EMERGING MARKETS DEBT

Investment Management
active.williamblair.com

2020 Outlook for Sovereign Debt Restructurings

Historically, a combination of high yield and minimal default risk has led emerging markets debt (EMD) investors to enjoy strong returns—but the impact of COVID-19 has called into question the potential for such favorable returns in the future. Historically speaking, however, markets have overestimated the probability of default and underestimated eventual recovery rates.

July 2020

Head of Emerging Markets Debt
Marcelo Assalin, CFA

Portfolio Managers
Jared Lou, CFA
Daniel Wood

Introduction

Historically, sovereign defaults in EMD have been rare events, and the combination of high yield and minimal default risk has led EMD investors to enjoy strong returns.

On the rare occasions that EMD issuers have felt it necessary to restructure their external debt obligations, investors have often been compensated with high recovery values, reducing their potential losses, as exhibit 1 shows.

"We believe the market has already priced and identified default candidates, and recovery values are generally understated."

However, the impact of COVID-19 has called into question the potential for such favorable returns. Not only has the virus had tragic consequences for human life, but the lockdown response also has had a devastating economic impact, with sharp downward revisions to global growth. This has led to fiscal deficits and debt ratios deteriorating at a significant pace. And this, in turn, has raised concerns about the sustainability of historic sovereign EMD returns and fears of an increase in default levels.

That said, we believe the market has already priced and identified default candidates, and recovery values are generally understated.

In the pages that follow, Jared Lou, CFA, and Daniel Wood, portfolio managers on our team, provide insights that I hope offer a useful guide to the current environment.

Marcelo Assalin, CFA
HEAD OF WILLIAM BLAIR'S EMERGING MARKETS DEBT TEAM

EXHIBIT 1

Recovery Rates on Defaulted Sovereign Bond Issuers

Default Year	Default Country	Rating at Default	Recovery Rates*
1998	Russia	Caa1	18%
1999	Pakistan	Caa1	52%
1999	Ecuador	B3	44%
2000	Ukraine	Caa3	69%
2000	Ivory Coast (NR)**	n.a.**	18%
2001	Argentina	Caa3	27%
2002	Moldova	Caa1	60%
2003	Uruguay	B3	66%
2004	Grenada (NR)**	n.a.**	65%
2005	Dominican Republic	B3	95%
2006	Belize	Caa3	76%
2008	Seychelles (NR)**	n.a.**	30%
2008	Nicaragua***	Caa1	49%***
2008	Ecuador	Caa1	28%
2010	Jamaica	Caa2	90%
2012	Greece	C	24%
2012	Greece	C	37%
2012	Belize	Ca	40%
2013	Cyprus***	Caa3	53%***
2013	Jamaica***	B3	89%***
2013	Grenada (NR)**	n.a.**	36%
2014	Argentina***	Caa2	68%****
2015	Ukraine	Ca	80%
2016	Mozambique	B3	88%
2017	Mozambique	Caa3	61%
2017	Belize	Caa2	65%
2017	Republic of Congo	Caa2	81%
2017	Venezuela	Caa3	23%
Issuer-Weighted Recovery Rates			**55%**
Value-Weighted Recovery Rates			**40%**

Source: Moody's Investors Services, "Sovereign Default and Recovery Rates, 1983-2017," as of July 2018. *Recovery is measured as the average trading price in percentage of the par value of the bond at the time of the initial default event, 30-day post-default for missed payments or around the close. ** NR = not rated by Moody's at the time of default. Pricing information is not available for three other recent unrated sovereign defaults on local-currency bonds: Turkey 1999, Dominica 2003, and Cameroon 2004. ***When the trading price is not available, we calculate an equivalent measure estimating the recovery as the ratio of the present value of the cash flows of the new debt instruments received as a result of the distressed exchange versus the outstanding face value of those initially promised, discounted by an approximated market yield at the time of default. ****For Argentina, the trading-price-based recovery rate at the time of default in 2014 was 68%. The ultimate recovery as of the time of default resolution in 2016 was about 97% as the missed interest payments were repaid in full.

Defaults Priced In, Recovery Values Understated

The bad news is that we believe that in 2020, we will likely see more sovereign defaults than we have ever seen before in a single calendar year. On a positive note, however, we believe the asset class is already priced to reflect this dynamic.

Argentina, Lebanon, and Zambia (and to a lesser extent Ecuador) were all pricing in a relatively high probability of default before COVID-19 affected financial markets. Each of these countries already had debt sustainability problems. While exacerbated by the negative impact of the coronavirus, these problems would have likely led to sovereign restructuring anyway.

Since the COVID-19 outbreak, Suriname, Belize, and Angola in particular have all begun to price in a high probability of default as well.

Despite an elevated number of restructuring candidates, there are reasons to be optimistic about the potential impact on future asset-class returns. First, Suriname, Belize, and Angola collectively represent less than 1% of the total value of the J.P. Morgan EMBIGD. Second, we believe few other emerging markets will be forced into restructuring. Third, we believe potential recovery values will be higher than the market is currently pricing.

There are a few reasons for this optimism. A sovereign default with a low recovery value can adversely affect a country's ability to access international capital markets, expose the country to litigation, and impair its citizens' standard of living. Therefore, it is generally in a sovereign issuer's best interests to reach a benign settlement agreement with creditors.

IMF and Multilateral Support

Investors can also be comforted by the multilateral support a sovereign issuer is likely to receive in order to improve current and future debt sustainability. This support comes through financial aid, and arguably more importantly, technical expertise and policy improvement. An IMF program's stamp of credibility generally reduces some of the uncertainty of economic policy, which can help motivate investors to invest.

As a recent example, African nations have asked multilateral creditors to provide $44 billion in debt relief while maintaining market access, which remains a priority for most. For those countries that have experienced liquidity issues rather than structural debt problems, the IMF has already disbursed billions of dollars under Rapid Financing Instruments (RFIs) to help countries combat the pandemic by alleviating pressure on potentially problematic financing gaps.

Defaults Remain Rare

Sovereign defaults remain rare and recovery rates relatively high, offering EMD hard currency investors attractive return potential. The main reasons are strong interest in retaining market access and strong support from multilateral organizations.

Moody's, for example, estimates that from 1983 to 2019, the sovereign default rate on bonded debt was only 0.73%, as exhibit 2 illustrates.[1] Median recovery rates have been about 52 cents on the dollar, implying that EMD sovereign credit spreads historically have offered investors a very attractive risk premium relative to historical credit losses.

Moreover, sovereigns want the ability to run fiscal deficits and need access to capital markets to fund them. They also want to act as a benchmark for companies within their borders to grow and access financing abroad. When a country is in default, these goals become problematic.

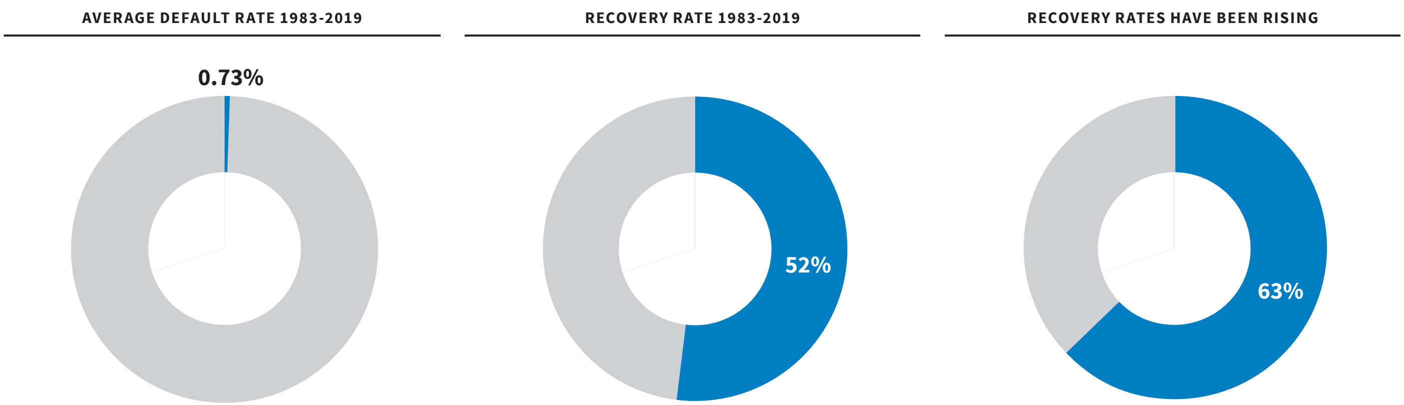
A Good Opportunity

Despite economic hardship brought on by the pandemic, we believe sovereign credit offers a very attractive opportunity set with respect to risk and reward. We believe that investors are being overcompensated for the risks, despite a higher-than-normal default outlook in 2020.

1 Source: Moody's Investors Services, "Sovereign Default and Recovery Rates, 1983-2019," as of May 2020.

EXHIBIT 2

Historical Default Rates



Moody's estimates that the **average default rate over the period 1983 to 2019** was 0.73%.

The **historical recovery rate** for emerging markets sovereigns over this period was 52%

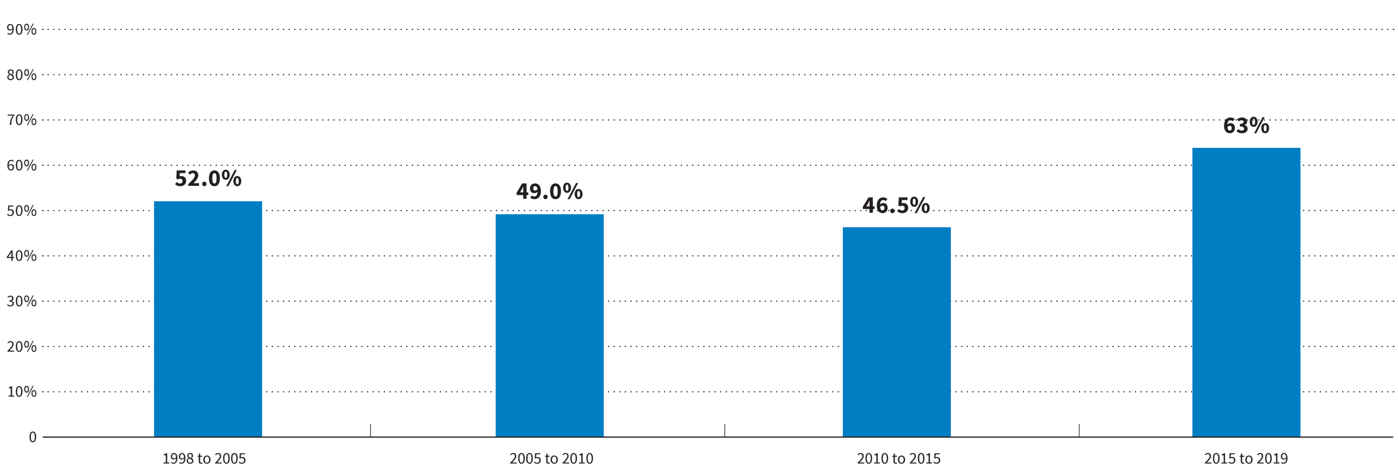
The **median recovery rate** from 2015 to 2019 was 63%.

- **The coronavirus crisis should result in a temporary increase in default rates.**
- **Multilateral and bilateral support limits the scope for widespread technical defaults.**
- **We believe default rates should converge toward the long-term average in the medium term.**

Source: Moody's Investors Services, "Sovereign Default and Recovery Rates, 1983-2019," as of May 2020.

EXHIBIT 3

Median Recovery Rates on Defaulted Sovereign Bond Issuers



Source: Moody's Investors Services, "Sovereign Default and Recovery Rates, 1983-2019," as of May 2020.

Our Experience With Historical Sovereign Defaults

Despite the favorable outlook we have for EMD returns, as mentioned above, we believe there will be a record level of restructurings across the asset class over the next two or three years.

Moreover, the process of restructuring can be long and complex. There are many complexities investors should understand and assess, including investor positioning, prospectus legalities, jurisdiction, bondholder rights, issuer mentality, issuer access to resources, reform efforts, and the future sustainability of debt stock.

Because of this, our team's decades of experience investing in emerging markets and seeking enhanced returns from distressed sovereign assets should prove valuable. Below we highlight some lessons we have learned working with sovereign defaults.

Politics and Policy Matter

Many politicians have strong ideological viewpoints that may contrast with lessons learned in economic history. Politicians rarely see the world in the same way technocrats do. Understanding the political and economic motivations of a particular regime regarding capital market access is very important in determining the probability of default and potential recovery values.

Latin America has historically had more defaults than other parts of the world. In Latin America, high exposure to cyclical commodities, inadequate buffers, populism, and unsustainable currency/current account dynamics have all been catalysts for default. However, each country in the region differs in both its economic policy and attitude toward investors. Understanding these dynamics is key to determining the investment case for each sovereign issuer.

For decades, Colombia has pursued drastically more market-friendly policies than Venezuela, and the two countries have experienced drastically different economic outcomes.

Why Nations Fail[2] illustrates this point well. The author argues that political inclusion leads to economic inclusion, which leads to a reason for the private sector to invest, eventually leading to successful nations. Countries that enact policies that market participants believe in will likely experience economic success, which may lead to lower credit spreads and greater market access than countries that do not enact policies that market participants believe in. Countries with low credit spreads are likely to have a more successful private sector because firms located within the country will experience a lower cost of capital.

> "Understanding the political and economic motivations of a particular regime regarding capital market access is very important in determining the probability of default and potential recovery values."
>
> **Daniel Wood, Portfolio Manager**

Aside from politics determining policy and the likelihood of default, politics can also play a material role in how and when a country exits default.

Willingness to Pay Can Matter Just as Much as Ability to Pay

Venezuela is perhaps the best example of the importance of willingness to pay. When Nicolás Maduro succeeded Hugo Chávez in 2013, he tried to honor the country's debt, and Venezuela continued to service its debt long after most countries would have considered reasonable. Venezuela had a particularly high willingness to pay because oil is essentially the only source of foreign exchange in the country. All assets for marketing and refining Venezuela's oil are in the United States and potentially subject to attachment via a judgment from a U.S. court.

Similarly, outside Latin America, Ukraine and Iraq continued to service their debt despite military and terrorist incursions causing these countries to lose control over significant parts of their territory.

2 Acemoglu, Daron. Why Nations Fail: The Origins of Power, Prosperity and Poverty. London: New York: Profile; Crown Publishers, 2012.

On the other side of the spectrum, while still maintaining the ability to pay, Ecuador defaulted in 2009 for political reasons. Targeting the restructuring of specific bonds issued in a restructuring earlier in the decade by a former administration, President Rafael Correa surprised the market by refusing to honor this debt commitment.

Africa Has a History of Debt Forgiveness—a Topic Again Up for Discussion

The Multilateral Debt Relief Initiative (MDRI) in the mid-2000s provided many highly indebted poor countries (HIPCs), most in Sub-Saharan Africa, multilateral debt forgiveness.

This was controversial, with many arguing that the MDRI was a failure because debt-service costs have risen to pre-debt-relief levels (as a percentage of revenues).

The coronavirus crisis has once again elevated the importance of the topic of debt relief. A dramatic fall in growth levels across Africa, caused by the virus, has left many countries on the continent with unsustainable levels of debt. African countries are now engaging international financial institutions such as the IMF and World Bank as well as other multilateral and private creditors.

In addition to debt forgiveness from multilaterals, discussing a payment freeze with private creditors has also been on the table for negotiations. Debt relief today from private creditors would likely lead to decreased market access and higher credit spreads in the future, so it is not our base-case assumption that Eurobond holders will be widely expected to participate in losses that arise as a result of debt forgiveness and coupon suspension.

> "When a country faces economic hardship, creditor engagement and dialogue is generally the most constructive method of finding a solution."
>
> **Jared Lou, CFA, Portfolio Manager**

Legal Considerations Can Prevent Sovereigns From Borrowing

Though creditors generally have weak legal recourse, creditors can prevent sovereigns from borrowing again in the international capital markets if they get a judgment.

Argentina, for example, was locked out of international capital markets for 15 years following its 2001 default.

One way sovereign bond documentation has evolved is the inclusion of a more clearly worded *pari passu* clause in the new International Capital Markets Association (ICMA) standard.[3]

When 75% or more of bondholders support a restructuring, it becomes more challenging to claim it has been unsuccessful. Public perception can matter in sovereign restructurings, which is one reason (among many) why a consensual solution is preferred.

3 Pari-passu is a Latin phrase that means "equal rank."

Three Potential Areas of Win-Win

Through our experience working on sovereign debt restructurings over the past decade, our team has recognized the following three ideas that can help result in a win-win situation for both the investor and the sovereign.

1. Whether the default was caused by force majeure[4] or policy mismanagement, having a credible policy framework can lead to a reduction in borrowing costs and lower exit yields.

Take a look at Argentina today. Many in Alberto Fernandez's party believe that Argentina suffers from a structural shortage of dollars. But if you placed a million pesos in the bank in Argentina in the 1990s, it would be worthless today. Given the history of monetary financing and value destruction, why would you bring your dollars into Argentina today?

As negotiations with creditors evolve, a credible policy framework would likely result in a lower discount rate implied by the market, which would result in a win-win situation for Argentina and its creditors.

The less frequently sovereign defaults occur and the more often market-friendly policies are enacted by emerging markets sovereigns, the lower average credit spreads will likely be for countries that wish to borrow in international markets.

Sovereign defaults can lead to greater risk premiums in the asset class, potentially providing greater excess returns for those with the right skill sets.

2. Value recovery instruments (VRIs) can be successful in sovereign restructurings if structured well.

Following the 2008 global financial crisis, the idea of a debt-for-equity swap seemed like the only plausible way forward for many highly indebted companies. GDP and oil warrants have been used in sovereign debt restructurings to achieve the same result.

Although we believe VRIs have merit, creating a perfectly structured instrument is close to impossible. A common criticism of the GDP warrants issued during Ukraine's 2015 restructuring is that they left the potential upside for investors uncapped.

Nevertheless, VRIs can be a useful and fair tool to provide creditors some upside if economic conditions improve more than expected. Ultimately, they can help get deals done and reduce fixed cash payments the sovereign would otherwise need to pay as they allow creditors to recoup losses and participate in a country's success (or failure).

Meanwhile, debt sustainability analyses (DSAs), although a useful tool for discussion, are flawed (in our view) because they require many assumptions about economic variables that are notoriously hard to predict (exchange rates being one of them).

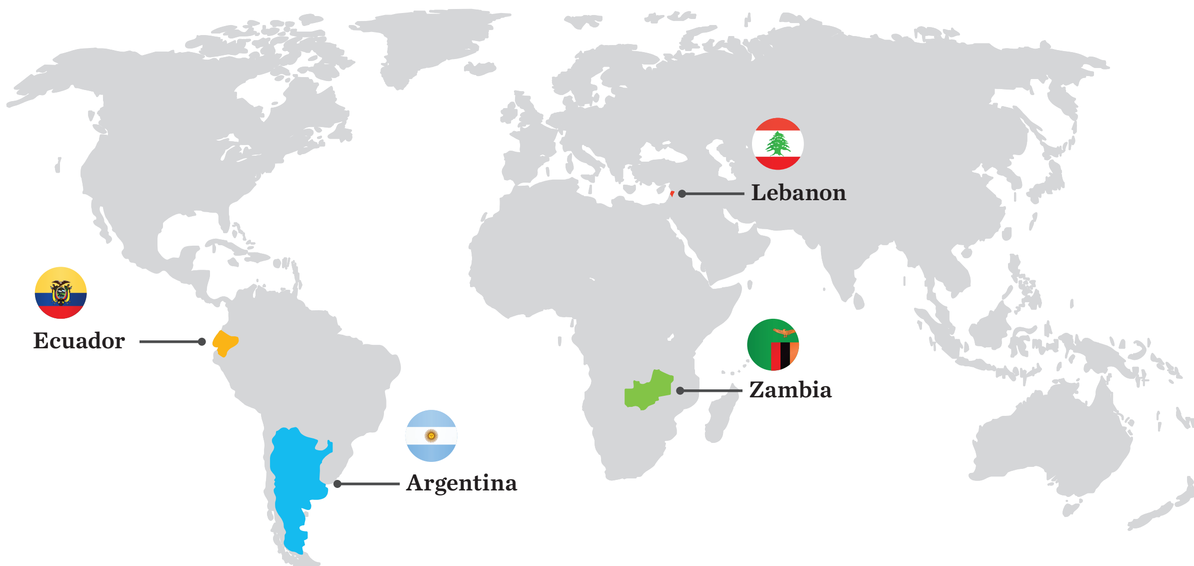
We thus believe VRIs will be key ingredients in restructurings in both Argentina and Venezuela—eventually.

3. Lawyers usually benefit the most when litigation is required.

Many times when a creditor is forced to exercise the rights and remedies in an indenture, both the country and the bondholder are in a difficult predicament, and legal action may be considered. The statute of limitations is one reason filing a lawsuit may make sense. However, our team has experience with sovereign litigation, and we know well that litigation is a path that should not be considered lightly. Even while in default, interest continues to accrue at the federal judgment rate, which is usually less than the coupon rates of most emerging markets bonds. In some instances, then, it is simply better to wait than litigate.

4 An unforeseeable circumstance that prevents someone from fulfilling a contract.

Outlook for Sovereign Defaults in 2020



Now, let's look at the countries that are likely to restructure in 2020 and explain how we believe we are positioned to capture excess returns on behalf of our investors.

Argentina

In the fall of 2019, many investors were hopeful that Alberto Fernandez would be a pragmatic leader who would take policy in a materially different direction than his Peronist predecessor (and current vice president) Cristina Fernandez de Kirchner.

The evidence so far seems mixed, with the most recent example of the government seizing soy-bean-crushing company Vincente making us wonder who really is in charge.

However, what Fernandez seems to understand differently than his predecessor are the limits and shortcomings of monetary financing. It is hard to think of a historical precedent in which monetary financing has been a successful strategy.

Ultimately, Argentina would prefer to finance a deficit rather than run fiscal surpluses, but to do that it would need to regain market access—and to regain market access it needs both successful debt restructuring and policy credibility.

Unsuccessful negotiations with bondholders will not achieve any of these objectives. We believe a compromise will ultimately be made, offering upside from today's prices.

The best thing Argentina can do for itself today is to implement policies that will convince the world that another default will not occur in the future.

> "Despite an elevated number of restructuring candidates, there are reasons to be optimistic about the potential impact on future asset-class returns."
>
> **Jared Lou, CFA, Portfolio Manager**

Ecuador

During a conference call in the fall of 2019, the IMF lauded the Ecuadorian administration for trying to enact an ambitious and unpopular fuel subsidy reform. But protests crippled the country and eventually forced the government to backtrack (presumably led in absentia by former President Correa). Then, in May 2020, the government once again tried to liberalize fuel prices (and succeeded). But then COVID-19 struck, and Ecuador has been one of the hardest-hit Latin American countries.

Given the stresses from oil and COVID-19, creditors (us included) gave Ecuador the benefit of the doubt and voted to delay coupon payments until August. This was in great part due to Minister of Finance Richard Martinez dramatically improving Ecuador's credibility in the international bond market, which had never repaid a bond in its history until 2015.

Given the market-friendly policy and credibility earned by Martinez, we believe bondholders are better off enacting a friendlier restructuring with this administration than delaying the restructuring until the next administration. Elections are scheduled for February 2021.

Ecuador has been one of our larger overweights in our hard currency strategy, and we still see upside from current levels, albeit limited, in our opinion.

Lebanon

For decades diaspora Lebanese poured their deposits into the banking sector. Banks then bought government bonds, helping finance unsustainable deficits longer than any responsible country should have been able to stay afloat.

Political and social challenges ensued. Lebanon was unable to form a government for years, leading to poor policy management (particularly fiscal). That led to the calamity we have today. Lebanon is in dire shape, with debt-to-GDP ratios above 150%.

This leads us to believe that recovery values in Lebanon may be lower than the median recovery value of EMD sovereigns. Having said that, we believe the market overreacted as bond prices fell precipitously, and we see value in the bonds going forward.

Zambia

Macroeconomic mismanagement has been rampant in Zambia for years. Domestic debt has been issued at particularly high rates and inflation has been soaring. Debt-to-GDP ratios have more than tripled from 2013 to approximately 90% today. And Zambia recently hired a debt restructuring advisor to begin talks. We had a favorable view of Zambian bonds, but would need to see a commitment to reforms to reduce exit yields.

Conclusion

When thinking about what the future holds for these counties, we cannot stress enough that policy really matters when navigating a sovereign default. Policy can have significant economic consequences for a country and its citizens.

Although different cultures have different views of what works, we have learned many lessons by looking at economic history. Although we believe Eurobond financing is beneficial to emerging market sovereigns in aggregate, the Eurobond market does not serve the same purpose as multilateral financing. Multilaterals, although not always aligned with bondholders, can help implement reforms and point countries in the right direction. In the aftermath of COVID-19, we expect multilaterals to play an even larger role in helping countries recover from an unprecedented economic shock.

> "Historically speaking, markets have underestimated eventual recovery rates, and have overestimated the probability of default."
>
> **Jared Lou, CFA, Portfolio Manager**

Historically speaking, markets have underestimated eventual recovery rates, and have overestimated the probability of default. We believe that the underestimation of recovery values will likely be the case today in the four distressed sovereigns discussed above. Thus, we hold overweight positions in these sovereigns, with the magnitude depending on our conviction level.

We will continue to engage via creditor committees and look forward to participating in a resolution that will once again seek to align investors' incentives with those of the countries and ultimately open capital markets again for these countries in the near future. As shown in *Why Nations Fail*, we believe improving the conditions for private sector investment is critical to a country's economic success.

About William Blair
William Blair is committed to building enduring relationships with our clients and providing expertise and solutions to meet their evolving needs. We work closely with most sophisticated investors globally across institutional and intermediary channels. We are 100% active-employee-owned with broad-based ownership. Our investment teams are solely focused on active management and employ disciplined, analytical research processes across a wide range of strategies. As of March 31, 2020, we manage $46.6 billion in assets. We are based in Chicago with resources in New York, London, Zurich, Sydney, Stockholm, and The Hague, and dedicated coverage for Canada.

Important Disclosures
This material is provided for information purposes only and is not intended as investment advice, offer, or a recommendation to buy or sell any particular security or product.

This material is not intended to substitute a professional advice on investment in financial products and any investment or strategy mentioned herein may not be appropriate for every investor. Before entering into any transaction each investor should consider the appropriateness of a transaction to his own situation and, the need be, obtain independent professional advice as to risks and consequences of any investment. William Blair will accept no liability for any direct or consequential loss, damages, costs or prejudices whatsoever arising from the use of this document or its contents.

Any discussion of particular topics is not meant to be complete, accurate, comprehensive, or up-to-date and may be subject to change. Data shown does not represent and is not linked to the performance or characteristics of any William Blair product or strategy. Factual information has been taken from sources we believe to be reliable, but its accuracy, completeness or interpretation cannot be guaranteed. Information and opinions expressed are those of the author and may not reflect the opinions of other investment teams within William Blair. Information is current as of the date appearing in this material only and subject to change without notice. This material may include estimates, outlooks, projections and other forward-looking statements. Due to a variety of factors, actual events may differ significantly from those presented.

Past performance is not indicative of future returns. Investing involves risks, including the possible loss of principal. Investing in foreign denominated and/or domiciled securities may involve heightened risk due to currency fluctuations, and economic and political risks. These risks may be enhanced in emerging markets. Investing in the bond market is subject to certain risks including market, interest rate, issuer, credit, and inflation risk. Rising interest rates generally cause bond prices to fall. Sovereign debt securities are subject to the risk that an entity may delay or refuse to pay interest or principal on its sovereign debt because of cash flow problems, insufficient foreign reserves, or political or other considerations. High-yield, lower-rated securities involve greater risk than higher-rated securities; portfolios that invest in them may be subject to greater levels of credit and liquidity risk than portfolios that do not. Individual securities may not perform as expected or a strategy used by the Adviser may fail to produce its intended result. Diversification does not ensure against loss. Portfolio information is based on a representative portfolio and is subject to change without notice.

The **J.P. Morgan Emerging Market Bond Index Global Diversified (EMBIGD)** tracks the total return of U.S.-dollar-denominated debt instruments issued by sovereign and quasi-sovereign entities. (Index information has been obtained from sources believed to be reliable but J.P. Morgan does not warrant its completeness or accuracy. The indices are used with permission. The indices may not be copied, used, or distributed without J.P. Morgan's prior written approval. Copyright 2020, JPMorgan Chase & Co. All rights reserved.)

This material is distributed in the United Kingdom and the European Economic Area (EEA) by William Blair International, Ltd., authorized and regulated by the Financial Conduct Authority (FCA), and is only directed at and is only made available to persons falling within articles 19, 38, 47, and 49 of the Financial Services and Markets Act of 2000 (Financial Promotion) Order 2005 (all such persons being referred to as "relevant persons"). This document is distributed in Australia by William Blair Investment Management, LLC ("William Blair"), which is exempt from the requirement to hold an Australian financial services license under Australia's Corporations Act 2001 (Cth) pursuant to ASIC Class Order 03/1100. William Blair is registered as an investment advisor with the U.S. Securities and Exchange Commission ("SEC") and regulated by the SEC under the U.S. Investment Advisers Act of 1940, which differs from Australian laws. This document is distributed only to wholesale clients as that term is defined under Australia's Corporations Act 2001 (Cth).

This material is not intended for distribution, publication, or use in any jurisdiction where such distribution or publication would be unlawful. This document is the property of William Blair and is not intended for distribution or dissemination, directly or indirectly, to any other persons than those to which it has been addressed exclusively for their personal use. It is being supplied to you solely for your information and may not be reproduced, modified, forwarded to any other person or published, in whole or in part, for any purpose without the prior written consent of William Blair.