Emerging Debt Report

October 23, 2017

Biggest Movers in Spread

6/30/2017 to 9/29/2017

	Spread Change	Spread Level	Total Return
EMBIG	(21)	308	2.4%
Country Sub-Index:			
Mozambique	(263)	1512	7.0%
Ukraine	(114)	471	6.7%
El Salvador	(113)	448	9.7%
Ecuador	(100)	606	6.7%
Lebanon	16	445	0.6%
Namibia	16	247	0.2%
Jordan	16	370	0.2%
Venezuela	630	3094	-10.6%

Biggest Movers:

Spot Emerging Currencies

	Total Return
ELMI+*	2.0%
Brazil	4.7%
Czech Republic	4.1%
Colombia	4.0%
Chile	4.0%
Indonesia	-1.1%
Israel	-1.2%
South Africa	-3.0%
Argentina	-4.4%

* Total return

Biggest Movers:

Emerging Rates

	Total Return
GBI-EMGD**	2.2%
Czech Republic	-1.0%
Romania	-0.3%
Argentina	0.3%
Poland	0.6%
Peru	3.4%
South Africa	3.6%
Indonesia	4.0%
Brazil	5.7%

** Local Currency Total 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, but the degree of attractiveness has fallen significantly over the past quarter, due to a strong rally and USD weakness. External debt valuations stabilized, as lower spreads were offset by improving credit rating trends in the asset class.

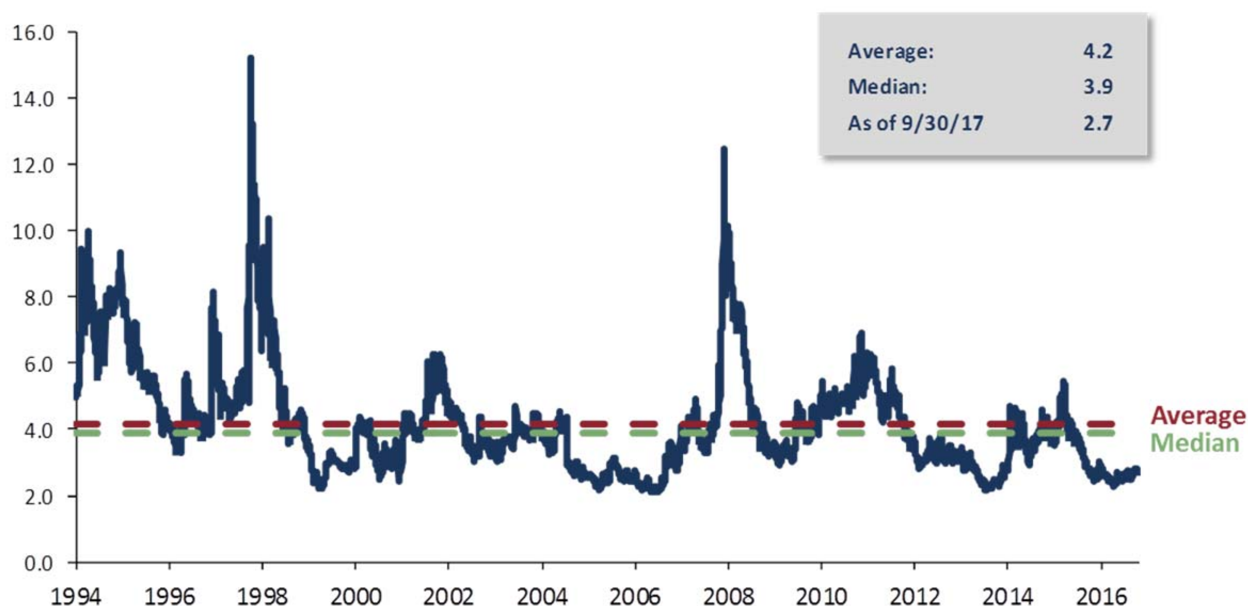
External Debt Valuation

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. This fair value spread is the spread on a portfolio represented by the EMBIG that would be needed to compensate for expected credit losses. 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 a signal of being attractive when the fair value multiple is above the long-run average and median lines, and unattractive when it lies below.

[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.

As seen in the chart, the current spread multiple remains well below the level that the market has historically demanded. The multiple stood at 2.7 on September 30, 2017, slightly higher than the 2.6 multiple observed on June 30, 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 quarter. The historical minimum ratio was 2.1 in April of 2007, when the spread on the EMBIG index was +161 bps over Treasuries, and the 10-year Treasury yield was 5.0%. During the third quarter, the EMBIG benchmark total return was 2.4%, accompanied by a spread tightening of 21 bps to +308 bps over Treasuries. For the year-to-date through September 30, the EMBIG's total return has been 8.7% with a spread tightening of 58 bps.

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



Notwithstanding periodic and disturbing geopolitical headlines and some devastating natural disasters, the global backdrop remained quite positive for hard currency emerging debt markets during the third quarter. The global growth recovery remained on track while inflation remained low to stable in most countries. Developed world central banks remained cautious in terms of the normalization of monetary policy. The Trump administration refrained from policies that might damage financial and trade linkages on a global scale, even though sanctions were expanded on Venezuela, talks began with Mexico on renegotiating NAFTA, and bilateral relations between the United States and Russia also deteriorated. Moreover, oil prices as measured by the WTI, were up 12% on the quarter as supply disruptions and geopolitical risks increased. Within reasonable bounds, higher oil prices are positive for the asset class, as they relieve fiscal pressure on the oil-producing countries. In this context, emerging debt markets showed signs of strength. Inflows into emerging debt funds remained strong, as did new issuance volumes.

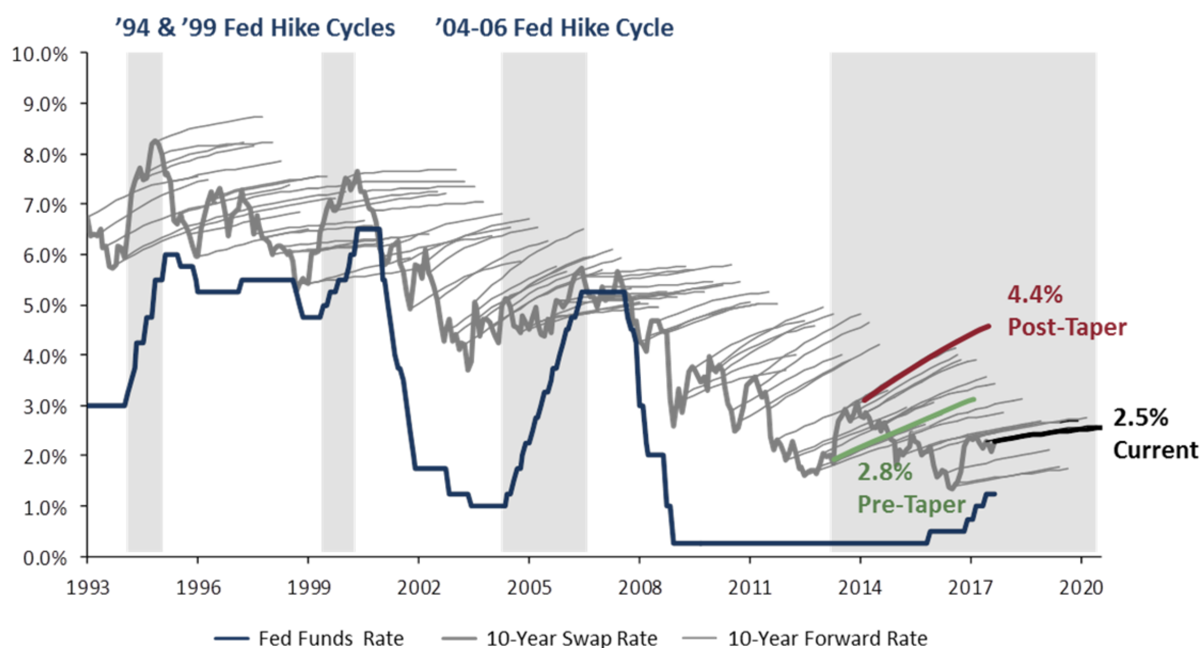
According to data compiled by Bank of America, the third quarter saw $33.8 billion in new issuance, bringing the year-to-date total to $130.8 billion, or 29% above 2016's record pace.

Changes in sovereign credit ratings, which are instrumental in our fair value algorithm, were relatively benign during the third quarter, following a trend from the second quarter. Moreover, we observe a stabilization in credit ratings relative to 2016, when sovereign rating momentum was negative. A few double-A countries were downgraded by S&P, notably Chile and China, but default risk is so low that it did not affect the fair value spread significantly. In contrast, several low-rated countries, where default risk is higher, saw positive rating actions during the quarter. These countries included El Salvador, Zambia, and Honduras. Mexico and Brazil, two large index constituents, also had positive rating actions. Finally, Venezuela, a country with heightened default risk, not only continued to pay its external obligations, but its index weight fell, reducing its impact on the fair value spread.

Based on these rating changes and market moves, our new calculation of the "fair value" spread of the EMBIG that would be required to compensate for expected credit losses fell from 127 bps at end-June (139 at end-December 2016) to 115 bps by end-September 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 3 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

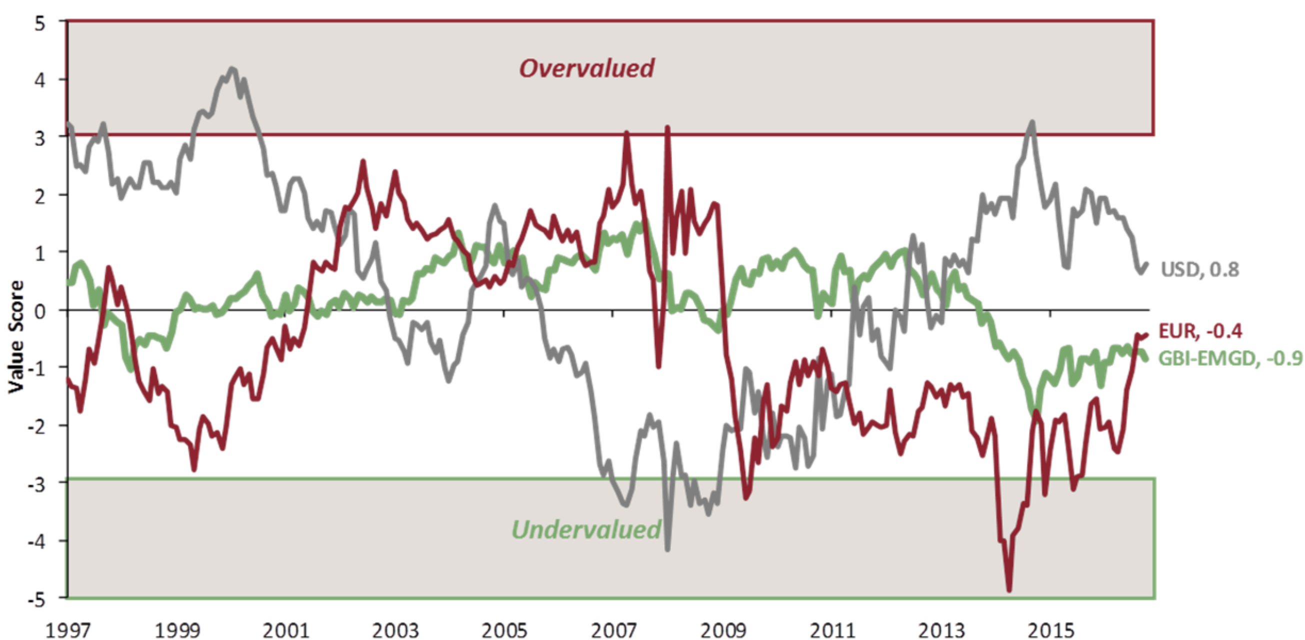


On this metric, we have a similar-to-slightly worse risk-free-rate cushion than we had in the previous quarter. The 10-year US Treasury yield was essentially flat during the quarter on a point-to-point basis, but this masks a fairly large roundtrip move in the 10-year yield, when it reached a low of 2.0% in early September. Meanwhile, the slope of the 10-year forward curve was broadly stable. It flattened by a further 4 bps, from about 33 bps (to the 3-year forward point) to 29 bps as of end-September. This level of 29 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 continues the process of monetary policy normalization.

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



There have been some recent moves in the chart that warrant some comment. The most notable is the ongoing rally in the EUR that began early in the year and continued during the third quarter, perhaps based on the favorable growth outlook in the EU and the "pro-Europe" outcome of the French election.

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This has significantly impacted our value score for the EUR, moving it closer to our notion of fair value, from relative cheapness in recent years. The second point is the waning strength of the USD, as it has given back some of its post-election rally. The DXY index of the dollar against its major trading partners fell 2.7% during the third quarter, and is down 9% year-to-date. Our value score for the benchmark GBI-EMGD has not changed much during the quarter (recall it is a weighted average of 18 countries, so its trend tends to be more stable). **GBI-EMGD currencies continue to look relatively cheap to the USD on a weighted average basis, but less so than the previous quarter. GBI-EMGD currencies are beginning to look much more attractive versus the EUR, though both still look cheap relative to the dollar.** EM currencies outperformed the US dollar by 1.3% on average during the third quarter. However, there were some large disparities in terms of performance. Higher-yielding commodity currencies such as BRL (5.0%), COP (4.1%), and RUB (3.1%) outperformed as oil prices recovered from a weak second quarter. Lower-yielding currencies of the CEEMEA region such as CZK (4.1%) and HUF (2.3%) also outperformed, helped in large part by the EUR rally. The ARS (-4.4%) was the worst-performing currency during the quarter, but the currency remained overvalued according to our valuation framework. The ZAR (-3.1%) was the second worst performer. The currency faced different challenges during the quarter: credit downgrade, unexpected rate cuts and negative political noises.

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 US real yields. In the emerging world, the quarter saw a slight uptick in the real yield of the GBI-EMGD countries, from 2.1% to 2.2%. Lower nominal yields in several countries were roughly offset by lower inflation prints. Most bond markets within the benchmark registered positive local returns in the third quarter. Higher yielding countries like Brazil (5.7%), Indonesia (4%), South Africa (3.6%), and Peru (3.4%) outperformed their peers. Brazil continued its easing cycle in the third quarter while Indonesia, Peru, and South Africa surprised the market by cutting rates more than expected. Low yielders in CEE4 and Asia were the worst performers once again. The Czech Republic (-1.0%) and Romania (-0.3%) were the only countries with negative returns. In the Czech Republic economic growth is rebounding and markets expect the central bank to hike rates when the ECB will begin to tighten liquidity. In Romania, where economic recovery also seems well underway, the central bank narrowed the interest rate corridor during the quarter to tighten liquidity while rate hikes are expected for next year. Argentina's local bonds were the worst performers among high yielders, as the central bank had to tighten liquidity with inflation remaining higher than expected. 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 and Hungary, 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 valuation differentials narrowed in the third quarter according to our methodology. The rally in the EUR improved EM relative valuations against the EUR, but the weakness in the USD further narrowed the valuation differential between the dollar and EM currencies. EM currencies still look cheap relative to the USD, but less so than at the beginning of the year, and the end of the second quarter.
2. Local debt markets continue to look attractive, based on real yield differentials between EM and developed market bonds. Differentials remain well above historical norms, despite the rally in nominal rates in emerging countries over the past quarter.
3. External debt remained in "rich" territory in the third 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). Spread compression was offset by strong credit rating momentum.
4. Finally, it is worth noting that, at the beginning of the year, our valuation methodology suggested local emerging debt markets were significantly more attractive than hard currency debt markets. For the year-to-date through September 30, the GBI-EMGD local benchmark is up 14.28%, while the EMBIG hard currency benchmark is up 8.73%.

Sources for charts: Bloomberg, J.P. Morgan, GMO

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