Transcript

>> You're listening to All the Credit, a monthly podcast series brought to you by PGIM Fixed Income, an active global fixed income investment manager. And now your host, senior portfolio manager, Mike Collins.

>> Hello. Welcome to PGIM Fixed Income's podcast All the Credit. I'm Mike Collins, just one of the many senior portfolio managers at PGIM Fixed Income, and your host. I'm excited to have one of my longstanding colleagues, Cathy Hepworth, join us as our guest. Cathy is a managing director and head of emerging markets debt at PGIM Fixed Income. Cathy and I are here to bring you all the credit. Welcome, Cathy.

>> Hi. Thanks, Mike. I'm glad to be here.

>> Yeah. So, you and I have not only worked together for about 30 years at PGIM Fixed Income, we've actually known each other a lot longer than that. We actually grew up together, a lot of people don't know this, in the small town of Verona, New Jersey, which is actually just around the corner from our offices in Newark.

>> Right. I live right down the street from you. And I believe I graduated with your brother.

>> Yeah, that's right. In fact, I knew your sister and your brother-in-law pretty well and played many little league games with your brother-in-law. So that's -- I always feel like it's a family office, a lot of collegiality and really strong long relationships at PGIM Fixed Income in this. So I think it's just another example of that. So, tell us a little bit about how your career has progressed. I mean, you're the head of emerging market debt at PGIM Fixed Income. It's a big job, a lot of assets under management, a huge team. How did you start in emerging markets and your -- make your way to this spot?

>> I always had a passion for emerging markets broadly and in particular, Latin America. As an undergrad, I studied at Georgetown and I was in the School of Foreign Service. I originally thought I wanted to be a diplomat. And then I sat freshman year in my first economic class and absolutely fell in love with economics. While in high school, I had lived in Peru for a summer. And, you know, that just sort of further inflames my passion for all things Latin America. As an undergrad, I studied in Brazil as well. So, I then majored in development economics. So when my -- I always knew I wanted to do something that pertained to the developing world. Now, interestingly enough, my first few jobs out of undergrad were not in -- necessarily in emerging markets. And I ended up at what's now PGIM beginning in 1989. And I was a credit analyst and I happened to be at the right place at the right time. Obviously, we have a lot of assets, fixed-income assets, I've always done fixed income, a lot of fixed-income assets, right about the time of the Asia crisis, a little before the Asia crisis. And we decided internally that we need to manage emerging markets as a separate asset class. When we first started, it was only hard currency. We only had exposure to hard currency emerging markets. So, I hope --

>> That's dollar denominated emerging --

>> Exactly.

>> -- market debt primarily.

>> Yeah.

>> Right.

>> Yeah, thanks for clarifying that. So I was one of the cofounders of our emerging market strategy beginning in 1996. And over the years, we've grown our assets substantially, most of it third party, and it -- to include strategies that are not only hard currency, i.e. dollar denominated assets and -- but also blended assets where the benchmarks include local bond benchmarks, hard currency assets, or emerging market corporate assets, local only, long, short, et cetera. So we were very flexible in the different types of EM strategies that we manage like the rest of PGIM Fixed Income, very flexible in the different amounts of risks that we take. And, you know, as you alluded to, I have a very big team not only of portfolio managers, but also of economists and analysts who specialize themselves in emerging markets.

>> Yeah. So how was your role changed? You're kind of an analyst, a portfolio manager, a co-head and now as the sole head of emerging markets, how does that change your job day to day?

>> No, it's very much a team process and it's always been a team process here. And it was, you know, it's never -- you know, it's not the Cathy Hepworth show because -- and, you know, it's not like that really across any of the different strategies and asset classes that we manage because our process is so bottom up. While there's a clearly a top-down component to it, there's very much a bottom-up aspect of it that's very relative value driven and very alpha-generating driven. So that really comes from the analyst, the economist, the portfolio managers. However, you have to have somebody who directs that, and who's in charge of all of that, and who thinks strategically. So, as my responsibilities have increased to now I'm head of the group, I see my role as making sure that everything comes together, that we continue to follow the process that really established in the beginning. And that's the beauty of this, that we have a four-step process that, you know, we started back when this asset class was new for us. And it's -- as the asset class broadly has grown, our process has been able to adapt to the changes in the asset class and as our team has grown likewise. So I'm always making sure we stick with the process, that it's repeatable, so that we're able to deliver to the clients the, you know, the performance and the type of alpha from the sources of alpha that they expect.

>> OK, so let's dive into the asset class, talking about some of the challenges, as well as some of the opportunities. I mean, clearly here we are in May of 2020, really in the midst of the biggest global recession we've had, effectively since the Great Depression in terms of the drawdown in economic activity, and it's certainly hitting some of the emerging markets or developing countries really harshly. And there's also the healthcare crisis aspect of it that a lot of people think maybe developing countries aren't as well equipped to handle some of those issues. How do you parse those two aspects of this and how does it impact the emerging market countries?

>> Yeah, yeah, good question. Because there's the -- when you say emerging market countries, it includes lots of different types of emerging market countries. So you have -- So the emerging market indices include single A-rated countries, double A-rated countries all the way down to defaulted countries. So, clearly, the macro impact, the healthcare impact is varied by -- based on the preparedness of the country, the starting point of the country from a -- an economic health perspective in terms of how much debt they had, whether or not they were depending on borrowing externally, what the fiscal impact is not only of the crisis, the needs to spend more for health reasons, but the closing of the economies. I mean, global trade essentially shut down, you know, global growth, essentially, you know, as you mentioned, we're in a depression. So these countries had to increase their fiscal spending significantly. A lot of these countries cannot raise that money domestically. And this is particularly true for lower-rated countries, single B countries, countries in some parts of Latin America or in Sub-Saharan Africa. So they are needing to rely on the IMF, the World Bank, or the G20 and bilateral sources for funding.

>> Yeah, so the emerging market asset class, like you said, they -- you know, we take for granted in the developed world sometimes that, you know, the treasury needs to raise money for fiscal stimulus. They can access the treasury market and borrow and that's certainly not the case in a lot of these emerging markets. And there's -- Typically, I think of it as four really sub-asset classes in emerging market debt. And you alluded to it as we've shifted from many years ago focused on hard currency emerging market debt into a variety of different other niche areas within emerging markets. There's traditional hard currency, the dollar or euro denominated bonds, there's local currency, both on the rate side, meaning exposure to local interest rates in emerging markets and currencies. And then there's actually emerging market corporates. How do you think about those four components? And how do you rank them? I know we do a zero to 10 scoring system every week at our strategy meeting. In fact, we just finished our strategy meeting earlier today. So, on a zero to 10, how do you rank them? And how do you think about those subcomponents of the emerging market debt asset class?

>> Sure. So what typically happens when there's a shock, a macro shock, either, you know, it's an exogenous shock that hits the global economy or even specific to EM, usually, what typically happens is local bonds, local rates, these are bonds that are issued in domestic currencies. And there aren't a lot of emerging market countries that have, obviously, large and deep domestic capital markets, but there are a few and there are clearly some local indices out there. Oftentimes in the initial stages of a shock, because economies are contracting, central banks are cutting rates. So those -- that part of the local bond market on a hedge basis, and that's importantly, so you're hedging out the FX risk on a hedge basis, those markets outperform. And that was clearly the case so far year to date, it happened after the '08 crisis. And it's happened so far this year. So on a hedge basis, local bonds have outperformed, as we would expect, as these emerging markets have cut rates significantly.

>> Yeah. And that's different than in some past cycles, right? I mean, you know, in some past cycles, when there's weakness in emerging market countries, their currencies get hit, their inflation goes up. And in some cases, the central

banks actually raise rates to defend their currency and protect against inflation. And that certainly hasn't happened this cycle, right?

>> It hasn't because there's no inflation. So emerging market currencies have clearly -- have they've underperformed and they have sold off although there's a huge dispersion of performance among the emerging market currencies as well as local bonds hedged. But given that there's no inflation, and there's so much scope for emerging market countries to cut rates like the developed market countries have, right, our best case scenario from a firm is that developed market rates are going to remain low for quite a long time. That doesn't necessarily mean that emerging market rates will remain low for as long, but they're going to remain low for a very long time. But to answer your specific question about, OK, so how do we think about the different EM asset classes from a relative perspective, we initially expected that local bonds hedged without perform, that's been the case. But now given how much spreads, i.e. the hard currency dollar denominated assets have sold off, we actually think there's more value there. So let's put that into perspective. So before the crisis, the spread on that hard currency sovereign index was just about 300 basis points. It got too wide in the third week of March about 725 basis points. Now, it's come into -- by the end of today, it will probably be close to 550 basis points. So, clearly, hasn't retraced as much as some other asset classes but it's retraced somewhat. But what's really interesting, I think, at hard currency for the sovereign spreads in particular, is to decompose the spread on that index between the high yield part and the investment grade part because, again, in emerging markets, there's no limitation on the lower credit qualities that you could have. So the high yield portion of that index, the spread is over 1,000 basis points. The high grade, the spread on that is just about 300 basis points. We actually think there's value in both of those, but the trades that we've been focusing on is clearly more up in quality trades, because we find that historically the first things to recover and the base cases that spreads are going to mean revert. But the assets that recover first are the higher quality assets, because they were still double the spread what they were before this selloff, they have market access. I can elaborate a bit more later on just about the new issue supply that's happening in EM for those countries, the have countries, the countries that can access the market. And then you have all the single B countries, in particular, the oil sensitive ones who don't have market access, who are still trading at very wide levels. We think there's value there. So from how we rate them from a long-term perspective in terms of the rating, we would put an eight on hard currencies sub --

>> But this is again zero to 10. Ten, we love it, zero, we hate it, five or neutral. So an eight is really, really high rating.

>> An eight is very high rating, so an eight on sovereign spreads and on corporate spreads as well, a seven on EM FX. So right now -- So that's a long-term rating. Right now, we actually don't think there's lots of opportunity in emerging market currencies in large part because the outlook for emerging market growth is not that great over the course of the next year or so. And because we think the dollar will just be strong and the yield on emerging market currencies is low. So, over the longer term, however, given how much emerging market currencies have sold off already, we think that there's value there. And because EM local bonds have done well already, our long-term rating for EM local bonds is closer to a six.

>> OK, that's great. And I like how you always break down the different risk profiles within emerging markets. I think a question I get and I'm sure you get all the time is what region do you like in emerging markets? Do you like LATAM, or Asia, or Europe? And to me, that's not the right question. That's like asking a corporate bond manager, do you like corporations in the East Coast of the US or the West Coast, right? So how do you break down the different types of risks within, let's say, hard currency emerging markets?

>> I think the best way to do it is by quality. And -- Because, you know, it's always all about bottom up and picking the right credits. And I think an easier way to think about it, in particular in the current environment, when there is such a distinction between countries that have market access and those that don't, you really need to think of it in terms of a tiering, higher quality EM, kind of mid-quality EM and then the lower quality, and you can even add distressed as another category, a separate category.

>> So what are your -- some of your, you know, best ideas in each of those category or give me an example of a country or a credit that you're looking at or that you like in each of those categories.

>> So, let's take the higher quality first. So I talked earlier about some countries that had more market access and that were issuing new debt. And so far in -- since the selloff, since the worst of the selloff in March, there's been about over $70 billion of new issue supply in emerging markets, primarily sovereigns and quasi-sovereigns in corporates. So, clearly, not as much as we've seen in US high grade, but it's a decent amount of new issue supply. But the -- what's different is the countries that can issue. So countries, for example, like Qatar, oh, OK, that's oil sensitive. It's part of the GCC. But Qatar, their debt -- So Qatar, we internally, you know, Qatar is rated, you know, double A and their debt, 10-year debt, used to

trade at about 70 basis points. At the wides, it got to 250 basis points. When they tap to the markets, they're a relatively new issuer in the emerging market universe. When they tap to the markets, they came in the 10-year space at 300 basis points. So it used to trade at 70. It came at 300 basis points. It since rallied over 100 basis points, but there's still value there, right?

>> Absolutely. Even if that tightens just another hundred back to -- from 200 to 100, that's, you know, eight points of upside.

>> Exactly. So credits like that, what -- so why is it that they were able to issue, you know, multi-tranche deal, multibillion dollars of supply, because they have lots of cushion, because they have reserves that will cushion the blow for them, even though they're oil sensitive. Countries such as Philippines and Peru, also investment grade emerging market, countries that have very solid balance sheets, if you will, they don't have a lot of external vulnerabilities. They're not frequent issuer. So the technicals there are very solid. And those two issuers were trading inside of 100. And they -- when they access the market, you know, they were at, you know, a couple of hundred basis points in spread. And those two have done well. So those are countries that I put in the category of higher quality and we're doing up in quality trades names that we want to increase our exposure to. Then you get to, let's call it the middle tier or, you know, just for simplicity's sake, I'll say the double B type of credits. And interestingly enough, I'm going to throw out there Pemex. So Pemex is the 100% owned-oil company that's part of Mexico. As you're well aware, it got a downgrade to below investment grade, so now it's out of the IG indices because of that downgrade. It got to -- Because of the technical selling that took place as a result of the downgrade. Pemex bonds were trading as wide and I will give you a 10-year point, they were trading almost 1,000 basis points in spread. So relative to where the sovereign Mexico is trading, it was trading 700 basis points wide to where the sovereign was trading. And that's a good, you know, three to 400 basis points wide to where it was trading from before the crisis. Obviously, it also suffered because of its oil sensitivity. It has since rallied from that, now it's 100% of the investment thesis is that Mexico will do whatever it takes to make sure that Pemex isn't going to default. And they've proven that both explicitly and implicitly in the past in terms of injecting money. So that spread, which got as wide as 700 basis points from technical selling, now is inside of 500, the spread of Pemex relative to Mexico. So we think that there's, you know, decent value there for -- while it's a double B credit, trading at a spread of, you know, plus 800 basis points or so, we don't think that there's significant default risk. Because we think Mexico, which is still investment grade, the sovereign will stand behind it.

>> So what are some of the higher beta ideas out there?

>> So one that comes to mind is Ukraine. So Ukraine is interesting because it's not -- it's an oil importer. It's a, you know, low single B-rated country. But interestingly enough, it's a country that continues to make progress on reforms. And they have actually recently completed some really important reforms as it pertains to the banking sector, as it pertains to corruption and land reform, which were critical to help them get a formal another -- an additional formal IMF program. So a country that wouldn't necessarily have market access because of its lower rating. It has debt coming due over the next few years, needed that extra kind of backstop, if you will, from the IMF. It did what it needed to do. So we've got access to another large program. And that's, you know, something that had underperformed significantly at the beginning of this selloff because lots of people are overweight Ukraine. But now it's come back and it's one of our -- one of the positions that we think will continue to outperform for the reasons mentioned. There are other --

>> And of course, everybody wants to talk about Argentina.

>> Yeah. And, well, the interesting thing -- So I put Argentina in the distressed category. So we all knew that Argentina was going to have to restructure its debt coming into this year. The question was, well, when is that going to happen and under what conditions? The expectation was the new government in Argentina wanted a "friendly restructuring", because it wanted to be able to get on with this administration with the default behind them so that they could have Argentina grow, so that they could get reelected four years from now. Of course, with the onset of the crisis, that did not come to pass. And instead, what happened was the government presented bondholders with a much more aggressive restructuring package than had initially been contemplated. And by that, what do I mean by more aggressive, in terms of the haircut, the expectation of how big the haircut would be, and what the recovery value would be. So before the crisis, Argentina bonds, depending on the bonds, were trading in the 50s or 60s. So, again, distressed levels, the market knew they were going to restructure, thought they would have decent recovery values. Throughout March, they all got down to about 25 cents on the dollar. The initial proposal by the government not necessarily that friendly or attractive to bondholders. But there's been lots of bonds back and forth between the bondholder groups and Argentina and their scope to have the actual, the final

package, actually be a lot more attractive. So now the bonds have traded from 25 cents on the dollar, for example, up to 30 and 40 cents on the dollar. And we think depending on the bond, there's scope for recoveries to be in the high 40s or 50s.

>> OK, so let's wrap up, Cathy, by talking about how you're positioned in your portfolios, you gave some insights and that you like some of the higher quality names. But it sounds like there's value across all of these different risk profiles, if you will, within EM and the different subsectors within EM. So how are you positioning your portfolios either to take advantage of these values or just restructure given your changed outlook following this big crisis?

>> So let's use a blend portfolio as an example, one where there's lots of flexibility where we can take lots of different risks. So in that portfolio were overweight spreads. So we're, you know, sort of toward the max threshold of our spreadsheet risk budget, because we think there's great value over the long term for the higher quality, which we think is going to recover first. So, I gave you a few examples, but there are, you know, other investment grade issuers that we think fall into that category in addition to the ones that we mentioned, in particular, at the back end of the curve, and EM spread curves tend to be steep. So, we take advantage of that and thinking spreads definitely mean revert overtime, and we think that will happen in EM. But we also recognize -- we're very careful when we're looking to fund some of those higher quality names, that we look at the lower quality names, and we have sold some of them. We sold names like Turkey. We sold some other single B Sub-Saharan African countries where we just don't have a lot of conviction, for those countries like the Ukraine or like Ghana, which has a, you know, a strong relationship with the multilaterals, which has a dialogue with investors that they're going to continue to service their debt. We're comfortable continuing to have positions in countries such as that. We talked about some of the mid-tier, the Pemexes of the world. I would include Petrobras in that, the Dominican Republic, which is a country in the Caribbean, which benefits from low oil prices. So it's a mix of different countries and different risks. We're -- In terms of the overall amount of emerging market corporates we have exposure to, we think since there's such good value in some sovereigns and quasi-sovereigns, we don't have as much EM corporate exposure. But, you know, we think there's selective good opportunities and certain sectors in emerging market corporates. We still think there's value in some local bond markets on a hedge basis. So while over the longer term we don't rank it as high as we do spread, right now, we think countries that are going to continue to aggressively cut rates such as Mexico, such as Russia, or even China which will continue to use, you know, monetary and fiscal policy, we think there's opportunity in those local bond markets. And in emerging market currencies, quite honestly, we're long the dollar. So, one of the things that's helped the portfolios through this crisis is having a long dollar position relative to EM-FX positions, and being very careful in the EM currencies that we do have exposure to that they're not very commodity sensitive. And if we -- like in emerging market currencies, because it has some -- carry some yields and the growth prospects in that selective country is better than the broader universe of emerging market countries.

>> All right, and just so everybody understands. So I manage a lot of our multi-sector portfolios, core plus, et cetera. And a lot of those best ideas, Cathy, that you talked about also find their way into the emerging markets leave within the multi-sector portfolio. So thank you for all the hard work your team does, not just in our emerging market strategies, but in -- across the board in the multi-sector portfolios. So that's a great discussion. Cathy, thank you very much for all your wisdom, all your experience, your thoughts in today's challenging markets. It sounds like you're pretty constructive on the asset class. And I'm sure that's going to bode well for our clients in the space. So thank you very much.

>> Absolutely. Thank you.

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