How do global investors differentiate between sovereign risks? The new normal vs the old

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Summary of the paper

Interesting and policy-relevant questions

1. When global investors decide to buy or sell emerging market bonds, how do they differentiate between the different economies?
2. Is there a 'new normal' since the 2008 Global Financial Crisis?
3. What economic fundamentals do investors consider important?

Summary of the paper

Key findings

- Global factors drive risk premia over time. The extent to which these spreads rise or fall depends on country-specific factors.
- Evidence of structural break (new and old normal):

Risk Factor	**Representation**	**Old Normal** (Jan 2004 – Aug 2008)	**New Normal** (May 2009 – Dec 2014)
First risk factor	Investor differentiation for advanced vs emerging economies	Dominant	More dominant
Second risk factor	Risk appetites of relatively conservative investors	Supporting role	Reduced supporting role

- While the emerging markets designation summarizes key aspects of sovereign borrowers, it lacks further granularity in the assessment of country specific fundamentals.

Comments and questions

Claim 1: **Use of CDS spreads as a measure of risk premia; determines the cost at which a country can raise funds abroad.**

Comments:

- Other country-specific granularities for sovereign debt markets also matters:
  - Currency denomination.
  - Composition of bondholders.
- Differences in CDS and bond spreads suggest that there may be other factors driving the divergence.

Claim 2: **First global risk factor is highly correlated with most global asset return variables. This suggests that investors who drive the sovereign risk market are also investors who drive other asset markets.**

Comments:

- Recent trends in emerging market sovereign bond and equity markets suggest a diverging trend. A ***new new*** normal?
  - Sustained non-resident demand for sovereign bonds despite volatility in equity markets.
  - Implication of low global interest rates on investors' preferences

Comments and questions

Claim 3: **Global investors do not seem to differentiate meaningfully between emerging markets, although they differentiate sharply between emerging markets and advanced economies.**

Comments:

- This highlights the perennial rift between emerging and advanced economy markets.
  - Risky vs safe haven
- As emerging markets are viewed as a bucket, this could indicate that the risk of contagion exists even for emerging markets that have relatively better fundamentals.
  - Even though an emerging market may have better fundamentals compared to the rest, global investors would shift from emerging market assets as a whole to 'safer' financial assets in advanced economies during periods of financial stress.

Claim 4: **Investors driving movements in sovereign spreads are those that tend to follow index tracking**

Comments:

- This implies implicit trade-off for emerging markets; inclusion to global bond indices facilitates deepening of domestic bond markets, but could lead to more volatile risk premia.
- Implications to domestic monetary and financial conditions would depend on overall structure of financial system.