FOCAL POINT

Opportunities in EM EUR Sovereign Bonds

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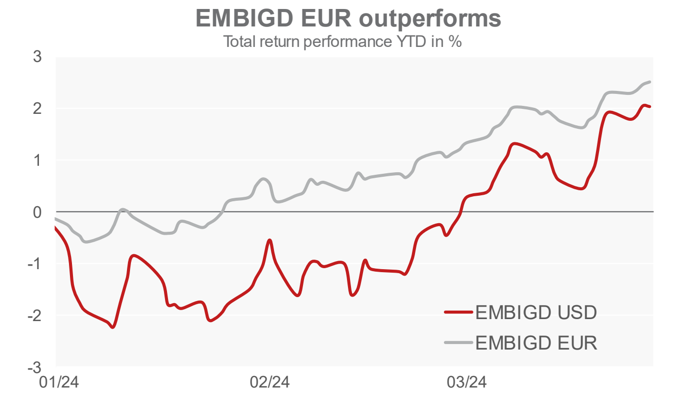
Our Focal Point series explores topical issues on macro, markets and investment

- **EM sovereign external debt in EUR has recently outperformed EM USD external debt, both in spread and return terms. This outperformance has been driven by exceptional factors and it will not persist.**
- **The total return prospects are better for the EM USD debt index than the EUR debt index. In our central scenario, we expect EM USD debt to provide a 3.7% return (fx-hedged) vs 2.5% for EM EUR debt over 6 months.**
- **At the country level, several EM EUR bonds remain more attractive for European investors as they still offer a pickup in yield over the equivalent EM USD bonds (same maturity and issuer). Romania remains a top pick in the EM EUR IG space.**
- **Technicals are supportive for EM EUR sovereign debt, albeit less than before. EUR issuance is due to increase but it will be absorbed by growing redemptions.**

EM external debt in EUR has surprisingly been outperforming USD external debt year-to-date both in return and spread terms. Some opportunities have remained. First, we take stock of the recent drivers of this EUR outperformance. Second, we present our future EM EUR and USD return prospects. Finally, we note that EM EUR bonds still offer a better yield pickup than USD bonds for European investors and we identify the opportunities across the EUR curves vs the USD curves.

Surprising EM EUR outperformance will not continue

EM EUR debt has been surprisingly outperforming EM USD external debt year-to-date. It is unusual in normal market conditions as both EM EUR and USD debt returns tend to move in tandem. There are exceptions, in sell-off periods like during the Covid-19 episode when EM US debt underperformed because of its more liquid nature or when US rates spike led to a more significant negative duration effect.

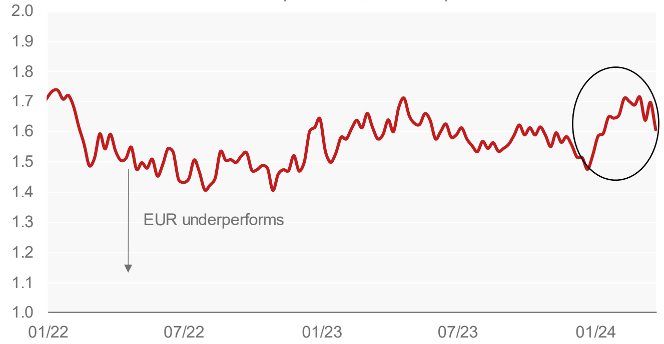


Source: Bloomberg, JP, GIAM

This time, the EM EUR outperformance has been essentially driven by better spread performance. Both in the IG and HY space, the USD/EUR spread ratio shows a better performance for EM EUR names. Moreover, when comparing the beta of spread to global risk appetite, EM EUR spreads have benefited more than usual from the positive risk environment.

EM EUR outperforms in spread terms too

USD/EUR spread ratio, EMIBGD bp



Source: Bloomberg, JP Morgan, GenAM

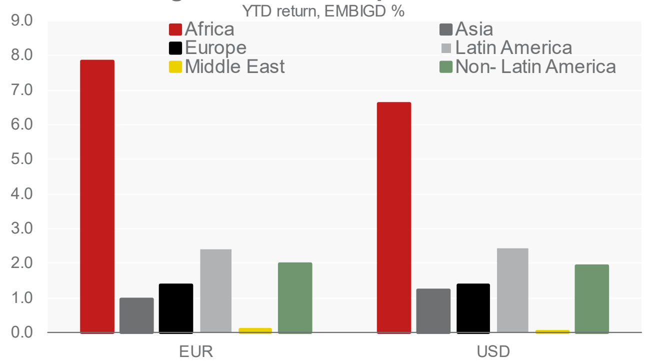
In our view, barring specific events, this outperformance will not persist in the quarter to come.

First, seasonality tends to be more supportive to EM EUR spreads in Q1. We think that large USD issuance has been a factor and the lack of fund inflows according to EPFR data has likely weighed more on US debt. Indeed, it has been the second-best start to the year for issuance historically, with a strong focus on USD debt. Thus, the difference in the USD-EUR spread move in January has been three times larger and five times larger in February than usual. Seasonality is due to turn more positive for USD debt.

Second, both EM EUR IG and HY have outperformed but it is the African region that has driven the most outperformance. The EM EUR HY is mainly constituted of African names. The reopening of the primary markets to African countries has provided a boost to EUR African names. That said, it is a one-off event and the EM EUR HY spread performance is already faltering.

Large EUR Africa outperformance

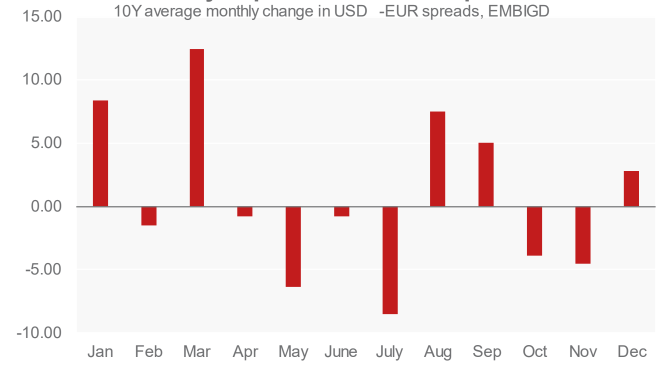
YTD return, EMBIGD %



Source: Bloomberg, JP Morgan, GenAM

January is positive for EUR spreads

10Y average monthly change in USD -EUR spreads, EMBIGD



Source: Bloomberg, JP, GenAM

Better expected total return for EM USD debt

In the medium term, at the index level, the return prospects are better for EM USD debt than for EM EUR debt. In the next six months, even if we assume a scenario of spreads and core rate stability, EM USD debt would provide a 3.8% return vs 2.2% for EUR debt. If we consider a 6-month FX-hedging cost at 0.77% FX hedging cost, USD debt return is still higher to EM EUR debt return at c. 3.0%.

Our central scenario is even more supportive for EM USD debt. Indeed, we expect 10Y USD rates to decline by 20bp to 4.05% in 6 months while we target a modest 10bp decline of 10Y Bund to 2.25%. We expect EM EUR and USD spreads to widen by the same magnitude. Then, the expected EM USD debt return will be close to 4.5% or 3.7% FX-hedged vs. 2.5% for EUR debt. The EM USD debt is fully benefiting from higher duration. In addition, there is a 1.6ppt difference in carry that lifts the EM USD return up significantly.

To obtain the same return for EM EUR debt, EUR core rates would have to fall to 1.95%. It would be a level just seen during the Q4 24 rally. This kind of decline could happen in a scenario where European growth slows down significantly but, in the meantime, one could expect that CEE countries would be affected and that EM EUR spreads could widen in response.

EM USD returns scenario

6M total return for different scenarios, EMBIGD

OAS spread	US 7Y							
	3.8%	4.0%	4.1%	4.2%	4.3%	4.4%	4.5%	4.6%
297	9.4%	8.4%	7.8%	7.1%	6.5%	5.8%	5.1%	4.5%
307	8.8%	7.8%	7.1%	6.5%	5.8%	5.1%	4.5%	3.8%
317	8.1%	7.1%	6.5%	5.8%	5.1%	4.5%	3.8%	3.2%
327	7.4%	6.5%	5.8%	5.1%	4.5%	3.8%	3.2%	2.5%
337	6.8%	5.8%	5.1%	4.5%	3.8%	3.2%	2.5%	1.8%
347	6.1%	5.1%	4.5%	3.8%	3.2%	2.5%	1.8%	1.2%
357	5.5%	4.5%	3.8%	3.2%	2.5%	1.8%	1.2%	0.5%
367	4.8%	3.8%	3.2%	2.5%	1.8%	1.2%	0.5%	-0.1%
377	4.1%	3.2%	2.5%	1.8%	1.2%	0.5%	-0.1%	-0.8%
387	3.5%	2.5%	1.8%	1.2%	0.5%	-0.1%	-0.8%	-1.5%
397	2.8%	1.8%	1.2%	0.5%	-0.1%	-0.8%	-1.5%	-2.1%

Source: Bloomberg, GenAM

Opportunities in the EM EUR space

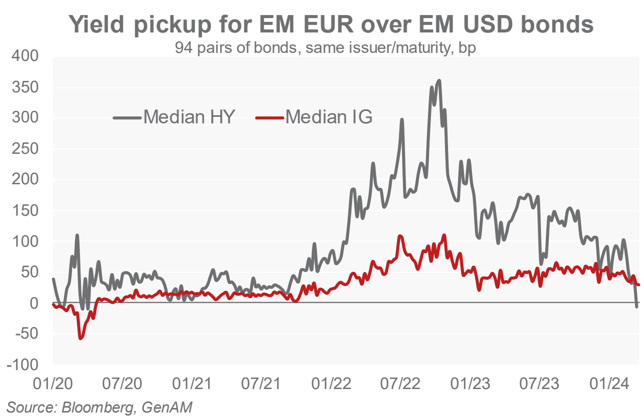
Beyond the better EM USD return prospects, several EM EUR bonds offer a significant yield pick-up over their equivalent EM USD bonds (same maturity and issuer).

Indeed, when analysing 94 pairs of bonds, the current pickup in yield for EM EUR Bonds over equivalent EM USD bonds is close to 44bp. The pick-up has been on a downward trend, but it remains above the 2020-2021 long-term average. The pickup is not homogenous across the rating spectrum and there are still numerous discrepancies across countries.

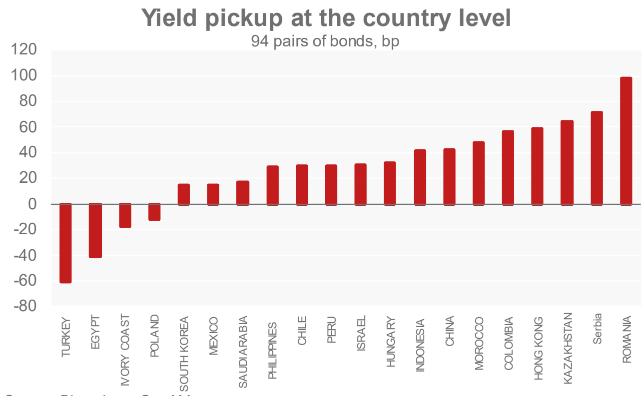
First, Turkey and Poland USD bonds are more attractive for European investors as it has been the case over the past couple of years. The latest USD9.0bn Poland issuance in mid-March has also weighed on the USD spread. It was the largest USD issuance for CEE countries.

Second, the more striking change is the rapid collapse of the pickup in the HY space. For instance, Egypt and Ivory Coast USD bonds are now more attractive. We tend to link this change to the sharp performance of the EUR HY segment year-to-date after the reopening of primary markets, especially for Sub-Saharan African countries and the Egypt support package from the IMF and UAE. For Ivory Coast, the environment is not homogenous. The USD short-end is attractive while in the long-end it is the EUR curve.

Third, Serbia's EUR bonds pickup stands out. It is trading wide in the front end compared to peers. Likewise, Romania EUR bonds continue to offer a large pick up over USD bonds, especially at the long end of the curve. Romania has ramped up its USD issuance, but the bulk of the supply remains in EUR. The MoF has recently announced new EUR issuance later this year. That said, Romania remains one of our top picks in the IG space. It still offers a compelling valuation on a relative rating basis, trading like a BB name. It offers the highest carry in the EM IG sovereign space. It still benefits from a fiscal anchor to Europe, being one of the largest EU funds beneficiaries.



Source: Bloomberg, GenAM



Source: Bloomberg, GenAM

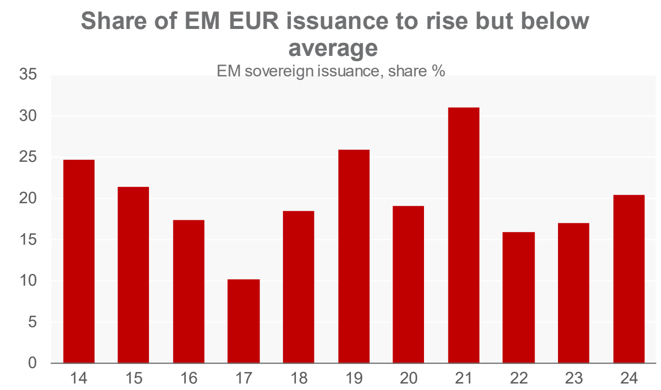
Supportive technicals for EM EUR bonds in 2024-25

Globally technicals are still supportive for EM EUR bonds but less than before.

First, EM EUR issuance is expected to ramp up. Over the past couple of years, its share in EM sovereign issuance declined as EM sovereign issuers tapped the most liquid parts of the markets. As primary markets have reopened, the share of EUR issuance has increased. That said, the impact will be manageable as this rise of EUR share is concomitant with better primary markets. Moreover, the EUR share remains below its long-term average.

Second, EUR redemptions are due to increase in 2024 and 2025 to reach their highest levels since 2020. These high levels will help to absorb the new EUR issuance.

Third, the GCC region has been the largest issuer so far this year, as fiscal deficits have increased due to weaker oil prices and poor economic diversification. This region typically issues in USD.



Source: Bloomberg, GenAM

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