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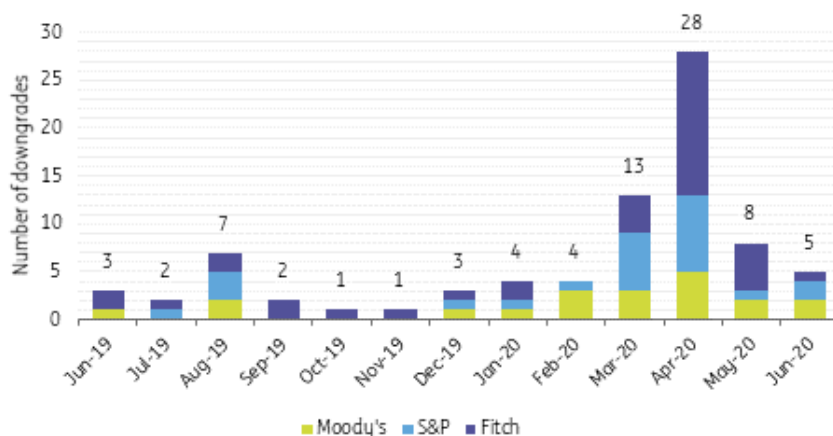
EM sovereign debt: No time to be complacent on fallen angel risks

Amid the pandemic and oil price collapse, fundamentals of emerging market sovereigns have come under pressure across the board, resulting in a peak of 28 downgrades in April 2020 - out of 82 in total over the last year



Source: Shutterstock

Pandemic and oil price collapse led to a surge in rating downgrades for EM sovereigns



Source: Moody's, S&P, Fitch, Bloomberg, ING

Since then, the number of downgrades has dropped substantially, but it's not the time to become complacent. While the stabilising external backdrop has helped to cushion the fall, the fundamental deterioration is slow to materialise, and there is no guarantee that 2021 will bring a much-needed rebound. As another warning sign, 54 sovereign ratings have been placed on a negative outlook since March (vs 29 to stable and 1 to positive).

This sets the context for a handful of 'BBB' rated sovereigns which face the risk of losing investment-grade status in the foreseeable future. Among the sovereigns we cover in this note, this is especially true for **Colombia, India, Morocco** and **Romania** which are one or two downgrades away from becoming fallen angels, further exacerbated by negative rating outlooks. It's however, not set in stone as investors and rating agencies alike are trying to look through the cycle and assess the post-pandemic outlook. For India and Morocco, lifting growth to potential will be essential alongside structural reforms. For Colombia and Romania, downgrade risks are linked to restoring fiscal credibility.

Meanwhile, **Mexico** remains some distance away from losing investment-grade status. Still, the combination of persistently weak growth, faltering business confidence and PEMEX-related financial troubles will become more evident in 2021. **Indonesia** is in the most favourable position here with limited downgrade risks in the near-term. However, should the pandemic and economic slump turn out more severe, this would weigh on the debt outlook and external sentiment (already being tested by fiscal monetisation and the suspension of the fiscal rule), and ultimately on ratings.

We also scrutinise rating relevance for EM debt funds and look at bond performance around the time of losing investment-grade status for some issuers.

We conclude that concerns of such a rating event have resulted in underperformance ahead of actual downgrades, but prospects diverge afterwards (most ratings have fallen further). Finally, yet importantly, forecasting the timing of a downgrade remains a science of its own.

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