Focal Point

EM relative value tools to navigate in a rising rate world.

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

- We present our new EM relative value tools to track opportunities in the EM USD and EUR external debt spaces.
- EM external debt will be more a carry and relative value play than a directional play. EM external spreads have been within a tight range since the summer. With the prospect of higher core rates, the expected total return will be low in the months to come
- At the region level, Asia is not attractive given its low spread buffer in case of rising core rates. On the other hand, CEEMEA BBB countries are offering one of the best yield-to-risk profiles. In LatAm, the environment is heterogenous, but IG countries have been attractive on average.
- More specifically, at the country level, we like Mexico, Romania, and Chile in terms of valuation. Likewise, in MENA, Saudi Arabia, Qatar, and Israel continue to offer value. On the other hand, China is rich like Kuwait.
- Despite the rise of UST rates, EM EUR bonds are offering a better yield for the same rating. Expected total return is also due to be higher.

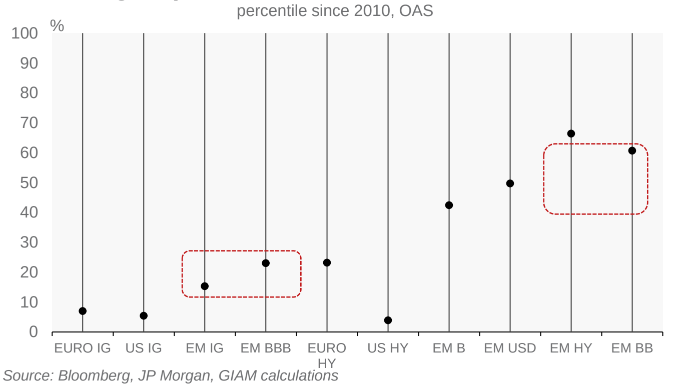
EM USD and EUR sovereign spreads have been recently in a tight range, nearly back to their pre-Covid levels. The global EM macro-outlook has been improving as Chinese growth has bottomed out, and the latest EM PMIs point to growth acceleration in Q4. As a result, the outlook has proved to be less challenging, with the risk-reward being more attractive, although we do not expect a rally.

In the months to come, volatility will remain high, and the improving macroeconomic outlook will only allow a modest spread compression. Indeed, valuations have been rich, especially on the IG side, but LatAm is an exception.

There is limited value in HY too. On average, EM fiscal deficit will decline only to 5.8% in 22 from 6.6%, and debt-to-GDP will climb further to 65.8 %, according to the IMF. Fiscal pressures will keep debt-sustainability concerns at high levels, and interest costs have not declined as much as in DM countries. Growth will be above trend, but it will slow down, making the fiscal consolidation difficult on average. Likewise, we continue to see weak idiosyncratic stories in the low-rated countries. That said, the default rate will decline from 6-7% this year, and the framework to resolve sovereign debt crisis has been beefed up substantially. The Common Framework has yet to prove its efficiency, but the DSSI has helped alleviate funding concerns so far.

Tight spread valuations in IG, better in HY

percentile since 2010, OAS



Source: Bloomberg, JP Morgan, GIAM calculations

The small spread compression will not be enough to offset the risk related to higher interest rate volatility and higher core rates in the months to come. US real yields have remained surprisingly low in 2021, and risks are skewed for higher levels. Tighter liquidity conditions with lower growth should not attract significant portfolio inflows. Expected total return for the next three months will be barely positive. Therefore, EM external debt is not a directional play, but it is more a carry and relative value play at the moment.

Dispersion will help relative value trades. In the IG space, dispersion has been low, and valuations are tight. Dispersion will gain momentum with the rise of real yields, in our view, highlighting each country's strengths and weaknesses. In the HY space, dispersion is more significant, clearly distinguishing between the distressed names and the low BB and B countries. Rising real yields will put more pressure on external refinancing needs, and we would expect the dispersion to widen further.

Higher UST to lead to very modest TR in Q1

3M TR for different scenarios, BofA index

OAS spread	US 8Y 1.31%	1.41%	1.51%	current 1.61%	1.71%	1.81%	1.91%	2.01%
259	7.93%	7.08%	6.23%	5.38%	4.53%	3.68%	2.83%	1.98%
269	7.08%	6.23%	5.38%	4.53%	3.68%	2.83%	1.98%	1.13%
279	6.23%	5.38%	4.53%	3.68%	2.83%	1.98%	1.13%	0.28%
289	5.38%	4.53%	3.68%	2.83%	1.98%	1.13%	0.28%	-0.57%
299	4.53%	3.68%	2.83%	1.98%	1.13%	0.28%	-0.57%	-1.43%
309	3.68%	2.83%	1.98%	1.13%	0.28%	-0.57%	-1.43%	-2.28%
319	2.83%	1.98%	1.13%	0.28%	-0.57%	-1.43%	-2.28%	-3.13%
329	1.98%	1.13%	0.28%	-0.57%	-1.43%	-2.28%	-3.13%	-3.98%
339	1.13%	0.28%	-0.57%	-1.43%	-2.28%	-3.13%	-3.98%	-4.83%
349	0.28%	-0.57%	-1.43%	-2.28%	-3.13%	-3.98%	-4.83%	-5.68%
359	-0.57%	-1.43%	-2.28%	-3.13%	-3.98%	-4.83%	-5.68%	-6.53%

Source: Bloomberg, GIAM calculations

New relative value tools in a rising rate environment

In a rising rate environment, relative value play will gain more importance in 2022, in our view. The purpose of our new relative value tools is to provide a comprehensive and easy-to-read report to (1) analyse the latest market movements, (2) identify market discrepancies, (3) value opportunities at primary auctions. It covers both the USD and EUR spaces and the largest EM countries issuing external debt.

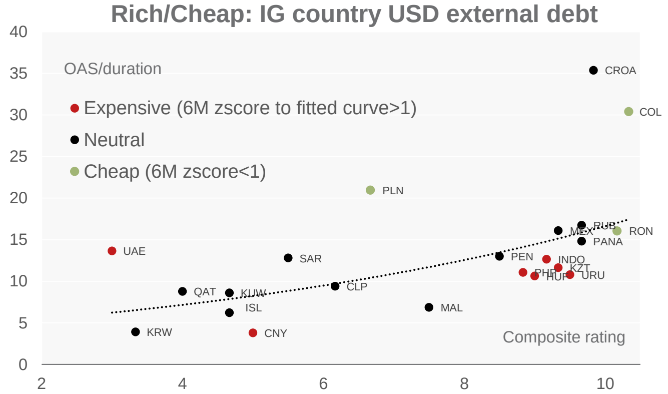
These tools provide a top-down approach that identifies which countries are rich/cheap vs. their ratings and which bonds are rich/cheap at the country level. Likewise, we highlight opportunities in the EUR space vs. the USD space, especially in a rising USD rate environment.

These tools offer a short-term market view and highlight relevant opportunities. However, it can only come in addition and after our fundamental macroeconomic and financial analysis that we presented in our Focal point – EM Vulnerabilities Monitor.

Which country is rich or cheap?

The most straightforward approach to assessing a country's value is to compare its subindex spread vs. its rating. It allows having a uniform approach based on external and stable factors like the rating. Given the different market dynamics and types of investors, we analyse the IG and HY countries separately. Likewise, we consider the OAS spread divided by the duration to account for the different issuance strategies of a country. To this end, we run an exponential regression for the OAS spread/duration of the country subindexes vs. their composite ratings.

Rich/Cheap: IG country USD external debt



Source:Bloomberg, BofA, JP Morgan, GIAM

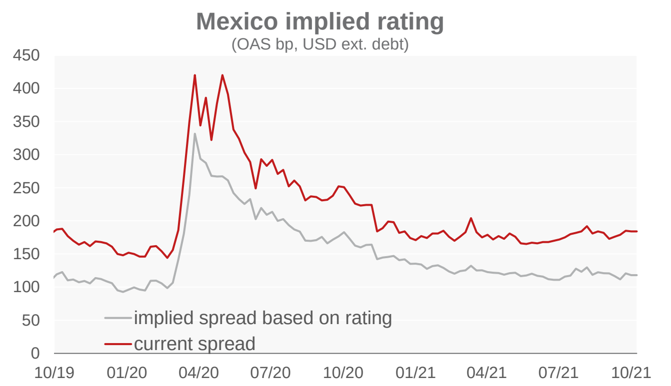
At the IG and HY level, the output shows how a country is trading vs. what its rating would suggest. We highlight three caveats.

Firstly, rating agencies are lagging market movements, so there can be some misalignment between spreads and rating as the market anticipates a rating change. One way to circumvent it is to consider the outlook in the composite rating.

Secondly, some countries are always expensive or cheap for structural reasons, like the UAE. To this extent, we compute a historical score, i.e., we run the exponential regression over the past months to get a six-month z-score of the distance to the fitted curve for each country. So, for example, the UAE tends to trade cheap but based on its history, it is currently trading richer than usual.

Thirdly, it is needed to normalise the country distance to the fitted curve to get a relative score. A country can be wide/tight to the fitted curve, but other countries can exhibit wider discrepancies. For instance, the UAE is currently trading wide to the fitted curve, but Colombia is currently trading even wider. Thus, we divide the distance to the fitted curve by the regression residuals. Finally, we sum the historical and relative scores to get a final Rich/Cheap score.

Based on this final score, IG GCC countries are at neutral levels. We will favour Qatar over Saudi Arabia, given the limited upcoming supply. In EMEA, Romania is standing out in terms of cheapness. Rating downgrade risk is lower, but pending political risks are weighing on the spreads.



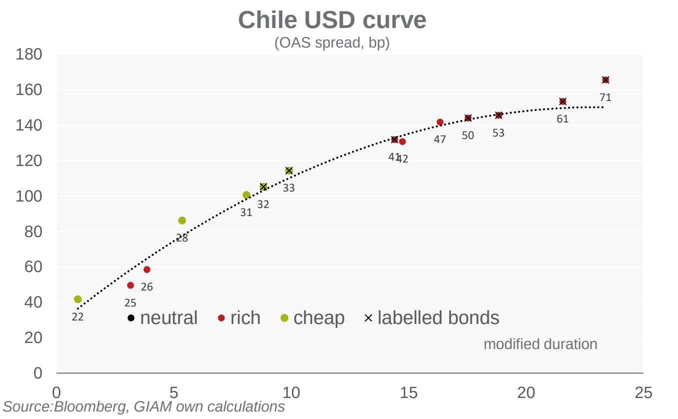
Source: Bloomberg, GIAM calculations

Which bond is rich or cheap?

In the quest to find yield, a more straightforward approach is to compare all the EM bonds and pick the ones which offer the highest yield for a particular rating and duration. The approach seems simple, but with the decline of core rates, crossover investors and non-specialised EM investors have been more numerous in the EM space, adopting a pure yield-picking approach. Therefore, we find the usual suspects with low BBB countries like Romania, Kazakhstan, and Mexico offering the most attractive yield.

We pursue the analysis at the country level to determine whether a specific bond is rich/cheap vs. both the USD and EUR curves. This time, we run a polynomial regression of the OAS spread to the modified duration to obtain a fitted yield curve. Then, like at the country level, we run the same process to get a final rich/cheap score.

The main caveat is the liquidity issue that can explain a bond spread discrepancy vs. its peers or a new issuance that temporarily hurts market pricing. Another structural factor is the ESG label of a bond that can have some impact. That said, this does not look systematic. For instance, there is no difference in Chile, which is one of the largest ESG issuers across the EM sovereign space. Labelled bonds are not necessarily offering a substantially lower yield compared to their closest peers.



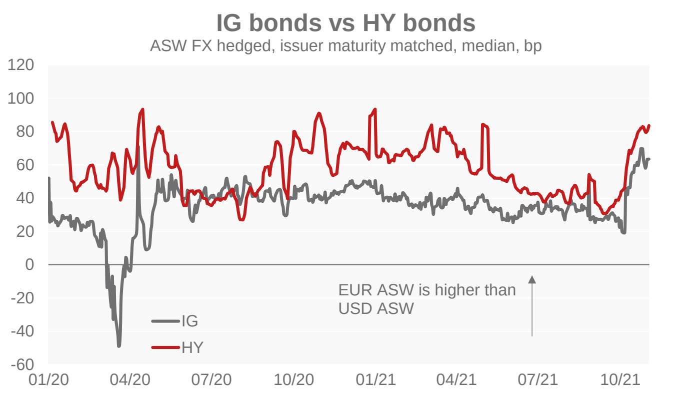
Source:Bloomberg, GIAM own calculations

EUR vs. USD bonds: EUR still attractive

Given the latest significant USD rate movements, opportunities can emerge between EM EUR and EM USD bonds. To this extent, we compare when it is possible EM USD and EUR bonds for the same issuer and same maturity. We run 119 comparisons between the EUR and USD universes.

On a global basis, despite the latest rise of USD rates, EM EUR bonds are still more attractive, offering a higher yield. The pickup has been climbing on the back of the recent sell-off. The split is even more acute between IG and HY bonds. The recent sell-off in the HY space has led to a significant pickup of EUR HY bonds. Generally, the difference can be explained by the different nature of bondholders in the EUR and USD spaces, liquidity, and different issuance strategies.

At the country level, the long end of the EUR Romania curve is more attractive. In Russian and Ukraine, there is value in the EUR curve too. On the opposite, the Polish USD curve offers a better pickup over EUR bonds.



Source: Bloomberg, GIAM calculations

Appendix

We use the Bank of America indices for all countries, otherwise EMBIGD when it is not available. BofA indices tend to be more sovereign-oriented. For instance, Mexico USD EMBIGD includes PEMEX, and it is always cheap compared to the fitted curve. Likewise, China EUR EMBIGD includes state-owned entities' bonds.

On the USD side, we cover 64 countries, and we use the EMBIGD indices for Oman, Kuwait, Saudi Arabia, and the UAE. On EUR external debt, 32 countries are covered. EMBIGD is used for Benin, China, Chile, Egypt, Indonesia, Ivory Coast, Kazakhstan, Peru, Philippines, Saudi Arabia, Serbia, Ukraine. Rating-wise, we average the S&P, Moody's, and Fitch ratings. We lower/increase the rating by -0.5/+0.5 if the outlook is positive/negative.

Here below, we provide a few examples of output tables.

EM USD Sovereign Rich/Cheap Analysis

		Ratings			OAS/Duration				Rich and Cheap			Score
		S&P	Moody's	Fitch	Current (bp)	1Y min	1Y max	6M Zscore	Deviation from Fitted Spread (bp)	6M Zscore deviation to Fitted spread	Crosscountry relative deviation	Final Score Rich or cheap?
cheap	POLAND	A-	A2	A-	21	5	22	2.1	11	-2.1	-1.7	cheap
	CHILE	A	A1	A-	10	7	10	0.7	0	-0.7	-0.1	neutral
	UAE	AA	Aa2	AA	13	65	101	-1.7	7	1.4	-1.8	neutral
	QATAR	AA-	Aa3	AA-	9	8	11	-1.0	2	0.5	-0.6	neutral
A&Above	SAUDI ARABIA	A-u	A1	A	12	15	22	-0.9	4	0.9	-0.8	neutral
	ISRAEL	AA-	A1	A+	6	6	8	-0.8	-1	0.2	0.4	neutral
	Kuwait	A+	A1	AA	6	68	85	-0.6	-1	0.5	0.4	neutral
	SOUTH KOREA	AA	Aa2	AA-	4	4	7	-2.2	-2	0.4	1.0	rich
expensive	CHINA	A+	A1	A+	3	3	6	-1.5	-4	0.9	1.9	rich
	COLOMBIA	BB+	Baa2	BB+	31	18	33	2.9	13	-3.5	-1.3	cheap
	CROATIA	BBB-	Ba1	BBB	35	14	37	1.6	19	-1.6	-1.7	cheap
	ROMANIA	BBB-	Baa3	BBB-	16	12	17	2.2	-1	-2.2	0.1	cheap
	RUSSIA	BBB-	Baa3	BBB	17	15	22	2.3	1	-0.3	-0.1	neutral
BBB	PERU	BBB+	Baa1	BBB	13	9	15	0.8	-1	0.4	0.1	neutral
	PANAMA	BBB	Baa2	BBB-	15	11	16	1.5	-1	0.6	0.2	neutral
	MEXICO	BBB	Baa1	BBB-	16	14	19	1.1	1	1.5	-0.2	rich
	HUNGARY	BBB	Baa2	BBB	11	10	19	-0.6	-3	1.2	0.6	rich
	MALAYSIA	A-	A3	BBB+	7	5	8	-0.3	-5	1.3	1.2	rich
	URUGUAY	BBB	Baa2	BBB-	11	1	11	0.3	-5	1.8	0.8	rich
	PHILIPPINES	BBB+	Baa2	BBB	11	8	14	-0.7	-3	3.0	0.6	rich
	KAZAKHSTAN	BBB-	Baa2	BBB	12	10	14	-0.8	-3	3.2	0.6	rich
	INDONESIA	BBB	Baa2	BBB	12	12	17	-2.1	-2	3.8	0.4	rich

Source: Blomberg, GIAM calculations

Country analysis - Chile USD bonds

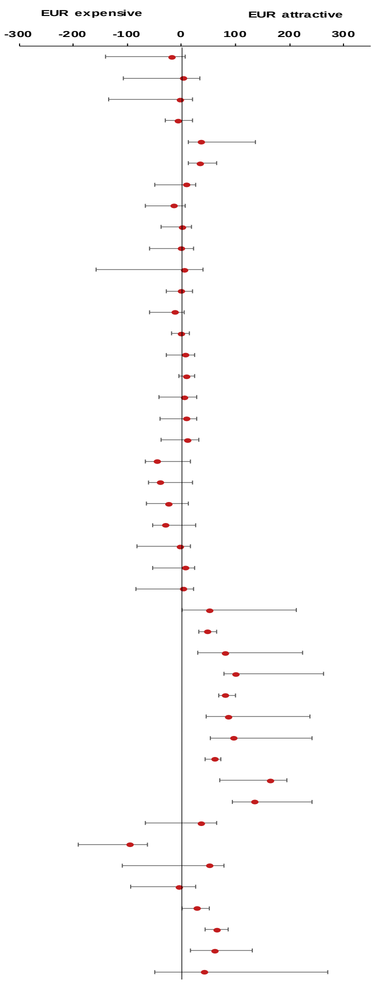
Bond	Details					OAS Spread				Rich and Cheap			Score
cheap to expensive	Coupon	Duration	Yield	Bp/duration	Price	Current (bp)	1Y min	1Y max	6M Zscore	Deviation from Fitted Spread (bp)	6M Zscore deviation to Fitted spread	IntraCountry deviation Zscore	Final Score Rich or cheap?
27Jul33	2.55%	9.9	2.9	28.9	96.9	129	94	141	1.2	5	-17.8	-0.8	cheap
31Jan31	2.45%	8.1	2.6	32.8	98.4	116	51	104	2.8	7	-12.5	-1.0	cheap
06Feb28	3.24%	5.3	2.4	44.7	104.8	105	51	97	1.0	17	-9.0	-2.5	cheap
30Oct22	2.25%	0.9	0.7	73.5	101.4	51	18	59	1.3	-2	-8.6	0.3	cheap
27Jan32	2.55%	8.8	2.7	30.5	98.8	105	64	122	1.1	-10	-9.0	1.5	cheap
21Sep71	3.25%	23.3	3.6	15.6	91.3	178	145	180	1.8	-52	-6.7	7.7	rich
07May41	3.1%	14.4	3.3	23.1	96.8	145	96	141	0.9	-15	3.3	2.2	rich
22Jan61	3.1%	21.5	3.5	16.3	91.3	166	100	164	2.0	-50	-1.0	7.4	rich
21Jun47	3.86%	16.3	3.4	20.8	108.0	154	108	150	1.0	-21	4.4	3.1	rich
15Apr53	3.5%	18.8	3.4	18.3	101.2	159	99	154	1.5	-35	2.8	5.2	rich
27Mar25	3.125%	3.1	1.5	49.1	105.1	68	44	75	-0.8	-2	8.0	0.4	rich
25Jan50	3.5%	17.5	3.4	19.6	101.3	157	108	150	1.5	-27	5.1	4.0	rich
30Oct42	3.625%	14.7	3.3	22.4	104.9	143	99	153	-0.3	-20	12.5	2.9	rich
21Jan26	3.125%	3.8	1.8	46.5	105.3	78	57	145	-12.9	2	22.8	-0.2	rich

Source: Bloomberg, GIAM calculations

EUR - USD bond pairs

	Bonds				Asset swap spread (bp)			YTM (%)			Amount outst. (mn)	
	Rating	Country	EUR	USD	EUR	USD hedged	Spread	EUR	USD hedged	Spread (bp)	EUR	USD
CEE	HY	CROATI	May22	Apr23	18	25	**-7**	-0.3	-0.2	**-17**	1,250	1,500
	HY	CROATI	Mar25	Jan24	24	19	**5**	0.1	-0.1	**20**	1,500	1,750
	IG	REPHUN	Oct25	Mar24	21	16	**5**	0.1	-0.1	**22**	1,000	1,851
	IG	REPHUN	Nov30	Sep31	56	59	**-3**	0.7	0.8	**-1**	1,250	2,250
	IG	REPHUN	Apr32	Sep31	97	59	**39**	1.2	0.8	**46**	1,000	2,250
	IG	REPHUN	Nov50	Sep51	141	107	**35**	1.9	1.4	**46**	1,250	2,000
	IG	ISRAEL	Jul22	Jun22	15	-3	**18**	-0.3	-0.5	**21**	2,050	1,500
	IG	ISRAEL	Jan24	Jun23	4	-4	**8**	-0.2	-0.5	**21**	3,550	1,000
	IG	ISRAEL	Jan27	Mar26	14	1	**13**	0.1	-0.1	**21**	1,750	1,000
	IG	ISRAEL	Jan29	Jan28	22	18	**4**	0.3	0.2	**13**	1,650	1,000
	IG	ISRAEL	Jan49	Jan48	110	102	**8**	1.3	1.4	**-7**	1,250	1,000
	IG	POLAND	Feb22	Mar22	4	4	**0**	-0.5	-0.5	**2**	527	3,000
	IG	POLAND	Jan23	Mar23	4	19	**-16**	-0.4	-0.2	**-16**	1,500	2,000
	IG	POLAND	Jul23	Mar23	14	19	**-6**	-0.2	-0.2	**1**	2,000	2,000
	IG	POLAND	Jan24	Jan24	9	12	**-3**	-0.2	-0.2	**-1**	2,000	2,000
	IG	POLAND	Jun26	Apr26	15	18	**-3**	0.1	0.1	**0**	460	1,750
	IG	POLAND	Aug26	Apr26	13	18	**-5**	0.1	0.1	**1**	1,000	1,750
	IG	POLAND	May27	Apr26	18	18	**0**	0.2	0.1	**12**	1,000	1,750
	IG	POLAND	Oct27	Apr26	18	18	**1**	0.2	0.1	**15**	1,000	1,750
	IG	POLAND	Feb33	Oct35	43	95	**-52**	0.6	1.3	**-65**	300	100
	IG	POLAND	Feb34	Oct35	50	95	**-46**	0.7	1.3	**-56**	300	100
	IG	POLAND	Feb35	Oct35	65	95	**-30**	0.8	1.3	**-45**	500	100
	IG	POLAND	Jan36	Oct35	60	95	**-36**	0.9	1.3	**-40**	2,000	100
	IG	ROMANI	Apr24	Jan24	45	47	**-3**	0.2	0.2	**1**	1,250	1,000
	IG	ROMANI	Oct24	Jan24	57	47	**9**	0.4	0.2	**19**	1,500	1,000
	IG	ROMANI	Oct25	Jan24	56	47	**9**	0.4	0.2	**26**	2,000	1,000
	IG	ROMANI	Mar29	Feb31	167	112	**55**	1.7	1.3	**45**	1,150	1,300
	IG	ROMANI	Dec29	Feb31	161	112	**49**	1.8	1.3	**53**	1,000	1,300
	IG	ROMANI	Feb30	Feb31	197	112	**85**	2.1	1.3	**85**	750	1,300
	IG	ROMANI	May30	Feb31	216	112	**104**	2.2	1.3	**95**	2,000	1,300
	IG	ROMANI	Jul30	Feb31	197	112	**85**	2.2	1.3	**94**	2,000	1,300
	IG	ROMANI	Jul31	Feb31	202	112	**91**	2.3	1.3	**99**	1,400	1,300
	IG	ROMANI	Jan32	Feb31	212	112	**101**	2.4	1.3	**115**	1,400	1,300
	IG	ROMANI	Apr42	Jan44	276	215	**61**	3.4	2.6	**82**	1,500	1,000
	IG	ROMANI	Apr49	Jun48	357	193	**164**	3.7	2.3	**138**	1,950	1,200
	IG	ROMANI	Jan50	Feb51	303	165	**138**	3.5	2.0	**149**	1,600	2,000
	HY	SERBGB	Jan29	Dec30	178	111	**66**	1.8	1.3	**51**	100	1,200
CIS	IG	KAZAKS	Nov23	Oct44	40	148	**-108**	0.1	1.9	**-182**	525	1,000
	IG	KAZAKS	Sep26	Jul25	73	15	**58**	0.7	0.0	**71**	500	2,500
	IG	RUSSIA	Dec25	May26	67	65	**2**	0.5	0.5	**-1**	1,750	3,000
	IG	RUSSIA	Nov27	Jun27	112	77	**34**	1.1	0.7	**43**	1,250	2,405
	IG	RUSSIA	May36	Mar35	213	145	**68**	2.5	1.8	**74**	1,000	4,000
	HY	UKRAIN	Jun26	Sep26	503	444	**59**	4.8	4.4	**38**	1,000	1,318
	IG	UKRAIN	Jan30	May29	497	462	**35**	5.4	4.7	**65**	1,250	1,750

EUR - USD ASW spread (1Y high and low)



Source: Bloomberg, GIAM calculations

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