BlueBay Asset Management

Insights

Emerging Market Aggregate

July 2015

The benefits of a best ideas, asset allocation approach to emerging market hard currency debt.

Emerging market debt (EMD), as an asset class, remains an interesting long term investment opportunity offering attractive value, but as is evidenced from the performance during the last few years, it can also be prone to periodic volatility. We believe an aggregate approach across the hard currency sovereign and corporate universe, but without significant local currency exposure, is a suitable solution in this regard, especially if implemented with an element of tactical asset allocation between the sovereign and corporate sectors.

An aggregate approach to emerging market (EM) hard currency debt provides investors access to a broader and more diverse credit universe in an efficient way:

- An EM aggregate strategy would provide investors with **exposure** to a broad range of EM sovereigns, quasi-sovereigns and corporate securities, thereby allowing access to an eclectic mix of economies, which are at various different stages on the road to maturity
- In addition to offering a wider opportunity set, this approach also allows the manager to reduce volatility through the impact of **diversification**
- Both the **spread** and the **carry** of the EM sovereign and corporate sectors, relative to the developed market counterparts, remain very attractive
- **Asset allocation** is increasingly important in the EMD universe given the divergent return streams over the last few years across various sub-sectors in EMD; tactical asset allocation can be demonstrated to add value

An aggregate approach to EM hard currency debt provides access to a broader and more diverse credit universe

A large and diverse opportunity set

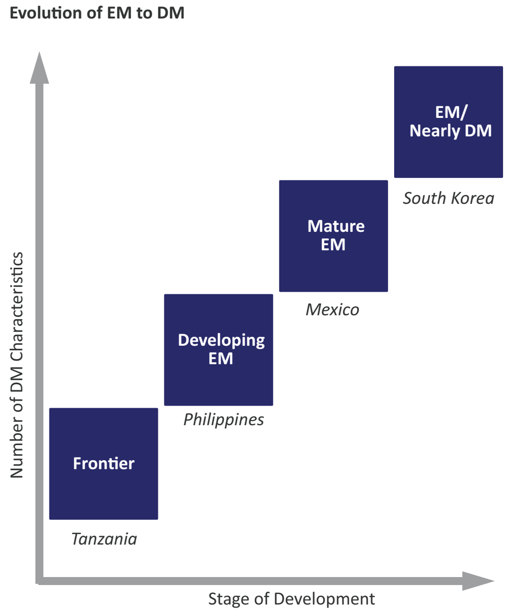
An EM aggregate portfolio provides investors with access to the broadest range of countries and corporates.

Sovereign

The sovereign benchmark JP Morgan EMBI Global Diversified Index has over 60 countries at various stages of development – from frontier markets such as Tanzania to more mature markets like Mexico (Fig. 1). In general, EM countries start out by issuing bonds in hard currencies, thereafter gradually moving on to issuing in local currency debt as the demand from domestic institutions increase and institutional frameworks are established. In addition to the sovereign credit itself, the index also allows access to a vast array of sovereign owned quasi-governmental entities in wide ranging industries. The size of the market is approximately US$700 billion (source: JP Morgan) and much of it can be accessed via the benchmark.

RBC Global Asset Management

Fig. 1 The Evolution of EM to DM



DM characteristics

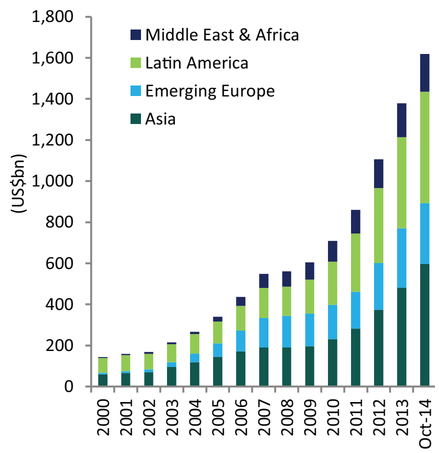
- Well-established, liquid local debt markets
- Established local insurance/ pension fund industry
- Structural reforms to engender competitiveness within the economy
- Established regional and international banking system
- Free-floating currency/liberalised exchange rate regime
- Open economy (lack of strict barriers to entry/tariffs etc.)
- Clearly-defined and enforced institutional framework (i.e. laws/regulations etc.)
- Orthodox, independent, inflation-targeting central bank
- Market exchange + regulatory framework

Data source: BlueBay

The size of the EM hard currency sovereign market is approximately US$700 billion

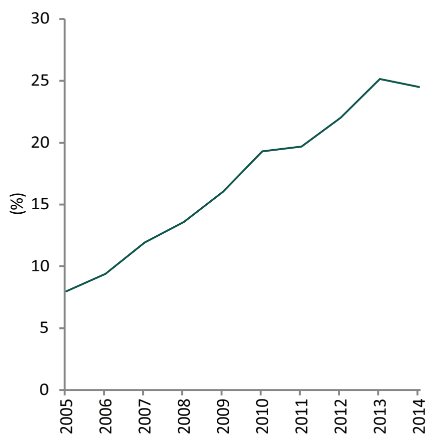
As a natural consequence of this evolution, many state-owned enterprises also start accessing the markets once the country is more mature. As can be seen in Fig. 3, the proportion of quasi-sovereign entities have increased for nearly 25% of the JP Morgan EMBI Global Diversified Index.

Fig. 2 Total corporate debt stock outstanding (in US$bn)



Data source: BIS and JP Morgan, 31 October 2014

Fig. 3 Quasi-sovereign proportion in JP Morgan EMBI Global Diversified Index (as % of Index)



Data source: JP Morgan, as at 31 December 2014

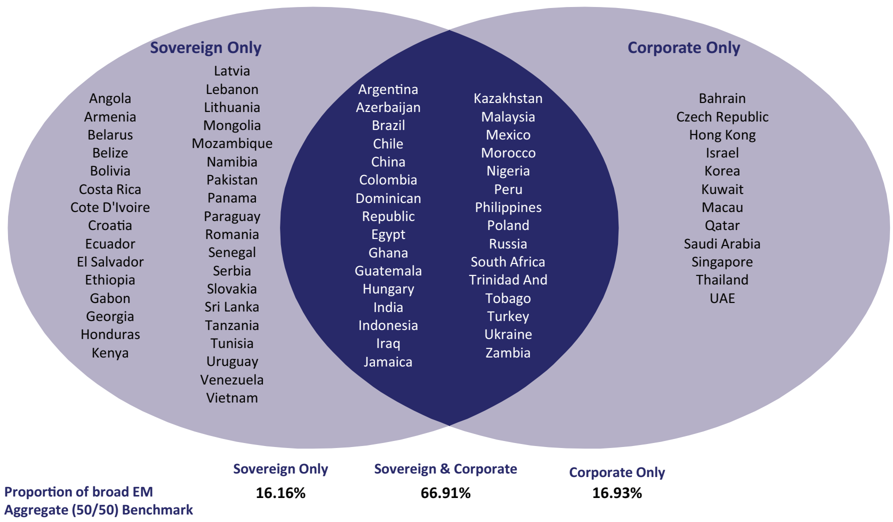
Corporates

EM corporates, on the other hand, are typically domiciled in the more 'developed' EM countries which have successfully developed institutional and legal frameworks and deeper capital markets. The EM corporate market is an exciting mix of corporate issuers, industries and countries, with the market currently estimated to be around US$1.7 trillion in size – larger than the US high yield market and indeed the EM hard currency sovereign market. Perhaps the most important of all the emerging markets, China, has a much larger opportunity set in corporate markets than sovereign, and therefore this remains an important avenue to be exposed to the dynamics of the Chinese economy. Given the low interest rate environment over the last few years, various EM companies have taken advantage of the new issue market and we have seen, on average, close to US$300 billion (source: JP Morgan) gross issuance coming from EM corporates every year.

An integrated opportunity set

This means that when an EM sovereign universe is combined with an EM corporate universe, it is possible to access the broadest range of countries with hard currency bonds in existence; from the early 'frontier' sovereigns coming to market for the first time, such as Rwanda or Tanzania, to large corporates that are household names. Fig. 4 highlights the countries accessed via an EM aggregate portfolio.

Fig. 4   A broader representation of the EM asset class



Data source: JP Morgan, as at 31 May 2015. For illustrative purposes only

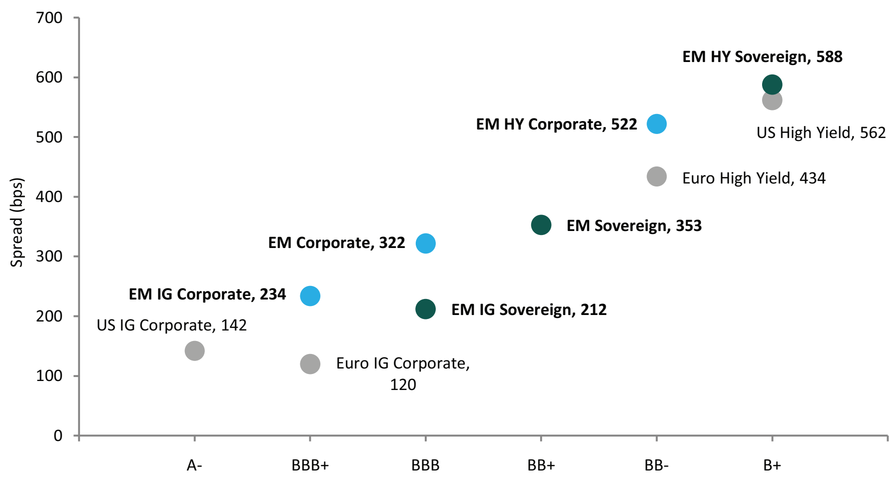
Attractive carry and spread offered by EM spread sectors

Against the backdrop of a developed market fixed income world that has been stuck in an ultra-low interest rate environment for several years, and is increasingly flirting with negative interest rates in the government bond sectors, we believe the attractiveness and value of EM sectors are easy to see.

As Fig. 5 indicates, for similar rating levels, the EMD sectors consistently offer better value, when compared to developed market counterparts. Further, the yield levels remain some of the highest across the fixed income world as well (Fig. 6).

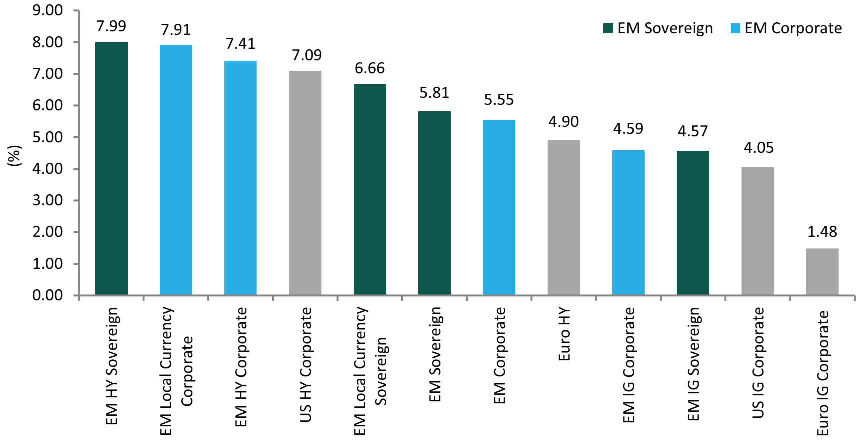
When an EM sovereign universe is combined with an EM corporate universe, it is possible to access the broadest range of countries

Fig. 5 EM sovereign and corporate spreads versus other fixed income asset classes



Data source: JP Morgan, as at 31 May 2015. For illustrative purposes only.
Note: EM Sovereign: JPM EMBI Global Diversified Index; EM Corporate: JPM Corporate EMBI Diversified Index; US IG Corporate: JULI US Investment Grade; Euro Investment Grade Corporate: BAML Euro Corporate Index; US High Yield: JPM US HY; Euro High Yield: BAML Euro High Yield; EM IG Corporate: JPM Corporate EMBI Diversified IG; EM HY Corporate: JPM Corporate EMBI Diversified HY; EM IG Sovereign Credit: JPM EMBI Global Diversified IG Index; EM HY Sovereign Credit: JPM EMBI Global Diversified HY

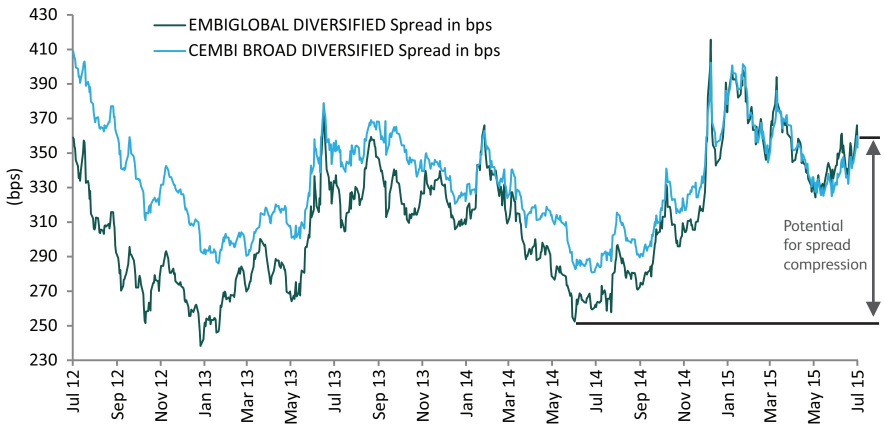
Fig. 6 EM yields versus US and European risk asset classes



Data source: Bloomberg, as at 30 June 2015

Further, it is worth noting that the current spread levels, relative to historical trends, appear to offer sufficient room for spread compression going forward – both on a standalone basis and when compared to respective developed market counterparts. The hard currency sovereign sector (BBB/BB) currently has a 150bps premium against the BBB rated US high grade corporate market (Fig. 8).

Fig. 7 EMBI Global diversified and CEMBI Broad diversified spreads



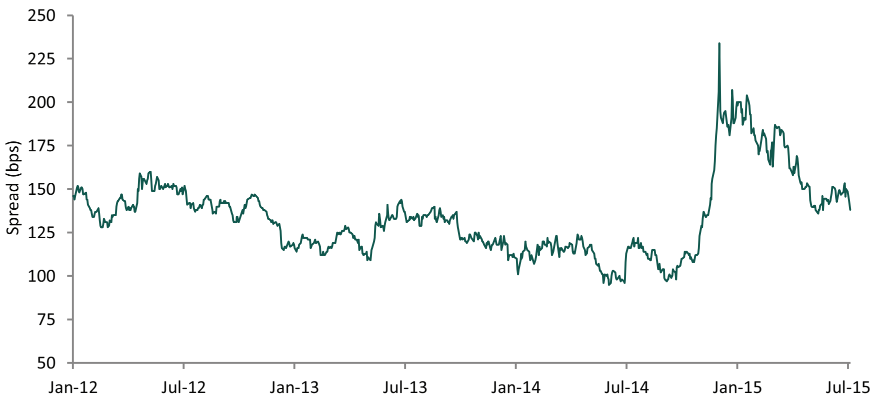
Data source: JP Morgan as at 30 June 2015

Current spread levels appear to offer sufficient room for spread compression

Asset allocation and an efficient way of portfolio construction

As Fig. 8 highlights, the relative value argument between corporates and sovereigns evolves over time, and therefore we believe a strategy that takes advantages of both is warranted.

Fig. 8 EM corporate spread over sovereign (ratings adjusted)



Data source: JP Morgan, as at 17 July 2015

As EMD sectors mature and investors look closely for differentiation, there are increasing divergences of returns between the sectors. In the initial days of quantitative easing, most EMD sectors performed very strongly, and returns were very similar between sub-sectors (Fig. 9, 2010–2012 period). However, as the potential rate rise by the US Federal Reserve came into the picture, the various sectors performed very differently indeed (Fig. 9, 2013–2014 period).

Given this divergence, it is prudent to be able to actively asset allocate in the portfolio to obtain the most efficient mix.

Fig. 9 Calendar year performance of three EMD asset classes (in US$, unhedged)

2010	2011	2012	2013	2014	Jun-2015
EM LC Govt 15.7%	EM Sovereign 7.3%	EM Sovereign 17.4%	EM Corporate -1.7%	EM Sovereign 7.4%	EM Corporate 3.8%
EM Corporate 13.5%	EM Corporate 3.2%	EM Corporate 17.0%	EM Sovereign -5.3%	EM Corporate 5.7%	EM Sovereign 1.7%
EM Sovereign 12.2%	EM LC Govt -1.8%	EM LC Govt 16.8%	EM LC Govt -9.0%	EM LC Govt -5.7%	EM LC Govt -3.6%

Data source: Bloomberg, as at 30 June 2015
Note: EM Local Currency: JPM GBI-EM Broad Diversified Index; EM Sovereign Credit: JPM EMBI Global Diversified Index; EM Corporate Credit: JPM Corporate EMBI Diversified Index

Risks

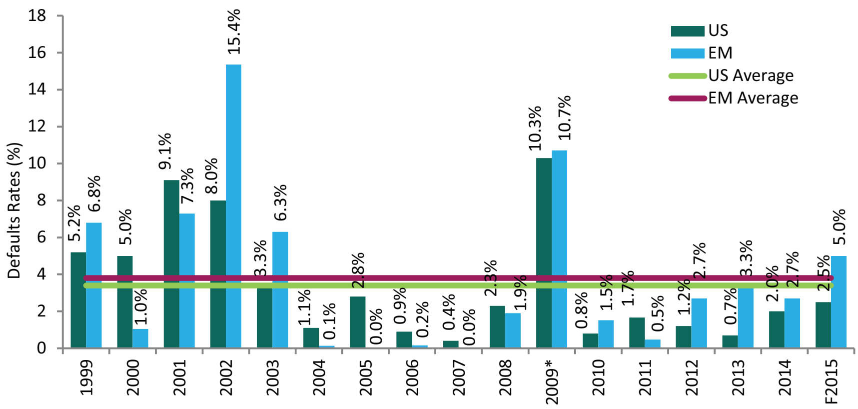
From a design perspective, an EM aggregate strategy is exposed to duration, spread and default risks, as is typical for most fixed income spread products. However, being an emerging market credit strategy, spread and default risks are higher than average.

The composite portfolio will have approximately six years of duration in its neutral asset allocation phase, which exposes this product to the risk of potential US rate rises, more than some of the other shorter duration asset classes. However, we would try to mitigate some of that risk in the portfolio through active duration management (mainly through overlay US Treasury futures), and the portfolio has an ability to vary the duration by +/-1 year relative to the benchmark.

It is important to actively asset allocate to obtain the most efficient mix

We also note that in the corporate space, defaults remain relatively manageable and are comparable, or better than US high yield defaults as seen in Fig. 10.

Fig. 10 Historical defaults (as a % of HY bonds outstanding)



Data source: S&P, JP Morgan, as at 31 December 2014. F = Forecast
Note: * Figure includes distressed exchanges

The EM sovereign and corporate universe has evolved significantly over the last few years but it remains, by its very nature, not without risks. However, in our view, on a risk-adjusted basis, there are segments within this universe that offer compelling value and long-term investment potential. We believe a portfolio specifically designed to benefit from the aggregate EM hard currency sovereign and corporate universe, along with the ability for tactical asset allocation and an investment process designed to exploit the inherent inefficiencies of the asset class, should prove to be a successful strategy against the uncertain outlook of the future. Such a strategy should be considered for core emerging market debt allocation for investors and continue to provide compelling risk-adjusted return in the long run.

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