UNION BANCAIRE PRIVÉE

FLASH UPDATE

G20 Common Framework and Value vs. US High Yield
16 November 2020

For Professional Investors in Switzerland or Professional Investors as defined by the relevant laws

Key takeaways

- The G20 Debt “Common Framework” was released on Friday last week
- It includes no suggestion of forced involvement from the private sector (i.e. bond holders)
- The yield differential between Frontier Markets and US High Yield is at an extremely wide level
- With this existential threat for frontier markets now behind us (again) we would expect this gap to narrow

In April this year, the G20 launched the Debt Service Suspension Initiative (DSSI) which was conceived by the World Bank and the IMF. This initiative offered liquidity relief to the poorest countries in the world, in order to help them mitigate the impact of the COVID-19 pandemic. Initially, this offered a moratorium on payments until the end of 2020. At the time, the G20 (and other policymakers and multilaterals) “called on” private creditors to participate. This, naturally, caused some market jitters and underperformance of frontier markets debt at the time. As it became clearer (and as we have been vocal in prior flash notes on the subject) that the practicalities would be very complicated, and the implications perhaps undesirable (ratings downgrades, losing access to funding from international capital markets, etc.), the idea slowly faded.

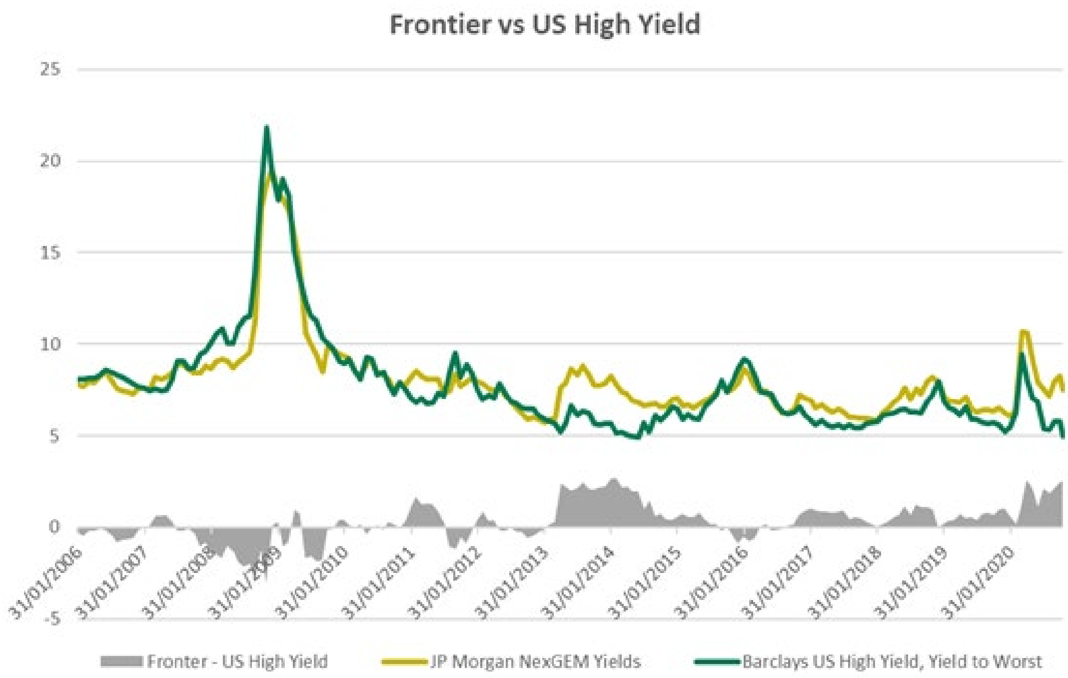
Coming into the IMF meetings in October, calls for an extension of DSSI started to emerge. On October 14th, Paris Club members and the G20 agreed to extend the DSSI by 6 months. At the same time, the Paris Club creditors agreed on a “Common Framework for Debt Treatments beyond the DSSI”. This was also agreed by the G20 in principle, with the explicit notice that this would be further discussed at the G20 Leaders’ Summit. Following these statements, the discussions of private sector involvement began to resurface. We, and the market generally, remained sceptical of any such involvement, but nevertheless the risk remained.

On Friday, November 13th, the G20 finalised a common debt framework proposal. This proposal extends a Paris Club style, country-by-country, approach to debt re-profiling of poor countries’ debt, to the other lenders from the G20 (most notably China). Any countries’ attempt to fully reprofile debt will, of course, involve the private sector. Not really a material change, but perhaps a small shift in that the Chinese state appears to be more on board (and prepared to apply a transparent, standardised, approach). However, and more importantly for the UBAM – Emerging Markets Frontier Bond fund, the announcement and details of the framework brought no news of any intended forced private sector involvement. So, while always remote in our view, clearly this takes one risk off the table – at least for the time being.

Frontier vs. US High Yield

We have written much about the comparison with US High Yield in prior publications. The two asset classes have the same average ratings, and reasonably high correlations. Over the last 15 years, frontier markets have yielded 0.32% more than US High Yield on average, with slightly higher volatility. With higher yields and more volatility, it would be natural to assume this meant slightly more defaults. But the opposite has been true. Over the history, roughly 2% of the frontier markets universe (using JP Morgan NexGEM Index) has defaulted each year – compared with 4.4% of the US High Yield markets. And average weighted haircuts on defaulting frontier bonds have been 0.37%, while they have been 0.59% for US High Yield. The combination means substantially higher realised losses for US High Yield, and an *annualised* outperformance of frontier markets of nearly 2% over a period of nearly 20 years (cumulative outperformance of 165%)! Therefore, we have recommended global investors should move some of their US High Yield allocation (where most investors have sizeable exposure) to Frontier Markets (where most investors have little to no exposure). We believe this should be a structural position.

In 2020, Frontier markets are in-line with their historical averages in terms of defaults, and recovery rates, where both Argentina and Ecuador were roughly in line. More concerningly for US High Yield, already 6% of the universe has defaulted, and recovery rates on those have been well below (less than half) their historical average at just 17%. Despite this, the spread between Frontier Markets and US High Yield has *widened* significantly. Last week, the Bloomberg Barclays US Corporate High Yield index reached the lowest level of yield in its history, at 4.56%. The JP Morgan Frontier Index, the NexGEM, still yields just over 7.5%, which is more than 175bps above its historical low (5.75%) reached in 2013. This means that **Frontier Markets currently yield 2.53% more than US High Yield**. This is very near the widest level over the past 15 years, 2.67%, which was reached back in February 2014.



	Frontier Markets	US High Yield
Latest Yield	**7.52%**	**4.99%**
Average Yield (2006-present)	**8.06%**	**7.75%**
Difference	**-0.54%**	**-2.76%**

Average Differential (2006-present)	**0.32%**
Current Differential	**2.53%**
Maximum Differential (2006-present)	**2.67%**
Minimum Differential (2006-present)	**-3.08%**

*Sources: UBP, JP Morgan, Bloomberg Finance L.P. – as at 13.11.20. Past performance is not an indicator of current or future results

We believe a number of factors contribute to this (the Fed buying of US High Yield being one) but from the frontier side, at the macro level, the main risk has been the G20 DSSI mentioned above. With this now behind us, we believe this spread should tighten, and view todays levels as a very attractive entry point for entering this structural trade, buying Frontier Markets vs US High Yield.

Zambia Default Confirmed

Finally, we should note that Zambia officially entered default at the end of last week, as the grace period of the coupons due on their 2024 bonds expired. This had been flagged, and was widely expected by the markets. Bonds already traded around $45, and the reaction over the last two days has been muted (at the index level, bonds were down less than 1% Monday). We believe negotiations could be complicated (and protracted) but ultimately view the risks as skewed to the upside from current price levels – as a result the fund holds roughly 1.5% in Zambian Eurobonds.

Thomas Christiansen
Managing Director
Head of Sovereign & Frontier EMD

Union Bancaire Privée, UBP SA
Seymour Mews House | 26 – 37 Seymour Mews
London | W1H 6BN
T +44 20 7663 1584 | thomas.christiansen@ubp.com

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