The Coming Emerging Market Default and its Contagion

by BNPP IP Emerging Market Fixed Income Team

August 2016

Who's Next?

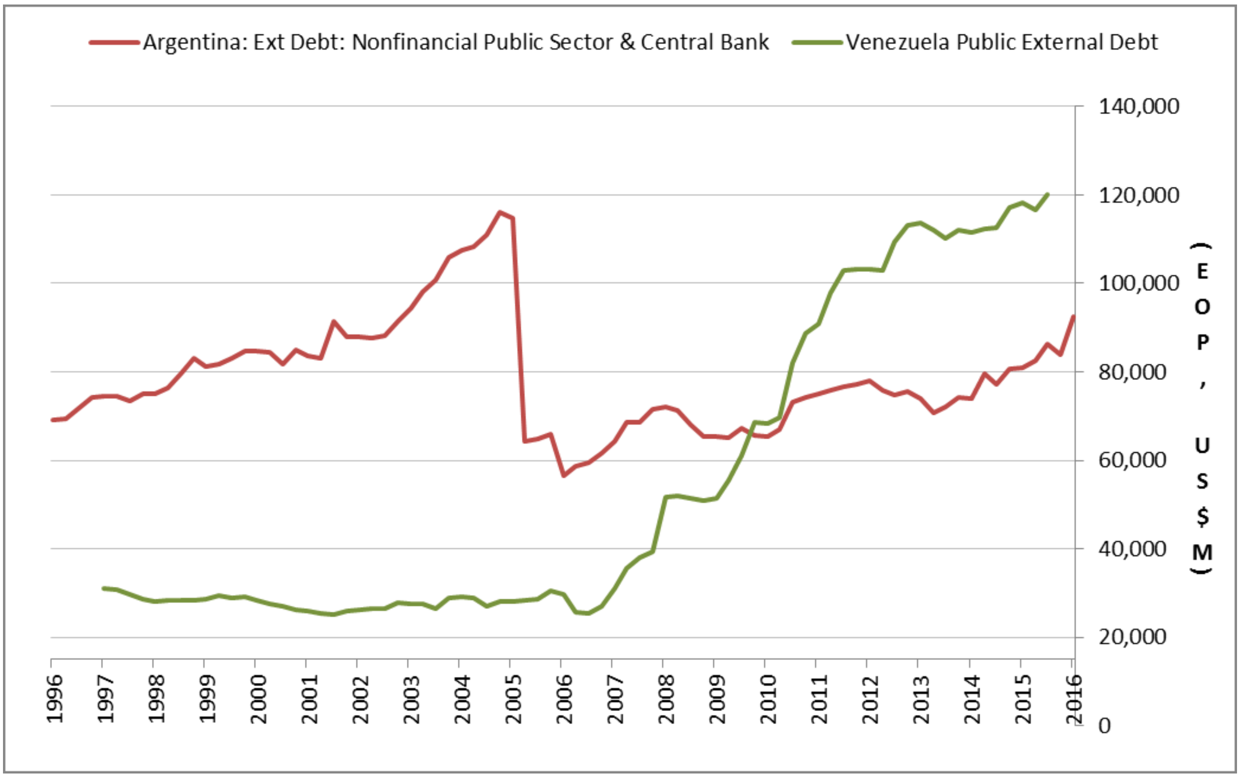
Investors are not known for their long memories.

Merely 15 years have elapsed since the last major emerging market (EM) default event. Argentina's 2001 default was an earthquake that sent shockwaves through emerging assets globally, damaged several multinational banks, and turned bondholders into veritable lawyers as they navigated the court system for years, ultimately re-writing the book on holdout rights.

The next Argentina has arrived. Although Venezuela's benchmark weight may seem small, that's mostly because the bonds are already pricing at distressed levels in view of the country's weakened cash position and loss of market access. In notional amounts, the scale of the risk is similar to Argentina then: the face value market cap of the country's benchmark bonds stands at nearly $17.93 billion vs. $14.75 billion for Argentina in 2001. Then as now, bonds are held by nearly every investor type the world over, and EM benchmark investing is broader than ever. Taking the full view of liabilities, Venezuela poses an even larger problem. As shown in the table below, total external debt including from state-owned companies stands at nearly $120 billion, nearly 50% more than Argentina's 2001 position. Most painfully, the country's lack of operating standard has left the market with at least 26 individual issues, operating in several different legal frameworks, linked to multiple government entities (including notably Petróleos de Venezuela), and with litigious cross-default clauses and substantial collateral attachment potential. The fact that China is now Venezuela's single largest creditor but does not participate in or adhere to Paris Club procedures, further complicates the story. Venezuela is undeniably a systemic threat.

In short, the coming workout has the potential to make the Argentina default look like a friendly game of polo by comparison.

Figure 1: Venezuela vs. Argentina Total External Debt



Source: BNP Paribas Investment Partners, Haver

<u>How will it Happen?</u>

For Venezuela, the writing is on the wall. Ninety-five percent of Venezuela's exports are oil-based, and both production and prices have declined dramatically over the past two years. Extricating yourself from a discussion of oil prices (which have a multiplier effect on the country's finances in both directions), Venezuela is now quite simply out of money and faces imminent dollar access shortages. We know the government is already running domestic arrears, prioritizing foreign debt service over payments to government employees and suppliers. We also know the situation has become a humanitarian crisis with accumulated product shortages, especially in foodstuffs, now affecting the mass populace. The situation is untenable and we are watching the Venezuelan street for potential catalysts. The upcoming protest march on September 1st for example is likely to be well attended.

Taking a view on the timing of default requires two key inputs: firstly, oil prices, and secondly, the likelihood of political transition (and whether that takes the form of economic revolution or opens new sources of funding). Several possible scenarios result:

a) Oil rallies sharply (in which case the likelihood of default and, arguably, political transition both recede). **In this scenario, Venezuela can afford to kick the can down the road through a combination of heterodox policies and potential bilateral rollovers.** Same old, same old. Bonds should do well in the near term; however, investors will ultimately focus on long term structural issues. Oil prices are no longer enough to keep Venezuela on a sustainable track.

b) Oil remains depressed and the governing United Socialist Party of Venezuela (PSUV) remains in control. Essentially the status quo, we face rising default risk with each obligation coming due. A default doesn't have to happen this year, especially if Venezuela benefits from a combination of: compressing imports (depreciation of the secondary official exchange rate for anything non-essential), additional bilateral relief from China and regional support, ongoing sales of gold reserves, prioritisation of debt service over other expenditures, as well as a "voluntary" debt exchange with participation by investors. **With such luck, it's entirely conceivable that Venezuela continues to make good on its payments this year. 2017 is another story.** The country will have run down reserves perilously, with limited room for further import compression (hitting the buffers on slowing decline already) and likely will not achieve the required participation of a broad enough range of investors to participate in the debt extension. Under this scenario, should Venezuela default, investors will assess expected recovery rates. We would expect high volatility in the market and bonds changing hands quickly. The fact that bonds are already trading near traditional post-default recovery prices raises uncertainties on the depth and scope of ultimate restructuring.

c) Political transition. This scenario entertains the possibility that Venezuela may not default even if oil remains weak, depending on what the political transition means for economic policy. A transition to more orthodox economic policies and an investment-friendly environment (coupled with improved relations with institutions that potentially provide emergency loans), similar to what we have seen in Argentina under the new government there, could dramatically alter the market perception. We are clearly not there yet as first a credible team must be in place. Second, it's not clear what the opposition intends in that regard. In contrast, if a new government took a hard-line stance against bondholders and/or claim that the debt is not legitimate, the path to default could actually accelerate. The IMF's policy on so-called "bail-ins," and in particular its stance in recent European sovereign debt restructurings, means it's possible debt forgiveness would be supported by the international community, to the detriment of investors. **Overall, it seems to us that the market has been misreading the scenario of regime change: a political transition combined with a painful restructuring is a quite likely scenario, and we would not become bullish simply due to a new government.**

Contagion and Linkages

In the event of a default by non-payment (as opposed to pre-emptive debt restructuring), contagion is likely to spread regionally at first: economic linkages with Colombia and Brazil will prompt investors to second-guess their investments there first and ask questions later. Contagion could also touch the assorted Caribbean countries that have benefitted from Venezuela's Petrocaribe program. Fund managers will make or break their year depending on how they were positioned entering the default and how they played the subsequent risk re-allocation. Bond price losses and writing down missed coupons will likely be offset by investors in the junk-rating bucket, selling assets elsewhere and pressuring high yield spreads wider globally. Investors will suddenly remember that EM is not risk-free, prompting outflows particularly at the retail level.

With regard to sovereign default risk, the world has become too complacent. Witness low correlations during recent risk events such as the attempted coup in Turkey: the market has overcome fear and ventured back into the realm of euphoria. While we don't gauge that emerging assets are yet in bubble territory, we do see that the market has forgotten what an EM default means and what havoc contagion brings. Whereas some may argue that Venezuela's coming default has been well telegraphed and already "in the price," we see the potential for volatility when the market is forced to hash out a recovery price. We believe that under a default event, global correlations will rise. We recommend investors take early note of their managers' Venezuela exposures and positioning (not all bonds are born equal) and assess their risk tolerance for weathering the default ahead.

About the EMFI team

BNPP IP's global emerging markets team, based in London, counts nine experienced and skilled investment personnel covering EM sovereign and corporate credit, rates and FX. The team manages assets in hard currency, local currency, and hard/local blended strategies. The individuals that contributed to this piece include Sovereign Credit PM Hardeep Dogra, EMFI head L. Bryan Carter, EMFI deputy head JC Sambor, and Investment Specialist Michael Victoros.

DISCLAIMER

This material is issued and has been prepared by FFTW, a trading name of BNP Paribas Investment Partners UK Limited ("BNPP IP UK")*, a member of BNP Paribas Investment Partners (BNPP IP)**.

This material is produced for information purposes only and does not constitute:

1. an offer to buy nor a solicitation to sell, nor shall it form the basis of or be relied upon in connection with any contract or commitment whatsoever or

2. any investment advice.

This material makes reference to certain financial instruments (the "Financial Instrument(s)") authorised and regulated in its/their jurisdiction(s) of incorporation.

No action has been taken which would permit the public offering of the Financial Instrument(s) in any other jurisdiction, except as indicated in the most recent prospectus, offering document or any other information material, as applicable, of the relevant Financial Instrument(s) where such action would be required, in particular, in the United States, to US persons (as such term is defined in Regulation S of the United States Securities Act of 1933). Prior to any subscription in a country in which such Financial Instrument(s) is/are registered, investors should verify any legal constraints or restrictions there may be in connection with the subscription, purchase, possession or sale of the Financial Instrument(s).

Investors considering subscribing for the Financial Instrument(s) should read carefully the most recent prospectus, offering document or other information material and consult the Financial Instrument(s)' most recent financial reports. The prospectus, offering document or other information of the Financial Instrument(s) are available from your local BNPP IP correspondents, if any, or from the entities marketing the Financial Instrument(s).

Opinions included in this material constitute the judgment of BNPP IP UK at the time specified and may be subject to change without notice. BNPP IP UK is not obliged to update or alter the information or opinions contained within this material. Investors should consult their own legal and tax advisors in respect of legal, accounting, domicile and tax advice prior to investing in the Financial Instrument(s) in order to make an independent determination of the suitability and consequences of an investment therein, if permitted. Please note that different types of investments, if contained within this material, involve varying degrees of risk and there can be no assurance that any specific investment may either be suitable, appropriate or profitable for a client or prospective client's investment portfolio.

Given the economic and market risks, there can be no assurance that the Financial Instrument(s) will achieve its/their investment objectives. Returns may be affected by, amongst other things, investment strategies or objectives of the Financial Instrument(s) and material market and economic conditions, including interest rates, market terms and general market conditions. The different strategies applied to the Financial Instruments may have a significant effect on the results portrayed in this material. Past performance is not a guide to future performance and the value of the investments in Financial Instrument(s) may go down as well as up. Investors may not get back the amount they originally invested. The performance data, as applicable, reflected in this material, do not take into account the commissions, costs incurred on the issue and redemption and taxes.

This document is directed only at person(s) who have professional experience in matters relating to investments ("relevant persons"). Any investment or investment activity to which this document relates is available only to and will be engaged in only with Professional Clients as defined in the rules of the Financial Conduct Authority. Any person who is not a relevant person should not act or rely on this document or any of its contents.

* BNP Paribas Investment Partners UK Limited, is authorised and regulated by the Financial Conduct Authority. Registered in England No: 02474627, registered office: 5 Aldermanbury Square, London, England, EC2V 7BP, United Kingdom. FFTW is a brand name of BNP Paribas Investment Partners UK Limited in the UK.

** "BNP Paribas Investment Partners" is the global brand name of the BNP Paribas group's asset management services. The individual asset management entities within BNP Paribas Investment Partners if specified herein, are specified for information only and do not necessarily carry on business in your jurisdiction. For further information please contact your locally licensed Investment Partner.