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Global

EM Credit Weekly

Sell-off not done yet!

- We remain cautious on EM spreads — While we acknowledge that valuations are becoming attractive, negative idiosyncratic developments for large credits belonging to the index are strong headwinds.
- With performance dispersion increasing among credits, we recommend investors to be selective. We prefer short-end bonds with positive developments (Argentina and Ecuador) yet we remain neutral in Mexico and underweight in Brazil ahead of the elections.
- In Africa, we reduce our weighting in South African corporates to neutral and believe Angolan sovereign spreads should widen. On the technical side, light supply should be a positive catalyst in the short-run.

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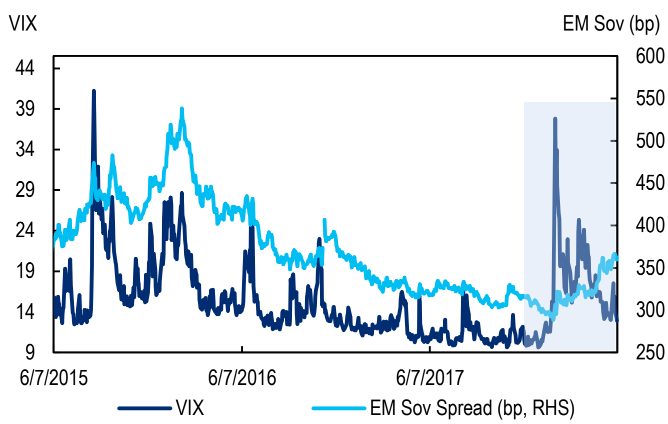
With thanks to
Ruchi Rohra and Kush Berry

EM Credit: Sell-off not done yet!

We remain caution on EM spreads. While we acknowledge that valuations are becoming attractive, negative idiosyncratic developments for large credits belonging to the index are strong headwinds, in our view. With performance dispersion increasing among credits, we recommend investors to be selective. We prefer short-end bonds with positive developments (Argentina and Ecuador) yet we remain neutral in Mexico and underweight in Brazil ahead of the elections. In Africa, we reduce our weighting in South African corporates to neutral and believe Angolan sovereign spreads should widen. On the technical side, light supply should be a positive catalyst in the short-run.

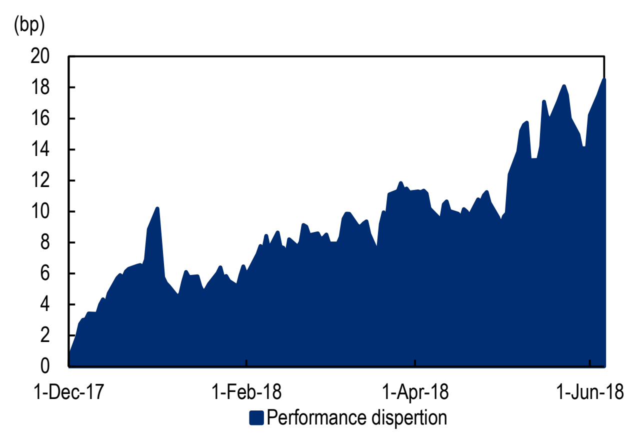
EM spreads have another volatile week. EM credit spreads remained under pressure this week. Though the Citi EM sovereign spreads are off the widest level, the environment remains volatile. Of the large credits, Brazil has been in the spotlight underperforming its peers. The weakness was driven by concerns over political pressure on Petrobras pricing, combined with large depreciation of the BRL and fears that the election outcome will not be positive for the much needed social security reform. Mexico has been underperforming as well -- lack of progress on NAFTA has accelerated the sell-off, in an environment that remains uncertain due to the elections next month. On the positive front, Argentina (IMF program) and Turkey (emergency hikes) credits, which have been recently under fire, are beginning to stabilize.

Figure 1. EM credit spreads have continued to widen



Source: Citi Research

Figure 2. Performance dispersion among individual credit has been increasing, suggesting that correlations have been breaking down



Source: Citi Research

We remain caution despite a healthy equity market. We have been cautious on EM spreads since March this year, advocating that developed market 'policy normalization' i.e., increase in interest rates and political development would have taken a toll on spreads (EM Credit Weekly - A Cautious Stance). We remain of the same view. Indeed, despite a healthy equity market, particularly in the US and subdued volatility (see Figure 1), we think EM idiosyncratic developments are likely to prevent any meaningful spread compression, especially if EMFX continue to be under pressure. In conclusion, a rising rate environment, combined with 'removal of liquidity' from developed world, has been challenging for EM. Given this we advocate for a light position. The risk to this view, however, is a reversal of the strong USD environment. With the Italian political situation calmer now, focus is shifting to the upcoming ECB meeting next week. Citi believes that the ECB could address taper in a more official manner. Inflation has continued to move higher and policymakers are confident they will hit their target in the medium term. The timing for announcement (June vs. July) is unlikely to impact investor sentiment in a significant manner.

Credit selection is becoming more important. As highlighted in Figure 2, the dispersion of the performance among the largest weighted credit in the index has been increasing over the last few months. This suggests that credit selection has become more important and investors should be focusing on that. To put it differently, global factors are influencing credit in a different manner and spreads correlations are diminishing.

We are overweight Argentina and prefer the short-end of the curve. The IMF announcement is likely imminent, with a potential 36-month package. Local media suggests the total package could be around USD40bn (including other multilaterals, e.g. WB, CAF, IABD), some of which will be cash, available funds, and last resort funds. On the fiscal front, targets could be slightly tighter for this year (~2.5% of GDP), keeping the 1pp step for 2019 (1.5-1.7% of GDP), and an almost balanced budget by 2020. The fiscal adjustment could come by reducing subsidies, public employment, public investment and transfers to the provinces. On the monetary front, we expect the inflation targeting regime to remain in place, but the program is likely to bring new inflation targets which are more consistent with the fiscal targets (e.g. something in line with the latest REM could be considered more achievable). The package is also expected to strengthen the autonomy of the BCRA (a new central bank charter is likely to be announced), and separate the Treasury from the BCRA (e.g. no more transfers to the Treasury). All in all, we continue to expect a pragmatic IMF, supportive of Argentina's policies, which suggests limited bond supply and the possibility to have a smoother path toward election next year. We think the short-end of the bond curve remains cheap.

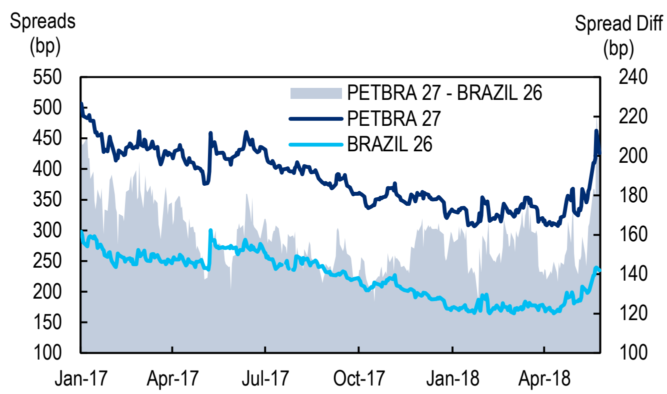
We remain constructive on Ecuador despite external supply. The economy has continued with the impulse it had since the end of 2017, though future USD inflows are key. As a consequence of a boost in consumption propelled by both the elimination of safeguards as well as a 2pp reduction in VAT, the economy had a strong rebound in 2H2017. This has persisted into 2018 as evidenced by the monthly activity index. However, it is worth noting that an important challenge for growth lies in the availability of local financing, since a dollarized economy such as Ecuador relies on positive inflow of USD to keep the monetary base growing. New funds are needed to keep the current GDP growth alive. The imposition of import restrictions in past years was a tool to keep the current account relatively flat and rein in USD outflows. After being suspended, these are now on track to be re-imposed, which we see as a positive development.

The most readily-available source of new USD is external issuances. This has been the case since in 2016. It is important to note that the new issuances worsened the debt/GDP ratios at a time when the country’s total outstanding debt was not publicly known, generating uncertainty. President Lenín Moreno pledged greater transparency upon taking office, and this promise began to be fulfilled last month when newly appointed Minister of Finance Richard Martínez authorized the publication of detailed debt statistics, showing that debt to GDP currently stands at 57% (bonds and loans with multilaterals represents 47% of GDP). With this new level of transparency, we believe the government is seeking to show the market its intentions to clear up its finances, which should help an eventual issuance, but we believe they must also strive to better convince the international community that a fiscal consolidation plan is not only feasible but on the way. In light of this, a set of metrics that we have introduced in order to time new issuances (see our Ecuador

[Economics View: Timing New Issuances](#)) show that we could be seeing a new issuance taking place as early as next month.

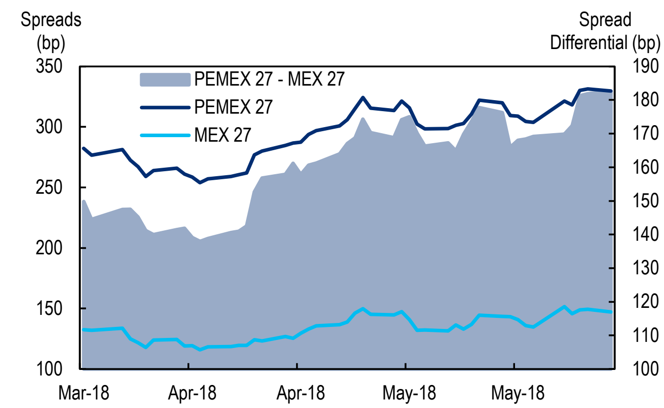
In Brazil, Petrobras CEO's resignation negative for sentiment. We have been de-risking our Brazil portfolio on rising political concerns despite an improving deleveraging story domestically. The CEO's resignation was initially seen to be at President Temer's behest, but the market has had reports of him leaving for a food producer for some time. In any event, the recent turmoil highlights the growing potential for a return to government interference in Petrobras' business practices as well as corporate governance. Even if President Temer publicly attempts to allay investor worries on Petrobras' independence in the future, we do not think his words will be sufficient to assuage fears, with his term ending in a few months and the disposition of the likely second round candidates toward privatization and intervention still to be determined. In other words, this risk is not going away and is far from certain in being seen as a one-time event. In other words, this risk is not going away and is far from certain in being seen as a one-time event.

Figure 3. We recommend selling the Petrobras rally…



Source: Citi Research

Figure 4. …Pemex is a better value play on Mexican elections

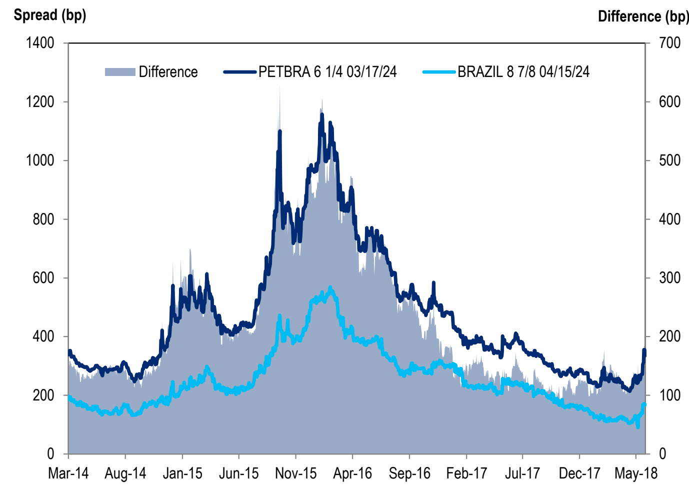


Source: Citi Research

Politics takes center stage, even if micro level story is intact. We do not think that pension and fiscal reforms will necessarily take a backseat but such fears will likely rise, and the probability of only watered down reforms being implemented is growing. The current political cast (and polls) makes it difficult to envision a market friendly outcome in Brazil. Alckmin is lagging in the polls and likelihood of Bolsonaro winning has increased. Market focus is quickly shifting to the October elections, which thus far have been overshadowed by Mexico. An AMLO win there is quickly becoming a foregone conclusion in the market, even though the extent of his win remains debatable. We believe Pemex is attractive at the current spread-to-sovereign levels in all but the "big AMLO win" scenario whereby he gets a supermajority, a scenario we see having a low probability of happening.

Is Pemex where Petrobras was, but may be again? The fear factor for Pemex under the "big AMLO win" scenario is fairly simple: Its halting steps toward being a "normal company" allowed to keep its cash for investment and set prices and labor policies according to the market is reversed, and it returns to being a tool of the state for economic development, perhaps to the detriment of other stakeholders like creditors. This is a similar scenario that Petrobras was in earlier this decade when PT governments under President's Lula and Rousseff which resulted in the 2015-16 credit crisis at the company. A possibility of reversal of policies implemented by the outgoing CEO (asset sales, market determined pricing) rightly is seen as a step backwards. It remains somewhat open as to how much of a backward step as the real test will be the policy of the next administration, which will take power in December. That is why we believe the SoS for Petrobras needs to adjust to similar levels as Pemex, as they both should be pricing a degree of political interference.

Figure 5. Where can spreads go? Perhaps not to 2015 levels but we see downside ahead of elections



Source: Citi Research

Where can spreads go? Fortunately (or unfortunately) we don't need to look very far to understand where PETBRA spreads can go if politics turn south. A short trip down memory lane shows PETBRA spread-over-sovereign reached 600bp in the thick of the PETBRA crisis in 2015. At that time, however, the matter was compounded by oil prices plummeting. Indeed, Brent at $78 provides some floor to how much PETBRA can weaken due to the strong upstream business, but higher oil prices and weakening BRL puts intense pressure on fuel prices in local terms for the downstream business, which in an election year has already proven to be fodder for populist policies. We believe this pressure will only intensify in the next several months. We have exited our PETBRA 27 ($98.45, 6/7/2018 15:45 ET) trade based on this rationale. (Emerging Markets Credit Strategy Flash - Pricing the sovereign risk: Petrobras vs Pemex)

CEEMEA

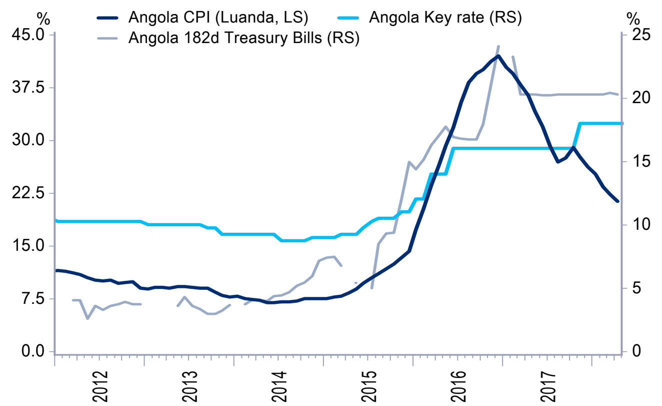
Angola's currency weakness beginning to leak into credit spreads

Angola's president João Lourenço remains in an effort to establish the credibility of government policies by dismantling corruption networks and enacting bold reforms. One important pillar in this economic and institutional re-structuring effort is the change of currency regime. The local currency depreciated 42% to 238.05 this year. While this is a meaningful devaluation, the kwanza trades around 415 on the black market, fueling further inflation pressure (as the economy is highly dependent on imports). Despite the high policy rate (key rate at 18% since November 2017), inflation is reluctant to march towards the 7-9% inflation target (**Figure 6**).

The soaring inflation continues to deteriorate the competitiveness of AOA. We designed the NEER and REER of Angola versus the ten largest export trade partners. As we can observe in **Figure 7**, the REER slumped by 20% in January

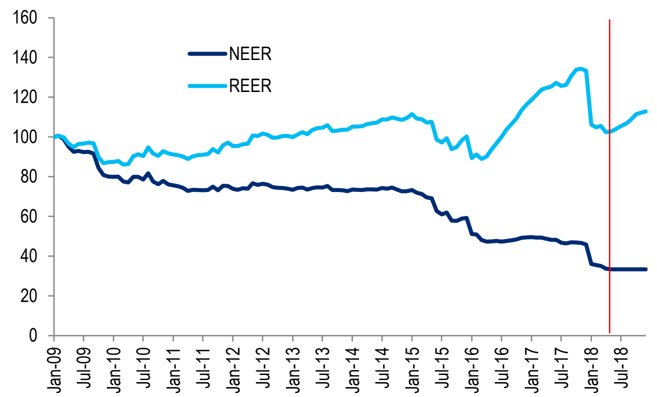
2018 and remained relatively stable since then. If we take into account Citi's CPI and exchange rate forecasts of Angola's trade partners, the REER is likely to accelerate by 10% by the year-end. This suggests that the central bank has to depreciate at least 10% the AOA by the end of the year to offset the REER deterioration for the next six months.

Figure 6. Inflation reluctant to march towards the central bank's target



Source: Haver, Citi Research

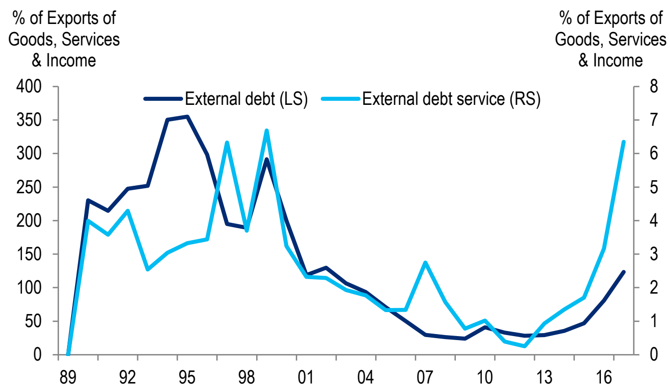
Figure 7. The REER will continue to deteriorate in the coming months



Source: Bloomberg, Citi Research

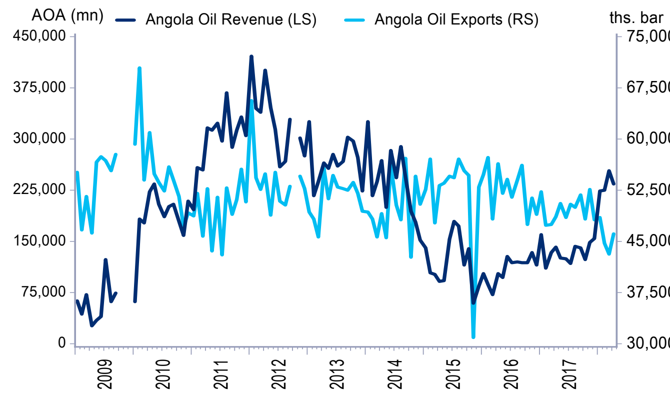
Oil panacea is temporary. While external debt as a percentage of exports of goods, services and income is much smaller than in the 1990s, interest payments on the external debt as % of exports of goods, services and income has soared since 2012 reaching 6.35% (**Figure 8**) at the end of 2016. While we don't have the available data for 2017 and 2018, we believe Angola's external debt service has deteriorated even further. Although external debt stock is estimated around USD 43.7bn at the end of 2017, the bilateral financing issue raised in Zambia still fuels the scepticism of market participants regarding the official numbers. On the plus side, high oil prices boosted oil revenues (**Figure 9**) in the past months, and they are likely to ease the fiscal pressure and austerity measures. With Citi's view of oil moderating later this year and weak Angolan oil exports, we believe that the oil revenue boon will fade in the coming quarters.

Figure 8. External debt service is at alarming level



Source: Citi Research

Figure 9. Oil revenues have increases significantly

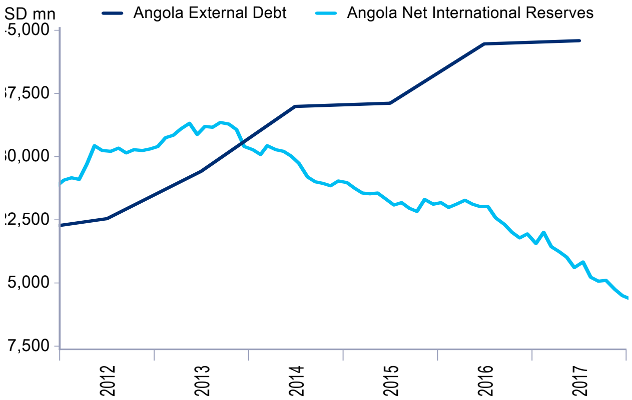


Source: Citi Research

Angola applied for the Policy Coordination Instrument in April 2018, which is a non-financial assistance program. While the IMF program will rebuild the external credibility of Angola's economy, this is unlikely to fix the dollar shortage that leads the AOA to trade nearly twice on the black market as the net international reserves of the central bank are only USD 12.9bn at the end of April 2018 (**Figure 10**).

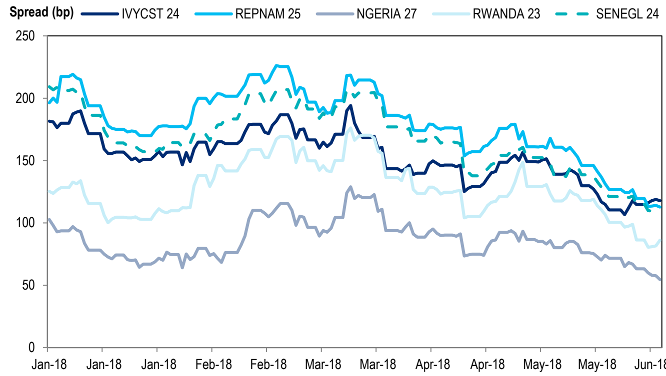
Angola bonds have outperformed its peers since the beginning of the year on the back of higher oil prices and expectation of an IMF program. Technicals were supportive too as Angol 19s was excluded due to the thirteen-month EMBI exclusion criteria and investors poured their funds into Angol 25s. As we expect oil prices to moderate later this year, AOA to depreciate further and non-financial assistance program from IMF unlikely to solve the dollar shortage in the nearest future, we believe that the tightness of Angola bonds are not justified. ***Considering high prices of these bonds, we believe Angol 25s ($112.23, 6/7/2018 15:45 ET) is likely to widen in an environment of higher pressure on DM yields.*** Also, given the current USD-EM adverse price action and any potential impact on the OAO, we believe the flatness of the Angola $ curve may be challenged in the medium-term. Expectations of very light EM new issuance over the summer and some anecdotal rotation from the battered high-yielding credits in Latam to SAA credits may have recently supported the Angolan curve. Once these flows recede, together with sustained pressure from DM rates, we believe the Angolan curve may be biased towards some steepening again.

Figure 10. The FX reserves are at very low level



Source: Citi Research, Haver

Figure 11. Angol 25s spread over peers



Source: Citi Research, Bloomberg

South African growth trajectory looks more uncertain. The ripe successes of Ramaphosa's first 100 days in office were overshadowed by weak GDP numbers on June 5 (South African Economics Flash: Q1 GDP Weak). The rebranding of South African politics came in February when Zuma was ousted and Ramaphosa began to institute change. The President prioritized efforts to tackle corruption and SOE governance with Pravin Gordhan as he was appointed as Minister of Public Enterprises to "un-capture" the captured state. It remains unclear whether new boards can really overturn years of mismanagement across Eskom, South African Airways, Denel and Prasa. One ought to question whether corporate decay can be rectified in quick succession without near-term financing through debt issuance, capital injections or even government shareholder loans. All it took in October was a misguided Medium-Term Budget Policy Statement and bearish rating agency comments.

How long does a honeymoon last? There might be clear water between Ramaphosa and the previous ANC government, but challenges lie with fiscal reform mainly over wages, land expropriation and uncertainty over the Mining Charter. All three were politically inherited although we can expect near-term clarity from the Minister of Mineral Resources (Gwede Mantashe) on the Mining Charter this month. Language concerning the "once empowered, always empowered" is likely to be a key talking point, which could retrospectively enforce minimum ownership (Mining Charter III). What separates the Mining Charter proposal from June last year is industry consultation and the Ramaphosa/Mantashe experience within the National Union of Mineworkers. Nevertheless the likelihood of draconian measures could be a further source of volatility for the mining sector.

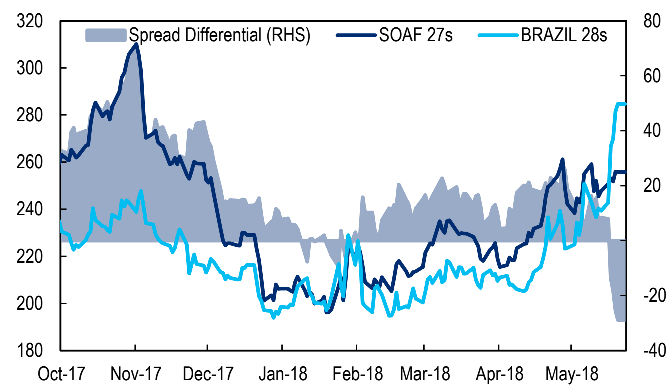
Would you really call it SOE reform? An experienced board now guides Eskom at the helm, although we are yet to see any material reform. Eskom may have tapped existing debt through domestic markets but has not auctioned new tenors under its DMTN program as previously slated. Capex commitments still remain high, NERSA tariff reviews are unlikely to offer much upside and RCA clawbacks would be stretched over a prolonged period. That said, Eskom does intend to reduce the workforce by 4.2% and continues to look to dispose of Eskom Finance Company for a sum of c.R8-10bn. Unfortunately we are not convinced the above will stand to reduce Eskom's deeply negative FCF position and USD funding through the GMTN (USD debt) is unlikely to fix the deteriorating credit profile.

A better scenario for Eskom involves asset disposals. In 2016 European utilities divided the business between conventional and renewable energy to hive down assets and debt. Similarly National Grid, SSE and Fortum have recently sold stakes or full ownership in distribution assets over the past 2-3 years. As a loose metric, Eskom could transfer the Distribution segment (18% EBITDA) while maintaining control of Generation and Transmission. Assuming a similar multiple of 10-15x that has been applied to European distribution assets, then Eskom could unlock a value of c.R67-100bn (Eskom: Cautious but Overweight South Africa). The opportunity to then deleverage, in line with management's once mooted new "capital structure" could then be achieved, perhaps improving the standalone credit profile.

Increasing the heat on early elections as ANC cast polls. As Rampahosa seeks to build on the tangible successes of economic reform, he may be unable to paper over the cracks late in to 2018 and early 2019. This may perhaps increase the probability of early snap elections, seize what some call "Ramaphoria" and prompt the President into pursuing a stronger, fresh mandate. The slender ANC victory in December means Ramaphosa is somewhat driving through the rear-view mirror, as political opponents are never too far away. **Given the rising political temperature we revise our country allocation to Neutral from Overweight.**

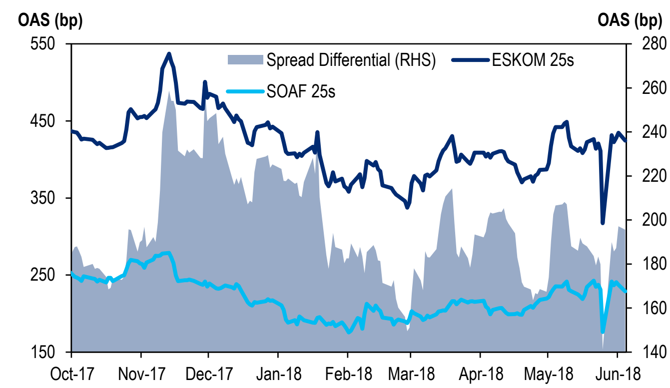
Ukraine votes to pass ACC bill – Lawmakers convened for the second parliamentary reading of the Anti-Corruption Court on June 7. Expectations of passing reform to win over IMF support via the fourth tranche looks set to proceed although the devil is in the detail regarding numerous amendments (Have UKR and the IMF reached a compromise). We also believe the legislation is instrumental in continuing the EFF program. However, political infighting has now seen the dismissal of the Finance Minister which may stand to complicate Ukraine's path forward. We remain Neutral across corporate credit given the uncertain backdrop (Living on an IMF Prayer). The next important signpost lies with the IMF's decision.

Figure 12. South Africa versus Brazil



Source: Citi Research

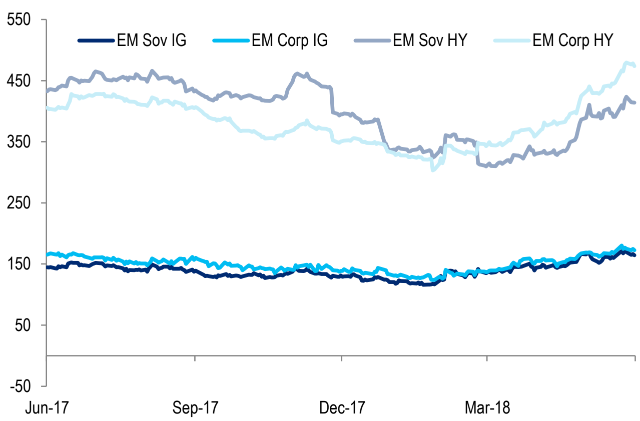
Figure 13. Eskom 25s still trade too richly



Source: Citi Research

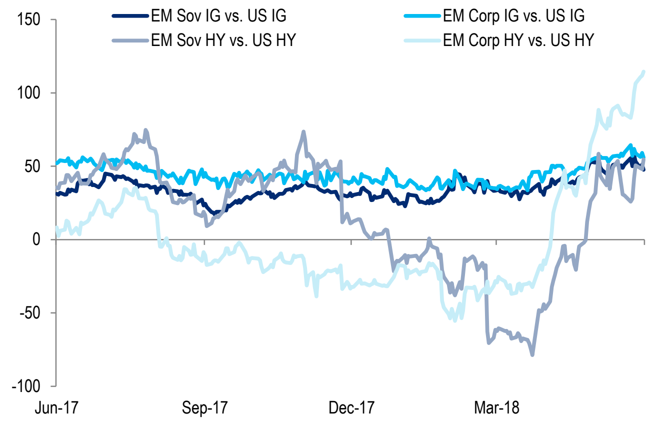
EM Credit Weekly Key Market Indicators

Figure 14. EM Credit Spreads – Sovereign & Corporate



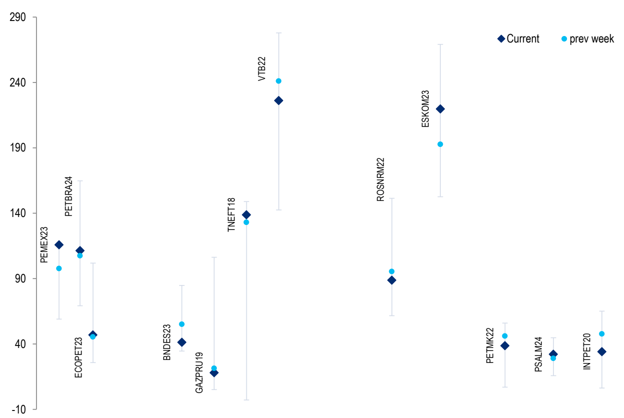
Source: Citi Research

Figure 15. EM Credit Relative Spreads (vs US IG and HY)



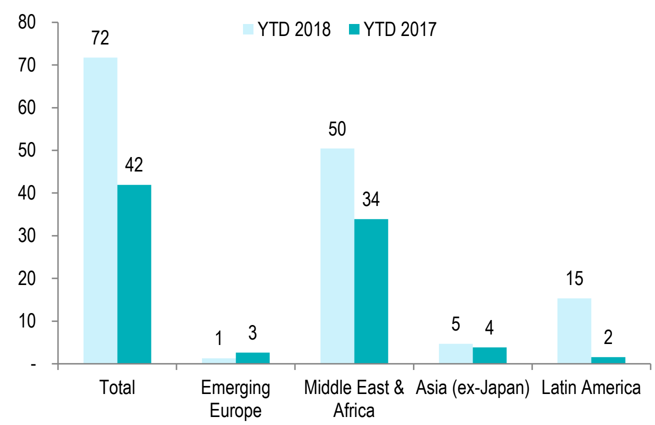
Source: Citi Research, Citi Fixed Income Indices, Bloomberg

Figure 16. Quasi Sovereign Spread over Sovereign (with 1Y range)



Source: Citi Research. Nearest matching sovereign maturity chosen for spread calculations.

Figure 17. Sovereign: Net Issuances – Regional Breakdown (USD bn)



Source: Citi Research, Bloomberg

Appendix A-1

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