Emerging Debt Report

January 19, 2018

Biggest Movers in Spread 9/29/2017 to 12/29/2017	Spread Change	Spread Level	Total Return	Biggest Movers: Spot Emerging Currencies	Total Return	Biggest Movers: Emerging Rates	Total Return
EMBIG	3	311	0.5%	ELMI+*	2.0%	GBI-EMGD**	0.8%
Country Sub-Index:							
Ecuador	(148)	459	9.1%	South Africa	9.1%	Mexico	-2.2%
Angola	(131)	456	8.5%	Korea	7.0%	Uruguay	-2.0%
Ghana	(103)	354	5.5%	Poland	4.9%	Czech Republic	-1.9%
Kenya	(101)	312	4.8%	Malaysia	4.3%	Romania	-1.7%
Tajikistan	37	536	-1.5%	Brazil	-4.6%	South Africa	2.3%
Pakistan	51	375	-0.1%	Turkey	-6.2%	Peru	2.3%
Belize	102	771	-6.7%	Mexico	-7.2%	Indonesia	2.7%
Venezuela	1760	4854	-28.5%	Argentina	-7.7%	Russia	3.1%

* Total return

** 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: One year ago, our valuation metrics strongly favored local debt markets over external debt markets, and returns ended up being consistent with that relative value assessment. In 2017, the hard currency EMBIG index returned 9.3%, while the local currency GBI-EMGD returned 15.2%, due in part to dollar weakness. As a result, the relative cheapness of local debt markets, while still attractive, is less so than a year ago, especially for dollar-based investors. For euro-based investors, local debt markets look much more attractive than one year ago. Hard currency debt remains on the expensive side of its historical valuations, but those valuations improved marginally in the fourth quarter.

External Debt Valuation

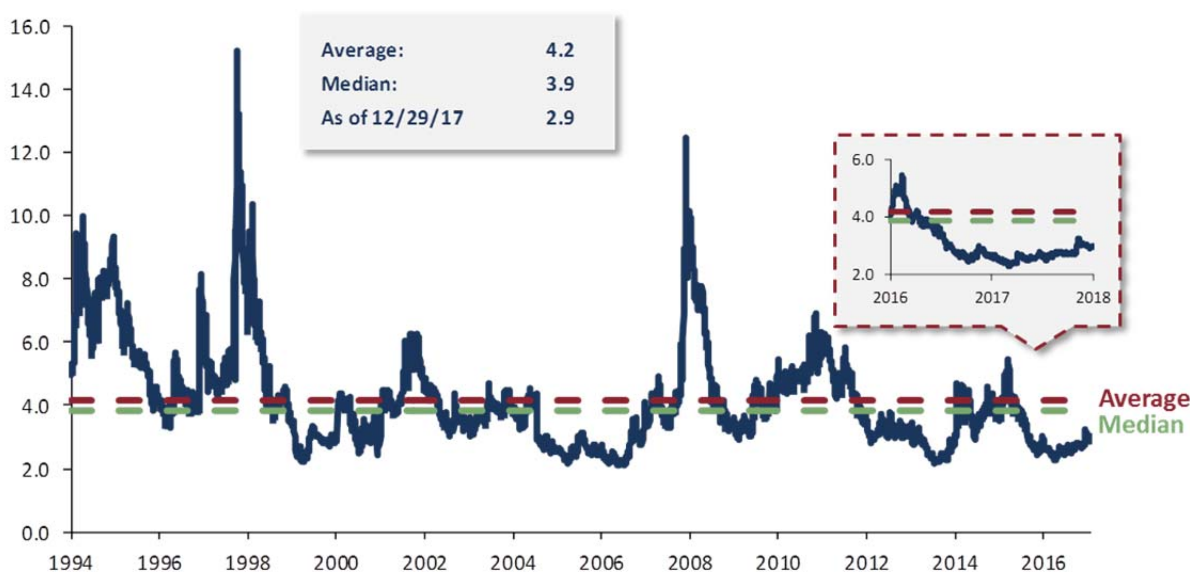
Exhibit 1 shows our familiar valuation chart for external sovereign debt. We calculate a "fair" spread of the EMBIG over US Treasuries, accounting for the credit rating profile of the EMBIG, default probabilities, and recovery values under default scenarios, based on rating agency studies of the historical experience. 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.

As seen in the chart, the current spread multiple remains well below the level that the market has historically demanded, a condition that has been sustained since the first half of 2016. The multiple stood at 2.9 on December 31, 2017, up from the 2.7 multiple observed on September 30, 2017, and significantly higher

[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.

than the 2.2 level observed during the first quarter of 2017. The ratio remains 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 reason is that although credit spreads are tightening, credit quality as measured by rating agencies is stabilizing. 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 fourth quarter of 2017, the EMBIG benchmark total return was 0.54%, accompanied by a widening in the credit spread of 3 bps to +311 bps over Treasuries. The index's performance was skewed somewhat by Venezuela, whose bonds suffered a massive drop in price and spike in spreads during the quarter. Although Venezuela now represents less than 2% of the index, its huge move (-28.5% in total return for the quarter) was impactful. For example, although the index spread over Treasuries widened slightly, 53 of the benchmark's 67 countries actually saw their credit spreads tighten relative to Treasuries during the quarter, and only a handful of countries had negative total returns on their sub-indexes.

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



For hard currency emerging debt, the ongoing deterioration in socioeconomic conditions in Venezuela was a major market theme for the quarter. The country's financial crisis entered a new phase as the Maduro administration announced its need for debt service relief amid an ever-tightening sanctions regime that has made issuing new debt virtually impossible and the serving of existing debt more technically challenging. A combination of delayed payments from the government, and the extreme caution of financial system intermediaries that are afraid of running afoul of US sanctions, resulted in defaults on several Venezuelan bond issues, triggering rating downgrades and credit default swap contracts. As we enter 2018, the majority of Venezuelan bonds are priced at around 20% of face value, even as the government vows to continue honoring its obligations as it seeks debt service relief. This is relevant for our fair value model because the collapse in prices has dramatically reduced Venezuela's weighting in the index to well under 2%, reducing the marginal impact of a default. Venezuela represents a unique situation that we have never before witnessed and will continue to be a key issue for the market in 2018.

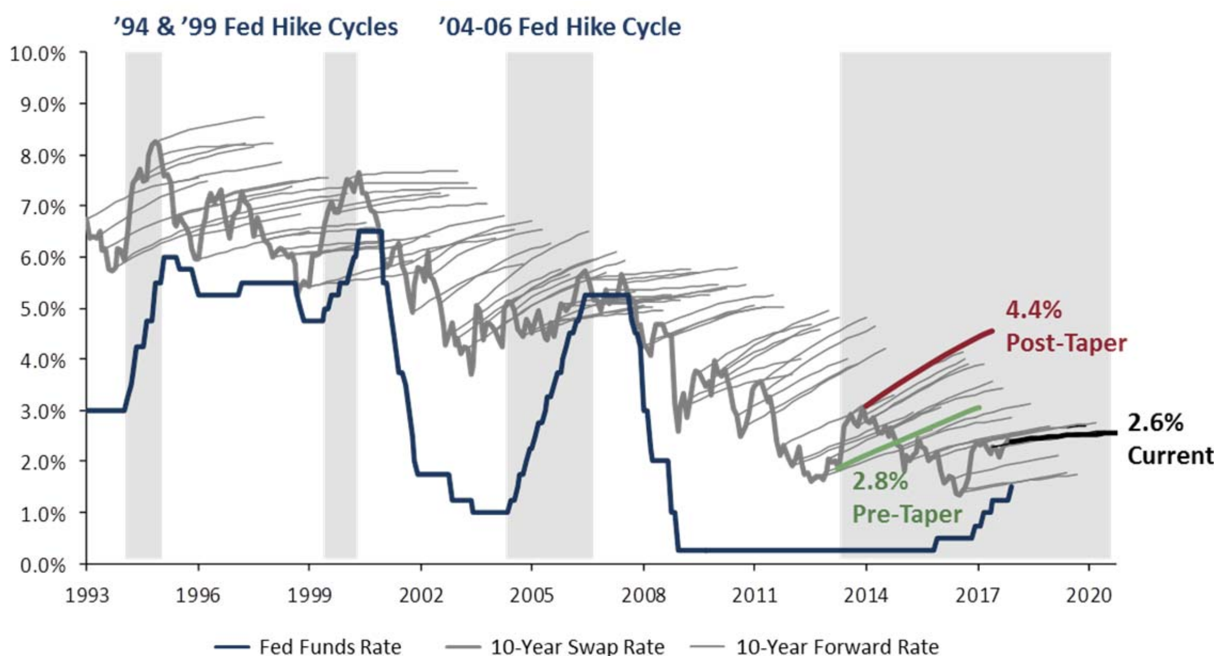
Another major theme during the quarter was the rise in oil prices, as Brent crude rose to above $65 per barrel and the WTI contract rose 17% to above $60. Prices have continued to rise in the first few weeks of 2018. The combination of strong global economic growth and a fairly strong commitment by OPEC and non-OPEC participants to curtail production supported oil markets. This reduced financing pressure on many oil-producing countries during the quarter.

Changes in sovereign credit ratings, which are instrumental in our fair value algorithm, were relatively benign during the fourth quarter, following a trend from the second quarter of the year. South Africa was the most significant country that suffered downgrades, from both S&P and Moody's. Moreover, sovereign rating trends are somewhat more favorable than one year ago. Today, the ratio of negative rating outlooks to positive outlooks is roughly balanced among emerging sovereigns, compared with roughly a 7 to 1 ratio at the beginning of 2017.

Based on these rating changes and market moves, our new calculation of the "fair value" spread of the EMBIG required to compensate for expected credit losses fell from 115 bps at end-September (139 at end-December 2016) to 107 bps by end-December 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 higher during the quarter on a point-to-point basis, to the tune of 7 bps, fluctuating between about 2.30% and 2.50%. Meanwhile, the slope of the 10-year forward curve flattened significantly over the quarter. It flattened by 12 bps, from about 29 bps (to the 3-year forward point) to 17 bps as of end-December. We have not seen a forward curve this flat in many years. This indicates little to no cushion for a surprise rise in Treasury yields, and is relevant in the context of current macroeconomic policy in the US, which can be described as monetary tightening and fiscal loosening.

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 fourth quarter thanks to the ongoing favorable growth outlook in the EU. This has significantly affected our value score for the EUR, moving it to overvalued territory, from relative cheapness in recent years. The second point is the waning strength of the USD, which now lies in cheap territory. The DXY index of the dollar against its major trading partners fell 1.0% during the fourth quarter, and was down 9.9% in 2017. 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 are beginning to look much more attractive versus the EUR, while more neutral versus the USD.** EM currencies were flat versus the US dollar on average during the fourth quarter. There were some disparities in terms of performance. Higher yielding currencies such as ARS (-7.8%), TRY (-6.2%), MXN (-7%), BRL (-4.7%), and COP (-1.6%) were the worst performers, each driven by idiosyncratic factors. Lower yielding currencies of the CEEMEA region such as CZK (3.3%) and PLN (4.9%) continued to outperform, helped in large part by the good performance of the EUR rally. The ZAR (9.3%) was the best performer after underperforming in the third quarter on the back of credit downgrades, unexpected rate cuts, and negative political noise. The fourth quarter was buoyed by the news that Cyril Ramaphosa won the ANC elections in December. The CLP (3.7%) and MYR (4.4%) also outperformed during the quarter.

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 fall during the fourth quarter, due in large part to a fall 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 2.3%. Higher nominal yields in several countries were roughly offset by higher inflation prints. Most bond markets within the benchmark registered positive local returns in the third quarter. Performance of EM local bonds within the benchmark was mixed in the fourth quarter. Higher yielding commodity-linked countries like Russia (3.1%), South Africa (2.3%), Indonesia (2.7%), Colombia (2.1%), and Peru (2.3%) outperformed their peers. The Czech Republic and Romania's local rates continue to underperform as the two economies are registering stronger growth and the central banks are on a hiking path. Uruguayan local bonds also underperformed as inflation bottomed in the fourth quarter. Mexican local interest rates were the worst performers during the quarter as the market repriced NAFTA risks to the downside and the central bank decided to resume hikes to contain inflation pressures. 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 further in the fourth 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 now look neutral relative to the USD, for the first time in several years.
2. Local debt markets continue to look attractive, based on real yield differentials between EM and developed market bonds. Differentials remain above historical norms.
3. External sovereign debt remained in “rich” territory in the fourth quarter, but the broad improvement in credit ratings during the quarter meant that the asset class valuation marginally improved on our metrics (it became “less rich” on a risk-adjusted basis).
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 full year, the GBI-EMGD local benchmark returned 15.21%, while the EMBIG hard currency benchmark was up 9.32%.

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

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