Investment **Research**

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Euro funding more enticing for EM corporates

ECB's QE favours euro denominated debt issuance in EMs

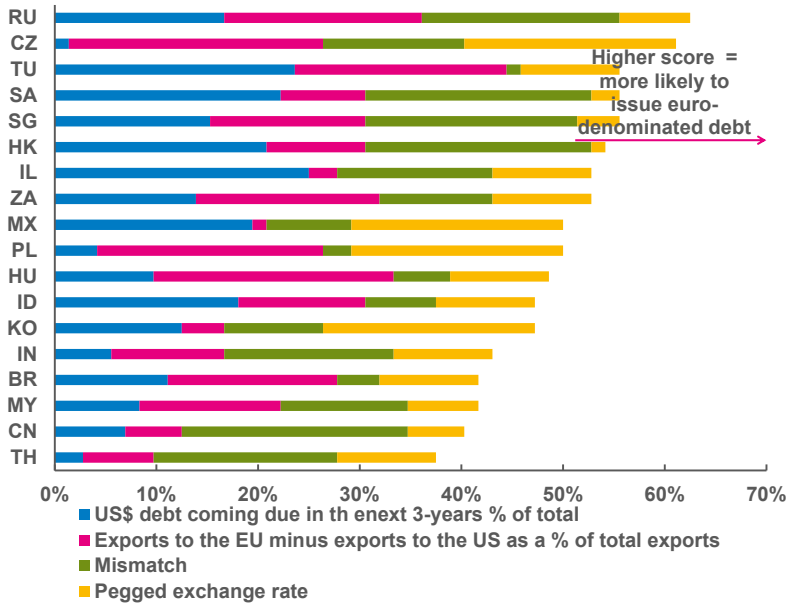
Key points

- US monetary policy is on a tightening mode, contrary to that of the euro area, implying that euro funding would be cheaper for EM corporates relative to dollar funding.
- A low share of euro-denominated debt in total EM corporate debt is hinting that there is room for developing this market segment.
- Monetary policy divergences between the US and the euro area, EM exports shipped to the EU relative to the US; existing currency mismatch and global risk are among the most important factors in determining whether to issue EM corporate debt in euros or in dollars.
- The collapse in euro yields presents the opportunity to EM borrowers to issue euro denominated debt, locking-in material debt servicing cost savings.
- Eastern European economies are more likely to issue debt in euros rather than economies in emerging Asia. A high share of exports shipped to the euro area and low mismatching make the Czech Republic, South Africa, Russia and Turkey the most likely candidates for issuing euro debt.
- Within investment grade, the savings are highest for Asia, followed by Latam and then Middle East and Africa (MEA). Exports shipped to the euro area trump the financial arbitrage and make MEA one of the regions with a high propensity score to borrow according to our analysis.

Exhibit 1

Scoring the EM class

Scoring the ability/willingness to issue euro-denominated corporate debt by country and factor, 2014



Source: Datastream, Institute of International Finance (IIF), IMF, Bloomberg and AXA IM Research

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ECB/Fed's monetary policy in multiple tracks

Central banks in developed economies had to step up monetary policy stimulus in order to boost economic activity during the Global Financial Crisis (GFC). The US Federal Reserve (Fed) was the first to phase in unconventional monetary policy, triggering a surge in global liquidity that landed in emerging markets (EMs) in search for yield. The European Central Bank (ECB) launched its Public Sector Purchase Programme (PSPP) in 2015 when the Fed had completed tapering its asset purchases. The first fed fund rate hike in December '15 only confirmed that the two economies are different in terms of monetary policy orientation.

The Fed-ECB divergence implies that euro liquidity is becoming more attractive than dollar liquidity, as euro area rates decrease and US rates increase. As yet, the ECB's verbal communication implies that its PSPP will be extended until March 2017 with a possible extension by six to nine months, pending the outcome of the September 2016 review of the programme's modalities. If this is the case, the divergence between the US and the euro area would widen, while euro liquidity would be even cheaper than dollar liquidity. The purpose of this report is to examine whether EMs will seize the opportunity and replace the more expensive dollar funding with euro-denominated bonds.

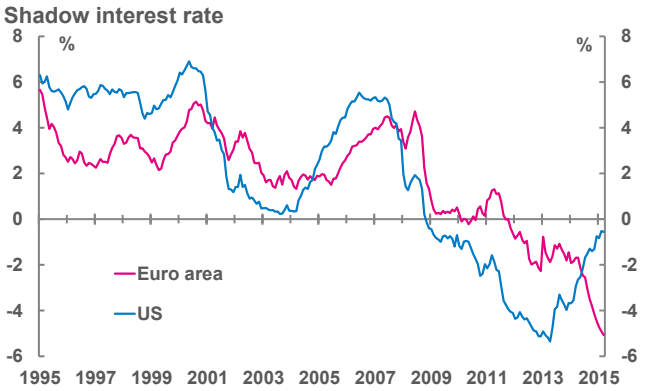
Monetary divergences and a low starting point

Two features suggest that EMs will issue more debt denominated in euros going forward. First, monetary policy in the US is on a normalising mode, contrary to that of the euro area, implying that dollar borrowing will become more expensive than euro borrowing. Economists have devised the shadow interest rate concept, which is the hypothetical short-end of the yield curve if there was no zero lower bound. In other words, the shadow interest rate answers the question: if interest rates were allowed to take negative values, how negative should they become in order to generate the same impact on economic activity as an increase in the central bank's balance sheet? We see in *Exhibit 2* the diverging paths of the shadow interest rate of the US and the euro area in relation to the world. The US shadow interest rate trends north and that of the euro area south. If the ECB's PSPP is to be extended beyond March '17, this divergence in trends would continue.

According to IMF's research[1], global factors proxied by the shadow interest rate in developed economies is a key determinant of the change in the post-GFC probability of EM debt issuance. For EM corporates, for example, the shadow interest rate is a more important determinant of debt issuance relative to firm specific characteristics such as outstanding leverage and profitability. The divergence in the shadow interest rate was insignificant in the pre-GFC period.

Exhibit 2

Monetary policy in the shadows

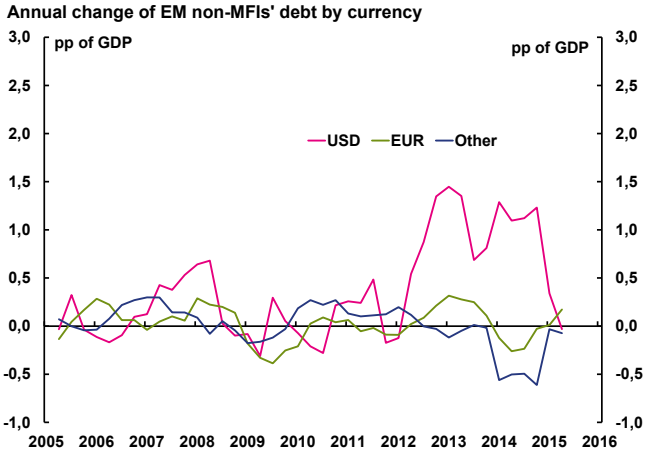


Source: IMF and AXA IM Research

Diverging monetary policies among developed economies had an impact on the dynamics of the currency of issuance of EM debt. The annual growth of EM corporate debt issued in euros is currently on the rise, while that in local currency and dollar is sliding (*Exhibit* 3). The reverse held in the run up to the May 2013 market tantrum episode triggered by the looming Fed tampering.

Exhibit 3

Euro-denominated corporate debt issuance is rising



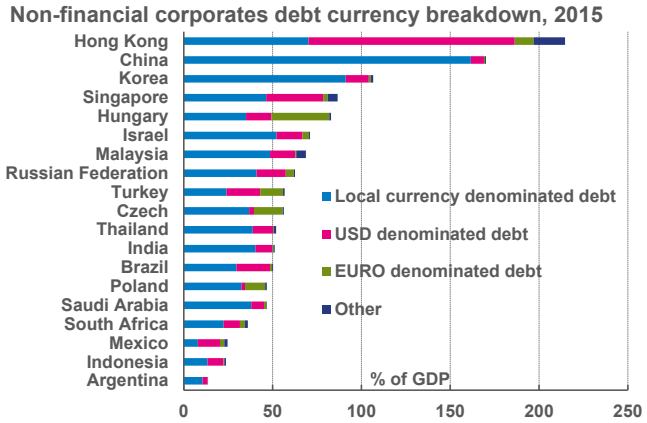
Source: IIF and AXA IM Research

Second, the share of euro-denominated debt in total EM corporate debt is low, hinting that there is room for developing this market segment. Indeed, for most countries, it is either local currency or the dollar which are the principal currencies of EM corporate debt issuance (*Exhibit 4*). It is only for the EU-member EMs where the share of euro-denominated debt exceeds that of dollar-denominated debt. Euro area membership aspiration and close trade relations most likely explain this finding.

[1] Global Financial Stability Report, IMF, October 2015.

Exhibit 4

EM non-MFIs' debt by currency



Source: IIF and AXA IM Research

Factors determining the currency of debt issuance

We distinguish the factors determining the currency of EM debt issuance into push and pull factors. Push factors are the exogenous or global factors that dictate global risk perceptions. The shadow interest rate is in that group. Pull factors include country-specific factors. This group includes factors such as the share of total exports shipped to the US relative to the euro area. The higher the share of exports shipped to the US, the higher the stream of dollar denominated income that could be used in order to refinance maturing dollar debt. Another factor is the foreign exchange arrangement a country has. For example, a country which has its currency pegged to the dollar is more likely to issue dollar debt rather than in euros as its foreign exchange reserves have to be in dollars in order to support the peg. Other pull factors include the currency match or the alignment between foreign currency assets and liabilities. If the latter is higher than the former, the country is unlikely to issue more foreign exchange currency liabilities. Finally, the percentage of dollar denominated debt that is coming due in the medium to long term (next three years) is another pull factor. A high percentage of debt would imply that if the euro area interest rates are becoming lower than US rates, indebted entities would prefer to rollover the maturing dollar debt to euros.

According to our calculations[2], the relative shadow interest rate between the euro area and the US, the share of EM exports shipped to the EU relative to the US, the currency mismatch and the spread of the US corporate BBB spread are able to explain almost 70% of the variation of the change in the EM debt issuance in euro, relative to the dollar. Unfortunately, we did not have a time series for neither the share of the dollar-denominated EM debt maturing in the medium to long term (next three years) and the currency decomposition of the total EM debt, nor the foreign exchange regime of the various EMs.

We assess the ability/willingness of each EM to issue debt in euros on the basis of the scorecard appearing in *Exhibit 1.* The scorecard includes the country-specific factors found to explain almost 70% of the variability in the quarterly change of the difference between the euro-denominated debt and dollar-denominated debt. We assume that the sensitivity of each country to the global factors proxied by the US corporate BBB spread and the quarterly change in the relative shadow interest rate between the euro area and the US is the same.

The chart illustrates the score each country achieves at each of the listed areas: the share of the dollar debt coming due in the next decade, the share of each country's exports shipped to the euro area relative to those shipped to the US, the mismatch index[3] and the peg index [4]. Every country is ranked in ascending order by each variable and the total score is calculated as the sum of the ranking each country achieves by each variable. The higher the total score, the more likely it is that the country under consideration will issue debt in euros. The score is expressed as a percentage of the highest score each country could have achieved (18 countries x 4 indicators = 72).

We see that Eastern European economies are more likely to issue debt in euros rather than economies in emerging Asia. Within the Central Eastern European/Africa/Middle East region, the Czech Republic, South Africa, Russia and Turkey are the most likely candidates for issuing euro denominated debt. A mix of high share of exports shipped to the euro area and low mismatching characterises these economies. In emerging Asia it is mainly Singapore and Hong Kong. Latin America (Latam) is not expected to raise euro denominated debt en masse given the higher mismatch and the low share of exports shipped to the EU relative to the US.

Funding arbitrage for EMs in euro

Even amid the global trend towards lower rates, the collapse in EUR credit yields has been impressive from 7 to 8% in 2009 to below 3% today. This presents the opportunity to non-EUR borrowers to issue debt in EUR and lock-in material savings in terms of debt servicing

[2] We estimate a model of the quarterly change of the deviation of the EM corporate debt issued in euro from the debt issued in dollar (in % of GDP) determined by the quarterly change in the deviation of EM exports shipped to the euro area from the EM exports shipped to the US as % of total exports; the quarterly change in the difference between the euro area shadow interest rate and that of the US; the US corporate BBB spread; the quarterly change in the stock of EM corporate debt, and the quarterly change of the mismatch index we have developed in Davradakis, M. and Venizelos G. (2015), "Pulling the punch bowl away from Emerging Markets", AXA IM Research, 28 July 2015. Quarterly data were retrieved from the IIF, Datastream, IMF and Bloomberg spanning 2005-2015. Data were checked for unit roots and stationarity was achieved by taking first differences. Estimated coefficients were all statistically significant at the 5% significant level with the anticipated signs. The overall R^2 was 65%.

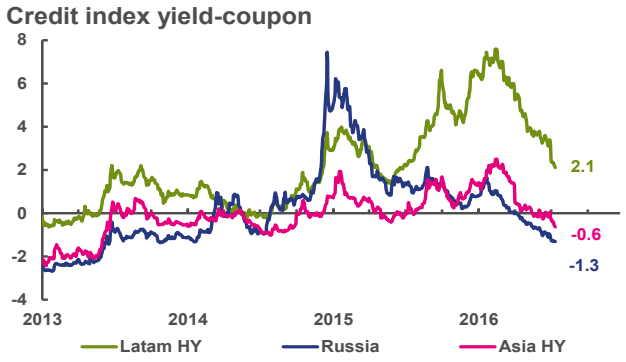
[3] Davradakis, M. and Venizelos, G. (2015), op. cit. p. 3. Positive (negative) values imply that foreign currency assets are higher (lower) than foreign currency liabilities. Higher values imply a lower mismatch.

[4] A country takes a score from one (no separate legal tender) to ten (free floating) subject to the IMF's characterization of the country's foreign exchange arrangement which could be no separate legal tender; currency board; conventional peg; stabilized arrangement; crawling peg; crawl-like arrangement; pegged exchange rate within horizontal bands; other managed arrangement; floating and free floating.

costs even after hedging has been accounted for. This is particularly important to those areas of credit where the market currently prices borrowing costs above those of existing debt, like in the case of Latam HY (*Exhibit 5*). Indeed, we consider here emerging markets across regions and ratings in terms of hard currency debt.

Exhibit 5

Latam HY index yield-to-coupon differential remains elevated



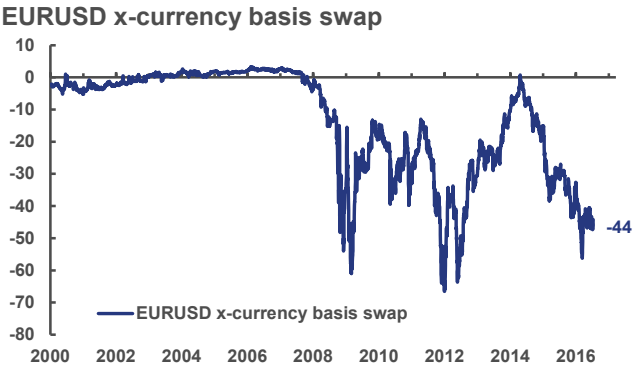
Source: Bloomberg, BAML and AXA IM Research

In order to estimate the savings in borrowing costs, we need to convert the market pricing from one base currency to another. A simple way to do this is to assume that the borrower will have to pay the same spread over govies as in its 'native' currency – in the case of hard currency EM this is predominantly USD. We then add this spread to Bund yields to obtain the borrowing cost in EUR, before FX hedging costs.

The last step is to add FX hedging costs via the cross currency basis swap spread between EUR and USD. This is not negligible, given that the EURUSD cross currency basis has declined markedly over the ECB's QE (*Exhibit 6*). *Exhibit 7* below shows the relevant figures across EM regions and by rating category. The key quantities in *Exhibit 8* are the borrowing cost in USD, that in EUR and the associated saving, as shown. Within IG, the highest saving is in Latam, followed by Asia and then Middle East and Africa (MEA), all above 1%. MEA is one of the regions that our earlier analysis flagged as having a high propensity to borrow in the euro market, along with Central and Eastern Europe (CEE), where the saving is also material at 0.7%.

Exhibit 6

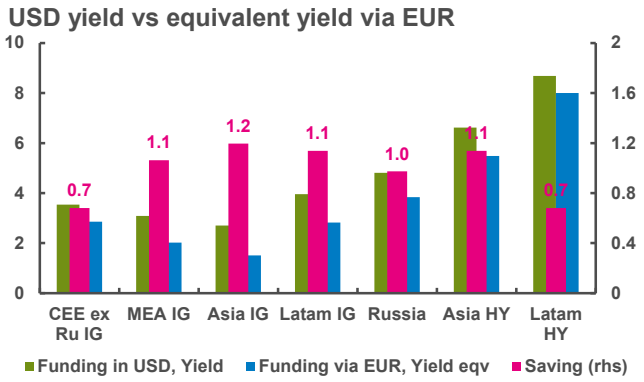
ECB QE has widened the €-$ x-currency basis markedly



Source: Bloomberg and AXA IM Research

Exhibit 7

Substantial borrowing cost savings from USD to EUR across EM regions and by rating



Source: Bloomberg, BAML and AXA IM Research

In our separate piece about corporate leverage[5], we stress tested corporate debt affordability under adverse top line scenarios. Funding in euro at cheaper levels could prove a useful avenue for raising the affordability headroom, were such adverse scenarios to materialise.

[5] Ghotgalkar, V., "Rising corporate leverage….'", AXA IM Research, 18 July 2016

Exhibit 8

Borrowing cost savings' estimates between dollar and euro credit markets including currency effects

	A	B	C	D	E	F	G	H	J	K	L
					Funding in USD			Basis swap	Funding via EUR		Saving
	Coupon	Duration	Spread		Yield	Yield-coupon	Bund yield	EURUSD	Yield equival.	Yield/ coupon	(rhs)
	%	Years	bp	bp	%	%	%	bp	%	%	%
				Duration adjusted			Duration matched				
				C/B		E-A			G+C-H	J-A	E-J
CEE ex RU IG	4.9	4	303	76	3.5	-1.4	-0.67	-44	2.8	-2.1	0.7
MEA IG	4.4	5	212	43	3.1	-1.3	-0.59	-45	2	-2.4	1.1
Asia IG	3.9	5	164	33	2.7	-1.2	-0.59	-45	1.5	-2.4	1.3
Latam IG	5.1	7	272	39	3.9	-1.1	-0.44	-46	2.7	-2.3	1.2
Russia	6.1	3.8	402	105	4.8	-1.3	-0.67	-44	3.8	-2.3	1
Asia HY	7.3	3.2	564	175	6.5	-0.7	-0.71	-42	5.4	-1.9	1.2
Latam HY	6.6	4.6	799	173	8.6	2	-0.59	-45	7.8	1.3	0.8

Note: IG: Investment Grade; Latam: Latin America; HY: High Yield - Source: Bloomberg, BAML and AXA IM Research

Country codes used in the text

CZ: Czech Republic; ZA: South Africa; RU: Russia; TU: Turkey; PL: Poland; SG: Singapore; HU: Hungary; HK: Hong Kong; IL: Israel; SA: Saudi Arabia; ID: Indonesia; MX: Mexico; KO: South Korea; IN: India; BR: Brazil; MY: Malaysia; TH: Thailand and CN: China.

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