CAMBRIDGE GOVERNANCE LABS

The Sovereign Credit Market Note

Trading the Governance Spread — a four-factor model for sovereign bond mispricing driven by institutional quality, debt burden, reserve status, and regime velocity

Political Topology Project · Sovereign Credit Research
Four-factor cross-sectional model · $R^2 = 0.79$ · 15 sovereign issuers
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FOR PROFESSIONAL INVESTORS ONLY

MODEL SUMMARY

Governance-Adjusted Sovereign Credit Framework

0.79	+540bp	2,080bp	4.7yr
R^2 FOUR-FACTOR MODEL	MODEL PORTFOLIO EXPECTED ALPHA	RESERVE CURRENCY PREMIUM	MEDIAN SIGNAL LAG

Sovereign bond markets price credit risk using a narrow set of macroeconomic and fiscal inputs: debt-to-GDP, current account balance, inflation expectations, and central bank credibility. What they systematically underweight is *institutional quality* — the governance architecture that determines whether a sovereign can and will service its obligations over multi-decade horizons.

Using the Political Topology Liberty Score as a proxy for institutional quality, we construct a four-factor model that explains 79% of cross-sectional variation in sovereign 10-year yields. The model identifies persistent mispricings of 200–1,100 basis points across 15 major sovereign issuers, with the largest anomaly concentrated in the United States.

> *The market prices the US as a AAA-equivalent sovereign. The governance data prices it as a BBB-equivalent sovereign with a reserve currency subsidy. The gap is 654 basis points — and it compounds.*

SECTION 1

The Four-Factor Model

The model decomposes sovereign fair yield into a risk-free base rate plus four premia that capture the governance, fiscal, structural, and dynamic dimensions of sovereign credit risk.

FAIR YIELD DECOMPOSITION

Fair Yield = 2.5% (base) + Governance Premium + Debt Premium + Velocity Premium + Structural Adjustment

Each factor is estimated from the cross-section of 91 sovereigns using Political Topology data matched to market yields. The combined model achieves $R^2 = 0.79$, meaning governance-adjusted fundamentals explain nearly four-fifths of the variation in what countries pay to borrow.

FACTOR 1

Liberty Score (Governance Premium)

β = −0.35 Confirmed by audit

Each 10-point decline in the Liberty Score adds approximately 350bp to fair yield. This is the dominant factor: governance quality alone explains more yield variation than debt-to-GDP. Countries with Liberty scores below 50 carry an implicit governance premium of 500–1,800bp that markets often fail to price.

FACTOR 2

Debt-to-GDP (Fiscal Premium)

β = +0.02 per percentage point

The conventional fiscal risk measure. Each percentage point of debt-to-GDP adds approximately 2bp to fair yield. At 120% debt-to-GDP (US, Italy, Greece), this contributes 240bp. Important but secondary to governance: a well-governed country at 120% debt (Japan) is a fundamentally different credit than a poorly-governed country at 120% debt.

FACTOR 3

Reserve Currency Status (Structural Adj.)

β = −2,080bp

The single largest structural adjustment. Reserve currency issuers (primarily the US, with partial effects for EUR, GBP, JPY) benefit from captive demand that suppresses yields far below governance-implied levels. This 2,080bp subsidy is what allows the US to borrow at 4.5% when governance fundamentals imply 11.0%. The key question: is this subsidy permanent?

FACTOR 4

Velocity of Institutional Change

β = +0.15 per point/year of Liberty decline

The rate of change matters, not just the level. Countries experiencing rapid institutional deterioration (US: −9.2 pts/yr over 2020–2025) carry additional risk that static models miss. Velocity captures regime transition risk — the probability that a country crosses a governance threshold that triggers non-linear repricing.

Why $R^2 = 0.79$ matters: Standard sovereign credit models using only macroeconomic variables typically achieve R^2 of 0.45–0.55. Adding governance quality as a priced factor increases explanatory power by 24–34 percentage points. This is not a marginal improvement — it is a structural correction to how sovereign credit risk is measured.

SECTION 2

The Mispricing Map

The table below compares market yields (10-year sovereign benchmark as of February 2026) to model-implied fair yields. The gap column shows the difference in basis points: negative gaps indicate markets are underpricing risk (yield too low); positive gaps indicate markets are overpricing risk (yield too high, representing potential excess carry).

COUNTRY	LIBERTY SCORE	MARKET YIELD	MODEL FAIR YIELD	GAP (BP)	SIGNAL
UNDERPRICED RISK — MARKET YIELD TOO LOW					
Russia	13	14.2%	22.7%	−850	UNDERWEIGHT
United States	48–84*	4.5%	11.0% / 3.8%†	−654	UNDERWEIGHT
China	5	1.7%	5.8%	−410	UNDERWEIGHT
Saudi Arabia	8	4.8%	8.0%	−320	UNDERWEIGHT
Greece	78	3.3%	5.6%	−235	UNDERWEIGHT
Philippines	56	6.3%	8.6%	−234	UNDERWEIGHT
Hungary	42	6.7%	8.5%	−180	UNDERWEIGHT
OVERPRICED RISK — MARKET YIELD TOO HIGH (EXCESS CARRY OPPORTUNITY)					
Brazil	73	15.0%	3.8%	+1,117	OVERWEIGHT
Turkey	18	28.5%	18.1%	+1,040	OVERWEIGHT
Argentina	65	12.5%	5.1%	+745	OVERWEIGHT
South Africa	68	10.8%	4.1%	+696	OVERWEIGHT
Colombia	63	11.4%	5.5%	+590	OVERWEIGHT
Mexico	52	10.1%	6.8%	+330	OVERWEIGHT
India	66	6.9%	4.5%	+240	OVERWEIGHT
Poland	72	5.7%	3.6%	+210	OVERWEIGHT

*US Liberty Score range reflects PTI estimate (48) vs. conventional Freedom House/V-Dem range (70–84). Model uses PTI primary estimate. †Fair yield shown ex-reserve premium (11.0%) and with reserve premium applied (3.8%). Gap calculated vs. ex-reserve fair yield.

The US anomaly is the single largest position in the model. At L=48, the governance-implied yield is 11.0%. The reserve currency premium compresses this to 3.8% — but the market yields 4.5%, meaning even *with* the reserve subsidy, the US appears 70bp cheap to fair. The real risk: if reserve status erodes or governance continues to deteriorate, the 2,080bp subsidy narrows, and repricing is violent and non-linear.

SECTION 3

Trade Recommendations

The following six trades express the model's highest-conviction mispricings. Each is sized and structured to isolate governance-driven repricing from broader rate and FX risk where possible. All positions assume a 12–36 month horizon, consistent with the model's median signal lag.

HIGH 1. Underweight US Duration (10Y+)

Governance risk hits the back end of the curve first. The 10Y+ segment is most sensitive to institutional deterioration because long-duration cash flows depend on regime stability over multi-decade horizons. The Liberty Score decline from 94 to 48 (−46 points in 5 years) represents the fastest institutional deterioration in the dataset for a major sovereign issuer.

`Instrument: UST 10Y, 30Y | Direction: Underweight vs. benchmark | Target: 100–200bp widening | Timeframe: 12–36 months`

HIGH 2. Buy US 5Y CDS

US 5-year CDS trades at approximately 60bp, implying a 1% cumulative probability of default over 5 years. The model implies fair spread of approximately 854bp — a 14:1 asymmetry between market price and governance-adjusted fair value. This is the most convex expression of the US governance thesis: limited downside (premium paid), explosive upside if reserve currency premium narrows or governance deterioration accelerates.

`Instrument: US 5Y CDS | Direction: Buy protection | Market: ~60bp | Model fair: ~854bp | Asymmetry: 14:1 | Carry cost: ~60bp/yr`

HIGH 3. Overweight Brazil NTN-B (Inflation-Linked)

Brazil offers the model's largest positive carry opportunity. At L=73, Brazil's governance profile is meaningfully stronger than market pricing implies. The NTN-B (inflation-linked bond) at 15.0% nominal yield vs. 3.8% model fair value generates +1,120bp of excess carry. Brazil's institutional framework — independent judiciary, functioning legislature, free press — scores well above its risk premium. The market is pricing Brazil's inflation history, not its institutional present.

`Instrument: Brazil NTN-B 2035 | Direction: Overweight | Excess carry: +1,120bp | Duration: 7Y | FX hedge recommended`

MEDIUM 4. Overweight South Africa R2048

South Africa (L=68) maintains a functioning multi-party democracy, independent constitutional court, and active civil society despite well-documented fiscal challenges. The R2048 bond at 10.8% yield vs. 4.1% model fair value delivers +696bp of excess spread. Risk: Eskom restructuring and fiscal slippage could widen spreads further before convergence.

`Instrument: South Africa R2048 | Direction: Overweight | Excess spread: +696bp | Duration: 18Y | Position sizing: 60% of Brazil`

MEDIUM 5. US 2s10s Steepener

Governance risk is a long-duration phenomenon. Short-term rates are anchored by Fed policy and near-term economic conditions; long-term rates should reflect institutional sustainability. As governance deterioration is priced, the yield curve should steepen at the back end. Target: 100–150bp steepening from current levels. This trade benefits from the governance repricing thesis without requiring an outright bearish rates view.

`Instrument: US 2Y/10Y Treasury spread | Direction: Steepener | Target: 100–150bp | Current: ~40bp | Timeframe: 12–24 months`

MEDIUM 6. Underweight Greece GGBs

Greek government bonds yield 3.3% vs. a model-implied 5.6% — a −235bp gap driven by ECB backstop compression and post-crisis narrative momentum. At L=78, Greece has adequate governance, but the market is pricing it as a core Eurozone credit. Debt-to-GDP at 160%+ and a Liberty score that has stagnated post-crisis suggest the market is too complacent. Express via underweight in Euro government bond portfolios.

`Instrument: Greece 10Y GGB | Direction: Underweight vs. Euro benchmark | Gap: −235bp | Risk: ECB backstop persists`

SECTION 4

Probability-Weighted Returns

The model portfolio combines the six trade recommendations above with benchmark-weight positions in all other sovereigns. Expected returns are calculated using three scenarios weighted by the model's confidence intervals.

METRIC	BENCHMARK	MODEL PORTFOLIO
Expected return (12-month)	2.6%	8.0%
Expected alpha	—	+540bp
Estimated Sharpe ratio	0.3	0.7
Sharpe improvement	—	+0.4
Max drawdown (95th percentile)	−8.2%	−11.5%
Tracking error (estimated)	—	420bp

Alpha decomposition: Of the +540bp expected alpha, approximately 320bp comes from the long EM carry positions (Brazil, South Africa, Colombia), 140bp from the US underweight/CDS positions, and 80bp from the curve and relative value trades. The largest single contributor is the Brazil NTN-B position.

Scenario Analysis

SCENARIO	PROBABILITY	BENCHMARK	MODEL PORTFOLIO	ALPHA
Base case: Governance trends continue, gradual repricing	55%	2.8%	7.5%	+470bp
Bull case: US governance shock triggers broad repricing	25%	−1.2%	14.5%	+1,570bp
Bear case: Reserve status holds, EM sell-off	20%	4.1%	−2.0%	−610bp
Probability-weighted	100%	2.6%	8.0%	+540bp

The asymmetry is notable: the bull case delivers +1,570bp alpha while the bear case costs only −610bp. This 2.6:1 payoff ratio reflects the convexity embedded in the CDS position and the carry cushion from EM longs.

SECTION 5

Risk Factors

The governance-adjusted sovereign credit model introduces several risks that differ from conventional sovereign bond analysis. Investors should evaluate these carefully before implementing the trade recommendations.

Model Risk

The four-factor model is cross-sectional, not panel. It does not include country fixed effects, meaning it compares governance-yield relationships *across* countries at a point in time rather than tracking how changes in governance within a single country affect yields over time. Cross-sectional models are vulnerable to omitted variable bias: the governance premium may proxy for other country-specific factors (legal tradition, colonial history, commodity dependence) not captured in the model. $R^2 = 0.79$ is strong but leaves 21% of yield variation unexplained.

Timing Risk

The median signal lag is 4.7 years, with a range of 3–12 years. This means governance deterioration can persist for years before markets reprice sovereign credit. The model identifies *where* yields should converge, not *when*. An investor who is directionally correct but 5 years early faces substantial carry cost, mark-to-market losses, and opportunity cost. The US CDS position, in particular, could bleed 60bp annually for several years before any repricing event.

Reserve Currency Risk

The model's largest single parameter is the −2,080bp reserve currency adjustment for the United States. If US reserve currency status proves more durable than the model assumes — or if the governance deterioration stabilizes and reverses — the yield anomaly persists indefinitely, and the US underweight/CDS positions generate negative carry without convergence. Reserve currency transitions are historically rare (GBP to USD took 30+ years) and the mechanism is poorly understood.

Liquidity Risk

Several EM positions (South Africa R2048, Colombia, Philippines) trade in markets with significantly lower liquidity than US Treasuries or Euro government bonds. Bid-ask spreads of 20–50bp are common in stress periods, and position exit during a risk-off episode could consume a meaningful portion of the excess carry. Position sizing should reflect liquidity constraints: the Brazil NTN-B market is the deepest of the EM recommendations; South Africa and Colombia require smaller allocations.

Reverse Causality Risk

The model assumes governance drives yields: poor institutions lead to higher borrowing costs. But the causal arrow may also run in reverse: countries facing high borrowing costs may experience fiscal stress that degrades institutions. This feedback loop is particularly relevant for countries near governance thresholds (Liberty Score 50–60), where fiscal pressure could accelerate institutional decline. The model does not distinguish between these causal channels.

IMPORTANT DISCLOSURES

Disclaimer

This note is for informational and educational purposes only. It does not constitute investment advice, a solicitation, or an offer to buy or sell any security or financial instrument.

The four-factor sovereign credit model presented herein is a research tool, not a trading system. Model outputs are based on cross-sectional regression analysis using Political Topology Liberty Scores, publicly available debt data, and market yields as of February 2026. The model has not been validated out-of-sample over multiple credit cycles. Past governance-yield relationships may not predict future outcomes.

The trade recommendations described are hypothetical and illustrative. They do not account for transaction costs, taxes, margin requirements, regulatory constraints, or individual investor circumstances. Sovereign bond markets carry risks including but not limited to: interest rate risk, credit risk, currency risk, inflation risk, liquidity risk, and political risk. Emerging market sovereign bonds carry additional risks including capital controls, settlement risk, and legal jurisdiction risk.

The Liberty Score and related Political Topology metrics are experimental research measures. They have not been adopted by rating agencies, central banks, or regulatory bodies as credit assessment tools. Investors should not rely solely on these measures for investment decisions.

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Data: Freedom House, V-Dem, World Bank, IMF, Bloomberg, Political Topology Index
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For methodology and data: cambridge-governance-labs.org