Oxford Analytica

VAPOR Country Risk Ratings 2Q19

Introducing Value at Political Risk country ratings for decision-makers

Your quarterly guide to measuring and mapping political risk

Willis Towers Watson

VAPOR

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Executive summary

While political risks remain elevated globally, our research indicates that -- due to mispricing of risk -- investors could increase exposure to emerging and frontier markets (EM and FM) without increasing risk tolerance thresholds.

AR **Developed Market Benchmark,** Outlook: **Stable**
The DM Benchmark indicates a stable outlook for 2019. However, in addition to the United Kingdom and United States (covered in last quarter's report), we would add Spain and Japan to the watchlist.

BR- **Emerging Market Benchmark,** Outlook: **Positive**
The EM Benchmark has been positively impacted by a cautious but upgraded outlook to Turkey, although concerns in Mexico are growing.

CR+ **Frontier Market Benchmark,** Outlook: **Negative (downgraded from BR-)**
Argentina weighs heavily on the negative outlook of the benchmark; although VAPOR does see green shoots in Sri Lanka and Vietnam.

Contents

VAPOR Quarterly

April, 2019

Following the launch of VAPOR Quarterly in 2018, this quarter we delve into some of the more significant changes to the twelve-month outlook for political risk across the world, as well as feature new issue areas.

VAPOR Ratings

VAPOR Ratings provide global corporations and investors with a relative measure of commercial political risk for more than 160 countries. Each rating incorporates the expected losses for five perils across 14 industries. The ratings are designed to anticipate where unexpected market exposure will emerge, and where headline risk may conceal opportunities for well-prepared organisations. Unlike generic political risk scores, each VAPOR Rating is tied to a corresponding estimate of expected loss (information that is available upon request).

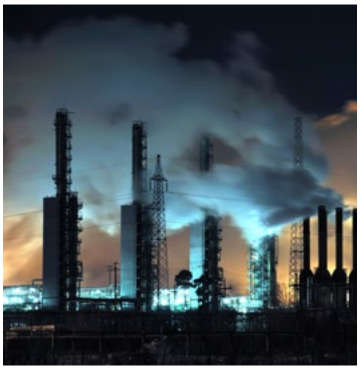
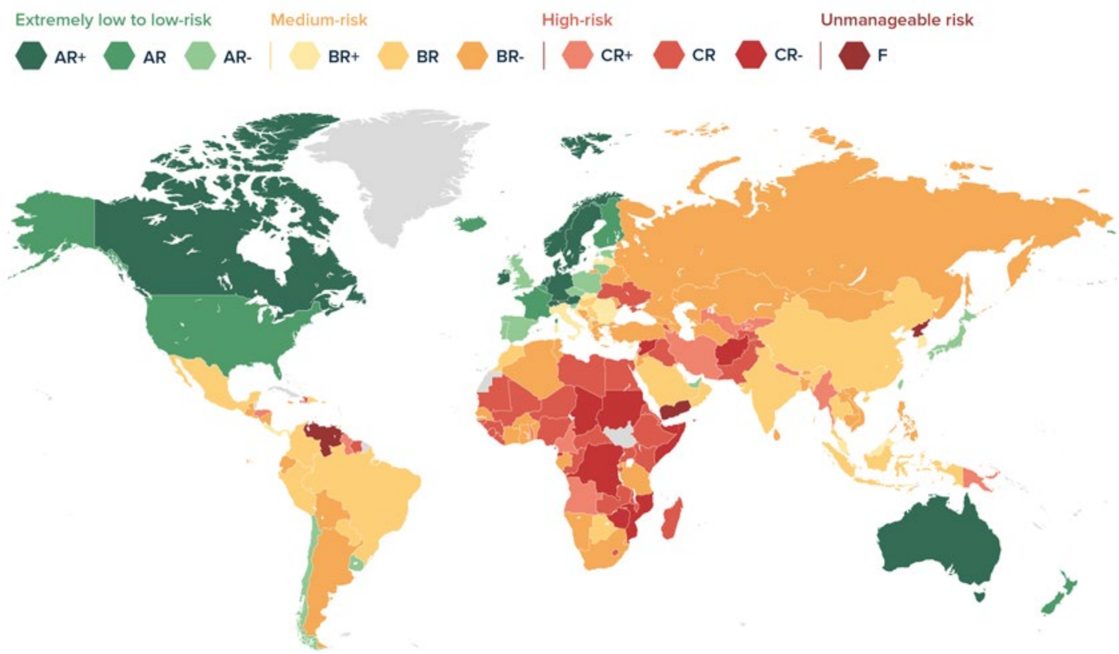


Figure 1. Map of VAPOR Ratings



Source: Oxford Analytica, Willis Towers Watson

AR ratings (AR+ to AR-): Extremely low to low-risk environment

Investors in these countries are typically exposed to infrequent and low impact (immaterial) business risk, and are largely comfortable with concentrated exposure and passive management.

BR ratings (BR+ to BR-): Medium-risk environment

Investors are typically exposed to frequent but medium impact (sometimes material) business risk. Mitigation occurs through broad-based exposure and active management.

CR ratings (CR+ to CR-): High-risk environment

Investors are typically exposed to ongoing and high impact (material) business risk. Exposure in one of these countries typically requires active on-the-ground management.

F rating: Unmanageable risk environment

Political risk has an outsized negative impact on the overall business environment. Risk conditions in these countries exceed the ability of institutional and corporate investors to manage the risk.

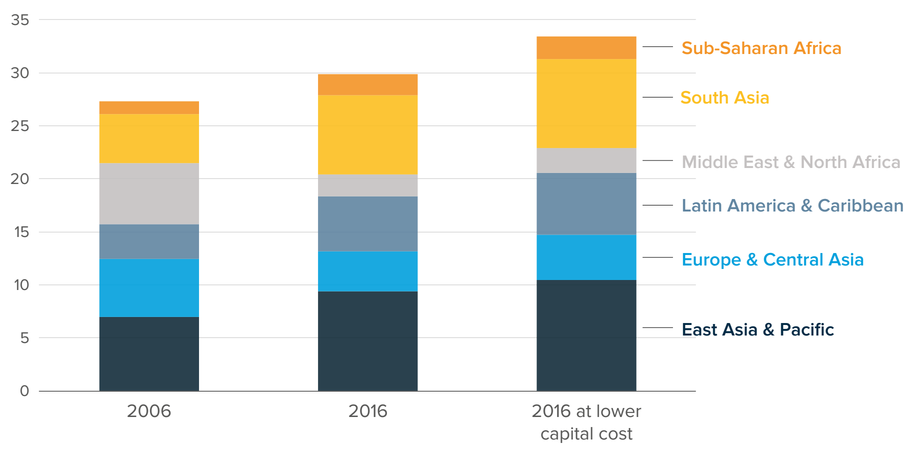
Risk inverted environment

The value of VAPOR in what we internally refer to as a risk inverted environment – one where political actions or consequences pose more concerns than economic trends – is in ensuring sufficient consideration of political risk by non-practitioners such as many CEOs and Heads of Business Development. While risk remains elevated globally, we find that misunderstanding of risk is leading companies to avoid net positive investments in higher risk markets. In other words, the inclusion of political risk earlier in business decision-making could increase returns (or financial performance) without increasing internal risk thresholds.

Our research indicates that better measurement of political risk could increase cross-border investment to risky regions. For example, research into standard methods of quantifying political risk reveal that it tends to be over-estimated. The most common proxy -- sovereign spreads -- contains more information than just political risk, leading certain components to be double-counted when project costs are assessed and discounted against projected returns.

The mis-measurement of political risk is resulting in the cost of capital being valued 2-4 percentage points higher than it should be in assessments ahead of cross-border investment decisions. Without adjusting risk tolerance, we calculate that FDI inflows into emerging markets could have been 3.6 billion dollars greater in 2016 had political risk been measured more accurately (see Figure 2).

Figure 2. FDI inflows, country average across region
(constant 2018 billion dollars)



Sources: Oxford Analytica, UNCTAD

We hold a negative twelve-month outlook on 46% of countries in the Morgan Stanley Capital International (MSCI) basket of EMs, down from 54% in December 2018. FMs have been downgraded from BR- to CR+, with Argentina continuing to pull down general expectations for the group. Changes to US interest rate rise expectations are an important reason for non-Argentina positivity; however, deteriorating global growth expectations will increase the risk of political instability and business disruption, although on the positive side, lower growth environments have historically witnessed fewer expropriation events in resource rich countries.

In Figure 3, which is a relative ranking of industry exposure to political risk, VAPOR estimates that Gas and water utilities and Power utilities are now the most politically exposed industries globally. The catalyst for this outlook is global growth. Especially in EM and FM countries, where lower growth environments increase the risk of governments unilaterally deciding to freeze utility rates, which often contravene prior pricing guarantees to investors. In some instances, this can lead to outright expropriation or periods of reduced service or investment; in turn increasing political violence risk to investor assets and, in extreme cases, confiscation or expropriation.

Figure 3. Industry exposure to political risk (ranked 1 to 14, 2Q19)

Industry	Expropriation	Inconvertibility	Political violence	Sovereign default	Trade embargo	Overall
Gas and water utilities	1	9	8	1	7	1
Power utilities	1	1	7	6	7	1
Public services	3	11	5	1	7	3
Mining	4	1	2	9	3	4
Oil and gas	4	11	3	9	4	5
Leisure and real estate	6	1	1	9	7	6
Infotech	8	1	8	6	1	7
Agriculture	10	1	4	12	6	8
Professional services	9	1	8	1	7	9
Transport and logistics	7	13	8	13	2	10
Construction	12	10	8	6	7	11
Manufacturing	12	1	5	1	7	11
Wholesale and retail	12	1	8	1	7	11
Finance services	11	14	14	14	5	14

Sources: Oxford Analytica, Willis Towers Watson

Developed Markets (DMs)

VAPOR Rating: **AR** Outlook: **Stable**

The DM Benchmark indicates a stable outlook for 2019. However, in addition to the United Kingdom and United States (covered in last quarter's report), we would add Spain and Japan to the watchlist.

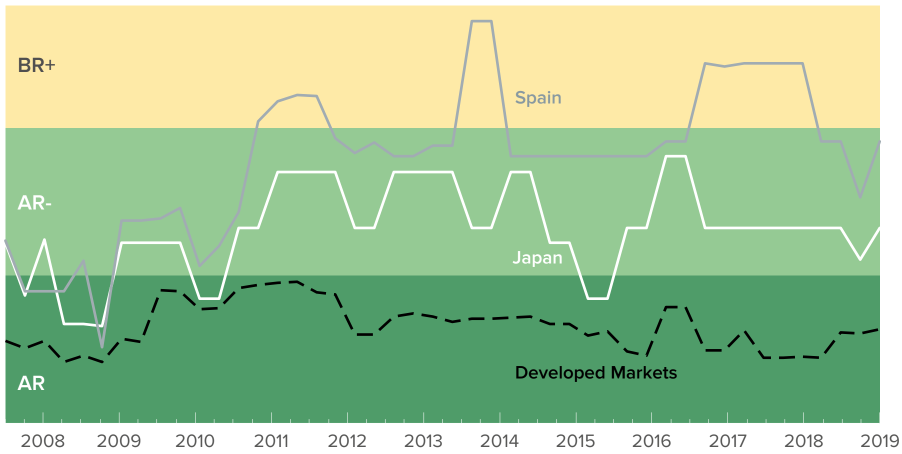
BOTTOM LINE

The twelve-month outlook of the DM Benchmark remains stable. In Spain (AR-), the outlook has changed from positive to stable ahead of the April's general elections despite the expectation of a fragmented parliament which could lead to a right-wing coalition government between Vox, PP and Ciudadanos.

In Japan (AR-), the outlook has also changed from positive to stable, in part because of deteriorating global growth and, perhaps more pertinently short-term, the underlying weakness in global trade means any US-China deal will be unlikely to support Japan much. However, some countries will switch some trade away from the United States and China to Japan to avoid the tariffs, cushioning Japan's exporters.

More specifically to political risk, we also regard the recent opening of new bases on Miyako Island and Amami Oshima by the Ground Self-Defense Force Japan -- intended for rapid response emergencies -- as a sign of a long-term trend towards confrontation with China, despite bilateral ties having eased over the past couple of years. Notably, both islands will host surface-to-air and surface-to-ship missile units.

Figure 4. VAPOR Benchmark: DM



Source: Oxford Analytica, Willis Towers Watson

VAPOR Benchmark

Developed Markets

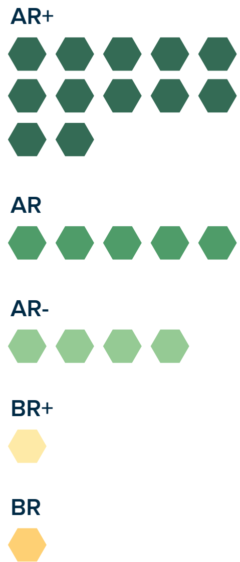
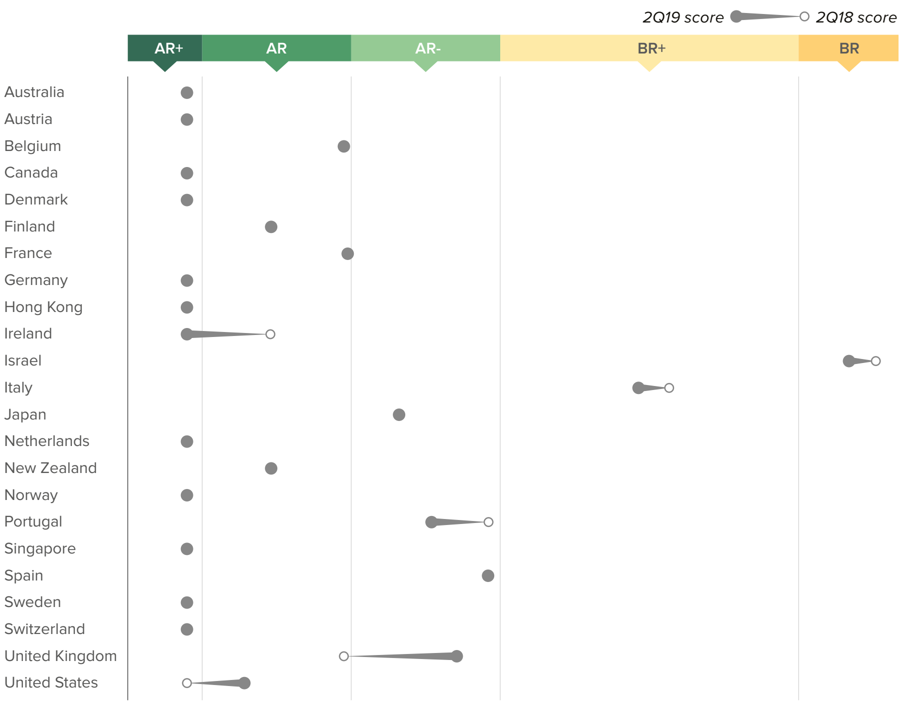


Figure 5. Twelve-month VAPOR outlook (2Q18 versus 2Q19)



Emerging Markets (EMs)

VAPOR Rating: **BR-** Outlook: **Positive**

The EM Benchmark has been positively impacted by a cautious but upgraded outlook to Turkey, although concerns in Mexico are growing.

BOTTOM LINE

Of the 24 EMs in the VAPOR Benchmark, four are AR-, four are BR+, nine are BR, five are BR , and two are CR. The countries that impact the GDP-weighted Benchmark most heavily are China (BR), India (BR), Brazil (BR), Russia (BR-) and South Korea (BR+).

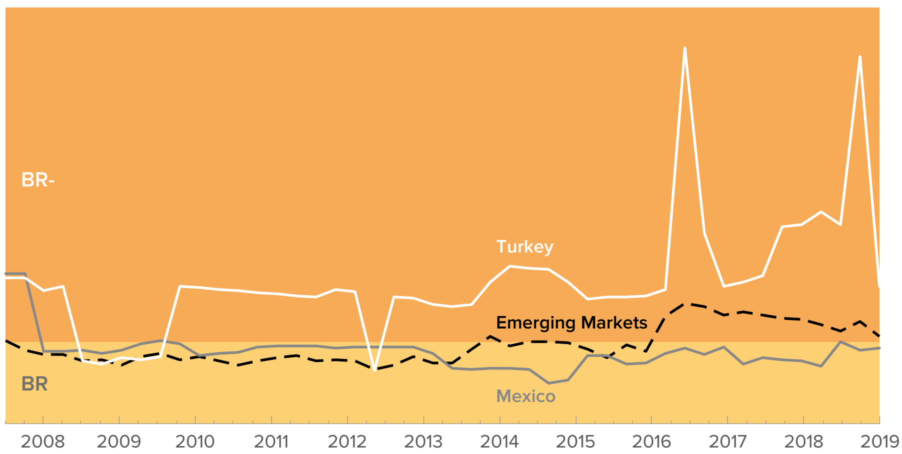
Turkey (BR-) has moved from a negative to stable outlook in large part due to still meaningful, but abating concerns about sovereign default and exchange rate inconvertibility. The Central Bank of Turkey (TCMB) decision to increase borrowing at the overnight rate of 25.5% instead of the 24.0% policy rate underscored its decisiveness despite President Recep Tayyip Erdogan's antipathy to high interest rates.

However, these risks remain. Over the next twelve months nominal depreciation is likely and lira volatility almost certain. Inflation may decline, but only to 12-15% from September onwards. Economic discontent will persist into 2020, inducing Erdogan to continue clamping down despite the tradition for post-election conciliation.

More broadly, local election upsets pose a challenge to Erdogan, whose main priority will be to break the opposition. The ruling Justice and Development Party (AKP) faces a difficult choice between cracking down on its rivals and seeking coexistence with them -- something Erdogan will be loath to do. Erdogan could respond in a dramatic manner, but the way recounts are progressing suggests there is little scope for this. He is more likely to bide his time, put pressure on the opposition and then strike back, as he did after losing control of parliament in mid-2015, relying on opposition missteps.

Mexico's (BR) twelve-month outlook has changed from positive to negative. This is driven by President Andres Manuel Lopez Obrador (AMLO)'s attempt to build investor trust and demonstrate his leftist credentials at the same time. Amid uncertainty over the commitment and ability of AMLO's government to run the economy sensibly, decisions such as that to create an Investment, Employment and Growth Promotion Council to reach out to business and adopt a more collaborative stance are undoubtedly positive. However, whether such moves prove a genuine effort to rebuild private sector trust and engage with businesses remains to be seen. AMLO's critical stance on private capital -- which he has repeatedly portrayed as corrupt and exploitative -- is intrinsic to his political legitimacy and will not change. His public rhetoric will encourage the more radical leftist representatives of his National Regeneration Movement (Morena) to push agendas that will dampen investor confidence.

Figure 6. VAPOR Benchmark: EM



Source: Oxford Analytica, Willis Towers Watson

VAPOR Benchmark
Emerging Markets

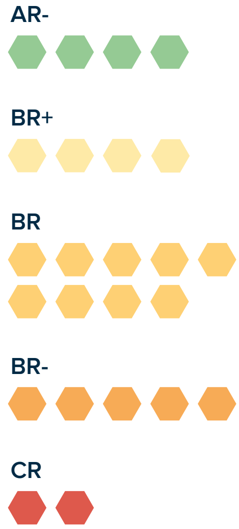
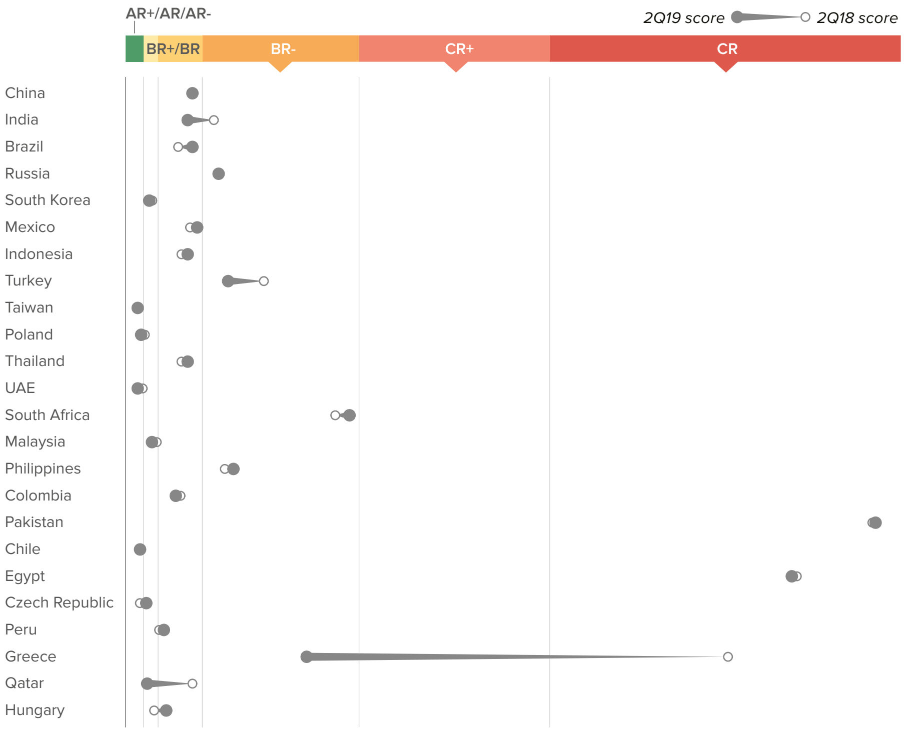


Figure 7. Twelve-month VAPOR outlook (2Q18 versus 2Q19)



Source: Oxford Analytica, Willis Towers Watson

Frontier Markets (FMs)

VAPOR Rating: **CR+** Outlook: **Negative**

Argentina weighs heavily on the negative outlook of the benchmark; although VAPOR does see green shoots in Sri Lanka and Vietnam.

BOTTOM LINE

Of the 21 FMs in the VAPOR FM Benchmark, three are AR-, two are BR+, five are BR, eight are BR-, one is CR+ and two are CR. The countries that impact the GDP-weighted Benchmark most heavily are: Nigeria (CR); Argentina, Bangladesh, Vietnam and Kazakhstan (all BR-); Romania (BR+).

With the FM Benchmark having been pushed over the edge from BR- to CR+, it finds itself back in 4Q17 territory. Argentina is the main catalyst for the recent fall and outlook[1], with the exchange rate continuing to weaken and inflation and economic activity not showing any signs of improvement. Based on the latest Opinaia survey, 71% of Argentine voters have a negative view of the economy, which contracted by 2.5% last year. The October elections remain too close to call, although Macri at present appears slightly more likely to be the (narrow) winner of a second round[2]. The climate both pre-and post-election will be highly volatile.

While Willis Towers Watson and Oxford Analytica's 2018 survey of how leading companies are managing political risk highlighted multiple material political risk losses in Vietnam (BR-), efforts to spur deregulation and promote foreign ownership support a positive outlook. Within the next year, the country will likely remove the cap on foreign holdings with regards to many listed firms. Greater investor interest will increase liquidity and decrease trading volatility in the country's equity market, while Vietnam's growing exposure to international markets in energy commodities will likely encourage domestic market deregulation. Otherwise, Hanoi risks a build-up of debt.

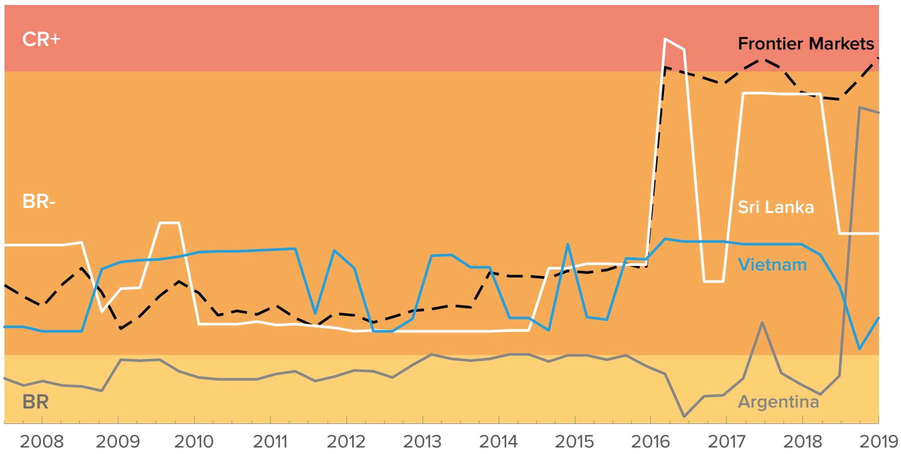
The twelve-month outlook in Sri Lanka (BR-) has also improved. This is primarily due to the government trying to adhere to IMF expectations regarding fiscal prudence, with the projected budget deficit for this year falling to 4.4% from a provisional 5.3% in 2018. Furthermore, the IMF recently agreed to extend a 1.5-billion-dollar loan programme that was agreed in 2016 but suspended late last year during a constitutional crisis, when President Maithripala Sirisena replaced the United National Party (UNP)'s Ranil Wickremesinghe as prime minister before eventually reinstating him.

Nevertheless, the post-civil war reconciliation process should be watched carefully. Irrespective of Sirisena and Wickremesinghe's personal commitments to post-war reconciliation, which may be compromised by fears of a backlash from Sinhalese nationalists, the government's persistent delays in working towards accountability risk alienating Tamils and stoking ethnic tensions.

[1] In June 2018, MSCI announced the MSCI Argentina Index will be reclassified to Emerging Market status from Frontier Market status. This change is set to take effect in May 2019.

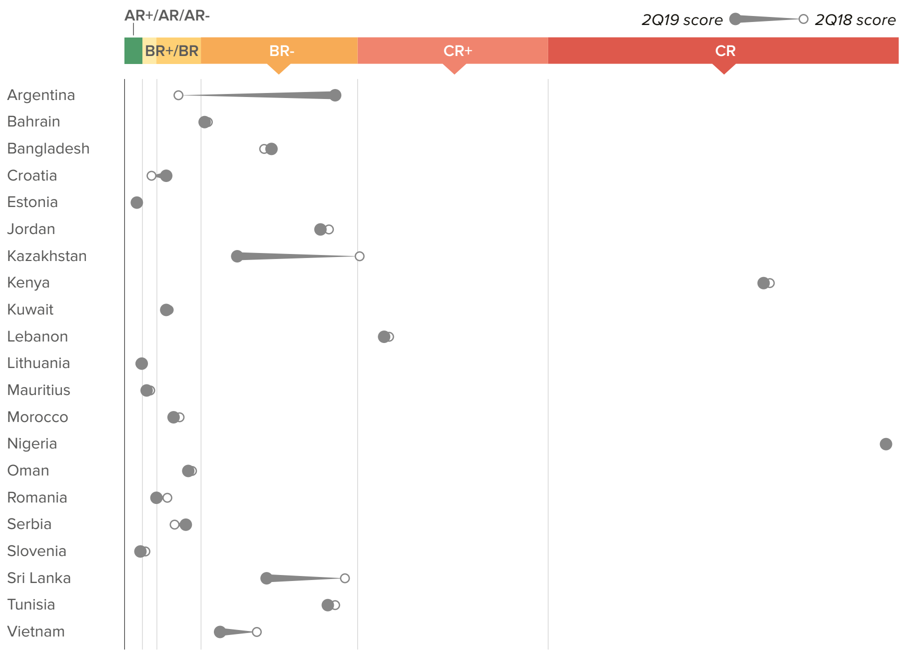
[2] If no candidate receives at least 45% of the vote, or 40% with a lead of 10 percentage points over the runner-up, a second round is held.

Figure 8. VAPOR Benchmark: FM



Source: Oxford Analytica, Willis Towers Watson

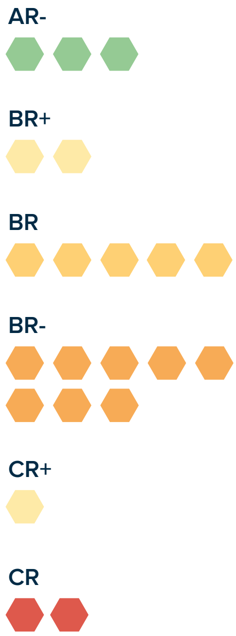
Figure 9. Twelve-month VAPOR outlook, FM (2Q18 versus 2Q19)



Source: Oxford Analytica, Willis Towers Watson

VAPOR Benchmark

Frontier Markets



The Watchlist: Brazil

VAPOR Rating: **BR** Outlook: **Negative**

Brazil: Blunders could rein in Brazil's reform agenda

President Jair Bolsonaro's government faces falling popularity and congressional clashes that put legislation at risk.

Outlook

President Jair Bolsonaro called on the military to celebrate the 55th anniversary of their 1964 coup on March 31. The controversial move, followed by a still undefined legal battle as groups of victims of the 1964-85 dictatorship and their families sought to ban coup celebrations, added another to an already long list of controversies and political blunders by the far-right government which took office on January 1. These are not only quickly undermining its popularity, but also increasingly threatening its ability to achieve what it has defined as its top priority, passing an ambitious pensions reform.

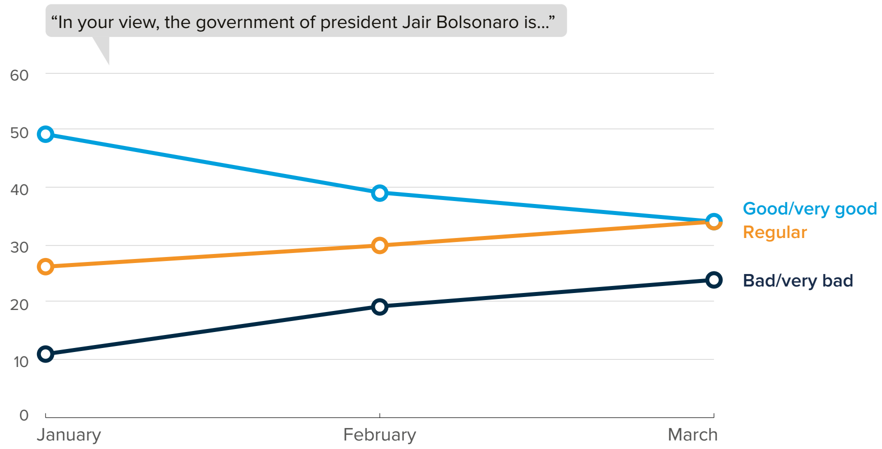
What next

During its first three months, the Bolsonaro government has spent significant political capital without achieving much progress on its agenda. This does not mean the pensions reform is doomed, but the chances of passing the ambitious changes the executive seeks are fast diminishing. Unless the government manages to stop creating unnecessary controversies in non-central areas and dramatically improves its handling of Congress, the prospects of advancing this or other parts of its legislative agenda will continue to fade.

Impacts

- The left-leaning opposition is as yet failing to capitalise much on the government's serial blunders.
- The opposition will struggle to unite following clashes within the left and centre-left camp during the 2018 election campaign.
- The government risks continuing to fall into self-laid traps.
- Market jitters over the pension reform's prospects risk further falls in stock prices and the exchange rate.

Figure 10. Bolsonaro popularity ratings (% of the 2,002 Brazilian adults surveyed)



Source: IBOPE, Oxford Analytica

VAPOR Ratings – 2Q19

AR rating: Extremely low to low risk

BR rating: Medium risk

CR rating: High risk

F rating: Unmanageable risk

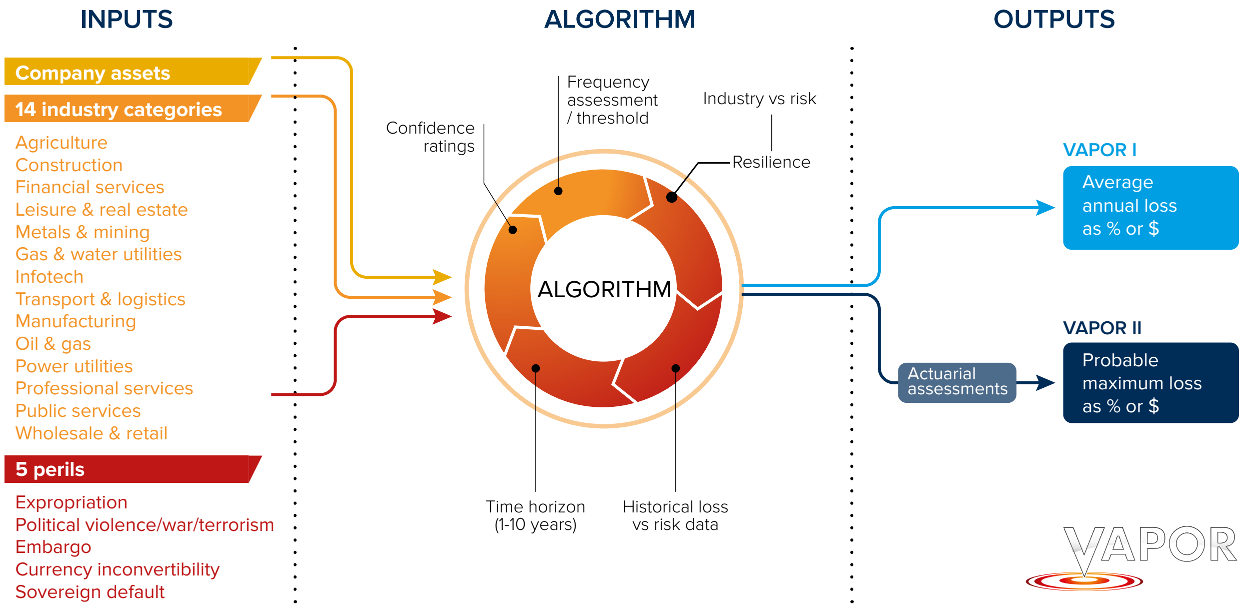
		VAPOR Rating	Outlook
	Afghanistan	CR-	Positive
	Albania	BR	Negative
▲	Algeria	BR-	Positive
	Angola	CR+	Positive
	Argentina	BR-	Negative
▼	Armenia	CR	Negative
	Australia	AR+	Stable
	Austria	AR+	Stable
	Azerbaijan	BR-	Positive
	Bahrain	BR-	Positive
	Bangladesh	BR-	Negative
	Belarus	BR-	Positive
	Belgium	AR	Stable
	Benin	BR-	Positive
▲	Bhutan	BR	Negative
	Bolivia	BR-	Positive
	Bosnia and Herzegovina	BR-	Positive
	Botswana	BR	Negative
	Brazil	BR	Negative
	Brunei	BR+	Positive
	Bulgaria	BR+	Positive
	Burkina Faso	BR-	Positive
	Burundi	CR	Negative
	Cambodia	BR-	Negative
	Cameroon	CR+	Positive
	Canada	AR+	Stable
	Central African Republic	CR	Negative
	Chad	CR-	Positive
	Chile	AR-	Negative
	China	BR	Positive
	Colombia	BR	Positive
▲	Congo	CR	Negative
	Congo-Brazzaville	CR-	Positive
▲	Costa Rica	BR+	Negative
▼	Croatia	BR	Negative
	Cyprus	BR+	Positive
	Czech Republic	AR-	Negative
	Denmark	AR+	Stable
	Djibouti	CR	Positive
▼	Dominican Republic	BR	Positive
	Ecuador	BR-	Positive
	Egypt	CR	Positive
	El Salvador	BR-	Positive
	Equatorial Guinea	CR-	Positive
	Eritrea	CR	Positive
	Estonia	AR-	Stable
	Ethiopia	CR	Negative
	Finland	AR	Stable
	France	AR	Stable
	Gabon	BR-	Negative
	Georgia	BR-	Negative
	Germany	AR+	Stable
	Ghana	BR-	Negative
	Greece	BR-	Positive
	Guatemala	BR-	Positive
	Guinea	CR	Positive
	Guinea-Bissau	CR	Negative
	Guyana	CR+	Negative
	Haiti	CR	Negative
	Honduras	CR+	Negative
▼	Hungary	BR	Negative
	Iceland	AR	Negative
▲	India	BR	Positive
	Indonesia	BR	Negative
	Iran	CR+	Negative
	Iraq	CR	Positive
	Ireland	AR+	Positive
	Israel	BR	Positive
	Italy	BR+	Positive
	Ivory Coast	BR-	Positive
	Jamaica	BR-	Positive
	Japan	AR-	Stable
	Jordan	BR-	Positive
	Kazakhstan	BR-	Positive
▼	Kenya	CR	Positive
	Kuwait	BR	Positive
	Kyrgyzstan	CR+	Positive
	Laos	BR-	Negative
	Latvia	BR+	Negative
	Lebanon	CR+	Positive
	Lesotho	CR	Positive
	Liberia	CR	Negative

		VAPOR Rating	Outlook
▲	Libya	CR	Positive
	Lithuania	AR-	Stable
	Luxembourg	AR+	Stable
	Macedonia	BR	Positive
	Madagascar	CR	Negative
	Malawi	CR	Positive
	Malaysia	BR+	Positive
	Mali	CR	Positive
	Mauritania	CR	Positive
	Mauritius	BR+	Positive
	Mexico	BR	Negative
	Moldova	BR-	Positive
	Mongolia	BR-	Positive
	Montenegro	BR-	Negative
▲	Morocco	BR	Positive
	Mozambique	CR-	Negative
▼	Myanmar	CR+	Negative
	Namibia	BR-	Negative
	Nepal	CR+	Positive
	Netherlands	AR+	Stable
	New Zealand	AR	Stable
	Nicaragua	BR-	Negative
	Niger	CR	Positive
	Nigeria	CR	Positive
	North Korea	F	Positive
	Norway	AR+	Stable
	Oman	BR	Positive
	Pakistan	CR	Negative
	Panama	BR+	Positive
	Papua New Guinea	CR+	Positive
	Paraguay	BR	Positive
	Peru	BR	Negative
	Philippines	BR-	Negative
	Poland	AR-	Positive
	Portugal	AR-	Positive
	Puerto Rico	BR	Stable
▲	Qatar	BR+	Positive
	Romania	BR+	Positive
	Russia	BR-	Stable
	Rwanda	BR-	Stable
	Saudi Arabia	BR	Positive

		VAPOR Rating	Outlook
	Senegal	BR-	Positive
	Serbia	BR	Negative
	Sierra Leone	CR	Positive
	Singapore	AR+	Stable
	Slovakia	BR+	Positive
▲	Slovenia	AR-	Positive
	Somalia	CR-	Positive
	South Africa	BR-	Negative
	South Korea	BR+	Positive
	Spain	AR-	Stable
	Sri Lanka	BR-	Positive
	Sudan	CR-	Negative
	Suriname	CR	Positive
	Swaziland	BR-	Stable
	Sweden	AR+	Stable
	Switzerland	AR+	Stable
▼	Syria	CR-	Positive
	Taiwan	AR-	Stable
	Tajikistan	CR	Positive
	Tanzania	BR-	Negative
	Thailand	BR	Negative
	Togo	CR+	Negative
	Trinidad and Tobago	BR	Negative
	Tunisia	BR-	Positive
	Turkey	BR-	Stable
	Turkmenistan	BR-	Negative
	UAE	AR-	Positive
	Uganda	CR	Negative
	United Kingdom	AR-	Negative
	Ukraine	CR	Positive
	United States	AR	Negative
	Uruguay	AR-	Stable
	Uzbekistan	CR+	Positive
	Venezuela	F	Negative
	Vietnam	BR-	Positive
	Yemen	F	Positive
	Zambia	CR	Positive
	Zimbabwe	CR-	Negative

VAPOR Ratings methodology

VAPOR Ratings are based on the VAPOR (Value at Political Risk) model and platform developed in partnership with our partners Willis Towers Watson. VAPOR is an algorithmically-driven system that models -- based on asset exposure and corporate risk environment across five perils and 14 industries -- the estimated average annual losses and probable maximum losses for political risk events over time. VAPOR Ratings allow for global views and country comparisons across all perils and industries for more than 160 countries and have been designed to help decision-makers map, measure and monitor exposure at an organisational level.



VAPOR Ratings are an independent opinion on political risk, which can serve as a useful starting point to assess the opportunities and risks of operating in a country. They provide a relative measure of a company or investor's risk profile across countries based on expected frequency and severity of losses to political risk.

Political risk can be defined as the risk faced by investors, corporations and governments that specific political decisions, events or conditions will impact the earnings or value of assets. This is what we refer to as Value at Political Risk. It includes risk of expropriation, political violence, embargo, currency inconvertibility and sovereign default.

For organisations requiring a more precise approach to their political risk, we provide access to the **VAPOR Dataset** -- containing nearly 500,000 political risk data points, updated quarterly -- and to the full **VAPOR service**, an online platform giving annualised average and probable maximum expected losses in dollar terms, and permitting clients to explore the effects of different scenarios.

VAPOR services

VAPOR Ratings

(AR+ to F)

Overview of the likely frequency and severity of losses to political risk in a country.

Report published quarterly

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Model your exposure across countries, risks and industries with nearly 500k quarterly datapoints for 160+ countries, across 5 risk perils and 14 industries for 10+ years.

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VAPOR Online

Expected loss (% or $)

For each country, across 5 risk perils and 14 industries. Estimate average annual losses and probable maximum losses to political risk events over time in dollar terms.

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