from the FTSE World Government Bond Index (WIGBI) (the exclusion may be delayed due to the crisis, for what it's worth). The country also has limited fiscal resources, so growth could remain problematic, or the rating could face further downside if fiscal policy becomes too stimulative. Nonetheless, even if fiscal policy becomes stimulative, we don't see an impact on inflation and we also don't see the current account deficit growing, which are the main immediate problems from such stimulus. Finally, South Africa is also a "super-liquid" that attracts short-selling, and is extremely oversold, in our view (both bonds and currency).

- **Uruguay local currency.** Uruguay had everything going for it—low inflation, high real interest rates, fine external accounts and limited leverage—other than its fiscal trajectory. Therefore, we only initiated our exposure going into the late-2019 presidential elections, which held the promise of restarting fiscal consolidation. The reformist coalition that won, led by Mr. Lacalle Pou, delivered, initially front-loading a fiscal consolidation, which was a positive surprise. In particular, they promised a significant consolidation, including tackling social security, implementing a fiscal rule, shrinking the public sector and creating a budgetary savings fund. Additionally, the new central bank governor is working to reform the monetary system in order to bring inflation down further over the medium term. Finally, a major investment in a new pulp plant via foreign direct investment (FDI) may bring over $3B into the economy in 2020. As a result of the coronavirus crisis, though, social benefits have been increased. Still, the government is signaling that it has no room or inclination for permanent spending increases. In fact, there were revenue-raising measures as well, including a small increase in regulated tariffs and lower VAT reimbursements. Moreover, Uruguay should benefit from lower oil prices, and this applies to both fiscal and external accounts (and the last were already in decent shape with a current account surplus in Q3 of 2019 and international reserves that stayed close to the high level of approximately 30% of GDP). Finally, lower oil prices should mitigate any inflationary impact from passthrough of the weaker currency that was hit along with all EM local currency (EMFX).

- **Dominican Republic local currency.** The Dominican Republic is experiencing a balance of payments shock from the sudden stop to tourism. However, it has ample buffers to weather this storm. The simultaneous fall in oil prices is a significant offsetting factor, along with gold exports and a new coal plant coming online. Jefferies estimates that the overall deterioration of the current account balance will be just 0.6% of GDP. Importantly, the Dominican Republic is starting from a much stronger position than its peers. The government and central bank are also taking proactive measures to cushion the shock to the economy by cutting the policy rate, providing liquidity to the banking sector in both pesos and dollars, easing regulatory requirements on banks and providing direct lending and payment forbearance to the real economy. With a policy rate of 3.5% and a similar rate of inflation, 3-year local government bonds with yields north of 11% offer both a significant real yield and a significant term premium, despite the low policy rate.
- **Ukraine local currency.** Ukraine's more orthodox policy mix and emphasis on structural reform are having a what we view as a strong impact on local rates and the price dynamics. Headline inflation—which was north of 60% year-on-year just a few years ago—dropped below 3% in February, allowing the central bank to finally lower its policy rate. The real policy rate is still being kept high at approximately 10%, due to the government's concern about inflation passthrough from global EMFX selloff. Market rates for 2-year local bonds are approximately 20%, so the roll-down is dramatic. Cooperation with the IMF is not questioned, providing a good anchor to the entire set of fundamentals and expectations, as discussed in our description of Ukraine in USD above. The authorities are now looking to double the size of the future program (to the tune of $10B), and progress toward this goal is accompanied by reforms (land reform, in particular) that may boost future growth and improve relative growth differentials with the rest of the world, providing more lasting fundamental support for the currency (the hryvnia).

Some key metrics that guide our "tests" in determining good buys are listed below.

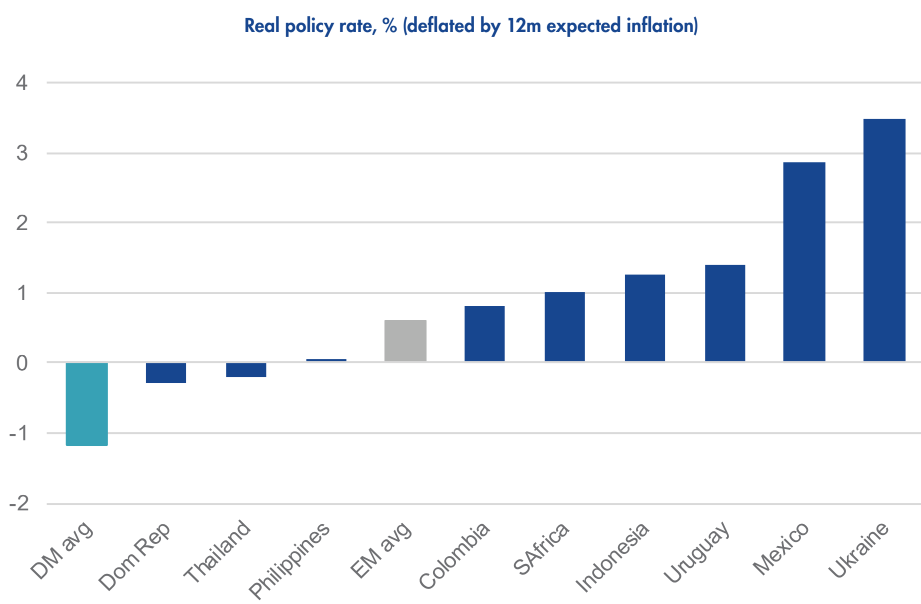
- **Short-term USD liabilities (total economy).** Our summary description of the data below are that a number of our favored countries look good on this metric—Mexico, South Africa, and Uruguay. Those that look bad, which we nonetheless own—Argentina, Ukraine, Gabon, Indonesia and El Salvador—are either priced (Argentina) or have IMF support and/or reform programs that should allow financing once things cool down.



Source: Moody's

Note: (Interest + Current-Year Repayment of Principal)/Current Account Receipts

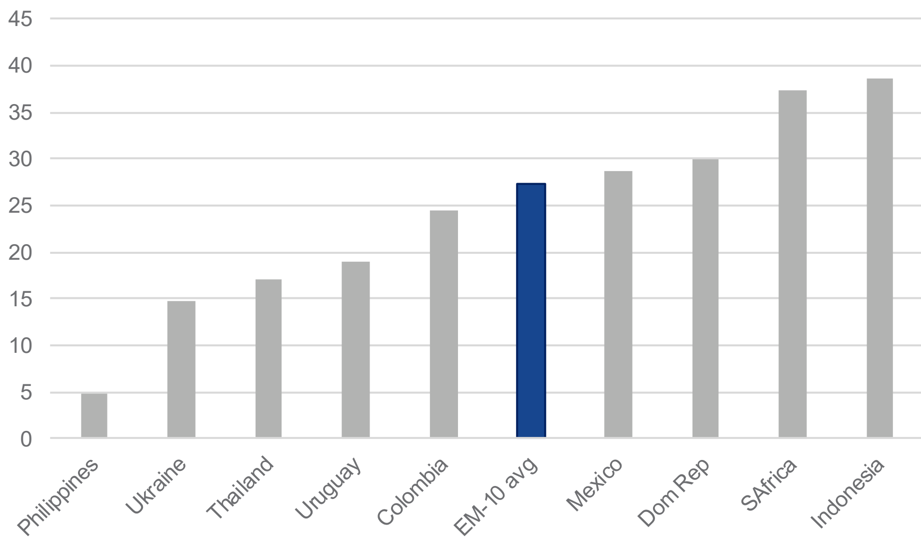
- **Real interest rates.** The main point here is the higher real rates in EM compared to DM. The rest should speak for themselves and are consistent with our positioning in local markets, so we won't add prose to the chart. In the Dominican Republic, the real policy rate is low, we should note, but the market rate is high.



Source: VanEck Research; Bloomberg LP

- **Offshore portfolio ownership stocks.** This is a risk to our views, as is evident in the chart below. Still, we think that reform momentum and high real policy rates are more important. You should worry about this if you think the crisis is worsening. But, if it is turning, these stocks of offshore ownership should persist—they existed for a reason in the first place. Still, these should be characterized as a risk, not a strength.

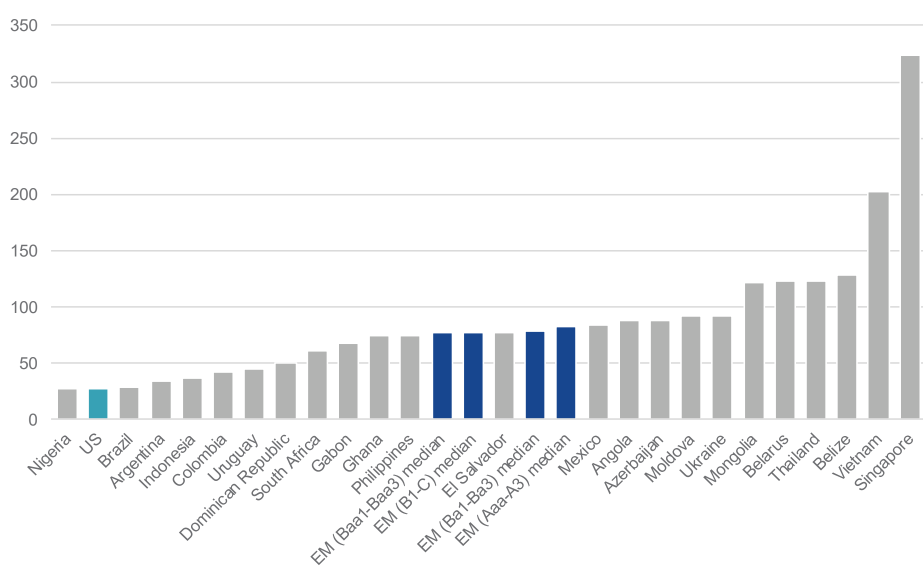
Local Bond Ownership by Non-Residents, %



Source: Credit Suisse; Bank of America; AsianBondsOnline.com

- **Growth elasticity to DM demand.** The chart below should speak for itself. Mongolia, Ukraine, Mexico and Angola stand out as beneficiaries from a global V-shaped recovery, which we think should be the base case. We'd also note that the DM median is significantly boosted by Europe.

Openness of the Economy (2020 exp)



Source: Moody's

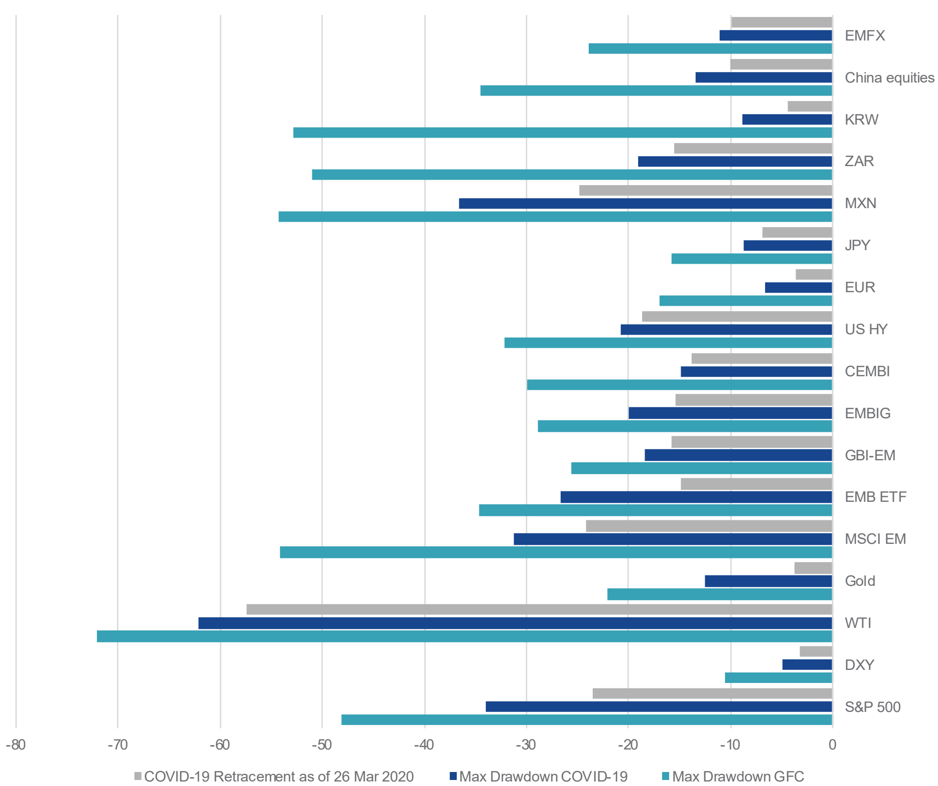
'When'?

Timing is clearly tough, but we think the Fed actions to stabilize current markets, combined with global fiscal stimuli that should gain traction once the crisis abates, generate the following answer— start accumulating now. We are reluctant to model the asset price reaction to previous Fed emergency rate cuts due to the small sample size. Instead, we'll make the general observation that emergency cuts seem to boost markets when the cause (in this case COVID-19) peaks.

> There is an abundance of (constantly fluctuating) charts on the virus' path in the popular media, so we won't repeat them here. We'll only say that the psychological fear of coronavirus strikes us as peaking now.

More analytically and formally, a table below showing where asset price markets are in the current crisis, compared to the GFC. We don't want the prose to dominate the chart, so we'll just make a few observations—the Mexican Peso (MXN) and credit (HY, EMBIG, and CEMBI) look to be peaking in this crisis versus the GFC. They also saw big retracements in the risk-on bounce of the last few days of March. WTI (West Texas Intermediate oil) looks truly fully crushed in this crisis relative to the GFC, and the S&P 500® looks similar. We believe that if those are the best generic risk proxies, that's also consistent with 'peak fear' psychology. The policy reaction from the Fed is another phase in experimentation, not experimentation for the first time. As such, one should assume lower peaks for many assets. We aren't chart-enamored, though, so we'll leave it at that.

Exhibit F – Where are we: Key Asset Price Moves Now vs. GFC
Max Drawdowns: Global Financial Crisis vs. COVID-19

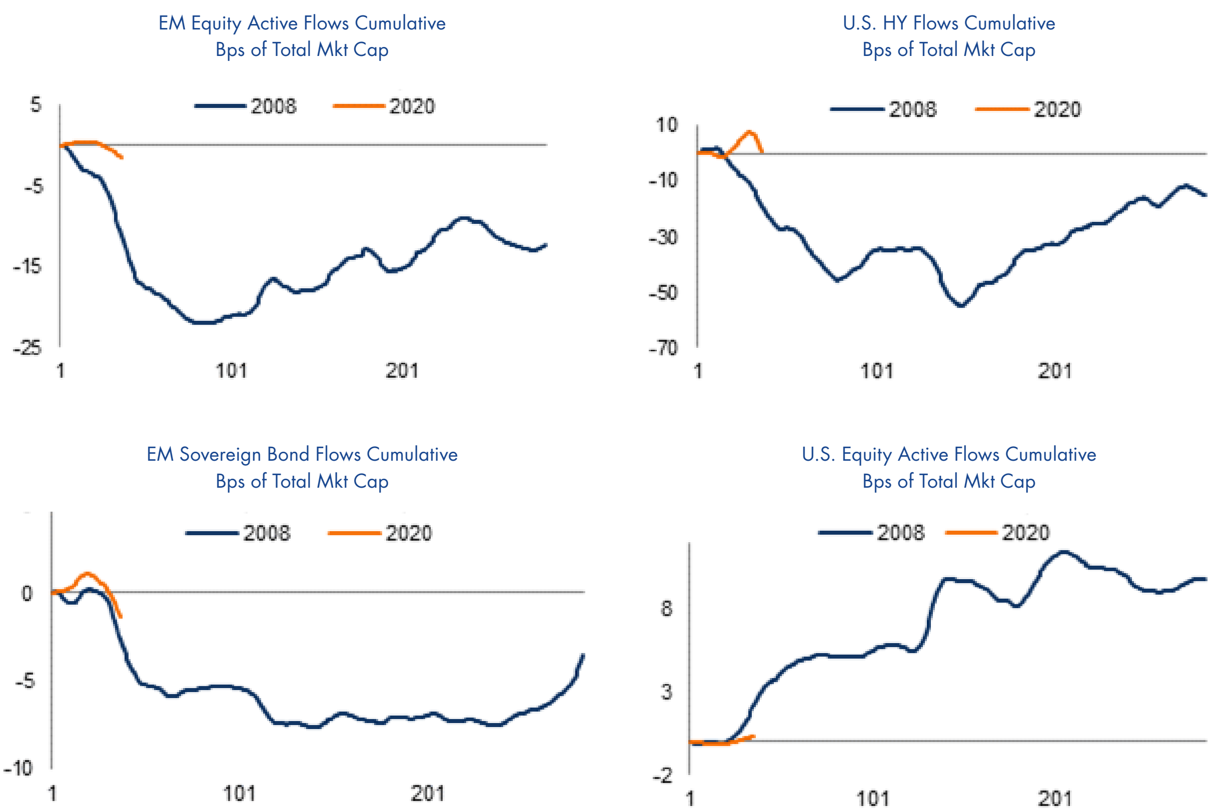


Source: VanEck Research; Bloomberg LP

Another guide to 'When' is comparing outflows in the current crisis compared to the GFC—this points to caution as outflows could continue if the eventual EM bounce after the GFC doesn't anchor flows. The current crisis could arguably be said to have mitigating factors against outflows, simply because the GFC saw EM debt largely acquitted and greeted with secular inflows. Here, we'll let the prose take charge a bit. Overall, it looks from this data that flows are still extremely vulnerable. It's a reason we see a bumpy road ahead, especially for below investment grade. Nonetheless, this is precisely what the market is pricing and is precisely what the Fed had to eventually address—problematic credit markets. It's why we deigned to even discuss the Fed. Anyway, the charts look bad from a flow perspective, but the Fed reaction more than counterweighs them, in our view.

> Anyway, the data says it is a risk, even if the policy narrative (and that it worked after the GFC) is a convincing counter-argument.

Exhibit G – Fund Flows Now vs GFC (1 Sept 2008 start for GFC and 1 Feb 2020 for COVID-19)



Source: State Street

A Brief Comment on Oil/Saudi Arabia

We think the narrative on oil prices and Saudi Arabia is confused—we don't really see Russia as an actor in this game, Saudi holds virtually no cards given its economic fragility and we see the market seeing too much of a demand shock and not enough of a supply shock. The correct narrative, in our opinion, is that Saudi threatened Russia with a supply shock if they didn't cooperate and Russia walked away in the face of those threats. Saudi followed through and oil prices collapsed. Our key view is that this is unsustainable—Saudi has a fiscal deficit of almost 6.2% of GDP and USD government debt equates to 12% of GDP and growing. Its banks have been jammed with local currency paper (and the morally-swayed purchases of

Aramco equity), so its key financing vehicle is USD debt, of which we are seeing a seemingly endless supply. Russia, on the other hand, has a fiscal surplus of 1.4% of GDP and very low levels of government debt in USD, currently at 12% of GDP and declining. (Russia's reserves in USD are high and really not needed for anything other than repaying debt. Saudi's reserves, on the other hand, are needed for multiple purposes, including an old-fashioned defense of its currency, which most countries in EM no longer need). This is not a contest. To drive it home—Saudi's currency is pegged to the USD, so any weakness there means it is "game over." Russia has a floating currency, one that hasn't been passing through into inflation and has set up a mechanism to keep oil proceeds offshore in USD to prevent "Dutch disease". This is really not a contest, economically.

The oil price drop happened during the coronavirus reaction and a fearful market conflated the drop with a demand shock—we think the demand shock is very temporary given all the stimulus and have noted above that Saudi can't really afford to keep this supply shock going for too long. When economies reopen, pent-up demand and all the fiscal stimulus should lead to a V-shaped recovery, in our view. Saudi is not just vulnerable economically, as reviewed above, but politically. Its Yemen war is showing profound deficiencies in its fighting capability. There are growing bipartisan moves to cut off U.S. arms sales. Don't forget, too, that the supply shock came days after what appears to be yet another coup attempt against the current heir-apparent Mohammed bin Salman (MbS), so we believe this is a sign of weakness not strength. Perhaps the Saudi agenda is to weaken Iran, but Iran seems to be doing a great job of that all by itself, in our view, so this is a costly way to defeat an adversary already in its death throes. Again, we find it hard to take the Saudi moves as anything other than desperate, whatever their aim. Finally, one should recall that one strike on Saudi production (whether from a cruise missile or drone or whatever remains unclear) took 1/3rd of production offline instantaneously. We don't see why that should be forgotten.

Van Eck Securities Corporation, Distributor
666 Third Avenue | New York, NY 10017
vaneck.com | 800.826.2333