ConnText Podcast

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TRANSCRIPT

Emerging Markets Overview with Alia Yousuf, Emerging Markets Credit Analyst, Global Evolution

Conning ConnText is a quarterly podcast that features our firm's view of capital markets, trends and investment strategies for the insurance industry, hosted by Rich Sega, Conning's Global Chief Investment Strategist.

[OPENING MUSIC]

SEGMENT 1 – OPENING

[Rich Sega (RS)]

Hello, Rich Sega here, with our Conning ConnText podcast for the second quarter of 2022. We are still sorting out the impacts of the year's first quarter, which roiled the markets with some new concerns, a couple of old concerns, and a few surprises too.

I'll be joined today from Singapore by my colleague, Alia Yousuf from Global Evolution, where she analyzes emerging market credit. She'll discuss trends in that broad and diversified segment of the global markets in light of recent geopolitical events.

SEGMENT 2 – ECONOMIC/CAPITAL MARKETS OVERVIEW

[RS]

It is a challenge to be an optimist given the pessimistic state of the world these days, but I will give it my best shot right here.

Our outlook at the start of the year for growth in global economies, and particularly for the U.S., was positive. Compared to 2021's great recovery, it seemed likely to be somewhat slower but solid and more sustainable. That, coupled with moderating inflation, suggested a very promising year for investors. We had two main concerns. The first was potential overreach by the U.S. Federal Reserve and other central banks fighting inflation. The other was the threat of substantially higher taxes, spending, and regulation (particularly in the energy arena) arising from the Biden Administration's so-called "Build Back Better" fiscal plan and climate initiatives. Each of those concerns appeared to be easing as January unfolded.

Then the invasion happened, erasing the hopes and dreams of so many Ukrainian families now subjected to the scourges of war. The humanitarian tragedy far outweighs our concerns for the economy, but if there is to be recovery and opportunity to heal for the displaced, it will necessarily come from the growth and prosperity of free and peaceful capital markets and the investors who support them. There are reasons for hope, and risks to watch out for. Of course, markets hate surprises, and we had a few.

Policymakers and investors alike were surprised - and continue to be - by the vehemence of the Russian invasion, but then too by the apparent miscalculations and ineffectiveness of the Russian military. Also surprising has been the courage, resolve, and tactical prowess of the Ukrainians. Somewhat surprising is the Western response, with sporadic layering of various sanctions with varying effectiveness. Now we have new concerns about demand destruction and supply interruptions in energy and commodities markets possibly leading to global recession and even stagflation (something not in play at the year's start). Sanctions affect not only their target – Russia – but their cost of compliance falls on portfolios and issuers of securities that might come under them. Finally, there is the pace of Russia divestment, with its far-reaching, long-term implications. As the war grinds on, the fields of Ukraine that produce a substantial portion of Europe's grain aren't being planted, raising the specter of food shortages in the fall.

At the same time, our old concerns in the U.S. for central bank overreach and fiscal damage have been revived. The rising cost of everything, but energy in particular, has strengthened the Fed's resolve to take a strong anti-inflation stance. Further, a much-reduced but still growth-threatening fiscal-tax-and-spending package has new life in the Senate. So where in all this do we find optimism?

We have had a remarkable recovery so far in the U.S. and we have good momentum to sustain it. Evidence for that comes from continuing strength in the labor market. In the pandemic year 2020 and its recovery year 2021, we saw labor markets divided into those jobs that adapted well to the work-from-home model and those that didn't. The former, mostly higher-income sectors like financial services and tech, did fairly well. But the latter, low-wage earners especially in service jobs, have had a much tougher time of it and are especially vulnerable to inflationary pressure. There are five million more job openings than nominally unemployed people in the U.S. and those jobs will be filled through the year. Wage growth will continue and with it, consumer demand, retail sales, housing; all good reasons to be optimistic.

The huge negative supply shock and then big positive demand shock led to inflation. Those inflationary forces are self-regulating; that is, they will cure without policy help. But others, like war and energy shortages, are created by policy. As such, they can be managed through policy if we have the will to do it. We can try to be optimistic about that.

The world is slowing down in the wake of turmoil. Europe is directly affected and much more vulnerable to the impacts of the war than the U.S.; still, it threatens everyone. But the countries feeling the biggest impact, and indeed several of the major players in the turmoil, are themselves emerging markets.

SEGMENT 3 – EMERGING MARKETS OVERVIEW Q&A w ALIA YOUSUF, GLOBAL EVOLUTION

[RS]

Global Evolution is a Conning affiliate that specializes in emerging market debt, both sovereign and corporate. Our guest, Alia Yousuf is responsible for the EM corporate strategy at Global Evolution and is based in Singapore. Hi Alia, welcome to the program. I'm really looking forward to hearing your thoughts on some of the pressing questions in the world of emerging market investing.

First, given the current market uncertainties with developed market rates volatility and emerging market geopolitical risk, where do you see potential opportunities within the EM corporate space?

[Alia Yousuf (AY)]

Thank you for inviting me to the podcast, Rich.

By the nature of the asset class composition, as a much lower duration and higher diversification compared to other emerging market indices, emerging market corporate returns tend to be overall a lot less volatile.

In the near term, EM corporates performance will be driven by the geopolitical risk that we are seeing in Russia and Ukraine, but in the medium term, the trajectory would depend more on the interplay between rates, inflation and monetary policy and how that affects the demand for the asset classes as well as all of emerging market fixed income and global credit more broadly.

EM corporate standalone fundamentals remain robust, but a negative scenario of slower growth together with higher inflation and tighter financial conditions could make the macro environment more challenging.

We expect Asia and Middle East to provide better stability, with Asia supported by higher quality composition and local investor support while Middle Eastern corporates benefit from elevated oil and commodity prices, as you would imagine. Commodity-heavy Africa should also fare better, despite the lower ratings spectrum, however they are susceptible to higher inflation pressure. We are slowly growing more positive on Latin America as political noise seems to be improving in certain countries like Colombia, for example. In terms of sector, the higher commodity prices make us prefer related sectors across the regions outside of Russia and Ukraine, though less so for quasi-sovereigns where the inflationary considerations could put pressure on corporate margins.

[RS]

EM economies tend to be highly leveraged to volatility in interest rates, currencies, and commodity prices. Which emerging markets are most helped or hurt by rising commodities and energy demand and the resulting prices?

[AY]

In general, high commodity prices can have adverse effect on emerging market economies given the higher share of food and energy prices in their consumption basket. However, within the corporate universe space we can pick winners during a rising commodity price scenario. We were positive on these sectors in the beginning of the year and going into the recent invasion, hence we had several of these names in the portfolio already.

Looking across the regions and sectors, maybe I can highlight some of the themes that we are currently thinking about.

Within Middle East and Africa, I would say Gulf oil and gas producers will clearly benefit from higher oil prices and a majority of these corporates have very limited exposure to Russia and Ukraine. This is also the only region which has the spare capacity to make up for the supply shortages from Russia, but valuation in these corporates already reflect these positive dynamics.

Within the Latin American oil and gas space, all producers and exporters should benefit from higher oil prices. These producers usually export the majority of their capacity globally, mostly to Asia and Europe.

Also, going into 2022 most of these producers reduced their hedges in anticipation of higher oil prices, so these higher oil price that we’re seeing currently will be helpful for their balance sheet.

For Latin petrochemicals, higher oil prices generally lead to higher corporate margin spreads across the value chain and these prices will benefit the Latin players who largely sell regionally across the continent or to the US. Hence on

the pricing and on the volume side, I think these producers will benefit.

Now looking at Asia, typically higher energy and other commodity prices should be fundamentally negative for Asian economies compared to the rest of EM, and this is because Asia is a net importer of commodities. But looking at some of the larger countries within Asia – India, for example – higher oil price will be generally negative for the macro environment with added pressure on their already fragile fiscal balance.

China's oil sectors are mostly driven by government-owned entities so they would potentially benefit from higher energy prices, although we acknowledge the slight offset by the drag on China's near-term weaker macro environment. But net-net we believe Chinese sovereign is in a much better position to withstand such pressure.

Looking at other Asian oil and gas producers, quite a lot of them tend to be sovereign-owned and they do have pretty solid fundamentals and low leverage ratios which will give them a pretty good standing in terms of any form of negative oil price shock.

The other sector that we are looking at within Asia is aluminum, and I think these producers, especially within Indonesia, should benefit from high coal, aluminum and nickel prices. Decreasing Russian supply and lowering plant utilization rate from the European producers (because of high fuel costs) will keep the aluminum market undersupplied, and I think this will be supportive for some of the Indonesian names that we are looking at.

[**RS**]

With the pandemic receding in almost all EM countries, authorities have begun to ease restrictions on movement. A notable exception to that: the latest Omicron wave is creating the most challenging environment for China's zero-COVID policy. What does it mean for opportunities there?

[**AY**]

China's economy has its own internal issues, with a weak and over-leveraged property sector, continued reliance on the manufacturing export sector while household domestic consumption remains a negligible part of their economic engine. So the recent continuation of their stringent zero-COVID policy will only dampen their near-term growth outlook. However, we think the negative impact is probably a little less severe than the headline numbers suggest. The aggregated GDP of high- and medium-risk cities, as defined by the National Health Commission, now account for less than 25% of national GDP compared to around 30% in mid-March. So we think the Chinese macro policy will have to remain on an easing bias, both on the monetary and fiscal front.

So far in 2022, Chinese corporates have had a pretty rough year. They've had to navigate through the well-telegraphed property sector slowdown, regulatory crackdown on the tech sector, and geopolitical risk in eastern Europe. Going forward we think local factors, like their stringent COVID policies and shift in regulatory stand across different sectors, will probably continue to drive the corporate performance within China.

With the more recent omicron wave intensifying, we think the macro policy will remain pro-growth focused with targeted credit support for rural area development projects and to smaller and medium-sized companies. However, given the narrowing differential between the U.S. and the Chinese government rate, we think monetary policy will be focused on smaller rate cuts, let's say a five-basis-point cut, rather than more aggressive monetary easing.

[**RS**]

Two of the geopolitically most important EM countries are China and Russia. How does their relationship with each other affect your outlook?

[AY]

Yes, Russia (pre removal from EM indices) and China are both a significant part of EM corporate sector's investable universe. At the end of January, Russia was around 4.7% of the corporate index, while China – the largest country weight - was around 7.7% of the index (and here I'm talking of the JP Morgan CEMBI BD, one of the largest followed corporate indexes). Both countries have very deep and diverse offshore corporate bond curves with issuers ranging from financial institutions to commodity, consumer, and tech names.

China is a large trading partner for Russia, especially since 2014 when the U.S. and EU imposed sanctions on Russia after it annexed Crimea from Ukraine. However, the bilateral trade dependence is a bit disproportional, as shipments to China account for around 15% of Russia's exports, but less than 3% of China's total imports. Also, exports from China make up of nearly 24% of Russia's imports, but only around 2% of China's total exports. Going forward, we only see this relationship either remaining stable or actually growing from here.

China over the last 15 to 20 years has increased its exports of machinery to Russia substantially from about 10% to around 80% currently of Russia's total machinery imports, resulting in clearly a high reliance on China for Russia. So, as you can see, they are trading partners, but it is somewhat biased and disproportional.

We think the recent invasion of Ukraine has put China in a bit of an awkward position with respect to their relationship with Russia. We expect their bilateral trade relationship to be stable going forward. China is cognizant of potential incremental sanctions on Chinese corporates and to that extent we think some of the bigger Chinese banks – especially the ones with largest offshore business exposure – may be risk averse and avoid Russia-related business dealings.

And further on that note, we are seeing headlines of some of the well-established joint ventures within Chinese government-owned entities, in the oil and gas sector for example, are temporarily suspending any further investments. I don't think they're cutting off investment completely but I think China wants to avoid being in the headlines about their relationship with Russia.

SEGMENT 4 – CLOSE

[RS] (**12:56**)

Thank you, Alia, for your insights into the diverse EM investment universe.

So, what's next?

At this point, the problems caused by the war and the subsequent sanctions are liquidity crises, not solvency crises. But prolonged liquidity crunches damage confidence, and that could ultimately lead to a crisis in solvency too. That poses a significant threat to Europe and for global growth broadly, with somewhat lesser impact on the US. Global markets are certainly challenged and while the risks are heightened, we still believe in the resilience of the U.S. economy.

I'd like to thank Alia from Global Evolution for joining us on our podcast. We hope this information is helpful and we always welcome your feedback and questions. You can get messages to us through your relationship manager, your portfolio manager, or send them directly to us at ConnText@Conning.com (that's ConnText w/ 2 Ns).

So that concludes our Conning ConnText podcast for the second quarter of 2022.

[FADE TO MUSIC]

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