MARKET UPDATE:

SOVEREIGN RESTRUCTURINGS MAKING PROGRESS

WHAT IT MEANS FOR BENCHMARK CREDIT SPREADS AND YIELDS

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GlobalEvolution

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SPREAD CHANGES BREWING

Significant progress has been made in debt restructuring efforts this year, mainly via the G20's Common Framework process, with countries like Zambia and Ghana successfully concluding negotiations. The progress owes much to the development of mutual understanding and experience among stakeholders, including non-traditional official creditors like China, India, and Saudi Arabia. Defaulted bonds in the EMBIGD index have caused significant spread volatility, but restructuring may not necessarily solve that: restructured bonds from Zambia, Ghana, Sri Lanka and Ukraine entering the EMBIGD at lower spreads may continue to cause volatility.

By Michael Wainø Hansen, Senior Strategist

Restructurings making progress

Restructuring negotiations under the G20's so-called Common Framework process have been challenging and protracted but finally yielded results in 2024. The progress is largely due to the development of mutual trust and experience among stakeholders, including non-traditional official creditors like China, India, and Saudi Arabia, which have accelerated the restructuring process.

Zambia and Ghana have successfully concluded debt restructuring negotiations with bondholder committees this year, both under the Common Framework as well as though other methods. Sri Lanka concluded its restructuring negotiations successfully with the process notably faster than it was for Suriname. Ghana and Sri Lanka are awaiting bondholder votes to secure the necessary majority. Ukraine announced its agreement with bondholders on 22 July, but it has yet to be formally finalized. Remaining countries in default include Lebanon, Venezuela and Ethiopia.

We also note a decline in emerging market sovereign defaults and requests for comprehensive debt relief since the peak in 2021 and 2022; Ghana's request in January 2023 was the last significant instance **(index weight close to 1%) noting that Ethiopia defaulted in December 2023 (index weight 0.1%)**

Noisy credit spreads

Defaulted bonds in the Emerging Market Bond Index Global Diversified (EMBIGD) have caused significant spread volatility over the past few years.

After reaching a peak spread of 1203 basis points in March 2020, the EMBIGD high yield spread narrowed to 556 basis points in June 2021, only to widen again to 1088 basis points in July 2022.

The EMBIGD HY spread, bps

Source: JP Morgan, Bloomberg

JP Morgan, a prominent index provider for emerging markets hard-currency debt including the flagship EMBIGD, calculates index spreads and yields under the assumption that all payments originally listed in bond prospectuses will be made on time. Hence, benchmark yields and spreads can be misleading, a point we address below.

Also, JP Morgan will launch duration-weighted EMBI spread and yield calculations in Q1 2025, running concurrently with the current 'Superbond' method until it is completely phased out at the end of 2025. This will result in a significant decrease in index yields and spreads, as per JP Morgan's calculations issued earlier this year.

Estimated changes in yields and spreads

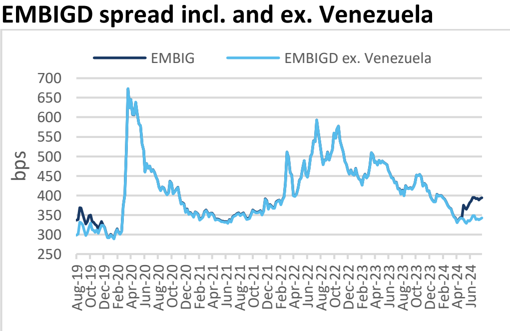
	Current STW, bp	Dur. Wgt. STW, bp	Diff, bp	Current YTW, %	Dur. Wgt. YTW, %	Dif., bp
EMBIGD	380	260	-120	8.42	7.21	-120
EMBIGD HY	708	468	-240	11.69	9.28	-241
EMBIGD ex default	241	217	-24	7.03	6.80	-24
EMBIGD ex. default HY	404	373	-31	8.65	8.34	-31

Source: JP Morgan

Venezuela a special case

Generally speaking, we consider credit spreads at the index level to be relatively rich, noting that one should not be dazzled by the re-entry of Venezuela into the EMBIGD. Venezuelan Sovereign and Petroleos de Venezuela S.A. bonds completed their three-month phase-in to the EMBIGD benchmarks on June 28, 2024. Following this final installment, Venezuela's index weight was 62 basis points, primarily accounting for the EMBIGD spread widening from 341 basis points on April 29 to 391 basis points on June 28.

EMBIGD spread incl. and ex. Venezuela



Source: JP Morgan, Bloomberg

Restructured bonds entering the index

Moving forward, the high yield spread will remain volatile as restructured bonds from Zambia, Ghana, Sri Lanka, and Ukraine enter the index at significantly lower spreads compared to their defaulted bonds.

For instance, Zambia's EMBIGD spread has already experienced a substantial compression from approximately 3000 basis points in late June 2024 to just 12 basis points in mid-July, although this is highly misleading. The reason for this artificially low spread is that Zambia's restructured B bonds are modelled based on a scenario with a 0.5% coupon and a maturity date in 2053. However, the restructured B bonds include an "upside case" with a potential coupon step-up from 0.5% to 7.5%, a 6.00% payment in kind, and a maturity shift to 2035 if a specified adjustment event occurs.

As a result, since the market anticipates that an adjustment will occur and prices the B bonds accordingly, we have the 12-basis-points spread level as of July 12 based on the index providers' assumption of a 2053 maturity date. Consequently, Zambia has single-handedly reduced the headline EMBIGD spread by approximately 10 basis points during the two weeks prior to July 12.

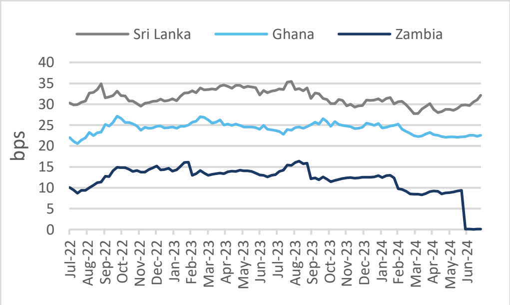
Zambia's EMBIGD spread

Source: JP Morgan, Bloomberg

It goes without saying that should value-recovery instruments become more prevalent in restructuring deals, the headline EMBIGD spreads may become increasingly opaque.

The chart below illustrates the daily spread contribution to the headline EMBIGD spread from Sri Lanka, Ghana, and Zambia, calculated as spread multiplied by floating index weight. As of July 12, these three sovereigns combined contributed more than 50 basis points of the EMBIGD's 389-basis-points spread. (Note the compression of Zambia's spread contribution as the restructured B-bond enter the index)

Spread contribution in EMBIGD



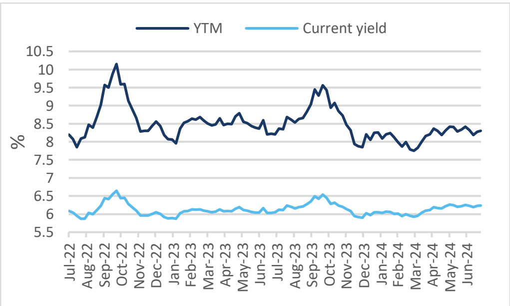
Source: JP Morgan, Bloomberg, Global Evolution

EMBIGD YTM with a pinch of salt

Similar to how the high-yield/high-risk segment of the EMBIGD generates noise in the headline spread, the yield to maturity (YTM) of the index can also be misleading due to the impact of defaulted and distressed pricing. Current yield may provide a more accurate measure of the index yield, as YTM assumes that bonds will mature at par, which is clearly not the case for bonds already in default and undergoing restructuring.

However, as restructured bonds enter the index, its YTM should converge toward the current yield, providing a more accurate representation of both the spread and YTM. Although spreads and YTM may appear less attractive following the entry of restructured bonds, at least investors can have greater confidence that coupons will be paid.

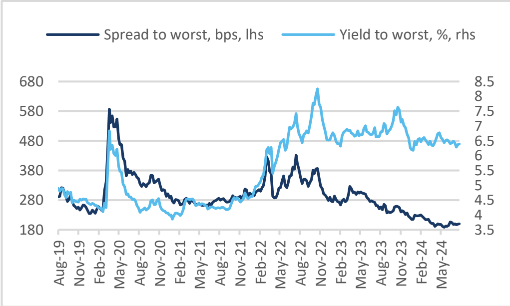
EMBIGD, YTM and current yield



Source: JP Morgan, Bloomberg

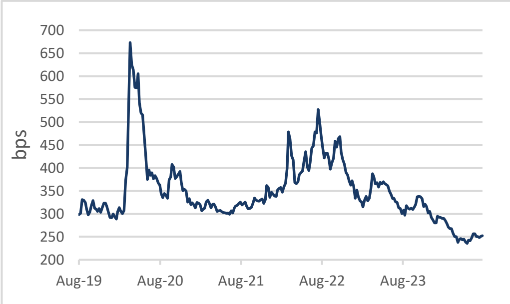
Alternatively, to avoid the noisy high-yield/high-risk segment, investors should examine the EMBIGD excluding CCC-rated bonds spread and YTM, or the EMBIGD excluding defaulted bonds, to gain a clearer understanding of the relative value and the "true" spread and YTM.

EMBIGD ex. CCC



Source: JP Morgan, Bloomberg

EMBIGD spread to worst ex. default

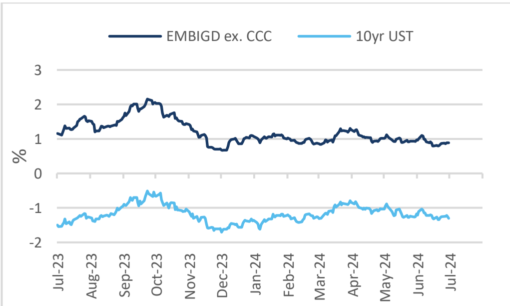


Source: JP Morgan, Bloomberg

Why invest in EM sovereign dollar debt?

Despite spreads screening tight in a historical context, the duration exposure of the EMBIGD (6.59) combined with the YTM of the index excluding CCC bonds still provides investors with a positive all-in carry over the upper bound of the U.S. Fed funds rate. This contrasts with the duration exposure via 10-year U.S. Treasury notes (7.88), which are currently yielding around 4.20%. (as of July 26, 2024)

EMBIGD ex. CCC YTM and 10yr UST YTM, carry over Fed funds, %



Source: JP Morgan, Bloomberg, Global Evolution

One might also consider that the term premium for 10-year U.S. Treasury bonds arguably is nonexistent, leaving investors without compensation for fiscal risks, including a U.S. debt-to-GDP ratio increasing from approximately 99% currently to 122% by 2034, per projections by the non-partisan U.S.

Congressional Budget Office. For reference, the IMF has aggregate EM-debt-to-GDP at 69.4% in 2024.

Moreover, we believe the positive carry of the EMBIGD (even if excluding CCC-rated bonds) offers better protection against a potential Trump policy-induced bear steepening of the U.S. Treasury yield curve than duration exposure to U.S. Treasury bonds.

In our view, investing in EM sovereign dollar debt thus presents an opportunity for investors seeking better returns and risk management in the current economic environment.

[i]Definition of indices

Index	Definition	Index Returns				
		2023	2022	2021	2020	2019
J.P. Morgan EMBI GD	is the J.P. Morgan EMBI Global Diversified Index (EMBI GD): The index is a market capitalization-weighted total return index of hard currency (USD, EUR, GBP) denominated Brady bonds, loans, Eurobonds and local market debt instruments traded in emerging markets.	11.09	-17.78	-1.80	5.26	15.04
J.P. EMBI Global Diversified ex. CCC	is a sub index consisting of all constituents in the J.P. Morgan EMBI Global Diversified Index (EMBI GD) that are rated above CCC.	9.21	-17.25	-2.04	6.09	15.72
10 yr UST	Bloomberg US Government 10 Year Term Index Total Return.	3.55	-14.79	-3.14	10.05	8.53

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