MyStratWeekly

Market views and strategy

Ostrum ASSET MANAGEMENT

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N° 118 // **June 19, 2023**

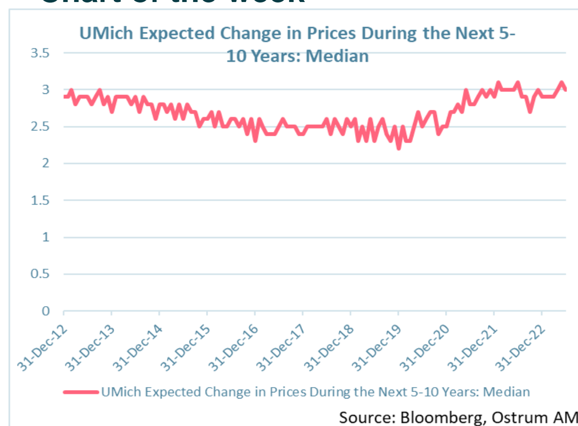
Topic of the week: EM Sovereign Debt 5.0: Nature and Climate!

- **Funding to reach the 1.5°C target is very insufficient;**
- **Poor countries are the most vulnerable and have limited fiscal room to invest;**
- **In the face of stalled restructuring negotiations, interest in the natural debt exchange has increased;**
- **These instruments were an integral part of the Latin American debt restructuring and can be part of the solution.**

Market review: Hawkish turn before summer

- **Fed: 50 bps of additional tightening in 2023;**
- **ECB: towards a deposit rate of 4% in September;**
- **Long-term yields proving insensitive to hawkish rhetoric;**
- **Strong performance out of credit and equity markets.**

Chart of the week



Source: Bloomberg, Ostrum AM

Inflation expectations are a key variable for monetary policy. The message from the Fed is that further tightening is likely needed to ensure inflation converges to the target. Indeed, when agents anticipate inflation, they include it in their offers (of labor or of goods and services), which tends to perpetuate price adjustments. It is therefore crucial for central banks to convince them of the common benefit of keeping inflation at a low and stable level. So far, medium-term household expectations are still at levels (around 3°%) incompatible with the definition of price stability.

Figure of the week

5.4%

Source : ECB

The increase in wages expected by companies over the next 12 months according to an ECB survey. In addition, firms anticipate a 6.1% increase in their selling price.

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Topic of the week

EM Sovereign Debt 5.0: Nature and Climat

The high climate vulnerability of developing countries, as well as their great difficulties in repaying their debts, pose a threat to global financial stability. However, there is a strong push from international financial institutions as well as private actors to introduce nature and climate into emerging sovereign debt.

Still very insufficient funding at global level

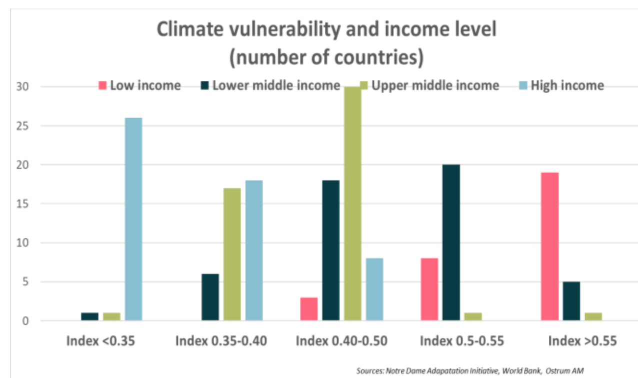
Meeting the Paris Agreement's 1.5°C target (and adaptation targets) requires between $3 trillion and $6 trillion annually until 2050 (according to Mobilizing Private Climate Financing in Emerging Market and Developing Economies, IMF, July 27, 2022) while the current level of investment is only $632 billion. In addition, investments in developing countries must be multiplied by 4 or 8 by 2030.

The amounts mentioned at COP 27 are also very far from these objectives. The United Nations has promised a $3.1 billion plan to strengthen countries' ability to prepare for dangerous weather. The V20 (the club of countries most vulnerable to climate change) and G7 also launched the "Global Shield against Climate Risks", with Germany contributing 170 million euros (179 million dollars). So, we are still very far from the funding needs to achieve the objective, when there is an emergency, especially for poor countries.

A triple crisis for poor countries

Climate crisis…

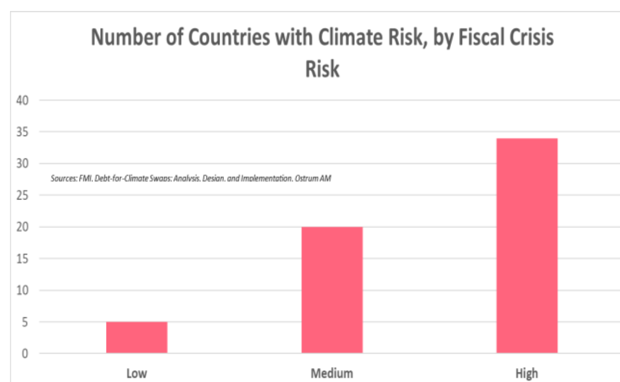
Poor countries are the most vulnerable to the consequences of climate change. The graph below shows climate vulnerability as a function of the country's income level. We take all available Notre Dame Adaptation Climate Vulnerability Initiative (ND) indices and rank countries according to their income level according to the World Bank classification. The higher the ND index, the higher the climate vulnerability of countries.



High-income countries are the least vulnerable to climate change with a ND index below 0.35. Low-income countries are based on an index above 0.5, which is characteristic of high climate vulnerability.

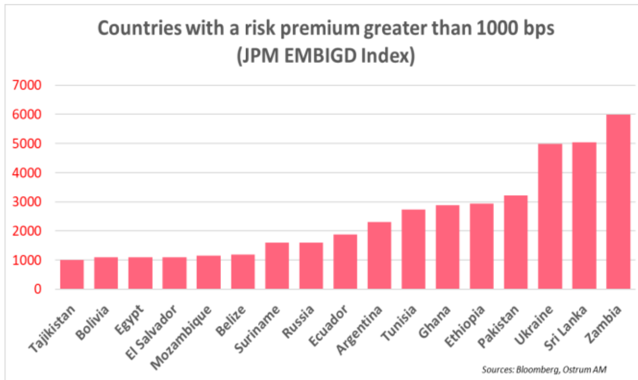
…And the Covid-19 and debt crisis

Low-income countries are also often those that lack the capacity to invest because of their high levels of debt. Covid-19, the Fed's aggressive monetary policy tightening and the war in Ukraine have exacerbated the fiscal position of many developing countries. The graph below ranks the 59 most vulnerable countries according to the International Monetary Fund, based on the risk of a fiscal crisis.



34 out of 59 countries most vulnerable to climate are thus at high risk of budget crisis, but represent only 0.5°% of global carbon emissions! The climate and the problems of debt sustainability are therefore correlated, but not necessarily causal. This simply highlights that many developing countries with a history of debt vulnerability are also the most vulnerable to climate change.

Several countries also no longer have access to capital markets to finance themselves. The chart below shows countries with a risk premium greater than 1000 bps in the JPM EMBIGD (dollar denominated debt) index.



Pakistan and Sri Lanka are two countries that are highly vulnerable to the consequences of climate change, deteriorating their sovereign credit risk. Both countries are in default.

Deadlock of restructuring negotiations and financial support

To help these countries regain fiscal room, the G20 established the Debt Service Suspension Initiative (DSSI) between May 2021 and December 2021. This initiative has benefited 47 countries for $12.9 billion. This has come to an end and should be replaced by the New Common Framework for restructuring the debt, which is slow to be implemented. Only three countries have formally requested debt restructuring: Zambia, Ethiopia, and Chad. This new debt restructuring framework also faces a major challenge in coordinating creditors, particularly with China, the leading creditor of low-income countries. Ethiopia owes 17°% of its GDP to China, 23°% to Zambia, 11.6°% to Pakistan and nearly 10°% to Sri Lanka. Under the G-20 common framework for restructuring the debt of poor countries, China's guarantee is a prerequisite for the disbursement of IMF financial support. It is in this difficult context that interest in debt-for-nature-swaps has increased.

A renewed interest in the debt-for-nature swaps

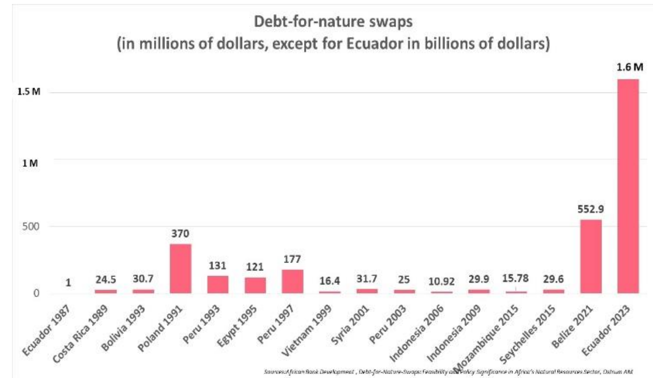
The idea of simultaneously solving the debt and climate crisis seems to be emerging, generating renewed interest in debt-for-nature swaps.

The principle

Debt-for-nature swaps are normally negotiated as part of the restructuring of public debt and long-term public debt guaranteed to official bilateral creditors, such as members of the Paris Club. Debtor countries are eligible if they are heavily indebted (according to IMF standards), if they have exhausted other more favorable debt relief instruments (for example unconditional debt relief), and if they can convince creditors that they are able of allocating a sustainable part of the resources, that have been budgeted for debt repayment, to the financing of important environmental projects at the national, regional or global level.

Debt-for-nature swap: an integral part of debt restructuring in Latin America

The debt-for-nature swap began in the 1980s, during the Latin American sovereign debt crisis. The chart below shows debt swaps with a significant amount since the late 1980s.



Of the 140 swaps entered since 1987, only 3 have a value of more than $250 million. The average size is $26.6 million.

Belize's 2021 debt-for-nature swap is interesting to mention because it is the first multiparty debt swap. It included the Government of Belize, the Government of the United States, and the Nature Conservancy (TNC), US Development Finance Corporation (USDFC), and private creditors who held the sovereign bond in default of face value of $553 million, (about 30 percent of Belize's GDP!).
Using a "blue bond" issued on the capital market, a TNC subsidiary had arranged a "blue loan" to the Government of Belize to finance a bond swap with a 55 cents per dollar nominal discount. About 85°% of the debt holders had accepted the offer, but through a class action clause, the debt was fully exchanged.
For its part, Belize agreed to use part of its debt relief to pre-finance an endowment of $23.4 million to support the conservation of the seabed.
The country has also committed $4.2 million a year to marine conservation and to expand its protected ocean area by approximately 16°% to 30°% by 2026. Following the transaction, the S&P rating agency raised Belize's external sovereign rating to B-, previously lowered to "Selective Default". The improved sovereign rating had also enabled Belize to borrow on the capital markets at a lower borrowing rate in dollars.

Ecuador: the world's largest debt-for-nature swap !

Ecuador concluded the largest swap of $1.6 billion on 9 May. The new blue bond of $656 million, issued by GPS Blue Financing DAC, with a maturity of 2041, allows Ecuador to

pay a coupon of 5.645°%, with a $85 million credit guarantee from the Inter-American Development Bank and $656 million against the political risks of the U.S. International Development Finance Corp. (DFC). Note that the new “blue bond” has a yield well below an Ecuadorian bond of the same maturity (equator 1.5°% maturity 30/07/2041) whose yield is above 18%!

This allows Ecuador to save $1.13 billion in debt service over the next 17 years, including $473 million invested in conservation and sustainable activities. Ecuador holds $16 billion in bonds that will mature in 2030, 2025 and 2040. The rating agency Moody’s has assigned the rating of AAA- to the new “blue bond” which is 16 steps above the current sovereign rating of Ecuador!

Debt-for-nature swap : the solution for solvency problems?

A minimal budget impact…

According to the African Development Bank, debt-for-nature swaps have historically had a minimal fiscal impact on the countries concerned. Since 1987, the nominal value of the debt treated globally by swap is only about 3.7 billion dollars (excluding Ecuador), of which only 318 million dollars for Africa. African countries will have to repay around $242.8 billion in debt service by 2028.
In addition, the study of the International Monetary Fund, Debt-for-Climate Swaps: Analysis, Design, and Implementation, shows that when a country’s debt is sustainable, Debt-for-nature swaps are less effective than just climate action through conditional grants, as swaps subsidize non-participating creditors.
Belize, for example, is the exception. The debt-for-nature swap did not fully restore the sustainability of the country’s debt, but it did remove the only bond that accounted for 30°% of its GDP, in exchange for a smaller bond with significantly larger fiscal margins than before.

… And a difficult implementation

As the two examples from Belize and Ecuador show, the organization of debt-to-nature swaps is constraining. This requires concerted efforts across government and very thorough preparations: strong pre-feasibility studies, strong fiscal capacity, commitment to transparency and international credibility of domestic spending program that is attractive to the whole of government. However, the debt-for-nature swap can play an important role in integrating the environment into government policies and national environmental financing.

… But debt-climate swaps can be useful instruments when the main constraint on climate investment is the lack of fiscal room.

In such cases, standard climate finance (green loans or government bonds) will not solve the solvency problem of countries, as it would increase indebtedness. Instead, promoting investment to address the consequences of climate change requires fiscal transfers. These could take the form of climate-conditional subsidies, climate-debt swaps, or global debt. Debt-for-nature swap can also be effective when the consequences of climate change threaten sovereign risk, as in Pakistan and Sri Lanka.

… And allow for concessions from creditors

The debt-for-nature swap has an important potential to obtain concessions from private sector creditors. When a country needs comprehensive debt restructuring, climate-debt swaps could encourage reluctant creditors to participate in debt relief, while attracting new players into the development finance system.

Conclusion

Faced with the deadlock in debt restructuring negotiations and financial support for poor countries, the debt-for-nature swap has generated renewed interest from both multilateral and private lenders. These instruments were an integral part of Latin American debt restructuring. Their implementation is constraining and the budget impact is minimal. However, the debt-for-nature swap makes it possible to obtain concessions from reluctant creditors and brings new players into the development finance system. The debt-for-nature swap can also be useful instruments when the main constraint for climate investment is the lack of fiscal room. They will probably be only part of the solution to the current triple crisis in poor countries.

Zouhoure Bousbih

Market review

Hawkish turn before summer

Western central banks are taking a more restrictive stance, unlike the BoJ and the PBoC. In this context, the performance of risky assets sounds like a challenge to central banks.

Monetary tightening is entering a second phase. The Fed and the ECB, far from really considering a pause, have joined the hawkish stance reinstated by the BoC and the RBA a few weeks ago. The BoE should follow suite given the latest labor market data. On the other hand, the PBoC is taking stock of the fragility of Chinese growth by easing its monetary policy and the Bank of Japan still doubts the sustainability of the pickup in Japanese inflation. The financial markets seem to be withstand the tensions in short-term interest rates. Equity markets are posting weekly gains of 2°% in the euro area. The Nasdaq (+4°%) and the main US technology stocks (+5°%) once again rose sharply. The Japanese Nikkei benefits from the relapse in the yen which depreciated beyond 141 against the US greenback. Growth stocks are clearly benefiting from the inertia of long-term bond yields, which seem insensitive to the rhetoric of Western central banks. The bull run in equities is taking place in an environment of particularly low volatility. The fall in the US dollar is also igniting a relief rally in industrial raw materials, which are nonetheless faced with economic sluggishness in China.

The Federal Reserve observed the expected status quo in June, but its economic forecasts and interest rate projections should have led immediate action on the Fed funds rate. The Fed forecasts 1°% growth year-over-year in 4Q 2023, i.e., 0.6°pp more than in March. The resilience of the labor market also led the FOMC to lower its unemployment rate forecast to 4.1°% at the end of the year. Finally, core inflation will turn out to be stronger, reaching 3.9°% in 4Q 2023. In addition, no member of the Fed plans to cut interest rates this year and the median path now includes 50 bps of tightening in the second half. Jerome Powell is implicitly indicating that the Fed will not react to the mechanical fall in inflation while wages and household price expectations remain inconsistent with the 2°% target. In the euro area, the ECB thus raised rates by 25 bps, preannounced another hike next month and confirmed the end of APP reinvestments from July. This decision will lead to a contraction of the balance sheet the tune of €148 billion over six months. In turn TLTRO repayments planned between June and December will amount to €607 billion. In addition, core inflation forecast comes out at 5.1°% on average in 2023 and 3°% in 2024. These forecasts have been raised by 0.5pp since March and probably foreshadow an additional rise in September. The deposit rate would be displayed at 4°%. In this context, the situation appears untenable for the BoE given the latest wage figures. Markets are pricing in hikes at every meeting through December. The publication of the CPI on the eve of Thursday's MPC could even raise the high point of the monetary cycle further. Conversely, Kazuo Ueda remains in denial about inflation. The BoJ's pain threshold to change the YCC seems out of reach so that market participants prefer selling the yen to short positions on Japanese government bonds.

The announced tightening only accentuated the inversion of yield curves. The US 10-year is hovering around 3.75°%, or nearly 100 bps below the 2-year level. The yield on the 30-year T-bond even fell over the past week. The inertia of long rates testifies to the credibility of the Fed regarding the objective of price stability. However, break-even inflation (2.51°%) widened by 5 bps with the rebound in commodities and the 1.5°% drop in the dollar. In the euro area, the inversion of the yield curve is still significant, so that the Bund yields struggle to stay about 2.50°%. At the same time, we observe a sharp narrowing in swap spreads and even more so in sovereign bond spreads. The 10-year BTP plunged below 160 bps against Bunds after a very solid BTP Valore issuance enabling the Treasury to raise €18 billion from Italian households. This source of financing is welcome at a time when the Italian government cash deficit is dangerously rising. BTPs are thus making up for the previous underperformance vis-à-vis Greece and other peripheral debt.

The equity and credit markets are very well oriented to the point of wondering whether current central bank policies are really restrictive at this stage. Risk aversion appears to be very low given that implied volatility trades around 15°%. Flows invested in equities remain favorable to US large caps, particularly technology stocks, which are driving the Nasdaq ever higher. In Europe, the rebound in the euro-dollar exchange rate and mediocre equity fund flows are slowing the performance of European indices. In the eurozone, credit spreads narrowed by more than 5 bps to 96 bps in terms of asset swap. Valuations remain attractive on credit unlike high yield where recent performance has significantly compressed yield premia on the lowest ratings. However, the low default rate and low volatility are still fueling carry strategies. Risk appetite is allowing the gradual reopening of the AT1 market, shaken by Credit Suisse.

Finally, on the foreign exchange market, the Fed's communication supported risky assets more than the greenback. This barometer of risk aversion fell by 1.5°% in favor of most developed currencies with the exception of the yen. The yuan is penalized by monetary and fiscal stimulus announcements in China.

Axel Botte

Main market indicators

G4 Government Bonds	19-Jun-23	1wk (bp)	1m (bp)	2023 (bp)
EUR Bunds 2y	3.15%	+24	+39	+39
EUR Bunds 10y	2.51%	+12	+8	-6
EUR Bunds 2s10s	-64.3bp	-11	-31	-44
USD Treasuries 2y	4.71%	+14	+45	+29
USD Treasuries 10y	3.76%	+3	+9	-11
USD Treasuries 2s10s	-95.5bp	-11	-36	-40
GBP Gilt 10y	4.45%	+11	+45	+78
JPY JGB 10y	0.4%	-3	-2	-14
€ Sovereign Spreads (10y)	**19-Jun-23**	**1wk (bp)**	**1m (bp)**	**2023 (bp)**
France	51bp	-1	-5	-3
Italy	160bp	-7	-20	-53
Spain	92bp	-3	-13	-16
Inflation Break-evens (10y)	**19-Jun-23**	**1wk (bp)**	**1m (bp)**	**2023 (bp)**
EUR 10y Inflation Swap	2.53%	+12	+10	-2
USD 10y Inflation Swap	2.54%	+3	+6	+1
GBP 10y Inflation Swap	3.89%	+8	+21	-2
EUR Credit Indices	**19-Jun-23**	**1wk (bp)**	**1m (bp)**	**2023 (bp)**
EUR Corporate Credit OAS	159bp	-5	-13	-8
EUR Agencies OAS	74bp	-3	-8	-5
EUR Securitized - Covered OAS	83bp	-1	-8	-1
EUR Pan-European High Yield OAS	443bp	-22	-65	-69
EUR/USD CDS Indices 5y	**19-Jun-23**	**1wk (bp)**	**1m (bp)**	**2023 (bp)**
iTraxx IG	76bp	-2	-7	-15
iTraxx Crossover	398bp	-12	-36	-76
CDX IG	69bp	-2	-10	-13
CDX High Yield	436bp	-7	-57	-48
Emerging Markets	**19-Jun-23**	**1wk (bp)**	**1m (bp)**	**2023 (bp)**
JPM EMBI Global Div. Spread	445bp	-11	-43	-7
Currencies	**19-Jun-23**	**1wk (%)**	**1m (%)**	**2023 (%)**
EUR/USD	$1.092	1.534	1.083	2.0
GBP/USD	$1.281	2.406	2.933	6.0
USD/JPY	JPY 142	-1.586	-2.728	-7.6
Commodity Futures	**19-Jun-23**	**-1wk ($)**	**-1m ($)**	**2023 (%)**
Crude Brent	$76.6	$4.8	$1.1	-8.4
Gold	$1 949.1	-$8.8	-$28.8	6.9
Equity Market Indices	**19-Jun-23**	**-1wk (%)**	**-1m (%)**	**2023 (%)**
S&P 500	4 410	2.58	5.19	14.8
EuroStoxx 50	4 375	1.36	-0.46	15.3
CAC 40	7 339	1.23	-2.04	13.4
Nikkei 225	33 370	2.89	8.32	27.9
Shanghai Composite	3 256	0.84	-0.84	5.4
VIX - Implied Volatility Index	14.05	-6.40	-16.42	-35.2

Source: Bloomberg, Ostrum AM

Additional notes

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