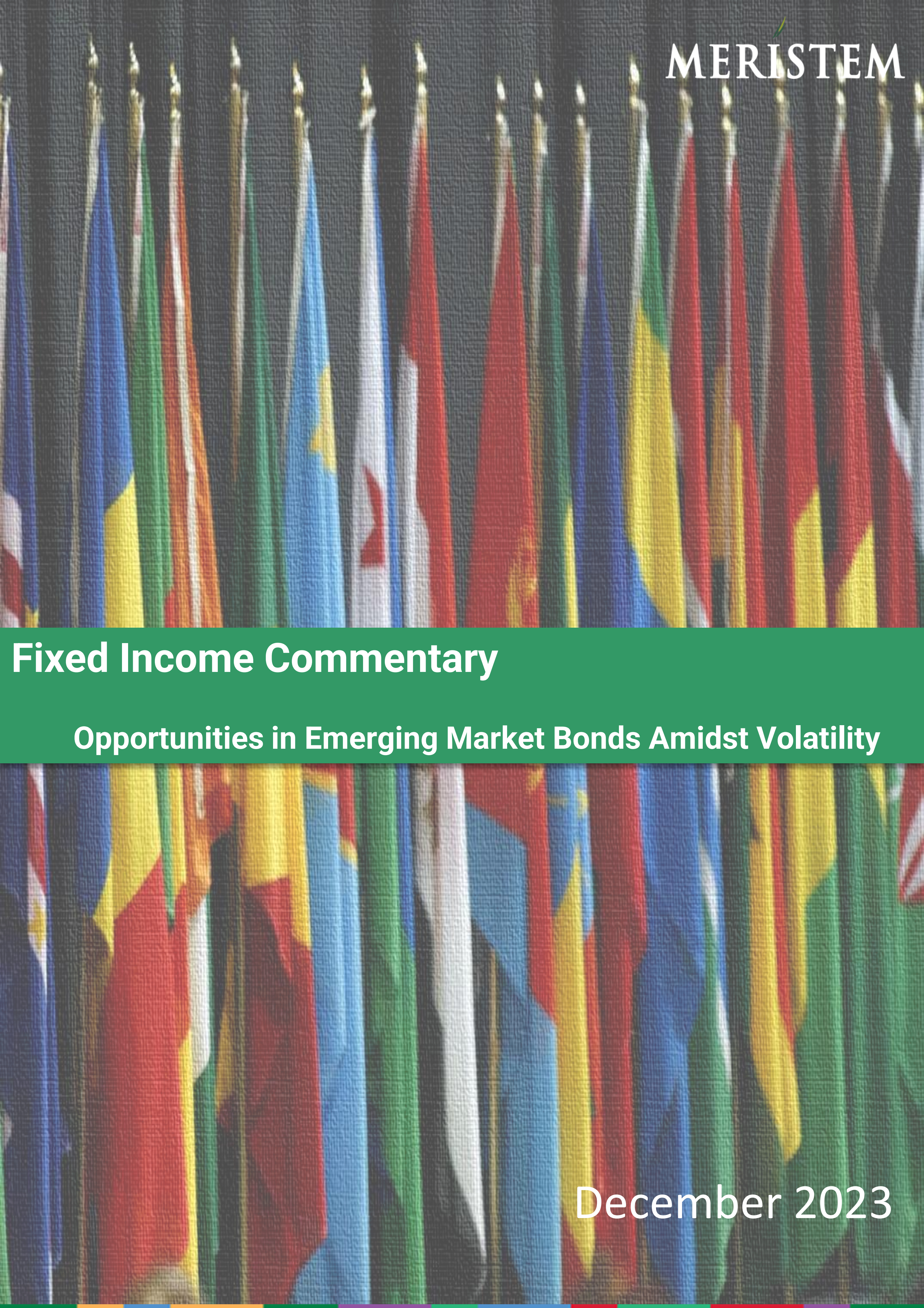


MERISTEM

Fixed Income Commentary

Opportunities in Emerging Market Bonds Amidst Volatility

December 2023

MERISTEM

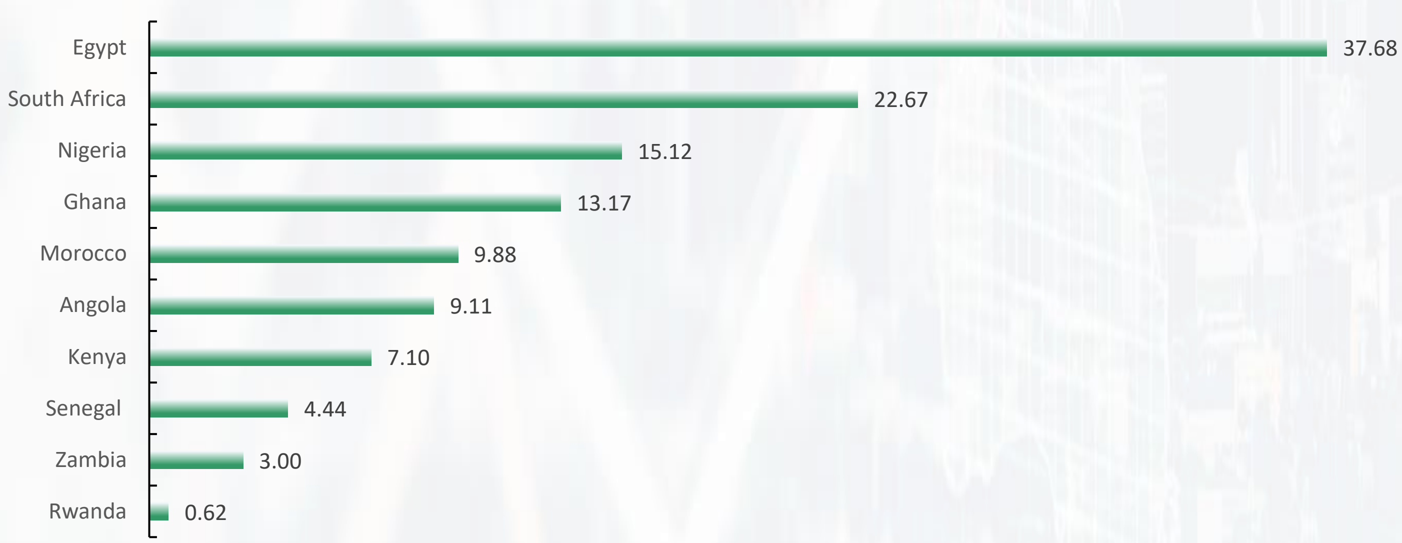
Opportunities in Emerging Market Bonds Amidst Volatility

Most emerging market (EM) countries (especially in the sub-Saharan African region) continue to battle declining-but-high inflation rates, humongous debt profiles, contractionary monetary policy, and depreciating currencies. Despite these numerous headwinds, economic growth in EM has remained relatively resilient in 2023 compared to the developed markets (DM). In fact, major emerging economies recorded higher growth compared to major advanced economies. Furthermore, the growth prospect, as projected by the International Monetary Fund (IMF) and World Bank, is greater for the EM countries than the DM countries.

As a result of the higher growth prospect, countries in the EM appeared more attractive to investors seeking investment in growing regions. For the major EM countries (Brazil, Indonesia, India, Mexico, Poland, and South Africa), 2023 began to reverse the capital flight witnessed in 2022. Also, the narrower inflation differential and brighter economic outlook were crucial for investors in rotating funds into the EM countries. Conversely, the trend differed for most African countries as key macroeconomic events increased the volatility of their instruments and prompted sell-offs from investors.

Fiscal authorities in the region also issued instruments to attract the increasing capital inflows. In fact, as of Q1:2023, the issuance of Eurobonds was at c.40% of total issuance in 2022. During that period, countries such as Egypt, Costa Rica, and Morocco issued sovereign Eurobond instruments. Specifically, Egypt issued a 3-year 10.875% USD1.50bn Sukuk notes, Costa Rica issued a 10-year 6.55% USD1.50bn Eurobond, and Morocco issued a 5-year 5.95% USD1.25bn and 10.5-year 6.50% USD1.50bn Eurobond.

Chart 1: Fair Value of Outstanding Eurobonds of Selected African Countries (USD'bn)



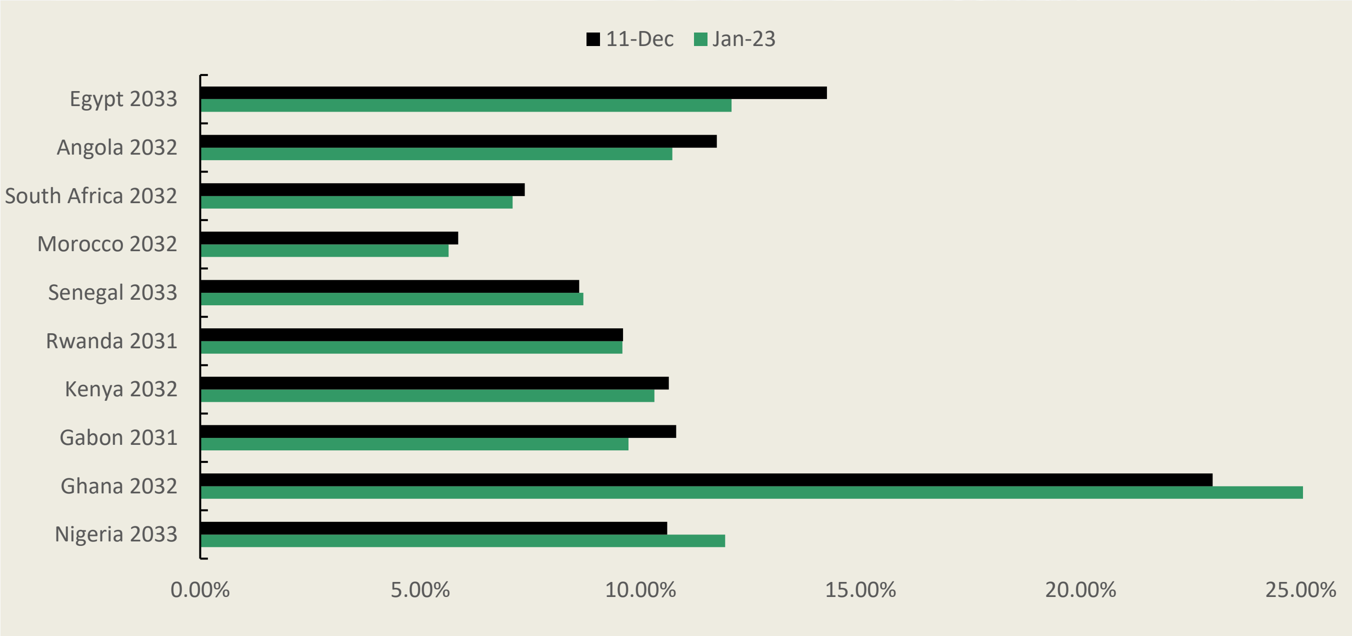
***Source:** Bloomberg, Meristem Research*

For African countries particularly, the confluence of positive and negative macroeconomic developments periodically influenced the direction of the Eurobonds in 2023. While there were certain idiosyncratic risks across the issuers, developments in the global space remained a critical consideration for investors during the period. Essentially, the US economic outlook, projections for policy rate direction, global financial stability, and US fiscal deficit size notably influenced the price movement of the instruments.

Other significant events that impacted the market during the period include elections across specific African countries, implementation of the twin economic reforms by the new Nigerian government, Nigeria, Ethiopia and Egypt credit rating downgrade by Moody's, downgrade of Tunisia's credit rating by Fitch, default by Ghana, Zambia's debt reduction agreement with China, and full redemption of Eurobond by Egypt and Rwanda.

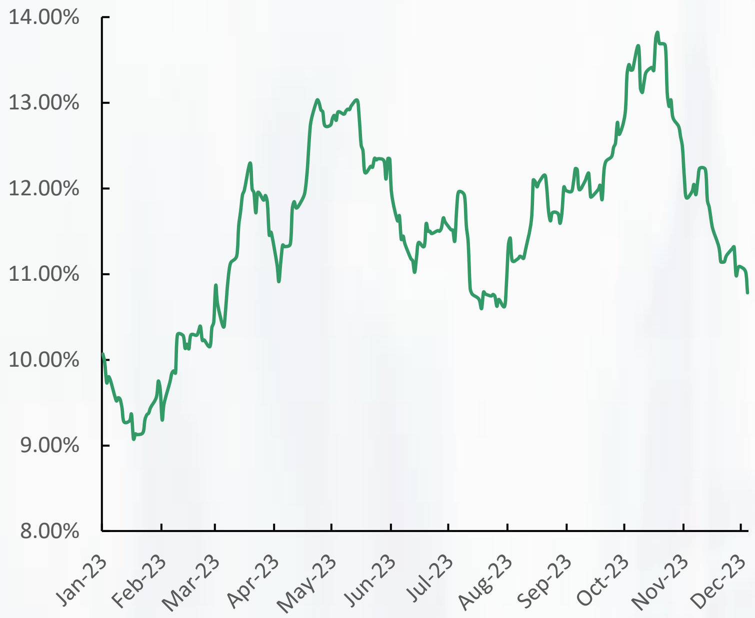
As a result of the above considerations and events, there was mixed sentiment across the Eurobonds market in 2023. This underlines the widened credit spread during the period, as investors continuously demanded higher premiums to compensate for the increased credit risk. Thus, most countries' Eurobond yield has increased moderately (as of Dec 11) relative to the yield at the start of 2023. Using the 10-year Eurobond yield as a proxy, Egypt, Gabon, Angola, South Africa, Morocco, Rwanda, and Kenya increased by 216bps, 108bps, 100bps, 28bps, 22bps, and 33bps to 14.24%, 10.81%, 11.73%, 7.37%, 5.86%, 9.61%, and 10.64%, respectively. Contrarily, there was significant price appreciation on the Eurobonds of Senegal, Nigeria, and Ghana.

Chart 2: Yield of Selected African 10-Year Eurobond (Jan-23 vs. Dec 11, 2023)



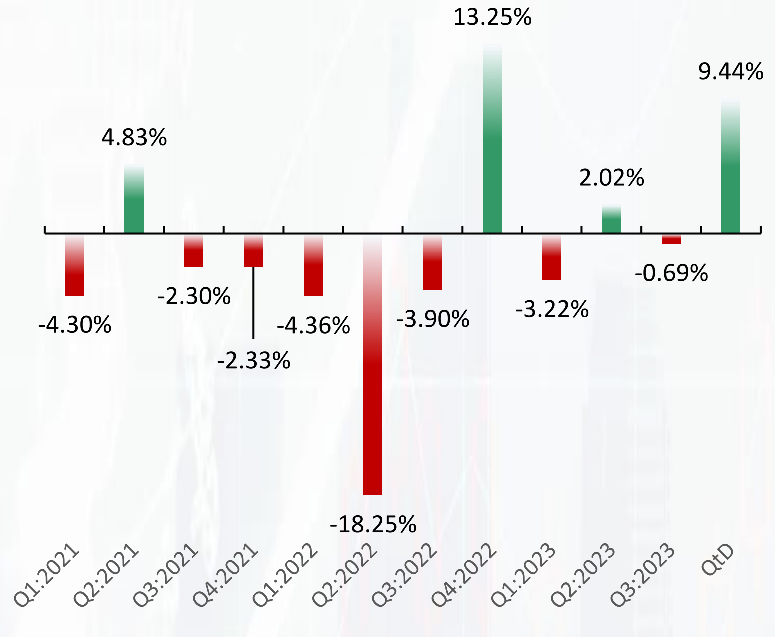
Source: *Bloomberg, Meristem Research*

Chart 3: YtD Yield Movement of S&P Africa U.S. Dollar Sovereign Bond Index



***Source:* S&P Global, Meristem Research**

Chart 4: Quarterly Performance of S&P Africa Hard Currency Sovereign Bond Index



***Source:* S&P Global, Meristem Research**

As of Dec 11, the S&P Africa U.S. Dollar Sovereign Bond Index (which tracks the performance of USD currency-denominated sovereign debt publicly issued by the African governments) has recorded a YtD return of 7.55%. Equally, the S&P Africa Hard Currency Sovereign Bond Index (designed to track the performance of African sovereign government bonds issued in euros, Japanese yen, and U.S. dollars) has recorded a YtD return of 7.23%. These positive returns can be mainly traced to the increased buying activities by investors in Q4:2023 following the prospects of rate cuts by the U.S. Federal Reserve in 2024.

Table 1: Market Performance of Selected Indices (as of Dec 11, 2023)

	MtD	QtD	YtD	1 Year	3 Year	5 Year
S&P Africa U.S. Dollar Sovereign Bond Index	+1.82%	+9.47%	+7.55%	+7.18%	-12.04%	+14.90%
S&P Africa Hard Currency Sovereign Bond Index (USD Hedged)	+1.68%	+9.44%	+7.23%	+6.92%	-12.82%	+13.47%

***Source:* S&P Global, Bloomberg, Meristem Research**

Many African countries are battling high debt obligations as they face substantial repayments on their sovereign Eurobonds, especially in 2024 and 2025. This debt burden arises amid declining but high inflation rates, sluggish economic growth, diminishing foreign reserves, and rapidly depreciating currencies. As a result, it is estimated that some countries might encounter difficulties settling their obligations when due. Recently, Ethiopia announced its inability to settle its USD33mn bond interest obligation due on December 11. Furthermore, Kenya faces a potential risk of credit rating downgrade and repayment crunch considering the USD2bn Eurobond due to mature in June 2024. Also, we note the difficulty encountered by the Zambian government in reaching a deal with its Eurobond holders and the maturity of its USD1bn Eurobond in 2024 as key downside factors to the country's repayment ability.

The developments, as mentioned earlier, underscore the rising fiscal sustainability issues that are currently rocking the region and are expected to worsen in 2024. For most African countries, inflation is likely to moderate albeit high. Given this outlook, monetary authorities should continue their contractionary policies to rein in the high inflation rate. Thus, the economic growth rate should remain sluggish as the high policy rate and borrowing costs may limit business activities.

Notwithstanding, we remain optimistic about the EM hard currency debt instruments relative to their local currency debt instruments. In 2024, the projected dovish stance to be adopted by the US Fed in the second half of the year could limit the USD appreciation against these countries' currencies, thus increasing the countries' ability to service their dollar-denominated obligations.

The table below summarizes selected African countries, their macroeconomic fundamentals, 1-yr default probability risk using Bloomberg DRSK model, credit ratings, and our recommendation.

Table 2: Recommendation on Selected African Countries' Eurobonds

Countries	Macro Fundamentals	1-yr Default Risk	Credit Ratings	Comment
Angola	**Moderate** (Weak growth; improving revenue outlook; high inflation rate)	Moderate	B3 (Moody's) B- (Fitch)	**R**
Egypt	**Moderate** (Moderate growth; unstable revenue outlook; high inflation rate)	Moderate	Caa1(Moody's) B- (Fitch)	**NR**
Ghana	**Weak** (Moderate growth; unstable revenue outlook; high inflation rate)	High	Ca (Moody's) C (Fitch)	**NR**
Kenya	**Moderate** (Moderate growth and revenue outlook; moderate inflation rate)	Moderate	B3 (Moody's) B (Fitch)	**NR**
Nigeria	**Moderate** (Moderate growth; unstable revenue outlook; high inflation rate)	Low	Caa1(Moody's) B- (S&P)	**R**
Rwanda	**Strong** (Strong growth and revenue outlook; high inflation rate)	Moderate	B2 (Moody's) B+ (Fitch)	**R**
South Africa	**Moderate** (Weak growth; improving revenue outlook; moderate inflation rate)	Moderate	Ba2 (Moody's) B (S&P)	**R**
Zambia	**Moderate** (Moderate growth and revenue outlook; high inflation rate)	High	Ca (Moody's) WD (Fitch)	**NR**

R = Recommended; NR = Not Recommended

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