Credit Conditions Emerging Markets:

A Vaccine Won't Erase All Risks

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Key Takeaways

- **Overall:** Credit conditions in emerging markets (EMs) continue to improve following positive news about progress in developing a coronavirus vaccine, which augurs well for a faster recovery over the second half of 2021.
- **Credit:** Negative rating actions have plateaued, but lower ratings overall and a record high number of negative outlooks indicate increased vulnerability. A slower economic recovery or delays in delivering a vaccine could lead to further downgrades.
- **Risks:** Short-term risks still loom large. The coming winter could lead to a resurgence of COVID-19 cases in EM countries in the northern hemisphere. A recent spike of cases in Europe and the U.S. are already denting economic activity in the final quarter of 2020. The pandemic will also undermine another relevant season for tourism.

Emerging-market governments and corporations have limited flexibility to face a resurgence of COVID-19 cases

Credit conditions strengthened over the third quarter of 2020, although the economic recovery is looking weaker in the last quarter. On the positive side, China's pandemic management is enabling a swift economic recovery, as shown by an upswing for many commodities (including metals and certain agricultural products). This has supported exporters with strong trade ties to China, such as Brazil, Chile, South Africa, and Indonesia, which should continue to benefit from China's resilient demand for industrial and agricultural commodities. The U.S. election results and progress on a vaccine are whetting investors' appetite for EMs, since many expect more-predictable policies under President-elect Biden, including a more supportive stance toward trade. This is leading to a rise in capital flows to EMs, alongside appreciating currencies and easing of financing conditions.

Despite this, threats remain, particularly over the next few months. The coming winter represents a major hurdle for EMs in the north, due to the increased risk of a resurgence of COVID-19 cases. Although we don't expect full lockdowns in EMs, governments might implement partial lockdowns and other social-distancing measures in response, preventing the return to normal activities. In addition, a recent rise in cases in Europe and the U.S. will likely subdue economic activity over the last quarter of 2020, affecting EMs that depend on those countries. The pandemic and related restrictions will also hamper the lucrative tourism seasons (Christmas for EMs in the northern hemisphere and summer in the south). Combined, these factors will most likely result in a sluggish economic recovery, increasing risks for corporations and households.

Corporate leverage, although higher, remains manageable in most cases. The key risk for EM corporations we rate is reduced earnings, hit by lockdowns and social-distancing measures. Overall, many corporations and small and midsize enterprises (SMEs) are running out of options, and would be particularly vulnerable to new COVID-19 containment measures. The number of EM ratings with a negative outlook remains at record highs: 43% in Asia-Pacific (excluding China) and 52% in Latin America. Only EMs in Eastern Europe, the Middle East, and Africa (EEMEA) show a lower negative bias versus historical averages. So far, 19 corporations have defaulted, and we have taken 287 rating actions related to the pandemic and falling oil prices.

Few of the top 16 EM countries have room to accommodate higher debt, which we expect will increase by around 12% of GDP by the end of 2020. Additional debt will probably also affect credit quality. Of our ratings on the key 16 EM sovereigns, five carry negative outlooks (Chile, Colombia, Mexico, Indonesia, and Malaysia). In EMs, our sovereign ratings usually cap the ratings on domestic corporates and banks. This means that a downgrade of any of these countries could also result in lower ratings for the respective corporates and banks, rising funding costs, and, in cases where ratings fall below investment grade, tighter market access.

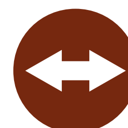
Top Emerging Market Risks

Table 4

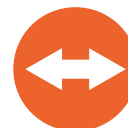
Risk levels are based on the likelihood and systemic impact of such an event occurring over the next one to two years. Typically these risks are not factored into our base case rating assumptions unless the risk level is very high.

COVID-19 spreading across key EMs and potential policy missteps that slow the growth trajectory
The pandemic situation in EMs remains mixed, with many EM countries struggling to contain the coronavirus. A vaccine could be available early in 2021. But, unlike in developed markets, EMs may find it difficult to get the vaccine and effectively distribute it, delaying an economic rebound. A vaccine will nevertheless be a positive factor since developed markets will probably be able to deliver the vaccine efficiently, which will most likely reactivate the global economy. With winter around the corner, EMs in the northern hemisphere could see a spike in COVID-19 cases, and the pandemic will also hurt tourism. We still see a risk that mounting fiscal pressures will make it tougher for governments to implement large stimulus packages, especially if GDP growth stays low due to company failures and job losses stemming from COVID-19. A sluggish economic recovery will also challenge key EMs, since few can provide additional stimulus without hurting their credit quality.

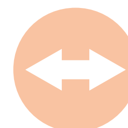
Debt overhang among governments and pressure on corporate earnings would constrain an economic recovery
EM corporates have taken several steps to remain afloat during the COVID-19-led downturn, including cutting costs, increasing liquidity, and issuing debt. A slowdown in the recovery will depress corporate earnings, increasing sector risks, particularly for those with little flexibility to cope with continued stress. Struggling and failing corporations will most likely result in additional layoffs, with knock-on effects for households. Moreover, the impact could spill over to banks as credit forbearance and fiscal stimulus measures wind down. Combined, these factors could lead to rapid asset-quality deterioration for banks, absent additional mitigating measures.



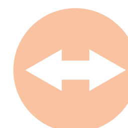
Economic spillover from a strained U.S.-China relationship and increasing geopolitical tensions
U.S. President-elect Biden is likely to initially focus on domestic issues, especially COVID-19, so U.S.-China relations are unlikely to worsen in the short term. The incoming and outgoing U.S. administrations seem to have broadly similar views on China, while the Chinese government has recently shown its determination to rely less on the U.S., such as in technology. An escalation in tensions would hamper cross-border investment, supply chains, and access to intellectual property and markets, thereby increasing the risk of business disruption and loss of investor confidence. Regarding the geopolitical situation, Turkey's increasing military presence in EEMEA has raised tensions with its neighbors. Armenia and Azerbaijan have reached a cease-fire agreement but the situation is fragile. Moreover, the potential reinstatement of the Iran nuclear deal could bring discomfort to Saudi Arabia and Israel. It's uncertain how these governments will tackle the related social and economic challenges.



High income inequality, limited access to health services, and lockdown fatigue spurring social unrest
The pandemic has exacerbated existing income disparities, precarious living conditions, and limited access to health services for the poor, stoking social discontent, with politicians raising their voices. Furthermore, the deep economic contraction resulting from the pandemic will lead to a sharp rise in poverty, which would be a huge setback for many EMs that made progress in this area in previous years. These conditions could ignite protests, with the population demanding change.



Volatile financing conditions that could limit access to credit markets
Financing conditions continue improving, more recently due to the U.S. election results and positive news on the development of a COVID-19 vaccine, but also thanks to accommodative monetary conditions in advanced economies. Spreads for EMs continue to narrow, except for the weakest issuers. Such conditions have also eased the pressure on most key EMs' currencies. Nevertheless, uncertainty and fragile investor sentiment prevail. Financing conditions could become volatile in the future if there's a delay in finalizing effective treatment or a vaccine for COVID-19, or if the economic recovery is slower than expected, triggering fresh capital outflows.



Source: S&P Global Ratings.
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This report is an extract from the S&P Global Ratings report, "Global Credit Outlook 2021: Back On Track?"

This report does not constitute a rating action

S&P Global Ratings believes there remains a high degree of uncertainty about the evolution of the coronavirus pandemic. Reports that at least one experimental vaccine is highly effective and might gain initial approval by the end of the year are promising, but this is merely the first step toward a return to social and economic normality; equally critical is the widespread availability of effective immunization, which could come by the middle of next year. We use this assumption in assessing the economic and credit implications associated with the pandemic (see our research here: www.spglobal.com/ratings). As the situation evolves, we will update our assumptions and estimates accordingly.

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