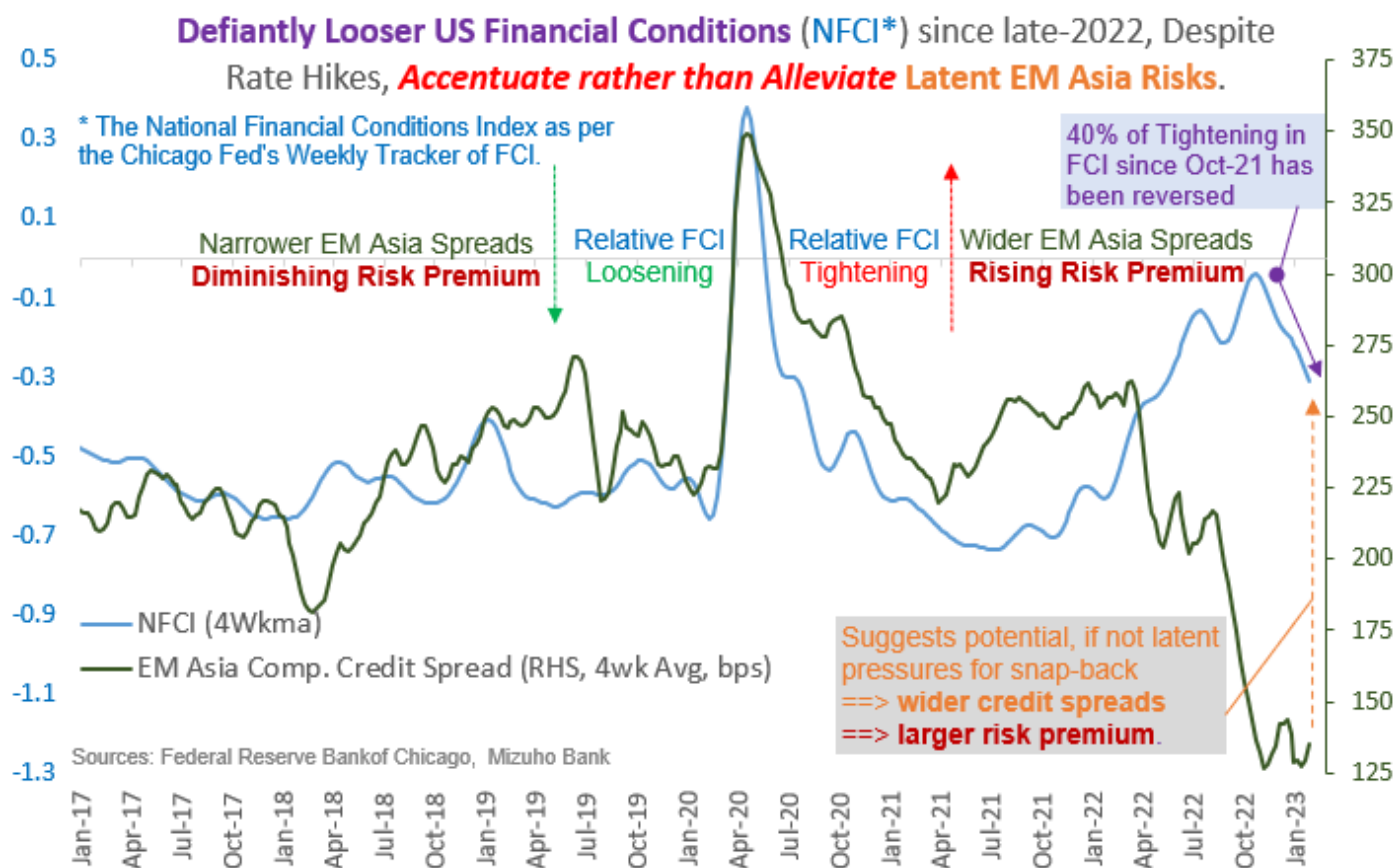


Understated EM Asia Risks



“Great kid. Don’t get cocky.”- Han Solo, Star Wars, A New Hope

Understated EM Asia Risks: Even after accounting for recent loosening in US financial conditions, **EM Asia risks appear to be significantly underpriced**; a point we recently alluded to*, but bears repeating. Point being, using *EM Asia sovereign credit spread* (vs. USTs) as a baseline measure of EM Asia risk premium, the evidence *points to exceptionally suppressed risk premium*.

Loosening US Financial Conditions: Admittedly, **diminished EM Asia risk premium**, corresponding to tightening EM Asia credit spreads, **has coincided with a significant loosening of US financial conditions index (FCI) since-late October last year**. Specifically in just three months, *some 40-60% of Fed-induced tightening in financial conditions* (which started in Q4 2022) *has been reversed*.

From Fed Pivot Bets: Looser financial conditions, *correlated to improved risk appetite* and consequently *higher asset prices* (lower yields/tighter credit spreads), has **resulted from “Fed pivot” bets**. That is, markets looking past on-going rate hikes to price in a pause to, perhaps even a reversal of, tightening. This renders an **attendant rally** in EM Asia assets, and resultant **reduction in EM Asia risk premium**, a tempting conjecture.

Convenient Cover, Not Overriding Cause: *Nevertheless*, it is **misguided to ascribe the sharp erosion in EM Asia risk premium solely to looser US financial conditions**. Point being, this is at best **convenient**

cover, not convincing cause. Especially as **closer scrutiny reveals disproportional reduction in EM Asia’s risk premium vis-à-vis** (corresponding loosening in) US financial conditions

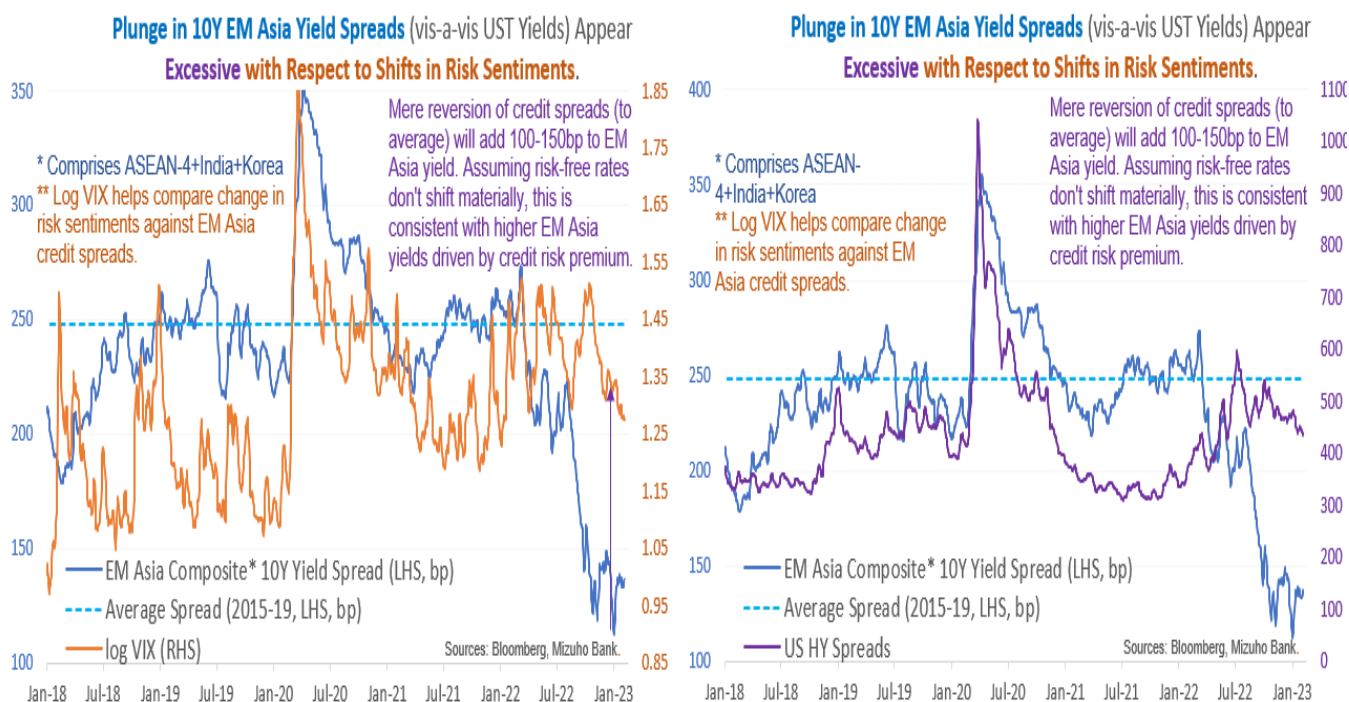
Exceptional Risk Premium Erosion: Fact is, **EM Asia’s risk premium erosion is exceptional;** not only *significantly outpacing*, but also having *predated*, loosening US financial conditions. What’s more, *in some instances*, steep reduction in EM Asia risk premium has even **defiantly overwhelmed tightening US financial conditions.**

Reveals Larger Latent Risks to EM Asia: As such, the **narrative of EM Asia risk re-pricing passively driven by, and subordinated to, US financial conditions, falls short of recognizing far larger risks associated with EM Asia risks mis-pricing.**

Accentuated, Not Alleviated: Especially given that **recent loosening in US financial conditions, accentuate, rather than alleviate, latent EM Asia risks.** Mainly as **sustaining loosening financial conditions is at odds with “higher for longer” Fed rates.** And so, the *threat of Fed hawks having to compensate for overly-exuberant markets may very well set off* **painful, abrupt correction in EM Asia risks (mis-)pricing** down the road. **More so with fading “China cheer” and dissipating real yield advantages.**

And so, it is **best to take on Han Solo’s advice “(to not) get cocky” about EM Asia’s exceptionally suppressed risk premium.** Especially in assuming this diminished risk premium to be a sustainable state of “new norm”, without regard for sudden dislocation from elevated global uncertainty.

* Please see Mizuho Chart Speak - EM Asia Yields: Watching Upside Risks from Credit Premium, 4th Jan 2023



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