EM sovereign ratings: Downside risks

KEY MESSAGES
Based on our revised outlook, we simulated the impact of Covid-19 outbreak on sovereign ratings and found an average one-notch downgrade for EMs.

Worsening debt dynamics and negative GDP growth per capita are likely to pose increasing risks. Our simulator suggests 15 out of 25 EMs might be at risk of a revision to negative outlook, or downgrades.

Companies’ ability to withstand crisis seems to have improved from 2008-09, but we flag increased debt levels and more foreign participation as two concerning trends.

MARKET VIEWS
Global monetary and fiscal measures to address credit availability, market liquidity and economic growth will lead to some near-term stabilisation in EM credit, in our view. Earlier this week, we added allocation in 5y CDS in defensive and/or heavily mispriced markets: Russia, Brazil and Colombia (see links p.3).

We think the risk/reward is less attractive in the cash bond market, since it will likely continue to be negatively influenced by fund outflows, the need to build higher cash buffers and challenging technicals for a period of time. Assuming there is a post-virus one-notch downgrade to global EM sovereigns transpires as our analysis suggests, global EM sovereign indices are likely to settle at a higher spread levels, all other factors being equal.

Fig. 1: Comparing our sovereign rating simulator to current assessments

<table>
<thead>
<tr>
<th>“Fair”, Jan-20</th>
<th>Current rating</th>
<th>Post Covid-19</th>
</tr>
</thead>
<tbody>
<tr>
<td>AA- or higher</td>
<td>A+ or higher</td>
<td>AA- or higher</td>
</tr>
<tr>
<td>BBB+ or higher</td>
<td>A+ or higher</td>
<td>BBB+ or higher</td>
</tr>
<tr>
<td>BB or higher</td>
<td>A+ or higher</td>
<td>BB or higher</td>
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<tr>
<td>B+ or higher</td>
<td>A+ or higher</td>
<td>B+ or higher</td>
</tr>
<tr>
<td>BBB or higher</td>
<td>A+ or higher</td>
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<tr>
<td>BB or lower</td>
<td>A+ or higher</td>
<td>BB or lower</td>
</tr>
<tr>
<td>CCC or lower</td>
<td>A+ or higher</td>
<td>CCC or lower</td>
</tr>
</tbody>
</table>

We caution that this exercise is merely for indicative purposes, and should not to be taken in any form as a credit assessment. The methodology used, based on that of credit rating agencies, is subject to change.

Visible risk of downgrades: Increased debt and negative GDP growth per capita are likely to put a downside bias on credit ratings, according to our updated sovereign rating simulator, which incorporates our latest forecasts and the fiscal stimulus measures announced by governments (see EM – Policy toolkit, published on 23 March 2020).

Our simulator suggests that of the 25 EMs, 14 have a “fair” rating of a notch or more below their current rating, while three (down from five in our January assessment) show ratings that is better than their current one.

EM countries, on average, could likely see a one-notch downgrade to their credit ratings, possibly taking four countries outside investment grade territory. Countries that are likely to gain the most would be the BB rated ones (three sovereigns), according to our simulator.

High quality to take the biggest toll: Our simulator also suggests that companies that are now rated as A- or higher could fall to the lower A- category, taking at least a two-notch drop, as strong GDP growth and benign debt dynamics take a swift turn for the worse.

Corporates at risk: Four in 10 EM companies are rated as BBB (with three rating notches within this category) and risk falling below investment grade as financial metrics deteriorate and sovereign downgrades occur. EMs that have more companies rated as barely above high yield, risk seeing the biggest number of “fallen angels” over the coming months (Figure 2).

Fig. 2: Percentage of EM corporates classified as BBB+, BBB-, or BBB, by country

Sources: S&P, Bloomberg, CEMBI, BNP Paribas.
EM: Sovereign credit simulator by country

Markets might have priced in downgrades already: CDS spreads have widened substantially since the virus outbreak. We found an 125bp average increase since January, but with substantial discrepancies within the same credit rating class, suggesting things may have already moved in credit markets (Figure 3).

Our simulator suggests that 14 out of 25 EMs are at risk of being downgraded. That is almost double the assessment we had in January 2020. The main deterioration has come from fiscal and economic scores, as most countries have shifted to a scenario of negative GDP per capita, coupled with an increase in debt levels (see Table 1).

EMs to show some degree of resilience. We note that improvements in institutional and monetary scores suggest some degree of resilience for many EMs, as was seen during the 2008-09 global financial crisis: on average, the sovereign credit rating of DM reduced by three notches, compared to only one for EMs (Figure 4).

Table 1: BNPP Sovereign credit rating simulator by country versus current rating

<table>
<thead>
<tr>
<th>Structural factors</th>
<th>Flexibility and performance</th>
<th>BNPP simulator</th>
<th>S&amp;P (current)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Institutional</strong></td>
<td><strong>Economic</strong></td>
<td><strong>External</strong></td>
<td><strong>Fiscal</strong></td>
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<td>---------------------</td>
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<tr>
<td>Argentina</td>
<td>6.0</td>
<td>5.0</td>
<td>3.0</td>
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<td>Bahrain</td>
<td>6.0</td>
<td>2.0</td>
<td>2.5</td>
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<td>Brazil</td>
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<td>3.0</td>
<td>3.0</td>
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<tr>
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<td>3.2</td>
</tr>
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<td>Colombia</td>
<td>4.6</td>
<td>3.0</td>
<td>3.0</td>
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<td>4.0</td>
<td>3.0</td>
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<tr>
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<td>6.0</td>
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<tr>
<td>Oman</td>
<td>8.0</td>
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<td>Philippines</td>
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<td>3.4</td>
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<td>Romania</td>
<td>3.6</td>
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<td>3.0</td>
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<td>Russia</td>
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<tr>
<td>Saudi Arabia</td>
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<td>5.0</td>
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<td>Thailand</td>
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<td>3.0</td>
<td>3.0</td>
</tr>
<tr>
<td>Ukraine</td>
<td>6.0</td>
<td>6.0</td>
<td>3.0</td>
</tr>
</tbody>
</table>

Sources: National statistics bureaus, Eurostat, Macrobond, Bloomberg, BNP Paribas.

Our methodology: Explaining our sovereign credit rating simulator
- We use the S&P sovereign rating simulator based on S&P’s full methodology, to include the items (and classifications) it analyses. The methodology includes actual scores attributable to each item, making the replication easier.
- As part of our analysis, we first examine the basic scorecards for five items, giving them a general score based on objective criteria (1) and another (2) for the so-called adjustments, which cover the fine-tuning aspects that can explain the difference in ratings between similar countries.
- We then match “structural” (institutional, economic) and “flexibility/performance” (external, fiscal, monetary) profiles, based on those scores, for the final rating outcome.

Luiz Eduardo Peixoto, Emerging Markets Economist | BNP Paribas London Branch
**Risks compounded by increasing debt piles:** Favourable liquidity conditions have led many companies and governments to borrow, with short-term debt forming a large portion of the borrowing (Figure 6). As a result, some sovereigns are likely to find it difficult to roll over their debt under much tougher financing conditions, and those with substantial needs this year (Figure 7) could be at risk of downgrades.

**Situation of corporates vary widely by country:** As noted by our Strategy team (see The channel of the US dollar into the real economy, published on 23 March 2020), corporate debt in some countries is mostly owned by foreigners. In the second half of 2019, out of 773 EM companies analysed, some 323 were rated BBB. Only about a third of these companies were high yield (Fig. 5).

**Fig. 5: Corporate credit ratings, distribution by country**

Sources: S&P, Bloomberg, CEMBI, BNP Paribas.

**Links to recent publications**

**Credit ideas**
- **Russia:** Sell protection through 5y CD, 25 March
- **Colombia** sovereign credit – Aftershock, 25 March
- **Brazil 5y CDS:** Attractive and 120bp above fair value, 24 March
- **EM - Harbingers of FX and rollover risk,** 24 March

**Macro fundamentals**
- **Emerging markets – Policy toolkit,** 23 March
- **Oil price slump and effects on EM domestic accounts,** 9 March
- **EM trade tracker - Weak momentum,** 19 February
- **EM inflation - Double dip,** 10 February

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