CAPITAL ECONOMICS

GLOBAL MARKETS UPDATE

Global risks and the outlook for EM dollar sovereign bonds

- **We think the macroeconomic environment will continue to play the key role in the outlook for emerging markets (EM) dollar-denominated sovereign bonds this year and next. Despite country-specific risks, we expect the yields of most of those bonds to fall by the end of 2024.**
- As of this week, when the IMF published its annual Global Financial Stability Report, EM economies seem to be in significantly better shape than they were around the last publication of that report. Since then, several major EMs have, for example, decreased their levels of FX debt and have narrowed current accounts sharply. It was these improvements that have helped EMs generally hold up relatively well in the face of the global bond market sell-off over the last couple of months. (See here.)
- That said, perceived risk has still risen in most EMs in recent weeks, especially in places with persistent sovereign debt risks, such as parts of Latin America, or with large currency risks, like Turkey. (See Chart 1 and here.). **Therefore, in this update, we take stock of where the dollar-denominated sovereign debt market is currently and assess its near-term outlook**.
- Over the past week, there has been a lot of volatility in the EM dollar sovereign bond market – captured by J.P. Morgan's EM Bond Index (EMBI) – and in long-dated bonds globally, amid changing expectations about the US monetary policy outlook. (See here and here.) This follows a global surge in sovereign bond yields, which has left most yields decidedly above their levels at the end of July. In the case of EMBI yields, while a higher "risk-free" rate was a significant contributor to the rise, the spreads of those bond yields over that rate widened as well. (See Chart 2.)
- **In this context, there are three key points to make**. **First, we think that Treasury yields will soon turn from a headwind for EM dollar bonds into a tailwind over the next couple of years.** This is because we forecast that long-dated Treasury yields will fall over the rest of this year and next, as the Fed cuts the policy rate faster than money markets currently discount. That means that, not only will the risk-free components of those yields fall, but that the pressures that have come with higher interest rates will ease.
- **Second, we expect a slowdown in major advance economies to weigh on investors' appetite for risk and give the dollar a boost in the next couple of quarters, pushing EMBI spreads up. But, as the global economy recovers later next year, improving risk sentiment and downward pressure on the dollar will probably mean those spreads will narrow.** (See our *Global Markets* & *FX Markets* *Outlooks* for more details.)
- **Third, even though there are pockets of vulnerability in some EMs which may increase perceived risk of default by those sovereigns further, the risk of broad distress in the dollar sovereign debt market is still at a relatively low level.** Admittedly, about a fifth of the ~70 country constituents of the JPM EMBI Global index now have dollar bond yields above levels at which issuance has tended to drop sharply, and spreads at levels that have often preceded sovereign defaults in the past – including countries that have already defaulted and haven't yet restructured their debts. (See Chart 3.) However, of the highest risk EM sovereigns, only five are among the 25 largest members of the index; and much of the bad news there are already discounted (See Chart 4). Indeed, the face value of sovereign foreign bonds in countries at high risk of default is only ~14% of the total index.
- **The upshot of all this is that, while country-specific risks may weigh on certain government bonds, global factors will probably continue to be the main driver of EM dollar-denominated sovereign yields in general. We forecast them to end this year close to their current levels and fall over 100bp on average over 2024**.

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Chart 1: Changes In 5-Year USD CDS Premia On Sovereigns (bp)

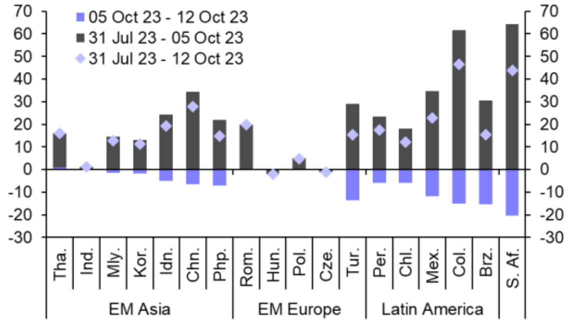


Chart 2: Change In EMBI Global Government Bonds yields & Components Since 31st July 2023 (bp)

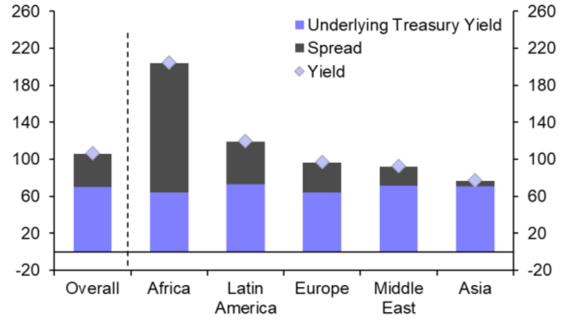


Chart 3: Highest 25 EMBI Country Index Government Yields & Spreads

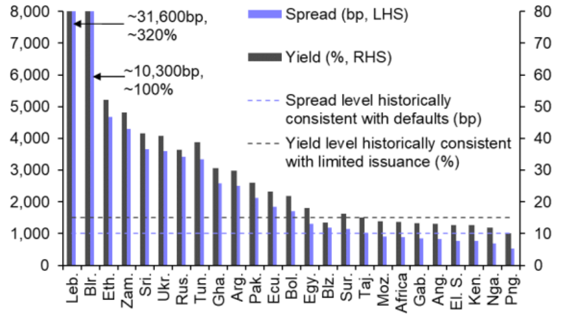
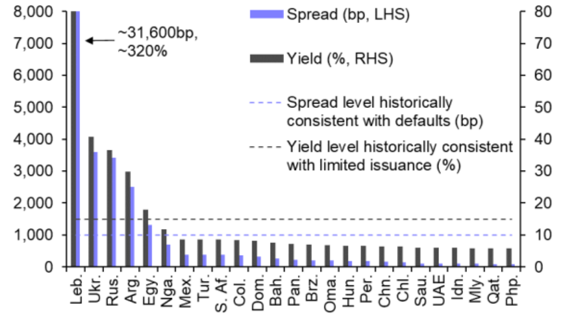


Chart 4: Yields & Spreads Of Largest 25 EMBI Constituent Country Indices



Sources: Refinitiv, Capital Economics

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