FFTW

A BNP Paribas Investment Partner

Weekly commentary

The Coming Emerging Market Default and its Contagion

by L. Bryan Carter
Head of Emerging Markets Fixed Income
bryan.carter@bnpparibas.com

August 29, 2016

Key takeaways

- Merely 15 years have elapsed since Argentina's 2001 default, and the next Argentina has arrived.
- Venezuela's benchmark weight may seem small due to bonds already being priced at distressed levels, in notional amounts; the scale of the risk is similar to Argentina.
- 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).
- 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.

Full commentary

Who's Next?

Investors are not known for their long memories. Merely 15 years have elapsed since Argentina's 2001 default, and the next Argentina has arrived. Venezuela's benchmark weight may seem small due to bonds already being priced at distressed levels, in notional amounts; the scale of the risk is similar to Argentina. The face value market capitalization of the country's benchmark bonds stands at nearly $17.93 billion vs. $14.75 billion for Argentina in 2001. Taking the full view of liabilities, Venezuela poses an even larger problem. Total external debt, including state owned companies, stands at nearly $120 billion, nearly 50% more than Argentina's 2001 position (see chart below). The country's lack of operating standards 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.

How will it Happen?

Ninety-five percent of Venezuela's exports are oil-based. 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 now affecting the mass populace. We are watching the Venezuelan street for potential catalysts.

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:

- Oil rallies sharply causing the likelihood of default and, arguably, political transition to both recede. I**n this scenario, Venezuela can afford to kick the can down the road through a combination of heterodox policies and potential bilateral rollovers.** 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.
- Oil remains depressed and the governing United Socialist Party of Venezuela (PSUV) remains in control. A default doesn't have to happen this year, especially if Venezuela benefits from a combination of compressing imports, 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. W**ith such luck, it's conceivable that Venezuela makes 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 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.
- 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), could dramatically alter the market perception. 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," means it's possible debt forgiveness would be supported by the international community, to the detriment of investors. Overall, it appears the market has been misreading a regime change scenario: a political transition combined with a painful restructuring is quite likely, and we would not become bullish simply due to a new government.

This week's market developments

Tuesday, August 23
- Markit Eurozone Manufacturing PMI (preliminary estimate) decreased to 51.8 for August
- Markit Eurozone Services PMI (preliminary estimate) increased to 53.1 for August
- Markit US Manufacturing PMI (preliminary estimate) decreased to 52.1 for August
- Eurozone Consumer Confidence (advance estimate) decreased to -8.5 for August
- US New Home Sales increased to 654,000 for July

Wednesday, August 24
- US Existing Home Sales decreased to 5,390,000 for July

Thursday, August 25
- US Durable Goods Orders growth (preliminary estimate) increased to 4.4% for July
- Markit US Services PMI (preliminary estimate) decreased to 50.9 for August

Friday, August 5
- UK GDP growth (preliminary estimate) remained at 0.6% q.o.q. (s.a.) for Q2
- US Wholesale Inventories growth (preliminary estimate) decreased to 0.0% m.o.m. for July

Source: Bloomberg, as of August 29, 2016

Contagion and Linkages

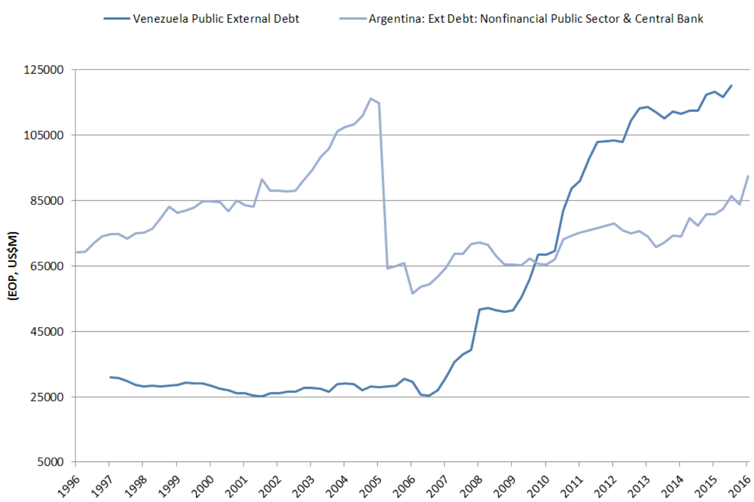
In the event of a default by non-payment (as opposed to pre-emptive debt restructuring), contagion is likely to spread regionally at first: economic linkages with Colombia and Brazil will prompt investors to second-guess their investments there first and ask questions later. Contagion could also touch the assorted Caribbean countries that have benefitted from Venezuela's Petrocaribe program.

With regard to sovereign default risk, the world has become too complacent. While we don't gauge that emerging assets are yet in bubble territory, we do see that the market has forgotten what an emerging market default means and what havoc contagion brings. We believe that under a Venezuelan 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.

For additional information please refer to the full article: The Coming Emerging Market Default and its Contagion.

Chart of the week

Venezuela vs. Argentina Total External Debt



Source: BNP Paribas Investment Partners, Haver, as of June 30, 2016

Central Bank watch

	Last move	Date of move	Current policy rate	Implied 3m rate on December 2016 Interest Rates Futures Contract	Next meeting
Fed	+25 basis points	December 16, 2015	0.25 % - 0.50 %	0.54 %	September 21, 2016
ECB	-5 basis points	March 10, 2016	0.00 %	-0.19 %	September 8, 2016
BoJ	-20 basis points	February 16, 2016	-0.10 % - 0.00%	0.01 %	September 21, 2016
BoE	-25 basis points	August 4, 2016	0.25 %	0.31 %	September 15, 2016

Source: Bloomberg, as of August 29, 2016

Next week's market developments

Monday, August 29

- US Personal Income growth is expected to increase to 0.4% m.o.m. (s.a.) for July
- US Personal Spending growth is expected to decrease to 0.3% m.o.m. (s.a.) for July
- UK Mortgage Approvals are expected to decrease to 61,900 for July

Tuesday, August 30

- US Existing Home Sales are expected to decrease to 5,500,000 for July
- US Consumer Confidence Index is expected to decrease to 97.0 for August
- Japan Industrial Production (preliminary estimate) is expected to decrease to 0.8% m.o.m (s.a.) for July

Wednesday, August 31

- Eurozone Unemployment Rate is expected to decrease to 10.0% (s.a.) for July
- US Chicago Purchasing Manager Index is expected to decrease to 54.0 for August

Thursday, September 1

- Markit UK Manufacturing PMI is expected to increase to 49.0 (s.a.) for August
- US ISM Manufacturing is expected to decrease to 52.0 for August

Friday, September 2

- US Change in Nonfarm Payrolls growth is expected to be 180,000 for August
- US Unemployment Rate is expected to decrease to 4.8% (s.a.) for August
- US Factory Orders growth is expected to increase to 2.0% m.o.m. (s.a.) for July

Source: Bloomberg, as of August 29, 2016