OAKTREE INSIGHTS

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SPECIAL EDITION: RISKS AND OPPORTUNITIES IN EM AMID A GLOBAL SLOWDOWN

OAKTREE

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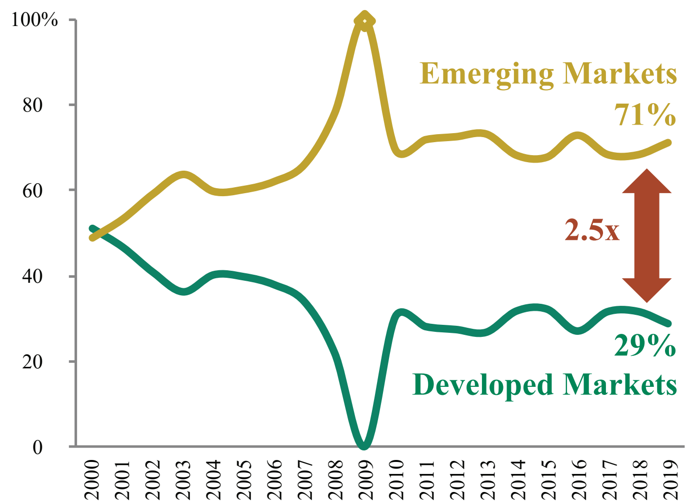
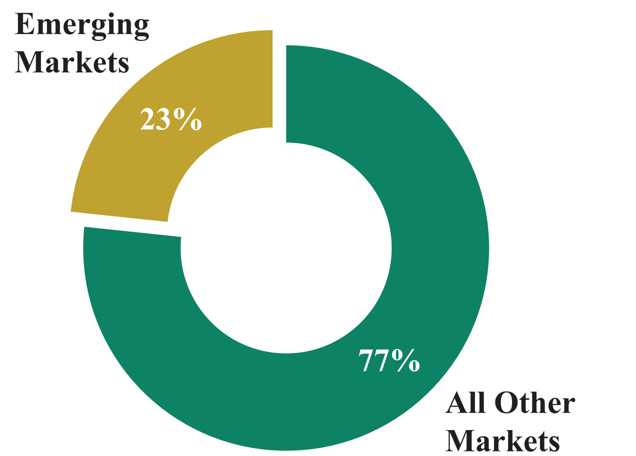
RISKS AND OPPORTUNITIES IN EM AMID A GLOBAL SLOWDOWN

Emerging markets have become too large and too important for global equity and credit investors to ignore. EM economies accounted for 71% of global GDP growth in 2019, and their stocks represent about a quarter of global equity market capitalization. EM corporate debt outstanding has reached record levels, amounting to about double the size of the U.S. high yield bond market.

SHARE OF GDP GROWTH[1]

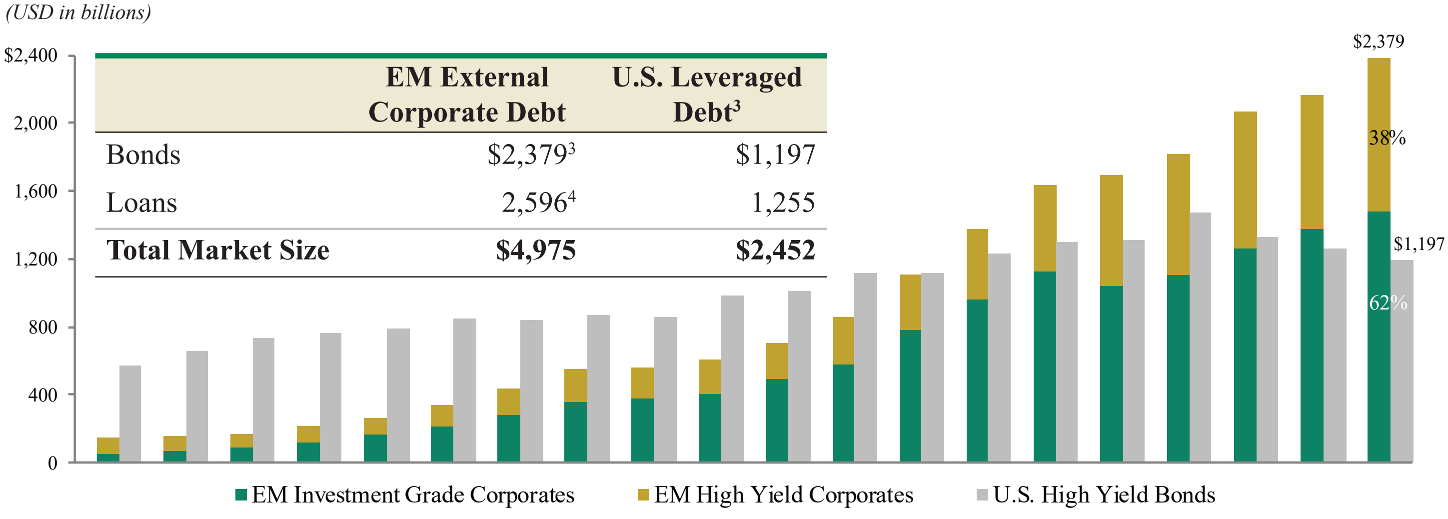


MARKET CAPITALIZATION[2]



EM EXTERNAL CORPORATE BOND DEBT AND U.S. HIGH YIELD BOND DEBT OUTSTANDING[3]

(USD in billions)



	EM External Corporate Debt	U.S. Leveraged Debt[3]
Bonds	$2,379[3]	$1,197
Loans	2,596[4]	1,255
Total Market Size	**$4,975**	**$2,452**

Consider also that favorable growth dynamics, including a widespread increase in consumption and improving policy framework, serve to support EM countries' long-term economic prospects, especially as growth drivers in developed markets stagnate. At the same time, emerging markets may be more susceptible to the impact of fundamental and technical global shocks, such as the COVID-19 outbreak, the collapse in energy prices associated with it, and the resulting bout of market and currency volatility.

What do these dynamics mean to investors focused on emerging markets? Where are the best opportunities today, and what risks accompany them? These and other topics are covered in the edited excerpt below from a March 11 conversation among Oaktree's chief product officer and a trio of portfolio managers focused on public and private equity and debt opportunities in the emerging markets.[5]

Nicole Adrien (Chief Product Officer and Global Head of Client Relations): To set the stage, why don't you each briefly describe the specific emerging market asset classes on which you focus, as well as your investment approach to them?

Frank Carroll (Co-Portfolio Manager, Emerging Markets Equities): I co-head Oaktree's Emerging Markets Equities business, which has existed since 1999. We began by managing a long-short hedge product and then pivoted our focus to a long-only strategy in 2011. Consistent with Oaktree's investment philosophy, our strategy employs a bottom-up, value-driven approach to stock picking, and our primary focus is on getting investments "right" and holding them for a long time. We invest in a large number of EM countries, but relative to the benchmark, we are most heavily weighted today to Brazil, Russia and China.

Julio Herrera (Portfolio Manager, Emerging Markets Debt): I run two EM debt strategies at Oaktree, both highly opportunistic in nature. The flagship EM Opportunities strategy focuses on stressed, distressed and other value-oriented credit investments. The second strategy — EM Debt Total Return — emphasizes investments in performing credit instruments without the use of leverage. Our approach in both strategies is to invest on a bottom-up basis in the debt of companies with robust balance sheets, but usually they are tinged by some degree of current difficulty. About a fifth of our EMDTR portfolio comes from the investment grade universe; otherwise, our holdings are typically fallen angels or high yield bonds that have characteristics that we believe render them relatively safe during an economic cycle. The EM countries in which these strategies are most focused are Argentina, Mexico, Russia, Brazil and Ukraine.

"If there is a protracted global slowdown, which now seems likely, I believe the pain will be felt much more acutely in emerging markets."
– Julio Herrera,
Portfolio Manager,
Emerging Markets Debt

Pedro Urquidi (Global Co-Portfolio Manager, Distressed Debt, and Head of Distressed Debt for Europe and Asia): I co-manage our global distressed debt portfolios, which constitute perhaps the most flexible pool of capital at Oaktree. Our strategy generally seeks opportunities to buy the distressed debt of what we consider to be good companies with troubled balance sheets, where our investment generally secures us a claim on the companies' assets. In addition to traded securities, our team focuses on private deals, many of which have been the source of more compelling opportunities in recent years.

About four years ago, we identified a great opportunity to expand our footprint into Asia. Much of that initial focus was on two principal EM markets: China and India. Both are a source of significant distressed and stressed debt: about \$1.7 trillion in China and \$230 billion in India.[6] That scale and the nature of the opportunity in these territories led Oaktree to build a dedicated team in Asia, an effort that prompted my move from London to Hong Kong last year.

Nicole Adrien: Let's start with the equity markets. Frank, looking at the MSCI EM Index, 2019 was an incredibly strong year for emerging markets. But the about-face here in 2020 has been quite dramatic. The MSCI EM Index and the MSCI World Index are each down more than 20% from year-end 2019. Where, in your view, has the price shock been the strongest?

Frank Carroll: Markets don't necessarily behave as one might expect. Over the past year, the global economies and markets saw no shortage of challenges, including a major trade war that affected various corners of the world. But emerging markets had a great year, with China being one of the world's best performing markets. So far into 2020, China stocks are down but faring better than those representing the overall global stock market: the Shanghai Composite Index is down 9.9% this year through March 30, as opposed to the 20.2% slide for the MSCI World Index. Given that China was squarely in the middle of the trade war and that COVID-19 originated there, its relative equity-market strength is rather counterintuitive.

Meanwhile, the worst-performing market for us so far has been Brazil. The country experienced a significant currency correction, with its real touching new lows this year. Brazil actually had a lot going for it in 2019; inflation was low, which gave the government the ability to lower interest rates. But perhaps they went a bit too far — at least the markets will tell you so — and the currency subsequently corrected. That has had a big negative impact on Brazil's markets.

Of course there's a lot of discussion around coronavirus. The pandemic has hurt broad stock indices and has brought some obvious sectoral displacement in areas such as airlines and energy. But it hasn't hurt where one might think it would, and I would say it has created more opportunity for us on balance.

Nicole Adrien: How will today's market dislocation and a global recession affect EM countries relative to developed ones? Should we expect to see a disproportionate impact on emerging markets?

Julio Herrera: If there is a protracted global slowdown, which now seems likely, I believe the pain will be felt much more acutely in emerging markets. That's because EM countries tend to have less room to navigate in terms of monetary and fiscal policy. Many of them are already running fiscal and current account deficits, and many are commodity-oriented, which means there will be big winners and losers based on factors such as production versus importation of oil. Against this backdrop, and within the context of security prices having already moved with relatively high correlation, continued market turmoil will cause a significant number of companies and credits to become undervalued.

Pedro Urquidi: The reality is that the knock-on effects of the virus and the economic fallout have yet to flow through to actual company performance, aside from perhaps the most obvious sectors such as travel, hospitality and gaming that are directly hit by the world's lock-down efforts. It'll take even longer for the full effects of these shut-down measures to manifest in the market for private investments. Eventually, the ripple effects specific to emerging markets, layered on top of ongoing volatility in the developed markets, could intensify pressures in the emerging markets and create bigger corrections in their credit markets.

In respect to monetary and fiscal policy, as Julio mentioned, EM countries have less room to navigate. On the other hand, China's response has been to aggressively employ tactics that mitigate negative economic effects. The Chinese government isn't bashful about injecting liquidity, for example, and that's the kind of policy action that can support asset prices and thus delay opportunities for us to transact at price levels that align with our risk-adjusted return expectations.

Nicole Adrien: Pedro, tell us more about your approach to the private opportunity set in Asia. Would you say you're somewhat insulated from what's going on in the liquid markets? And how are you sourcing these private deals?

Pedro Urquidi: We're insulated to the extent that the things we buy don't have market prices that change every day. But the reality is the reality. Economies adjust; specific sectors and companies have specific pressures. My personal strategy in approaching a private market, built from having invested in numerous markets outside of the U.S. over the past 25 years, involves this initial checklist of questions:

- ✓ Is there significant potential supply?
- ✓ Is there overleverage?
- ✓ Are there quality assets and businesses that are associated with this overleverage?

The opportunity sets in China and India tick all these boxes. Especially in China, there is the overriding push by the central government to de-lever. The government knows it has a debt problem which needs to be addressed. China provided so much stimulus after the Global Financial Crisis to soften the impact of the correction that the country now has a non-financial sector debt-to-GDP ratio higher than that of the U.S. or Europe. China recognizes that such a debt load is not sustainable. There's also a push to de-lever in the country's shadow banking system. Meaningful progress in that arena has been made in the last two years, with the size of the industry decreasing from about $9.5 trillion to $8.5 trillion. These broad-based changes in China are likely to mean replacement capital will be needed, which in turn could create opportunities for Oaktree.

Sourcing private deals in Asia requires localized relationships, including with, for example, the Chinese asset management companies (AMCs), which are state-owned bad-debt specialists mandated to buy non-performing loans (NPLs) from Chinese banks. Today, the AMCs themselves have done so much buying that they have more NPLs on their balance sheets than the banks they were charged with helping to clean up. The AMCs have thus been looking to de-risk, and that creates room for us to engage. Our relationships with the AMCs are highly collaborative and transparent, and this has enabled us to develop a very symbiotic relationship with them.

Nicole Adrien: Let's turn to policy. Where do you think it's headed, particularly given that EM central banks today don't have a lot of flexibility?

Julio Herrera: That's right. Central banks have very little room to move at this point. In the old days — and by that I mean more than ten years ago — it was very difficult for many EM countries to borrow for the purpose of covering a fiscal deficit; there had to be some level of austerity. But interest rates collapsed, and yield hogs were turned loose in the international markets because they were unable to stand prospective returns of 2% or lower. That brought on a lot of lending in Africa, Latin America, Asia — perhaps a bit too much. So these EM countries will have to get through a period of de-levering. To the extent that any tools are left, the central banks do have some room to lower rates, but it would likely be at the expense of currency weakness.

Nicole Adrien: Investing in stressed and distressed situations requires an ability to navigate legal regimes – many different ones, in the case of emerging markets. How do you manage this across jurisdictions?

Pedro Urquidi: My first brush with distressed debt investing in China was in 1997. Since then I've been tracking the development in the legal framework there, and I can say the system has changed dramatically. What's challenging is that the written legal code may appear navigable, but the difference between what's written and what occurs can be night and day. The potential for discrepancy is especially high if you're looking to make corporate-oriented investments that require operational restructuring, which may result in job losses.

China has characteristics that are a mix of France, in terms of its socialist leanings, and a typical capitalistic economy. Any time there's a need for a workforce reduction or for an action that could affect retail investors in some way, the written code could be overridden by other interests. This means you need to negotiate with multiple levels of government and many more parties than might be necessary in other kinds of deals. So you'll see that our corporate-oriented distressed investments or restructuring-focused investments in China tend to be on the smaller side.

On the other hand, if you look at recapitalization lending involving hard assets or real estate collateral, we're generally able to navigate the system with greater confidence. If you pick your assets right and do your due diligence on the value of the underlying assets, then you're able to leverage the legal system and better predict outcomes. There may be delays, but timing tends to be better in China than in certain parts of Europe, such as Greece and Italy.

As for India, the legal code has matured over the years as well, becoming quite navigable for many investment types as long as you conduct very detailed due diligence on the opportunity and the counterparties. The problem in India, however, is that sometimes people are too optimistic about the time to resolution for any particular deal's legal process.

Nicole Adrien: Recognizing that the COVID-19 situation is very serious — affecting lives, communities and economies — do you think, as investors, that its shock presents, on balance, more risk or more opportunity?

Pedro Urquidi: I would say unequivocally more opportunity. The degree will differ by market, country, industry and so forth, but the dislocation we've witnessed isn't likely to be short-lived, and I believe its effects will be widespread.

Julio Herrera: More opportunity, for certain. We're looking closely at deeply cyclical sectors such as steel, oil and gas, chemicals and transportation. There will be value opportunities there that we'll look to mine, despite what now appears to be a relative lack of liquidity.

Frank Carroll: This shock will lead to further price dislocation, which should expand the number of stocks that enter "value" territory. This for us, on balance, tilts the scales toward greater opportunity.

FRANK CARROLL

Managing Director and Co-Portfolio Manager, Emerging Markets Equities

Prior to joining Oaktree in 1999, Mr. Carroll was the head of trading for Columbus Advisors LLC, where he worked for two years. Mr. Carroll previously was the Head Trader for Latin American Fixed Income at Banco Santander and Bankers Trust. For six years prior to joining Bankers Trust, Mr. Carroll was an emerging markets trader for Salomon Brothers Inc. He received a B.A. degree in history from Fairfield University. He is currently the Chairman of Fairfield's Board of Trustees as well as a Trustee at Brunswick School in Greenwich, Connecticut.

JULIO HERRERA

Managing Director and Portfolio Manager, Emerging Markets Debt

Mr. Herrera serves as the portfolio manager of Oaktree's Emerging Markets Opportunities and Emerging Markets Debt Total Return strategies. Prior to joining Oaktree in 2012, Mr. Herrera was the President of Fintech Advisory, Inc., a large family office specializing in distressed assets in emerging markets. During his fifteen-year tenure at Fintech, Mr. Herrera played a leading role in many of the largest debt restructurings in the emerging markets, particularly in Latin America, Asia and the Former Soviet Union. From 1995 to 1997, Mr. Herrera was Senior Vice President and Head of Emerging Markets Corporate Fixed Income Research with Lehman Brothers Inc., where he was responsible for asset recoveries and restructurings for a portfolio of Latin American distressed assets. From 1994 to 1995, Mr. Herrera was Vice President at ING Capital Holdings Inc., where he worked on the proprietary trading of distressed and special situations in the emerging markets. Before joining ING, he spent five years as an investment analyst and portfolio manager at RRH Capital Management. Mr. Herrera holds a B.A. degree from the University of California, Los Angeles.

PEDRO URQUIDI

Global Co-Portfolio Manager and Head of Distressed Debt for Europe and Asia, Oaktree Capital Management (Hong Kong) Limited

Mr. Urquidi is a co-portfolio manager within Oaktree's Distressed Debt group and head of its investment teams in Europe and Asia. He contributes to the analysis, portfolio construction and management of the Distressed Opportunities and Value Opportunities strategies. Prior to joining Oaktree in 2005, Mr. Urquidi spent ten years at Morgan Stanley & Co., where from 2001 to 2004 he worked in London as head of Morgan Stanley's European Special Situations Group as well as overall risk manager for the firm's European high yield, bank debt and distressed debt businesses. Between 1994 and 2001, he worked in New York and Hong Kong as a trader in Morgan Stanley's Global High Yield group, including roles as head of Emerging Market Corporate Trading and the senior high yield trader. Mr. Urquidi graduated with an A.B. degree in economics from Princeton University and an M.B.A. in finance from Columbia Business School.

NICOLE ADRIEN

Managing Director, Chief Product Officer and Global Head of Client Relations

Ms. Adrien is Oaktree's Chief Product Officer and Global Head of Client Relations. In this capacity, she oversees all aspects of our product management activities, including product design and governance, in addition to providing oversight of the firm's corporate and marketing communications and investor services functions. Ms. Adrien joined Oaktree in 2006 following graduation from the UCLA Anderson School of Management, where she was an Anderson Fellow and recipient of the J. Fred Weston Award for Excellence in Finance. Previous experience with Oaktree includes roles as marketing representative, Distressed Debt Product Specialist, and Director of Investor Relations for Oaktree's public entity. Prior to Oaktree, Ms. Adrien worked at Goldman Sachs & Co. in the firm's Investment Management, Equities and Executive Office divisions. She holds a B.A. degree in comparative area studies magna cum laude from Duke University, where she was elected to Phi Beta Kappa. Ms. Adrien is fluent in Spanish and proficient in French.

ENDNOTES

[1] Source: IMF, World Economic Outlook Database, October 2019. Developed Markets consist of "advanced economies" and Emerging Markets consist of "emerging market and developing economies" as defined by the IMF. Based on purchasing power parity.

[2] As of December 31, 2018. Source:World Bank, Institute of International Finance. Emerging markets universe based on the MSCI EM index. Data has not been examined on the company level to rule out double counting between exchanges.

[3] Source: J.P. Morgan as of December 2019. U.S. high yield bond debt includes outstanding high yield debt by U.S. issuers.

[4] Source: Bank for International Settlements, as of December 2019. Reflects cross-border loans from BIS reporting banks to the largest 20 EM countries.

[5] Unless otherwise noted, index data in this document have been updated as of March 30, 2020.

[6] China's opportunity set includes NPLs on banks' and AMCs' books; banks' special mentioned loans; offshore high yield and crossover bonds; and onshore privately owned enterprise bonds. Source: CBIRC, Bloomberg, WIND, PwC, Goldman Sachs, Company Filings, Moody's Investors Service. India's opportunity set includes banks' stressed and distressed assets; non-bank financial companies' stressed and distressed assets; and offshore and onshore stressed and distressed assets. Source: Bloomberg, Goldman Sachs, Reserve Bank of India, Anarock Property Consultants, OCM Estimates.