The strategy of selecting the "right assets" in the "wrong boxes" is strongly impacted in the short term, by construction. Indeed, and as always in periods of severe stress, markets move from the micro to the macro. This phenomenon creates dislocation, a fashionable concept to express a difference between the price of an asset on the markets at time "t" and its intrinsic value.

At the macro level, the markets have mainly focused on the theme of "protected assets vs. unprotected assets" following the idea that "unprotected" assets are de facto risky assets. However, this shortcut, which consists in necessarily making an "unprotected" asset a risky asset, seems to us to be wrong in many cases and now opens the way to the "rare" opportunity of being able to buy quality assets at a discount.

We have analyzed the forces at work in the markets, particularly emerging markets, and have highlighted some of the reasoning that we believe can explain this situation.

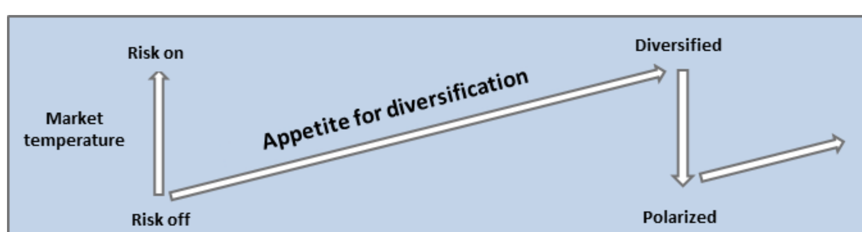
1. MOVING FROM A "DIVERSIFIED" TO A "POLARIZED" MANAGEMENT: A NECESSITY IN TIMES OF CRISIS

In the last few years, financial assets have been highly correlated as a result of globalization and low interest rate environment.

When markets are doing well ("risk-on"), portfolio managers look for diversification. Diversification that adopts a more or less "contrarian" portfolio approach, with the objective of obtaining a fair level of alpha and/or decorrelation.

In the Financial Markets universe, stressful situations could lead to generic reasonings. Those reasonings lead to conclusions that may also, in turn, be generic. They become more "macro": by asset class, geography, credit ratings, and therefore clustered... The market becomes a market of flow that by essence simplifies itself.

In the midst of uncertainty, it is necessary to refocus on what we know. The asset classes that traditionally represented "diversification" are the systematic casualties of this shift. Face with a positive overweight investment idea, there needs to be an underweight.



That is what happened in the past few weeks, with a polarization of the markets around two generic and apparently irrefutable arguments:

1."Assets that are not protected by central banks are all risky assets."

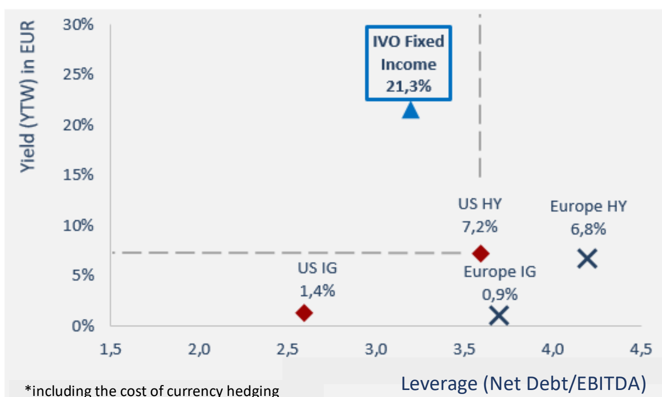
2. "Assets that are protected by central banks are all subject to low or moderate risk."

These "shortcuts" are sources of opportunities because they create a risk/return dislocation: some assets considered as unprotected become very cheap both in absolute terms - given their intrinsic credit risk - and in relative terms - given the deterioration of fundamentals and the compression of yields for issuers benefiting from sovereign protection.

Unprecedented outflows
Emerging markets saw unprecedented portfolio outflows in terms of both size and speed.

Sources: Bloomberg Finance L.P.; EPFR Global; Haver Analytics; Institute of International Finance; and IMF staff calculations.

YIELD TO WORST (in EUR*) / NET DEBT OVER EBITDA **30 April 2020**



2. POLARIZATION: DEVELOPED COUNTRIES VS. EMERGING COUNTRIES

It is interesting to note that the polarization goes beyond the geographical concepts of "developed countries" vs. "emerging countries"; it is also very strong within the emerging segment, where we see that the most "administered" economies, such as China and Russia, are currently the winners of this polarization, regardless of the leverage of their companies or their overexposure to certain sectors of activity.

As of May, 11st 2020

ID	Instrument	YTD Change (%)
CEMBI HY	Argentina	-30,22
CEMBI HY	Latin	-15,46
CEMBI HY	China	-2,47
CEMBI HY	Russia	-1,61

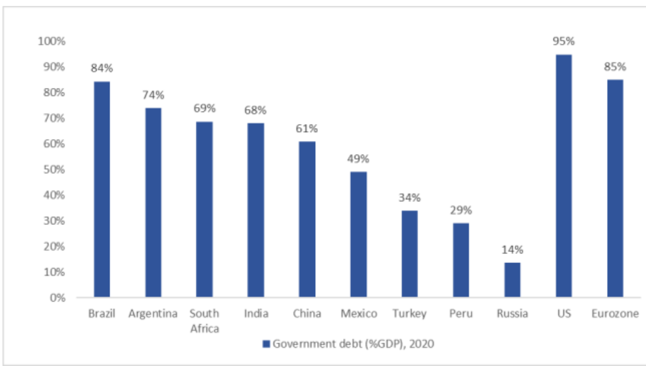
3. CONSIDERING « NON-ADMINISTERED » EMERGING MARKETS AS A SINGLE ASSET CLASS

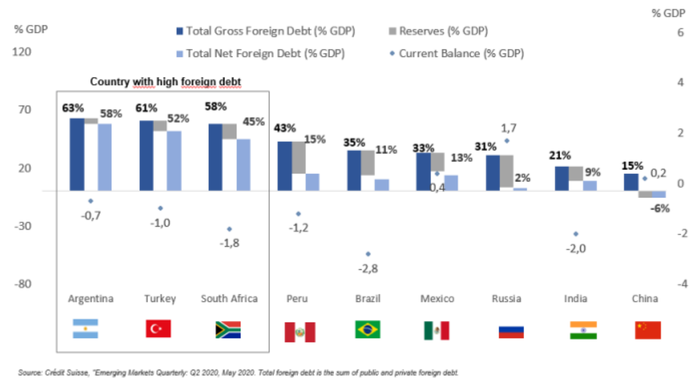
Most investors are not familiar with emerging market assets and especially emerging market's companies, no matter how international their scope is. As a consequence, investors usually take shortcuts when it comes to this "catch-all" asset class. The need to analyze data country by country, currency by currency, company by company, in such a large and heterogeneous universe, is certainly not compatible with a short timeframe.

This narrow timeframe leads to negative generic reasoning which generally relates to (i) the emerging sovereign being over-indebted in absolute terms and, particularly, in external currencies, (ii) the fall in local currencies will lead States and emerging companies into a bloodbath.

Without being exhaustive, and with regards to a few countries where we have corporate exposure - more or less contained - there is a wide disparity between countries, both in terms of debt levels and net debt in USD. There are also situations that are completely counter-intuitive: Brazil's net debt has just fallen to 52% of GDP as a result of the 26% depreciation of the BRL against the USD since the beginning of the year, as the country has large foreign exchange reserves in USD[1].

[1] Source: JP Morgan Morning Update on Brazil 4th May 2020

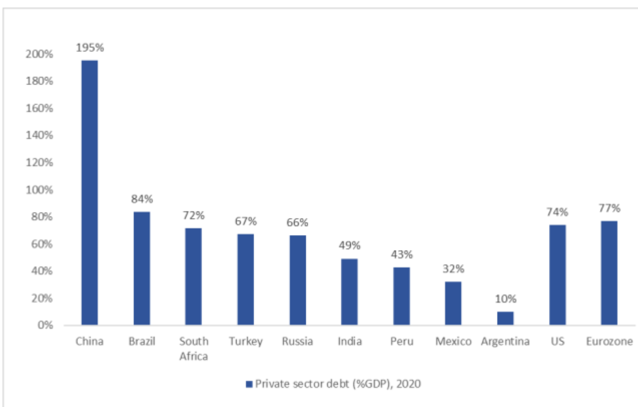




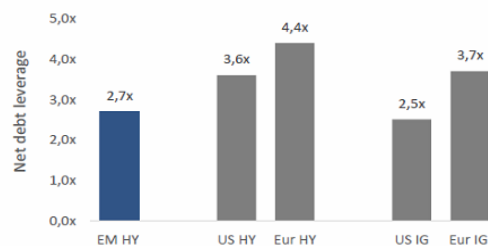
With the exception of Argentina, these emerging countries have entered this crisis with almost half as much debt on average as developed countries.

A distinction must be made between countries with little or no net external debt (Brazil, Mexico, Russia, China, India) and those with a large external debt (Argentina, Turkey, South Africa).

Regarding our segment – namely hard currency corporate bonds - we should remember that emerging market companies are generally underleveraged and have entered this crisis with lower debt levels than those in developed countries. Consequently, the Emerging High Yield segment is less leveraged than European Investment Grade segment. This is even more pronounced if we exclude the Chinese High Yield segment.



Emerging markets HY debt leverage comparable to US IG



Sources: JP Morgan, Bloomberg. Leverage calculated on JP Morgan's universe as a whole, in Q3 2019 for emerging markets and in Q2 2019 for the US and the euro zone.

A country with a lower leverage at the sovereign level may, however, reveal a very high level of corporate indebtedness (e.g. China). This is exactly the opposite case for Argentina and Mexico.

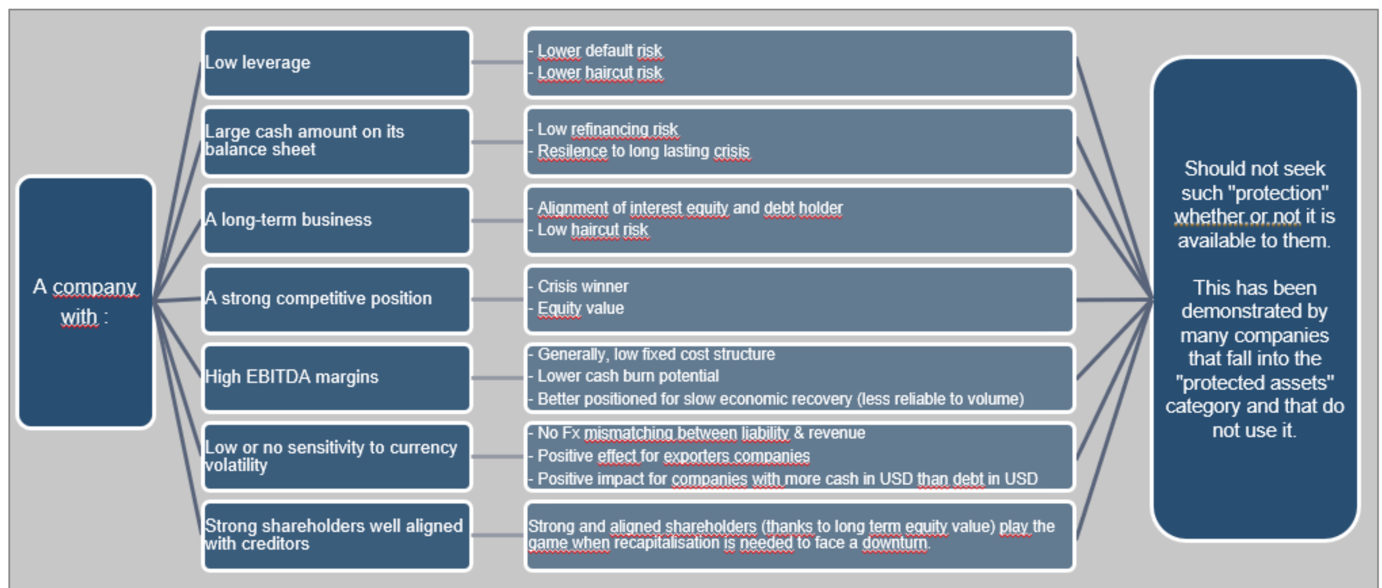
At the beginning of the crisis, emerging market companies had an average debt level equal to, or even lower than Investment Grade companies in developed countries.

4. FULLY EMBRACE TO THE CONCEPTS OF « PROTECTED ASSETS» AND « UNPROTECTED ASSETS »

UNPROTECTED ASSETS = HIGH-RISK ASSETS?

We do not agree with this shortcut.

A company (i) well managed, (ii) with low leverage, (iii) with cash on its balance sheet, (iv) a long-term business, (v) a strong competitive position, (vi) comfortable EBITDA margins, (vii) able to generate free cash flow without depending on a return to pre-crisis business volumes, (viii) with little sensitivity to currency volatility, (ix) with strong shareholders whose interests are well aligned with creditors', should not seek such "protection" whether or not it is available to them. This has been demonstrated by many companies that fall into the "protected assets" category and that do not seek such protection.



In the world without "protective hands", which is the world of the emerging countries (except for certain countries such as China, for example, which is already an administered economy), it is the quality of corporate balance sheets that enables companies to get through a downturn in the cycle. When the fundamentals are solid, companies can overcome the crisis without generating losses for senior creditors by deploying usual measures (capital increases, asset sales, friendly debt restructuring, etc.), provided that the activity has long term value.

PROTECTED ASSETS? ADMINISTERED ASSETS? LOW-RISK ASSETS?

The specificity of this crisis lies in the fact that this companies' "protection" consists in providing access to additional loans to the companies.

Central banks, that were already at the helm of the financial markets when the crisis erupted, reacted so quickly that they did not give time to the market to function when it comes to the usual stage 1 of a crisis. That is especially true for the equity markets. Before the market bottomed out in March 2009, many equity injections had already taken place, particularly in the affected sectors (banking, automotive, etc.).

April has broken records in terms of debt issuance over the last ten years. Euro-denominated corporate debt issuances (including banks) in April amounted to more than EUR 60 billion, while dollar-denominated issuances amounted to around EUR 250 billion.

So why do we call "protected/administered" companies that are coming out of this crisis with more debt - and therefore less equity value - and shareholders that are consequently less aligned with creditors? In the short term, we understand the concept. In the medium and long term, we would understand it if (i) these "aids" were injected directly into the company in the form of capital, (ii) if these loans were accompanied by a mandatory equity reinforcement, (iii) if governments announced the cancellation of these debts. In this case, what about the nature of the cancellation? Conversion into equity and thus potentially dilutive effect? Conversion of "state-guaranteed loans" into "Covid grants"?

As of today, the so-called "protected" companies are therefore those whose net debt leverage (Net Debt/EBITDA) increases both by increasing the numerator and by decreasing the denominator (decrease of EBITDA in 2020 and maybe also in the following years).

As a result, the liquidity risk is reduced in the short term, but this could only postpone the solvency risk related to the decline in revenues after the Covid crisis. Let us not confuse liquidity risk with solvency risk.

On the opposite, "unprotected" companies are those whose net leverage increases only by lowering the denominator. In the absence of "protection", "usual" operations are set up and companies with a liquidity problem propose exchange offers to deal with their liquidity problem, usually with an increase in returns and better guarantees as a new package.

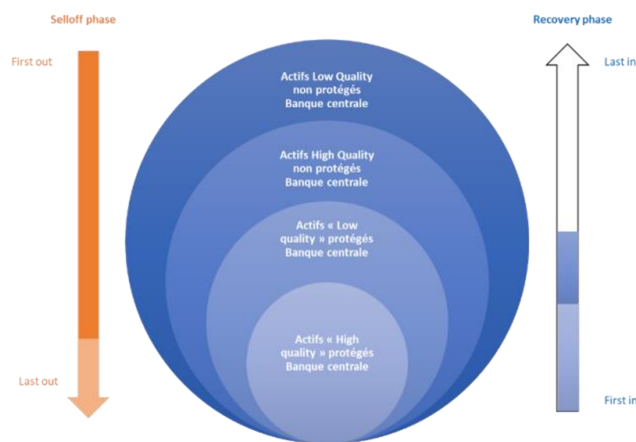
While it is possible for the term "protected/administered" to be equivalent to "low risk" - particularly if "protections" are transformed into "subsidies" - it seems to us that the language shortcut of mandatorily making an "unprotected" asset a risky asset is misleading in many cases.

5. THINKING THAT ONE CAN LEAVE ASIDE FUNDAMENTAL ANALYSIS ON A LONG-TERM BASIS…

If "dislocation", a fashionable term, is the difference between "a discount for technical reasons" and the "fundamental value of assets", how can you analyze dislocation if you don't have time for fundamental analysis?

For several days now, the market has been calmer because it has been reassured by the intervention of central banks - as it has always been since 2008. Historically, without a hegemonic central bank, fundamental analysis gradually returned. Today, the rapid action of central banks is greatly reducing the time for thinking, at least for so-called "protected" assets.

This "disappearance" of fundamental analysis leads to a dislocation that creates opportunities, which makes fundamental analysis necessary to take advantage of it. **The progressive return of the "risk/return" couple in reasoning is a necessary step towards normalization**.



A return of flows in one circle necessarily involves a prior return of flows in the previous circle... In this upward phase, the transition to the next circle is based on the gradual return to the markets of the "risk/return" analysis.

This analysis is done either in absolute terms (asset price vs. fundamental asset quality) or in relative terms (risk/return gap between the circles). The former requires fundamental and micro analysis, the latter can still function for a time without it but this irrationality between expected risk and loss/gain between the circles will end up bringing back asset prices to order.

E. GET LOCKED INTO POLARIZATION, DON'T GO BACK TO FUNDAMENTALS AND RISK/RETURN ANALYSIS

In a context of uncertainty, moving from the macro to the micro through a **risk/return** analysis is generally the way to regain comfort. **"Risk/return" is not only considered in absolute terms (vis a vis fundamental value) but also relative to other asset classes.**

If dislocation is one of the definitions of an opportunity in the financial markets, it is necessary to identify the engine that will make it disappear in time. On both engines, in absolute and relative terms, the risk reward is in favour of high-quality assets but in the wrong category. In other words, discount of bond cash price of high-quality assets based on the wrong category offer sa better protection even in default and restructuring scenarios and a higher upside in positive scenarios on global economy.

Another important thing has to be considered regarding the leverage ratio: « non-protected » companies are not increasing their net debt during this crisis (numerator of the ratio) as opposed to many "protected companies"…

Is it a good Risk / Return in comparison with the equity markets as well?

With such a level of return, it is interesting to draw a comparison with the equity markets, especially since a constructive view of developed country equities necessarily leads to economic assumptions that are a priori just as favourable for corporate bonds from emerging countries: (i) no lasting global recession, (ii) persistently low interest rates, (iii) winners and losers, (iv) the transformation of "protections" into "subsidies" in order to avoid impacts on equity value...

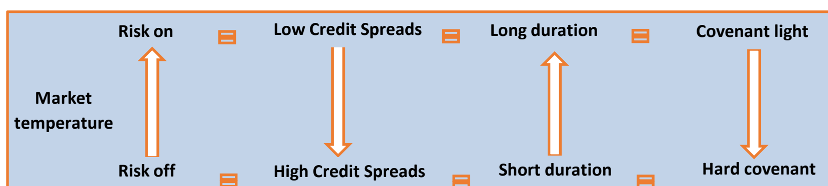
6. CONCLUSION

The "protected/unprotected assets" polarization is, in our view, the new source of opportunity in the markets.

To be contrarian today without having to make strong bets on the different scenarios of economic recovery could already start by simply tempering this polarization.

Protected or not, "good companies", no matter where they are located, do not use these "protections". Therefore, this "protection" probably does not have the discounted value it is given.

The contrarian approach of investing in an asset with good fundamentals but in the "wrong category" is more relevant than ever.



What is the best moment to invest ?

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