GMO
North America | Europe | Asia-Pacific

# Emerging Debt Report

**July 18, 2017**

**Biggest Movers in Spread**
**3/31/2017 to 6/30/2017**

| | Spread Change | Spread Level | Total Return |
|---|---|---|---|
| EMBIG | (3) | 328 | 2.2% |
| **Country Sub-Index:** | | | |
| Ghana | (95) | 543 | 7.2% |
| Ukraine | (82) | 585 | 5.9% |
| Cameroon | (80) | 416 | 6.7% |
| Vietnam | (40) | 167 | 3.2% |
| Lebanon | 46 | 430 | 0.0% |
| Belize | 75 | 730 | -3.3% |
| Venezuela | 87 | 2464 | 3.8% |
| Bolivia | 109 | 211 | -1.0% |

**Biggest Movers:**
**Spot Emerging Currencies**

| | Total Return |
|---|---|
| ELMI+* | 1.9% |
| Czech Republic | 10.3% |
| Poland | 6.8% |
| Hungary | 6.5% |
| Romania | 6.5% |
| Brazil | -4.2% |
| Russia | -4.9% |
| Colombia | -5.3% |
| Argentina | -7.4% |

* Total return

**Biggest Movers:**
**Emerging Rates**

| | Total Return |
|---|---|
| GBI-EMGD** | 2.4% |
| Czech Republic | 0.4% |
| Romania | 1.0% |
| Poland | 1.5% |
| Thailand | 1.5% |
| Mexico | 3.2% |
| Turkey | 4.0% |
| Peru | 4.0% |
| Argentina | 5.4% |

** Local Currency Bond Return

## Quarterly Update on Valuation Metrics in Emerging Debt

We review some of our favored valuation metrics for external and local emerging debt markets.[1]

The punch line: By our metrics, local currency debt continues to look attractive at current valuations, especially for dollar-based investors. External debt bonds continue to look rich, but sovereign credit ratings stabilized in the second quarter and credit spreads were broadly stable at the index level. Thus, external debt did not move further into rich territory during the quarter.

## External Debt Valuation

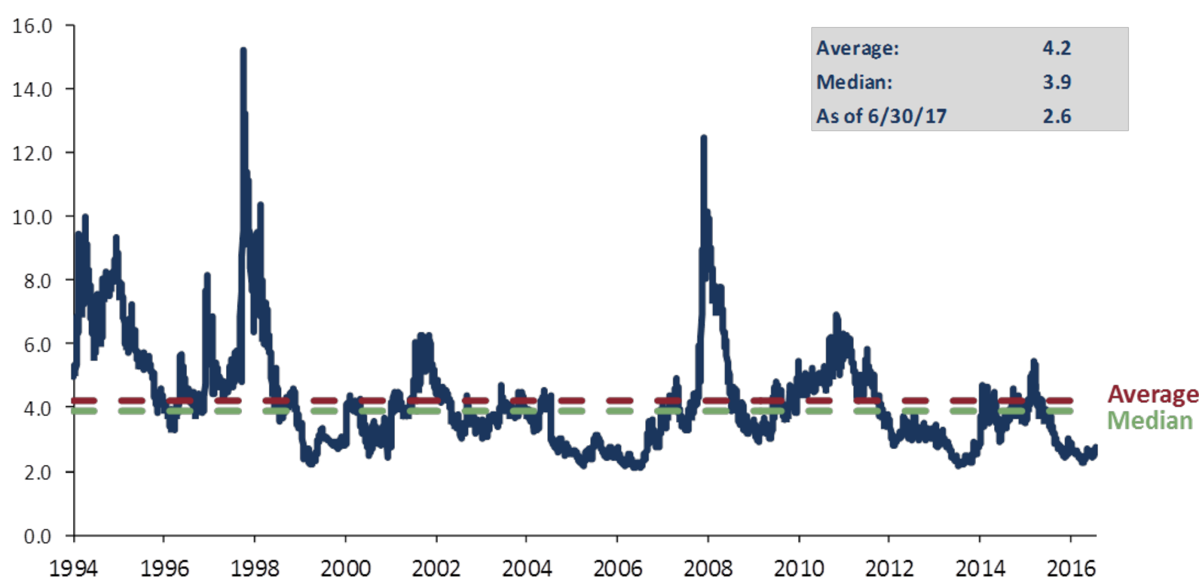
Exhibit 1 shows our familiar valuation chart for external sovereign debt. We calculate a "fair" spread of the EMBIG over US Treasuries, accounting for the credit rating profile of the EMBIG, default probabilities, and recovery values under default scenarios, based on rating agency studies of the historical experience. We then take the ratio of the actual EMBIG spread to the fair value spread and compare it to the historical norm. Assuming a long-term investment horizon, the chart suggests that the market shows signs of being attractive when the fair value multiple is above the long run average and median lines, and unattractive when it lies below.

**As seen in the chart, the current spread multiple remains well below the level that the market has historically demanded**. The multiple stood at 2.6 on June 30, 2017, slightly higher than the 2.5 multiple

[1] For a more detailed explanation of the valuation metrics contained in this report, please refer to the Emerging Debt Report dated April 27, 2015. This may be obtained from your GMO representative.

observed on March 31, 2017, but remaining in the same range it has been since September/October of 2016. The bad news is that this ratio is in overvalued territory, but the good news is that, by this metric, the market is not becoming more and more overvalued by the month. The historical minimum ratio was 2.1 in April of 2007, when the spread on the EMBIG index was +161 bps over Treasuries. During the second quarter, the EMBIG benchmark total return was 2.2%, accompanied by a spread tightening of just 3 bps to +328 bps over Treasuries. For the year-to-date through June 30, the EMBIG's total return has been 6.2% with a spread tightening of 37 bps.

**Exhibit 1 – Long-Term View of the "Fair Market Multiple" for Hard Currency Emerging Debt**



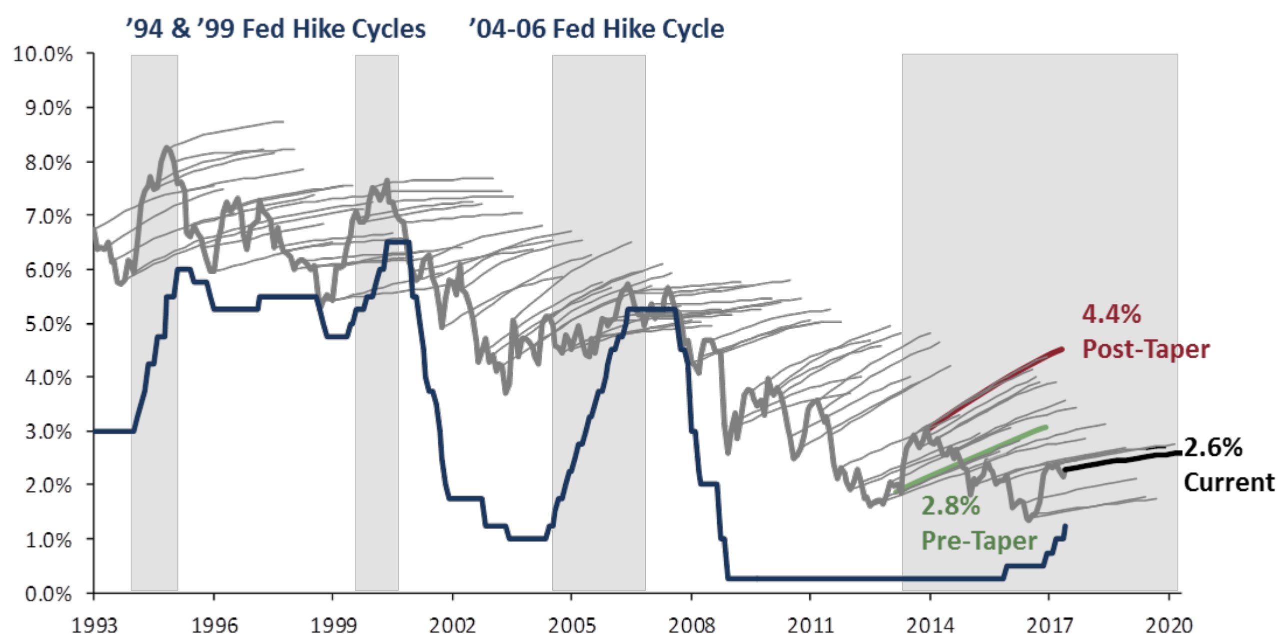

For the most part, themes from the first quarter were maintained into the second quarter, with a broadly positive backdrop for the emerging debt asset class. The IMF's World Economic Outlook, released in April, seemed to reinforce the view that the world economy was in a synchronized recovery. Developed world central banks remained cautious in terms of the normalization of monetary policy. The Trump administration refrained from policies that might damage global financial and commercial relationships, at least for the time being. A cordial bilateral meeting between Chinese President Xi Jinping and Donald Trump supported this benign view. In this context, emerging debt markets showed signs of strength. Data from EPFR Global, which tracks fund flows, showed a 15.9% increase in inflows to emerging debt funds in the first half, with positive flows in local currency and foreign currency debt funds during every week of the second quarter. According to data compiled by Bank of America, new issuance volumes in hard currency by sovereigns remained high. In particular, the second quarter saw $38.2 billion in new issuance, bringing the year-to-date total to $97.0 billion, or 19% above 2016's record pace. Saudi Arabia issued $9 billion of new debt. However, 18 other countries also issued, ranging from AA-rated Chile to several single-B rated sovereigns, including Belarus, Ivory Coast, Sri Lanka, and others.

Sovereign credit rating changes were relatively benign during the quarter. On the positive side, Indonesia was upgraded to investment grade by S&P, the third rating agency to do so. Argentina was upgraded by S&P to single-B, from B-minus, a reminder that Argentina has a long way to go in order to restore its creditworthiness, but is moving in the right direction. Belize was upgraded following its successful debt restructuring in the first quarter. South Africa and Brazil suffered negative rating actions during the quarter, with South Africa losing its investment grade rating from two of the three major agencies, amid weak economic performance and signs of institutional weakening under the ANC government of Jacob Zuma. Brazil's sub-investment grade ratings came under pressure from the ongoing corruption scandals that could threaten the administration of President Temer. Finally, the market shrugged off the Moody's downgrade of China to A1.

**Based on these rating changes, our new calculation of the "fair value" spread of the EMBIG that would be required to compensate for expected credit losses fell from 135 bps at the end of March (139 at the end of December 2016) to 127 bps by the end of June 2017**.

This analysis says nothing about the level of interest rates, but rather the level of spreads, or credit cushion. What about the interest rate cushion as embedded in the risk-free rate? Exhibit 2 shows the history of the 10-year US Treasury swap rate (heavy solid line), along with the forward curve (going out three years) for the 10-year swap rate (lighter lines) at each point in time (quarterly). In effect it tries to show three dimensions in a two-dimensional chart.

**Exhibit 2 – 10-Year US Treasury Swap Curves at Quarterly Intervals**






GMO
North America | Europe | Asia-Pacific

**On this metric, we have a similar-to-slightly worse risk-free-rate cushion than we had in the previous quarter.** The 10-year US Treasury yield fell a further 9 bps during the quarter after falling 5 bps during Q1 2017, in a further adjustment from the sharp rise in Treasury rates following the US election last November. Meanwhile, the slope of the 10-year forward curve was broadly stable. It flattened by 3 bps, from about 36 bps (to the 3-year forward point) to 33 bps as of end-June. This level of 33 bps represents a fairly flat forward curve relative to the recent historical experience, indicating a view in the market that 10-year US Treasury rates are likely to remain low well into the future, even as the Fed normalizes its monetary policy.

## Local Debt Markets

Now let's turn to local debt markets, where we consider some simple concepts of currency valuations and interest rate differentials. Exhibit 3 provides a snapshot of our currency valuation methodology. The underlying model analyzes trends in real effective exchange rates and the balance of payments and, via a z-score analysis, measures how far away current values are from their longer-term averages. These are combined into a single value score as shown in the exhibit, where we compare the weighted average of currencies in the GBI-EMGD with values for the USD and EUR. As the chart indicates, scores below the zero line indicate potentially "cheap" currencies while positive scores indicate potentially "rich" currencies.

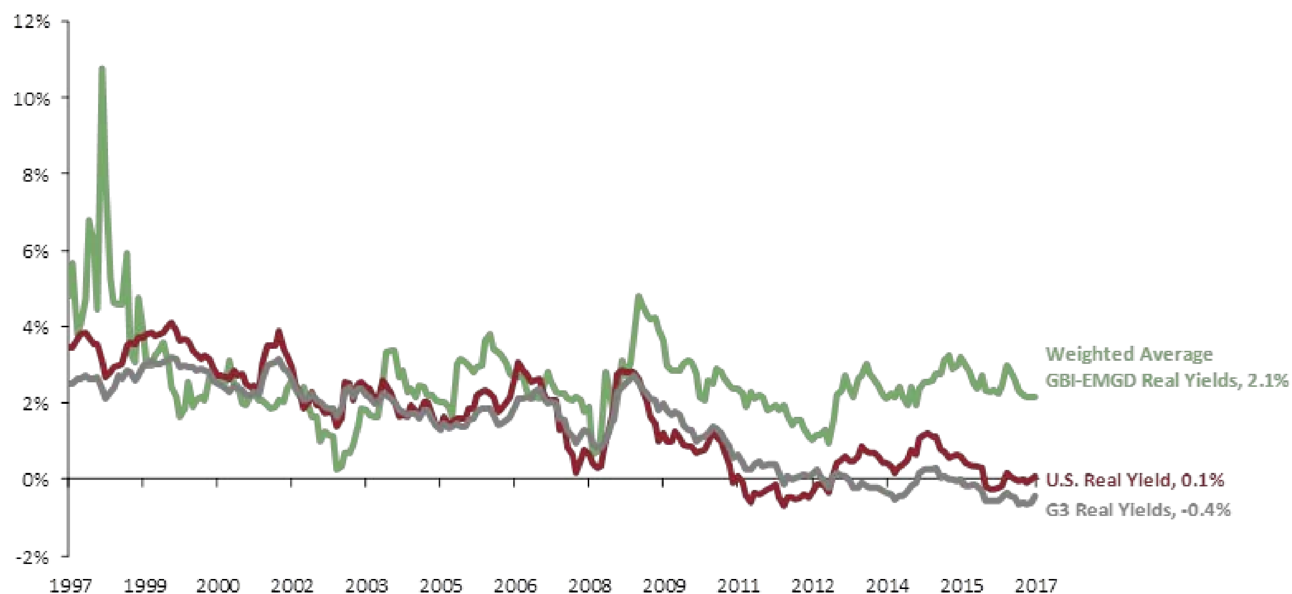
### Exhibit 3 – Weighted Average Value Score of GBI-EMGD Currencies vs USD and EUR

The key message of this chart has not changed much in the past several quarters, though there has been some convergence in valuations between the "rich" USD and the "cheap" EM currencies, which continued during the second quarter. GBI-EMGD currencies continue to look relatively cheap on a weighted average basis, but, also, a little less so than the previous quarter. The EUR continues to look cheap, but a strong

rally during the quarter moved it closer to the neutral line. EM currencies rallied against the US dollar on average during the first quarter. However, there were some large disparities in terms of performance. Higher yielding currencies in the Latam region such as ARS, COP, and BRL underperformed while most of the outperformers were found in lower yielding currencies of the CEEMEA region. The ARS was the worst performing currency during the quarter as political risks increased and the currency is seen as overvalued. Moreover, the Central Bank began to intervene in the FX market to weaken the currency. RUB and COP were the second and third worst performing currencies amid very weak oil markets in the second quarter, which saw the benchmark WTI price fall about 9% to $46.04 per barrel. In Brazil, the BRL sold off as news that President Temer was involved in a bribery case hit the wires. CEE3 currencies, PLN, HUF, and RON, were the best performers on the quarter as the EUR appreciated and the economic momentum remains strong. The MXN also continued to outperform as the market still perceived it as undervalued and the current account deficit is narrowing. Moreover, political risks have subsided after the results of the local elections, which showed the left-wing party losing ground ahead of the 2018 presidential election.

As for emerging market local interest rates, the story that has been in place for many quarters (years, actually) remains. They continue to look attractive on a relative basis, as seen in Exhibit 4. Real rates in the G-3 continue to be at or below zero, with a very slight uptick during the second quarter, due in large part to a rise in German Bund yields, which remain extraordinarily low in nominal terms. In the emerging world, the quarter saw a slight fall in the real yield of the GBI-EMGD countries, from 2.2% to 2.1%. Interest rates rallied in most of the benchmark countries during the quarter, with the exception of some of the lower-yielding countries in the CEE region whose rate markets tend to follow Bunds. Inflation and inflation expectations fell in most countries, keeping real interest rates broadly constant to slightly lower. The addition of the Czech Republic to the GBI-EMGD benchmark in April, another low-rate country in the emerging Europe region, also put some downward pressure on weighted average real yield calculation. Nevertheless, the real yield of the GBI-EMGD (inclusive of Argentina, which entered the benchmark in the first quarter with significantly negative real yields, and Czech, also with negative real yields), remains above 2%, in line with its 5-year average and only slightly lower than its 10-year average. The real yield differential with the G-3 remains fairly high by historical standards.

### Exhibit 4 – Inflation-Adjusted Bond Yields




### Conclusions and Observations

1. Emerging currency valuations continue to look attractive according to our methodology, especially relative to the USD. Relative valuation of EM currencies worsened slightly against the USD, and improved against the EUR during the second quarter.
2. Local debt markets also look attractive, based on real yield differentials between EM and developed market bonds. Differentials remain well above historical norms, even though the differential has fallen slightly over the past quarter.
3. External debt remained in "rich" territory in the second quarter, but the broad stabilization in credit ratings and credit spreads during the quarter meant that the asset class maintained its valuation metrics (it did not get richer).

Sources for charts: Bloomberg, JP Morgan, GMO LLC

Disclaimer: The views expressed are the views and understanding of Carl Ross through the period ending July 18, 2017 and are subject to change at any time based on market and other conditions. While all reasonable effort has been taken to insure accuracy, no representation or warranty for accuracy is provided nor should be assumed. This is not an offer or solicitation for the purchase or sale of any security and should not be construed as such. References to specific securities and issuers are for illustrative purposes only and are not intended to be, and should not be interpreted as, recommendations to purchase or sell such securities.