Quarterly Market Letter
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Quarantined World: The Largest Economic Shock of Our Lifetime

Macroeconomic Developments

Current credit market conditions are fragile but functional, following a growing sense of epidemic crisis exacerbated by an oil price war.

- The World Health Organization (WHO) formally declared that **coronavirus (COVID-19) is a global pandemic**. Governments are responding with 'lock downs' and travel bans. A dangerous pandemic in a highly-integrated global economy is an unprecedented shock and, with ever more countries in lockdown, causing a record drop in global GDP. Larger and faster policy actions than ever before are providing life support until a post-virus world is reached.
- COVID-19 has already spread to virtually every country in the world and cases, almost everywhere, are soaring. The **lockdown measures** put in place to contain it are curtailing economic activity, driving up unemployment, and depressing international trade. They have forced central banks and governments to commit trillions of dollars to keep households and companies afloat and prevent financial markets from seizing up. The IIF (Institute of International Finance) warns that the recession is likely to commence with global debt roughly USD 87tn (40%) higher than at the time of the Global Financial Crisis of 2008 (GFC1). Corporate debt is a particular problem. Central bank balance sheets are expected to increase by one-third compared with pre-crisis levels. U.S. money supply growth could end up being 15-20% according to Cross-Border Capital, which might augur a potential start of a **liquidity bubble** (there tends to be a financial crisis every 10 years).

- V-shaped recoveries are common in **economies**, less common in **markets.** The speed of market moves in this recession is unprecedented due to illiquidity. Many countries may be now past the peak, which suggests that <u>limited reopening of the economy may be weeks, rather than months away</u>, and that some of the models are overly pessimistic. Market volatility remains remarkably high, but for credit markets. It is important to acknowledge a key positive shift: the strengthening of the policy support in both the U.S. and Europe. Credit markets are nervous but remain functional. Lately, there is news that COVID-19 mortality rates, especially

in Italy and France, are moderating. Likewise, U.S. President Donald Trump said that there were signs that the virus might be stabilizing. Major equity markets are attempting to consolidate after the exceptional degree of de-risking and de-leveraging. Money market and corporate credit indicators are gradually improving, though dollar funding is still somewhat tight.

- **Record drop in global GDP:** This is the steepest global GDP slide since WWII and the eighth global recession since 1900. Labor markets in freefall are testing the limits of enacted policies to cushion the blow. JPM expects the global economy to experience an 11% fall in 1H20 and then rise by 13% during 2H20. A tepid China rebound has begun, but there are risks that restrictions are renewed in Asia. The IMF had once again downgraded its forecast for global GDP for 2020 and 2021. Managing Director Kristalina Georgieva remarked to the G20: "In our current baseline scenario, announced policies are implemented and China's economy would return to normal in the second quarter. As a result, the impact on the world economy would be relatively minor and short-lived". Even prior to COVID-19, the global economy was slowing down, as world trade slumped in reaction to the trade war. A significant part of the global economy currently faces recessionary conditions, i.e. China, the Eurozone and Japan, which collectively account for 35% of global GDP. There are other factors at work that will impede a quick recovery. IIF sees global activity falling more than 1% this year, with major developed markets in recession. According to the Organization for Economic Co-operation and Development (OECD), for each month of containment, there will be a loss of 2pp in annual GDP growth. The International Labor Organization (ILO) reckons that COVID-19 will cut working hours globally by 7% in the second quarter – equivalent to a loss of 195mn full-time workers. There is particular concern about countries entering shock under high external and fiscal vulnerability (i.e. South Africa) and places where cumulative growth underperformance is staggering (i.e. Mexico).

- The world's top oil producers pulled off a historic deal to cut global petroleum output by nearly a 10th, putting an end to the devastating price war between Saudi Arabia and Russia. **The price of crude had crashed** when Saudi Arabia and Russia, two of the world's oil super-powers, failed to agree on how to respond to plunging demand because of COVID-19 and threatening other higher-cost producers the world over. Brent crude, the global benchmark, tumbled to the low 30s. Oil price shock and COVID19 set to bring a **recession to the MENA** region for the first time in three decades. Oil demand destruction could amount to 9.1 mbd in 1H20. The main issue for the global oil market is the dramatic hit to global demand, which could contract circa 20% to 25%.

- COVID-19 **infection rate** is near zero in China. The China curve is in the recovery stage, but there is a risk of a second wave. Industrial activity seems to have plateaued. High-frequency indicators continue to decline in most countries outside of China. The most important determinant will be the progression of COVID-19 and whether the shelter in place order is rescinded on April 30. It is estimated that at least 25% of those infected with COVID-19 are asymptomatic as the Centers for Disease Control and Prevention has indicated.

- **EM economies** are falling into recession. The COVID-19 shock has resulted in a pronounced sudden stop in capital flows to Emerging Markets. JPM forecasts a 2.1% contraction in 2020 EM growth, ex-China, while the pace of outflows is now exceeding the 2008 Global Financial Crisis. EM policymakers are prioritizing growth as EM central banks act decisively with a mix of large rate cuts and other measures; fiscal policy likely to take center stage. EM monetary policy getting easier. Taylor-rule models suggest EM rates are still too high and need to be cut further. A global solution may be required to alleviate the USD liquidity crunch in EM, with focus on the IMF as the lender of last resort for EM, as over 100 countries have so far approached the Fund for emergency funding. The economic impact of the coronavirus on younger, low income countries would allegedly come primarily via the economic hit seen in developed markets – and not through self-imposed lockdowns.

- **FX:** The U.S. dollar often strengthens when risky assets decline: Some of it likely reflects classic "safe haven" flows, like buying of U.S. Treasuries. Other factors, related to the dollar's unique place in global trade and finance, also play a role—including a reduction of over-hedged equity positions and FX reserve rebalancing. For these reasons the **dollar should remain firm as long as risky assets remain weak.** If the S&P 500 makes new lows, the broad dollar will probably make new highs. Under the current environment it is complicated to forecast a materially weaker USD unless some extremely positive news out of healthcare professionals regarding COVID-19 treatments and/or innovative infection amelioration techniques come about.

- **Global trade had contracted in 2019** for the first time since the financial crisis and for only the second time since 1990. Although the trade deal between the U.S. and China removed the risk of a further escalation, a 25% tariff on $250bn in Chinese imports and a 7.5% tariff on another $120bn of imports remained in place.

- **U.S.:** Bloomberg puts the chance of U.S. recession in the next year at 100%. The Fed intervention and the passage of a record-breaking $2tn+ U.S. fiscal stimulus has supported fragile consolidation across many markets. Record U.S. debt levels alongside record U.S. fiscal deficits. Unemployment rate is expected to increase to 30%. Initial jobless claims reached a record of 6.6mn, vs 211,000 claims filed just three weeks before and shattering the previous high of 692,000, reached in 1982. McKinsey analysis finds that the first phase of the battle to contain COVID-19 could leave 42 million to 54 million net jobs vulnerable to reductions in hours or pay, temporary furloughs, or permanent layoffs. Record fiscal stimulus portends a massive expansion in issuance by the U.S. Treasury of about $3tn by year-end. Unprecedented $2tn+ fiscal stimulus bill will provide direct aid to individuals and small businesses as well as support for credit and financial markets. This comes after another round of Fed facilities to ease funding and liquidity pressures in the markets.

- **China** is FIFO, and its manufacturing activity as of mid-March shows a 30-40% recovery above normal levels, but consumption and exports have lagged. While supply chain disruptions across North Asia have started to ease along with China, the step-up in containment measures in the rest of EM are driving

widespread direct shutdowns of industrial activity.

Virus Timeline

The assumption embedded in what could be the too optimistic estimates for GDP in 2020 is that "life as we know it" will return to "normal" on May 1st after the shelter in place order expires. It is assumed that the number of infections will peak in mid-April and then trend lower.

The amount of testing that needs to be done and the development of an effective convalescent plasma therapy will not occur by the end of April or May, and a vaccine will not be available for at least a year. Containing the spread of COVID-19 will not be achieved by April 30 or the end of May, even if the infection rate has peaked and is falling. Suspending the shelter in place rule will require balancing the damage to the economy and the mental health of many, versus the risk of incurring a second wave of infections.

If the shelter in place rule is extended from April 30 to May 31 or beyond GDP estimates for 2020 will be revised lower as will S&P 500 earnings. We are not sure financial markets have priced in this risk.

Global Drivers

Global Growth

As Dr. Fauci has said, "You don't make the timeline, the virus makes the timeline."

Global growth stalled this quarter due to COVID-19 shock, however, China may be picking up in 2Q. The global economy ground to a virtual standstill in March as many countries invoked shelter in place orders for their citizens, major states in the U.S. followed suit, and the majority of service sector businesses were ordered to close their doors. The decline during March was unprecedented and larger than anything experienced even in the financial crisis. Unfortunately, the data for April is likely to worsen, as many of the lock downs didn't take effect until the second half of March.

Fed Policy Outlook

Moving to zero. The Fed announced a wide range of new measures, including buying a potentially uncapped amount of Treasury securities and agency mortgage-backed securities.

The FOMC cut the federal funds target range to a 0.00-0.25%. COVID-19, the stock market slump and the economic crisis compelled the Fed to take the fed funds rate back to near zero, adopt explicit QE and re-launch the GFC1 "alphabet soup" programs. The Fed's balance sheet now stands at a record high of USD 5.6tn, according to the weekly Fed H.4.1 Report. By the end of this year, the Fed's balance sheet could easily double in size. The Fed announced a $1,500bn repo operation.[1] Part of the problem is the big banks are not lending. A bigger problem is the highly unusual disruptions in the Treasury market. This is a problem because Treasuries are the risk-free anchor for an estimated $50tn in global dollar denominated debt.[1] Yet, gradually these problems are being solved.

Helicopter Money is finding its way into the real economy, whereas previous QE programs kept the money in the financial system. Hence there was just financial asset price inflation but not goods and CPI inflation as officially measured. Longer-term inflation expectations as of now remain depressed. A sharp increase in U.S. Treasury borrowing this year to USD 3tn is to be mostly absorbed by the Fed. The Fed has also acknowledged the problem of the dollar short,

[1] State Street Global Markets, March 2020

where dollar borrowers in the global economy struggle to find dollars. The Fed's extension of its FX swap lines and introduction of a repo facility for foreign monetary institutions goes some way to mitigating dollar funding pressures. It is certainly true that money market pressures are also easing, with LIBOR rates now starting to edge lower across the curve.

Commodities

Oil prices suffered their biggest one-day drop since the first Gulf war, one of its most dramatic declines in history. YTD WTI Crude has fallen about 67% to around $20/barrel, but later rebounded a bit. After a week-long marathon of bilateral calls and video conferences of ministers from the OPEC+ alliance and the Group of 20 nations, an agreement finally emerged.

Moscow said it's willing to reduce output by 1.6 million barrels a day, or roughly 15%. OPEC+ will cut 9.7 million barrels a day – just below the initial proposal of 10 million. Oil prices recovered. At stake is the fate of entire oil-dependent economies, thousands of companies and millions of oil industry jobs. Mexico won a diplomatic victory as it will only cut 100,000 barrels – less than its pro-rated share, having blocked the deal since the plan was first revealed on Thursday. Now its future inside OPEC+ is uncertain, as it's expected to decide over the next two months whether to leave the alliance, delegates said. The biggest winner appears to be Trump, who refused to actively cut American oil production and personally brokered the deal over phone calls with Mexican President Andres Manuel Lopez Obrador, Russian President Vladimir Putin and King Salman of Saudi Arabia.

The production restraints are set to last for about two years, though not at the same level as the initial two months. Copying the model adopted by central banks to taper off their bond buying, OPEC will also reduce the size of the cuts over time.

EM Investment Outlook

The bubble has burst. The macro scenario has downside and will take time to play out. A defensive posture makes sense.

Financial markets have started to take a more positive view of the outlook. The initial improvement was mostly policy-driven, but the greater optimism of the past week seems to be at least partly related to the virus itself. Investors' focus is actually on how the trajectory of the COVID-19 infection and mortality rate unfolds, especially in the U.S., UK and Europe.

The stock market has rallied in response to programs by the Federal Reserve to ease stresses in the financial markets. It is far too soon to signal the all clear, but we are observing signs of stabilization in COVID-19 case numbers. These are not yet at the stage where they signal that investors should overweight stocks relative to bonds, but they are less negative than a month ago. The market has also rallied as the number of infections seems to have peaked in New York State, Italy, as well other countries; and soon the number of deaths will also decline. This success in bringing down the rate of infection has been achieved by an unprecedented directive to effectively shut the economy down to limit interaction. The harsh reality is there are no treatments to help those who become infected in coming weeks, and a vaccine is at least a year away.

The second quarter is expected to show an exceptional contraction in real GDP growth. Indeed, Bloomberg's economy tracker suggests that a global recession started last month. The fact is that most of the major economies are largely shutdown. A recovery is contingent on

lockdowns being lifted and people returning to work. Investors hope this is sooner rather than later, but the risk, of course, is that economic recovery is deferred.

De-risking and de-leveraging are the main investment themes. Equity market sentiment generally remains fragile and VIX volatility is still elevated, but nevertheless there are signs that equity markets might stabilize and avoid a retest of the lows. The current narrative that the combination of unprecedented monetary and fiscal accommodation will revive the economy sooner and spur a strong second half rebound is powerful and a view most investors hope will develop. Since the financial crisis investors have been taught the stock market always goes up when the Fed is expanding its balance sheet. No one has ever experienced the economic fallout from a global pandemic, and human tendency is to go with what we know. Historical evidence says that equities, volatility and credit respond more to very early signs that growth is bottoming, while the major shifts in government bond and commodity markets seem to require something closer to a return to trend growth. When the rate of deterioration slows, even before real recovery occurs, and that is usually enough for market recovery to begin.

In EM, while the selloff has been fairly indiscriminate to date, we anticipate more differentiation as markets start to stabilize and investors become more focused on countries' external and fiscal vulnerabilities. Broadly speaking, we find that Asian economies typically score better on measures of external and fiscal sustainability, while the performance of economies in LatAm and CEEMEA is more mixed. IIF daily tracker of flows to EM is recording unprecedented outflows that exceed by a large margin the 2013 taper tantrum and the GFC1.

The developed world can afford to feed its people for months while the economy remains shut down, but EM does not. The levels of informality that continue to exist in the EM region are too significant, and the regional fiscal authorities do not have the degrees of freedom that the developed world has to react to this crisis via the implementation of aggressive spending policies. We believe that unless this crisis finds a climax in the next couple of weeks, markets will see a fair amount of negative news flow out of the region, with, under an extreme scenario, even well-run high-grade countries being forced to approach the IMF to receive some financing respite. Our base-case scenario remains that the LatAm region succumbs to an intense recession, but that high-grade countries (Panama, Peru, Chile) in the region continue to have access to voluntary markets.

The broad challenge is that this crisis is unique in its source and speed - rather than starting in the financial system and emanating out to the real economy, it begins with a sudden stop in the real economy and works its way into financial markets - and it is still possible to imagine scenarios where the stop is longer and leads to much larger economic losses. Given the risk of forthcoming downgrades and defaults – as well as significant challenges to corporate profit margins – the next phase of this economic cycle is going to be a slog and the battle for a substantial recovery will be a long one.

Emerging Market Equities

The quick spread of the COVID-19 virus and the ensuing economic havoc has brought the global economy to a standstill. In early March, the standoff between Russia and Saudi Arabia also caused a major downturn in oil prices. The combination of these events led to a historic

selloff in emerging market equities in 1Q. We have been more active than usual and are using the market volatility to improve the composition of the portfolio into higher-quality ideas. Having managed portfolios through similar crises such as the SARS virus, we believe fear-based selloffs are great opportunities to improve the quality of the portfolio if one can tolerate some short-term pain in the process. Given the availability of numerous high-quality companies at historically low valuations, we have both lowered the number of names in our portfolio and increased the weights to our highest-conviction ideas, which we have done in prior selloffs.

Going forward, we are seeing early stages of a rebound in EM, albeit on a selective basis. China, Taiwan, and South Korea are the three largest countries in the MSCI EM Index: they all have seen the number of new COVID-19 cases drop precipitously in recent weeks, and their equity markets have responded accordingly. We have been increasing our weights in these three countries since the crisis began by initiating positions in many world-class companies. The next largest countries in EM are India and Brazil, and they both appear to be still in the earlier stages of the virus growth. We would expect their markets to continue to stay volatile in the near-term, and our plan is to use the volatility to initiate positions in more high-quality companies that may drop to attractive prices for long-term investors. From a sector standpoint, we have increased weights to Communication Services (tech companies that stand to benefit from recent dislocations) and Materials (gold companies). We have lowered weights to Energy (we expect a short-term snapback then further volatility downwards) and Consumer Discretionary (anticipating further weakness in discretionary purchases).

With the help of our in-house economist, we are also carefully watching emerging market currencies for signs of stress: the recent oil downturn has created a mixed bag of winners and losers, and some EM countries may have difficulty paying for stimulus packages without significant economic stress. While the speed and magnitude of the recent EM selloff has been historic, we are surmising that EM in aggregate has already taken the worst of the blow and may relatively outperform developed markets that still have to bear significant economic pain in the short-term. While the next few months will be turbulent, we are confident that after COVID-19 is conquered by human innovation and cooperation, the global economic rebound driven by pent-up demand and coordinated liquidity by global central banks will be as historic as the recent downturn. We also anticipate the recent U.S. dollar strength will abate as the virus is defeated, providing an additional tailwind for EM performance.

Country Updates

China

Getting back to work. Normalization of economic activity. More policies are needed to stabilize the labor market and lift domestic demand.

China was the first country to buckle under COVID-19 and many economists are looking at China as being the first-in-first-out (FIFO), and are eager to seize any data point that suggests China is getting back to normal. Every recovery starts from a bottom which is why it’s worth noting that China’s starting point is lower now than in 2008 implying the journey back to real growth will take longer.

Many high frequency indicators show signs of recovery, although most remain below normal levels. While we recently saw an increase in China's official manufacturing PMI into expansionary territory, the rebound is more a reflection of a sequential recovery from very low levels, with activity likely still below trend last month. The recovery in domestic consumption may be very gradual in Q2.

The Chinese economy highlighted sharp declines in industrial production growth, retail sales growth (especially auto sales) and weak investment growth. The Chinese authorities faced a challenge in trying to deleverage high corporate debt and excessive leverage against securing official GDP growth targets. The global economy is still weakening so Chinese exports are getting weaker. Although exports as a percent of China's economy have dropped from 35% in 2008 to a bit under 20%, they still are important. So a significant portion of China's GDP will have to wait for the rest of the world to heal. As China's dependence on exports and manufacturing fell from 46.2% in 2009 to 39% in 2019, services grew from 43.4% of GDP to 53.9% in 2019 according to Statista. This transformation resulted in a big increase in the middle class from almost nothing in 2000 to the largest segment in 2020 based on estimates by the McKinsey Institute. The middle class has grown significantly since China was allowed to join the World Trade Organization in 2001.

The slowdown in China's economy will worsen a number of other problems. China's debt to GDP soared after the financial crisis rising from 160% of GDP in 2008 to 310% in 2019 (it will approach 350% by 2022).[2] A surge in corporate debt during this period was a main contributor to the overall increase in debt. Any extended period of slowing will put more pressure on many private companies to service their debts and there may be a sharp increase in the number of bankruptcies (problems for small and medium sized banks). That has the potential to further disrupt supplies chains in China and production outside of China that receive parts.

Brazil

50% of the economy hit by the lockdown: unavoidable near-term deterioration of the fiscal balances and debt indicators. [3]

COVID-19 is escalating in Brazil, prompting additional challenges to other sources of growth and to overall activity. GDP growth forecast to a contraction circa 3% in 2020. Inflation to remain well behaved throughout 2020 at 3.2%. The Selic rate is already low at 3.75%.[4]

Near-term fiscal outlook was already challenging, and the medium-term picture is likely to become even more difficult. The government and congress have been approving a number of measures and programs to deal with the economic, social, and public health impacts of the coronavirus pandemic, involving both tax relief/forbearance and extra spending. The large fiscal flow imbalance is likely to push the debt load significantly higher: from 76.5% of GDP at end-2019 to close to a high 90% of GDP in 2020.[5]

Mexico

Negative credit momentum.

The fall in oil prices is likely to weigh on Pemex. S&P downgraded Mexico's credit rating to BBB from BBB+, keeping its negative outlook.

[2] Macro Tides, Global Economy Tipping Toward Recession, March 2020
[3] Santander
[4] HSBC
[5] Goldman Sachs

President Donald Trump has allegedly offered to compensate the reduction corresponding to Mexico. The Mexican government has guaranteed revenues to support for $49 a barrel for the Mexican oil export basket, equivalent to about $60-$65 a barrel for Brent crude, through a hedge, which insures against low prices and is considered a state secret.[6] For the last two decades, Mexico has bought put options, in what's considered Wall Street's largest annual oil deal. The options give Mexico the right to sell its oil at a predetermined price. They are the equivalent of an insurance policy: the country enjoys the security of a minimum floor. The hedge has shielded Mexico in every downturn over the last 20 years. Mexico has spent about $1bn on annually buying the options. Pemex, the state-owned company, has its own separate, smaller oil hedge. This year, Pemex hedged 234,000 barrels a day at an average of $49 a barrel.

Forecast for a deep real GDP decline in 2020 (-4.3%), and eventual announcement of a fiscal stimulus package to deal with the expected significant business and social impact on the recession, with public sector borrowing requirements (nominal deficit) of -6.0% to -7.5% of GDP. [7]

Mexican peso depreciation of around 23% year to date, the government wants to avoid increases of public debt. This contrasts with the Finance Ministry's guidelines, which now envisions debt-to-GDP at 52.1% of GDP by the end of 2020 from 45.6% expected previously. [8] The government will reduce the tax rate for Pemex in order to support the company with additional MXN 65bn. The government explicitly mentioned that they do not plan to implement countercyclical fiscal measures. Instead, they expect to use resources coming from the country's stabilization fund, other public sector's trust funds as well as from the development banking.

Argentina

Restructure now or later? Re-profiling Argentine Law USD Debt.

Poor economic activity performance ahead of the key debt restructuring. The fall in activity associated with COVID-19 containment measures shifts the political incentives. Government's ability to continue servicing debt is diminishing. Non-conventional oil and gas in the Vaca Muerta basin at a standstill with WTI in the 20s. Argentina's Economy Ministry officials are telling investors that the country won't be able to make any interest payments – much less return any capital – until some point in 2024. Apparently, Argentina wants to stick with the "good faith" road in this restructuring because Judge Griesa's characterization of Argentina as a "recalcitrant" and rebellious debtor last time around cost the country huge coin in the form of arrears, penalties and PDI costs.

As of March 31st, The Government's Usable Reserves Had Held Up Surprisingly Well: only slipped from USD $12.0bn to USD $11.8bn during March, which is a pretty decent outcome given the global coronavirus meltdown. Bond prices dropped further (with the EMBIG spread currently above 4,000bp).

A sovereign default will undermine any economic recovery in 2021. Moreover, the pressure to finance a wider primary fiscal deficit by peso printing amid declining real peso demand and a lack of a monetary anchor could

[6] Bloomberg, The Secret Weapon Giving Mexico Power in the Oil-Price War, April 11, 2020
[7] Goldman Sachs
[8] Santander

put the country in a proto-hyperinflation state as early as 1H21.

Colombia

Paralysis of the local economy and the plunge of oil prices create BoP and fiscal tensions.

Before the COVID-19 crisis, growth was holding up well, at the cost of an elevated current account deficit. But now the measures are being taken to soften the impact.

Fitch downgraded Colombia (COLOM) last week from BBB to BBB- (negative outlook) and said it could take further active if there's a failure to achieve fiscal consolidation for an eventual reduction in government debt burden; there is damage to medium-term growth prospects; and/or there are sustained large external imbalances that lead to a continuous rise in external debt. Fitch now expects the Colombian economy to deliver an economic contraction of around 0.5% of GDP, one that will be followed by a moderate recovery in 2021 –when growth should amount to 2.3% y/y, according to Fitch. Fitch expects fiscal revenues to drop as oil prices may remain around USD 30 for some time. Also, Ecopetrol is not expected to start making a profit until late 2021, and remittances are expected to drop to an all-time low because of the ongoing global economic crisis.

Ecuador

Assembly calls for suspension of external debt payments.

Representatives of most parties in the National Assembly released a statement requesting that the government temporarily "suspend payment on external debt to creditors of the state" citing the domestic COVID-19 outbreak.

The sharp deterioration of the domestic growth outlook due to the viral epidemic will likely subtract about 2ppt of GDP from tax revenues this year, while the plunge in global oil prices may reduce revenues by another 2-3ppt of GDP.

Russia

Affected by the dramatic fall of oil prices. Given its low debt burden and high reserve coverage, Russia is one of the least vulnerable emerging markets to a sudden stop of capital flows.

The RUB has fallen sharply in response to the oil price move and is currently trading at close to its early-2016 lows. That said, the fiscal rule, which had not been adopted back then, should help absorb some of the pressure on the currency, along with a sizeable real interest rate buffer, healthy current account and budget balances, low public debt, and FX reserves (USD 150bn National Wealth Fund) corresponding to more than eight times the short-term external debt burden.

The key short-term risk to the growth outlook is a further decline in oil prices. The flexible Ruble, central bank credibility and significant macroeconomic buffers should help insulate the real economy. Russia's fiscal policy response is still modest but will need to be stepped up. The possibility of a deeper COVID-19-induced crisis is high, as Russia's healthcare system is poorly prepared for a pandemic—especially in the regions and following years of expenditure cuts.

Turkey

Set to benefit from the oil price decline.

Turkey entered the COVID-19 shock with strong momentum, which should keep full-year growth positive, despite an estimated sharp output contraction in Q2. It remains to be seen if the government's recent decision to double the Credit Guarantee Fund's (CGF) capital, as part of a sizable stimulus package, will be sufficient to maintain banks' ongoing risk-on attitude so that

they continue to provide robust credit growth. This should at least partially offset COVID-19 headwinds to economic activity.

A domestic demand driven economy, less integrated into global supply chains, should allow it to be relatively more resilient in the face of an external demand shock. But Turkey remains uniquely vulnerable to a funding shock, as short-term external liabilities (excluding the current account shortfall) stand in excess of 20% of GDP and the policy buffers that could have been relied upon to combat the recession, or the contractionary impact of capital outflows, have largely been used up.

South Africa

ZAR under pressure. Multilateral support critical. More downgrades may be on the way. Worsening of debt dynamics.

IIF projects a 2.5% decline in real GDP for 2020. Moody's rating downgrade to sub-investment grade keeping the negative outlook will likely trigger further capital outflows. Monetary easing will increase pressure on the ZAR (towards 20 vs USD) and stoke further outflows. The currency remains a key release valve and the 22% year-to-date depreciation vs the USD has already seen the external debt load increase the most in EM so far this year.

QE-like operations are unlikely to mask a now sub-investment grade credit rating and a double-digit fiscal deficit, while further FX depreciation should see higher risk premium in USD-denominated bonds. Economic contraction and higher funding cost. Rising debt service costs and an adverse feedback loop between stalling growth and rising fiscal deficits (in excess of 6% of GDP) make debt sustainability worsen. Limited policy space & a deteriorating debt sustainability outlook existed even prior to COVID-19. An IMF program could bring much-needed funding & shore up investors' confidence.

Egypt

Egypt has the external buffers to weather the shocks, but deterioration in external balance could potentially put pressure on the nominal exchange rate.

Central Bank of Egypt (CBE) total foreign assets fell by USD 5.4bn in March – the biggest ever single month drop. In a statement, the CBE said that it had drawn down reserves to "safeguard financial stability" against a backdrop of sharp portfolio outflows triggered by COVID-19. Despite the drop, central bank reserve assets remain high at around USD 40bn, the equivalent of more than seven months of import spending. Egypt will also need to fund a widening current account deficit as tourism revenues, Suez income, and remittances fall. FDI will also likely moderate.

The expectation is that as the initial COVID-19 shock fades, CBE intervention will ease and underlying depreciation pressures will see the currency steadily weaken. If this does not happen, our questions over the flexibility of the FX regime will increase, as will our worry that a reluctance to let EGP adjust in the near term will leave the currency exposed to a more disorderly decline in the longer term as imbalances build and reserve assets continue to decline.

Nigeria

FX controls. Naira Black-Market Rate Weakest in Three Years.

The foreign reserve is not at a comfortable level. If the major source of accretion is now pressured, the exchange rate will feel the pain and the situation will worsen. The Nigerian currency depreciated to its weakest level since February 2017 in the unofficial black market

after the country's central bank cut supply to dealers. The central bank announced that it was suspending FX sales to money changers until further notice. A move it said was in line with curtailing the spread of coronavirus in the country. This was after devaluing the exchange rate used by foreign bond and stock investors, which had been largely pegged since 2017, by about 4% to 380 per dollar.

Sub-Saharan Africa

Weak public balance sheets.

Sharp increase in funding needs raises concerns over whether countries will be able to stay current on debt service payments. Sub-Saharan African GDP will possibly be the most severe impact of the crisis on already stretched fiscal balances. Budget deficits would likely rise from an average of around 3.5% to high single digits, even before any loosening to soften the economic effects of the corona crisis. This implies a floor on the rise in funding needs of at least USD $75bn in aggregate contract for the first time since 1991.

The challenge is liquidity, not solvency. Much will depend on how much support can be mustered from development partners and international financing institutions. On this front, African governments have been proactive, focusing on budget support and leniency on multilateral and bilateral debt service. Given the nature of the challenge and the lack of moral hazard concerns in the face of a humanitarian crisis, IFIs are well-positioned to provide support.

India

Concerning fiscal and financial metrics. Weakening INR and rating.

Indian authorities will act boldly in adopting new fiscal and monetary support measures. Such policy action will come at a cost. The Indian rupee may have to further depreciate, and the credit rating agencies will be assessing if the sovereign's existing ratings are sustainable.

Indonesia

Near-term bearish outlook on the IDR.

President Jokowi signed an emergency law to ease the 3% deficit cap and allow the government to provide a meaningful stimulus to counter COVID-19. The government will now target a deficit of 5.1% this year to fight the pandemic. A corporate tax cut was already in the works under the Omnibus Tax Reform bill, but this was not expected to take effect until 2021. Most of the new spending will be destined for the public health system.

The wider fiscal deficit will coincide with a higher CAD this year, which may present financing challenges for the government. A collapse in tourism revenues and a reduction in commodity export revenues will weigh on the deficit, although the sharp fall in oil prices provides some offset. The government has stated that it will seek to attract external financing from multilateral agencies such as the World Bank or ADB.

Indonesia's stronger fiscal profile, healthier financial sector, and better inflation management give the authorities greater flexibility to respond to the economic loss attributed to virus containment. The sovereign's less robust external profile concerns are mitigated by its external liabilities being of reasonable long duration and healthy FX reserves to deal with rollover risk in the near term.

Bank of Indonesia has plenty of room to buy local government bonds. Cautious on the currency because one of the by-products of central bank purchases of government bonds is a weaker

currency. IDR's performance will be highly dependent on global beta.

Sri Lanka

Weak fiscal and external metrics.

Sovereign credit metrics will now deteriorate quick as the authority's attempts to cushion the domestic economy from the virus-triggered loss of economic momentum. The Sri Lanka rupee is likely to be the main loser so as to allow the authorities some flexibility to pursue possibly expansionary domestic policy measures. Sri Lanka's external debt load will be harder to service from internally generated resources plus the ability to refinancing, let alone tap the offshore capital markets for new expenditures will stay prohibitive for the near term.

We thank you for your continued support.

The RVX Team
RVX Asset Management LLC
20900 NW 30th Avenue, Suite 401
Aventura, FL 33180
www.RVX-AM.com | Phone: +1-305-363-6890
Fax: +1-305-675-0394

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