COUNTRY RISK: THE 2024 UPDATE!

The Flipside of Globalization!

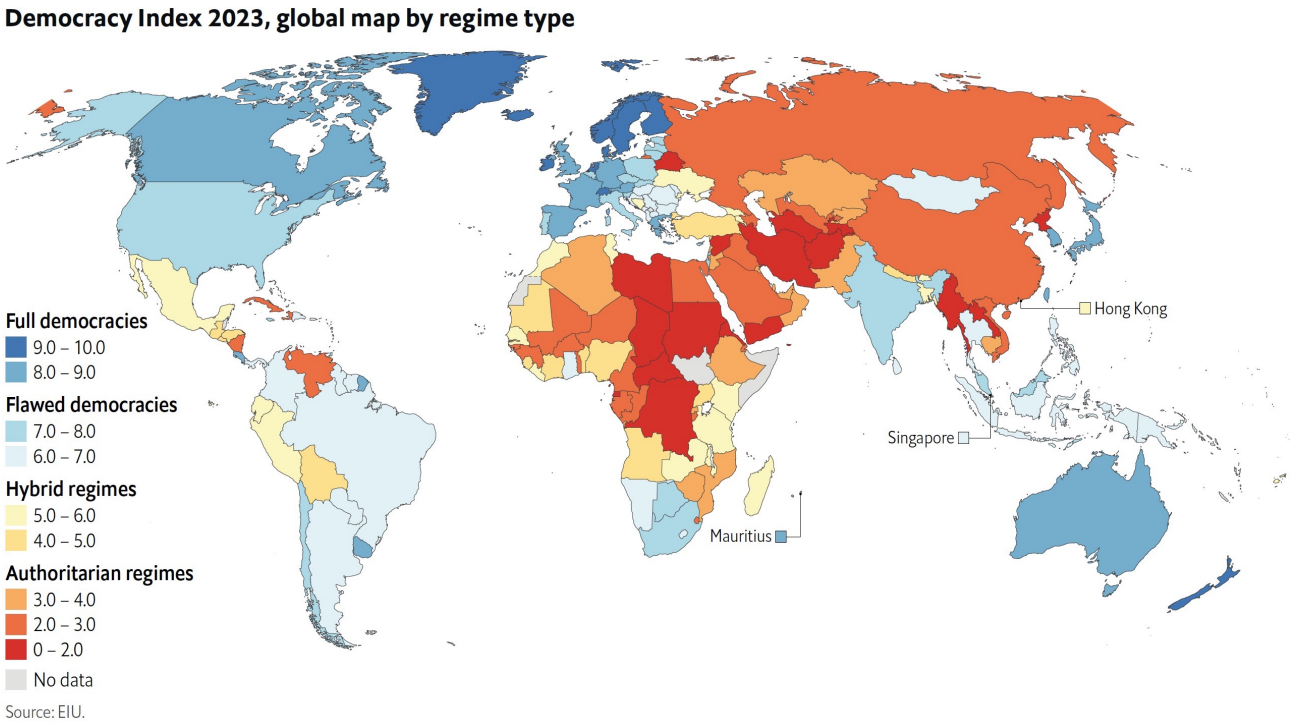
The Lead In…

- After the 2008 market crisis, I resolved that I would be far less casual in my assessments and updating of equity risk premiums, in the United States and abroad, more aware of the damage that can be inflicted on intrinsic value by significant shifts in risk premiums, i.e., my definition of a crisis.
  - That precipitated my practice of estimating implied equity risk premiums for the S&P 500, at the start of every month, and following up of using those estimated premiums when valuing companies during that month.
  - The 2008 crisis also gave rise to two update papers that I do each year:
    - The first looks at equity risk premiums, what they measure, how they vary across time and how best to estimate them, which I last updated in March 2024.
    - The second is focused on country risk and how it varies across geographies, with the focus again on determinants, measures and estimation, which I update mid-year each year. This post reflects my most recent update from July 2024 of country risk.

Country Risk: Drivers

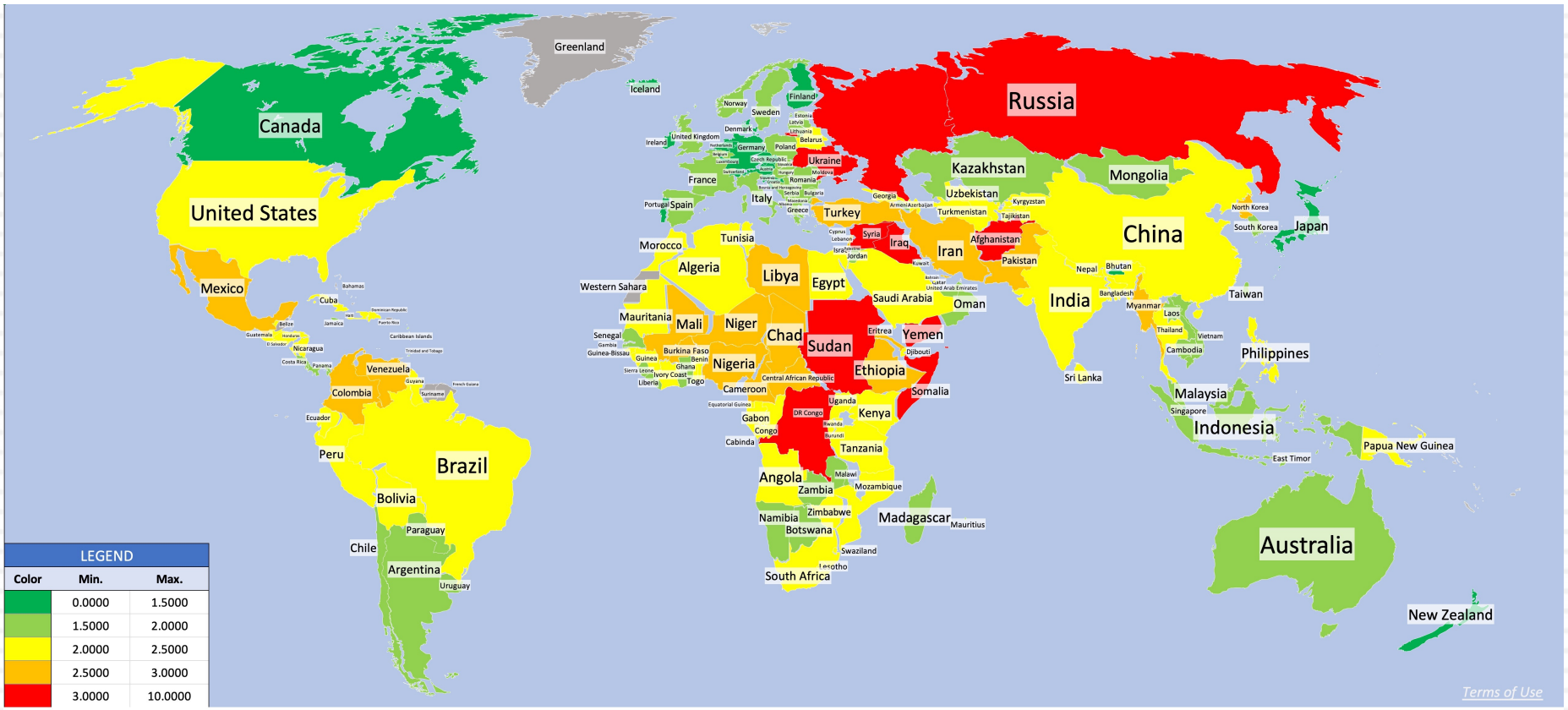
- At the risk of stating the obvious, investing and operating in some countries is much riskier than investing and operating in others, with the variations on multiple dimensions.
- Those variations in risk come from differences on four major dimensions:
  - Political structure
  - Exposure to war/violence
  - Extent of corruption
  - Protections for legal and property rights.

1. Political Structure



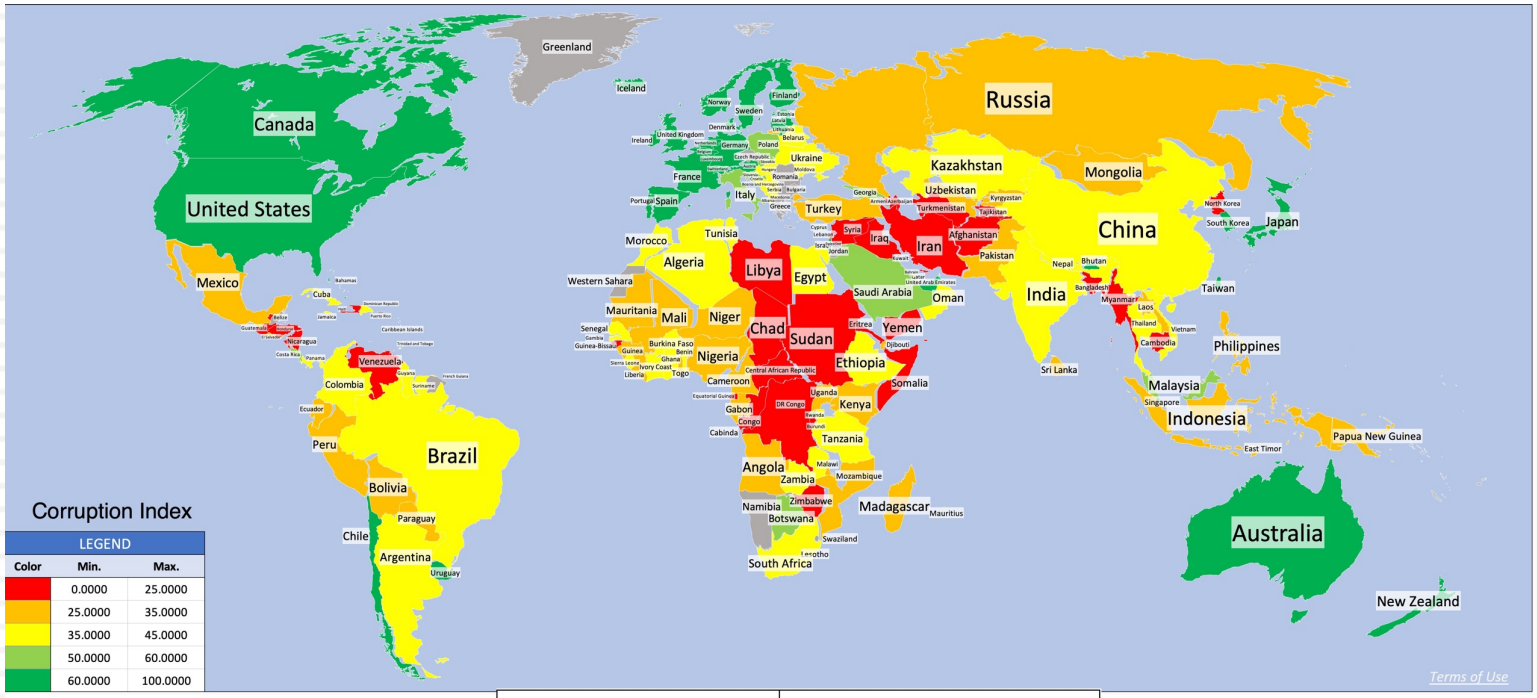
	EIU Democracy Index Score (Higher = More Democratic)				
	2006	2011	2016	2021	2023
Asia & Australasia	5.44	5.51	5.74	5.46	5.41
Eastern Europe & Central Asia	5.76	5.5	5.43	5.36	5.37
Latin America	6.37	6.35	6.33	5.83	5.68
Middle East & North Africa	3.53	3.62	3.56	3.41	3.23
North America	8.64	8.59	8.56	8.36	8.27
Western Europe	8.6	8.4	8.4	8.22	8.37
Sub-Saharan Africa	4.24	4.32	4.37	4.12	4.04
World	5.52	5.49	5.52	5.28	5.23

2. Exposure to violence



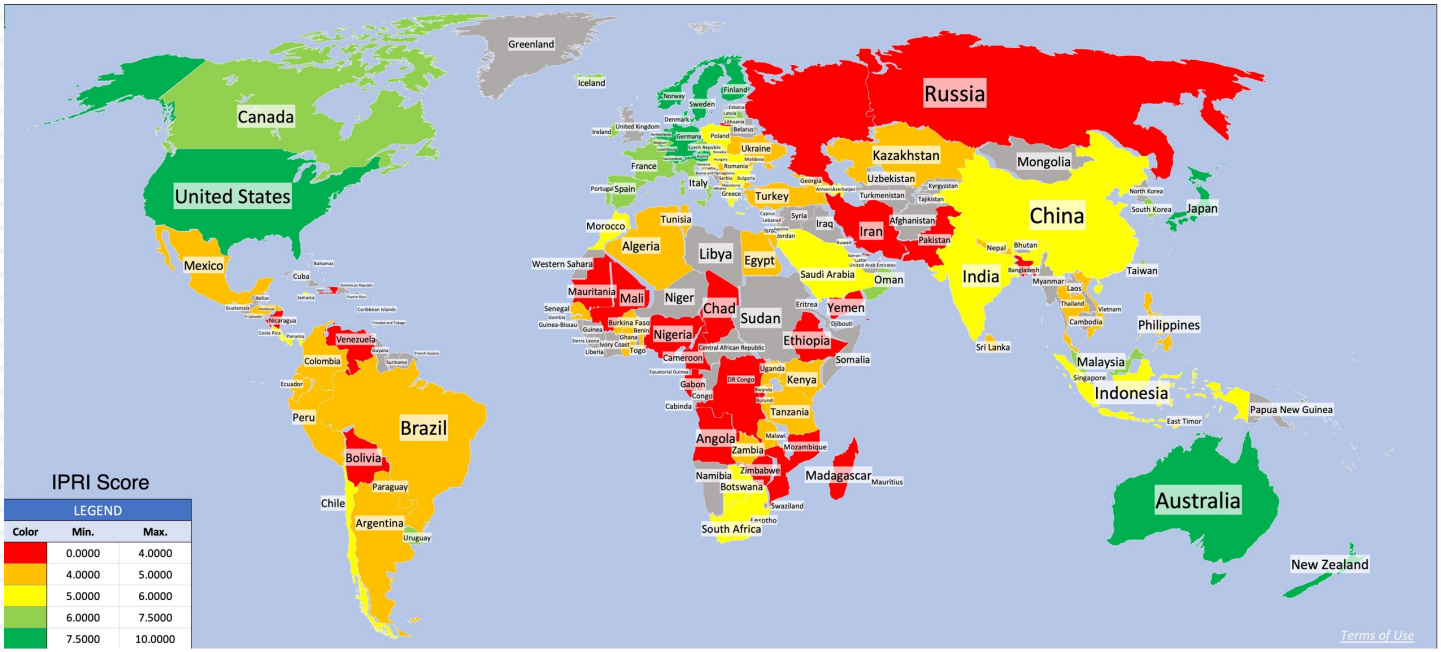
Higher scores correspond to more exposure to violence and risk

3. Extent of corruption



Least corrupt		*Most corrupt*	
Country	*Corruption score*	*Country*	*Corruption score*
Denmark	90	Somalia	11
Finland	87	South Sudan	13
New Zealand	85	Syria	13
Norway	84	Venezuela	13
Singapore	83	Yemen	16
Sweden	82	Equatorial Guinea	17
Switzerland	82	Haiti	17
Netherlands	79	Korea, North	17
Germany	78	Nicaragua	17
Luxembourg	78	Libya	18

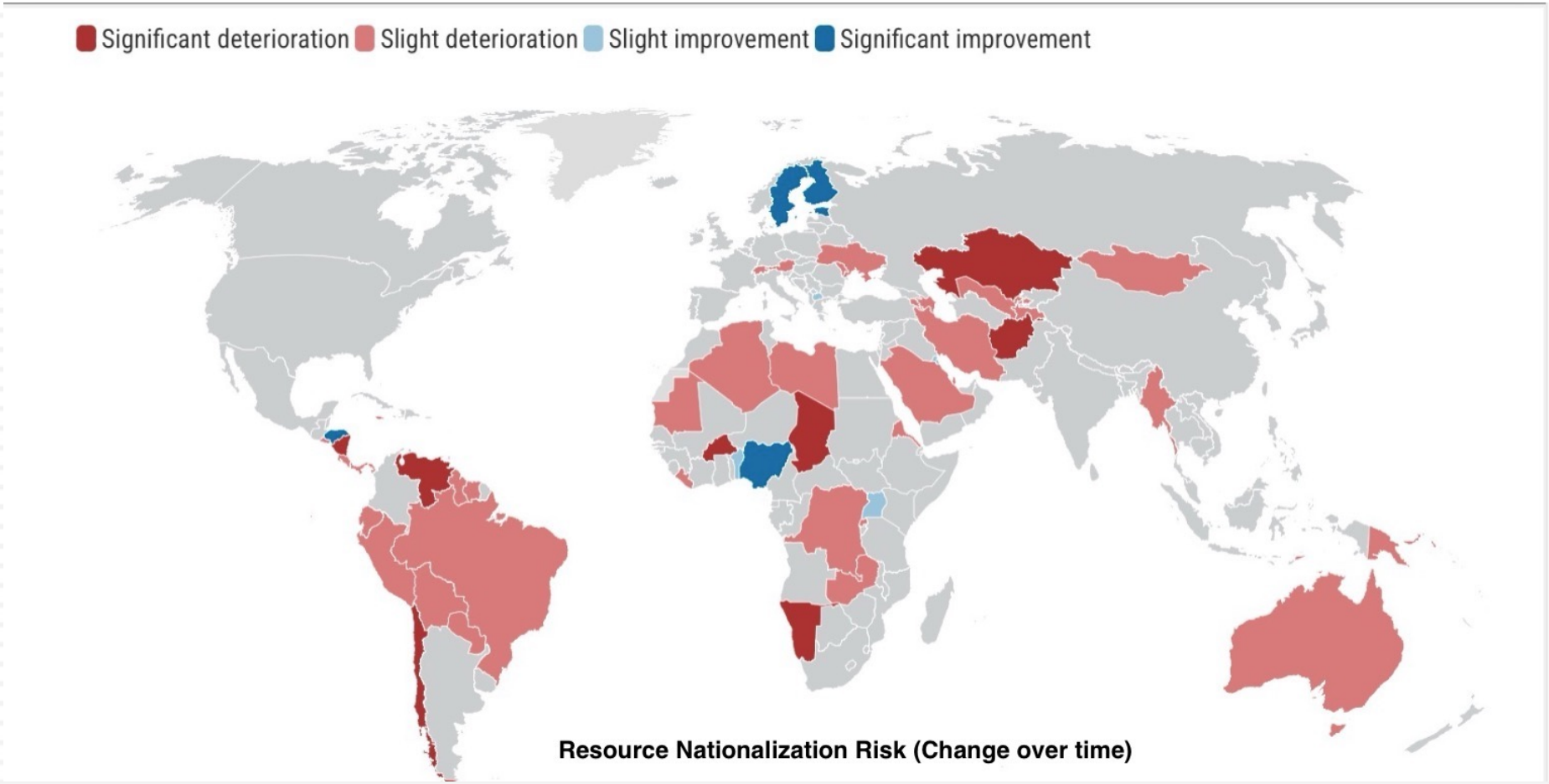
4. Legal and Property rights



IPR: Composite Property Rights
LP: Legal Property Rights
PPR: Physical property rights
IPR: Intellectual Property right

Region	*IPRI*	*LP*	*PPR*	*IPR*
Africa	4.146	3.726	4.254	4.459
Asia	5.264	4.913	5.736	5.142
Central America	4.490	4.154	4.366	4.949
European Union	6.564	6.956	6.119	6.618
North America	6.524	6.144	6.264	7.163
Oceania	7.740	8.407	7.572	7.242
Rest of Europe	5.351	5.172	5.341	5.541
South America	4.376	4.296	4.298	4.536

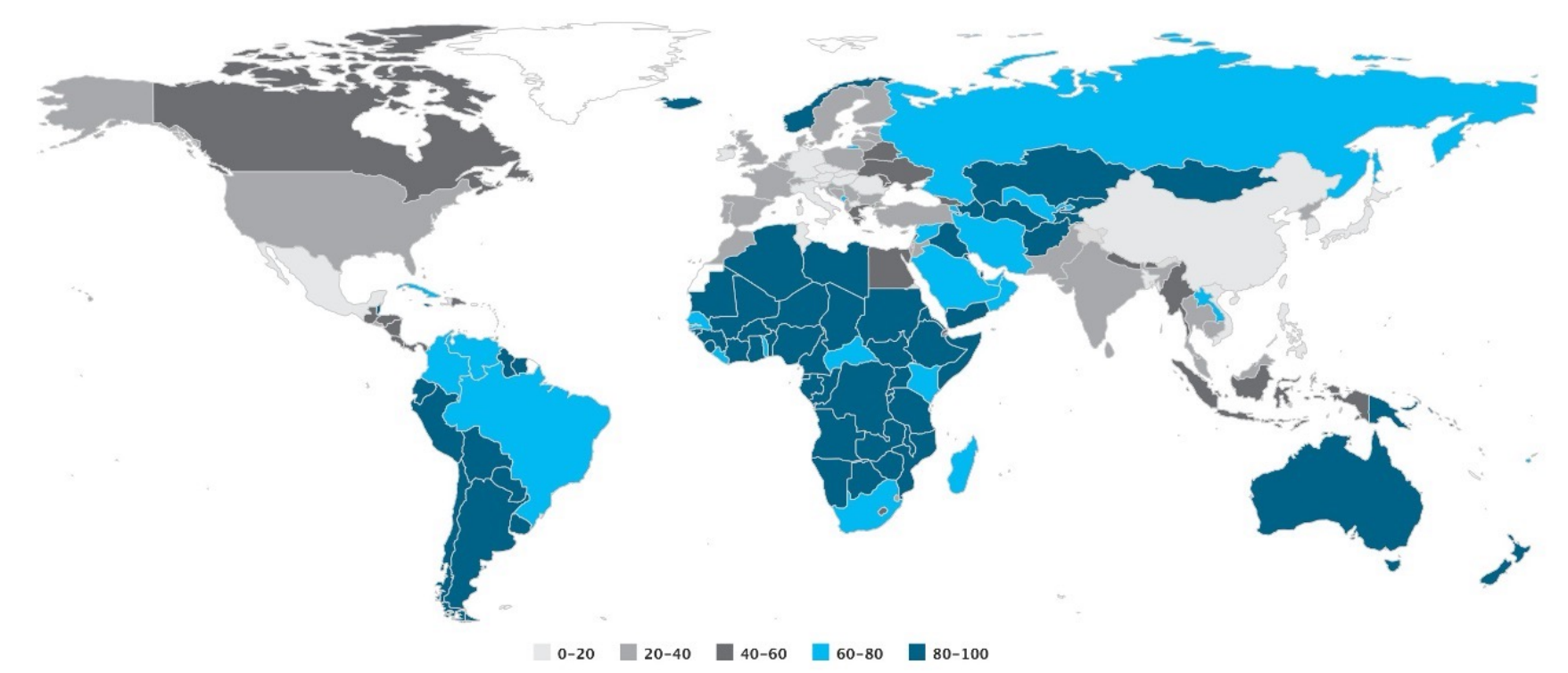
With nationalization risk an illustrative case..



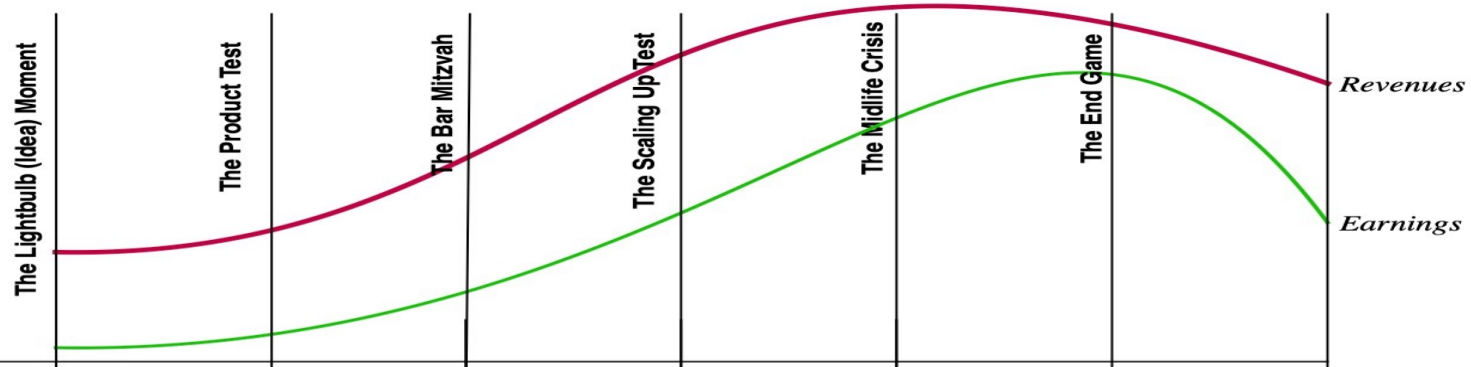
Country Risk: External Drivers

- Looking at the last section, you would not be faulted for believing that country risk exposure is self-determined, and that countries can become less risky by working on reducing corruption, increasing their legal protections for property rights, making themselves safer and working on their political structures.
- That is true, but there are three factors that are largely out of their control that can still drive country risk upwards.
  - Economic over-dependence on a commodity or commodities
  - Country's position in life cycle
  - Climate Change

1. Commodity Dependence

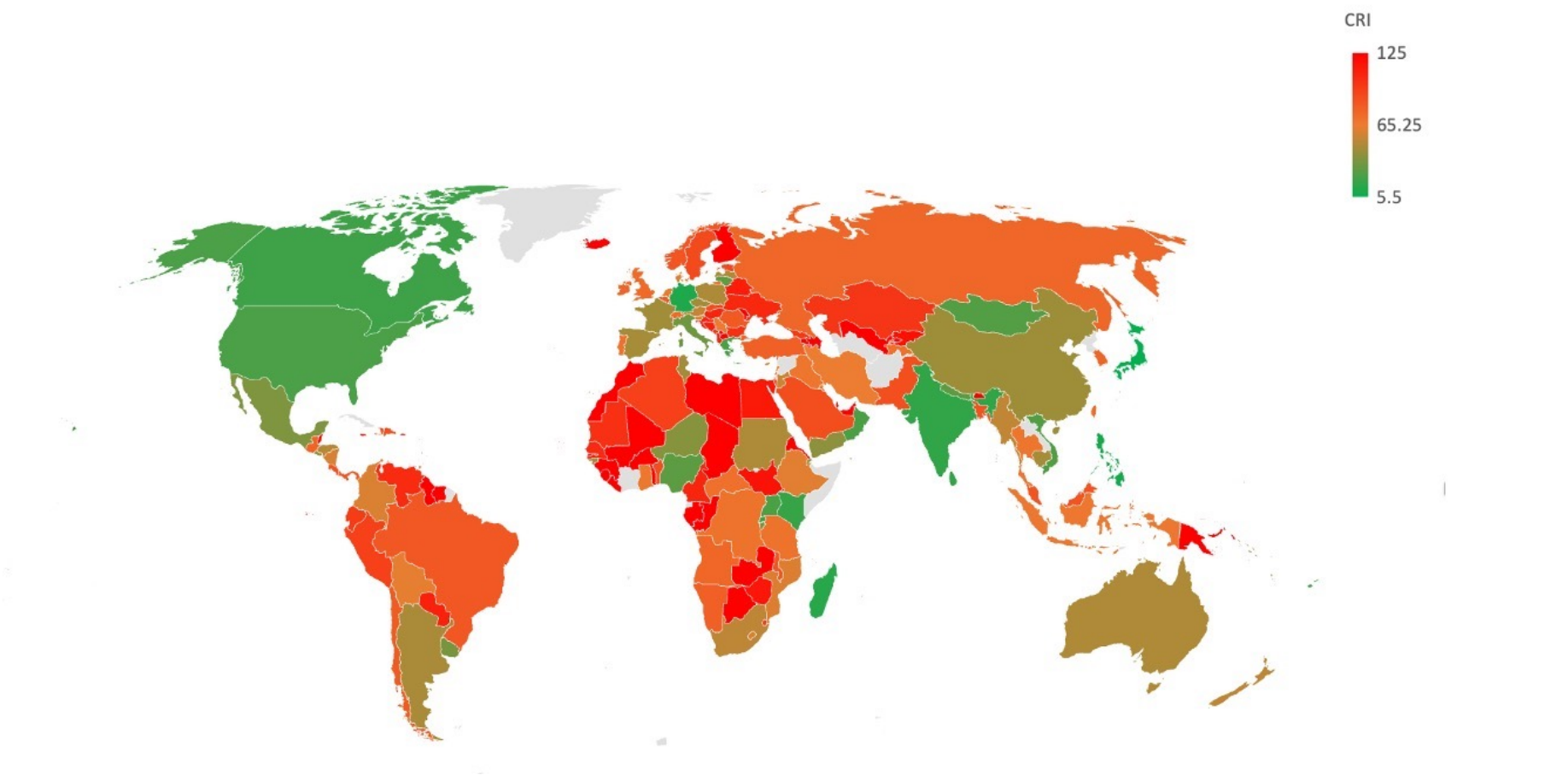


2. Country Life Cycle

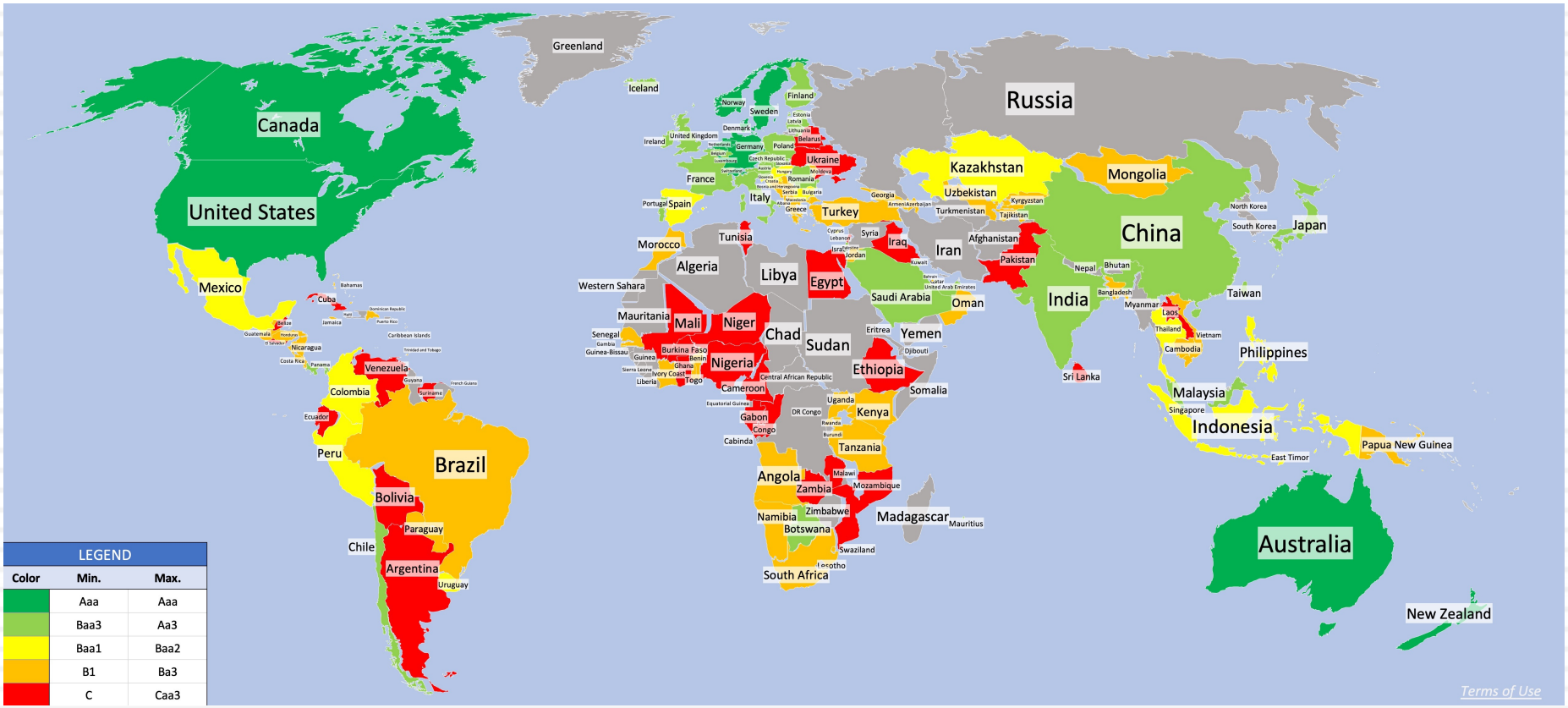


Life Cycle Stage	**Start-Up**	**Young Growth**	**High Growth**	**Mature Growth**	**Mature Stable**	**Decline**
Description	Business idea, nascent product	Build a business	Deliver results (growth & profits)	Scale up with profitability	Defend profit and share	Scale down
Operating characteristics	Little or no revenues, big losses, negative cashflows	High growth, continued losses and negative cashflows.	Growth continues, with margins and cashflows improve,	Growth sccales down, profits surge and cashflows follow.	Growth levels off, and cashflows catch up to earnings.	Declining revenues, shrinking margins.
Narrative versus Numbers	All narrative	Mostly narrative	Narrative + numbers	Numbers + narrative	Mostly numbers	All numbers
Narrative Drivers	How big is the narrative?	Plausibility of narrative	Profitability of inarrative	Scalability of narrative	Sustainability of narrative	How happy is the ending?
Narrative Differences	Unconstrained & large differences	*Constraints mount as numbers build up* *Differences across investors narrow as history deepens*				Constrained & narrow differences
Uncertainty	High	Mostly narrative	Narrative + numbers	Numbers + narrative	Mostly numbers	All numbers
Value drivers	Total market size	Revenue growth	Growing margins	Revenue scalability	Return on capital	Failure rate

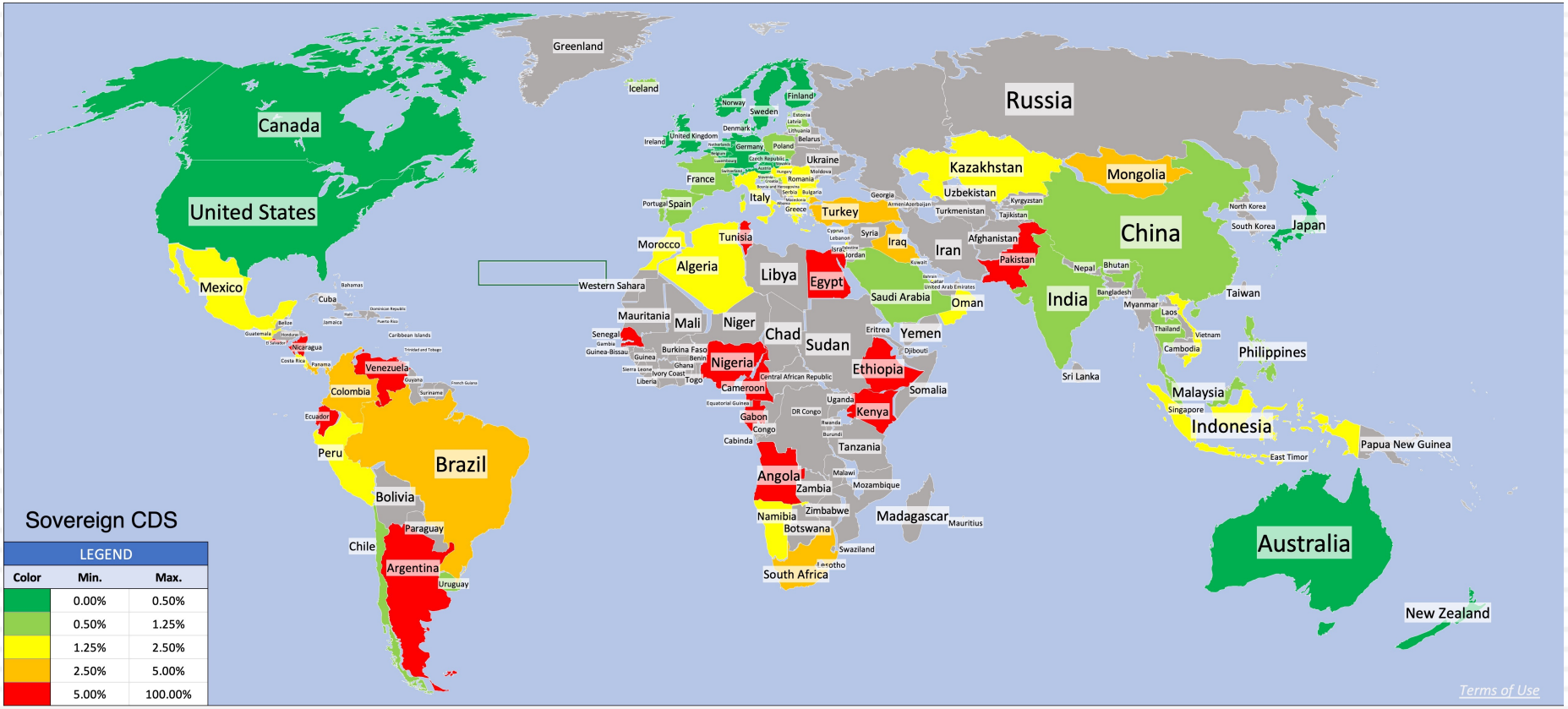
3. Climate Change



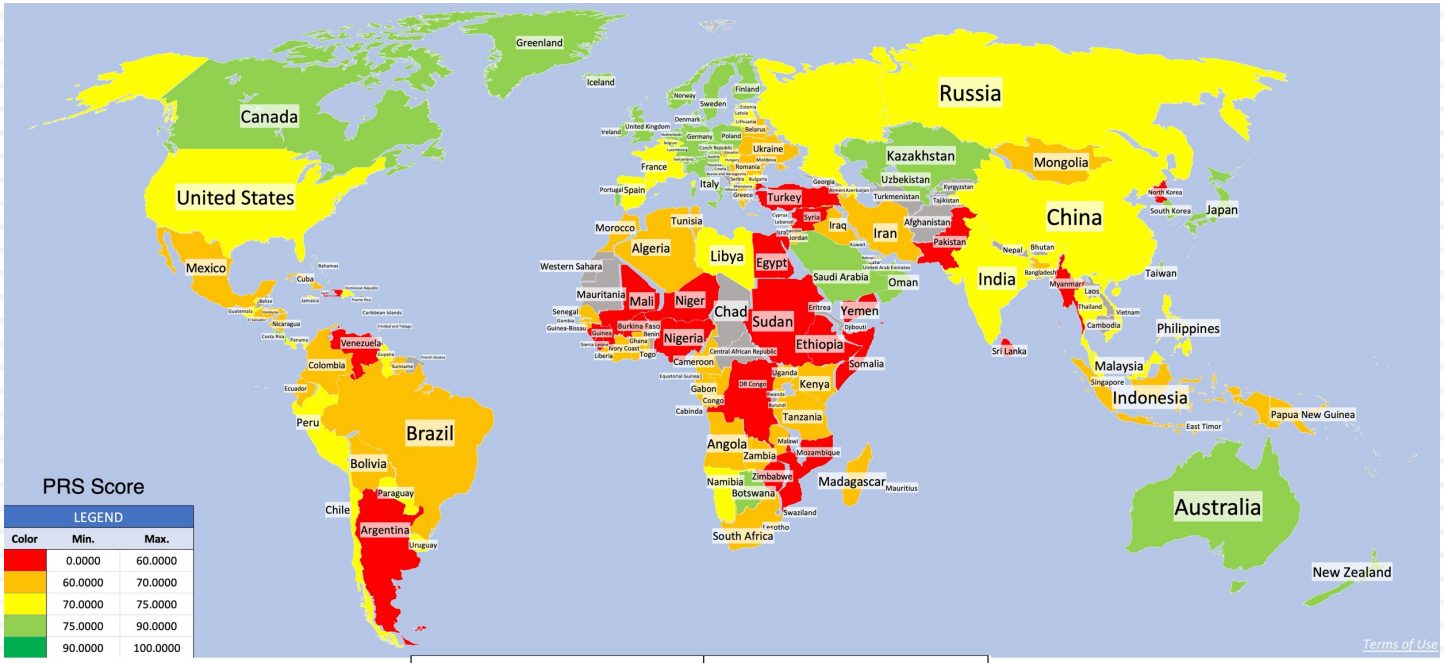
Measuring Country Risk –
1. Default Risk = Sovereign Ratings



A Market-based alternative – Sovereign CDS spreads



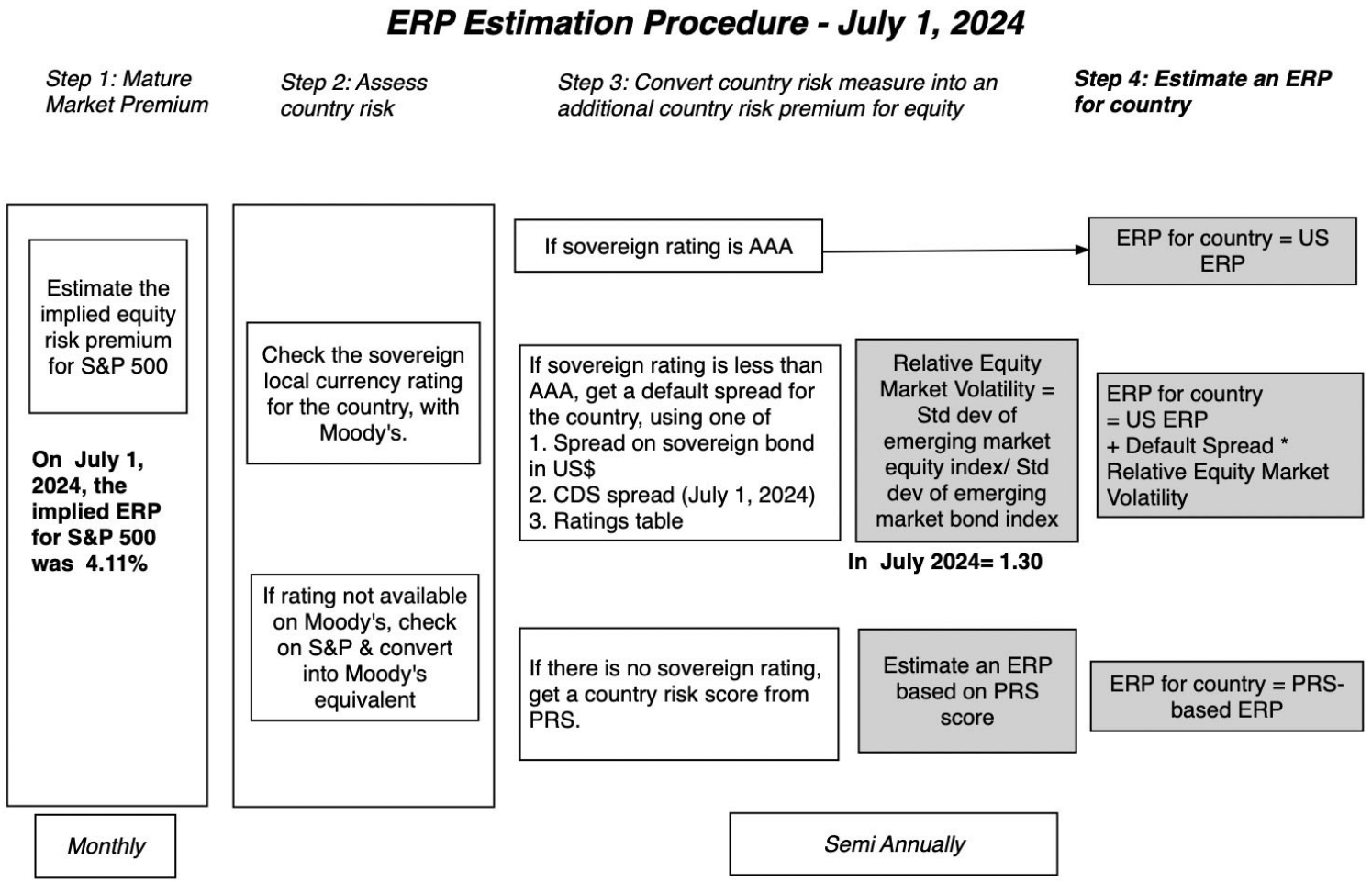
2. Country Risk Scores



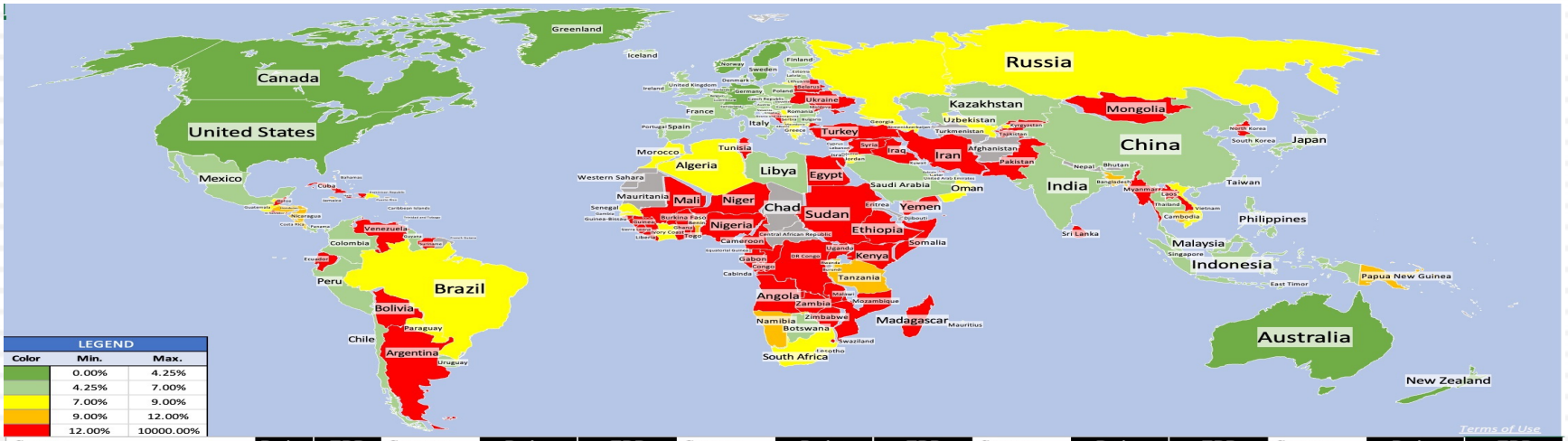
Lowest PRS scores indicate higher country risk

Riskiest countries		*Safest countries*	
Country	*PRS*	*Country*	*PRS*
Lebanon	34.3	Norway	87.0
Sudan	43.5	Singapore	86.5
Syria	44.3	Denmark	86.3
Niger	48.0	Taiwan	86.3
Korea, D.P.R.	49.3	Switzerland	86.0
Yemen, Republic	51.5	Luxembourg	84.3
Malawi	52.3	Ireland	83.0
Venezuela	53.0	Iceland	82.0
Nigeria	54.3	Brunei	81.8
Pakistan	54.3	Canada	81.8

3. Equity Risk Premiums - Approach



And results…

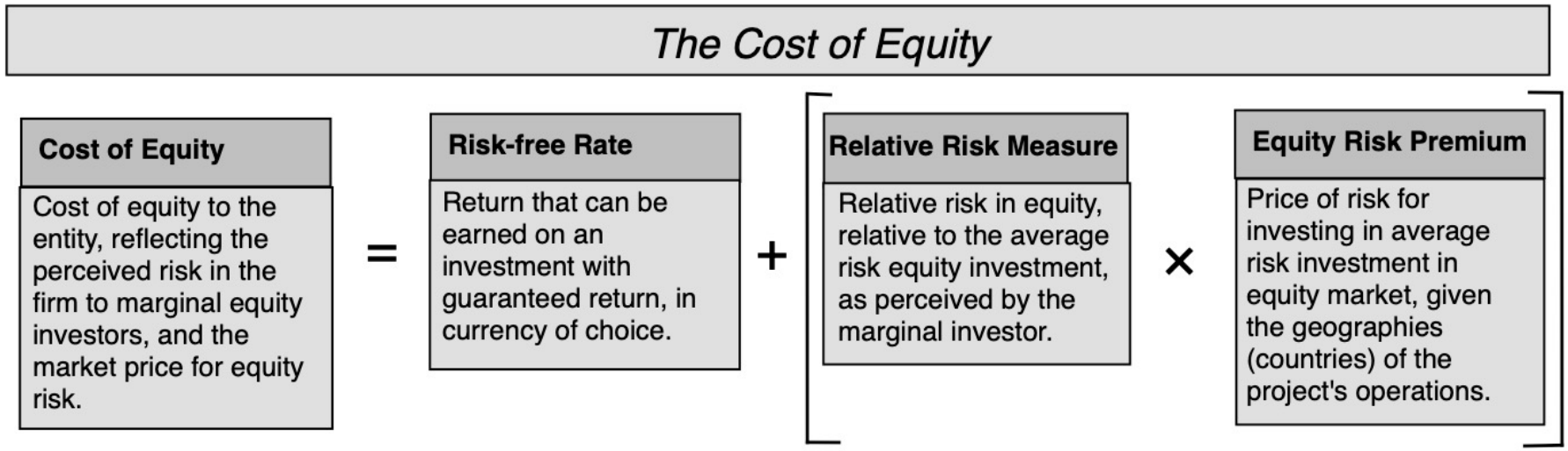


LEGEND		
Color	Min.	Max.
	0.00%	4.25%
	4.25%	7.00%
	7.00%	9.00%
	9.00%	12.00%
	12.00%	10000.00%

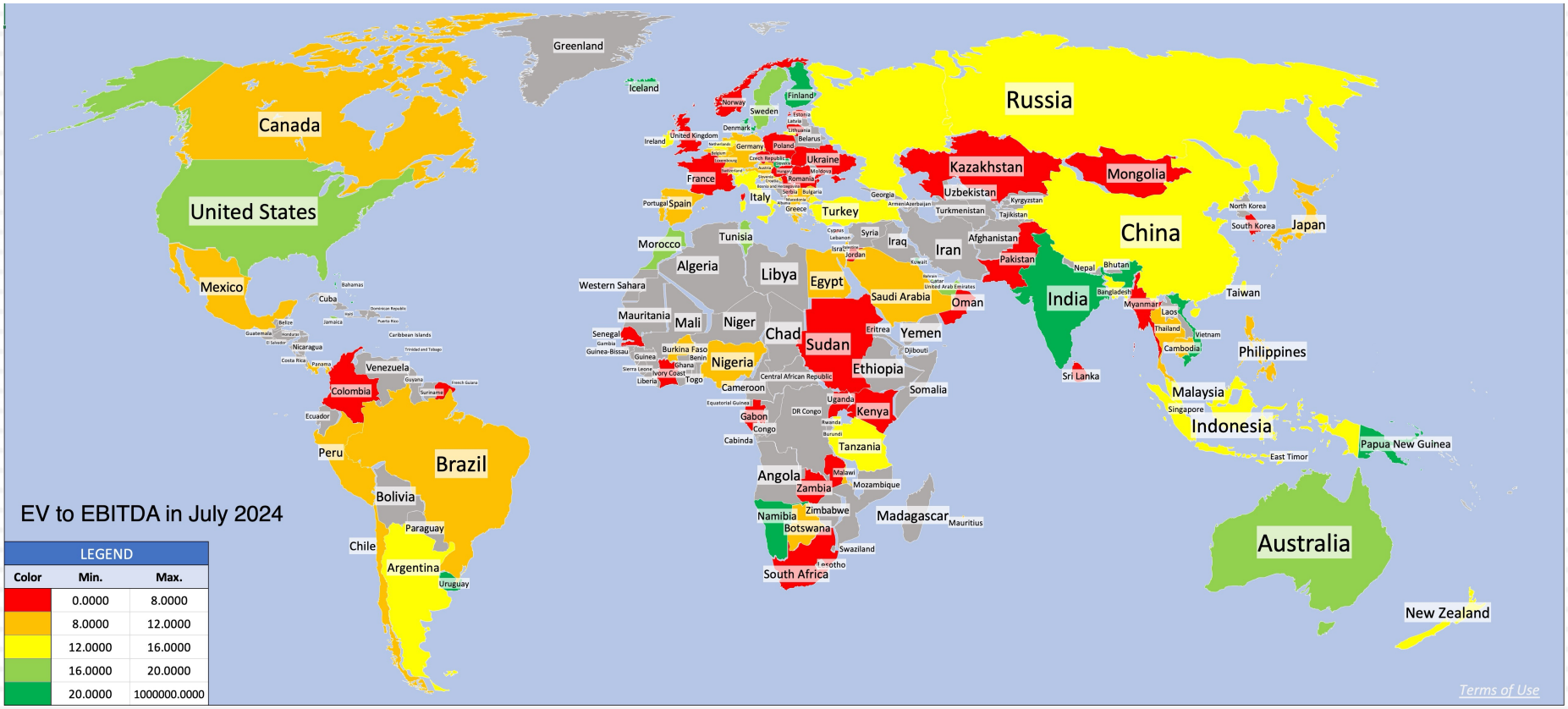
Country	Rating	*ERP*	*Country*	Rating	*ERP*	*Country*	Rating	*ERP*	*Country*	Rating	*ERP*	*Country*	Rating	*ERP*
Abu Dhabi	Aa2	4.71%	Congo (Repu	Caa2	15.11%	Indonesia	Baa2	6.44%	Mongolia	B3	12.05%	Somalia	NR	18.77%
Albania	B1	9.61%	Cook Islands	B1	9.61%	Iran	NR	12.05%	Montenegro	B1	9.61%	South Africa	Ba2	7.78%
Algeria	NR	7.78%	Costa Rica	B1	9.61%	Iraq	Caa1	13.27%	Montserrat	Baa3	6.79%	Spain	Baa1	6.06%
Andorra (Principality of)	Baa1	6.06%	Côte d'Ivoire	Ba2	7.78%	Ireland	Aa3	4.84%	Morocco	Ba1	7.17%	Sri Lanka	Ca	18.77%
Angola	B3	12.05%	Croatia	Baa2	6.44%	Isle of Man	Aa3	4.84%	Mozambique	Caa2	15.11%	St. Maarten	Ba2	7.78%
Argentina	Ca	18.77%	Cuba	Ca	18.77%	Israel	A2	5.14%	Myanmar	NR	15.11%	St. Vincent &	B3	12.05%
Armenia	Ba3	8.50%	Curacao	Baa3	6.79%	Italy	Baa3	6.79%	Namibia	B1	9.61%	Sudan	NR	26.83%
Aruba	Baa3	6.79%	Cyprus	Baa2	6.44%	Jamaica	B1	9.61%	Netherlands	Aaa	4.11%	Suriname	Caa3	16.33%
Australia	Aaa	4.11%	Czech Repub	Aa3	4.84%	Japan	A1	4.97%	New Zealand	Aaa	4.11%	Swaziland	B3	12.05%
Austria	Aa1	4.60%	Denmark	Aaa	4.11%	Jersey (State	Aa3	4.84%	Nicaragua	B2	10.83%	Sweden	Aaa	4.11%
Azerbaijan	Ba1	7.17%	Dominican R	Ba3	8.50%	Jordan	Ba3	8.50%	Niger	Caa3	16.33%	Switzerland	Aaa	4.11%
Bahamas	B1	9.61%	Ecuador	Caa3	16.33%	Kazakhstan	Baa2	6.44%	Nigeria	Caa1	13.27%	Syria	NR	26.83%
Bahrain	B2	10.83%	Egypt	Caa1	13.27%	Kenya	B3	12.05%	Norway	Aaa	4.11%	Taiwan	Aa3	4.84%
Bangladesh	B1	9.61%	El Salvador	Caa1	13.27%	Korea	Aa2	4.71%	Oman	Ba1	7.17%	Tajikistan	B3	12.05%
Barbados	B3	12.05%	Estonia	A1	4.97%	Korea, D.P.R.	NR	26.83%	Pakistan	Caa3	16.33%	Tanzania	B1	9.61%
Belarus	C	26.83%	Ethiopia	Caa2	15.11%	Kuwait	A1	4.97%	Panama	Baa3	6.79%	Thailand	Baa1	6.06%
Belgium	Aa3	4.84%	Fiji	B1	9.61%	Kyrgyzstan	B3	12.05%	Papua New (	B2	10.83%	Togo	B3	12.05%
Belize	Caa2	15.11%	Finland	Aa1	4.60%	Laos	Caa3	16.33%	Paraguay	Ba1	7.17%	Trinidad and	Ba2	7.78%
Benin	B1	9.61%	France	Aa2	4.71%	Latvia	A3	5.57%	Peru	Baa1	6.06%	Tunisia	Caa2	15.11%
Bermuda	A2	5.14%	Gabon	Caa2	15.11%	Lebanon	C	26.83%	Philippines	Baa2	6.44%	Turkey	B3	12.05%
Bolivia	Caa3	16.33%	Gambia	NR	9.61%	Liberia	NR	13.27%	Poland	A2	5.14%	Turks and Ca	Baa1	6.06%
Bosnia and Herzegovina	B3	12.05%	Georgia	Ba2	7.78%	Libya	NR	6.06%	Portugal	A3	5.57%	Uganda	B3	12.05%
Botswana	A3	5.57%	Germany	Aaa	4.11%	Liechtenstein	Aaa	4.11%	Qatar	Aa2	4.71%	Ukraine	Ca	18.77%
Brazil	Ba2	7.78%	Ghana	Caa3	16.33%	Lithuania	A2	5.14%	Ras Al Khait	A3	5.57%	United Arab	Aa2	4.71%
Brunei	NR	4.84%	Greece	Ba1	7.17%	Luxembourg	Aaa	4.11%	Romania	Baa3	6.79%	United King	Aa3	4.84%
Bulgaria	Baa1	6.06%	Guatemala	Ba1	7.17%	Macao	Aa3	4.84%	Russia	NR	7.78%	United States	Aaa	4.11%
Burkina Faso	Caa1	13.27%	Guernsey (St	A1	4.97%	Macedonia	Ba3	8.50%	Rwanda	B2	10.83%	Uruguay	Baa1	6.06%
Cambodia	B2	10.83%	Guinea	NR	15.11%	Madagascar	NR	12.05%	Saudi Arabia	A1	4.97%	Uzbekistan	Ba3	8.50%
Cameroon	Caa1	13.27%	Guinea-Bissa	NR	12.05%	Malawi	NR	18.77%	Senegal	Ba3	8.50%	Venezuela	C	26.83%
Canada	Aaa	4.11%	Guyana	NR	6.06%	Malaysia	A3	5.57%	Serbia	Ba2	7.78%	Vietnam	Ba2	7.78%
Cape Verde	B3	12.05%	Haiti	NR	18.77%	Maldives	Caa1	13.27%	Sharjah	Ba1	7.17%	Yemen, Repu	NR	18.77%
Cayman Islands	Aa3	4.84%	Honduras	B1	9.61%	Mali	Caa2	15.11%	Sierra Leone	NR	15.11%	Zambia	Caa2	15.11%
Chile	A2	5.14%	Hong Kong	Aa3	4.84%	Malta	A2	5.14%	Singapore	Aaa	4.11%	Zimbabwe	NR	15.11%
China	A1	4.97%	Hungary	Baa2	6.44%	Mauritius	Baa3	6.79%	Slovakia	A2	5.14%			
Colombia	Baa2	6.44%	Iceland	A2	5.14%	Mexico	Baa2	6.44%	Slovenia	A3	5.57%			
Congo (Democratic Republic of)	B3	12.05%	India	Baa3	6.79%	Moldova	B3	12.05%	Solomon Isla	Caa1	13.27%			

Country Risk in Business

Country risk in valuation



Country risk in pricing

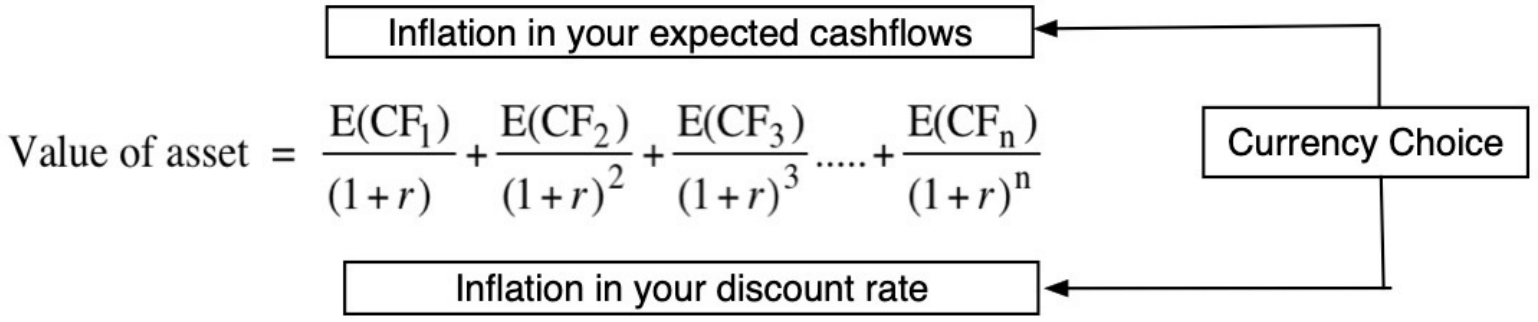


Where is the currency effect/risk?

- You may find it odd that I have spent so much of this post talking about country risk, without bringing up currencies, but that was not an oversight.
- It is true that riskier countries often have more volatile currencies that depreciate over time, but this more a symptom of country risk, than a cause.
- As I will argue, the currency choice affects your growth, cash flow and discount rate estimates, but ultimately should have no effect on intrinsic value.

Currency Consistency

- If expected inflation is lower in US dollars than in rupees, the cost of capital that you should obtain for a company in US dollars will be lower than the cost of capital in rupees, with the difference reflecting the expected inflation differential.
- However, since your cash flows will also then have to be in US dollars, the expected growth that you should use should reflect the lower inflation rate in dollars, and if you stay consistent in your inflation estimates, the effects should cancel out.



Riskfree rates and Inflation

- If my assertion about expected inflation is right, variations in riskfree rates can be attributed entirely to difference in expected inflation.
- At the start of July 2024, for instance, I estimated the riskfree rates in every currency, using the US treasury bond rate as my dollar riskfree rate, and the differential inflation between the currency in question and the US dollar:

$$\text{Riskfree rate in Currency} = (1 + \text{US Treasury Bond rate}) * \frac{(1+\text{Expected Inflation Rate in Currency})}{(1+\text{Expected Inflation Rate in US \$})} - 1$$

Exchange rates and inflation

- In the same vein, inflation also enters into expected exchange rate calculations:

$$\text{Expected Exchange Rate}_{C1,C2} = \text{Spot Exchange Rate}_{C1,C2} \frac{(1+Expected\ Inflation\ Rate_{C1})}{(1+Expected\ Inflation\ Rate_{C2})}$$

- Higher inflation currencies should see expected currency depreciation in future years. It is not the depreciation, per se, that is risk, but deviations from that depreciation.
- This is, of course, the purchasing power parity theorem, and while currencies can deviate from this in the short term, it remains the best way to ensure that your currency views do not hijack your valuation.