Country Risk / Financial Markets / Global Economy

Will sovereign risk premiums continue to fall?

Expansión (Spain)

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IN RECENT MONTHS WE HAVE WITNESSED A NOTABLE COMPRESSION IN SOVEREIGN CDS AT THE GLOBAL LEVEL, IN AN ECONOMIC SCENARIO THAT IS FULL OF UNCERTAINTY AND IN WHICH PUBLIC DEBT IS AT AN ALL-TIME HIGH.

The global median of sovereign CDS prices —which reflect the cost of securing against the risk of sovereign bond default— has reached its lowest level since the end of 2007, reaching levels not seen since 2009 in Greece and since mid-2008 in Portugal, before the sovereign debt crisis broke out in the EU. Spain's sovereign CDS is also very low, but it had already reached similar levels in early 2018. In any case, based on CDS prices, the financial markets appear to indicate that the European sovereign debt crisis is completely behind us.

Another case worth noting in the current scenario is the fact that Argentina's sovereign debt crisis has not spread to other sovereign markets. Over the past month, Argentina's rating has been through a series of downgrades and upgrades after it fell into a technical default when it announced that it would be postponing payments on its short-term debt, among other measures. Argentine CDS has skyrocketed, reaching levels associated with default, but this has not had the slightest impact on sovereign premiums in other Latin American countries. Furthermore, it has had no impact in any emerging country in general, where, similar to the global context, premiums remain at very low levels, even reaching all-time lows in several countries (Indonesia, Peru, the Philippines and Thailand).

These low levels in Latin America and emerging Asian countries are even more surprising when taking into consideration the current fiscal vulnerabilities in these regions. The fiscal indicators (balance sheets, public debt, etc.) in most of these countries are relatively high and/or worse than in recent years.

Theoretically, sovereign CDS premiums should reflect the market value of each country's sovereign risk. However, at present, these levels do not seem to reflect the current risk environment we are facing, which is marked by the worsening outlook for global growth, the arrival of worse macroeconomic data, greater political and geopolitical risks, and the worsening or stagnant fiscal vulnerabilities in many geographies, especially emerging countries.

In fact, the levels we are seeing clearly respond to investors' search for yield in an environment with very low and even negative rates due to increasingly lax monetary policies at the global level — a direct result of the slowdown in activity and the absence of inflationary pressures.

The sovereign risk assessment, which is implicit in any country's CDS premium, can be compared to the risk assessment by rating agencies (Moody's, S&P, Fitch) for that country, closer to that consistent with the sustainability risk of public debt. The difference between the two assessments gives us an indicator of the pressure exerted on the agencies by market perceptions to upgrade or downgrade the rating of that country. This great narrowing of sovereign spreads we are seeing has reduced global pressures to cut ratings and intensified pressures to improve ratings in general. This is particularly noticeable in most emerging European countries and countries on the periphery of the EU.

The answer to the question of whether these low levels of perception of risk will continue going forward, or whether they will return to levels in line with historical averages and, if so, when this will happen, must be open-ended given the current high level of uncertainty and the current backdrop of negative rates. However, it is worth remembering that, once these low levels have been reached, it is most likely that it will become increasingly difficult for the same downward trend to continue and for it to become easier for levels to start climbing. Thus levels would become more consistent with the risk levels suggested by macroeconomic fundamentals.

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