

Asia Conference 2023: Emerging Markets

Research 25 Jul 23, 08:57 PM Analysts: Regis Chatellier Sr. Analyst - EM Strategy

Executive Summary

- CreditSights held its Asia Conference 2023 in Hong Kong and Singapore earlier this month.
- This is the transcript for the presentation on emerging markets and sovereigns.

Relative Value

Please see:

- [EM Weekly: HY Sovereigns Enjoying the Ride](#)
- [EM Strategy: Focus on Sovereign IGs](#)
- [EM Strategy: Focus on EM Sovereign High Yield](#)



Emerging Markets

Relatively Benign EM Macroeconomic Prospects

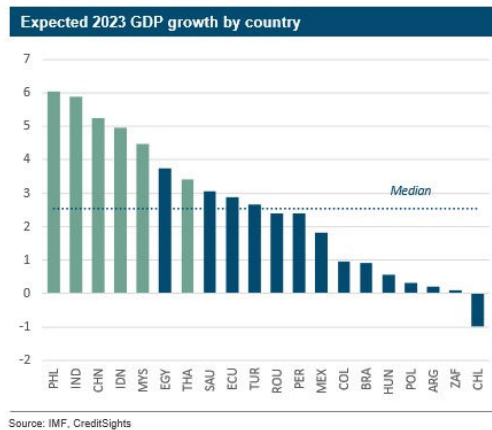
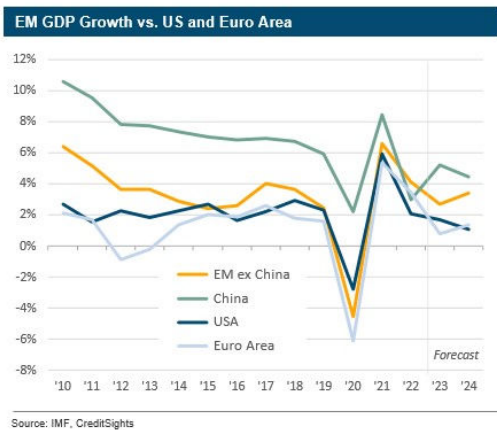
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EM macroeconomic prospects

EM Growth to remain stronger than in advanced economies



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- EM economic prospects are relatively decent: growth is expected to reach 4% this year, and the gap with advanced economies is likely to widen in the coming years.
- Asia is still leading in terms of growth performance, followed by the Middle East and Africa. LatAm and CEE countries are lagging given the severity of the inflation shock in these two regions.

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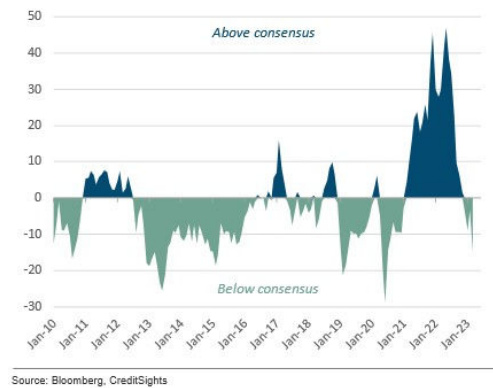
EM macroeconomic prospects

Inflationary pressures continue to ease across EM

EM Median headline inflation by region



EM Inflation surprise index



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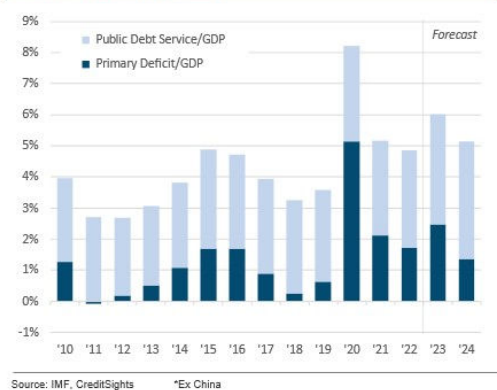
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- Inflation has been falling at faster pace than expected (CPI data continue to surprise on the downside).
- We expect the inflation downward trend to continue.

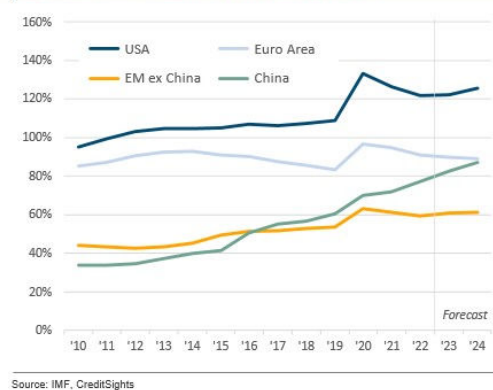
EM macroeconomic prospects

Elevated fiscal deficits, but relatively stable public debt/GDP

EM* Fiscal Deficit (% of GDP)



EM Government Debt/GDP vs. US and Euro Area



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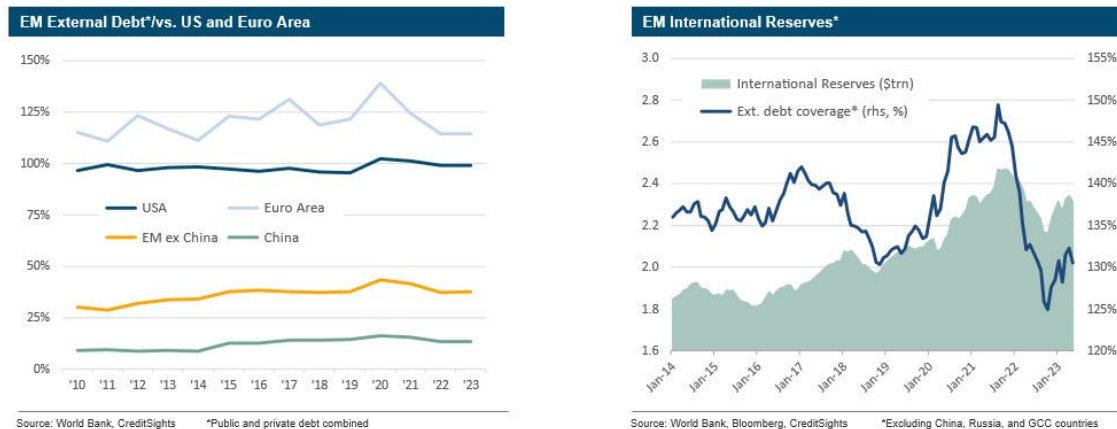
- EM public finances have deteriorated since the Covid pandemic. Fiscal deficits will remain relatively wide, and improve only at slow pace.

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- On the positive side, public debt levels (ex China) have been relatively stable when compared to GDP; they and remains much lower than in developed markets.

EM macroeconomic prospects

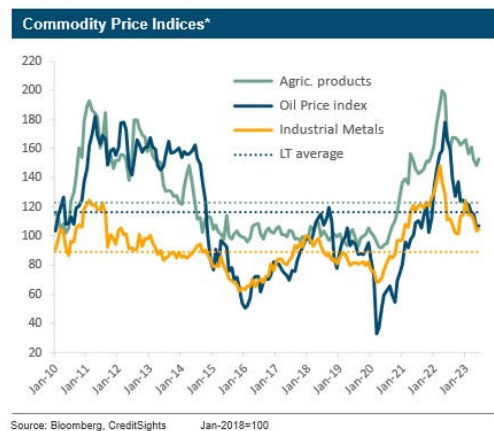
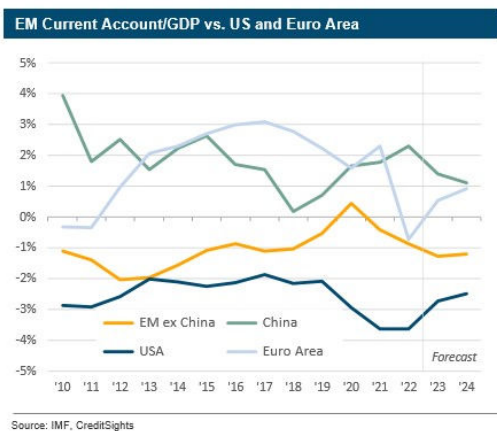
EM external debt much lower than in AEs; FX reserves being rebuilt



- EM external debt levels (public and private combined) have also remained contained in the past few years. EM External Debt/GDP is much lower than in advanced economies.
- EM FX reserves dramatically shrunk last year as the Fed embarked into aggressive monetary tightening, forcing EM central banks to use part of their reserves to defend their currencies. Reserves are on the rise again, and adequately cover short-term external debt.

EM macroeconomic prospects

Commodity prices to remain supportive for EM external trade



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EM sovereign credit

**Attractive Valuations;
Improving Market
Conditions**

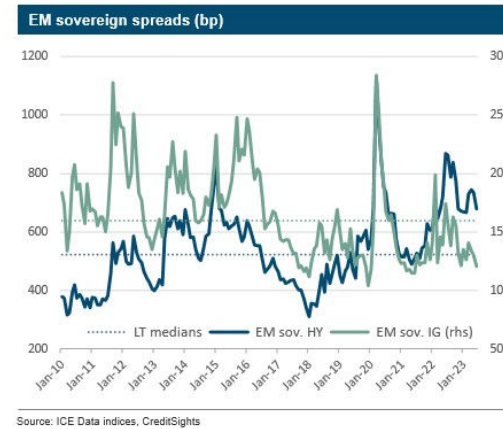
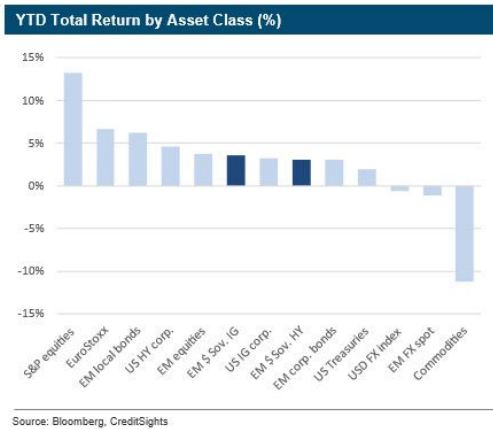
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EM sovereign credit

EM \$ bonds have had muted performance this year



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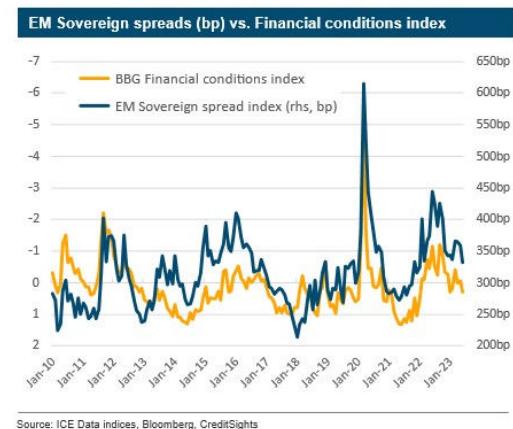
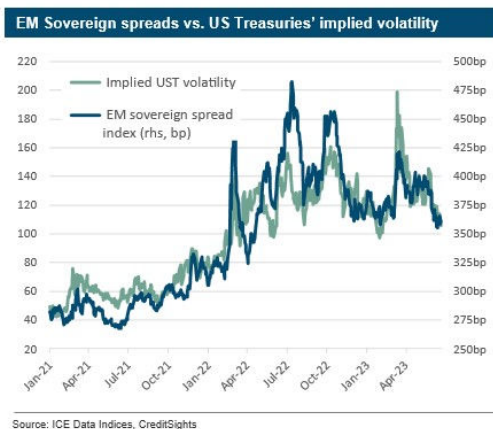
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- EM \$ bonds have had muted performance this year; we think there is significant upside, especially for the high yielders.
- EM sovereign IG spreads are relatively tight, but HY spreads remain wide by historical standards.

EM sovereign credit

Market conditions have been improving



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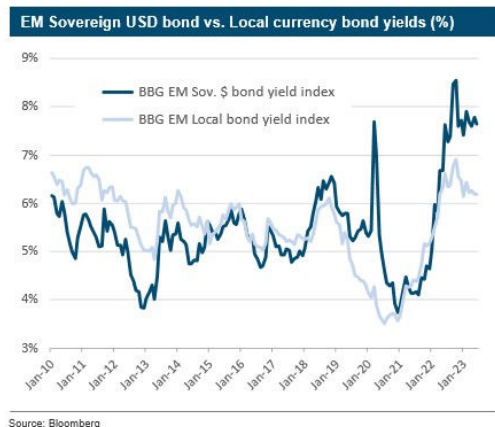
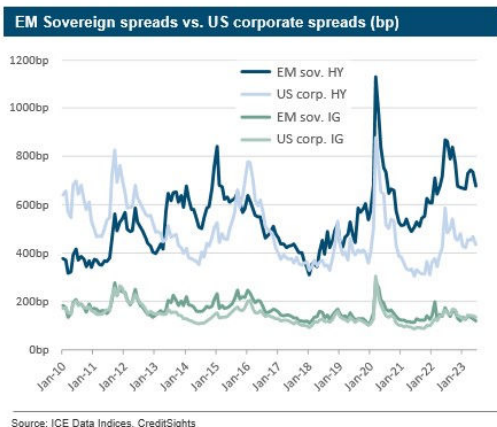
- Global market volatility has dropped, which should lead to further spread compression in EM.

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- Implied US Treasury volatility remains relatively high, but the trend of the last few months is supportive for EM bonds.

EM sovereign credit

EM Sovereign HY spreads are wide by historical standards



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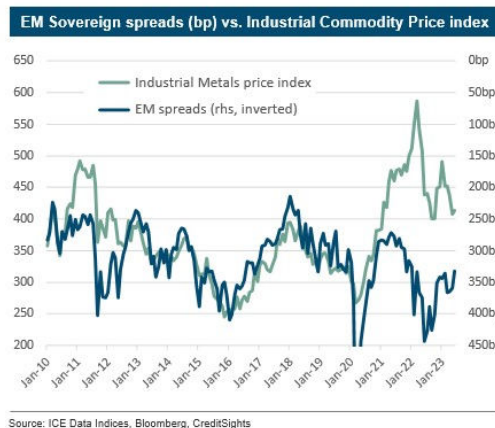
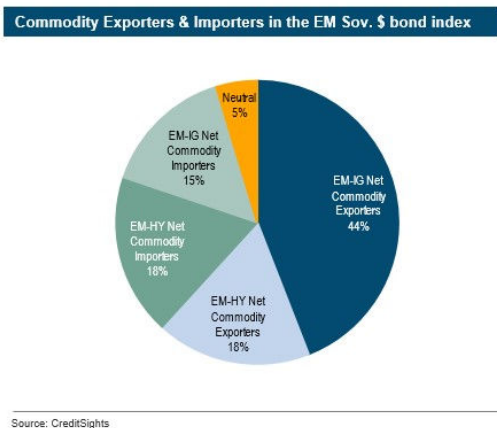
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- EM sovereign \$ bonds are cheap relative to EM local bonds.
- Sovereign IGs trade in line with US IG corporates; sovereign HYs are cheap relative to US HYs.

EM sovereign credit

EM spreads are too high considering current commodity prices



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- The sovereign credit market is dominated by net commodity exporters.
- In view of current commodity prices, EM sovereign spreads should be much tighter.

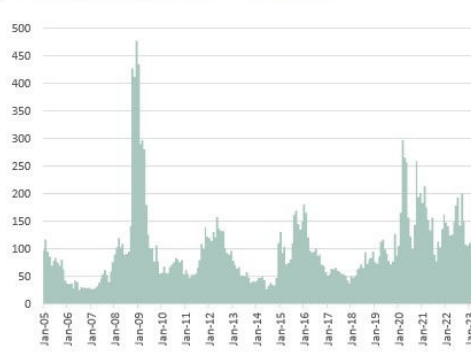
EM sovereign credit

EM sovereign HYs to outperform EM IGs

EM Sovereign HY-IG spread differential (bp)



Spread dispersion relative to fair value (bp)



- We expect the EM HY-IG spread differential to compress further.
- The spread dispersion is high by historical standards, suggesting there are plenty of arbitrage opportunities in EM.

Asia sovereign credit

Asia Sovereign Credit

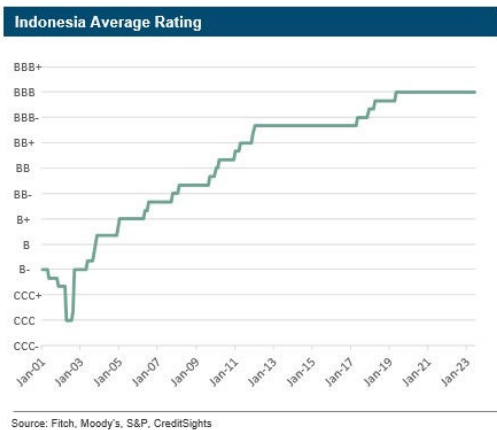
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Indonesia

Indonesia: Underperform



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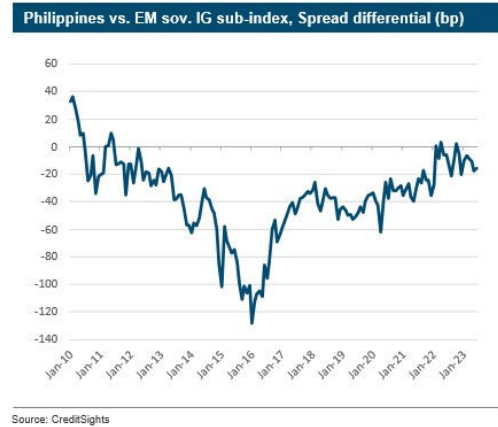
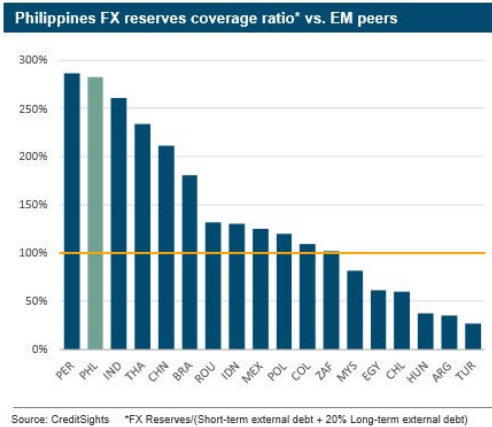
- We believe Indonesian sovereign USD bonds will underperform other EM IG bonds.
- Indonesian fundamentals have dramatically improved, as reflected by the series of rating upgrades in the past 20 years.

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- However, the improvement in fundamentals is already priced in, and market valuations are expensive relative to credit peers.

Philippines

Philippines: Market Perform

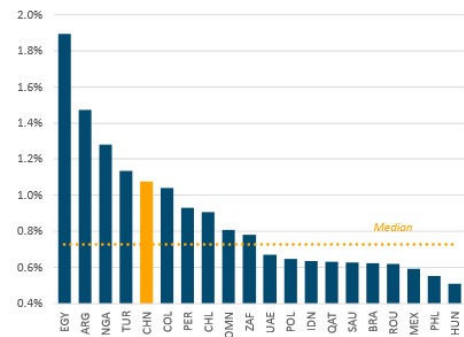


- We see Philippines' sovereign USD bonds performing relatively in line with other EM IG bonds.
- Philippines have underperformed in the past two years, but market valuations are still tight considering the deterioration in the fiscal outlook. On the other hand, relatively low external debt and very high FX reserves are limiting the downside.

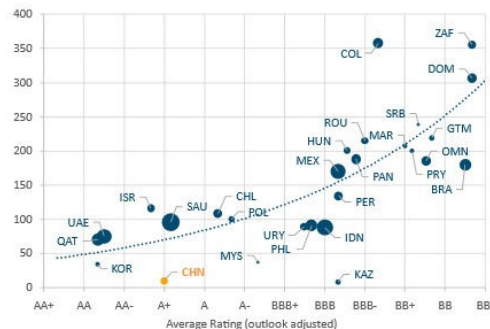
China

China: Underperform

Average transaction costs on EM sovereign \$ bonds (%)



China sovereign spread vs. EM peers



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- We keep an Underperform view on Chinese sovereign USD bonds.
- Chinese sovereign spreads are the tightest in EM owing to the very large reserves of the country: FX reserves amounted to \$3.2 trillion as of 30 June, or more than twice the level of short-term external debt, making a sovereign default extremely unlikely. It remains that Chinese USD bonds are unappealing at current market levels; they are also less liquid than single A-rated peers.

EM sovereign credit

EM Sovereign Credit

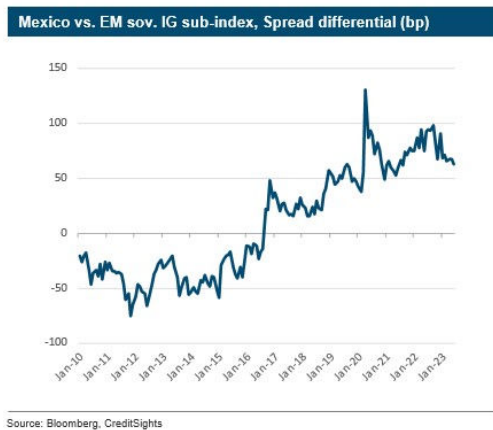
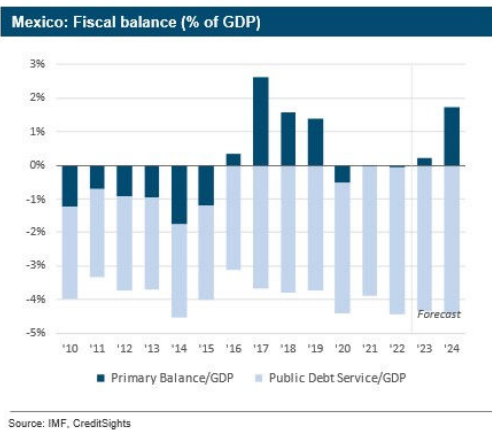
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Mexico

Mexico: Outperform



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- We hold an Outperform view on Mexican sovereign USD bonds.
- Mexican sovereign USD bonds have been outperforming other EM IGs over the past six months, but the spread differential remains historically wide. We find the risk-reward attractive at current levels given the significant increase in FX reserves and the relatively benign fiscal outlook.

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Colombia

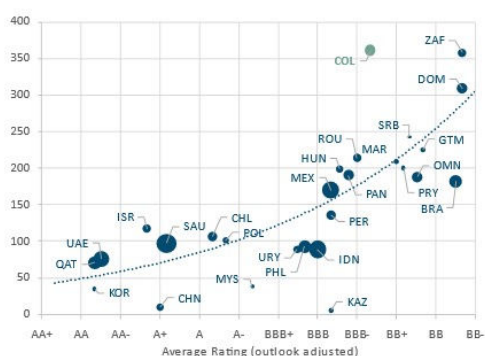
Colombia: Outperform

Colombia vs. EM sovereign index, Spread differential (bp)



Source: Bloomberg, CreditSights

Colombia Sovereign Spread (bp) vs. Credit Peers



Source: Bloomberg, CreditSights

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- We think Colombian bonds will outperform the EM sovereign credit index.
- Fundamentals have notably weakened in the past few years, with the twin deficits being particularly wide.
- Colombian sovereign USD bonds have underperformed the EM index, and they are now in line with low single B-rated assets. This means that the market is implicitly downgrading Colombia by nearly four notches relative to its current ratings – which looks overdone

Nigeria

Nigeria: Outperform



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- Nigeria is likely to continue to outperform other HY credits.
- The country faces huge challenges, but we do not expect any credit event in the short- to medium term. The recent trend suggests that oil output is on the rise, which should support the current account and public finances.
- The government has relatively low external financing needs until 2027, and although FX reserves have been declining, they still cover more than seven months of imports. The risk of further devaluation of the naira is elevated, but it would improve Nigeria's competitiveness and limit the pressure on FX reserves.

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