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Emerging market bond spreads and sovereign credit ratings: reconciling market views with economic fundamentals

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Abstract

This paper uses a panel data estimation of a simple univariate model of sovereign spreads on ratings to analyze statistically significant differences between actual spreads and ratings-based spreads. When such deviations are significant, we find that 'excessively high' spreads are on average followed by episodes of spread tightening 1 month later rather than credit downgrades. In contrast, observations with 'excessively low' spreads are on average followed by rating upgrades 3 months later rather than episodes of spread widening. The paper also illustrates how significant disagreements between market and rating agencies' views can be used as a signal that further technical and sovereign analysis is warranted. For instance, we find that spreads were 'excessively low' for most emerging markets before the Asian crisis. More recently, spreads were 'excessively high' for a number of emerging markets.
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1. Introduction

For emerging market sovereign borrowers, bond spreads over comparable US Treasuries are an indicator of the cost of capital at which they can access international

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capital markets. Investors also use sovereign spreads as an indicator of sovereign risk and as a tool to gauge market assessment of a country's economic and political fundamentals. In fact, sovereign spreads are a function of the probability of default and the recovery rates in case of default. In addition, they depend on interest rate and currency risk as well as technical factors such as trading liquidity conditions and changes in the investor base for a particular country's bonds.

Similarly, sovereign ratings convey analysts' views of a country's economic and political risk variables. Rating agencies view ratings as providing a forward-looking indication of the relative risk that a debt issuer will have the ability—and willingness—to make full and timely payments of principal and interest over the life of a particular rated instruments. The agencies, however, do not regard their ratings as providing either a prediction of the timing of default or an indication of the absolute level of risk associated with a particular financial obligation.

There is also evidence that sovereign ratings are key determinants of the pricing of sovereign bonds and that sovereign spreads incorporate market participants' views of expected credit rating changes (Erb et al., 2000). In particular, trading strategies based on anticipations of the rating cycle are commonly used by market participants seeking to exploit profit opportunities. Furthermore, since investment restrictions are often based on credit ratings especially for institutional investors, portfolio managers monitor credit rating changes closely. Similarly, financial regulators incorporate ratings in forming prudential requirements for banks.[1]

Empirical studies find that sovereign ratings are generally consistent with economic fundamentals. For instance, Cantor and Packer (1996) using ratings from Moody's and S&P's on 49 countries as of September 1995 find that high ratings were associated with high per capita income, low inflation, more rapid growth, a low ratio of foreign currency external debt to exports, the absence of a history of default on foreign currency debt since 1970, and a high level of economic development (as measured by the IMF's classification as an industrial country). In a follow-up study, Juttner and McCarthy (1998) find that the factors identified by Cantor and Packer continued to adequately explain the ratings in 1996 and 1997, but this relationship broke down in 1998, in the wake of the Asian crisis. For 1998, additional variables appeared to have come into play—notably, problematic bank assets as a percent of GDP and the interest rate differential.

The relationship between sovereign ratings and spreads can help compare sovereign spreads on a rating-adjusted basis. It can also be used to contrast market views of a country's economic and political fundamentals with rating agencies' assessment of the same variables. This paper studies the relationship between emerging market sovereign spreads and ratings on their long-term foreign currency denominated debt in order to develop a simple framework for the monitoring of market and rating agencies' views on emerging markets. Unlike most studies which use cross-section analysis, this paper uses panel data estimation to exploit the cross-sectional and time series dimensions of secondary market sovereign spreads and ratings.

[1] See Oxford Analytica, April 3, 2002 for a good discussion of sovereign spreads and ratings.

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