MyStratWeekly

Market views and strategy

Ostrum ASSET MANAGEMENT

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N° 074 // **June 13, 2022**

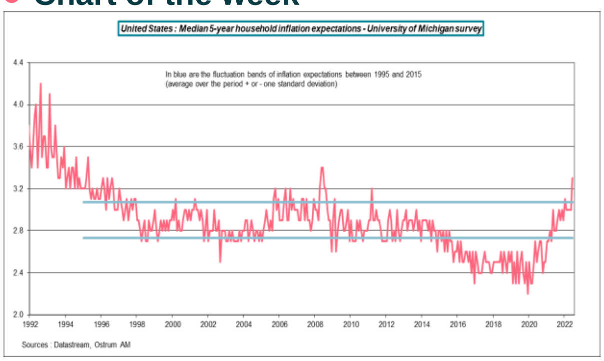
Topic of the week: ESG, a key element for investment prospects in Emerging Markets

- **Sovereign analysis of emerging markets was already based on Governance;**
- **We propose an approach that takes into account the three pillars E, S, and G as a whole;**
- **Our materiality score is very effective in identifying a set of countries at risk and refining the issuer's analysis;**
- **ESG will be a key factor in future investment prospects in emerging markets.**

Market review: Running for cover

- **ECB announces rate hikes in July and September;**
- **Bund yields near 1.5%, sovereign spreads under pressure;**
- **US inflation at 8.6%, inflation expectations drift higher;**
- **Equities plunge, the US dollar is the only place to hide.**

Chart of the week



US 5-year household inflation expectations in the University of Michigan survey accelerated sharply to 3.3 % in June, well above their average between 1995 and 2015. The acceleration of inflation also weighed on US household confidence, which reached an all time low in the same survey. This justifies a strong tightening of the monetary policy of the FED in order to stop the inflationary spiral which weighs negatively on the economic activity.

Figure of the week

80

Source : Ostrum AM

The inflationary wave is spreading to the Globe. 80 countries in the world, namely emerging markets, are expected to experience inflation between 5 and 10 % in 2022. Some 60 others, including France, should be able to keep inflation below the 5 % in annual average.

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Topic of the week

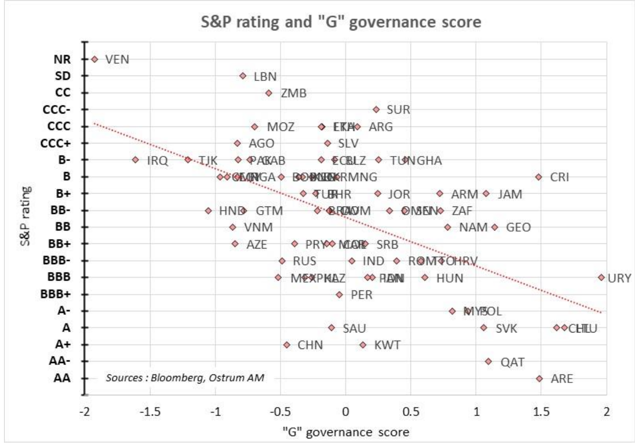
ESG, a key element for investment prospects in Emerging Markets

Traditional emerging market sovereign risk analysis is currently based mainly on the "G", pillar of governance. The idea of this paper is to show that the introduction of a global ESG approach in emerging market sovereign risk analysis will be decisive for future investment prospects.

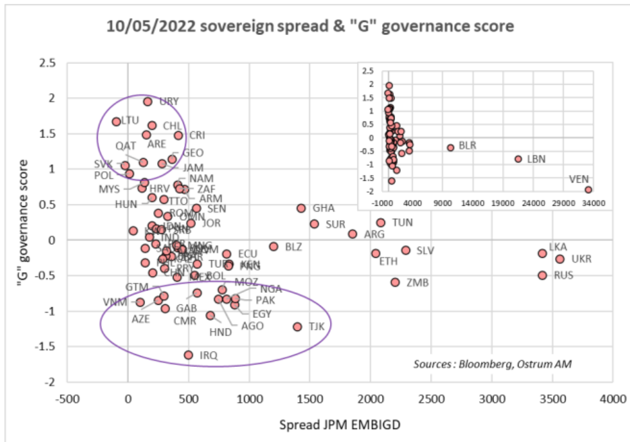
Traditional emerging market sovereign risk analysis is already based on the "G" and "S"

The "G" as a leverage for traditional sovereign analysis…

The Emerging Markets Economist/Strategist already considers the "G" pillar of governance in their sovereign analysis. Indeed, governance directly affects the country's credit profile. Moreover, there is a high correlation between the external sovereign ratings of emerging countries and the quality of their governance. To illustrate this relationship, we have built a governance "G"[1] score for the 72 countries that make up the JPM EMBI Global Diversified Index. A low score indicates poor governance while a high score indicates good governance. The graph below highlights this link.



A poor governance score usually results in a high risk premium. The graph below links our "G" score to the risk premium observed for the 72 countries that compose the JPMorgan EMBIGD index.



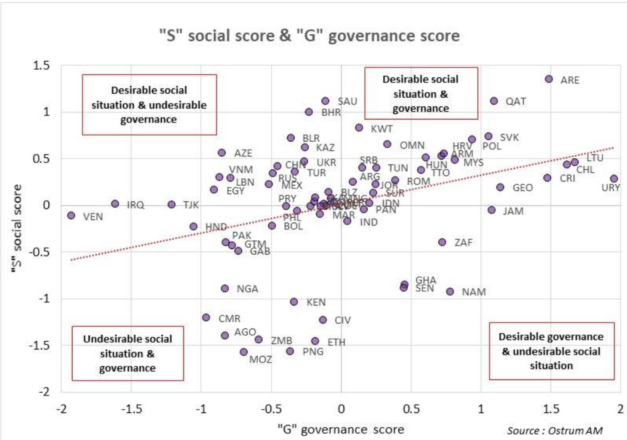
Countries with a "G" score above 1 (circled on the chart, on the top corner left) are characterized by a relatively low risk premium, also reflecting their very good sovereign rating. Below the threshold of 1, the dispersion of points is greater, especially when the "G" score becomes negative. Almost 90% of countries with a risk premium above 500bps have a negative G score; that is, very poor governance. This means that the economist/strategist's analytical effort must focus on countries with a governance "G" score below 0.5. The dial on the top right shows that countries with very high-risk premiums consistently have a negative score.

…and the "S" as an indicator of risk of social tensions

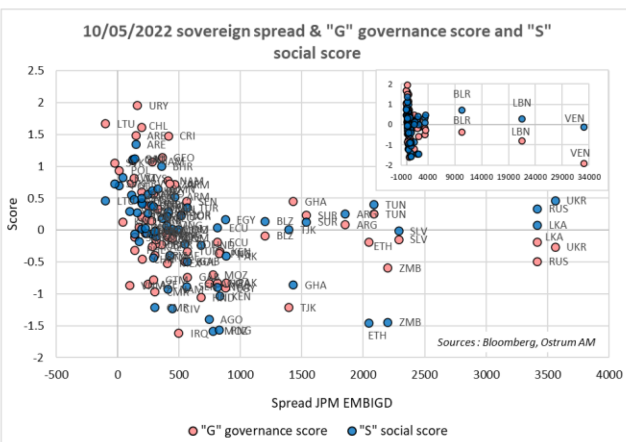
Consideration of the "G" pillar goes hand in hand with consideration of the "S" pillar. A deterioration in social conditions generally leads to political tensions in emerging countries, like those that broke out at the end of 2019. The inclusion of an "S" score as an indicator of social tensions is therefore also useful in the sovereign analysis of emerging

[1] Our governance "G" score is built as an equal-weighted average of the following three variables: press freedom index, corruption perception index and government effectiveness indicator; centered and reduced.

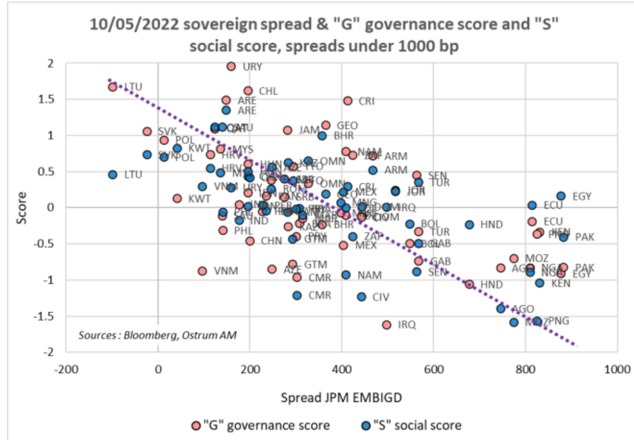
countries. As for the "G" score, we have built an "S" score that we put against the "G" score in the chart below. As for the "G" score, we have built an "S" [2] score that we put against the "G" score in the chart below.



In addition, the "S" score has the same relationship as the "G" score with the level of risk premiums, as shown in the chart below.



If we take out the extreme values (countries with risk premiums above 1000 bps), the same graph shows a linear relationship.



The two pillars "G" and "S" explain the credit profile of emerging countries very well. These two factors are also taken into account by investors, reflecting their close relationship with risk premiums in emerging countries. What about the environmental "E" pillar?

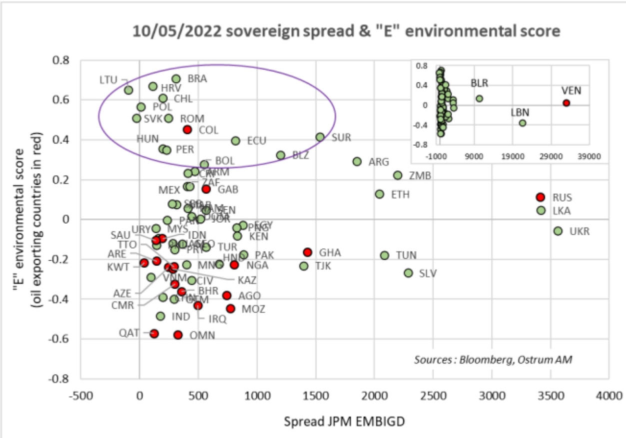
The "E": the dislike of international investors

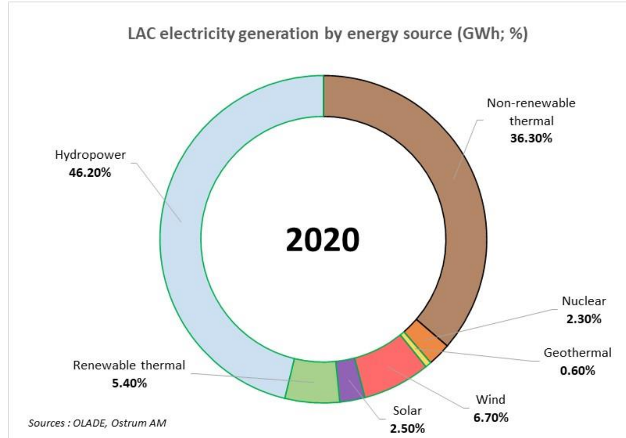
Economists, analysts and strategists are increasingly aware of the impact of climate change on the credit profile of emerging countries. Indeed, its effects are now evident in the image of the May heat records in India and Pakistan, which threaten the wheat crops of India, the world's second largest producer. Beyond the physical risks, the other risk for emerging countries is the transition to a low-carbon economy, which will lead to winners and losers. Countries producing fossil fuels, especially oil, should be the most penalized by this transition. This should be reflected in a revaluation of their risk premiums. Is climate risk taken into account by international investors?

To answer this question, we built an environmental score "E" [3] for the 72 countries that make up the EMBIGD JPM Index. The chart below shows our "E" score based on the level of risk premiums.

[2] Our "S" score is built using the same methodology as our "G" score, but with the following seven variables: the human development index, the male/female inequality index, the Gini coefficient, the demographic dependency ratios for the elderly population (over 64 years) and the young population (under 15 years), the share of the population with access to drinking water and the share of the population using basic sanitation services.

[3] The "E" score is built using the same methodology as the "G" and "S" scores using the following variables: energy intensity, CO2 emissions, oil exports, share of energy from renewable sources, trade-induced CO2 emissions and 11 other indices from the Environmental Performance Index.





Investors do not discriminate between countries that are environmentally virtuous and those that are not. Indeed, the countries represented in red on the graph, which include all Gulf countries, net oil producers and exporters, have a relatively low risk premium (10 bps in the case of Kuwait and 330 bps in the case of Bahrain for Gulf countries outside Iraq) while their “E” scores are very poor. They are also characterized by good sovereign ratings, since they are qualified as “investment grade” by the rating agencies.

It should be noted that the countries with a high “E” score, located at the top of the graph, are mainly Latin American countries. These countries are proving to be the most likely to meet the challenge of the energy transition. The region is home to the industrial metals needed for this transition, such as copper and lithium, involved in the manufacture of energy transition technologies. The «lithium triangle» formed by Argentina, Bolivia and Chile, thus concentrates nearly 60% of the world reserves of this ore. However, the three countries have little presence in the global production chain of lithium products such as batteries for electric cars. The three countries want to strengthen their cooperation in this area by stepping up their efforts in the qualification of the workforce in order to increase the level of the workforce to allow their full integration into global supply chains. In addition, in Latin America and the Caribbean (LAC), 61.4% of electricity production comes from renewable sources.

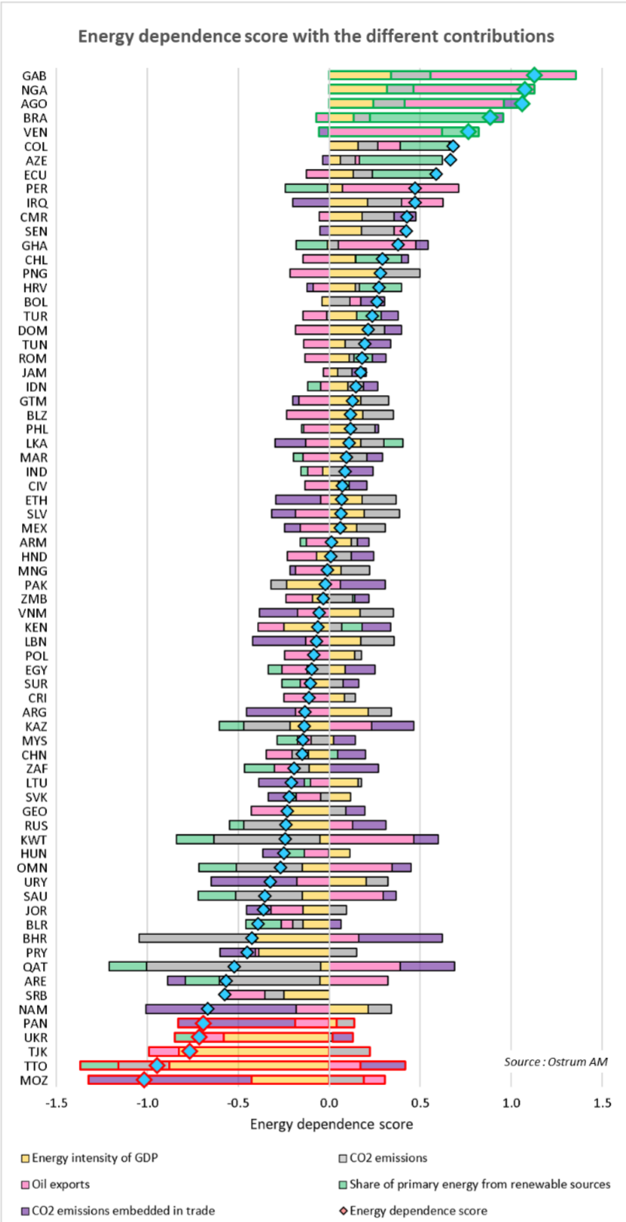
The Ukrainian shock reinforces the interest of the introduction of ESG in EM sovereign analysis

The energy shock: an accelerator for the “E” …

The war in Ukraine caused a shock on the prices of raw materials, especially energy, weakening the importing countries. Rising energy and food prices are worsening the external and fiscal accounts of these countries, which have already been weakened by the Covid-19 pandemic, and thus their credit profile.

To assess their vulnerability, we propose an energy dependency score[4] for the 72 countries in the JPM EMBIGD index. A low score indicates a high level of dependence, while a high score indicates a low level of energy dependence (the score is always interpreted in relative terms).

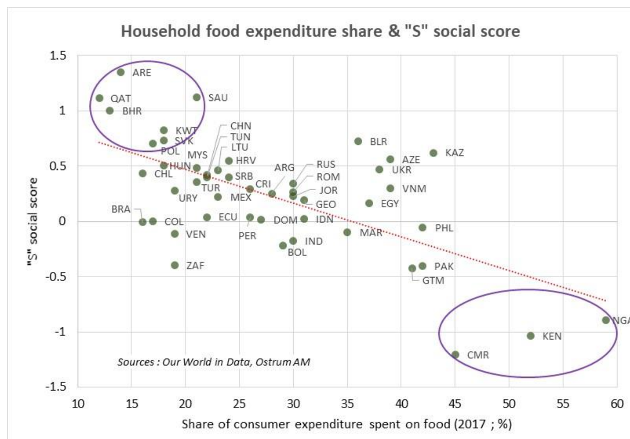
[4] The energy dependency score is built according to the same methodology as the scores «E», «S» and «G» but with the following 5 variables, also included in the score «E»: energy intensity, CO_2 emissions, oil exports, the share of energy from renewable sources and trade-induced CO_2 emissions. However, the contribution of some variables to the energy dependency score and the environmental score may differ (for example, oil exports contribute negatively to the environmental score and positively to the energy dependence score).



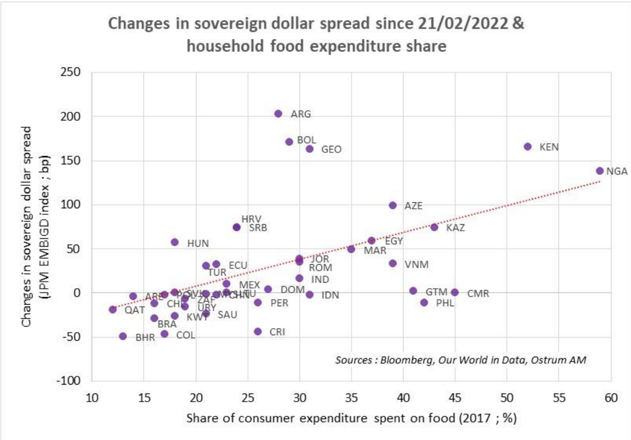
Among the countries with a low energy dependence (on the top of the chart), we find mainly sub-Saharan African countries like Gabon, and the two largest oil producers like Nigeria and Angola. In the short term, these countries will benefit fully from high oil prices. However, over the medium and long term, the contribution of "oil exports" to the score is very high and thus reflects the strong vulnerability of these countries to the energy transition. This is especially true for Angola, which is very dependent on oil, which accounts for 90 % of its exports, 60 % of its budgetary revenues and 50 % of its GDP! Angola is also financially and economically dependent on China. 70 % of its crude oil exports go to China. However, the Chinese authorities also announced that they would aim to have a "peak of CO2 emissions before 2030 and to achieve carbon neutrality before 2060". In other words, Chinese oil demand will drastically decrease in favor of natural gas. Angola's high dependence on oil and China makes it highly vulnerable to the low-carbon transition. On the other hand, Brazil stands out for the strong contribution of "renewable energy" to its score, making it less vulnerable to the green transition. The introduction of an "energy dependency" score helps to identify the emerging countries most vulnerable to the energy transition, key for future investment prospects.

… In addition, the food shock is an accelerator for the "S"

Finally, this conflict is also causing a shock on the prices of agricultural products because of the shortages it causes. However, two other factors are also expected to help keep agricultural prices high. These are the energy prices that are expected to remain high due to the green transition, and have an impact on fertilizer prices, as well as climate risk. However, food is not a raw material like any other, because it has a strong destabilizing power, especially for emerging countries. The chart below highlights the relationship between our "S" score, and the share of food spending in emerging countries to assess food dependency.



The relationship between the two variables is relatively strong. The higher the social level of a country, the lower the share of their income used for food. This is the case for the Gulf countries, which are located at the top of the graph. On the other hand, a low social score characterizes countries where the share of food is high in household spending. These include Cameroon, Kenya and Nigeria. They are the countries most vulnerable to the food shock to come. Is vulnerability in terms of food dependency taken into account by investors? The chart below shows the changes in risk premiums since February 21, 2022, just before the date of the Russian invasion, and the share of food in household spending.

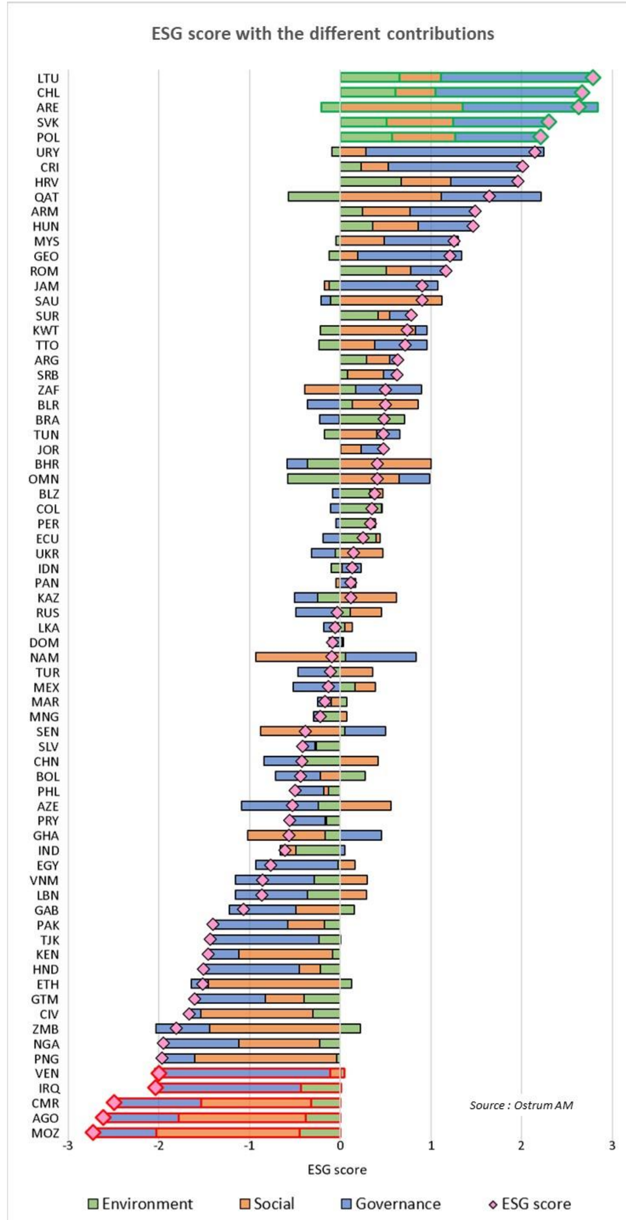


Food dependency is reflected in countries' risk premiums. Nigeria is a good school case. It is Africa's largest oil producer, but its heavy reliance on food is worsening its credit profile, which is reflected in its risk premium rising by almost 150 bps over the period. It is not enough to be a producer and exporter of fossil fuels, food, and therefore the social level of the country, is a differentiating factor for future investment prospects.

To sum up : our ESG score

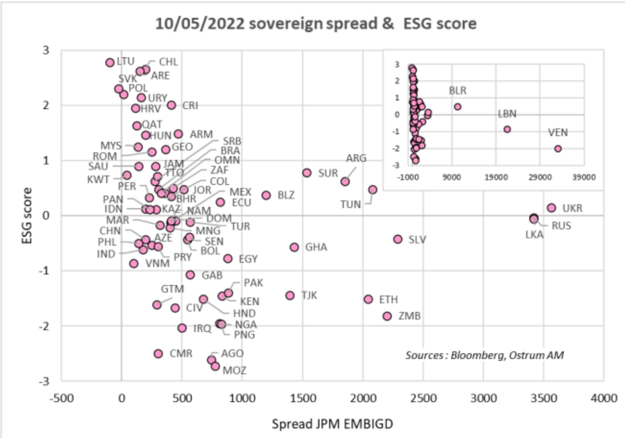
A global ESG score to better understand the challenges facing Emerging Markets

Finally, we present an overall ESG score [5] for all JPM EMBIGD countries. The graph opposite shows the ESG rating for each country and the contribution of each pillars.



At the beginning of the ranking, we find mainly countries from Eastern Europe, Latin America and the Gulf countries. Conversely, the bottom ranks are mostly occupied by sub-Saharan African countries. Finally, we note that these three pillars are quite related: among the countries in the first tier of the ranking as well as in the last tier, the scores «E», «S» and «G» very often go in the same direction. Finally, as the chart below illustrates, the overall ESG score manages to identify countries at risk (high-risk premium) as countries at lower risk (low risk premium). Again, countries with high risk premiums have scores below the threshold of 1. The value of an ESG score allows the economist/strategist to focus his analysis on these countries at risk. This is the case for Mozambique, Angola, Cameroon, Iraq, Venezuela, Paraguay, Nigeria or Zambia.

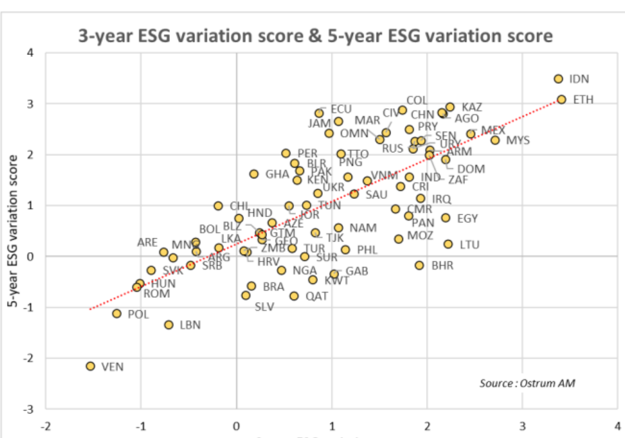
[5] This score is calculated as an equal-weight average of the three previously presented “E”, “S” and “G” scores.



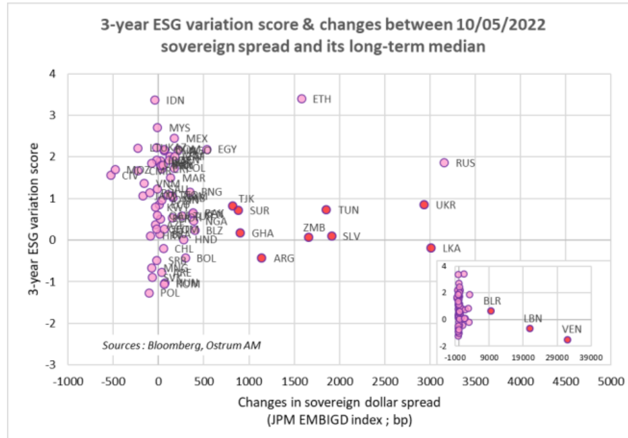
A dynamic ESG approach is essential to seize investment opportunities

We believe that what is important to differentiate emerging countries is the evolution of their ESG scores over time. This means that countries with low scores are not systematically penalized, since they could be an investment opportunity if they are in a phase of improvement. In this last section, we focus on the behavior of emerging countries in terms of ESG over different periods ranging from 3 to 5 years.

Without going into details, the “ESG score of variation” that we designed assesses the 72 countries studied in an absolute way (Have they improved or decreased?) but also in a relative way (rewarding countries with the best improvements and punishing those with the worst degradation). Thus, a positive score is a sign of an overall improvement in ESG variables over the period considered, while a negative score indicates the opposite. This score takes into account all the variables cited so far and weights the three scores “E”, “S” and “G”. We finally cross the ESG score of variation 3 years and 5 years to identify the countries that have improved or deteriorated the most and the period over which efforts have been concentrated.



Of the 72 EMBIGD countries, 82% improved in ESG terms over the past three years, while 18% saw their situation deteriorate. It is then consistent to find countries whose environmental, social and governance situation is initially much deteriorated with high scores and conversely for countries whose situation is initially correct.
Finally, in the chart below, we compare this 3-year ESG score with the difference between the current spread and its long-term median.



Here we note that 80% of countries that saw their spread increase by more than 500 bps over 3 years compared to their long-term median spread have a low score (countries in red on the chart). The latter have improved very little (scores between 0 and 1) over this period or even decreased (scores below 0) in terms of ESG. It is also emerging countries that are on the front page of international news.

Conclusion

The non-financial analysis for emerging countries focuses mainly on the governance part. We propose a more comprehensive approach taking into account each of the three ESG pillars. Our materiality score is very effective in identifying a subset of countries at risk. When our ESG score is below 0.5, emerging countries are part of a more vulnerable set. These countries are therefore likely to have an increase in their risk premiums. This approach, through a wider lens than the traditional financial spectrum, therefore allows a more detailed analysis of the issuer’s risk profile.
In addition, we think it is important to take into account the dynamics of the scores so as not to systematically penalize countries with low scores and not to pass through investment opportunities in the case of countries that are improving. ESG will be a key element in future investment prospects in emerging markets.

Zouhoure Bousbih and Lucas Revel-Mouroz

Market review

Running for cover

The ECB toughens its stance, US inflation calls for further tightening whilst markets nosedive

A highly anticipated ECB meeting took place last Thursday. The communication from the Central Bank left no room for doubt regarding the tightening bias to come. The yield on the 10-year Bund rose towards a weekly close above 1.50%, reigniting tensions on peripheral spreads. The spread on the Italian 10-year BTP broke through the 220bp ceiling. European equities plummeted immediately before another drawdown in New York the next day further darkened the outlook for equity markets. Credit spreads widen as equity markets fuel demand for protection. The iTraxx Crossover is trading near 500bp at the end of Friday's session. The bearish reaction of the euro exchange rate despite the outlook for interest rates in the euro area is undoubtedly problematic for the ECB. In fact, the dollar remains the only safe haven.

The ECB statement is unambiguous. The Central Bank has rarely been so explicit about the outlook for monetary policy. A 25 bp hike in July, thus immediately after the end of the quantitative easing program on July 1, is a done deal. The magnitude of the second rate increase, already scheduled for September, is conditional on the persistence of the inflationary risk. The probability of a 50 bp hike is therefore very strong given the price inertia and the current rise in crude prices. Christine Lagarde even mentions the "journey" of monetary tightening, which hints at a series of rate increases. These hikes will apply to all three policy rates. Regarding TLTROs, these long-term refinancing operations will become less favorable to borrowing banks from June with the end of the bonus rate (-50 bp below the deposit rate). These loans are no longer eligible to the NSFR (Net Stable Funding Ratio) when the residual maturity is less than one year. This explains the strength in covered bond issuance this year which could encourage early repayments despite the financial cost advantage of TLTROs compared to market financing. On the other hand, the ECB remained sibylline on the question of financial stability and the asymmetrical risks of fragmentation of the monetary union. A uniform transmission of monetary policy may require intervention by the ECB in the event of a crisis. In the absence of an explicit plan, the flexibility offered by PEPP reinvestments will be the first line of defense. We can imagine early reinvestments of the PEPP bond maturities or a departure from the current geographical bond allocation.

In the United States, inflation is at an "unacceptable" level in Janet Yellen's own words. The CPI hit a new high at 8.6% in May. The monthly price increase was 1%. Energy remains a major subject, but the price pressures are broad-based, and the strong dollar does not seem to have much impact on prices. The core inflation index barely slowed to 6%. The housing component continues to fuel inflation (0.6%m). This CPI release argues for continued monetary tightening by the Fed.

Christine Lagarde's speech added fuel to the market drawdown that had already started before the meeting. The Bund yield quickly sold off towards 1.46% on Thursday as short-term bond yields overshot. The yield curve flattening suggests that market participants were surprised by talks of 50 bp hikes. Moreover, the "anti-fragmentation" weapon hoped for by market participants remains elusive. The ECB clearly did not want to offer an explicit anchor for the Italian spreads. Amid high uncertainty, the market seems to be testing the ECB's "tolerance threshold". However, the question of the level of spreads triggering ECB intervention is perhaps not the most relevant. Like in the crisis of the summer of 2011, the critical issue for sovereign issuers will always remain the access to markets. In the United States, the inflation print will revive the debate on 75bp Fed funds rate hikes. The US 2-year soared past 3% on Friday. The long end is better supported by the final flows, as evidenced by strong bidding at this week's auctions (30 years in particular). Breakeven inflation rates, at 2.78% at 10 years, reflect an environment of persistent inflation. Households indeed anticipate median inflation of 3.3% over the next 5 to 10 years.

Credit is suffering like all risky asset classes. Since the beginning of the year, the euro IG market index has lost 11%. The primary market activity remains sluggish (just €5 billion issued this week). New issue premiums do not hold on the secondary markets. Higher liquidity of CDS indices allows for larger spread moves driven by the need for credit risk hedging. The iTraxx Crossover widened out by nearly 50 bp last week, as monetary tightening fuels the decompression trend. The high yield market, despite a still deserted primary market, started weakening again at the end of the week. High yield fund outflows continue.

Equity markets plunged again with the announced monetary tightening. Corporate earnings forecasts are well oriented but nothing seems to stem the decline in stock prices. All sectors are affected, including energy despite a barrel at $120. The homogeneity of the equity market drawdown reflects a form of market capitulation, especially since current investor sentiment indicators appear extremely bearish. European stocks are recording net outflows for the 17th consecutive week, according to data from EPFR. US investors keep selling European stocks, but moving money back to US failed to support US indices, down 5% last week.

Axel Botte
Global strategist

Main market indicators

G4 Government Bonds	13-Jun-22	1wk (bp)	1m (bp)	2022 (bp)
EUR Bunds 2y	1.15%	+46	+104	+177
EUR Bunds 10y	1.63%	+31	+68	+181
EUR Bunds 2s10s	47.4bp	-15	-36	+4
USD Treasuries 2y	3.25%	+52	+67	+252
USD Treasuries 10y	3.33%	+29	+41	+182
USD Treasuries 2s10s	7.8bp	-23	-25	-70
GBP Gilt 10y	2.51%	+26	+76	+154
JPY JGB 10y	0.26%	+1	-1	+3
€ Sovereign Spreads (10y)	**13-Jun-22**	**1wk (bp)**	**1m (bp)**	**2022 (bp)**
France	61.83bp	+10	+10	+24
Italy	238.67bp	+30	+39	+104
Spain	135.87bp	+20	+26	+61
Inflation Break-evens (10y)	**13-Jun-22**	**1wk (bp)**	**1m (bp)**	**2022 (bp)**
EUR 10y Inflation Swap	2.68%	+8	-9	+59
USD 10y Inflation Swap	3.05%	-2	+5	+28
GBP 10y Inflation Swap	4.2%	-3	-47	+3
EUR Credit Indices	**13-Jun-22**	**1wk (bp)**	**1m (bp)**	**2022 (bp)**
EUR Corporate Credit OAS	170bp	+7	+0	+75
EUR Agencies OAS	69bp	+4	+0	+20
EUR Securitized - Covered OAS	73bp	+0	-10	+27
EUR Pan-European High Yield OAS	484bp	+5	-31	+166
EUR/USD CDS Indices 5y	**13-Jun-22**	**1wk (bp)**	**1m (bp)**	**2022 (bp)**
iTraxx IG	105bp	+17	+13	+58
iTraxx Crossover	530bp	+90	+84	+288
CDX IG	97bp	+16	+12	+48
CDX High Yield	570bp	+97	+88	+277
Emerging Markets	**13-Jun-22**	**1wk (bp)**	**1m (bp)**	**2022 (bp)**
JPM EMBI Global Div. Spread	468bp	+20	-1	+99
Currencies	**13-Jun-22**	**1wk (%)**	**1m (%)**	**2022 (%)**
EUR/USD	$1.043	-2.524	0.135	-8.3
GBP/USD	$1.216	-3.000	-0.865	-10.2
USD/JPY	JPY 134	-1.670	-3.653	-14.2
Commodity Futures	**13-Jun-22**	**-1wk ($)**	**-1m ($)**	**2022 (%)**
Crude Brent	$119.7	$0.2	$10.0	58.94
Gold	$1 825.5	-$15.9	$13.7	-0.20
Equity Market Indices	**13-Jun-22**	**-1wk (%)**	**-1m (%)**	**2022 (%)**
S&P 500	3 752	-8.95	-6.74	-21.3
EuroStoxx 50	3 499	-8.84	-5.52	-18.6
CAC 40	6 016	-8.13	-5.45	-15.9
Nikkei 225	26 987	-3.33	2.12	-6.3
Shanghai Composite	3 256	0.59	5.55	-10.6
VIX - Implied Volatility Index	34.47	37.50	19.40	100.2

Source: Bloomberg, Ostrum AM

Additional notes

Ostrum Asset Management

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