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Emerging Debt Report

April 2018

Quarterly Update on Valuation Metrics in Emerging Debt

We review some of our favored valuation metrics for external and local emerging debt markets.[1]

The punch line: In the first quarter of 2018, the local debt benchmark significantly outperformed the hard currency benchmark (+4.4% against -1.8%). The major explanation for the sharp difference in performance was that the USD continued to weaken (helping local debt returns) and US Treasury rates rose significantly (hurting hard currency returns). As a result, the relative cheapness of local debt markets, which looked extraordinarily attractive in early 2017, while still attractive, is less compelling than last year, or even the beginning of this year. That said, for euro-based investors, local debt markets look much more attractive than one year ago. Hard currency debt remains on the expensive side of its historical valuations. Hard currency valuations neither improved nor deteriorated during the first quarter.

External Debt Valuation

Exhibit 1 shows our familiar valuation chart for external sovereign debt. We calculate a "fair" spread of the EMBIG over US Treasuries, accounting for the credit rating profile of the EMBIG, default probabilities, and recovery values under default scenarios, based on rating agency studies of the historical experience. This fair value spread is the spread on a portfolio represented by the EMBIG that would be needed to compensate for expected credit losses, ignoring risk aversion, liquidity, and other considerations. We then take the ratio of the actual EMBIG spread to the fair value spread and compare it to the historical norm, to try to gauge the premium that the market has historically demanded on a sovereign debt portfolio that is over and above that required to compensate for credit losses. Assuming a long-term investment horizon, the chart suggests that the market shows a signal of being attractive when the fair value multiple is above the long-run average and median lines, and unattractive when it lies below.

As seen in the chart, the current spread multiple remains well below the level that the market has historically demanded, a condition that has been sustained since the first half of 2016. The multiple stood at 2.9 on March 30, 2018, unchanged from the multiple observed on December 29, 2017, and significantly higher than the 2.2 level observed during the first quarter of 2017. The ratio remains in overvalued territory, but it is well off its historical lows. The historical minimum ratio was 2.1 in April of 2007, when the spread on the EMBIG index was +161 bps over Treasuries, and the 10-year Treasury yield was 5.0%, compared with +326 bps and 2.74%, respectively, at the end of the first quarter.

The EMBIG benchmark index returned -1.8% in the first quarter, with the benchmark spread finishing the quarter 15 bps wider, at 326 bps, on top of an increase of 34 bps in Treasury yields. The quarter was marked by fairly wide swings in the index spread over US Treasuries. Spreads tightened in January in

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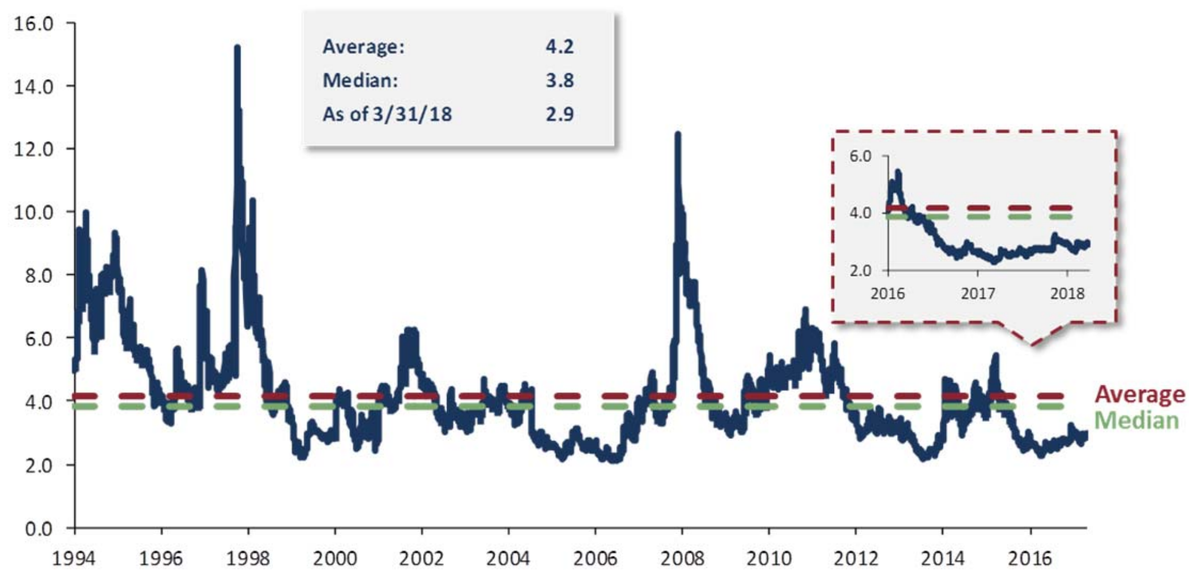
[1] For a more detailed explanation of the valuation metrics contained in this report, please refer to the Emerging Debt Report dated April 27, 2015. This may be obtained from your GMO representative.

sympathy with an optimistic global economy and stock markets. By February, emerging market bond spreads widened significantly amid rising risk aversion, due to a host of factors, including higher-than-anticipated inflation in developed economies, a US budget deal that raised the projected US fiscal deficit substantially, and the Trump administration's opening of new fronts in a nascent global trade war, with the announcement of tariffs on steel imports, targeted primarily at China. These and other factors resulted in a further repricing, higher, in US Treasury yields, and wider spreads overall in emerging bonds during the quarter. For now, an all-out trade war seems unlikely, but given that emerging countries have generally benefitted from open trade and globalization, the threat of a reversal in these decades-long trends is presenting a concern for the market. Sentiment was also not helped by a record amount of new supply. Issuance of new bonds in hard currencies by emerging market sovereigns was $61.7 billion in the first quarter, setting a new record, and about 5% above the year-earlier pace.[2]

Exhibit 1 – Long-Term View of the "Fair Market Multiple" for Hard Currency Emerging Debt



The trend in sovereign credit ratings was mixed during the quarter. Russia was upgraded by S&P back to investment grade, to BBB-, giving it two investment grade ratings, which is very important for inclusion in some global bond indices. Indonesia was upgraded by Fitch, and is now investment grade across all the major agencies. South Africa was downgraded further into junk status by S&P, but avoided a downgrade to junk status by Moody's, which gave credit to the new government of Cyril Ramaphosa for its policy outline. Brazil was downgraded further into junk status as prospects for fixing the deficit in the social security system dimmed as the country heads toward its general elections in October.

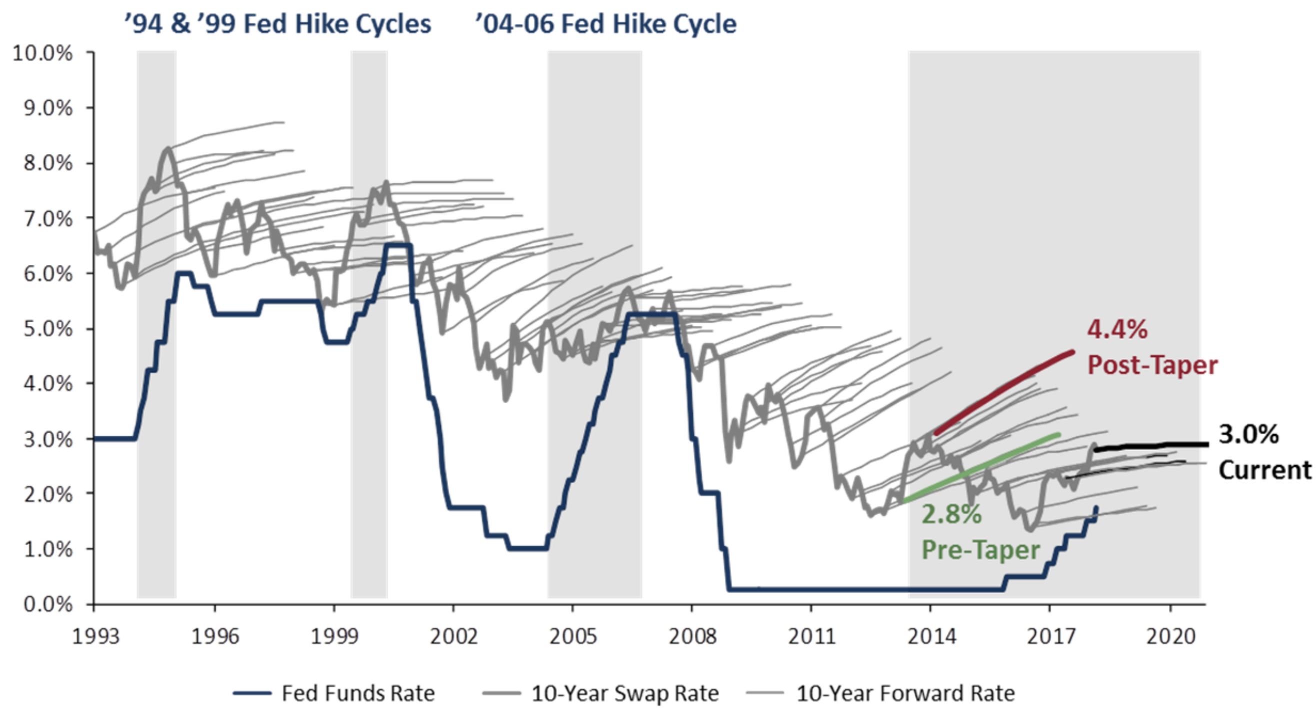
Based on these rating changes and other influencing factors, our new calculation of the "fair value" spread of the EMBIG that would be required to compensate for expected credit losses rose slightly,

[2] According to data compiled by Bank of America Merrill Lynch.

from 107 bps at end-December to 114 bps by end-March 2018 (compared with 135 bps at end-March 2017). The slight increase in expected credit loss was reflected in a moderate increase in the index spread, keeping the ratio essentially unchanged for the quarter.

This analysis says nothing about the level of interest rates, but rather the level of spreads, or credit cushion. What about the interest rate cushion as embedded in the risk-free rate? Exhibit 2 shows the history of the 10-year US Treasury swap rate (heavy solid line), along with the forward curve (going out 3 years) for the 10-year swap rate (lighter lines) at each point in time (quarterly). In effect, it tries to show three dimensions in a two-dimensional chart.

Exhibit 2 – 10-Year US Treasury Swap Curves at Quarterly Intervals

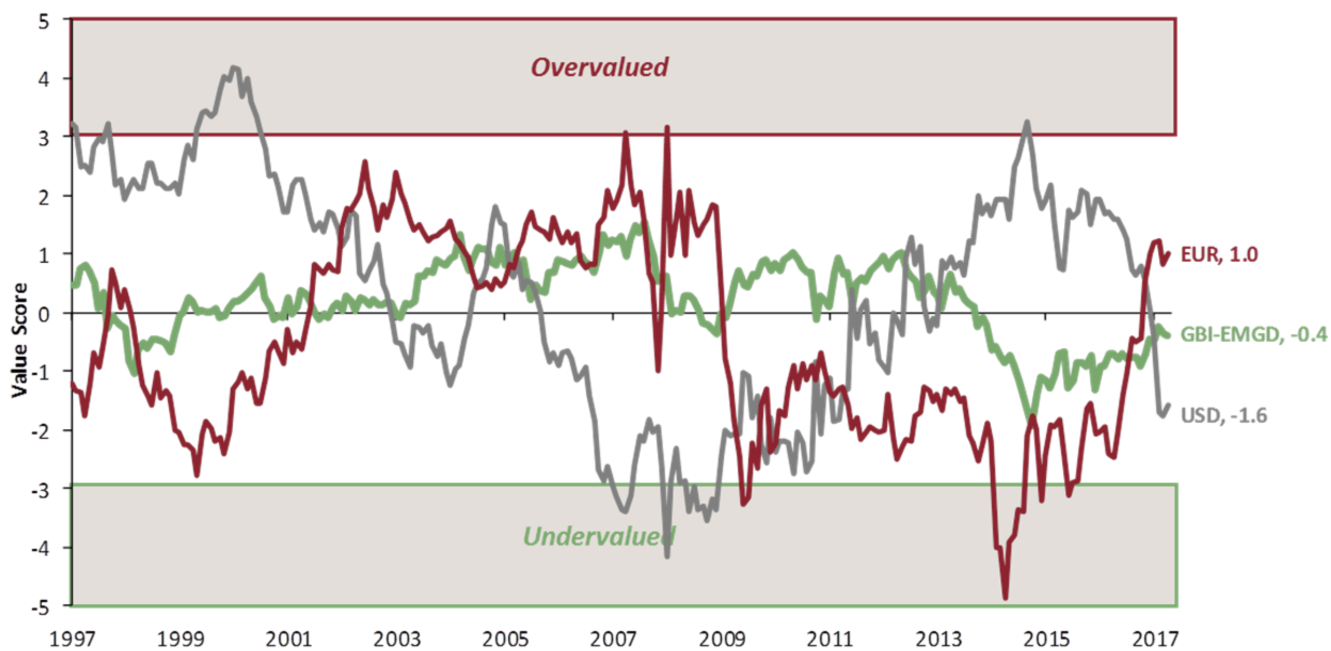


On this metric, we have a slightly worse risk-free-rate cushion than we had in the previous quarter. Two things happened in the first quarter that are worth highlighting. First, the 10-year US Treasury yield repriced. It rose 34 bps to 2.74%, negatively impacting most fixed income markets. Second, the slope of the 10-year forward curve continued to flatten. It flattened by 6 bps, from about 17 bps (to the 3-year forward point) to 11 bps as of end-March. We have not seen a forward curve this flat since the 2006-07 period, when the 10-year Treasury was yielding around 5%, and the Fed, although it did not know it at the time, was nearing the end of its tightening cycle. Regardless of the reasons, a slope this flat indicates little to no cushion for a surprise rise in Treasury yields, and is relevant in the context of current macroeconomic policy in the US, which can be described as monetary tightening and fiscal loosening.

Local Debt Markets Valuation

Now let's turn to local debt markets, where we consider some simple concepts of currency valuations and interest rate differentials. Exhibit 3 provides a snapshot of our currency valuation methodology. The underlying model analyzes trends in real effective exchange rates and the balance of payments and, via a z-score analysis, measures how far away current values are from their longer-term averages. These are combined into a single value score as shown in the exhibit, where we compare the weighted average of currencies in the GBI-EMGD with values for the USD and EUR. As the chart indicates, scores below the zero line indicate potentially "cheap" currencies while positive scores indicate potentially "rich" currencies.

Exhibit 3 – Weighted Average Value Score of GBI-EMGD Currencies vs. USD and EUR



The biggest story seen in this chart is not so much the level of the emerging currencies of the GBI-EMGD (recall it is a weighted average of 18 countries, so its value score tends to be more stable), but rather the movements and levels we calculate for the EUR and USD. The euro remained in moderately rich territory, while the dollar moved further into cheap territory. Indeed, the DXY index of the dollar against its major trading partners fell a further 2.2% during the first quarter, after being down 9.9% in 2017. Our value score for the benchmark GBI-EMGD was unchanged. **Based on this measure, GBI-EMGD currencies look much more attractive versus the EUR than the USD.** For dollar-based investors, the attractiveness of investing in local currency emerging fixed income markets might rest more on a diversification rationale than outright valuation. For euro-based investors, the valuation argument for investing in local emerging debt is more compelling.

Reflecting on the first quarter data, EM currencies were stronger against the US dollar, with the currency component of the GBI-EMGD index generating 2.1% of return. However, there were some disparities in terms of relative performance. The worst performing currencies were ARS (-6.6%), TRY (-4.3%), PHP (-4.3%), and IDR (-1.5%). In Argentina, the currency depreciated strongly in January as the Central Bank's credibility was put into question. Moreover, the current account deficit continued to deteriorate more than expected. In Turkey, the TRY remained under pressure with inflation surprising to the upside and the current account deteriorating more than expected. In addition, Moody's downgraded Turkey's credit rating further amid ongoing erosion of institutional arrangements in that country under the leadership of President Erdogan. The PHP remained under pressure as the central bank remained on hold and the current account deteriorated on the back of higher imports. MXN (7.4%) was the best performing currency, recovering from last year's fourth quarter losses as the NAFTA negotiations with the US seemed to take a better turn. The COP (7.0%) was the second best performing currency during the quarter due to higher oil prices and positive political developments. ZAR (4.9%) and MYR (4.7%) were also among the best performers.

As for emerging market local interest rates, we consider differentials in real yields to gauge the relative attractiveness of EM against developed markets (see Exhibit 4). In this regard, the story that has been in place for many quarters (years, actually) remains. Emerging real yields continue to look attractive on a relative basis, as the exhibit shows. Real rates in the G-3 continue to be at or below zero. That being said, US real yields seem to have broken out of their zero range, and now are solidly positive. Japanese and eurozone real yields remain negative by our calculations. In the emerging world, real yields remain broadly unchanged from the quarter earlier, and have hovered in a relatively tight range of 2.0% to 2.5% since the beginning of 2017.

Exhibit 4 – Inflation-Adjusted Bond Yields

Once again, most bond markets within the GBI-EMGD benchmark registered positive local returns in the first quarter despite 10-year US yields rising 34 bps. Higher-yielding commodity-linked countries like Russia (4.1%), South Africa (8.4%), Brazil (4.6%), Mexico (3.4%), and Peru (3.7%) outperformed their peers. Oil prices, which were up 7% in the first quarter as measured by the WTI, were supportive of those local markets in general. Moreover, Brazil and Russia continued to benefit from lower inflation and their policy easing cycles. South Africa continued to outperform after Cyril Ramaphosa, the previous pro-market Deputy President, was sworn in as President during the quarter after winning the ANC's electoral conference in December. The South Africa Reserve Bank ended up cutting rates by 25 bps during its monetary policy meeting at the end of March. Peru also resumed its rate cuts as inflation and growth have kept surprising to the downside. Inflation in Mexico has also been trending down during the quarter after peaking in December 2017. Local interest rates in the Czech Republic (-1.0%) and Hungary (-0.4%) continue to underperform as growth is rebounding. Uruguay's local markets (-2.7%) were the worst performers on the quarter as inflation rose more than expected. Turkey and Indonesia also registered some small negative returns during the quarter.

Conclusions and Observations

1. EM currencies continue to look attractive against the EUR, but now look much less attractive relative to the USD, for the first time in several years. The USD continued to weaken in the first quarter.
2. Local debt markets continue to look attractive, based on real yield differentials between EM and developed market bonds. Differentials remain at or above historical norms.
3. External sovereign debt remained in "rich" territory in the first quarter, with no significant change from the last quarter. Credit spreads widened in line with expected credit losses, so valuations remain broadly constant by our calculations.

Sources for charts: Bloomberg, J.P. Morgan, GMO