International Commentary — June 14, 2024

Which EM Sovereign Credit Ratings Are Due For Adjustments?

Summary

In this report, we update our sovereign credit ratings framework and offer insight into which emerging market sovereigns could see notable adjustments to their credit ratings in the coming quarters. According to our analysis—which we believe may be more forward-looking relative to the major credit assessment agencies—Latin American sovereigns such as Chile, Colombia and Mexico could see negative ratings actions over the course of the next 12 months. We also believe China will potentially be downgraded, which could have ripple effects given China's importance to the global economy. And despite an electoral surprise in India, we continue to believe India can receive a rating upgrade as the nation's reform agenda and strong growth profile remain intact.

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Assessing Sovereign Credit Ratings

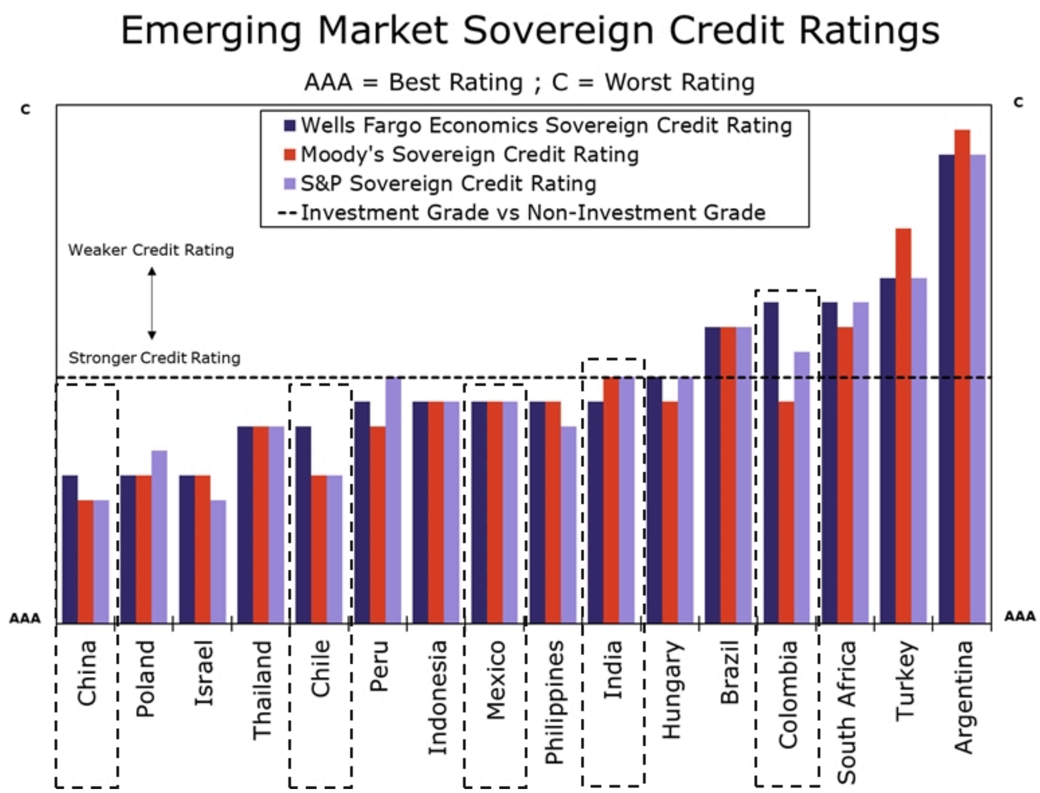
At the end of March we published a report outlining how we felt sovereign default risks across the developing world have receded. In that report, we highlighted how asset positions have improved, and how vulnerabilities and weaknesses in sovereign debt profiles have been reduced. The framework we used to assess sovereign default risks still identified nations where the probability of default was elevated, but our analysis indicated that another wave of sovereign defaults in the emerging and frontier markets was unlikely at this time. And going forward, if global growth remains solid and the U.S. dollar weakens as we expect, sovereign stress risks should remain limited for at least the next few years. While there is a degree of fundamental sovereign credit analysis embedded into our framework, we would not necessarily consider our sovereign default analysis to be a full creditworthiness assessment. We do, however, have a more robust framework that we consider to be a comprehensive creditworthiness analysis. We built this framework to get a sense of where domestic credit conditions are evolving as well as identifying which sovereigns could be moving closer to, or further away from, investment grade status. Our sovereign creditworthiness framework incorporates a more robust set of indicators and is designed to signal where credit ratings for larger emerging market sovereigns could be in the next 12 months. Our methodology for determining credit ratings is similar to the approach employed by rating agencies such as Moody's and S&P Global Ratings (S&P). Broadly speaking, indicators for assessing sovereign creditworthiness fall into four categories. These categories are: economic strength, financial resources & asset positions, political risk and institutional strength, and the composition of the sovereign debt profile. Each of these categories comprise multiple variables that, in aggregate, are representative of sovereign creditworthiness. As far as the individual variables that make up each category, the full set of indicators we incorporate to determine sovereign credit ratings are similar to the major ratings agencies, although our methodology does include indicators not employed by agencies. Our approach also excludes some variables used by agencies that we believe do not have a significant influence over sovereign creditworthiness.

In addition to the indicators in our framework, we overlay our methodology with discretionary judgment, especially where data may not have fully caught up to new economic or political realities. For example, we apply judgment to our assessment of political risk and institutional strength, and more specifically the governance and rule of law variables. While we use the World Bank's World Governance Indicators as a numerical starting point, the World Bank scores are updated on an annual basis, and in that sense can at times become dated. World Bank scores may not fully capture most recent political developments and any new risks to governance structures, especially around times of an election. To complement World Bank scores, we apply judgment to increase or decrease our political risk and/or institutional strength assessment to develop scores we believe are more timely and accurate. Political risk and institutional strength is up for interpretation, and the amount of judgment or the direction of judgment could explain a gap in the way we rate a sovereign versus how Moody's or S&P assigns their respective rating. Discretionary judgment could be a source of differentiation between our ratings and the agencies; however, the forward-looking nature when assessing each economic variable could also result in a gap between our rating and agency ratings. Not only could forecasts vary, but the way these forecasts act as an input into each analysis could also differ. Moody's and S&P incorporate forward-looking forecasts when assigning their credit ratings, and do not rely purely on historical performance or current conditions. However, we believe our methodology may be even more forward-looking. To that point, we utilize a rolling one-year outlook that is designed to consistently incorporate forecasts 12 months ahead of time. For example, in this analysis which covers the four quarters from Q3-2024, we incorporate 50% of the 2024 forecast for each variable and 50% of the 2025 forecast. If we were, for example, to update our analysis in a few months' time to cover the four quarters from Q4-2024, we would roll our calculations forward to include 25% of the 2024 forecast and 75% of the 2025 forecast. Using this approach to incorporate forecasts ensures that we are always dynamic, always forward-looking and always incorporating a view on potential future economic performance into the way we rate emerging market sovereigns. This methodology is slightly different from the approach employed by rating agencies, and is also likely to be a source of potential ratings differences.

Which Sovereigns Are Up For Ratings Actions?

For the most part, our sovereign credit rating framework assigns ratings that either match, or are broadly in line with, Moody's and S&P (Figure 1). To that point, of the 16 sovereigns we run through our framework, 4 match the ratings assigned by both Moody's and S&P (Thailand, Indonesia, Mexico, the Philippines). For most other sovereigns, our framework assigns a rating that matches either the S&P or Moody's rating, or at a minimum, is only 1 notch different. However, there are a few outliers where our framework flashes a notable difference relative to the agencies, and where we believe significant and notable rating actions could be forthcoming in the near future. Starting in Latin America, the first notable divergence worth highlighting is Chile. Our framework assigns a sovereign credit rating equivalent to Baa1 on the Moody's scale and BBB+ on the S&P scale, a two notch gap in a less creditworthy direction. Our framework assigns a weaker credit rating relative to the agencies as we expect Chile to experience more subdued growth, higher inflation as well as a further weakening of the sovereign's public finance position over the next few years. Economic activity has been sluggish this year, and while copper prices have risen, weak demand and broader economic prospects in China should spillover and weigh on Chile's medium-term growth prospects. Elevated inflation, in our view, should prevent the Chilean Central Bank from lowering policy rates much further, which, combined with a Federal Reserve that remains cautious on shifting to rate cuts, should keep government interest payments somewhat high for the time being. As of now, S&P has Chile on “negative” outlook signaling that a rating downgrade could be forthcoming. Should S&P deliver a downgrade, the agency will converge its rating toward our framework's output. Moody's, on the other hand, has a stable outlook on Chile's sovereign credit rating; however, Moody's did downgrade Chile in September 2022. We take a degree of comfort in Moody's latest rating action moving in the direction of where our framework suggests Chile should be rated. We should note, however, that even if S&P and Moody's rating converge toward our framework's rating, Chile will still be in investment grade territory.

Figure 1

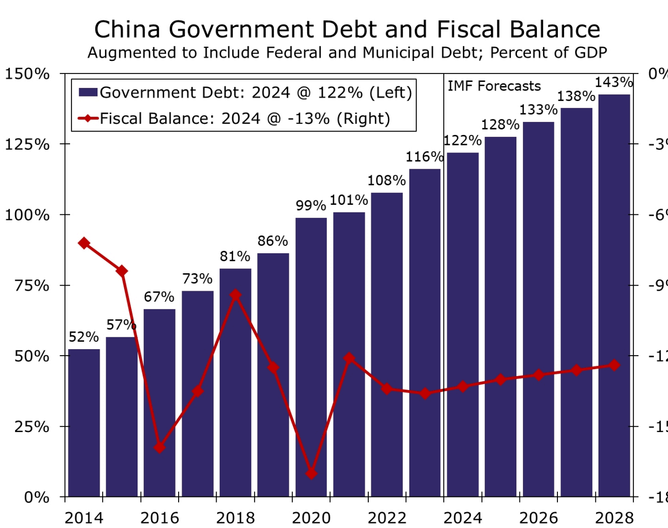


Source: Moody's, S&P Global Ratings and Wells Fargo Economics

Our framework also identifies Colombia as a sovereign where credit ratings could be poised for meaningful and multi-notch downgrades over the next 12 months. According to our analysis and methodology, Colombia's ratings are likely to be negatively impacted by a period of below-average economic growth combined with persistently above-trend inflation. In addition to poor growth and inflation dynamics, we believe political risk is more elevated under President Petro, which over the coming quarters, can also contribute to reduced creditworthiness. While Colombia's checks and balances system has prevented Petro's unorthodox agenda from being fully implemented, Petro's attempts to influence central bank monetary policy and state-owned enterprise operations, in our view, has weakened the nation's overall institutional strengths and governance structure. But perhaps most impactful on the evolution of Colombia's credit rating is that we believe Petro policies will result in a further deterioration of Colombia's public finances. In our view, the government is likely to run a wider fiscal deficit than previously anticipated. A wider deficit in itself drives Colombia's rating weaker; however, Colombia's debt burden is likely to rise more substantially as a result of a deeper deficit. Expectations for a rather serious deterioration in Colombia's public finance position—in addition to our view of more elevated political risk—are key differences between our framework's rating and agency ratings. Our framework assigns a rating equivalent to Ba3 on the Moody's scale and BB+ on the S&P scale, a rating that is 2 notches weaker than S&P and 4 notches weaker than Moody's. As of mid-June, S&P has a "negative" outlook on Colombia, which should a downgrade(s) be delivered in the near future, would take Colombia deeper into non-investment grade territory. However, and more importantly, should Moody's ultimately converge toward our framework's rating, Colombia would lose its final investment grade rating. No investment grade ratings would result in select asset managers being forced to sell exposures to Colombian sovereign debt due to mandates to only hold investment grade credits. Forced selling could spark sharp capital outflows from Colombian financial markets and potentially contribute to a bout of financial instability. Indeed, this scenario has recently played out as the Colombian peso has come under pressure due to concerns regarding the sovereign's stance on fiscal policy. While peso volatility has materialized already, in a scenario where forced selling comes to fruition, peso depreciation pressures could intensify.

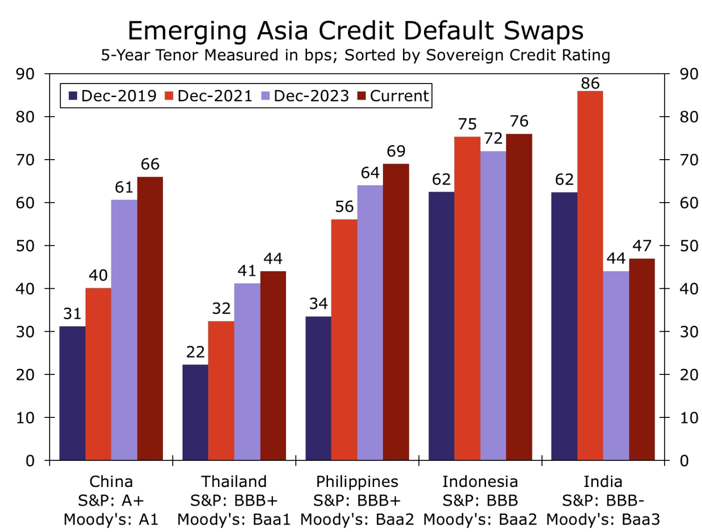
Rounding out Latin America, post-election concerns regarding the implementation of constitutional amendments that erode Mexico's governance structure and democratic process raise the possibility of negative ratings actions. While we shared our view that the markets' reaction to the possibility of constitutional amendments is overstated, we nevertheless used judgment to incorporate a higher degree of political risk in Mexico as well as the likelihood of a modest weakening of institutions to reflect the Morena coalition's effective congressional supermajority. According to our framework, incorporating new political and governance risks is not enough, at this point, to result in a rating downgrade. However, should political and governance risks be combined with a disregard for fiscal consolidation efforts and/or a material disruption to nearshoring activity—which are both entirely possible—our framework would in fact downgrade Mexico's rating by one notch. In that sense, for now, we believe the most likely outcome for Mexico's sovereign ratings is a move to "negative" outlook from both Moody's and S&P. We also believe both agencies would flag that a downgrade would come to fruition in an environment of fiscal and broader public finance deterioration. For Mexico, a one notch downgrade from Moody's and S&P would take the rating to the lower end of the investment grade spectrum. While a one notch downgrade would not result in forced asset manager selling, sentiment could nonetheless still worsen and the narrative around Mexico as an investment option or destination could begin to erode. In this scenario, local financial markets, including government bonds and the peso, could come under pressure.

Figure 2



Source: IMF and Wells Fargo Economics

Figure 3



Source: Bloomberg Finance L.P. and Wells Fargo Economics

There could also be notable rating adjustments to the two most economically important emerging Asian sovereigns. According to our framework, China is set to be downgraded in the coming quarters.

Given the importance of China's economy to the health of the global economy, a China rating downgrade fueled by deteriorating economic fundamentals would be notable. As far as deteriorating fundamentals, China's worsening public finance position and loss of policymaking effectiveness is likely to drive the rating downgrade. Our framework signals a China ratings downgrade due to a public debt burden that is expected to continue rising over time; however, we also take into account contingent liabilities due to central government support of local municipalities and state-owned enterprises. According to the IMF, this "augmented debt burden"—central government debt combined with contingent liabilities—could rise to as high as 143% of GDP by 2028 (Figure 2). In addition, China is likely to maintain an augmented fiscal deficit that is likely to hover ~13% of GDP over the next few years. Point being, public finances are a major contributor to our framework signaling a China rating downgrade. In addition to a worsening public finance position, we also believe China's policy effectiveness—both fiscal and monetary—has worsened. On the fiscal side, the majority of fiscal stimulus that has been deployed has been directed toward China's real estate sector, and while fiscal stimulus has been rather modest, fiscal support has not been effective at stabilizing the local property sector. As far as monetary policy, the People's Bank of China (PBoC) has been easing monetary policy for years. Despite lower lending rates and lower bank reserve requirement ratios, consumer demand remains sluggish and inflation especially subdued. In that sense, we believe the macroprudential toolkit in China is now less effective than previously, and a reduced ability to influence economic trends is a factor that, in our view, should lead to China's sovereign rating trending in a weaker direction. Moody's and S&P both rate China the same; however, Moody's has had China on negative outlook since December 2023, while S&P has maintained a stable outlook for an extended period of time. In our view, ratings actions will likely be taken, and in the coming quarters, we believe a one notch downgrade can be delivered by both agencies.

We end on a more optimistic note and highlight how our framework indicates a potential upgrade to India's sovereign credit rating. Earlier this year, we flagged the possibility of India being the beneficiary of positive rating actions due to our outlook for strong economic growth, fiscal consolidation, minimal political risk and a solid reform agenda that is likely to remain in place for the foreseeable future. BJP losing its Lok Sabha majority and Prime Minister Modi being forced to rely on coalition partners to form a government was a surprise election result; however, we remain steadfast in our view that the latest election does not fundamentally alter the political risk landscape in India nor does it upend Modi's reform agenda. While a coalition government introduces new risks to our fiscal consolidation view, we remain optimistic that the fiscal deficit will narrow over time and the government debt-to-GDP ratio can stabilize. Also, we believe India can benefit both from a growth and external account perspective from the reallocation of supply chains away from China and toward countries like India. New foreign investment can increase productivity, unlock new growth in the manufacturing sector, and offer capital flows that can ultimately support external balances. Our framework's rating upgrade is consistent with S&P recently revising its outlook on India to "positive" as well as financial markets pricing the probability of an India sovereign default. To that point, credit default swap (CDS) spreads have consistently narrowed over time, to the point where India's CDS spreads are narrower than peer sovereigns that have a stronger credit rating (Figure 3). An India sovereign rating upgrade would keep India in investment grade territory, but more importantly would push India further from non-investment grade status. In the next 12 months, we believe India can receive a one notch rating upgrade from at lease one, if not both, of the major rating agencies.

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