FOCAL POINT

EM sovereigns: open the issuance floodgate

Guillaume Tresca
February 14, 2024

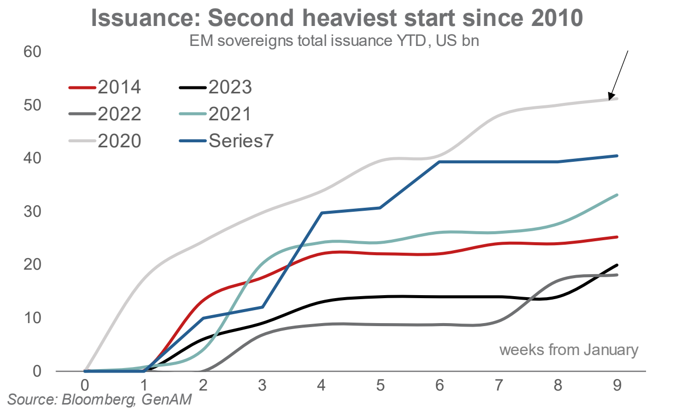
Our Focal Point series explores topical issues on macro, markets and investment

- **The start of the year has been the best for EM sovereign external debt issuance since the GFC, with $ 50bn issued. Primary market conditions have eased considerably. The success of issuance by low-rated countries opens the door for countries that haven't had access yet.**
- **The upcoming issuance will have a limited impact on EM external debt spreads. The long cash position of EM funds, the renewed appetite of US crossover funds and multilateral financing will help to absorb this supply smoothly.**
- **The easing of primary market access is welcome as EM HYs face a wall of redemptions in the coming years. We estimate that EM HY redemptions and coupons will rise from around $ 75bn in 2023 to $ 94bn.**
- **The share of ESG bonds in total issuance has been gradually declining. We expect more ESG issuance to come from first-time ESG issuers. However, this will not be enough to significantly increase the ESG share.**

Access to EM sovereign primary markets was difficult over the past two years but issuance conditions have eased considerably since January with several surprises from EM HY countries coming back to the markets. It fuels hopes of a better environment for EM sovereign external debt and renewed portfolio inflows into the asset class. We will see what it means in terms of expected issuance for the remainder of the year and the possible impact of EM spreads. Moreover, we will take stock of the large upcoming maturities across EMs.

Positive start raises hopes for EM HY

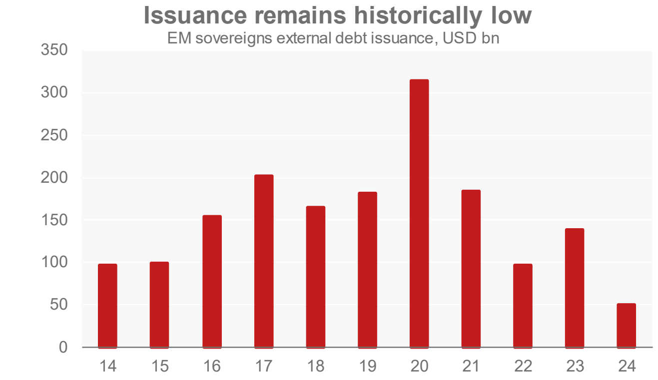
January has seen a revival in EM sovereign primary markets, as EM sovereign funding pressures have eased, and external debt spreads ex-distressed names are close to decade lows. Last January was probably the best start to the year since the GFC. In absolute terms, it is only surpassed by 2023 but it was a special, following a very weak year for fixed income returns and difficult market access.



Source: Bloomberg, GenAM

According to our calculations, January saw EM sovereign issuance of $ 45.9bn equivalent[1] well above the 10-year average. The positive risk appetite environment has led to a rush of EM sovereign issuers.

More interestingly, there are positive changes that could shape the rest of the year. First, coupons paid are on average significantly lower than last year. Second, issuance has been well absorbed in an environment where spreads of EM IG names have widened globally. Post-issuance performance has been positive on average for most of the bonds. Finally, African countries have returned to the market for the first since South Africa and Angola in April 2022 with the two tranches of Ivory Coast for $ 2.6 billion and Benin. These issuances, together with the upcoming Kenya's JPY bond, open the space for further African issuance.

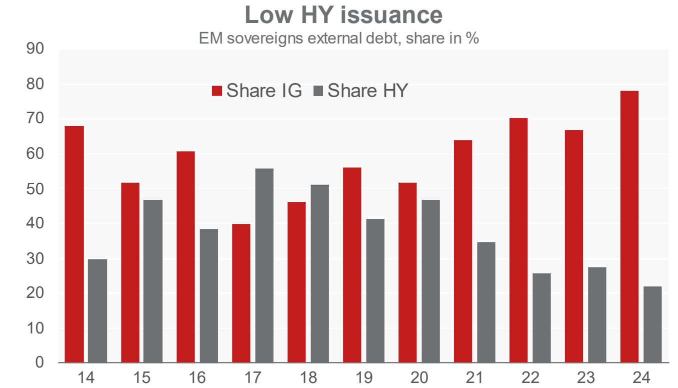


Source: Bloomberg, GenAM

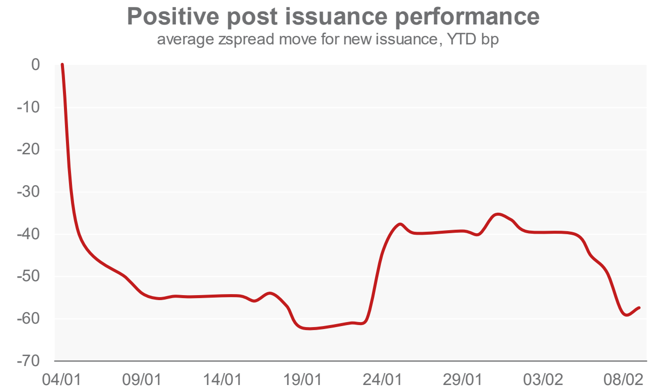
Certainly, the pace of issuance will slow in February, but not as much as in 2023, when global central banks were still tightening monetary policy. The outlook is more supportive. Indeed, the expected monetary easing combined with an expected decline in core rates should lead to issuance in line with the 2015-2021 period, averaging close to $ 150 bn for the full year.

What matters is not the absolute level of issuance, but the composition of issuers at the rating level. Market access has been difficult for the lowest-rated names and so far, issuance has been dominated by EM IG issuers with 83% of total issuance. The share of HYs has been gradually declining since 2018-19, with a low point in 2022. Yields are punitive at close to 10% in the low-rated spectrum. In the second half of the year, with monetary easing in full swing, will be a more attractive period for EM HYs, with even the possibility of countries such as Angola or Nigeria returning to the markets.

[1] Estimations vary depending on the EM countries perimeter. We consider all EM countries even those not included in the main benchmarks.



Source: Bloomberg, GenAM calculation



Source: Bloomberg, GenAM

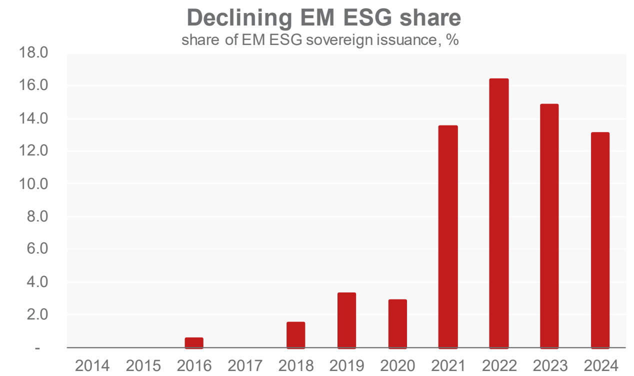
Decline of EM ESG issuance

Despite an increase in global EM sovereign issuance, ESG issuance has been on the decline recently. This is not a new trend, as the global share of EM ESG sovereign issuance has stagnated since 2023 at close to 14.5% of total issuance. This is a significant change after the rapid increase since 2018. Indeed, a few reasons can explain the recent slowdown. First, after a rapid expansion in the US, there has been a setback in the adoption of the ESG framework. In Europe, ESG is still a dominant factor in asset allocation, but the EM investor base remains US-centric. Second, the invasion of Ukraine was a wake-up call for the sovereign ESG framework.. It has brought renewed attention to the sovereign ESG framework and subsequently to ESG issuance. Third, primary market access has been difficult for most EM sovereign issuers since mid-2012, especially for HY names. Large EM sovereigns with easier primary market access had already issued ESG bonds, so the space for new issuance was limited. In a difficult environment, we suspect that some EM sovereigns may have preferred to postpone the publication of their ESG framework and focus on issuing plain-vanilla bonds.

As market access improves for the lowest rated names, we would expect to see more ESG issuance from first-time issuers. Côte d'Ivoire's recent green issuance is a good example of new entrants to the sovereign ESG space. However, this is unlikely to be enough to significantly increase the relative share of ESG issuance. Greenium[2] has been very volatile and not homogeneous, so there is little incentive for an EM country to issue ESG bonds.

In parallel, debt-for-nature swap deals (DFNs) will gain further traction, especially for distressed and low-rated countries. This can help EM countries meet the twin challenge of difficult access to primary markets and financing the climate transition. DFNs are an achievement in sovereign green finance, but they remain an incomplete solution. They can help alleviate EM debt burdens in specific cases by acting as a sweetener in broad sovereign debt restructurings, but they are not a solution in themselves.

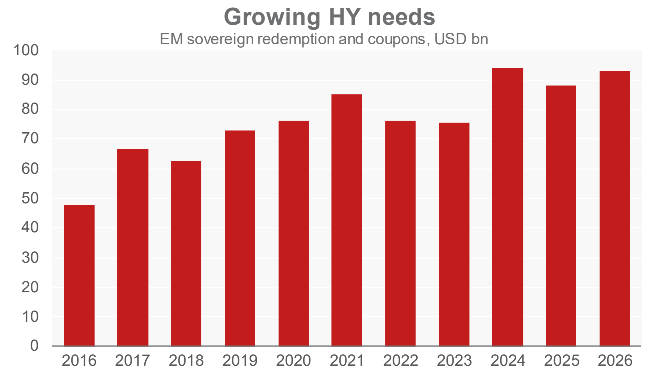
We would expect EM ESG issuance to stabilise around current levels, in lie with what is happening in the DM space.



Source: Bloomberg, GenAM

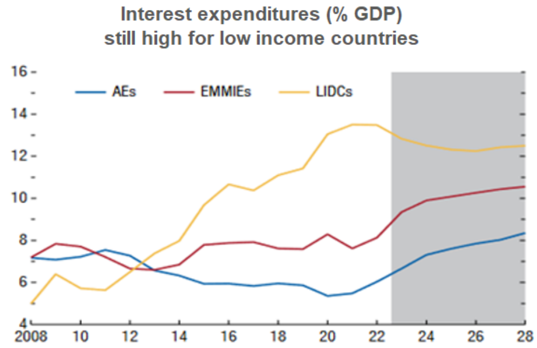
A wall of maturities for EM HY that can be absorbed

The easing of primary market access is welcome as EM HYs face a wall of redemptions. We estimate that EM HY redemptions and coupons will rise from around \$ 75bn in 2023 to \$ 94bn this year. The next three years will also see redemptions above recent averages, putting pressure on EM HY to refinance when market conditions improve.



Source: Bloomberg, GenAM calculations

Based on the IMF's projections, interest expenditure as a percentage of GDP will be close to record levels for the lowest-rated countries in the coming years. At the same time, the IMF expects EM countries to continue to run large negative primary deficits. In itself, this should not be a problem: debt ratios are unlikely to deteriorate on average as the interest rate/growth differential remains low enough to compensate for the primary deficit. However, larger deficits mean further financing needs, which will ultimately lead to more issuance. The new IMF facilities in place since 2020 will help absorb these financing needs for the lowest-rated countries, but we expect that any easing of market conditions, as we saw in January, will lead to renewed issuance.



Source: IMF staff calculations.
Note: AEs = advanced economies; EMMIEs = emerging market and middle-income economies; LIDCs = low-income developing countries.

Upcoming issuance should not meaningfully weigh on spreads

Given the improved market access, we would expect EM net issuance to turn positive this year. Estimates of gross sovereign issuance range from \$ 150 bn to \$ 160 bn, depending on the perimeter. Net of amortisation and coupons, it will be between \$ 20 bn and \$ 30 bn. This level should be well absorbed globally, and the impact spreads will remain limited.

First, various estimates show that most dedicated EM funds still have high levels of cash and therefore the capacity to accommodate increased supply. According to Morgan Stanley, EM fund cash balances[3] were close to 8% of AUM at the end of December 2023, a level not seen since January 2020.

Second, the level of net issuance is between 1.5-2.5% of total EM government debt. Fund cash can absorb some of this, but new inflows into the asset class are needed. Flows have been negative since Q123 and despite positive yields, the recovery has been limited. As we expect core rates to fall, inflows should turn positive. Anecdotal evidence and investor sentiment surveys also show a growing appetite for

[2] The greenium is the difference in yield between an ESG bond and a conventional bond of the same maturity. The term can also represent the difference in z-spread or option-adjusted spread.

[3] Estimations based on a sample of 16 EM hard currency funds with AUM of \$ 25.5bn

US crossover funds in recent January EM deals. EM IG now looks cheap relative to US IG and will ultimately attract more inflows from US-centric investors.

Third, alternative sources of funding will become more important. Multilateral organisations are already playing an increasing role in EM financing. Official bilateral financing will also contribute. China will remain on the sidelines, but the GCC countries will remain an important source of funding in North Africa and the Middle East.

Finally, private placement has grown, with more and more countries using it. It used to be a tool for the lowest rated countries, but more IG names have tapped the private market or used reverse inquiries to place Eurobonds (Romania). This has helped to mitigate the impact on the secondary curve. That said, on average, it remains a marginal tool.

Upcoming issuance

Going forward, issuance will remain concentrated in the IG space but the recent success of HY deals in the SSA region can open the doors for further deals from low rated sovereign names.

In the IG space, the largest expected issuers later this year are Indonesia, Poland, Israel, Romania, the UAE, Panama, Mexico., Saudi Arabia

- Indonesia already did $ 2.1bn with approximately $ 10bn remaining. Given its creditworthiness and large weight in the benchmark, there is no reason to rush, and can wait until later this year for better spread level.
- Poland has a larger budget deficit this year with c. € 14bn issuance expected. They already issued € 3.8bn in €. They could come in late Q1/Q2 in $ and in the second part of this year in € again.
- Israel: larger issuance expected, north of $ 10bn with a larger budget deficit in the wake of the ongoing conflict. That said, the latest taps were in the form of private placement.
- Panama: the volatile fiscal situation related to the closing of the Cobre Mine and the upcoming elections can lead to budget revision. The budget deficit will be wider and larger issuance than usual can weigh on the spreads, especially given the weak idiosyncratic factors.
- Mexico: larger issuance than before with the surprisingly wide 2024 budget. It has already done $ 7.5bn and € 2bn. Another $ issuance can follow in H2.
- Saudi Arabia: the largest issuer so far with $12bn done YTD. The wider fiscal deficit implies that it can issue another $3-4bn in H2.
- Romania: it can issue close to $10bn with upside risk in an election year and given the pension reform. $ 4bn has been done and it should be followed by € issuance in late Q2/Q3

In the HY space, Turkey is the largest expected issuer with c. $ 10bn expected. It has just announced a new 10Y, showing again its ability to come when the market is tight. Colombia still has to do close to $ 3bn with upside risk. Lower in the rating scale, Kenya has just announced a buyback operation and the subsequent issuance of Samurai bonds in Q2. In SSA, the next candidate could be Nigeria and Angola later in the year.

Imprint

Issued by:	**Generali Asset Management S.p.A.** **Società di gestione del risparmio, Research Department**
Head of Research:	**Vincent Chaigneau**
Head of Macro & Market Research:	**Dr. Thomas Hempell, CFA**
Team:	**Elisabeth Assmuth |** Research Operations **Elisa Belgacem |** Senior Credit Strategist **Radomír Jáč |** GI CEE Chief Economist **Jakub Krátký |** GI CEE Financial Analyst **Michele Morganti |** Head of Insurance & AM Research, Senior Equity Strategist **Vladimir Oleinikov, CFA |** Senior Quantitative Analyst **Dr. Thorsten Runde |** Senior Quantitative Analyst **Dr. Christoph Siepmann |** Senior Economist **Dr. Florian Späte, CIIA |** Senior Bond Strategist **Guillaume Tresca |** Senior Emerging Market Strategist **Dr. Martin Wolburg, CIIA |** Senior Economist **Paolo Zanghieri, PhD |** Senior Economist

"Edited by the Macro & Market Research Team. The team of 14 analysts based in Paris, Cologne, Trieste, Milan and Prague runs qualitative and quantitative analysis on macroeconomic and financial issues. The team translates macro and quant views into investment ideas that feed into the investment process."