EM Weekly: June 27, 2020

Featuring: THE IMF | SOUTH AFRICA | ANGOLA | ZAMBIA | BOLIVIA | NIGERIA

In addition to a weekly market recap, this week we comment on the IMF's material downward revisions to global growth projections, South Africa's challenging medium term fiscal path, Angola's 3-year standstill on Chinese debt, formation of creditor committee for Zambia's sovereign debt restructuring negotiations, rising political risks in Bolivia, and the World Bank's financing package for Nigeria's struggling power sector.

More uncertainty but loose U.S. regulation offers room to rally

Market Commentary: Volatility trended lower this week with lighter volumes, which provided a floor to equity markets after second wave concerns, IMF growth revisions, EU tariff headlines, and soft commentary from the ECB's Chief Economist. On Thursday, while markets began on a weak footing, the ECB stepped in to provide non-Eurozone banks additional liquidity and the Fed delivered a Stress Test verdict that was well received. Individual Stress Test results across 34 banks were not published, although the regulator will only cap dividends and share buybacks in 3Q. Meanwhile, the Fed also relaxed the Volcker Rule, which lifted equities as we now wait for the

new capital minimums next week. Nevertheless, uncertainly is prevalent in every asset class with U.S. Treasuries edging tighter while bull flattening as 10s30s remains firmly below 75bps. In spite of the equity moves through June, EM Credit has performed well with EM Sovereign HY 89bps tighter and EM Corporate HY 65bps tighter. We continue to witness EM outperforming U.S. credit through June. While the Fed have the ability to purchase corporate bonds via SMCCF, we also note that the balance sheet data continues highlight low usage where only 4% of the Fed's $2.6 trillion new firepower since March has been used. Needless to say, we continue to monitor oil markets which ended the week down 1.6% on Sunbelt second wave concerns denting demand. That said, Brent did rally up to June 8 highs on Tuesday, which put the commodity on par with levels last seen on March 10. Across EM, the cutting cycle continues in EM with Mexico and Philippines, while Turkey showed restraint after 9 cuts in 12 months amounting to 1575bps. Over the weekend we turn to Poland with presidential elections.

The IMF made major downward revisions to its global, regional and country growth projections for 2020 and 2021

Market Relevance: On June 24th the IMF released an update to its economic forecasts made in the April World Economic Outlook (WEO). The Fund now projects a deeper global recession and a slower recovery in 2021: global GDP is expected to decline by 4.9% YoY in 2020, 1.9 percentage points lower than the April -3.0% forecast, followed by a partial recovery of +5.4% in 2021 (0.4 points lower than the +5.8% projected in April). The IMF downgraded its EM GDP growth projections in line with global ones: -3.0% in 2020 (down from -1.0% in April) and a +5.9% recovery in 2021 (down from 6.6% in April).

Gramercy View: Although clearly concerning, the material downward global growth revisions by the IMF vs. projections made just 2 months ago should be hardly surprising for markets as economists and investors are grappling with an unprecedented level of uncertainty about the global economic trajectory. In addition, the Organization for Economic Co-operation and Development (OECD) had already come out in mid-June with even more severe 2020 contraction scenarios for the global economy (-6% YoY if the outbreak does not resurface after lockdowns are eased and -7.6% YoY if it does), followed by a very modest recovery from a low base in 2021. In the meantime, short-term global high frequency economic data is set to continue showing significant improvement supported by a very favorable base effect, while massive policy stimulus is fueling a risk-on tone in markets. As such, global investors find themselves in the midst of an intense tug-of-war between short-term optimism and a profoundly uncertain medium-term economic outlook. In "policy-driven" markets, EM credits are likely to see continued support from the unprecedented level of monetary and fiscal stimulus as investors are trying to escape DM financial repression in higher yielding assets. However, we caution that weaker idiosyncratic stories among EM sovereigns and corporates are facing accelerated fundamental credit deterioration and we expect solvency issues and market distress to become more frequent in the near future. Despite the powerful mitigating factor of historically low interest rates, as fiscal expenditures continue to increase sharply, fiscal revenues plummet and growth collapses due to the COVID-19 shock, we worry that the significant increase in EM public debt burdens and budget deficits in 2020 could push a few additional sovereign balance sheets closer to a breaking point.

South Africa's supplementary budget signals a very challenging medium-term fiscal path amid structurally lower growth and a materially higher debt burden post-COVID-19

Market Relevance: Minister of Finance Tito Mboweni presented a "special adjustment budget" to parliament. The proposal includes an ambitious public debt stabilization target over the medium-term anchored by aggressive public spending cuts in the context of a major structural downshift in growth due to the pandemic shock. In the updated budget, Treasury projects a consolidated public sector deficit of 15.7% of GDP (from 6.8% pre-COVID-19) in 2020 and 9.2% (from 6.2%) in 2021, against a backdrop of growth contracting by 7.2% YoY in 2020 and a muted recovery of 2.6% YoY in 2021. The combination of a massive fiscal deficit and growth contraction will push the government's debt burden close to 82% of GDP in 2020, from around 65% in 2019.

Gramercy View: The fiscal and macro numbers underpinning the supplementary budget paint a grim picture and outlook that we believe justify a structurally cautious view on South Africa's credit story. The focus on austerity post-2020 in order to stabilize escalating debt dynamics raises significant questions about the ability to implement such a plan due to the major political and social obstacles it is likely to encounter. The supplementary budget is generally light on detail on how the ambitious targets will be achieved, which is understandable given the unprecedented uncertainty due to the pandemic, but also kicks the can down the road to the October mid-year fiscal update for a clearer and more specific fiscal path going forward. South Africa benefits from a comparatively deep local market that provides the government with more flexibility relative to many peers with respect to budget financing. The authorities are planning to take advantage of it to meet the much larger than anticipated funding needs this year, while also maximizing external concessional borrowing from IFIs (i.e. the government expects IMF emergency assistance funds of $4-5 billion in 2020). While cheaper multilateral borrowing alleviates interest burden pressures and lowers Eurobond supply risk, a formal structural reform program with the Fund does not appear to be politically viable in the foreseeable future. Despite the challenging fundamental dynamics, in the short-term the domestic bond curve is likely to find support from factors such as low inflation (~3%), light positioning, and attractive real yields (especially FX hedged). At the same time, we expect pressures on the ZAR to persist given likely further easing by the SARB in the context of the ongoing crisis and difficult macroeconomic outlook.

Angola negotiates a 3-year debt moratorium on $22 billion of Chinese debt

Market Relevance: Luanda-based news outlet Expansao reported that China has agreed to a 3-year debt moratorium on the approximately $22 billion that Angola owes. No further details have been released and the deal has yet to be confirmed by official channels.

Gramercy View: The news of an agreement with China has come 3 weeks after Angola announced it was negotiating with oil importers to re-profile debt. It was well understood at the time that this was referring to China, which is by far the largest purchaser of Angolan oil and the country's principal lender with nearly half of the country's debt. Angola's fiscal position in 2020 will be significantly impacted by lower oil prices and lower production due to the OPEC+ cap.

With such an external environment, the budget deficit is expected to increase to 3% of GDP and the stock of debt to reach around 130% of GDP. The deferral of debt payments to China thus provides some much needed liquidity relief for Angola to weather this crisis. There is very little public information about the maturity profiles of these loans, but the moratorium is likely to save Angola at least $4.5 billion of debt servicing cost over the next 3 years, possibly more if obligations are frontloaded. Markets have reacted positively to this news, with bond prices rising to the 80s. While we agree that on balance the agreement is positive for Angola, it is important to recognize that at this stage we have very little information about the deal and whether there are any additional terms that the country must meet. As a result, Gramercy is cautiously optimistic on Angola's near-term debt servicing capabilities but remains vigilant for any devil in the details.

Zambia's private sector creditors have formed a committee in preparation for restructuring negotiations

Market Relevance: Ten foreign investment firms that hold around one-third of Zambia's outstanding Eurobonds have formed a creditors committee and appointed Newstate Partners as their advisor. This follows the Zambian Government's move to select Lazard as their advisor in May.

Gramercy View: The announcement shows that both the Zambian Government and foreign creditors are gearing up for restructuring negotiations. There appears to be an understanding on both sides that some level of restructuring of the government's obligations is unavoidable. Debt is expected to reach 92% of GDP in 2020 as large fiscal deficits and substantial depreciation of the kwacha in the last few years have pushed levels rapidly higher. Foreign reserves have also fallen to just $1.33 billion, which is insufficient to cover the country's external debt servicing for 2020. Up to this point, Zambia has been largely shut out of the IFI emergency funding that many other emerging markets have received due to its unsustainable debt path and poor track record of fiscal management. The outlook is further complicated by elections in August 2021, which could detract from political will to address debt restructuring negotiations. Zambian bonds have recovered to the mid-50s this week, which is pricing in a fairly mild restructuring scenarios, likely with IMF support. Yet, as the government continues to show little sign of making the adjustments necessary to receive an IMF deal, Gramercy believes that the process could be much more complex and protracted than the market's current view implies.

Political risk grows in Bolivia ahead of highly polarized September elections

Market Relevance: The Bolivian Government has announced an issuance of $1.5 billion Eurobond amidst significant policy uncertainty ahead of the first-round presidential and congressional elections scheduled for September 6th. The issuance will help cover increased financing needs along with a $327 million RFI loan from the IMF and $1 billion from the IDB and CAF (expected by year-end), but the outlook for the Bolivian economy and political landscape in 2021 is increasingly uncertain.

Gramercy View: With the economic situation in Bolivia worsening, pressure will mount for the next administration to enact market-friendly reforms. A centrist (Carlos Mesa) or conservative (Jeanine Anez) government would likely support fiscal responsibility, while a leftist (Luis Arce) government, would continue to support government-funded social programs and strong SOEs. Regardless, an increasingly polarized political environment will make it difficult for the next administration to advance its agenda. While the leftist party (Arce's MAS) is expected to lose its majority in the Legislative Assembly, it will maintain a significant presence and has already obstructed the Anez government's efforts to approve the Eurobond issuance and RFI disbursements. MAS lawmakers will likely impede a conservative or centrist candidate from carrying out meaningful reforms. Likewise, if the leftist Arce is elected, centrist and conservative lawmakers will likely join together to undermine a leftist agenda. The post-election reform outlook is further clouded by the increasing potential for social unrest amid a worsening economic outlook. Social unrest is only likely to increase given the need for unpopular policy reforms. Thus, we remain cautious on the outlook for Bolivia regardless of the outcome of September's election.

World Bank approves $750 million package to support Nigeria power sector

Market Relevance: On June 24th, the World Bank approved $750 million as part of a recovery fund for Nigeria's power sector. The money will aim to achieve both fiscal sustainability and enhance accountability in the power sector, according to the World Bank. The fund has the potential to grow up to $3 billion over the next few years, depending on Nigeria's ability to implement a more sustainable tariff regime and abolish government subsidies.

Gramercy View: The Nigerian power sector has long experienced an unsustainable tariff regime, resulting in numerous government bailouts and widespread power shortages. The Nigerian Government has spent N1.5 billion ($14.1 billion) since 2014 to bail out the power sector repeatedly, with the Central Bank of Nigeria (CBN) directly funding the bulk of the interventions using unbudgeted government funds. This loan will credit the Nigerian Government in dollars and be paid to the CBN in naira, which will help improve the country's foreign reserves while compensating the CBN for its recent bailouts. While we view this as a short-term positive for the health of the power sector, we recognize the funding is not a solution to the sector's deeper problems. Nigeria's electricity regulator halted the scheduled increase in tariffs planned for April, citing disruptions caused by the COVID-19 outbreak. Tariff increases are now scheduled to take place in July 2020. We view this as just the first step of many in Nigeria's quest to reform the power sector.

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