Q&A-Fallen angel risk in emerging markets low; Eye on Colombian fiscal reform; EM sovereign debt still attractive: Lupin Rahman, PIMCO

The risk of investment grade-rated debt of emerging market (EM) countries being downgraded to junk status is relatively low, **Lupin Rahman**, **Head of EM Sovereign Credit at PIMCO** told the Reuters Global Markets Forum on Friday, May 7.

Rahman said that of the countries at risk, Colombia is the one to watch, adding that fiscal reform will be key for the country to preserve its credit rating.

More broadly, she said that recent wobbles among Chinese corporate bonds is spurring investors to look more closely at regulation and ways to hedge risk.

Rahman said easy global liquidity, a supportive U.S. dollar, higher commodity prices and domestic policy response to the pandemic continues to make EM sovereign debt attractive.

Following are edited excerpts from the conversation:

Q: How do the recent ructions in China's corporate bond market affect the rising appetite for Chinese sovereign debt?

A: Investors and sovereign analysts are now increasing focus on several underlying themes as it pertains to China's sovereign credit and debt assessments. These include when and how implicit guarantees are triggered, the extent of information opacity, and the lack of a rule-based resolution framework. There is also focus on the quality of regulation especially in the non-bank financial sector.

Q: Is this prompting a broad change in views on the valuation of China's state-owned enterprise (SOE) credit?

A: In the near-term, there could be more concerns on SOE defaults rising, given their relatively poor financial performance, and higher leverage against a backdrop of tightening financial regulation and tapering credit policy. This could lead foreign investors to use Chinese government bonds as a risk mitigating instrument. In the long-term, orderly defaults should be positive for market development, which ultimately helps investors price risks better.

Q: The market has ebbed and flowed on its recommendation for local currency EM sovereign debt all year - but is this truly only dependent on the view of U.S. dollar?

A: The central thesis for EM local investments rests on the continuation of supportive global push factors including global liquidity, the dollar, higher commodity prices, the evolution of the pandemic and the domestic policy response. In addition, the repricing of U.S. rates in the light of large U.S. fiscal stimulus and how EM central banks navigate it versus domestic macro considerations are also critical. Some EMs are facing muted inflationary pressures and have relatively higher real rates and can remain on hold as their economies recover; while others where real rates are negative and lower than warranted are facing hiking pressures.

Q: In relation to commodity prices - are you looking at a "two-tone" view on EM debt given the strong YTD performance in metals and energy, i.e., broadly bullish on debt of commodity producers and bearish on heavy net importers?

A: EMs are highly differentiated currently, more so than usual, given the various factors at play mentioned earlier, but also as starting conditions and future policy proposals are important. So, higher commodity prices are benefitting commodity exporters but there are still many risks particular for sovereigns in the high-yield space which are just about "muddling-through". What we are looking for are countries which are navigating this crisis by implementing fiscal reforms needed to bring debt to a declining trajectory and at the same time looking to safeguard the recovery which we are seeing.

Q: Are there countries that you thought would default that you now think will muddle through? Also, do EM markets seem to be less reactive to COVID-19 waves now that vaccines are coming?

A: EM has been extremely resilient during this shock - last year there were five sovereign defaults, and in the majority of those cases there were pre-existing credit issues. This year higher commodity prices as well as positive catalysts, like the International Monetary Fund's Special Drawing Rights allocation expected in the fall, allow many countries much-needed liquidity. Countries like Sri Lanka, for example, would benefit enormously from the latter.

Q: Could you elaborate on the inflation pressures that emerging markets are facing? We have seen food prices rise, now higher commodity prices as well. Do you see this lasting for some time and cause second round effects?

A: The inflation in EM which we are seeing is a combination of cost-push inflation together with the effect of base-effects feeding through. In some select cases there is the element of second round effects coming through particularly in countries where COVID-19 stimulus was high and prolonged. For the bulk of EMs, we expect these inflationary dynamics to be transitory, although we are closely monitoring the effect on inflation expectations and core inflation for signs of second round effects.

Q: Which countries are you most concerned about for second round effects?

A: Some Latin American countries, e.g. Brazil, are ones we are monitoring given the hump of the inflation path and the historic overshoot of expectations, which is also why we have seen the central banks hiking recently.

Q: Do you think countries on the last rung of investment-grade rated debt, like Colombia, India and even Mexico, could lose their IG ratings? And should long-dated sovereign debt have a different credit rating to shorter-dated debt if the country in question is likely to be hit hard by climate change?

A: Fallen angel risk is relatively low in EM at present. Of the names at risk, it's no surprise that Colombia is the one to watch. Here, fiscal reform will be key.

Q: How does the ESG boom and carbon-aversion in investments affect EM? Should EM investors actively avoid Russia and the Gulf states, and what's the future of petrodollar recycling over the coming decades?

A: EM is well positioned for the focus on ESG investing. In general, investors are looking at helping EM economies move up the sustainability path and are willing to finance a just transition. Countries that have embraced ESG practices, like Chile, are likely to benefit from an untapped pool of capital from asset owners who are long-term in nature and willing to extend credit to EMs which are improving on the ESG scores.

Q: On renewables and energy transitioning, how are these targets are getting financed and what role can developed countries play to get EMs up to speed?

A: Sovereigns have started issuing in the green bond space leading to a rise in sovereign green issuance. This follows the growth of green bond issuance in the DM space which helps EMs by providing a barometer on green frameworks and structure of instruments. More broadly, the work DMs are doing on green taxonomy and providing technical assistance to EM looking to enter these markets are also very important.

Q: Your final thoughts on the ESG and EM spaces?

A: This is a growing area where investors need to do their homework, but also an area where they can have tremendous impact in assisting countries along their sustainability journeys.