



Political risk and expected government bond returns



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ABSTRACT

Political risk relates to both the ability and the willingness of governments to repay debts. We find that bond prices only slowly adapt to changes in political risk. The expected bond returns for countries whose political risk ratings have improved are higher than those for countries whose political risk ratings have deteriorated. This change in political risk premium cannot be explained by the risk factors default premium, term premium, and liquidity, or by momentum, changes in credit ratings, economic risk or financial risk. The risk-adjusted performance is 7.6% per annum for emerging bond markets and 0.8% per annum for euro government bonds.

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1. Introduction

The importance of political risk in developed government bond markets has recently been highlighted. Examples are the euro crisis and the October 2013 debate between the Republicans and Democrats on the US debt ceiling. These recent political developments have had a large influence on bond prices. During the US debt ceiling debate, US bond markets were clearly pricing in an increased possibility of a US default.¹ This sharp rise of short-term bond yields was reversed as soon as a resolution was found on 16 October, 2013. During the euro crisis, stock markets and European bond yields fluctuated heavily depending on estimates of whether Greece would leave the Eurozone and whether Italy and Spain needed a bailout by the other European countries. Changes in the Greek, Italian, and Spanish governments were needed to regain the trust from both investors and other European countries. As such, political risk seems to be very important for bond prices, even in developed markets.

In this paper, we analyze the relationship between political risk and bond prices. Our main contribution is to show that *changes* in political risk ratings *predict* the bond risk premium. Bonds from countries whose political risk ratings have improved outperform those from countries whose political risk ratings have deteriorated. By using political risk rating changes one can avoid the largest losses in bad times (when credit spreads increase) and keep up with the market index in good times.

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¹ Nippani and Smith (2014) provide a detailed analysis on this event and the reaction of the financial market.

We use political risk ratings from the Political Risk Services (PRS) group. PRS collects political information and converts this into risk points based on a subjective analysis of the available information.² The resulting political risk ratings are commercially but not publicly available. The ratings cover political risk in a broad sense, including government stability, socioeconomic conditions, investment profiles, internal and external conflicts, corruption, and law and order. The ratings are updated every month.

At the end of each month we select the four countries with the highest improvements in political risk ratings ('Best 4') and the four countries with the highest deteriorations ('Worst 4'). We evaluate the portfolio returns in the subsequent month. We find that selecting the Best 4 leads to higher bond risk premiums, measured by realized bond returns, especially when compared to the Worst 4. The return of this investment strategy based on political risk changes is called the change in political risk premium.

We investigate whether the change in political risk premium is subsumed by other well-known factors driving the bond markets. We control for the term premium and the default premium, which are found to be priced-in risk factors for corporate bond returns in Gebhardt et al. (2005). In addition, we analyse factors related to momentum, liquidity, credit ratings, and macroeconomic developments. The change in political risk premium cannot be explained by the risk factors. The unexplained alpha of a regression that takes into account the default, term and liquidity premium is 0.8% per annum for bonds issued by the euro countries in euros and 7.6% for emerging market bonds denominated in US dollars.

The bond market does not seem to react to changes in political risk in a timely matter. A logical explanation is that political risk ratings are not public information, and that it is not straightforward to quantify political risk. Changes in political risk ratings also contain valuable information for credit agencies. Countries with improving (deteriorating) political risk ratings on average also get a subsequent improvement (deterioration) in credit ratings.

Our findings are an important contribution to the literature on the price discovery in government bond markets. The US bond market reacts quickly to important macroeconomic announcements (Balduzzi et al., 2001) and order flows (Brandt and Kavajecz, 2004). Nowak et al. (2011) confirm that economic announcements are also important for the price discovery in emerging government bond markets and observe a slower absorption of information compared to developed government bond markets. We show for both the Eurozone and emerging countries that bond prices react to changes in political risk ratings, but both bond markets are not fully efficient in terms of the speed with which they adjust to these changes in political risk.

We also contribute to the literature on predicting financial market returns using changes in political risk. Erb et al. (1996a, 1996b) investigate the predictive power of various risk measures up to 1995, including those from PRS. They find predictive power of political risk changes for currency returns, but not for bond returns. We use a substantially longer sample period, up to 2014, which includes more bad times. We report significant predictive power for bond returns, especially in bad times. We also focus on bond returns with the same currency, eliminating any noise that currencies may have on the analysis. We conclude that changes in political risk are important for the price discovery in both developed and emerging government bond markets.

Related to our study is a strand of literature with the focus on the *level* of political risk and the relation with financial markets.³ We empirically confirm such a link by showing that poor political risk ratings are associated with poor credit ratings and high bond yields. Hence, unsurprisingly, countries which score poorly on political risk need to pay investors a higher bond risk premium. A recent study by Bekaert et al. (2014) finds that political risk accounts for one third of the sovereign credit spread in emerging market government bonds issued in US dollars, a very significant result underscoring the importance of political risk for bond yields.

The remainder of this study is organized as follows. Section 2 describes the data, including political risk ratings, bond data and credit ratings. Section 3 presents the methodology. The main results are discussed in Section 4. Section 5 investigates the importance of the components that make up the total political risk ratings. Section 6 concludes.

2. Data

In this section we first describe the political risk ratings. We then present the bond data and provide sample statistics on political risk ratings, spread levels and credit ratings.

2.1. Political risk ratings

The political risk ratings used in this study are produced by the Political Risk Services (PRS) group in the International Country Risk Guide.⁴ The political risk rating consists of 12 components, which are shown in Table 1. PRS collects political information and converts this into risk points for each individual risk component on the basis of a consistent evaluation process. The political risk ratings are made on the basis of a subjective analysis of the available information. The ratings are distributed monthly on a commercial basis to subscribers. We have a database of the real-time total ratings and the 12 components from December 1993 to April 2014.

² The PRS group was established in 1979, placing it among the first commercial providers of political and country risk forecasts. Several academic studies have made use of their data (see for example Bekaert et al., 2014).

³ Erb et al. (1999) find a strong relation between emerging market bond spreads and the composite risk rating of PRS, of which 50% is based on political risk. Similar findings are reported by Butler et al. (2009), who link state corruption to higher municipal bond yields, and Qi et al. (2010), who show that greater political rights are associated with lower corporate bond yield spreads. There is more empirical work on the importance of political risk for equity markets. See for example Erb et al. (1996a), Bittlingmayer (1998); Santa-Clara and Valkanov (2003), Belo et al. (2013), Mei and Guo (2004), Bouchkova et al. (2012) and Pástor and Veronesi (2012, 2013).

⁴ An alternative data source would be the newspaper coverage of policy-related economic uncertainty, see Baker et al. (2013) and www.policyuncertainty.com. These data, however, only cover five countries of the 35 countries we analyze.

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