

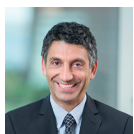


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EM Sovereign Debt: Spreads are Tight... So What?

INSIGHTS

A superficial look at EM sovereign spreads suggests they may be too tight to offer attractive upside. We disagree, and here's why.



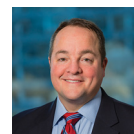
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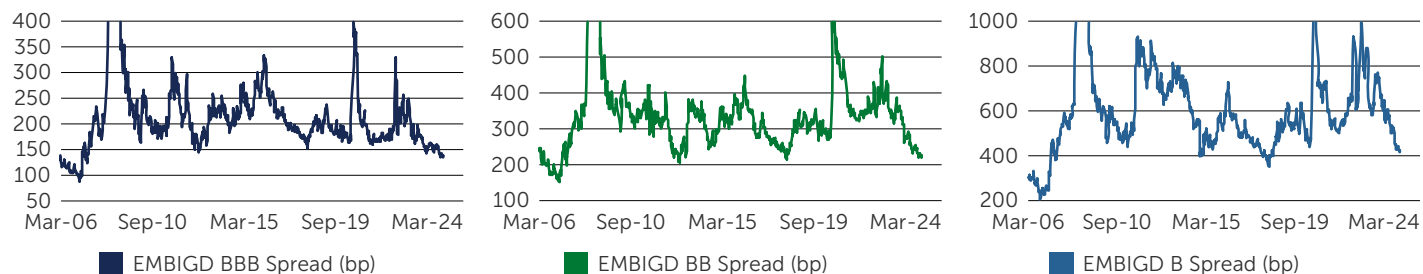


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A cursory look at EM sovereign debt over the past 20 years leaves most observers with the impression that spreads in the asset class are too tight and valuations are expensive, and therefore do not offer good risk-reward potential. Spreads of BBB, BB, and B-rated sovereigns are indeed testing multi-decade lows (Figure 1), which prompts two questions: Is a market “correction” likely, and if so, will potential returns be adequate?

Figure 1: EM Sovereign Spreads Test Multi-Decade Lows



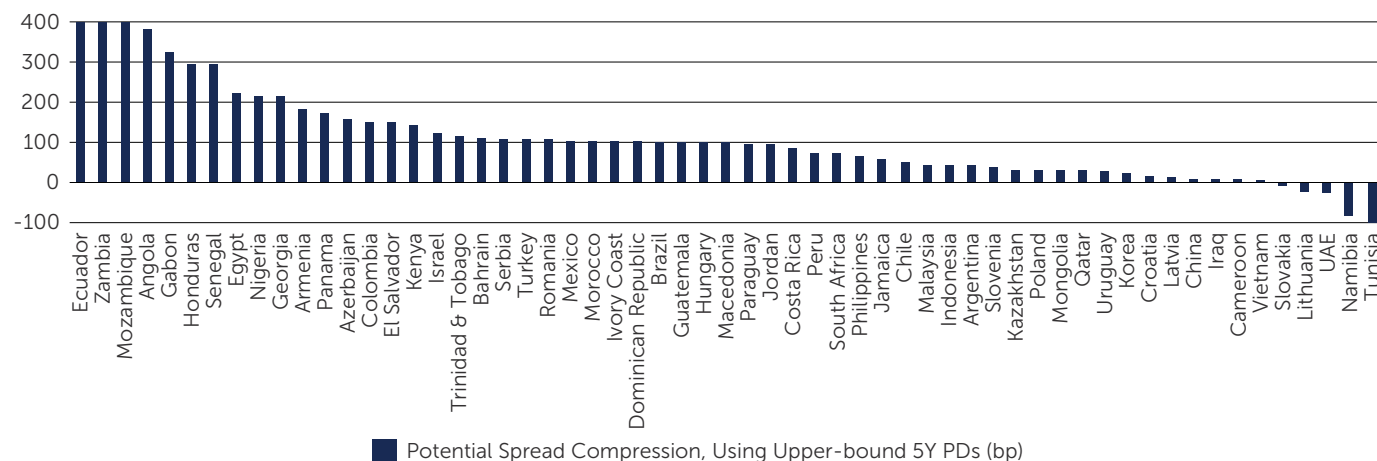
Source: J. P. Morgan. As of May 31, 2024.

If our analysis was limited to looking at spreads over the past 20 years, then we too might conclude that they are tight and that EM sovereign credit is expensive. However, a number of factors leads us to remain constructive on the asset class.

1. Spreads Still Over-compensate for Default Risk

In our view, there is no fundamental reason to think that spreads are too tight. In particular, spreads should be considered too tight when they undercompensate for the risk of permanent losses (i.e., the probability of default multiplied by the loss given default). Based on the probability of default that we assign to EM sovereigns and a recovery rate in the event of default, the debt of the vast majority of EM sovereigns overcompensate for default risk, as measured by the potential spread compression to the breakeven spread (Figure 2). Investors are therefore earning an attractive premium to own sovereign credit risk. As a result, we see scope for potentially generating “excess returns” through both spread compression and carry. That said, sovereigns with the highest spread compression potential may not be and often aren’t good risk-reward, because of the inherently high margins of error in forecasting the probability of default, and in the case of low-price bonds, the large differences between current yields and yields to maturity.

Figure 2: Potential Spread Compression in Select EM Sovereigns



Source: Bloomberg; Barings’ calculations. As of May 31, 2024.

2. Historically Attractive Yields & Compelling Return Potential

It may appear that the return potential for EM sovereign debt has declined, but we do not believe that is the case given the current high level of yields on U.S. Treasuries. Excluding the Global Financial Crisis (GFC) shock during 2008–2009, the current all-in EM BBB-rated USD sovereign debt yield is near a 20-year high at 6%.¹ The overall EM sovereign index yield is also near a 20-year high of 8.3%, but that is somewhat exaggerated by the pull-to-par of some sovereigns’ low-price bonds that may never in fact get paid in full.

Figure 3: Elevated U.S. Treasury Yields Lift EM Sovereign Yields Higher



Source: J. P. Morgan. As of May 31, 2024.

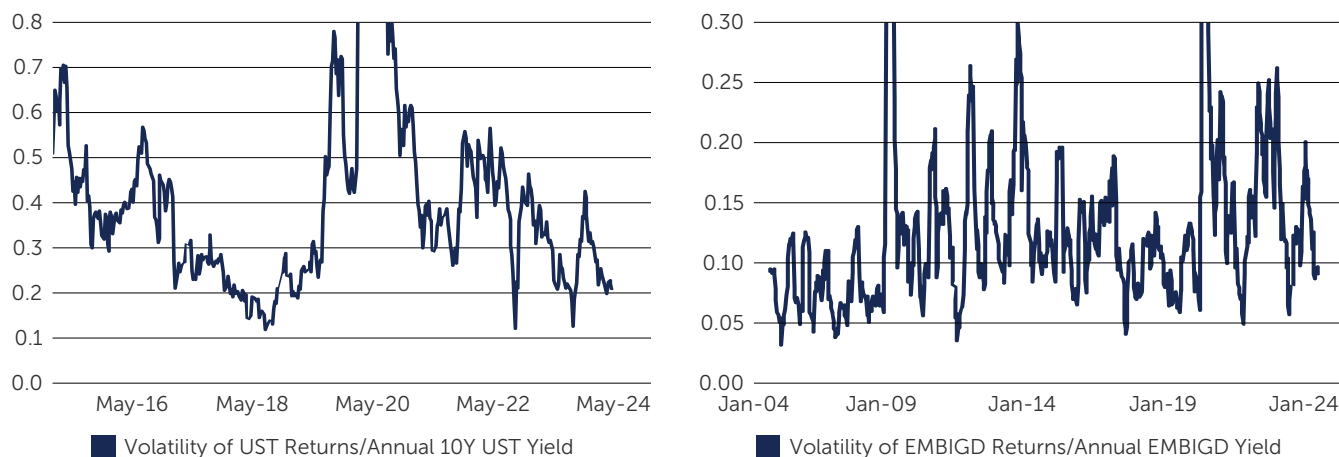
3. Higher U.S. Yields Imply Lower Spread Compensation for Market Risk

Academic studies of past market performance have empirically found that credit spreads compensate investors for both default risk and market risk, i.e., changes in the value of credit portfolios that are marked-to-market daily.² Here, we think the current, high level of U.S. Treasury yields provides fixed income a margin of safety that has reduced market risks, and therefore the portion (i.e., amount) of spreads that are needed to compensate for market risk. We reach this conclusion on the basis of a simple measure of market risk, the 12-week moving standard deviation of 10-year U.S. Treasury returns normalized by the level of generic 10-year U.S. Treasury yields.

1. Source: J. P. Morgan. As of May 31, 2024.
 2. Source: J. P. Morgan. As of May 31, 2024.

The volatility of U.S. Treasury returns adjusted for the level of U.S. Treasury yields is near the low end of its 20-year range and less than one-half of its average level (Figure 4). The same measure for EM sovereign hard currency debt—using the EMBIGD Index returns and yields—points to the same conclusion, albeit to a lesser degree, that the compensation in spreads needed for market risk is lower today than its average over the past 20 years.

Figure 4: U.S. Treasury Return Volatility is at 20-Year Lows

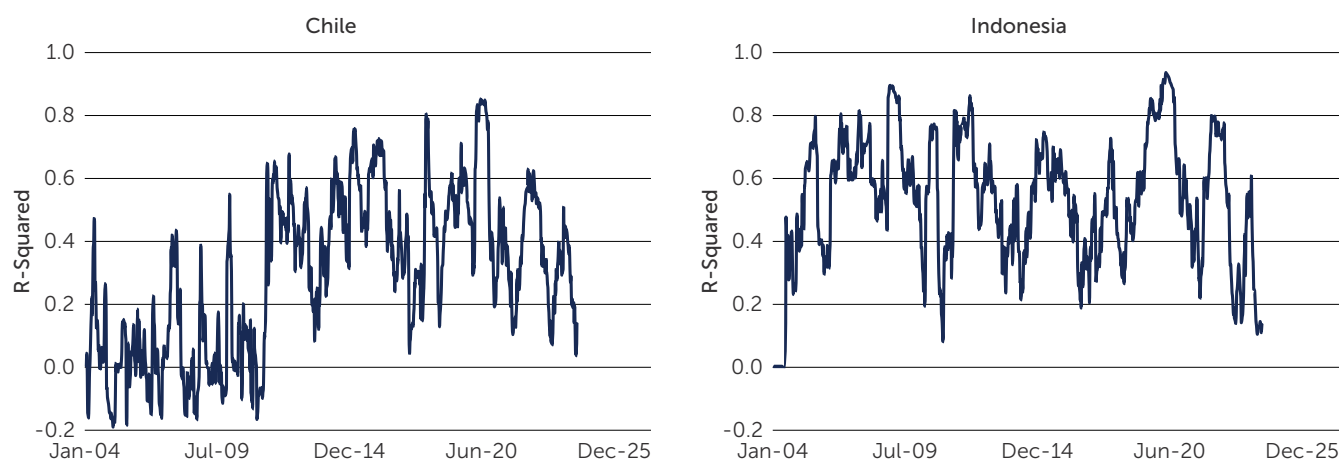


Sources: Bloomberg; J. P. Morgan and Barings’ calculations. As of May 31, 2024.

We also gauged the amount of market risk in EM sovereign debt spreads through a regression of spread changes to global risk factors such as U.S. Treasury yields, the S&P 500 index, oil prices and metals prices. The lower the regression co-efficient (R^2), the lower the market risk captured by these global risk factors. The residual spread (after adjusting for market risk) component thus captures default risk.

The R-squareds of the regressions for the sovereign bonds of Chile and Indonesia show that the market risk component of spreads has diminished substantially and that spreads still comfortably over-compensate for default risk (Figure 5). This means that there is scope for spread compression and capital appreciation on top of the high carry, even from these seemingly tight levels.

Figure 5: Market Risk Component for Chile and Indonesia Sovereign Bonds At Multi-year Lows



Sources: Bloomberg; J. P. Morgan and Barings’ calculations. As of May 31, 2024.

4. A Strong History of Outperformance vs. Other Risk Assets

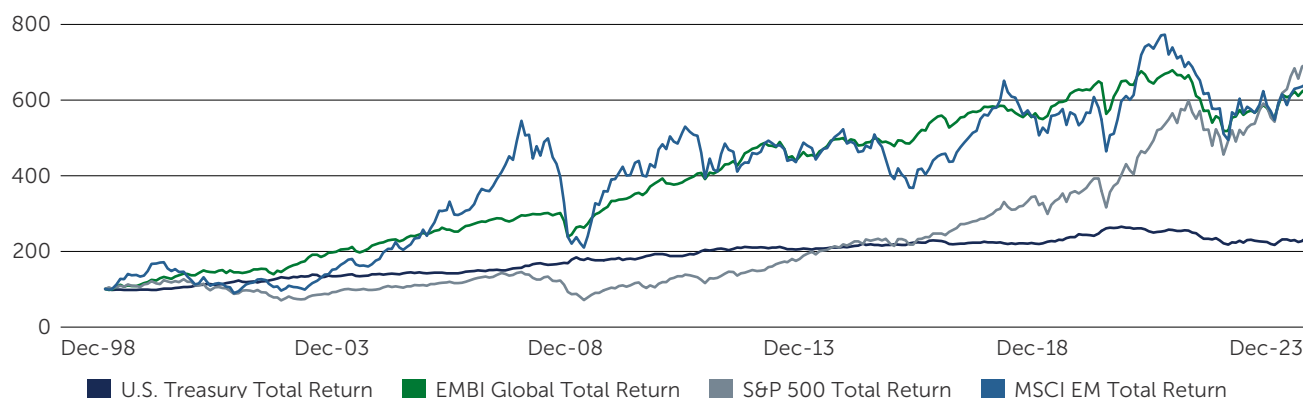
Lastly, and perhaps most fundamentally, EM sovereign hard currency debt returns have consistently outperformed U.S. Treasuries over decades (Figure 6). Drawdowns have been generally short and rebounds strong, particularly in the high yield segment of the market. We believe this time is no different. While the rebound has been shallow following shocks from COVID and the subsequent rapid interest rate rises from the Fed, we believe the current levels of yields and spreads are attractive.

EM sovereign debt returns also compare favorably versus other asset classes. For example, over the last 25 years, EM sovereign debt has returned an

average of 7.3% per year, ahead of EM equities (6.7%) and almost at par with the S&P 500 (7.7%) (Figure 6).

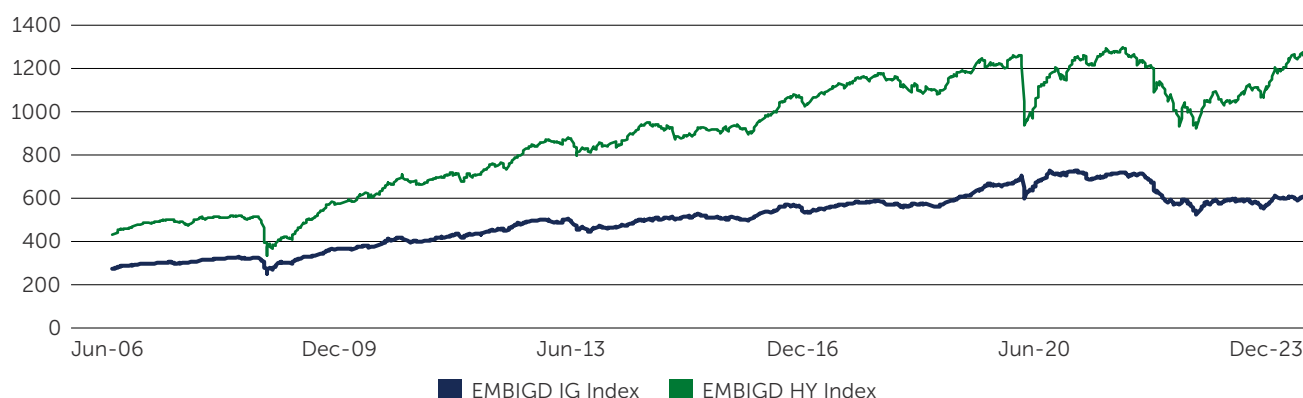
The history of the asset class also shows EM sovereign high yield debt has outperformed investment grade debt (Figure 7). This suggests that risk taken in the asset class has been rewarded over time. However, investors need to be selective, take on the right high yield risks, and avoid the wrong ones, as these can cause a significant setback on returns as happened during 2019–2022. This underscores the value of active management to get the best credit-risk reward over time, and find the high yield sovereign debt exposures that offer both carry and potential for capital appreciation via spread compression.

Figure 6: EM Sovereign Debt Has Outperformed U.S. Treasuries and is Comparable to S&P 500



Sources: J. P. Morgan; MSCI. As of May 31, 2024. PAST PERFORMANCE IS NOT INDICATIVE OF FUTURE RESULTS.

Figure 7: Within EM Sovereign Debt, HY Has Outperformed IG



Source: J. P. Morgan. As of May 31, 2024. PAST PERFORMANCE IS NOT INDICATIVE OF FUTURE RESULTS.

Opportunities in EM Sovereign Debt

In view of this analysis, Barings' EM debt sovereign hard currency portfolios are fully invested and long risk. Our EM sovereign debt portfolios are overweight spread duration versus their benchmarks. Our philosophy remains the same: we invest in high conviction, stable and positively trending sovereign credits. We do not invest simply because a sovereign is in the index. Specifically:

- **We see the most compelling risk-reward potential in BB-rated sovereigns.** The carry and potential for spread compression are attractive. This includes countries such as Serbia, Costa Rica, Paraguay, Albania, Oman, Morocco, Jamaica, Dominican Republic, and Colombia. In addition, for countries such as Costa Rica, Dominican Republic, and Jamaica, there are strong and positive trade linkages to the U.S., and economic growth remains strong and above trend—this should further support credit fundamentals. The same also applies to Albania and Serbia, which are benefiting from economic linkages to the European Union.
- **We are generally underweight and remain very selective on single B- and CCC-rated sovereigns.** Overall, we remain uncomfortable with the fundamental trajectory of most countries in these rating buckets and view the recent outperformance as unjustified by fundamentals and unsustainable. Consequently, we avoid most CCC rated sovereigns, including Argentina, Ecuador, and Gabon, and distressed and defaulted credits such as Ghana, Venezuela and Zambia.
- **Within IG, we see limited value in China and GCC sovereigns.** Spreads are tight, have very little room to compress, and, in our view, do not sufficiently compensate for domestic and geopolitical tail risks. Conversely, we remain comfortable with Mexico, despite the recent and ongoing setbacks to the quality of institutions. This is because Mexico's economy is diversified, competitive, and benefits from reshoring and its strong ties to the U.S. economy. Equally, countries such as Romania, Poland and Hungary benefit from ties to the E.U. In addition, Indonesia and India have solid credit fundamentals and positive financial trends.

“EM sovereign hard currency debt returns have consistently outperformed U.S. Treasuries over decades.”

Key Takeaway

A superficial look at EM sovereign debt suggests the asset class is expensive today. However, a more thorough analysis that considers other critical factors reveals the picture is more nuanced. We see many EM sovereigns that offer an attractive credit risk-reward potential, in which we are comfortable going long risk via spread duration. We believe long-term investors could benefit from staying invested in the asset class and potentially see attractive returns ahead.

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**As of March 31, 2024*

24-3619074