BlueBay
Asset Management

Insight

Reassessing a strategic allocation to emerging market debt in your portfolio

September 2015

Weak performance within emerging market fixed income masks underlying positive fundamentals and growth prospects, making now a good time to reassess your allocation.

Emerging market (EM) fixed income has been at the forefront of increasingly bleak investor sentiment for several months now, due to a number of headwinds. In sovereign hard currency debt the spread on the JP Morgan EMBI Global Diversified is hovering around 400bps, close to the widest levels of the past 5 years. In local currency the JP Morgan GBI-EM Global Diversified is down 12.5% year to date, caused by very weak performance from EMFX [1].

We believe this prolonged period of weakness offers a potential opportunity for investors with a medium-to-long-term timeframe to increase their sovereign EM fixed income exposure. Growth and policy challenges remain, and we find it difficult to call the exact bottom of the market, but we believe now is a good time to consider the strategic opportunity for the following reasons:

China: We think the market has over-interpreted the disinflationary impact of the new, more flexible FX regime of China. While several challenges remain, we don't believe China is headed to a credit crunch or a banking sector crisis, and we believe growth should continue to be around 6.5% in 2016.

G3 monetary policy: We believe the fear of an upcoming Fed hike may prove greater than the reality. We expect the Fed to emphasise 'gradual' tightening, which should not negate the attractiveness of higher-yielding assets. We also expect continued, and possibly additional, balance sheet expansion from the ECB and BoJ.

EM growth: We expect 2015 to be the weakest year in the EM growth cycle and recover to 4.5% in 2016, in line with the IMF projection.

Commodities: Commodity prices have significantly re-priced to reflect China risk. The JP Morgan Commodity Curve Index is down over 12% year to date. We feel that much of the structural challenges of the commodity markets are already in the price; we should also remember that over the long term, lower commodity prices benefit the majority of EM sovereigns.

Fund flows: Fund flow data suggests investor capitulation. The week of 26 August saw the second worst week of outflows for EM bond funds and the worst week of outflows from EM equity funds ever.

Valuations: Given the above fundamental picture we now find significant bottom-up value across sovereign credit. We believe many currencies have reached 'cheap' valuation levels on our long-term metrics. We also think real yields in EM local bond markets offer significant premium over the developed world.

Weakness offers an opportunity for investors with a medium-to-long term timeframe to increase their sovereign EM fixed income exposure

RBC Global Asset Management

Past performance in context

Emerging market debt (EMD) sectors are generally considered to have performed pretty poorly over the last few years, but on closer inspection this perception begins to unravel. In fact, on a year-to-date basis to the end of August, EM hard currency sovereign credit and EM corporate credit have performed relatively better than several other fixed income asset classes. The rates component of EM local currency debt also provided robust returns; much of the negative returns in local currency debt were actually a result of EMFX volatility. As Fig. 1 highlights, the total returns for EM sovereign debt (both hard and local currency) as well corporates is comparable, if not better, than US equities. In addition, when looked at from a risk-adjusted return perspective, the spread sectors of EMD as well as local rates have performed well relative to US high yield, and significantly better than US equities and the US Treasury market.

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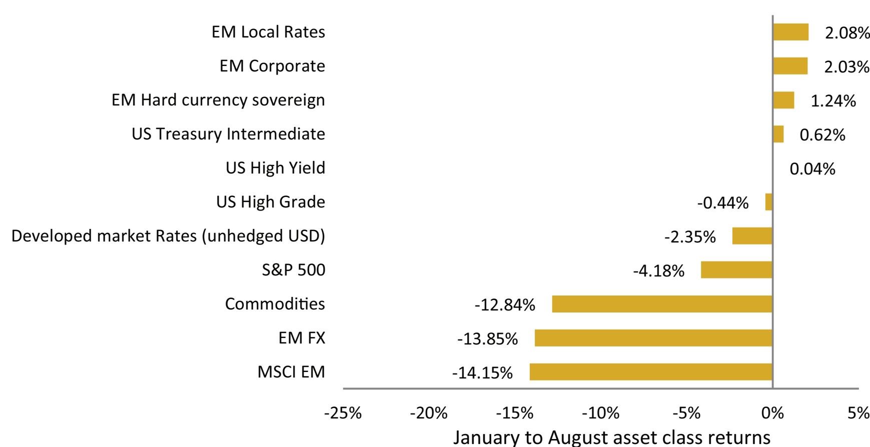
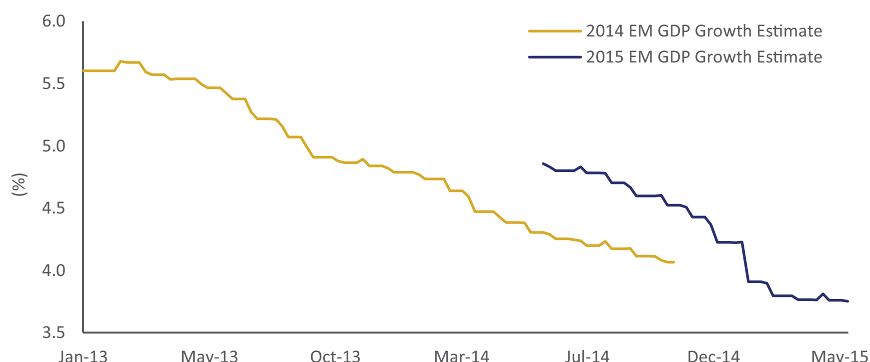
Fig. 1 EMD performance is comparable to developed markets



Source: BlueBay Asset Management, JP Morgan as at 31 August 2015
Note: See last page for details on indices used.

The worst performing sectors, such as EMFX, EM equities and commodities, all comprise growth-sensitive assets and have been hit by the strong negative sentiment surrounding the growth rates of EM countries. As seen in Fig. 2, the growth expectations of EM countries have been successively revised down on almost a continuous basis for the last 2 years. To a large extent this has been driven by the slowdown in China and other larger countries trailing in recession such as Brazil and Russia.

Fig. 2 EM growth expectations

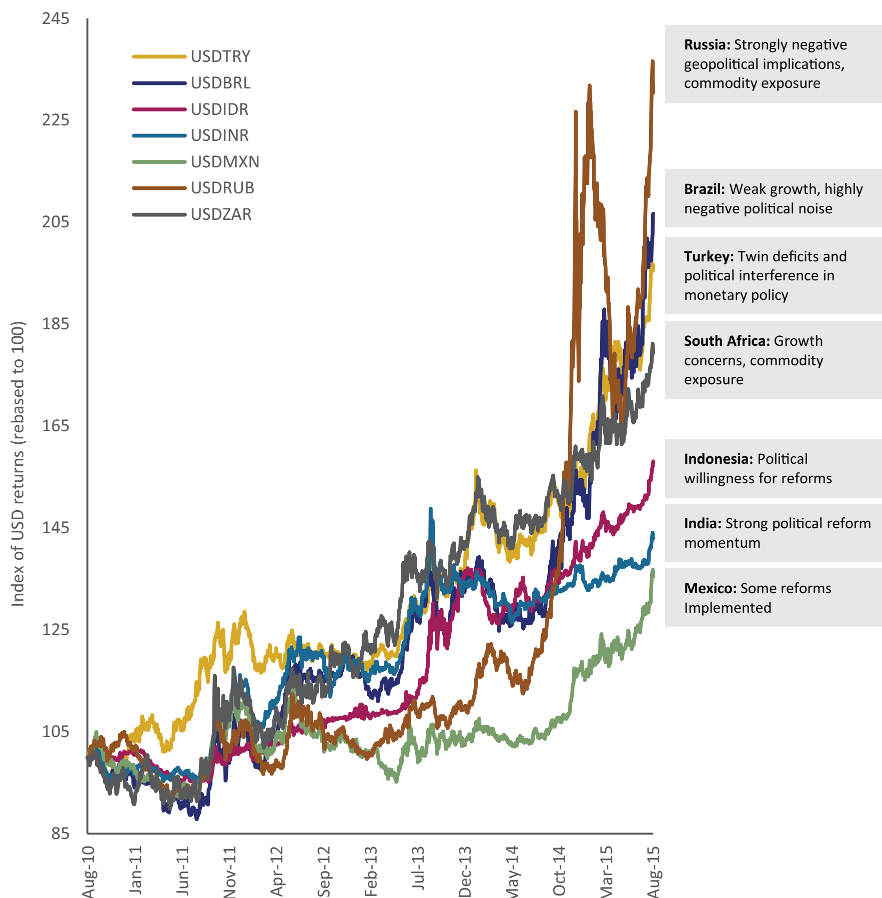


Source top chart: Consensus Forecasts, 30 June 2015; Source bottom chart: JP Morgan, August 2015

However, in addition to growth expectations, EM countries have seen significant capital outflows, particularly local currency-denominated assets such as EM equities. This has only intensified the downward pressure on the EMFX portion of the local currency asset class.

But if we consider a longer timeframe, over the last years there have been significant dispersions within the EMFX complex. On a relative basis investors have rewarded those countries and currencies which have stronger fundamentals and have implemented structural reforms; e.g. Mexico where the peso has been one of the stronger performers in the EMFX complex in relative terms. On the other hand, the Indian rupee and Indonesian rupiah have reflected the positive reform momentum backed by political willingness, and have fared somewhat worse than the Mexican peso, but significantly better than countries lacking such reform momentum. The currencies that have sold off the most are from economies with high commodity exposure and elevated political risks i.e. Russia, Turkey and Brazil.

Fig. 3 Strong divergence in currency performance



Source: Bloomberg, BlueBay Asset Management. Normalised as of August 2010 – 2015

EM countries have seen significant capital outflows

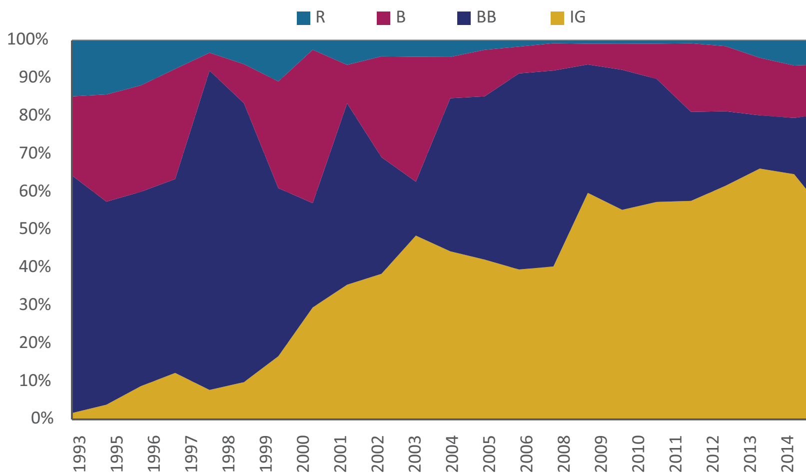
Back to basics

Investor sentiment could hardly turn any worse toward EM countries as is evidenced from myriad negative headlines surrounding the asset class. However, faced with unprecedented volatility and risk-off sentiment, it is worth taking a step back in order to assess EM countries from a more fundamental perspective. The gross debt-to-GDP levels for EM countries continue to appear more attractive relative to developed markets. The FX reserves also look robust, particularly relative to short-term debt.

Using credit ratings as a reflection of underlying fundamentals, countries in the EM hard currency universe have seen significant improvements over time (Fig. 4) and, except for countries substantially rated sub-investment grade, we believe the potential for countries to default on their obligations is relatively low. Looking at it from a historical perspective, as per Moody's research, over a 30-year period the average sovereign default rate stands at around 5% for purely passive, hold-to-maturity portfolios; the corresponding default rate for active portfolios would be significantly lower.

Fig. 4 Credit ratings are on an improving trajectory

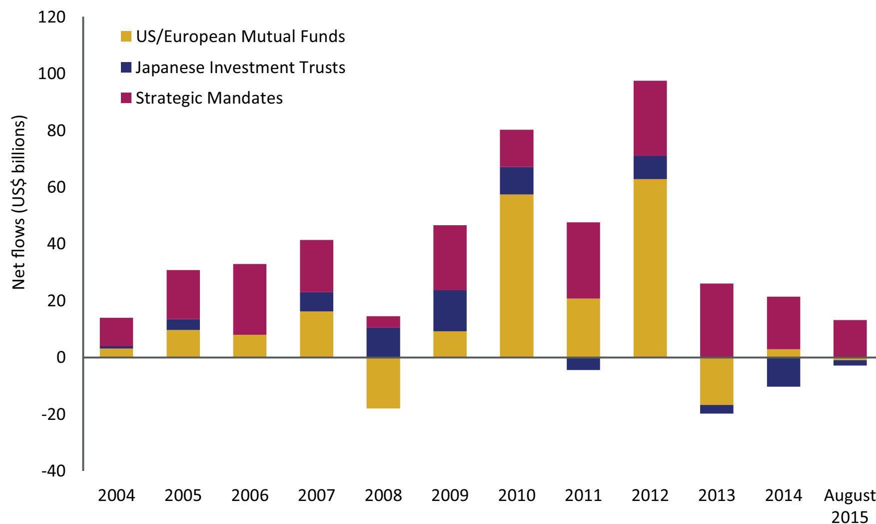
JPM EMBI Global Diversified credit bucket (% of market capitalisation)



Data source: JP Morgan as at 31 July 2015. R = residual

Countries in the EM hard currency universe have seen significant rating improvements over time

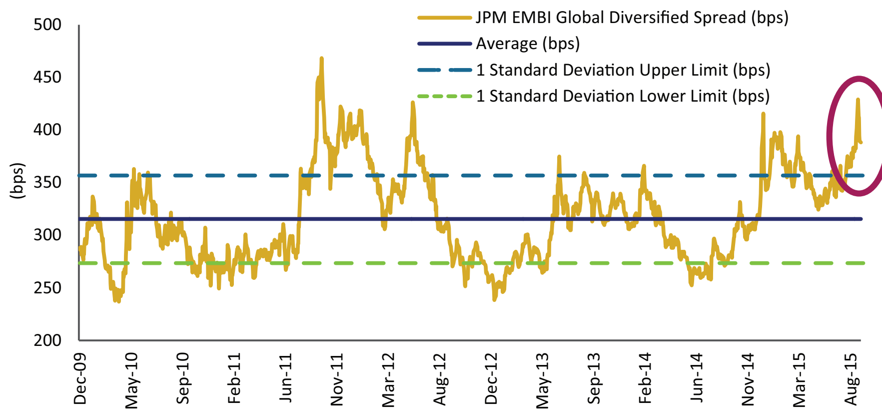
Fig. 5 Strategic inflows into EMD are positive on an historic basis



Source: JP Morgan, BlueBay Asset Management, as at August 2015

Emerging market debt also remains an under-owned asset class, with strong institutional interest. Retail flows into the asset class have been volatile, but over the last 10 years the strategic inflow into the asset class has consistently been in positive territory – often significantly higher than US$10 billion a year (Fig. 5). These investors are also able to better weather short-term volatility and therefore do not contribute to excess pressure on the asset class during periods of weakness. We expect this trend to continue as the hunt for yield gathers pace in a world dominated by loose monetary policy and plunging interest rates. Finally, we believe valuation of the hard currency sovereign universe looks very attractive, with the spread on the JP Morgan EMBI Global Diversified at approximately 400bps as of end of August (Fig. 6), leaving sufficient room for spread compression.

Fig. 6 Valuations are attractive



Source: JP Morgan, as at 31 August 2015

Potential catalysts for a turnaround in sentiment

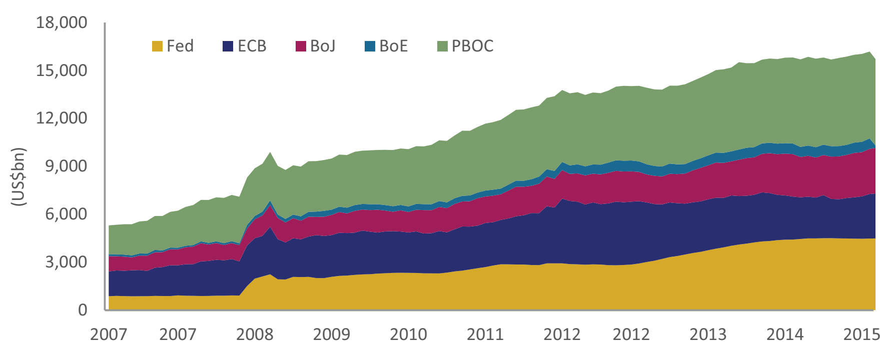
The pervasive negative investor sentiment could potentially experience a turnaround if we witness some catalysts emerging in the following areas.

1. G3 central banks and China

Broadly speaking the Fed's preference to embark on a hiking cycle puts it at odds with most other central banks. Growth has been particularly deficient in most EM countries given the chronic under-investment and a lack of implemented reforms (with the notable exception of China where the trend of over-investment has led to excess capacity and deflationary forces). Trade growth has also been weak and for many EM countries the export-driven growth model has lost momentum. Given this situation, we have already seen strong capital flows from EM to DM, and witnessed considerable strengthening of the US dollar against most currencies. However, despite the substantial currency depreciations most countries have not experienced much inflation pressure. This, combined with the weak growth at home, should allow central banks to be on the path of monetary easing for at least a few quarters to come. This muddle-through growth scenario seems supportive for carry and local rates in particular.

Negative investor sentiment could potentially experience a turnaround if we witness some catalysts emerging

Fig. 7 Continued expansion of balance sheets of main central banks



Source: MacroBond, 30 June 2015

This trend has been exacerbated by the recent Chinese currency devaluation. There has been much speculation in the market about the true intention of the Chinese FX liberation regime, implemented on a limited basis on 11 August. Without delving deeper into the causation we can look at the potential implications of the move. In our view the degree of renminbi depreciation has been limited, and is not material enough to provide a substantial boost in export competitiveness. However, to a limited extent this would export deflation and cause other regional export competitors to re-align their monetary policy.

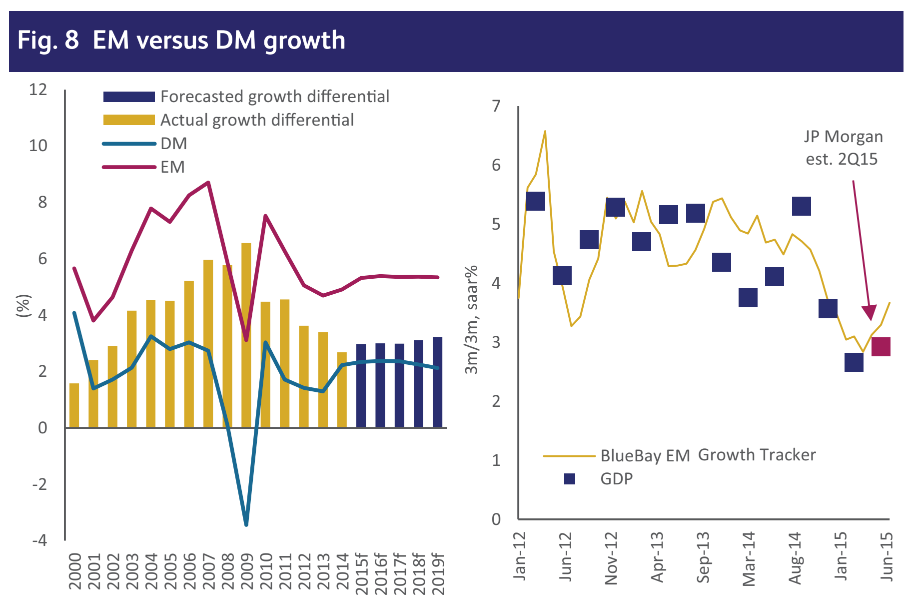
This could also result in some capital outflows in the form of unwinding carry trades, as well as have an adverse impact on China's foreign exchange reserves. Nevertheless, in the long term we believe some of that may be offset by the renminbi's potential inclusion in the IMF's SDR basket. As such we think the markets have over-interpreted the disinflationary impact of the Chinese devaluation. We do expect growth to come in at 6.5% and don't expect an abrupt 'hard-landing' as China attempts to veer its investment-driven economy to consumption-oriented one.

The global equity sell-off in late August has demonstrated that financial markets are far more correlated in EM and DM, even though the economies themselves may not be to the same extent. Overall we think this should underpin a more extended 'gradualist' approach for the Fed's hiking cycle. EMD investors have been psychologically preparing for a Fed hike for a prolonged period of time. In our opinion, the typical adverse effect of a currency sell-off, in addition to capital outflows, have already largely taken place. Therefore a relatively gradual normalisation of Fed policy may bring a degree of positive sentiment back to the markets, once it is clear that such gradual hiking does not constitute a tail risk event.

2. EM growth alpha

The main disappointment for EM countries over the last 2 years has not necessarily been about the absolute level of growth, but more about the relative growth differential between EM and DM. However, having declined for several years the IMF projects this growth alpha to bottom out in 2015 and start to grow from 2016 onwards (Fig.8).

Fig. 8 EM versus DM growth



Source: LHS chart: IMF, as at April 2015. Forecasts from 2015 to 2019; RHS chart: Proprietary BlueBay Asset Management model, which tracks a series of indicators to build an aggregate picture of EM growth rates, Macrobond, August 2015.

Our analysis indicates that EM growth may have bottomed out

Furthermore, our proprietary analysis indicates that EM growth may have bottomed out in April-May and seems to be moving up, and this is supported by some hard data.

In addition, there are signals that some of the major issues in the larger EM countries appear to be moving closer to a resolution. Although Brazil's economic slump is not bottoming-out just yet, it should see some reversal from next year onwards and inflation is also projected to come down. The political stalemate in Turkey, which led to the underperformance of Turkish assets, should also be on a path towards resolution in 2016 after November's election. Russia's external financing position remains relatively strong, while a weak rouble and import restrictions have helped, although we do not see a positive growth scenario just yet. However, any stabilisation in the oil price would help Russian assets rally. In India, Indonesia and Mexico, we think the positive economic momentum should also continue. In Ukraine, despite geopolitical tensions remaining relatively high, sentiment was boosted by the recent agreement of a 20% haircut with their creditors – which resulted in Ukraine spreads tightening by almost 1000bps over a few days. While much remains unresolved in the EM universe, investor sentiment should benefit from the resolution of issues in some of the larger EM countries.

3. Commodities stabilisation

A fundamental issue remains in that trade within EM continues to be fairly correlated with the overall commodity trade. However the commodities asset class has been through a significant repricing due to China and global growth concerns. Copper is near its 10-year low and iron ore prices have halved since 2013. The JP Morgan Commodity Curve Index is down nearly 12% year to date, driven by both hard commodities and energy.

Oil has been specifically volatile over the past 10 months, after the slump in prices driven by OPEC's decision not to cut production. Having examined the supply-demand balance in greater detail we believe it is premature to call a potential rebound in oil prices as the structural supply issues remain. However, for us, portfolio construction remains the key tool to navigate the volatile commodities territory. To that extent, we think our sensitivity analysis for commodities remains the key to credit selection in our portfolios. We also note that in the long run, lower commodity prices have a beneficial impact on the EM economies. Any stabilisation, or even a limited rebound in commodities prices, driven more likely by technicals rather than fundamentals, could prove to be a catalyst in this context.

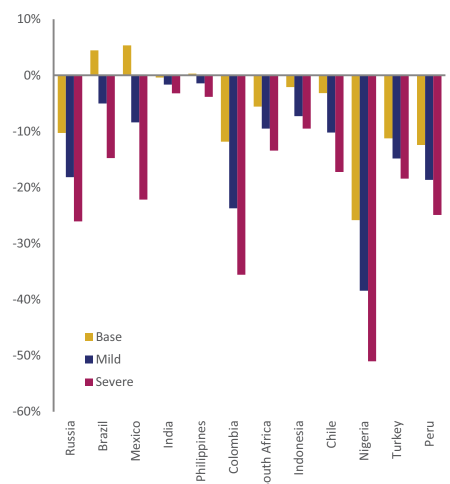
While much remains unresolved in the EM universe, investor sentiment should benefit from the resolution of issues in some of the larger EM countries

Fig. 9 Assessing the FX and spread sensitivity to further commodity price shocks

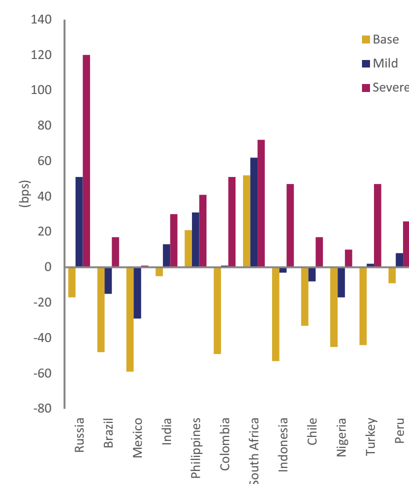
Price assumption

	Average 2015	Price (As at 06-08-2015)	Base Change vs. 2015 Avg.	Mild Change vs. 2015 Avg.	Severe Change vs. 2015 Avg.
Copper	268	234	-10%	-18%	-25%
Gold	1197	1090	-8%	-16%	-29%
Iron Ore	60	58	-17%	-25%	-45%
Oil - WTI	57	45	-4%	-12%	-30%
Coal	62	60	-11%	-27%	-44%

FX vs. USD



3m sovereign spread forecast



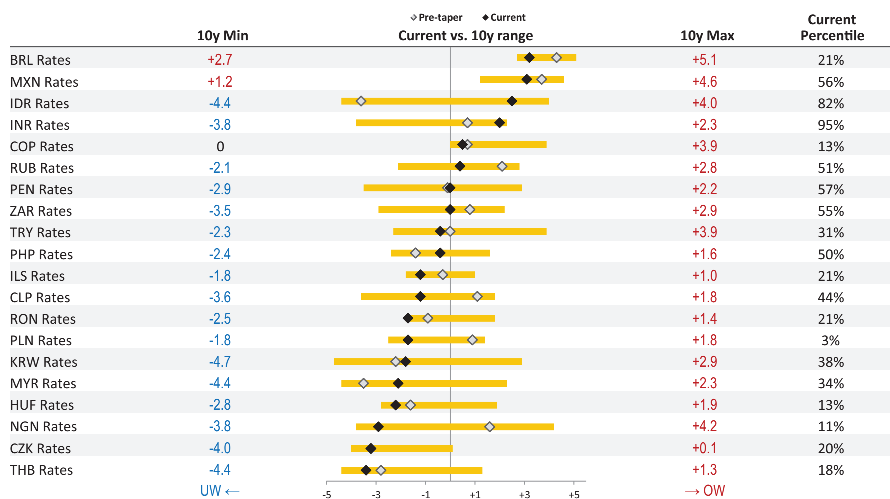
Source: BlueBay Asset Management. Forecasts as at 5 August 2015

4. Technical flows

The sustained outflows paint a picture of investor capitulation in EMD. The week of 26 August saw the second worst week of outflows for EM bond funds and the worst week of outflows from EM equity funds ever. Retail outflows over the past 2 weeks have totalled US$6.6 billion – 3% of AUM. This heightened level of outflows from local assets have led to a somewhat exaggerated underweight positioning around various EM currencies, as can be seen in Fig 10. However, we believe this indicates that the asset class is well positioned to benefit from a technical rebound. Also from the perspective of crossover investors many are underweight the asset class. At the same time, given the global uncertainty and elevated levels of volatility, the average cash level on investor portfolios are towards the higher end of the range. If the cash has to be deployed in order to benefit from a turnaround in the markets, we think spread sectors should benefit from that.

We believe the asset class is well positioned for a technical rebound

Fig. 10 AUM-weighted EMFX positioning score from JP Morgan's EM client survey



Source: JP Morgan, as at August 2015

Reassessing your allocation to EM

We believe that we are reaching the final stages of a bear market for EM risk. Significant differences in individual country stories remain, but a stabilisation in the overall fundamental story, and most particularly EM growth prospects, should allow investors to refocus on attractive valuation levels. We expect this story to gather steam as we approach 2016. Hence we believe that investors should consider increasing their exposure to EM sovereign risk at this stage.

Notes:

1. Data as at 31 August 2015
2. Indices: EM Local Rates: JPM GBI-EM Global Diversified Index (Interest Rate Component), EM Corporate Credit: JPM Corporate Emerging Market Bond Diversified Index USD unhedged; EM Hard Currency Sovereign: JPM EMBI Global Diversified Index, US Treasury Intermediate: JPM GBI Global Traded Index - US Treasury Index; US High Yield: JPM US HY Index; US High Grade: JPM US Liquid Index (JULI) Index; Developed Market Rates (Unhedged USD): JPM GBI Global Traded Index (Interest Rate Component); S&P 500; Commodities: JPM Commodity Curve Index Aggregate Total Return Index; EMFX: JPM GBI-EM Global Diversified Index (FX Component) and MSCI EM Index

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