GENERALI INSURANCE ASSET MANAGEMENT

Focal Point

EM: the relative appeal of EM EUR bonds over USD bonds

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Our Focal Point series explores topical issues on macro, markets and investment

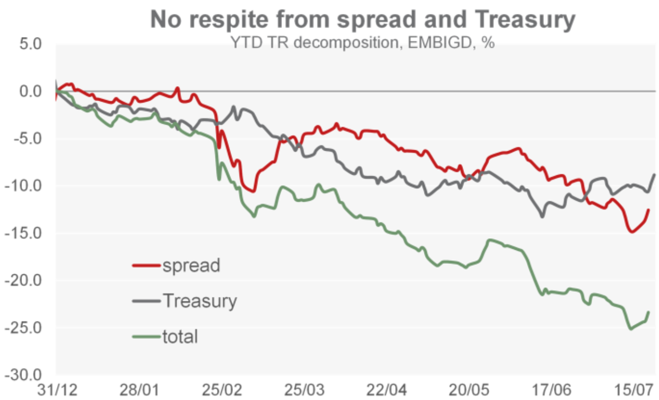
- The environment for EM external debt is facing many headwinds, that may persist over the next months. EM spreads will continue to widen. That said, total return in the second part of this year is likely to be positive thanks to the high carry. EM external debt remains a relative value and carry play.
- EM EUR debt remains more attractive. Indeed,. EM EUR bonds are offering one of the largest pickups over EM USD bonds since January 2020.
- We favour EM EUR IG bonds over EM EUR HY. EM EUR IG bonds are more defensive while they offer a large pickup over EM USD IG bonds. Moreover, EM HY dispersion is high and volatile.
- At the country level, we see value across the curve in Romanian EUR bonds vs USD. In Mexico, the 5-10Y part of the EUR curve is more attractive than the USD curve. In Chile, EUR bonds offer a substantial pickup in the front end of the curve, mainly driven by global factors than local factors.

EM external debt has experienced a significant sell-off that has accelerated recently. EM debt yield has reached new highs since the GFC, and EM EUR debt index has been recently underperforming EM USD debt amid rising European recession worries. Given the challenging market environment, the question is whether EM EUR debt is more attractive for European investors. To do so, we run a quantitative analysis on all similar EM EUR and USD bonds.

Wider EM spreads amid increasing fragmentation

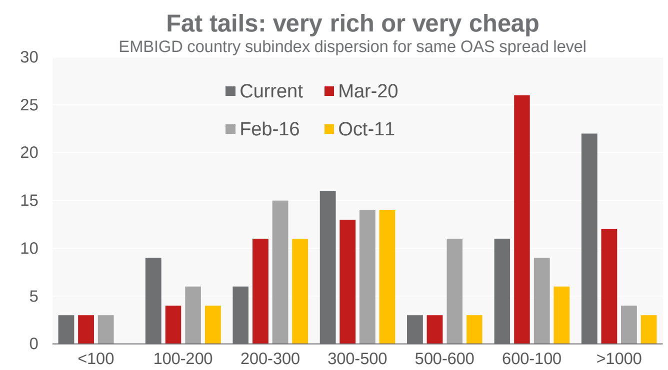
The EM environment remains challenging, both from a macro and market point of view, in the coming months, with EMs continuing to face multiple headwinds: higher real yields, persistently high inflation, an economic slowdown, and deteriorated country balance sheets. These factors have been compounded by more hawkish than expected DM and EM central banks and a strong USD.

EM external debt performance has been subdued, with the worst start into the year since 1994 resulting in a -19% return year-to-date. While initially, the underperformance was driven by the duration sell-off on the rise of core rates, the recession concern is now the main driver, leading to a widening of EM spreads. Fortunately, the recession concern has limited the increase of real yields but has not been enough to offset the negative impact of the widening spreads.



Source:Bloomberg, JP, GIAM

In the short to medium term, we expect EM external debt spreads to widen further by 25 bp as recession concerns materialise. The pace of widening should be more moderate than seen recently, but risks are still skewed towards high volatility and wider spreads. Indeed, the latest US CPI figures confirm that inflationary risks are still broad-based, and the Fed has shown no signs of less hawkishness. EM central banks have also remained hawkish with large hikes in CEE and unexpected monetary tightening in Asia recently.



Source: Bloomberg, JP Morgan, GIAM calculations

The fragmentation of the EM debt universe has been intensifying, and default risks will continue to rise in the EM HY universe, leading to wider spreads. On the one hand, many countries are in the 300 bp bucket. On the other hand, the EMBIGD index shows a fat tail distribution: EM IG is expensive, but the number of distressed countries with a spread above 1000 bp has never been so prominent. Therefore, we recommend maintaining a defensive stance preferring EM IG over HY, focusing on countries with solid fiscal and current account balances (e.g. MENA IG, Poland, Mexico, Indonesia). Refinancing risks rise with tighter financial conditions and very limited access to primary markets. These risks re-emerge as the balance sheets of EM countries have been deteriorated during the pandemic.

According to the IMF, the debt level for EMs has stabilised at c. 70%, but interest-to-revenue keeps growing. Frontier market payments will peak in 2026, while issuance costs have been rising fast for single Bs and below.

Favour EUR debt

In the current challenging environment, EM external debt is thus mostly a carry and relative play, not a directional one. Total return is likely to be positive in the second part of this year, thanks to a significant carry that will be more than enough to offset the 25 bp spreads widening we forecast. For EM USD debt, looking at the total return decomposition, the total return will be negative if spreads widen more than 25bp and US rates increase by more than 40 bp, a move that will bring them back close to their June highs. Likewise, the carry offers protection against a 20 bp EUR rate rise for EM EUR debt.

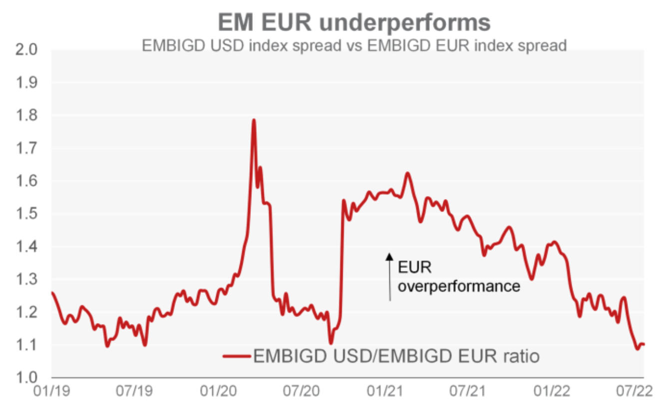
EM USD: carry provide a buffer

6M TTR for different scenarios

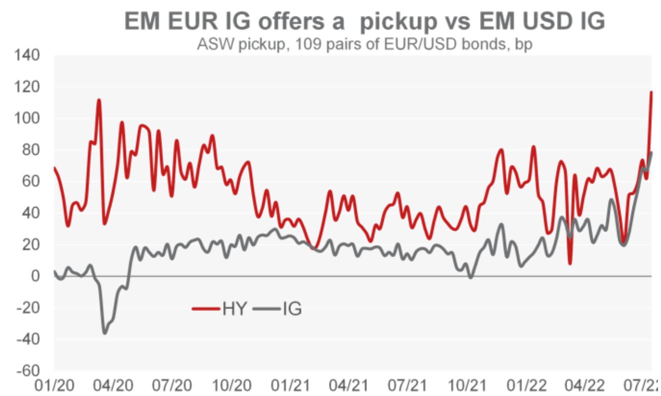
OAS	US 7Y							
spread	2.55%	2.65%	2.75%	2.85%	2.95%	3.05%	3.15%	3.25%
502	9.69%	9.00%	8.31%	7.62%	6.93%	6.24%	5.55%	4.86%
512	9.00%	8.31%	7.62%	6.93%	6.24%	5.55%	4.86%	4.17%
522	8.31%	7.62%	6.93%	6.24%	5.55%	4.86%	4.17%	3.48%
532	7.62%	6.93%	6.24%	5.55%	4.86%	4.17%	3.48%	2.79%
542	6.93%	6.24%	5.55%	4.86%	4.17%	3.48%	2.79%	2.10%
552	6.24%	5.55%	4.86%	4.17%	3.48%	2.79%	2.10%	1.41%
562	5.55%	4.86%	4.17%	3.48%	2.79%	2.10%	1.41%	0.72%
572	4.86%	4.17%	3.48%	2.79%	2.10%	1.41%	0.72%	0.03%
582	4.17%	3.48%	2.79%	2.10%	1.41%	0.72%	0.03%	-0.66%
592	3.48%	2.79%	2.10%	1.41%	0.72%	0.03%	-0.66%	-1.35%
602	2.79%	2.10%	1.41%	0.72%	0.03%	-0.66%	-1.35%	-2.04%

In our view, the subdued performance of EM external debt year-to-date has led to dislocations that create opportunities in EM EUR debt vs EM USD debt. Both EM EUR and EM US debt total returns have been almost similar year-to-date, but for European investors, there is currently more value in EM EUR debt than EM USD debt:

Indeed, EM EUR spreads have been underperforming as the spread widening on a beta-adjusted basis has been larger in the EUR space than in the USD space. It is an unusual move as EM EUR debt historically tends to outperform during sell-offs, like in March 2020. The recent underperformance illustrates the higher recession risk in Europe, the Ukraine war, and the uncertainty related to the gas disruption that will affect CEE countries, representing a relevant part of the EM EUR index.

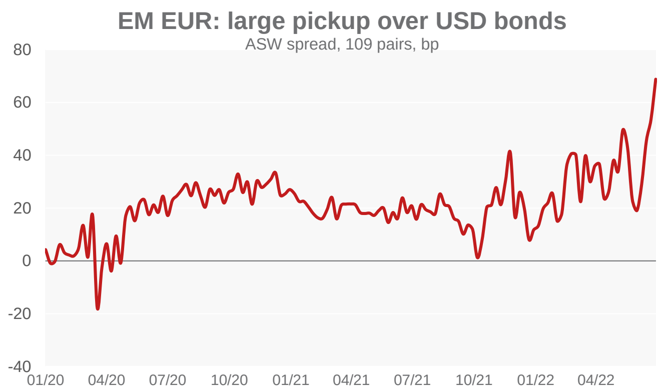


Source: Bloomberg, JP, GIAM calculations



Source: Bloomberg, GIAM calculations

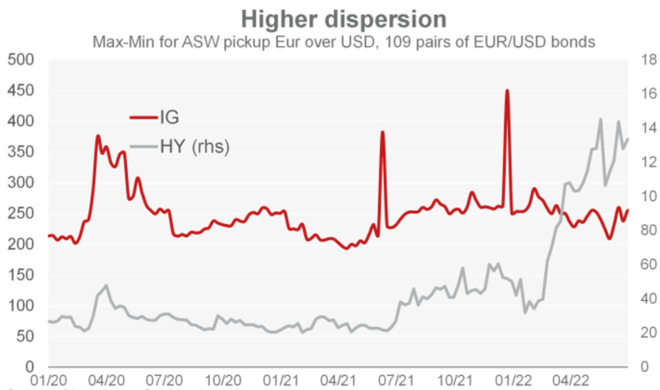
Above all, EM EUR debt is still offering a higher yield than EM USD debt on a FX-hedged basis despite the significant rise in US rates. The pickup has even increased recently alongside the rise of European recession concerns and the EUR bonds sell-off. At the index level, adjusted for duration and basis hedged, EUR EMBIGD offers a c. 40 bp pickup over the USD EMBIGD. It is in line with the post-pandemic average. That said, it is not the most accurate measure as the two bond indices have different maturity, issuer composition and credit risk. To have a better view, we analyse 109 pairs of EUR/ USD bonds for the same issuer and maturity. When FX hedged via a cross-currency swap, EM EUR bonds currently offer one of the most significant pickups ever over EMR USD bonds, with a median asset-swap pickup of 68 bp.



Source: Bloomberg, GIAM calculation

At the rating level, the EM EUR IG and HY segments offer a similar pickup, standing at the peak levels reached over the pandemic. That said, the pickup offered by HY bonds is highly volatile and driven by the illiquid low-rated countries.

We suspect that in the current challenging market environment, the difference in liquidity between EUR and USD bonds in the B and lower buckets explains a relevant part of the HY pickup, especially for distressed names. At a more granular level, the BBB and BB segments offer the best pickup in our view. It is more liquid and stable. The single A bucket stands at a lower level in terms of relative pickup. It is likely explained by the absolute low level of spreads and the movement of the EUR/USD basis, which can have a more significant impact on those high-rated names.



Source: Bloomberg, GIAM calculations

Relative value country opportunities

Romania continues to offer one of the most significant EUR pickup vs USD bonds across the curve, especially in the 5Y-10Y area. EUR bonds widened significantly in the aftermath of the war in Ukraine. Renewed USD issuance will weigh on the USD complex; thus, we favour EUR bonds in the belly of the curve.

In Chile, EUR bonds offer a substantial pickup in the front end of the curve, mainly driven by global factors rather than local ones. The curve is steep and Chile cheapened again vs its rating, pricing two notches of a downgrade. We would favour the EUR May 30 and July 31 over the USD January 31.

Mexico continues to offer a significant pickup in EUR bonds in the 5-10Y part of the curve. We do not expect Mexico to come to the market again in 2022, and a tight fiscal stance is likely to preserve it from a further downgrade until the next presidential elections in 2024. Mexico's spread widened significantly at the long end, and so we will favour the EUR October 33 or August 36.

Indonesia EUR offers a significant pickup in EUR bonds across the curve. The curve is flat, so we do not have a preference. Fundamentals are still solid, even if S&P's rating is slightly under pressure with a negative outlook. The large fiscal deficit is not a larger threat as being financed by local bonds. The fiscal deficit is due to improve, and it should benefit from higher commodity prices.

EM EUR bonds are still attractive

Despite a difficult environment that should see wider spreads, EM EUR bonds are still attractive. They may still offer a positive total return in the second part of the year, supported by a high carry. More interesting is the pickup that EM EUR bonds are offering over EM USD bonds: despite the large US rate sell-off year-to-date. For European investors it is still more attractive to buy EM EUR bonds than EM USD bonds. To this regard, we favour the IG sector that is more defensive and offers the highest pickup over USD bond since the pandemic.

EUR-USD bond pairs analysis

Bonds				Asset swap spread (bp)			YTM (%)			Amount outst. (mn)	
Rating	Country	EUR	USD	EUR	USD hedged	Spread	EUR	USD hedged	Spread (bp)	EUR	USD
IG	REPHUN	Oct25	Mar24	112	54	**58**	2.46	1.67	**79**	1,000	1,643
IG	REPHUN	Nov30	Sep31	212	139	**73**	4.31	3.14	**117**	1,250	2,250
IG	REPHUN	Apr32	Sep31	212	139	**74**	4.30	3.14	**116**	1,000	2,250
IG	REPHUN	Nov50	Sep51	162	152	**10**	3.99	3.33	**66**	1,250	2,000
IG	ISRAEL	Jan24	Jun23	22	-17	**39**	1.37	0.72	**65**	3,550	1,000
IG	ISRAEL	Jan27	Mar26	73	-4	**77**	2.18	1.26	**92**	1,750	1,000
IG	ISRAEL	Jan29	Jan28	89	19	**71**	2.52	1.65	**87**	1,650	1,000
IG	ISRAEL	Jan49	Jan48	128	111	**18**	3.17	2.98	**18**	1,250	1,000
IG	POLAND	Jan23	Mar23	1	-57	**58**	0.54	0.15	**39**	1,500	2,000
IG	POLAND	Jul23	Mar23	4	-57	**61**	0.88	0.15	**72**	2,000	2,000
IG	POLAND	Jan24	Jan24	34	-10	**44**	1.40	1.01	**39**	2,000	2,000
IG	POLAND	Jun26	Apr26	83	40	**43**	2.09	1.71	**39**	460	1,750
IG	POLAND	Aug26	Apr26	73	40	**33**	2.15	1.71	**44**	1,000	1,750
IG	POLAND	May27	Apr26	80	40	**39**	2.28	1.71	**57**	1,000	1,750
IG	POLAND	Oct27	Apr26	84	40	**44**	2.36	1.71	**65**	1,000	1,750
IG	POLAND	Feb33	Oct35	135	105	**29**	3.18	3.03	**14**	300	100
IG	POLAND	Feb34	Oct35	141	105	**36**	3.32	3.03	**28**	300	100
IG	POLAND	Feb35	Oct35	75	105	**-31**	2.54	3.03	**-50**	500	100
IG	POLAND	Jan36	Oct35	143	105	**38**	3.54	3.03	**51**	2,000	100
IG	ROMANI	Apr24	Jan24	139	83	**56**	2.51	1.96	**55**	1,250	878
IG	ROMANI	Oct24	Jan24	169	83	**86**	2.91	1.96	**95**	1,500	878
IG	ROMANI	Oct25	Jan24	217	83	**134**	3.52	1.96	**156**	2,000	878
IG	ROMANI	Mar29	Feb31	370	208	**163**	5.79	3.81	**198**	1,150	1,300
IG	ROMANI	Dec29	Feb31	337	208	**129**	5.75	3.81	**194**	1,000	1,300
IG	ROMANI	Feb30	Feb31	338	208	**130**	5.57	3.81	**176**	750	1,300
IG	ROMANI	May30	Feb31	393	208	**186**	6.09	3.81	**228**	2,000	1,300
IG	ROMANI	Jul30	Feb31	353	208	**145**	6.02	3.81	**221**	2,000	1,300
IG	ROMANI	Jul31	Feb31	344	208	**136**	5.97	3.81	**216**	1,400	1,300
IG	ROMANI	Jan32	Feb31	341	208	**133**	6.06	3.81	**225**	1,400	1,300
IG	ROMANI	Apr42	Jan44	317	301	**16**	6.29	5.01	**128**	1,500	1,000
IG	ROMANI	Apr49	Jun48	388	263	**125**	6.45	4.53	**192**	1,950	1,200
IG	ROMANI	Jan50	Feb51	326	221	**105**	6.19	4.04	**215**	1,600	2,000
HY	SERBGB	Jan29	Dec30	89	229	**-140**	2.44	4.01	**-157**	100	1,200
IG	KAZAKS	Sep34	Oct44	241	237	**3**	5.03	4.34	**69**	650	1,000
IG	KAZAKS	Sep26	Jul25	223	28	**196**	3.87	1.52	**236**	500	2,500
HY	UKRAIN	Jun26	Sep26	2587	2352	**235**	71.18	25.30	**4588**	1,000	1,318
HY	UKRAIN	Jan30	May29	1379	1520	**-141**	37.89	17.04	**2085**	1,250	1,750

LatAm	HY	ARGENT	Jul29	Jul29	2166	2050	**116**	26.73	20.57	**616**	90	2,635
	HY	ARGENT	Jul30	Jul29	2146	2050	**96**	22.56	20.57	**199**	1,166	2,635
	IG	CHILE	Jan25	Mar25	99	52	**47**	2.29	1.74	**55**	1,642	319
	IG	CHILE	Jan26	Jan26	123	73	**49**	2.60	2.03	**57**	1,110	709
	IG	CHILE	Feb29	Feb28	156	87	**68**	3.30	2.36	**94**	709	2,000
	IG	CHILE	May30	Jan31	162	87	**75**	3.43	2.58	**85**	1,491	1,758
	IG	CHILE	Jul31	Jan31	145	87	**58**	3.44	2.58	**86**	1,955	1,758
	IG	CHILE	Jan51	Jan50	140	137	**2**	3.68	3.21	**47**	1,250	2,318
	IG	CHILE	Jan40	May41	142	123	**19**	3.83	3.24	**58**	1,269	2,700
	HY	COLOM	Mar26	Apr27	373	272	**100**	5.25	4.17	**108**	1,350	1,897
	IG	MEX	Jan25	Jan25	126	20	**106**	2.54	1.44	**110**	1,200	1,717
	IG	MEX	Apr26	Jan26	183	55	**128**	3.28	1.85	**143**	1,327	2,060
	IG	MEX	Sep27	Jan28	198	96	**102**	3.65	2.43	**121**	750	1,878
	IG	MEX	Apr28	Jan28	230	96	**134**	4.05	2.43	**161**	1,324	1,878
	IG	MEX	Apr29	Apr29	255	134	**121**	4.23	2.93	**131**	1,000	3,086
	IG	MEX	Jan30	Apr29	233	134	**99**	4.40	2.93	**147**	1,250	3,086
	IG	MEX	Feb31	Aug31	271	156	**115**	4.64	3.31	**133**	1,700	1,157
	IG	MEX	Oct33	Apr33	243	179	**64**	4.97	3.66	**131**	1,515	770
	IG	MEX	Aug36	Sep34	253	208	**46**	5.18	4.04	**114**	1,250	1,706
	IG	MEX	Apr39	Jan40	268	237	**31**	5.28	4.41	**87**	1,429	2,843
	IG	MEX	Mar45	Jan45	257	235	**22**	5.05	4.31	**74**	993	2,764
	IG	MEX	Oct51	Apr51	228	232	**-4**	4.96	4.15	**82**	1,184	2,500
	IG	PERU	Jan26	Jan26	173	86	**87**	3.12	2.18	**94**	1,097	1,000
	IG	PERU	Mar30	Jun30	217	119	**97**	3.86	2.86	**100**	998	750
	IG	PERU	Mar33	Nov33	215	232	**-17**	4.52	4.24	**28**	825	2,152
MENA	HY	EGYPT	Apr25	Jun25	1115	927	**188**	14.59	10.66	**393**	750	1,500
	HY	EGYPT	Apr26	Feb26	1162	926	**236**	16.31	10.74	**558**	1,000	750
	HY	EGYPT	Apr30	Nov30	957	698	**259**	15.30	8.79	**650**	1,000	1,710
	HY	EGYPT	Apr31	Feb31	960	725	**235**	15.40	9.09	**631**	1,250	1,500
	HY	MOROC	Jun24	Dec22	245	133	**113**	3.67	1.71	**196**	1,000	1,500
	HY	MOROC	Mar26	Dec27	261	236	**25**	4.18	3.86	**33**	500	750
	HY	MOROC	Nov31	Dec32	334	230	**104**	6.06	4.16	**190**	1,000	1,000
	IG	KSA	Mar24	Mar23	75	-7	**82**	1.94	0.59	**135**	1,000	3,000
	IG	KSA	Jul27	Feb27	93	9	**84**	2.45	1.48	**97**	1,000	1,250
	HY	TURKEY	Apr23	Mar23	393	376	**17**	4.64	4.57	**7**	1,000	1,500
	HY	TURKEY	Mar25	Mar25	615	621	**-5**	7.87	7.52	**34**	1,250	2,000
	HY	TURKEY	Jun25	Mar25	588	621	**-33**	7.75	7.52	**23**	1,000	2,000
	HY	TURKEY	Feb26	Jan26	621	633	**-12**	8.05	7.75	**30**	1,500	1,750
	HY	TURKEY	Jul27	Mar27	632	647	**-15**	8.67	7.97	**70**	1,500	3,250
	HY	TUNIS	Oct23	Jan25	3047	2024	**1023**	44.10	21.86	**2223**	500	1,000
	HY	TUNIS	Feb24	Jan25	3213	2024	**1189**	52.74	21.86	**3088**	850	1,000
	HY	TUNIS	Jul26	Jan25	1704	2024	**-320**	27.55	21.86	**569**	700	1,000
ASIA	IG	CHINA	Nov25	Oct25	79	-20	**99**	2.14	1.06	**108**	750	2,250
	IG	CHINA	Nov26	Nov27	63	-19	**82**	2.06	1.26	**81**	2,000	1,000
	IG	CHINA	Nov30	Oct30	116	-28	**144**	3.07	1.38	**169**	2,000	2,000
	IG	CHINA	Nov39	Dec39	83	31	**52**	3.00	2.31	**69**	1,000	500
	IG	INDON	Jun23	Apr23	41	-64	**105**	1.20	0.25	**96**	1,500	1,261
	IG	INDON	Jul24	Feb24	108	-7	**116**	2.29	1.05	**124**	1,000	474
	IG	INDON	Apr25	Feb24	137	-7	**144**	2.66	1.05	**160**	1,000	474
	IG	INDON	Jul25	Jan25	157	46	**111**	2.88	1.67	**121**	1,250	2,000
	IG	INDON	Sep26	Jan26	178	75	**104**	3.30	2.04	**126**	750	2,170
	IG	INDON	Feb27	Jan27	176	72	**104**	3.37	2.10	**127**	1,000	1,250
	IG	INDON	Jun28	Apr28	232	78	**154**	3.88	2.29	**160**	1,500	1,000
	IG	INDON	Oct31	Mar31	216	72	**144**	4.33	2.43	**190**	1,000	1,250
	IG	INDON	Mar34	Oct35	201	242	**-41**	4.43	4.43	**0**	500	1,600
	IG	PHILIP	Feb23	Jan24	18	-27	**46**	0.83	0.82	**1**	600	1,500
	IG	PHILIP	May27	Mar26	155	57	**98**	3.12	1.87	**125**	750	1,032
	IG	PHILIP	Feb29	Jan29	160	52	**108**	3.42	2.06	**136**	600	1,500
	IG	PHILIP	Apr33	Jan32	170	143	**28**	3.91	3.21	**70**	650	1,022
	IG	PHILIP	Apr41	Mar41	171	108	**63**	4.14	3.09	**105**	800	2,000
SSA	HY	IVYCST	Jun25	Jul24	616	551	**65**	7.83	6.79	**104**	239	141
	HY	IVYCST	Mar30	Mar28	746	562	**184**	9.75	6.91	**284**	850	794
	HY	IVYCST	Oct31	Jun33	718	491	**227**	9.76	6.71	**304**	850	1,250
	HY	IVYCST	Jan32	Jun33	659	491	**168**	9.25	6.71	**254**	1,600	1,250
	HY	SOAF	Jul26	Apr26	335	260	**75**	4.89	3.95	**95**	500	1,250

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