Insights

Emerging market fixed income: a reversal of fortune?

July 2016

Emerging market fixed income has produced stellar returns year to date. Can the more positive outlook result in a continuation of this trend going forward?

Positive developments in emerging markets (EM) this year have resulted in spread compression in EM fixed income assets boosting total returns. With yields in core government fixed income in developed markets at record lows and even in negative territory, we believe the outlook remains positive for the EM debt for the second half of the year, providing an attractive proposition for investors looking to diversify their portfolios.

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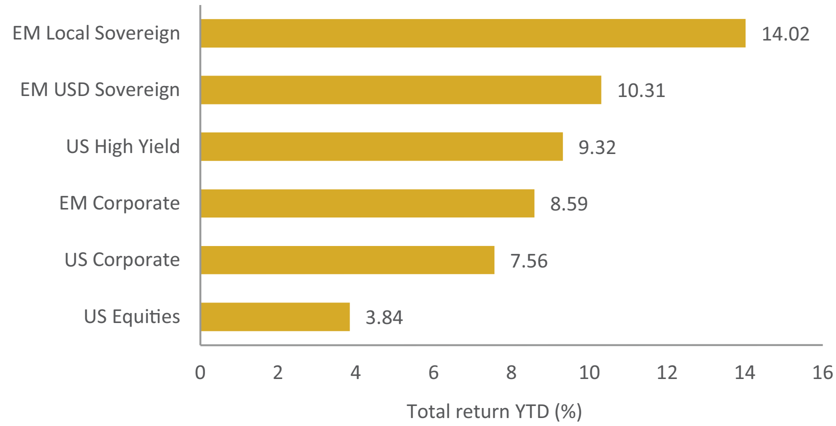
Fig.1 EM fixed income has outperformed developed markets



Source: JP Morgan, MSCI, BAML, S&P and Bloomberg, as at 30 June 2016. Note: EM Local Sovereign: JPM GBI-EM Global Diversified USD unhedged; EM USD Sovereign: JPM EMBI Global Diversified USD unhedged; EM Corporate: JPM CEMBI Diversified USD unhedged; US Corporate: BAML US Corporate Master (C0A0) USD unhedged; US High Yield: BAML US High Yield Master II (H0A0) USD unhedged; US Equities: S&P 500 (TR)

EM fixed income has produced exceptionally strong returns over the first half of the year. This is in stark contrast to the widespread scepticism about future prospects for the asset class at the beginning of the year, when most expected a continuation of the bear market of the recent past.

There are four key drivers of this outperformance:

1. **Reduced expectations of rate hikes by the US Federal Reserve (Fed)** and an explicit acknowledgement of a global dimension to the interest rate policy decision making process.

Global Asset Management

2. **A stabilisation of expectations surrounding China;** the Chinese authorities have successfully provided policy clarity on the future direction of the renminbi in order to stem capital outflows, and they have also boosted growth through policy stimulus.
3. **A turn in the political cycle in EM** which has provided more optimism about the future direction of reform. This has been most obvious in, but not limited to, Brazil.
4. **The start of the balance sheet repair stage for EM corporates;** the rebound in commodity prices, combined with a new focus on deleveraging, has led management to proactively repair their balance sheets through active liability management, cost-cutting, capital expenditure reductions and in some cases, asset sales.

As well as more positive market direction, we have also witnessed continuing performance differentiation in 2016, including:

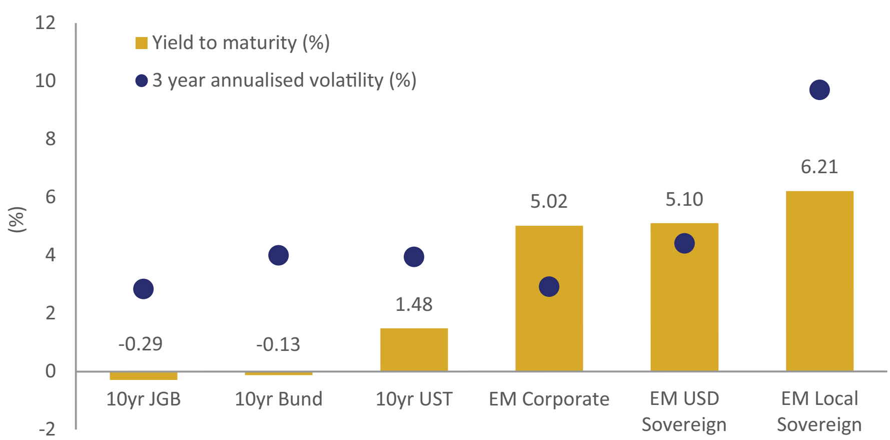
- In sovereign hard currency, Ecuador is the best performer registering 24% year-to-date (ytd), whilst Belize has been the worst, down-17% [1]
- Amongst the major EM countries, Brazil has returned 21%, whilst Hungary just 4% [2]
- In local currency the performance differentials have been even more marked. Brazil has registered a return of 47%, whilst Mexico's return has been -2% [3]
- In the EM corporate space, the big outperformer on the year is the metals & mining sector, which delivered 22.5%, whilst the bank, technology media and telecommunications (TMT) and real estate sectors have produced more modest gains in the 6% range [4]
- Dispersion on an individual name basis is also heightened; the total return differential between the top 10 performing credits and the bottom 10 performing credits this year is in the region of 60%

Strength to strength?

With EM fixed income posting compelling returns during the first half of the year, the question now turns to how sustainable the rally is moving into the second half. In our view the positive return environment is likely to continue this year, while differentiation will remain critical to maximising performance.

1. EM yields continue to appear attractive in an otherwise low yielding environment

Fig. 2 EM debt offers an attractive yield pick up over developed market government bonds

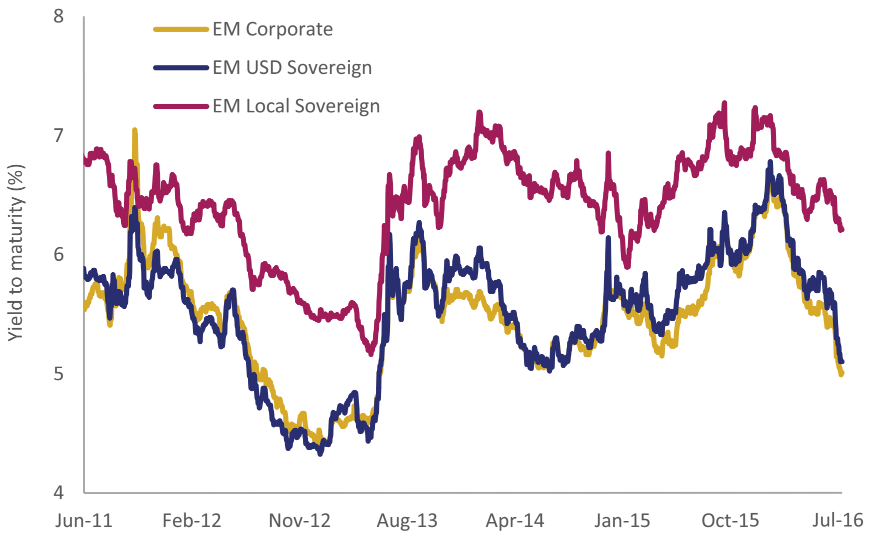


Source: JP Morgan, Bloomberg, as at 30 June 2016

Notes:
1 JP Morgan EMBI Global Diversified, as at 30 June 2016
2 Ibid
3 JP Morgan GBI-EM Global Diversified, as at 30 June 2016
4 JP Morgan CEMBI Diversified, as at 30 June 2016

Stabilisation of EM fundamentals will lead to significant reengagement from end investors facing a low yield world. Neither hard currency nor local currency yields look particularly stretched on a historical basis, reinforcing the prospects for further tightening.

Fig. 3 EM valuations

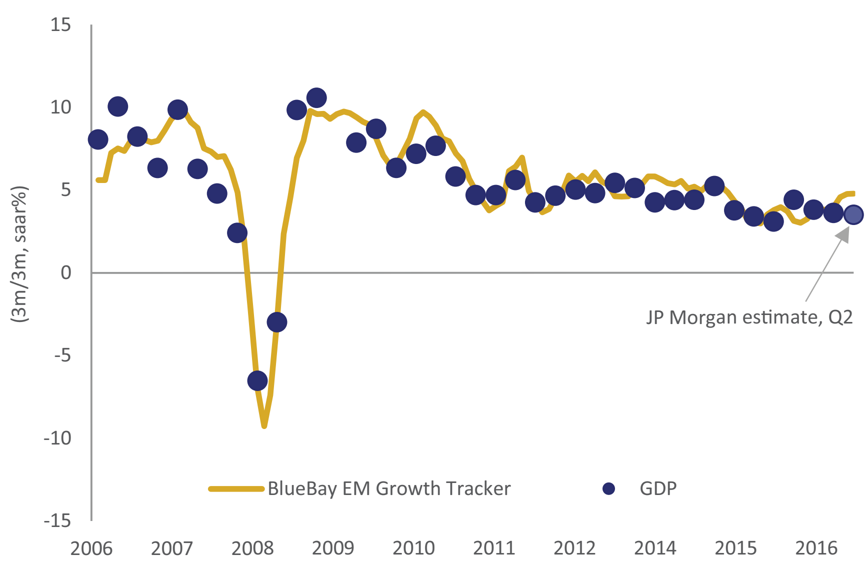


Source: JP Morgan, as at 30 June 2016

2. Fundamental improvements add scope for capital appreciation

Our growth outlook remains positive; we are detecting stabilisation and improvement in the growth outlook for EM after a long period of underperformance.

Fig. 4 EM growth appears to be stabilising



Source: Proprietary BlueBay Asset Management model, which tracks a series of indicators to build an aggregate picture of EM growth rates, Macrobond, JP Morgan, as at 30 June 2016

Previous currency depreciations are now beginning to boost competitiveness and interest rate reductions are beginning to improve the outlook for domestic demand. We believe stronger growth is the prerequisite for stabilising credit dynamics and improving FX performance. Therefore we believe it is realistic to expect further spread compression and currency appreciation in the second half of the year.

On a corporate level we expect the focus on deleveraging and balance sheet repair to remain at the forefront, as companies continue to announce bond tenders/buy backs and actively control costs while raising cash through asset sales to improve their credit profiles.

3. EM corporate market technicals remain strong

In our view, the technical backdrop in the EM corporate asset class remains very much intact. On one hand we continue to see new issuance decline – 2014 was a record year for new issuance with approximately US$370bn coming to market. New issuance in 2015 dropped 35% from its peak in 2014, and supply so far this year has dropped even further. This has happened for a variety of reasons – e.g. in Russia, ongoing sanctions mean most corporates are effectively prohibited from issuing; an uncertain political backdrop in Brazil has left Brazilian corporates reluctant to come to market; Chinese corporates are largely opting to issue domestically as opposed to internationally in US dollars; while in other sectors companies are benefiting from stronger liquidity profiles and as such do not need to issue debt.

This decline in new supply is being met with continued demand for higher-yielding corporate paper, which stems from investors' ongoing "chase for yield", as well as an expectation that maturities and coupon payments will increase into year-end, in our view provides a solid footing for this asset class to perform over the coming months.

4. Performance differentiation set to continue

We believe performance differentiation among EM countries is set to continue this year and this offers an opportunity for active managers and rewards flexible mandates. Brazil was the best performing mainstream sovereign in the first half of this year due to a country-specific political transition. Mexico registered the weakest performance of any country in EMFX due to weak growth and current account data. We believe other examples of performance differentiation will likely occur in the second half of this year as specific idiosyncratic stories play out, potentially triggering material market moves. We are particularly focused on:

- The upcoming municipal elections in South Africa, which may provide a catalyst for the removal of President Zuma
- The change of the central bank governor in India, and whether Rajan's successor provides policy continuity in a previous EM success story
- The scope for the Brazilian central bank to surprise the market with extra interest rate cuts
- Possible regime change in Venezuela
- Progress towards reengagement with the IMF in Sub-Saharan Africa (Ghana, Zambia)
- The reduction of inflation and the resurgence of growth in Argentina
- Continued cost cutting and asset sales amongst quasi-sovereigns such as Petrobras (Brazil) and Ecopetrol (Colombia), providing scope for continued spread compression in some quasi-sovereign credits while the outlook for others remains unclear (e.g. Eskom)
- Corporate default rates so far this year are running at around 3.75%, on track to reach our estimate of 5–7% for the year, representing the highest default rate since 2009
- Amongst the corporate credits trading at distressed levels, we expect a number of defaults to materialise in the second half of the year, while other issues could offer some strong capital appreciation potential. We believe asset selection will be key to capitalising on these moves
- In our view, the revival of the local currency corporate markets should open up a host of new investment opportunities in the EM corporate sector. This is evident with the recent opening of the Masala bond market in India as well as the reopening of the local corporate markets in Brazil and Argentina.

What is the best way to capitalise on the EM story?

The EM landscape comprises a universe of over 60 countries and approximately 1,000 corporate issuers, with a broad range of sub-asset classes and instruments for delivering alpha. The depth of the asset class provides a wide range of options to access EM assets, depending on the investment objectives and constraints that investors may face.

For example, those who have the flexibility to invest across regions, asset types, credit qualities and derivatives, would likely find an unconstrained strategy more appealing. We believe these strategies can capitalise on the positive EM landscape by directing exposure opportunistically to different assets and instruments across the asset class while minimising downside risks during times of market stress. Other investors may be drawn by the inefficiencies in the EM corporate market and can benefit from a strategy that can exploit mispricing both on the long and on the short side.

Those investors who prefer a more traditional long-only approach, but for whom yield enhancement is a primary objective have a number of options.

Those with an appetite for FX risk could look to access the asset class through local currency sovereign bonds, or indeed local currency corporate bonds. This provides a direct way to access the local markets within a smaller range of broadly more developed EM countries, where the average credit rating is investment grade across the board.

At the same time, we acknowledge some investors may be put off by the volatility associated with EM currencies, but still require higher yields. In our view, in the hard currency space a dedicated high yield corporate bond fund will meet these requirements and provides a compelling opportunity to exploit the EM corporate default cycle with skilled credit selection and focus on capital preservation.

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