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Economics Group

WELLS FARGO SECURITIES

Special Commentary

Brendan McKenna, Macro Strategist
brendan.mckenna@wellsfargo.com • (212) 214-5637
Erik Nelson, Macro Strategist
erik.f.nelson@wellsfargo.com • (212) 214-5652
Nick Bennenbroek, Macro Strategist
nicholas.bennenbroek@wellsfargo.com • (212) 214-5636

COVID-19 Creating a Risk for EM Corporates

Executive Summary

- As the COVID-19 virus intensifies, demand for the U.S. dollar has increased significantly. Safe haven flows have contributed to the greenback strength, but a lack of dollar liquidity has also pushed the dollar higher against all G10 currencies, while emerging currencies have come under the most pressure.
- The rapid depreciation in emerging currencies is becoming concerning as corporates across emerging markets have accumulated a notable amount of debt denominated in U.S. dollars. As of the end of Q3-2019, USD denominated debt sitting on EM corporate balance sheets is the highest it has ever been.
- As emerging currencies continue to depreciate, USD debt repayment capacity is being eroded. A stronger U.S. dollar, coupled with dollar funding strains and rising sovereign dollar bond yields, could present challenges for EM corporates if they need to refinance existing debt and should corporates find refinancing difficult, it could place additional stress on emerging economies going forward.

King Dollar Rules Again

Throughout the course of the year, the COVID-19 virus has intensified, with over 395,000 confirmed cases globally and over 17,000 fatalities associated with the virus. As the virus has intensified and the forecasted impact on the global economy has gotten worse, volatility within financial markets has skyrocketed. Global equities continue to come under extreme pressure, while riskier assets continue to be sold. With the risk-off tone permeating global markets, the U.S. dollar has strengthened broadly against both G10 and emerging currencies. As of now, the U.S. dollar index (DXY) is up close to 6% this year, while the Advanced Foreign Economies dollar index is about 7.5% higher.

There are multiple factors that have contributed to U.S. dollars outperformance, but we will choose to focus on just two. The first is the dollar's status as a safe haven currency. In times of stress and elevated volatility in financial markets, the U.S. dollar is typically one of the safe haven currencies of choice for market participants. Over the course of the current downturn, the safe haven status of the U.S. dollar has broadly held up, and as of now, the greenback is one of the few currencies to benefit from the recent turmoil in financial markets.

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The second contributing factor to greenback strength, and perhaps the most influential over the path of the dollar right now, has been a severe lack of dollar liquidity. One of the indicators we look at to gauge dollar liquidity is cross-currency basis, which is essentially a premium investors pay to get access to dollars. As the cross-currency basis becomes more negative, it is more expensive for investors to gain access to dollars and is a signal that a shortage of U.S. dollars is becoming more severe. Over the last few months, we have seen cross-currency basis for major G10 currencies such as the Canadian dollar, Japanese yen and euro turn sharply negative, approaching levels not seen since the financial crisis of 2008-2009 and the peak of the European sovereign debt crisis in 2011.

As a result of the dollar's safe haven status and lack of dollar liquidity, foreign currencies across the G10 spectrum have all sold-off. In this context, the Norwegian krone leads G10 currencies lower, down over 21% as oil prices have collapsed and Norges Bank has turned to aggressive easing of monetary policy. In addition, the Australian and New Zealand dollars are under pressure as a result of the broad sell-off in risk-sensitive currencies and significant monetary

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easing from the RBA and RBNZ, while the Canadian dollar is weaker as the dual shock of lower oil prices and policy rate cuts weigh on the Canadian dollar. Even the Japanese yen, another typical safe haven currency, has depreciated this year as dollar funding constraints placed downward pressure on the currency.

Emerging currencies in particular have come under the most stress, with the JPMorgan Emerging Currency Index down around 13% so far this year. More specifically, high beta currencies such as the Mexican peso, Russian ruble, South African rand and Brazilian real are down over 20%, while other emerging currencies like the Colombian peso, Indonesian rupiah and Chilean peso have also come under pressure. Sentiment has broadly turned negative towards emerging currencies, while many central banks in emerging countries have cut policy rates significantly in an effort to offset the negative economic impact of the virus. As of now, it is difficult to see what reverses this trend and helps emerging currencies strengthen over the short to medium-term, while the longer-term outlook is becoming even cloudier.

EM Corporates Coming Into the COVID Crosshairs

USD denominated debt sitting on EM corporate balance sheets is the highest it has ever been.

Weaker currencies can present numerous challenges for emerging market economies, although one potential issue we are paying particular attention to is the amount of U.S. dollar denominated debt obligations of corporates in emerging economies. Q3-2019 data from the Institute of International Finance (IIF) indicates dollar denominated debt on EM corporate balance sheets is the highest it has ever been, a little over three trillion U.S. dollars. In addition, EM corporates have taken on more USD debt as a percent of GDP as well, with corporates in almost every emerging country we analyze more USD indebted than during the financial crisis of 2008-2009.

Figure 1

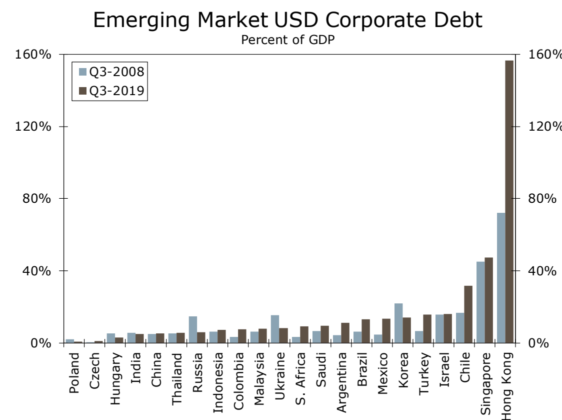
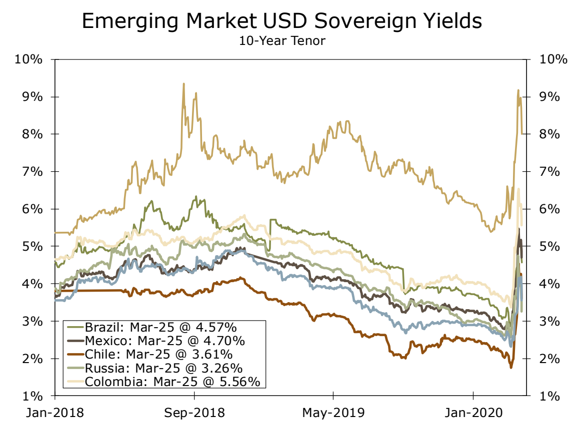


Figure 2



Source: Institute of International Finance, Bloomberg LP and Wells Fargo Securities

Elevated amounts of USD debt in the emerging world is not all that surprising as yields remained low as a result of significant monetary easing from the Fed post-financial crisis and as the U.S. dollar was relatively weak. Once the Fed suggested it would begin normalizing monetary policy in mid-2013 (i.e., Taper Tantrum), the dollar began to strengthen and the issuance of dollar denominated debt from EM corporates began to slow. However, given the sharp sell-off in many emerging currencies, the ability for many of these corporations to repay U.S. dollar-denominated debts could be starting to erode as these repayments are becoming more expensive as local currencies depreciate.

Sovereign yields of EM countries have spiked amid the current selloff in financial markets.

One potential solution for EM corporates could be to refinance their existing debt profile; however, in our view, refinancing outstanding USD debts may be quite challenging. Amid the risk-off tone in global markets, currencies haven't been the only emerging market asset class to come under pressure. Sovereign bonds of emerging countries have also experienced significant selling pressure as market participants look to de-risk amid the impact of the COVID-19 virus. Yields of many emerging market sovereigns have spiked recently, and despite having less

currency risk than local currency debt, USD yields have still risen significantly. With bond yields elevated, the refinancing is becoming more expensive and could put EM corporates in a difficult position when making financing decisions.

Economies Risk a Sharper Downturn

Looking ahead, we believe the current dynamics that are resulting in a surging U.S. dollar and higher emerging market sovereign yields are likely to continue over the short- to medium-term. Volatility is likely to stay elevated which should push yields higher and attract safe haven flows to the U.S. dollar, while dollar liquidity is likely to remain low, which should also result in dollar strength against most emerging currencies. Should the greenback continue to strengthen the way we currently forecast, emerging currencies are likely to stay under pressure for an extended period of time and it is possible that highly indebted countries could run into a situation where multiple corporates have difficulty paying debts. If a scenario materializes where numerous EM corporates have issues repaying debts, it is possible that multiple economies could experience stress on their respective financial systems and banking sectors, which in turn could lead to additional pressure on economies throughout the emerging world.

Should EM corporates have repayment issues, financial systems and banking sectors could come under pressure.

On the other hand, it is possible that the COVID-19 virus gets contained more quickly than expected and investor sentiment improves. In addition, central banks could find additional ways to free up dollar liquidity. The Fed's FX swap lines that have been announced should help with the lack of dollar liquidity, but authorities could conceivably extend these to additional central banks and provide even more access to U.S. dollars.

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Wells Fargo Securities Economics Group

Jay H. Bryson, Ph.D.	Acting Chief Economist	(704) 410-3274	jay.bryson@wellsfargo.com
Mark Vitner	Senior Economist	(704) 410-3277	mark.vitner@wellsfargo.com
Sam Bullard	Senior Economist	(704) 410-3280	sam.bullard@wellsfargo.com
Nick Bennenbroek	Macro Strategist	(212) 214-5636	nicholas.bennenbroek@wellsfargo.com
Tim Quinlan	Senior Economist	(704) 410-3283	tim.quinlan@wellsfargo.com
Azhar Iqbal	Econometrician	(212) 214-2029	azhar.iqbal@wellsfargo.com
Sarah House	Senior Economist	(704) 410-3282	sarah.house@wellsfargo.com
Charlie Dougherty	Economist	(704) 410-6542	charles.dougherty@wellsfargo.com
Michael Pugliese	Economist	(212) 214-5058	michael.d.pugliese@wellsfargo.com
Brendan McKenna	Macro Strategist	(212) 214-5637	brendan.mckenna@wellsfargo.com
Shannon Seery	Economic Analyst	(704) 410-1681	shannon.seery@wellsfargo.com
Matthew Honnold	Economic Analyst	(704) 410-3059	matthew.honnold@wellsfargo.com
Jen Licis	Economic Analyst	(704) 410-1309	jennifer.licis@wellsfargo.com
Hop Mathews	Economic Analyst	(704) 383-5312	hop.mathews@wellsfargo.com
Coren Burton	Administrative Assistant	(704) 410-6010	coren.burton@wellsfargo.com

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