

THE IMPACT OF SOVEREIGN CREDIT RATINGS ON INDIRECT FOREIGN INVESTMENT FLOWS TO EQUITY MARKETS: INTERNATIONAL EVIDENCE

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Abstract

The study investigated the impact of Sovereign Credit Ratings on Indirect Foreign Investment flows to equity markets through panel data for seven equity markets (Argentina, Brazil, Egypt, India, Nigeria, South Africa and the United Arab Emirates) from q1 2015 to q4 2019. The study created an index of equal weights based on Fitch, Moody's and Standard & Poor's assessments. The study found a significant impact of sovereign credit ratings on indirect foreign investment flows to equity markets at the level of 1%. This explains (12.89%) of indirect foreign investment flows to equity markets. The study can estimate other factors impacting the flow of indirect foreign investment, including factors such as the size of the equity markets and the level of equity market efficiency, It is recommended that these factors be tested in future studies.

Keywords: Sovereign Credit Ratings; Indirect Investment; Foreign Investment; Equity Markets

1. INTRODUCTION

An international portfolio is a collection of equities and other financial assets that focuses on overseas equity markets rather than domestic ones. If carefully planned, an international portfolio offers an investor exposure to emerging and international equity markets and offers diversity. This supports better performance for international portfolio vs. domestic portfolios.(see Fig. 1&2) The reason is due to the low correlation coefficient of international stocks compared to domestic stocks from one market.

This type of portfolio, on the other hand, carries additional types of risk due to the possibility of economic and political instability in certain Foreign equity markets, as well as the possibility that the domestic currency depreciation with comparison to international currencies such as the U.S. Dollar and the Euro. Other words, the international portfolio means that the investor get an investment opportunities under the risks of a non-domestic risk pattern, it is systematic risk, such as political risks and exchange rates. It has the ability to generate shareholder value through the exploitation of international and emerging equity markets (Driessen and Laeven. 2007).

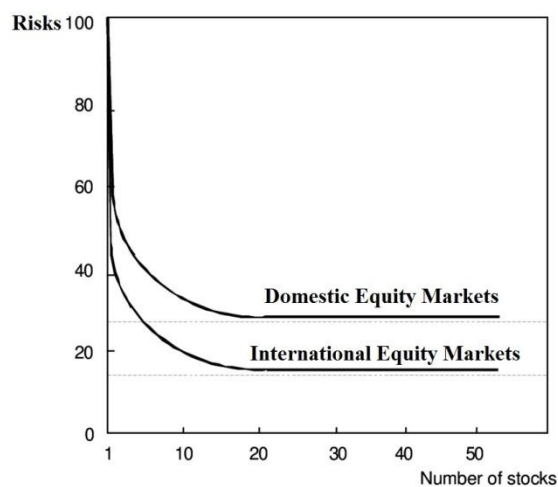


Figure No. (1):

Risk under International diversification Vs. Domestic diversification

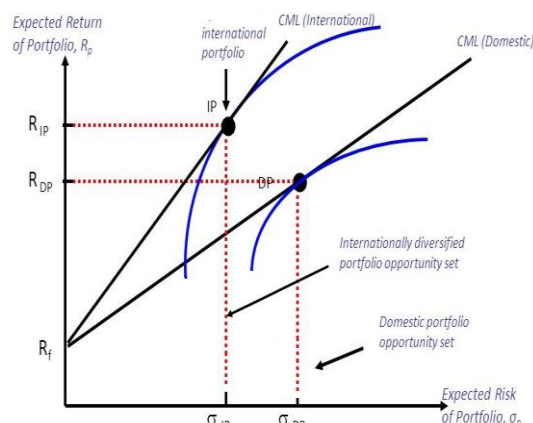


Figure No. (2):

International portfolio vs. Domestic portfolio

The current study seeks to dealt the impact of sovereign risks according to the credit rating on foreign investment in an equity markets by providing a theoretical framework in addition to a statistical test.

2. Theoretical framework and Literature Review

Globalization of financial markets and foreign investors' pursuit of better potential returns have resulted in large international equity investments, particularly in emerging economies (Lin & Swanson, 2003; Richards, 2005; Kim, J. B., & Cheong, 2015). The international portfolio flows of foreign investors into these markets have been investigated in the literature, with an emphasis on their behavior and the influence on stock prices. The majority of empirical financial research has concentrated on price impact effects (Bohn and Tesar, 1996; Brennan and Coa, 1997; Froot et al., 2001; Dahlquist and Robertsson, 2004; Richards, 2005; Richards, 2005; Gul et. al., 2010, He and Shen, 2014; Lim et. al., 2016; Kim and Jo, 2019; Kim et. al., 2020; Iwatsubo and Watkins, 2021), volatility effects (Bekaert and Harvey, 2000; Lin et al., 2010; Huang et. al., 2020), and destabilizing effects of foreign investors on domestic financial markets and economic growth (Bowe and Domuta, 2004). The effect of indirect foreign investment was not limited to the performance of the markets, but also included the cost of finance in this market (Vo, 2017; Tsaganos et. al., 2019; Tran, 2021)

However, because the foreign investor typically lacks local sources of information, they are vulnerable to information asymmetry, so the foreign investor places a high reliance on credit rating agencies. Credit rating agencies (CRA) such as Fitch, Moody's and Standard & Poor's issue ratings for companies and countries (Sovereign), as well as some financial instruments (Yalta and Yalta, 2018; Driss et. al., 2019). The three major credit rating agencies evaluate a country's capability and

present and future debt obligations based on a mixture of economic, social, and political factors; The higher long-term ratings ranging issues by both "Fitch" and "S&P" was "AAA" but "Aaa" by "Moody's". Moody's makes the most optimistic projections when it comes to country ratings. Moody's is followed by Standard and Poor's, while Fitch is the credit rating agency that issues the most pessimistic estimates (Genc and Basar, 2019).

Table No. (1) Sovereign Credit Ratings for Moody's; S&P and Fitch

Grade	Moody's	S&P	Fitch
Prime	Aaa	AAA	AAA
High grade	Aa1	AA+	AA+
	Aa2	AA	AA
	Aa3	AA-	AA-
Upper medium grade	A1	A+	A+
	A2	A	A
	A3	A-	A-
Lower medium grade	Baa1	BBB+	BBB+
	Baa2	BBB	BBB
	Baa3	BBB-	BBB-
Non-investment grade speculative	Ba1	BB+	BB+
	Ba2	BB	BB
	Ba3	BB-	BB-
Highly speculative	B1	B+	B+
	B2	B	B
	B3	B-	B-
Substantial risks	Caa1	CCC+	CCC+
	Caa2	CCC	CCC
	Caa3	CCC-	CCC-
Extremely speculative	Ca	CC	CC
			C
In default with little prospect for recovery	C	D	RD
			D
In default	C	D	DD
			DDD
Not rated	WR	NR	

The current study believes that an investor in foreign stock exchanges found an indication of the attractiveness of foreign stock exchanges for investment according to the high rating of the host country. By other words, there is a positive relationship between sovereign credit ratings and Indirect Foreign Investment flows.

Sovereign Credit Ratings methodology depends on a set of factors through which the drivers of return can be assessed on the one hand versus systemic risk on other hand; this is core of the rational investment declaration.

The sovereign credit ratings report seeks to offer investors a clear view of the dimensions of financial investment in foreign countries. It defines a sovereign as a country that administers its own government and is not subject to or dependent on another sovereign for all or most prerogatives. For instance, one of the most essential prerogatives of a sovereign is the ability to select the currency it uses, as well as the political and budgetary frameworks in which it functions. Thus, it defines "economic assessment", "monetary assessment", "fiscal assessment"; "political; government system and institutional assessment" and "regional security assessment". Figure No. (3): illustrates the relationship between sovereign credit ratings information and determinants of Indirect Foreign Investment flows

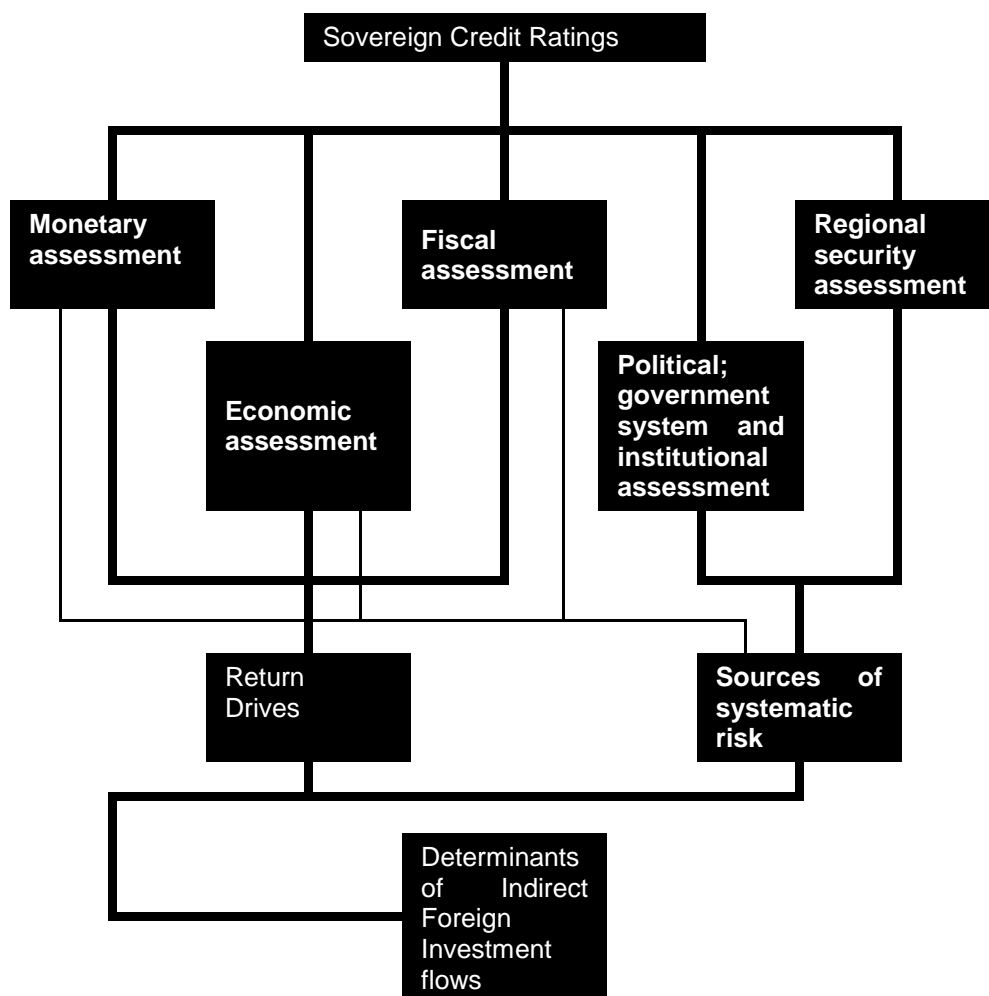


Figure No. (3): The relationship between sovereign credit ratings information and determinants of Indirect Foreign Investment flows

Thus, the sovereign credit ratings report is given to investors them a clear view of the business environment in foreign countries, in addition to analyzing many macroeconomic variables. Through literary reviews, there are many studies indicating the relationship between the performance of stock exchanges and macroeconomic variables (Jamaludin et. al., 2017; Ullah et al., 2017; Bhuiyan and Chowdhury, 2020; Igoni et. al., 2020; Lee and Brahmasurene, 2020; Nawindra and

Wijayanto, 2020; Banchit et. al., 2020). In addition to a study related to political risks and the performance of stock exchanges (Diamonte et. al., 1996; Helmy and Wagdi, 2016), The sovereign credit ratings report support the foreign investor's investment decision by disclosing the return drivers on the one hand versus the sources of systematic risk on the other, thereby enhancing the foreign investor's ability to assessment foreign markets on similar bases and in a very short time.

3. Methodology and Study Design

the study propose a cross-sectional time-series model to assess the Sovereign Credit Ratings in seven equity markets (Argentina, Brazil, Egypt, India, Nigeria, South Africa and United Arab Emirates) based on Fitch, Moody's and Standard & Poor's assessment. The study created an index of equal weights from the three assessments for the five-year, period from 2015 to 2019, with the index value updated on a quarterly basis, with the last announced assessment in 2014 being the base points for each equity markets. Table No. (2) illustrates the assessments' contribution to the index's value.

Table No. (2) The assessments' contribution of Sovereign Credit Ratings to the index's value

Grade	Moody's	S&P	Fitch	Points
Prime	Aaa	AAA	AAA	100
High grade	Aa1	AA+	AA+	97.5
	Aa2	AA	AA	95
	Aa3	AA-	AA-	92.5
Upper medium grade	A1	A+	A+	90
	A2	A	A	87.5
	A3	A-	A-	85
Lower medium grade	Baa1	BBB+	BBB+	82.5
	Baa2	BBB	BBB	80
	Baa3	BBB-	BBB-	77.5
Non-investment grade speculative	Ba1	BB+	BB+	75
	Ba2	BB	BB	72.5
	Ba3	BB-	BB-	70
Highly speculative	B1	B+	B+	67.5
	B2	B	B	65
	B3	B-	B-	62.5
Substantial risks	Caa1	CCC+	CCC+	60
	Caa2	CCC	CCC	57.5
	Caa3	CCC-	CCC-	55
Extremely speculative	Ca	CC	CC	52.5
			C	50
In default with little prospect for recovery	C	SD	RD	47.5
			D	45
In default	C	D	DD	42.5
			DDD	40

On the other hand, the study collected the published data on Indirect Foreign Investment flows to seven equity markets (Argentina, Brazil, Egypt, India, Nigeria, South Africa and United Arab Emirates) on a quarterly basis for the same period. The study analysed the stationarity of data to guarantee that the mean and variance were invariant using a unit root test. Additionally, the study evaluated the stationarity of time series of the fundamental independent and dependent indicators at level zero using the constant level. At a significance level of less than 0.05, this was accomplished using the Augmented Dickey–Fuller (ADF), Philips–Perron (PP), Im, Pesaran, and Shin W-statistic (IPSW), Levin, and Lin and Chu t (LLC) tests. Along with the Tau-statistic, the Z-statistic criteria were less than 0.05. The study investigated the impact of Sovereign Credit Ratings on Indirect Foreign Investment flows to equity markets through the panel data for seven equity markets within 20 quarterly from q1 2015 to q4 2019. 2020 data has been excluded according to the impact of the COVID-19 epidemic on equity markets (see: Alber, 2020; Zhang and Hamori, 2021; Lai and Hu, 2021).

4. Data Testing

Based on the theoretical framework and literature review, the study's test following hypotheses:

$H_{(0)}$: There isn't a significant impact of sovereign credit ratings on indirect foreign investment flows to equity markets.

$H_{(1)}$: There is a significant impact of sovereign credit ratings on indirect foreign investment flows to equity markets.

The study used the panel data within Fixed-effects for seven equity markets within from q1 2015 to q4 2019; based on quarterly data; Table No. (3) Illustrates the panel analysis output

Table No. (3) The panel analysis output

Model 1: Fixed-effects, using 140 observations

Included 7 cross-sectional units

Time-series length = 20

Dependent variable: IFIN

	Coefficient	Std. Error	t-ratio	p-value	
const	-7513.38	2857.45	-2.629	0.0096	***
SCR	181.526	41.0673	4.420	<0.0001	***

Mean dependent var	5083.217	S.D. dependent var	4670.916
Sum squared resid	8.10e+08	S.E. of regression	2476.412
LSDV R-squared	0.733068	Within R-squared	0.128933
LSDV F(7, 132)	51.78680	P-value(F)	7.36e-35
Log-likelihood	-1288.572	Akaike criterion	2593.144
Schwarz criterion	2616.677	Hannan-Quinn	2602.707
rho	0.333187	Durbin-Watson	1.312330

Joint test on named regressors -

Test statistic: $F(1, 132) = 19.5382$

with p-value = $P(F(1, 132) > 19.5382) = 2.03887e-005$

Test for differing group intercepts -

Null hypothesis: The groups have a common intercept

Test statistic: $F(6, 132) = 47.7481$

with p-value = $P(F(6, 132) > 47.7481) = 9.14406e-031$

Source: Gnu Regression, Econometrics and Time-series Library output.

The previous statistical results illustrates (LSDV F) was 51.7868, which is significant at the level of 1%, so table (3) illustrates a significant impact of sovereign credit ratings on indirect foreign investment flows to equity markets. Now, the study rejects the Null hypothesis and accepts the following alternative hypothesis:

$H_{(1)}$: There is a significant impact of sovereign credit ratings on indirect foreign investment flows to equity markets.

5. Conclusions and Recommendations

An international portfolio is a collection of equities and other financial assets that focuses on overseas equity markets rather than domestic ones. It offers an investor exposure to emerging and international equity markets and offers diversity. The study seeks to deal with the impact of sovereign risks on foreign investment in an equity markets.

The sovereign credit ratings report is supplied to investors them a clear view of the business climate in foreign equity markets, in addition to assessment various macroeconomic indicators and political risks. The sovereign credit ratings report support the foreign investor's investment decision by disclosing the return drivers on

the one hand versus the sources of systematic risk on the other, thereby enhancing the foreign investor's ability to assessment foreign markets on similar bases and in a very short time.

According to the statistical results, seven equity markets (Argentina, Brazil, Egypt, India, Nigeria, South Africa and the United Arab Emirates) are based on Fitch, Moody's and Standard & Poor's's assessment. For the five-year period from 2015 to 2019. The study found a significant impact of sovereign credit ratings on indirect foreign investment flows to equity markets at the level of 1%. This explains (12.89%) of indirect foreign investment flows to equity markets. The study can estimate other factors impacting the flow of indirect foreign investment, including factors such as the size of the equity markets and the level of equity market efficiency. It is recommended that these factors be tested in future studies.

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Appendix A

Sovereign Credit Ratings for Egypt

Nov-19	Developing	B	Standard & Poor's
Nov-19	Stable	B+	Fitch
Apr-19	Developing	B	Standard & Poor's
Apr-19	Stable	B2	Moody's
Mar-19	NR	B	Standard & Poor's
Mar-19	Stable	B+	Fitch
Jan-19	Stable	B3	Moody's
Aug-18	Positive	B3	Moody's
Aug-18	Positive	B	Fitch
May-18	Stable	B	Standard & Poor's
Jan-18	Positive	B	Fitch
Aug-17	Stable	B3	Moody's
Jun-17	Stable	B	Fitch
Dec-16	Stable	B	Fitch
Nov-16	Stable	B-	Standard & Poor's
Aug-16	Stable	B3	Moody's
Jul-16	Stable	B	Fitch
May-16	Negative	B-	Standard & Poor's
May-16	Stable	B	Fitch
Dec-15	Stable	B	Fitch
Nov-15	Stable	B-	Standard & Poor's
May-15	Positive	B-	Standard & Poor's
Apr-15	Stable	B3	Moody's
Oct-14	Stable	Caa1	Moody's

Sovereign Credit Ratings for India

Date	Outlook	Rating	Agency
Dec-19	Stable	BBB-	Fitch
Nov-19	Negative	Baa2	Moody's
Apr-19	Stable	BBB-	Fitch
Apr-18	Stable	BBB-	Fitch
Nov-17	Stable	Baa2	Moody's
May-17	Stable	BBB-	Fitch
Nov-16	Positive	Baa3	Moody's
Jul-16	Stable	BBB-	Fitch
Dec-15	Stable	BBB-	Fitch
Apr-15	Positive	Baa3	Moody's
Sep-14	Stable	BBB-	Standard & Poor's

Sovereign Credit Ratings for South Africa

Date	Outlook	Rating	Agency
Dec-19	Negative	BB+	Fitch
Nov-19	Negative	BB	Standard & Poor's
Nov-19	Negative	Baa3	Moody's
Sep-19	Developing	BB	Standard & Poor's
Jul-19	Negative	BB+	Fitch
May-19	NR	NR	Standard & Poor's
Dec-18	Stable	BB+	Fitch
Jun-18	Stable	BB+	Fitch
Mar-18	Stable	Baa3	Moody's
Nov-17	Stable	BB	Standard & Poor's
Nov-17	Stable watch	Baa3	Moody's
Nov-17	Stable	BB+	Fitch

Jun-17	Negative	Baa3	Moody's
Jun-17	Stable	BB+	Fitch
Apr-17	Negative	BB+	Standard & Poor's
Apr-17	Negative watch	Baa2	Moody's
Apr-17	Stable	BB+	Fitch
Dec-16	Negative	BBB-	Standard & Poor's
Nov-16	Negative	BBB-	Fitch
Jul-16	Stable	BBB-	Fitch
Jun-16	Stable	BBB-	Fitch
May-16	Negative	Baa2	Moody's
Mar-16	Negative watch	Baa2	Moody's
Dec-15	Negative	BBB-	Standard & Poor's
Dec-15	Negative	Baa2	Moody's
Dec-15	Stable	BBB-	Fitch
Nov-14	Stable	Baa2	Moody's

Sovereign Credit Ratings for Brazil

Date	Outlook	Rating	Agency
Dec-19	Positive	BB-	Standard & Poor's
Nov-19	Developing	BB-	Standard & Poor's
Nov-19	Stable	BB-	Fitch
Oct-19	NR	NR	Moody's
May-19	Stable	BB-	Fitch
Apr-19	Developing	BB-	Standard & Poor's
Aug-18	Stable	BB-	Fitch
Apr-18	Negative	Ba2	Moody's
Feb-18	Stable	BB-	Fitch

Date	Outlook	Rating	Agency
Jan-18	Stable	BB-	Standard & Poor's
Nov-17	Negative	BB	Fitch
Aug-17	Negative	BB	Standard & Poor's
May-17	Negative	Ba2	Moody's
May-17	Negative	BB	Fitch
Mar-17	Stable	Ba2	Moody's
Nov-16	Negative	BB	Fitch
Jul-16	Negative	BB	Fitch
May-16	Negative	BB	Fitch
Feb-16	Negative	BB	Standard & Poor's
Feb-16	Negative	Ba2	Moody's
Dec-15	Under Review	Baa3	Moody's
Dec-15	Negative	BB+	Fitch
Sep-15	Negative	BB+	Standard & Poor's
Aug-15	Stable	Baa3	Moody's
Jul-15	Negative	BBB-	Standard & Poor's
Sep-14	Negative	Baa2	Moody's

Sovereign Credit Ratings for Argentina

Date	Outlook	Rating	Agency
Dec-19	Developing	CC	Standard & Poor's
Dec-19	Negative	CC	Standard & Poor's
Dec-19	Developing	CC	Fitch
Sep-19	Developing	CC	Fitch
Aug-19	Negative	B-	Standard & Poor's

Aug-19	Negative	CCC-	Standard & Poor's
Aug-19	Under Review	Caa2	Moody's
Aug-19	Developing	RD	Fitch
Aug-19	Developing	CCC	Fitch
Jul-19	Negative	B2	Moody's
May-19	Negative	B	Fitch
Mar-19	NR	NR	Standard & Poor's
May-18	Stable	B	Fitch
Nov-17	Positive	B	Fitch
Oct-17	Stable	B+	Standard & Poor's
May-17	Stable	B	Fitch
Apr-17	Stable	B	Standard & Poor's
Mar-17	Positive	B3	Moody's
Oct-16	Stable	B	Fitch
Jul-16	Stable	B	Fitch
May-16	Stable	B-	Standard & Poor's
May-16	Stable	B	Fitch
Apr-16	Stable	B3	Moody's
Nov-15	Positive	Caa1	Moody's
Jul-14	Negative watch	CCC-	Standard & Poor's

Sovereign Credit Ratings for Nigeria

Date	Outlook	Rating	Agency
Dec-19	Negative	B3	Moody's
Dec-19	Negative	B+	Fitch
Jun-19	Stable	B+	Fitch
May-18	Negative	B+	Fitch

Nov-17	Stable	B2	Moody's
Aug-17	Negative	B+	Fitch
Jan-17	Negative	B+	Fitch
Dec-16	Stable	B1	Moody's
Sep-16	Stable	B	Standard & Poor's
Jul-16	Stable	B+	Fitch
Jun-16	Stable	B+	Fitch
Apr-16	Stable	B1	Moody's
Mar-16	Negative	B+	Standard & Poor's
Mar-16	Negative watch	Ba3	Moody's
Dec-15	Stable	Ba3	Moody's
Sep-15	Negative	BB-	Fitch
Mar-15	Stable	B+	Standard & Poor's
Feb-15	Negative watch	BB-	Standard & Poor's
Oct-14	Stable	BB-	Fitch

Sovereign Credit Ratings for United Arab Emirates

Date	Outlook	Rating	Agency
May-21	Stable	Aa2	Moody's
Nov-20	Stable	AA-	Fitch
Oct-19	Stable	Aa2	Moody's
Oct-19	Stable	AA	Fitch
Sep-19	Developing	AA	Standard & Poor's
Aug-19	Developing	A	Fitch
Mar-19	Stable	Aa2	Moody's
Jan-19	Stable	Aa2	Moody's
Aug-18	Stable	A	Fitch
Dec-17	Stable	AA	Fitch

Aug-17	Stable	AA	Fitch
Aug-17	Stable	AA	Fitch
May-17	Stable	Aa2	Moody's
Jan-17	Stable	AA	Fitch
Dec-16	Stable	AA	Fitch
Jul-16	Stable	AA	Fitch
May-16	Negative	Aa2	Moody's
May-16	Stable	AA	Fitch
Mar-16	Under Review	Aa2	Moody's
Feb-16	Stable	AA	Fitch
Nov-14	Stable	AA	Fitch