Emerging Market Default Outlook: January 2018

BI EM Fixed Income, Global Dashboard

Damian Sassower
Team: Strategy
BI Fixed Income Strategist

Alexander Graf
Team: Strategy
BI Associate Analyst

Emerging Market Spreads Suggest Benign Default Outlook in 2018

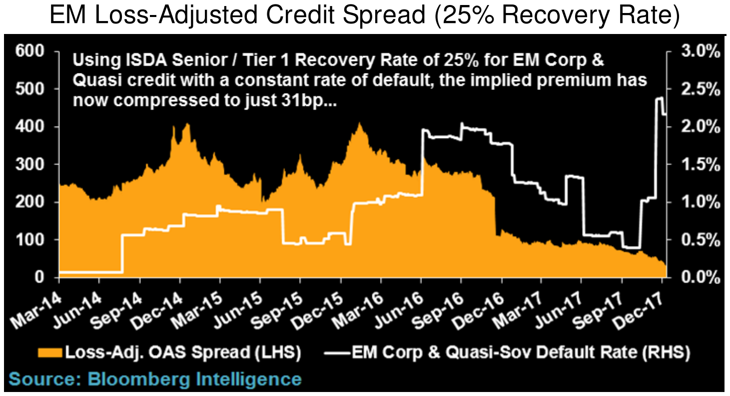
(Bloomberg Intelligence) -- Emerging market valuations suggest a favorable environment for defaults and recoveries in 2018. Improved default expectations are supported by the decline in emerging market debt trading at stressed and distressed levels. Latin America has higher default risk than regional peers, make up 99% of all EM distressed debt. (01/11/18)

1. EM Hard Currency Spreads Suggest Scant Corporate Defaults

Emerging market default expectations should remain subdued in 2018 as loss-adjusted credit spreads imply a premium of just 31 bps using the ISDA Senior/Tier 1 emerging market recovery rate of 25%. The corporate default rate rose to 2.2% from 1.8% as $24.4 billion of benchmark-eligible defaulted in the past year. Forward default-rate expectations are likely to reflect commodity, financial and property sector health, given they make up 65% of high-yield corporate and quasi-sovereign debt.

Loss-adjusted credit spreads subtract the expected default loss one-year forward from the Bloomberg Barclays EM U.S. Dollar Corporate and Quasi-Sovereign Average OAS at each point in time. For current data where a realized default rate is unavailable, the trailing 12-month rate is held constant at 2.2%. (01/11/18)

EM Loss-Adjusted Credit Spread (25% Recovery Rate)

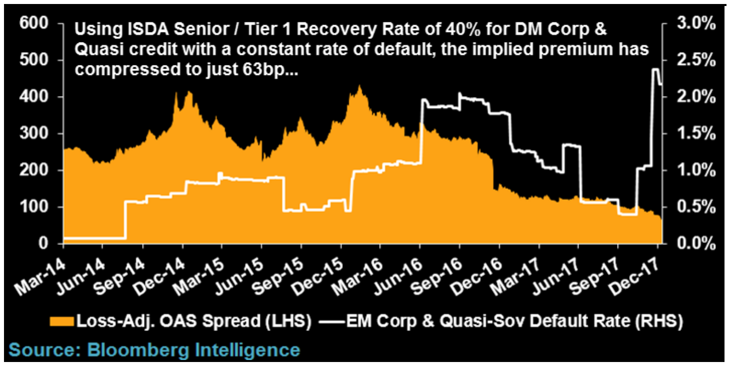


2. Loss-Adjusted Credit Spreads Point to Improved EM Recoveries

Emerging market option-adjusted spread levels may indicate an improved outlook for recoveries as the premium for taking on incremental default risk has declined to a secular low of 63 bps using the ISDA Senior/Tier 1 Recovery Rate of 40% for developed market corporate credit. An improved recovery outlook is credit positive for defaulted EM corporate and quasi-sovereign bonds, such as those issued by Oi, Samarco Mineracao, Empresas ICA, Oro Negro Drilling, Berau Coal and UkrLandFarming.

Loss-adjusted credit spreads measure the premium bond holders can expect to earn for taking on incremental default risk. ISDA Standard Model Recovery Rates range from 25% for Senior / Tier 1 fixed-coupon Latin America corporate debt to 40% for Senior/Tier 1 fixed-coupon Asia corporate debt. (01/11/18)

EM Loss-Adjusted Credit Spread (40% Recovery Rate)



3. Stressed Debt Skewed to Sovereigns; Venezuela, Argentina at Risk

Emerging market sovereign bonds account for an increasingly large proportion of stressed and distressed issuance when compared with quasi-sovereign and corporate debt. Stressed EM sovereign issuance, defined as bonds valued between 50-80% of par, totals $15.6 billion or 1.6% of the Bloomberg Barclays EM Hard Currency Sovereign Index. By comparison, the share of distressed sovereign bonds, or those trading at 50% of par or below, has jumped to 75% of total EM distressed issuance, from 42% in January 2017.

EM stressed and distressed sovereign debt is concentrated, with Venezuela and Argentina accounting for 98% of bonds valued at 80% of par or less. Belize 4% notes due 2034 are also valued at stressed levels, given the country's high debt and poor default history. (01/11/18)

Emerging Market Sovereign-Debt Defaults

Year	Country	Market Value	Year	Country	Market Value
1998	Russia	$ 72.7	2006	Belize	$ 0.2
1998	Ukraine	$ 1.3	2008	Ecuador	$ 3.2
1999	Pakistan	$ 1.6	2008	Seychelles	$ 0.3
1999	Ecuador	$ 6.6	2011	Cote d'Ivoire	$ 2.3
2000	Ukraine	$ 1.1	2012	Belize	$ 0.5
2000	Cote d'Ivoire	$ 3.5	2013	Grenada	$ 0.3
2000	Peru	$ 4.9	2014	Argentina	$ 0.5
2001	Argentina	$ 82.3	2015	Ukraine	$ 3.0
2003	Uruguay	$ 5.7	2017	Venezuela	$ 16.1
2005	Dominican Rep	$ 1.6			

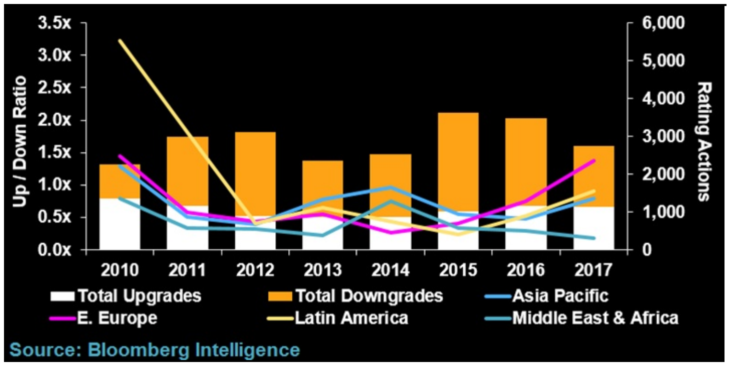
Source: Bloomberg, IMF, NBER

4. Upgrades Trail Downgrades, Yet EM Ratings Strengthen Into 2018

Emerging market credit-rating downgrades surpassed upgrades for the seventh consecutive year, yet migration trends are improving after falling to a post-crisis low of 0.4x in 2015. The ratio of EM upgrades to downgrades rose to 0.7x in 2017, as credit conditions in Asia, Eastern Europe and Latin America exhibit steady year-over-year improvement. The upward trajectory in Latin America was largely driven by issuer upgrades in Argentina, yet Brazil remains key to the region's outlook in 2018.

The ratio of upgrades to downgrades is a useful tool for measuring credit-rating trends over time. Latin America's strength is being fueled by Argentina as the country's debt issuers were responsible for most of the region's 362 upgrades in 2017. (01/11/18)

EM Credit Rating Migration by Region



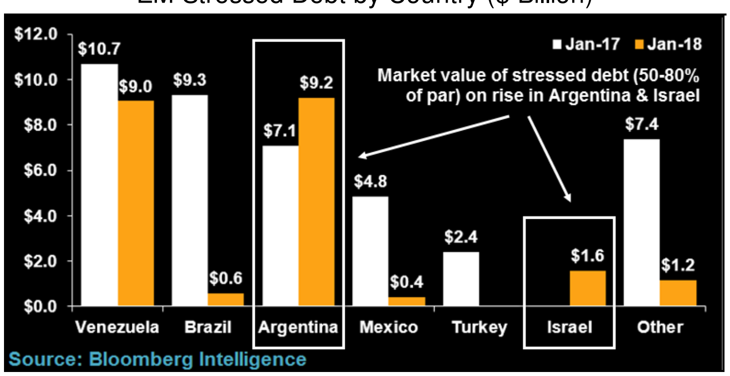
5. EM Stress Levels Decline, Teva Bonds Face Crossover Risk

Contributing Analysts Mike Holland (Credit)

The market value of stressed EM bonds, those valued at 50-80% of par, has declined 63% over the past year, as default and recovery prospects improve. Teva is the only high-grade issuer with bonds priced below 80% of par as crossover risk looms. Teva's senior unsecured debt is rated Baa3/BBB-/BB, yet slow growth and deteriorating margins are pressuring valuations, and another $9.4 billion of bonds trade at 80-90% of par. Teva is causing Israel's stressed-debt levels to rise on par with Argentina.

Seven EM bonds with a combined market value of $12 billion trade at 50-80% of par, down from 26 bonds totaling $32 billion in January 2017. Long-dated Teva and Argentina bonds carry a higher beta than EM hard-currency peers, and will have an outsized impact on benchmark returns in 2018. (01/11/18)

EM Stressed Debt by Country ($ Billion)

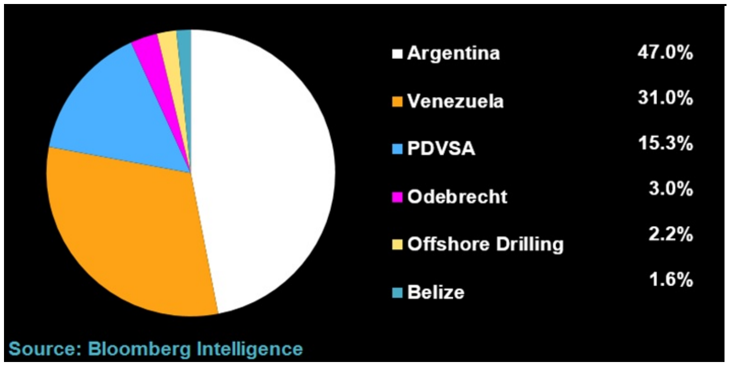


6. Latin America Dominates Distressed EM, Argentina Caught Offside

Latin America issuers make up 89% of stressed and distressed emerging market segment, with Venezuela and PDVSA bonds accounting for $9.1 billion, or 41% of the total. Benchmark-eligible bonds from Argentina, Belize, Odebrecht and Offshore Drilling are also trading below 80% of par, yet Argentina may be an outlier. Improved fundamentals have caused the option-adjusted spread on Argentina 2.5% bonds due 2038 to tighten by 121 bps the past year with recent upgrades by Moody's and S&P affirming the positive momentum.

EM bonds trading below 50% of par are in distress and carry a high risk of default. Distressed bonds represent $8.1 billion, or just 0.4% of the Bloomberg Barclays EM Hard Currency Aggregate Index. PDVSA was the first quasi-sovereign issuer outside Ukraine to default since the turn of the century. (01/11/18)

Latin America Stressed and Distressed Debt



To contact the analyst for this research:
Damian Sassower at dsassower3@bloomberg.net