

## **Beyond Borders: The Case for Foreign-Denominated African Sovereign Debt In Global Portfolios**

### **Executive Summary**

As global markets adjust to inflation and high interest rates in developed economies, foreign-denominated sovereign debt in emerging African markets offers an appealing opportunity for diversification and higher yield potential. This recommendation outlines the strategic benefits of investing in sovereign debt issued by African countries like South Africa, Kenya, and Nigeria. In an environment where developed market returns are increasingly correlated, African emerging market debt provides uncorrelated returns and attractive yields that can bolster portfolio performance while balancing risk. Additionally, foreign denominated (largely USD) debt securities avert the risk derived from country specific, currency volatility cycles.

### **Investment Thesis**

Emerging market economies in Africa, despite facing macroeconomic pressures, present an opportunity for bond investors seeking diversification. Historically, African sovereign debt has demonstrated lower correlation with Western markets due to unique economic cycles, political dynamics, and commodity-driven growth. Recent interest rate trends and monetary policies in developed markets have squeezed yields on traditional bonds, driving investor interest in emerging markets for potential yield premiums and currency diversification.

African markets stand out due to comparatively attractive yields, often between 8% and 12%, along with improving fiscal policies. However, due diligence is essential due to varying credit ratings and refinancing risks. The case for African debt centers around holding select sovereign bonds with strong refinancing prospects and manageable debt levels, balancing higher yields with prudent risk assessment.

### **Sector Analysis**

#### **1. South Africa: Balancing High Yield with Stability**

**Rationale:** South Africa's economy, rated BB- by S&P, benefits from its diversified industrial base and established financial markets, but it remains vulnerable to currency fluctuations and commodity prices. South Africa's foreign-denominated debt currently yields around 9.8%, offering a substantial spread over developed-market bonds. The country's recent focus on fiscal discipline and transparent debt management has improved investor confidence, with 75% of its \$34 billion external debt structured in medium to long-term maturities, limiting refinancing risk in the short term.

#### **2. Nigeria: High Yield with Moderate Risk**

**Rationale:** Nigeria's foreign-denominated debt, rated B- by S&P, presents a higher yield, currently around 11.5%. As Africa's largest oil producer, Nigeria's revenue is heavily influenced by oil prices, which adds volatility but also potential upside in an inflationary environment that favors commodities. Nigeria has recently restructured parts of its external debt and holds \$40 billion in reserves, sufficient for about 6 months of imports. These factors enhance Nigeria's ability to service debt but also require close monitoring given the higher credit risk.

#### **3. Kenya: Sustainable Growth Amid Fiscal Challenges**

**Rationale:** Kenya, rated B by Fitch, offers debt yields around 10%, supported by its growing infrastructure projects and robust agricultural sector. While Kenya's debt levels have risen due to significant infrastructure investment, the country has shown discipline in debt restructuring, extending maturities and reducing short-term refinancing risk. Kenya's continued economic growth, projected at 5.3% annually, supports a strong case for bondholders seeking exposure to a stable yet high-yielding market.

## Key Ratios and Comparative Analysis

Metric	South Africa	Nigeria	Kenya	US Treasuries
S&P Credit Rating	BB-	B-	B	AA+
Foreign-Denominated Yield	9.8%	11.5%	10%	4.5%
Debt-to-GDP Ratio	71%	35%	69%	122%
Interest Coverage Ratio	6.3x	4.8x	5.1x	9.5x

### Benefits of Diversification and Uncorrelated Returns

African sovereign debt offers a relatively low correlation with U.S. and European bond markets, largely due to differing economic cycles and fiscal policies driven by commodity exports and infrastructure growth. For example, while the S&P 500 has seen volatility in response to Fed interest rate hikes, African debt yields have remained stable or even increased due to local demand and regional factors, providing an alternative performance profile.

Additionally, African sovereign bonds are relatively immune to Fed policy, offering a hedge against the effects of quantitative tightening in Western markets. This low correlation, combined with the higher yield spreads, supports diversification by reducing the impact of Western economic cycles on portfolio returns.

### Debt Refinancing: A Tactical Opportunity

Many African governments are prioritizing debt refinancing strategies to extend maturities and reduce near-term repayment pressures. For instance, South Africa recently refinanced \$3 billion in Eurobonds, lowering its short-term debt obligations and reducing currency risk. This focus on refinancing strengthens the investment case, as it suggests more stable debt servicing and potentially lower volatility in the long term.

### Summary: Opportunities and Risks

#### Key Opportunities

- **Higher Yields:** African sovereign debt offers yields between 8% and 12%, significantly outpacing U.S. and European bonds.
- **Diversification:** Low correlation with developed markets provides a natural hedge, reducing portfolio risk from global economic shocks.
- **Debt Refinancing Improvements:** Efforts to restructure and extend debt maturities reduce refinancing risk and strengthen fiscal sustainability.

#### Key Risks

- **Currency Volatility:** Foreign-denominated debt in emerging markets is sensitive to exchange rate fluctuations, which could impact returns if local currencies weaken significantly.
- **Credit Risk:** Lower credit ratings reflect potential default risk, and economic or political instability could impair debt servicing ability.
- **Commodity Price Dependence:** Economies like Nigeria remain vulnerable to oil price shifts, impacting revenue and, consequently, debt performance.

### Final Recommendation

Investors should consider adding a mix of foreign-denominated bonds from South Africa, Nigeria, and Kenya to a diversified portfolio. This allocation leverages the high-yield potential of African debt while balancing sovereign credit risks. The recommended approach is to limit exposure to 5%-10% of the overall fixed income allocation for a strategic risk-return profile. By maintaining diversified exposure across these three countries, investors can capitalize on high yields, moderate risk through diversified holdings, and enjoy uncorrelated returns as a counterbalance to Western economic cycles.