



LATIN AMERICA AND THE COST OF FALLING ANGELS

BY ALEJO CZERWONKO AND BRENNAN AZEVEDO

The coronavirus crisis has forced many countries to extend sizable fiscal support to households and businesses, aiming to keep a recession from spiraling into an economic and social depression. Latin American nations are no exception, and they did not hold back; on average, the region’s fiscal deficit more than doubled to 8.8 percent of GDP in 2020 from 4.1 percent in 2019, with stimulus still being rolled out this year.

This average figure hides some significant contrasts, notably Brazil’s profligacy, with its 13.4 percent 2020 deficit – among the largest in emerging markets – versus Mexico’s relative austerity, with a shortfall of 4.5 percent. Despite these differences, however, the region is already facing the consequences of loosening its purse strings, most acutely in the form of additional pressure on sovereign credit ratings.

Over the coming years, Latin America may see a number of “fallen angels” – borrowers with investment grade ratings whose fiscal vulnerabilities cost them elite status and leave them in the speculative grade, also known as “high yield,” category. In financial markets, an issuer is considered a “fallen angel” when two of the three major rating agencies – Moody’s, Standard & Poor’s, and Fitch – withdraw high grade status.

A downgrade from a credit rating of BBB or higher to BB or lower carries material repercussions for both a borrower and investors. The most direct impact is higher interest rates for government borrowing. Over the last ten years, BB rated emerging economies have had to pay 105 basis points more on average in yield for their debt than their BBB rated peers. This differential can



exceed 200 basis points during periods of stress, such as the global financial crisis and last year's coronavirus shock.

This additional cost of capital exacerbates fiscal vulnerabilities by raising debt service spending – and it doesn't only affect governments. The vast majority of private companies operating in fallen-angel countries also experience an increase in financing costs, a deterrent to new projects and investments.

An additional impact of losing investment grade status is a shrinking pool of potential creditors. The investor base for high yield debt is markedly smaller than for investment grade debt. Some large global institutional investors, such as pension funds and insurance companies, have mandates that allow them to invest only in highly rated countries.

Lastly, while investors can be quick to assume a potential rating downgrade for any issuer, it takes them much longer to be convinced that a high yield borrower will return to its investment grade glory. For emerging markets, it's easy to see why: Only two of the nine fallen angels in the last decade have reclaimed their high grade status.

Every major Latin American country with BBB credit or higher has recently faced or is now facing downside rating pressure. Over the past year, Chile, Peru, Mexico, and Panama experienced negative revisions to their sovereign rating or outlook from more than one major agency. While the ratings for Chile and Peru remain well above the speculative threshold, neither country can afford to take its investment grade status for granted given the political uncertainties and policy changes. For all these countries, the overall balance of risks to their ratings appears tilted to the downside.

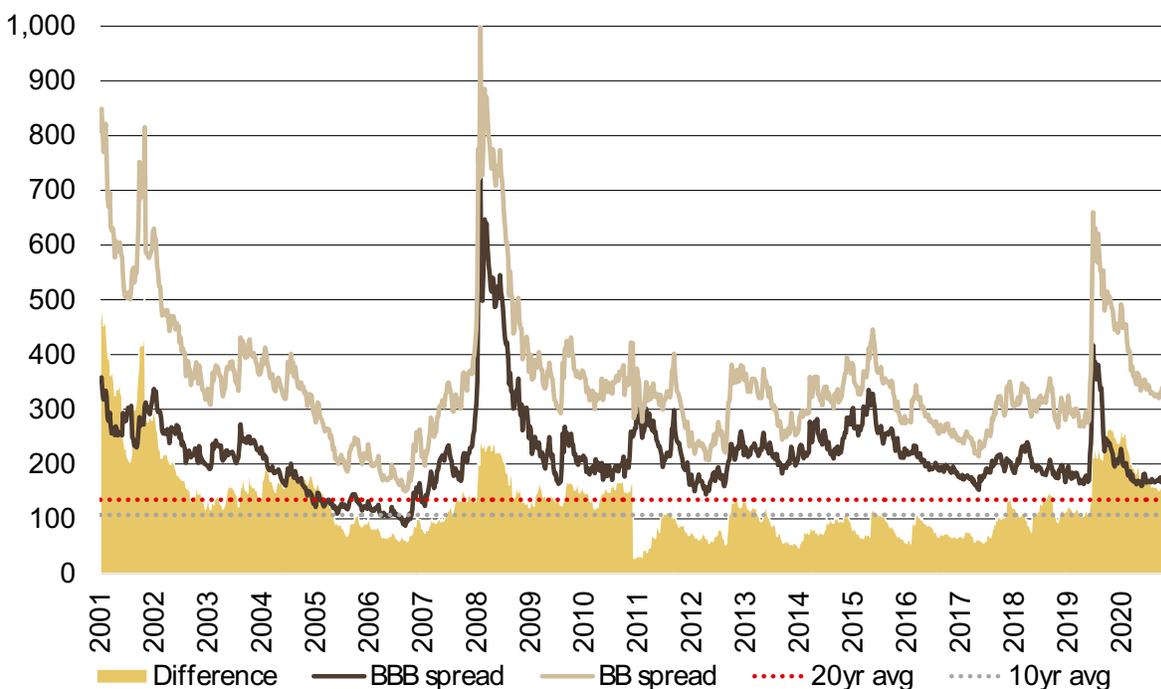
Latin American policymakers are in the difficult position, under pressure to rein in fiscal deficits while maintaining social order through support measures. The consequences of failing to nail that balance could be a double whammy of public outcry against austerity and a further deterioration in credit ratings, as Colombia endured earlier this year. Ultimately, the burden for policymakers is to successfully explain the importance of fiscal sustainability.

An investment grade rating is a valuable seal of approval, especially for emerging economies – one that history shows is much easier to lose than to regain, and thus worth the effort to protect.

*Alejo Czerwonko is UBS's Chief Investment Officer for Emerging Markets Americas.
Brennan Azevedo is an Emerging Markets Strategist at UBS.*

Figure 1: A Downgrade to High Yield Comes at a Cost

Spread over US Treasury of BBB and BB indexes, the difference between the two, and the 10- and 20-year average of the difference



Source: JP Morgan, Bloomberg, UBS, as of September 2021

Figure 2: Angels on the Edge of High Yield

Credit ratings and outlooks of Latin American investment grade sovereign issuers

	Moody's	S&P	Fitch
Chile	A1 / NEG	A / STABLE	A- / STABLE
Peru	Baa1 / STABLE	BBB+ / STABLE	BBB / STABLE
Mexico	Baa1 / NEG	BBB / NEG	BBB- / STABLE
Uruguay	Baa2 / STABLE	BBB / STABLE	BBB- / NEG
Panama	Baa2 / STABLE	BBB / NEG	BBB- / NEG

Source: UBS, as of October 2021

Note: Red indicates rating actions took place in 2020 or 2021.