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Emerging markets debt
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Emerging markets debt: Geopolitics and opportunities

The multitude of geopolitical flashpoints since the pandemic—or polycrisis period as some commentators have coined it—has had more of a direct impact on emerging markets debt (EMD) than on other fixed income assets.

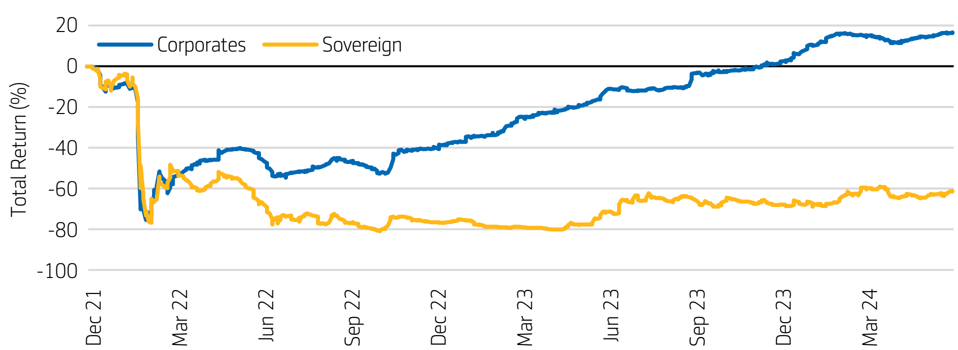
For example, the war in Ukraine has had tangible effects on credit issuers, not just in Eastern Europe but in Africa and Central Asia. Meanwhile events unfolding along Israel's borders have had ramifications for Egypt and other regional actors. In addition, the upcoming US elections and subsequent foreign policy changes have long been highlighted as an upcoming event risk for emerging markets (EM) and are likely to dominate discourse in the coming months.

There are several other existing geopolitical uncertainties causing dispersion within niches of the asset class, all requiring a more nuanced approach for active investments. The frequency of such hot spots across an asset class as varied as EMD continues to be a source of active return opportunity during periods such as now, when broader asset class headline spreads do not appear exceptionally attractive after the credit market rally of recent months.

Ukraine

Contrary to the human and economic toll exerted by Russia's invasion of Ukraine, the latter's corporate debt issuers have been one of the standout sectors of the past year, returning 32.3% relative to emerging market corporate returns of 9.2%.[1] Although there is no single sector pricing at levels as severely distressed as Ukraine corporates were in early 2023, there are still several potentially attractive total return prospects for dedicated EMD and crossover investors who are willing to undertake the necessary bottom-up analysis.

Ukraine corporate and sovereign debt: Total returns since December 2021



J.P. Morgan CEMBI Broad Diversified Ukraine Index and J.P. Morgan EMBI Global Diversified Ukraine Index. Data as of June 2024. Sources: Bloomberg, JP Morgan.

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[1] J.P. Morgan CEMBI Broad Diversified Ukraine Index and J.P. Morgan CEMBI Broad Diversified Index, respectively. Returns June 28, 2023 to June 28, 2024.

The “Stans”

Several hundred miles from the Ukraine front lines, Central Asia's "Stans" (as the post-Soviet states are often known) are a prime example of the war’s indirect impact. Eye-catching increases in the re-export of goods and a likely windfall from the likes of Kyrgyzstan to Russia may be generating the most attention, but of more global importance is landlocked Kazakhstan's oil.[2] The OPEC+ country is heavily reliant on access to Russia's Black Sea oil terminals for export of more than 80% of its product.[3] To date, the disruption due to the war has been negligible and Ukraine's own targeting of Russia’s oil and gas infrastructure is likely mindful of significant Western investment in Kazakhstan's oil fields.

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Still, this present risk—plus prior instances of “unscheduled” maintenance on the Russian sections of the pipeline that have temporarily reduced production—has rekindled diplomatic efforts to diversify oil export routes. The primary route to achieve that has been by shipping oil across the Caspian Sea to underutilized pipelines that bypass the Black Sea via Azerbaijan, Georgia and Turkey.[4] The figures quoted for shipment volumes are a fraction of that passing through the CPC pipeline to the Black Sea, but, viewed through the lens of a debt investor, such volumes should generate sufficient earnings to service existing investment grade debt interest obligations.

Major Caspian oil and natural gas export routes

Source: US Energy Information Administration base don HIS Market Midstream database. Data as of June 2024.

Georgia

The Caucasus region, where these alternative pipelines run through, remains an area of recurrent instability, as evidenced by Azerbaijan’s seizure of breakaway Artsakh last

[2]“‘Sanctions hole’: How secretive routes supply Russia with western tech and consumer goods,” The Guardian, June 11, 2024.
[3]“Interview: Kazakhstan diversifying oil export routes to mitigate impact of Ukraine conflict,” S&P Global, May 24, 2023.
[4]“Azerbaijan could assign disused Black Sea pipeline to Kazakh oil exports: source,” S&P Global, June 11, 2024.

year. In Georgia, the ruling party Georgian Dream's latest effort to consolidate power is the approval of the so-called "foreign agent" law that, despite its wide unpopularity, is unlikely to deter that party's re-election in October's parliamentary election. However, a more balanced parliament may precede a return to a more conciliatory approach to relations with the European Union and the US in an effort to retain tentative prospects of a European future.

The country and its publicly listed entities have been a notable economic beneficiary of recent years' external events, including the influx of Russian emigrants following the outbreak of the Ukraine war, to the redirection of East-West trade away from Russia and the spike in foreign investment, as recently evidenced by China's award of a stake in a new deep-sea port.[5] However, until some calm is evidenced following Georgia's elections, we believe bond pricing is unlikely to revert to levels that reflect its leading economic growth in the region.

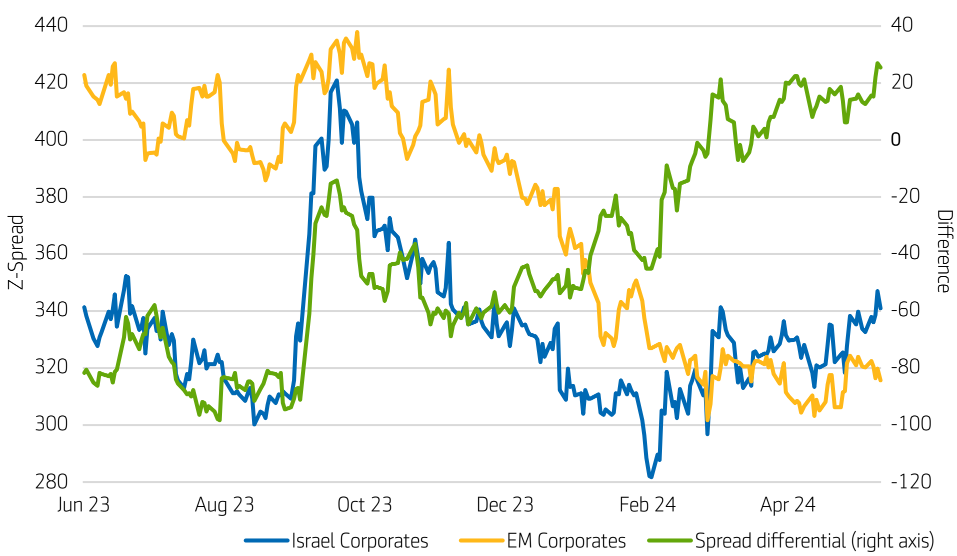
European divestment from Russia

In Europe, bank subsidiaries that are still operating in Russia frequent the headlines, even if they are unable to upstream the profits to their respective European parents given prolonged negotiations with their local counterparties over exit routes.[6]

This focus has overshadowed the numerous companies that have successfully severed ties with the country, including airlines, banking, mining and telecommunication companies. Yet in a couple of instances, bonds from such corporate entities continue to offer meaningful spread premiums relative to their EM counterparts de-linked from this Russian entanglement, in part likely due to a prolonged hiatus from capital markets, which we believe will be unwound over time as the value of the new, slimmer versions of these businesses is recognized.

Israel-Hamas war

Israel corporate and sovereign debt: Credit spread over US Treasuries



J.P. Morgan CEMBI Broad Diversified Index and J.P. Morgan CEMBI Broad Diversified Israel Index. Data as of June 2024. Sources: Bloomberg, JP Morgan.

[5]"China wins bid to build Georgia's new Black Sea container port," The Maritime Executive, May 30, 2024.
[6]"European banks find breaking up with Russia is hard to do," Bloomberg, May 15, 2024.

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Corporate bonds within proximity of the Israel-Hamas war continue to rightly offer a spread premium due to the ongoing uncertainty about the direction and magnitude of the conflict.

Yet indications from several data points, such as credit card expenditures and capital raises, indicate that economic activity in large parts of Israel's economy has nearly normalized, which has eased concerns about operational pressures. Indeed, the banks all have excess liquidity and capital, having further built capital buffers in prior quarters. Bond spreads may now be far from the wides seen in the days after October 7, 2023, but still offer quite a material pick-up compared to their other emerging market and European counterparts.

Israel's government has likely pushed out its target date for the full phase out of coal power generation from 2025 due to the war. Still the country's transition away from coal in recent years has been rapid in a global context, due largely to the ramp-up of the highly profitable production of its major offshore gas fields. Bonds of related entities offer a premium for far-from-negligible single-site risk, but like banks, these are assets are of significant economic and strategic importance.

In addition to powering the local Israeli economy, neighboring Egypt and Jordan have become dependent on these fields via existing pipeline connections for plugging their own domestic gas deficits.[7] In addition to the gas still flowing, Egypt's bondholders have ultimately benefited from the wider Gulf's interest in not having additional fallout in the region due to the war, with the UAE investing approximately $35 billion in the country.[8] A deal that, for now, shores up Egypt's precarious finances and has been of some benefit to Egyptian oil and gas field operators as the government starts to settle arrears.[9]

Iraq and Turkey

Garnering far less attention is the prolonged closure of the Iraq-Turkey oil pipeline since March 2023, which once handled about 0.5% of the global supply.[10] That closure was the result of an International Chamber of Commerce arbitration ruling favouring Iraq over Turkey, which has long disputed the northern region of Kurdistan unilaterally exporting oil through Turkey. Although this extended closure is a near-terminal blow to the long-term investment case for international oil companies operating in Iraq's autonomous region, the operators are still generating positive cashflow despite heavily discounted sales to local refineries owing to industry-leading low lifting costs.

A resumption of exports sold at global prices via the pipeline would be a boon to shareholders. However, from a bondholder's perspective the operators' long track record of running very conservative balance sheets and undertaking creditor-friendly bond refinancings often provides a sufficient buffer to further price volatility while earning an attractive coupon.

Corporate bonds within proximity of the Israel-Hamas war continue to rightly offer a spread premium due to the ongoing uncertainty about the direction and magnitude of the conflict.

[7]"East Med: Gaza crisis tightens regional gas balances," The Oxford Institute for Energy Studies, November 2023.
[8]"Abu Dhabi steps in to ease Egypt's currency crisis with $35bn investment," Financial Times, February 23, 2024.
[9]"Egypt starts repaying up to $1.5 bln in oil company arrears, sources say," Reuters, March 26, 2024.
[10]"Iraq says resuming Kurdish oil exports will 'take some time,'" Bloomberg, April 22, 2024.

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