GENERALI INSURANCE ASSET MANAGEMENT

FOCAL POINT

Renewed attractiveness of EM USD bonds vs EM EUR bonds

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

- **EM EUR bonds are no longer cheap relative to USD peers after this year's outperformance. The relative pickup vs. EM USD bonds on a cross-currency hedged basis has reverted to the long-term average across all the maturity buckets except the lowest-rated countries.**
- **EM USD bonds have become more appealing to European investors, as certain countries now provide a compelling pickup in the USD space relative to their EUR equivalents. The total return outlook for the remainder of the year favours the EM USD index, supported by a higher carry and better duration prospects.**
- **Yet, the EM EUR bond index may still benefit from positive technical factors. For the past, two years, EUR issuance has been on a declining trend which is expected to continue.**
- **At the country level, Poland and Mexico's long-end USD bonds are more attractive than their EUR equivalents. In the EUR space, EUR Romania bonds continue to be cheap compared to its rating peers and offer an attractive yield vs its USD equivalents (cross-currency hedged, same maturity).**

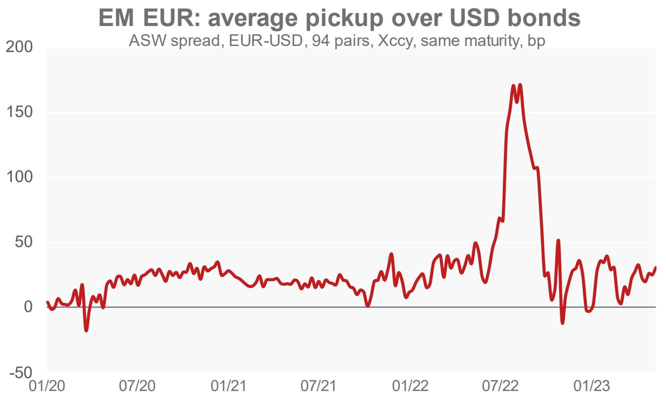
Following wild moves over the past year, rates in developed markets (DM) have calmed somewhat, and so have EM sovereign bond markets. Some of the dislocations have now disappeared. First, we will see that for European investors EM USD bonds have regained some attraction vs EM EUR bonds. Second, even if the EM EUR index may benefit from positive technicals, the total return outlook is more appealing for the EM USD index for the remainder of the year. Finally, we note interesting relative-value opportunities across the EM USD and EUR complex.

EM EUR bonds currently provide a modest pickup over EM USD bonds.

EM USD sovereign bonds have become more attractive to European investors, as some countries now offer a compelling pickup relative to their EUR equivalents. This shift follows the outperformance of EM EUR bonds since the reopening of the Chinese market in Q4 22.

Indeed, during the 2022 duration sell-off, EM EUR bonds were significantly more appealing to European investors on a cross-currency hedged basis compared to EM USD bonds. Despite the rebound in US rates, EM EUR bonds offered a more attractive yield at that time. Based on the analysis of 94 pairs of EUR and USD bonds (same issuer, same maturity), the median asset swap pickup over USD bonds reached 160 basis points.

Since then, the pickup offered by EM EUR bonds has gradually declined. With the relative stabilization of core rate markets, the median asset swap pickup is now only around 30 basis points, in line with its long-term average. The pickup compression is observed across all maturity buckets, except for the lowest-rated countries, where idiosyncratic factors and liquidity play a larger role.



Source: Bloomberg, GIAM calculation

At the index level, the EM EUR index has experienced lower total returns due to the sharp decline in UST rates and its lower duration. However, in terms of pure credit performance, the EM EUR index has outperformed as spreads compressed more significantly. This is an unexpected outcome, as EM EUR bonds tend to underperform during fixed-income rallies when investors prefer more liquid bonds such as USD bonds. Indeed, the EM fixed-income market remains predominantly driven by USD investors, with most of the supply being in dollar-denominated bonds. The current unusual excess return of the EUR index can be attributed to the receding European growth concerns and energy-related issues. Additionally, the majority of the EUR index consists of Central and Eastern European (CEE) names, which have benefited from the reopening of the Chinese market and the reduction of the fears from the fallout of the war in neighbouring Ukraine.

EM USD index to provide a better total return outlook

EM USD return scenario for different assumptions

6M TR for different scenarios, BofA index

	OAS spread	US 8Y 3.58%	3.68%	3.78%	current 3.88%	3.98%	4.08%	4.18%	4.28%
	259	13.2%	12.5%	11.7%	11.0%	10.3%	9.6%	8.8%	8.1%
	279	11.7%	11.0%	10.3%	9.6%	8.8%	8.1%	7.4%	6.7%
	299	10.3%	9.6%	8.8%	8.1%	7.4%	6.7%	5.9%	5.2%
	319	8.8%	8.1%	7.4%	6.7%	5.9%	5.2%	4.5%	3.8%
	339	7.4%	6.7%	5.9%	5.2%	4.5%	3.8%	3.0%	2.3%
current	359	5.9%	5.2%	4.5%	3.8%	3.0%	2.3%	1.6%	0.8%
	379	4.5%	3.8%	3.0%	2.3%	1.6%	0.8%	0.1%	-0.6%
	399	3.0%	2.3%	1.6%	0.8%	0.1%	-0.6%	-1.3%	-2.1%
	419	1.6%	0.8%	0.1%	-0.6%	-1.3%	-2.1%	-2.8%	-3.5%
	439	0.1%	-0.6%	-1.3%	-2.1%	-2.8%	-3.5%	-4.2%	-5.0%
	459	-1.3%	-2.1%	-2.8%	-3.5%	-4.2%	-5.0%	-5.7%	-6.4%

Source: Bloomberg, GIAM calculations

Following a strong performance by the EM EUR index, the total return outlook for the EM USD index looks superior for the remainder of the year.

In a scenario where nothing changes, the EM USD return would be 2.9% vs 2.8% for the EM EUR index (next 6 months and assuming a 0.86% FX-hedging cost). However, we expect duration movement that ultimately will lead to a larger EM USD index outperformance. Indeed, the EM USD index benefits from higher duration, and we expect the 10-year US rate to decline by 55 basis points by the end of the year, compared to only 25 basis points for the 10-year Bund rate. Similarly, the USD carry is more attractive at 7.6%, compared to 5.7% in EUR, although it may be distorted by many US distressed names which have not paid their coupon thus far.

Assuming a stable spread scenario, the expected total return for EM EUR in the next six months would be around 4.0%, while that on the EM USD index is expected to be c. 6.9% (FX-hedged).

EM EUR return scenario: lower carry and duration

6M TR for different scenarios, BofA index

	OAS spread	GER 8Y 2.14%	2.24%	2.34%	current 2.44%	2.54%	2.64%	2.74%	2.84%
	199	10.8%	10.2%	9.6%	9.0%	8.3%	7.7%	7.1%	6.5%
	219	9.6%	9.0%	8.3%	7.7%	7.1%	6.5%	5.9%	5.3%
	239	8.3%	7.7%	7.1%	6.5%	5.9%	5.3%	4.7%	4.0%
	259	7.1%	6.5%	5.9%	5.3%	4.7%	4.0%	3.4%	2.8%
	279	5.9%	5.3%	4.7%	4.0%	3.4%	2.8%	2.2%	1.6%
current	299	4.7%	4.0%	3.4%	2.8%	2.2%	1.6%	1.0%	0.4%
	319	3.4%	2.8%	2.2%	1.6%	1.0%	0.4%	-0.3%	-0.9%
	339	2.2%	1.6%	1.0%	0.4%	-0.3%	-0.9%	-1.5%	-2.1%
	359	1.0%	0.4%	-0.3%	-0.9%	-1.5%	-2.1%	-2.7%	-3.3%
	379	-0.3%	-0.9%	-1.5%	-2.1%	-2.7%	-3.3%	-4.0%	-4.6%
	399	-1.5%	-2.1%	-2.7%	-3.3%	-4.0%	-4.6%	-5.2%	-5.8%

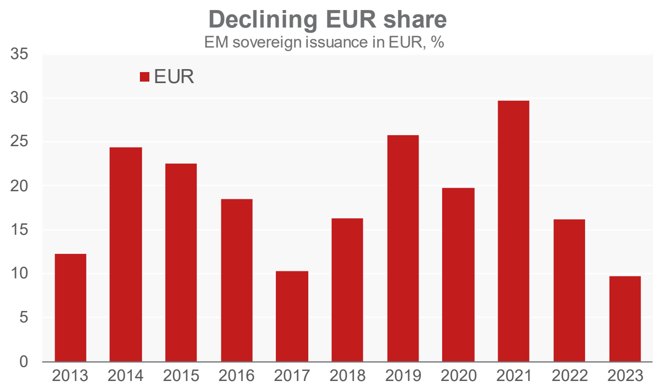
Source: Bloomberg, GIAM calculations

The question is how the spread performance will be for both indexes. Globally, we expect EM sovereign spreads to widen due to a global growth slowdown and a mild recession in the US in H2 23. Historically, during US growth slowdown episodes, EM EUR spreads tend to outperform. This can be explained by their lower beta and the fact that the index is more focused on Europe. We should expect a similar pattern this time but for EM EUR to achieve a similar total return, the widening of EM USD spreads would need to be twice as large as the widening of EM EUR spreads. In our view, this seems unlikely, so the EM USD return index is likely to deliver slightly better FX-hedged performance in the end.

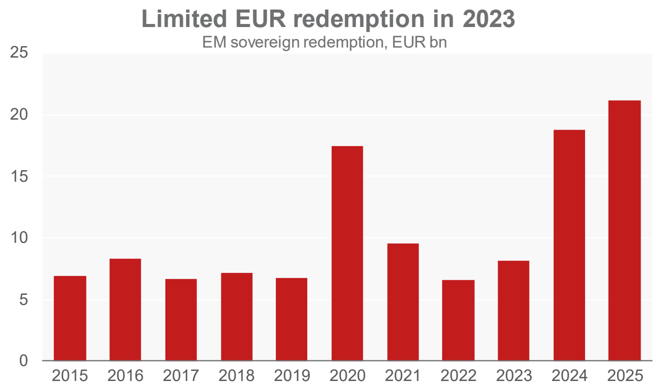
Positive technicals for EM EUR bonds in 2023

Despite the better return expectations for the EM USD index, technical factors are expected to be positive for the EM EUR index due to limited supply. So far, EUR issuance has only accounted for 12% of the total sovereign hard currency issuance, whereas in a normal year it is usually around 20%. After a challenging 2022 for the primary market, EM issuers have likely preferred to test investors' appetite with USD issuance, which is easier to place given that the natural investor base in EM is predominantly USD-centric. Even natural EUR issuers have chosen the USD market (e.g., Romania, Serbia, Hungary). We anticipate that EUR issuance will catch up in the second half of the year, but it will continue to lag for the following reasons:

- The EM environment has been less supportive, with crossover funds having less appetite for EM bonds due to higher core yields. It is easier to issue in USD, so the first currency of choice will remain the USD.
- While it may be cheaper to issue in EUR in absolute terms, the spread differentials are currently close to their lowest levels. EUR supply is becoming less attractive.
- The GCC region has been the largest issuer so far this year, as fiscal deficits have increased due to weaker oil prices and poor economic diversification. This region typically issues in USD.
- The upcoming EUR redemptions are lower than the 5-year average, and so is the need for EUR supply.



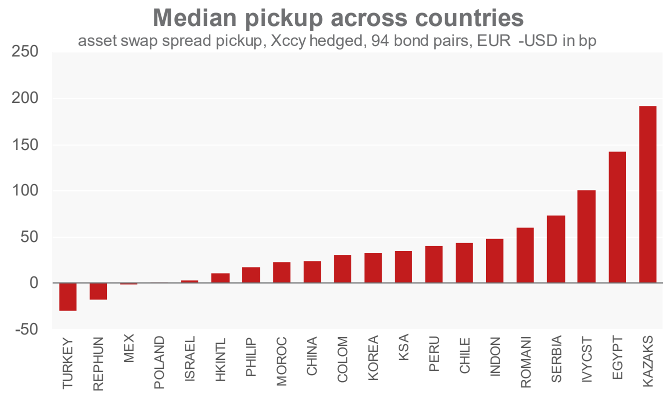
Source: Bloomberg, GIAM calculations



Source: Bloomberg, GIAM calculations

Heterogeneous opportunities

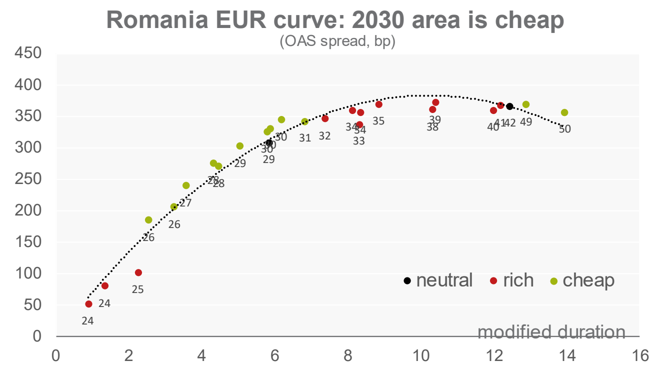
Despite the convergence of EM EUR-USD asset swap spreads, there are still numerous discrepancies to consider. The landscape is not uniform, but it is now worthwhile to consider EM USD bonds. For example, the long-term USD bonds of Poland offer a better pickup, as do the very long-term bonds in the Mexican USD curve (cross-currency hedged, same maturity). In Serbia, the recent USD issuance is weighing on the USD curve, making EUR bonds slightly more attractive, although this effect is expected to be temporary. In Turkey, the entire curve is more attractive in USD than in EUR in asset swap terms. Historically, EUR-USD



Source: Bloomberg, GIAM

spread differentials have been tight, despite the recent USD issuance in Q1. An expected EUR issuance later this year could impact the EUR market.

We also see selected opportunities in EM EUR bonds in the IG space. Indonesia and Peru continue to offer some pickup across the curve. Romania still exhibits one of the largest discrepancies in the IG space, as the belly and long end of the curve offer an asset swap pickup between 30 and 100 basis points or a yield pickup of over 150 basis points. Historically, Romania has consistently provided a pickup in EUR, likely due to an excess of EUR supply. The pickup could shrink as Romania plans to issue more in USD in the coming years. Although there is a risk of increased EUR supply later this year, in late Q3 as a prefinancing for 2024, we maintain an overweight position in Romania, and we see value in the 2030-32 area. On a pure relative-value basis, it is the cheapest segment of the curve with a decent roll-down. The curve is steep in this area, and it offers the largest pickup over the USD curve.



cheap/expensive: 6M zcore of the distance to the fitted curve

Source:Bloomberg, GIAM calculations

Imprint

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