Global Asset Management

BlueBay Asset Management

Portfolio Manager Perspectives
BlueBay Emerging Market Debt Update

June 1, 2017

Brazil remains the focal point for emerging market (EM) investors. We have had no decisive developments in the corruption scandal over the past week, but Brazilian fixed income markets have recovered strongly. The strongest move has been in the local sovereign bond market. After close to a 200bps sell off the previous week, Brazilian 5-year interest rates recovered over half of that loss. Investors concluded that the political uncertainty would not preclude a continuation of the ongoing easing cycle.

As discussed last week, we established a new long position in the wake of the sell off. The strong rally there obviously benefited performance. This week's recovery in Brazilian asset prices means that our short term targets for Brazil FX and interest rates have now been met, and so we are reducing exposure there again. At the moment President Temer appears determined to keep hold of his job. The potential for a drawn out fight over whether he should go and who should replace him seems to be growing. This would mean that social security reform approval would also be delayed further.

Aside from Brazil, market conditions were quiet, but relatively firm ahead of the Memorial Day long weekend. Global interest rates remain becalmed, incentivising investors to search for high carry assets. Oil prices weakened, as the OPEC agreement to extend supply cuts for a further 9 months had already been widely anticipated, but there was little effect on oil exporters in the EM space.

There were a number of notable new stories in EM fixed income. Firstly in Venezuela it emerged that Goldman Sachs Asset Management had struck a controversial deal with the government to buy US$2.8bln face value of 2022 maturities at 31 cents on the dollar. This provided the central bank with US$800mln of badly-needed liquid FX reserves, but triggered a firestorm of criticism from those who believe that the deal would prop up a regime committing widespread human rights abuses. Moral sermonising around EM investing is a hazardous topic. Who is so virtuous that they can determine what is an "ethical" as opposed to an "unethical" investment? However, the term "hunger bonds" used by the Venezuelan opposition to describe transactions similar to the above has some resonance. All investors in Venezuelan bonds, including BlueBay, must to some degree come to terms with the fact that the dollars being used to service our debt are therefore not being used to provide food for a population that is starving. Having been an investor in EM for over 20 years, I would regard this as maybe the most morally dubious instance I can recall.

South Africa also garnered attention as speculation built of a renewed attempt to oust President Zuma at the ANC NEC meeting. Such speculation came to nothing. Zuma has an important core of support within the party that makes his survival likely. We think the key to the South Africa story for the rest of the year is the macroeconomics, however. Continued falls in inflation make local 10-year bond yields above 8.5% attractive, in our view. This remains one of our core local market bond positions.

Mexico will be a key focus in the forthcoming week as the gubernatorial election in the State of Mexico will be watched as a key indicator as to the strength of populist candidate Lopez Obrador ahead of next year's presidential election. We remain short the Mexican peso and long Mexican credit protection ahead of this event.

In Azerbaijan we were surprised by the initial restructuring terms presented for International Bank of Azerbaijan bonds. We don't fully understand the reason to introduce a re-profiling to save approximately US$200mln, at the reputational cost to a country that has a very strong sovereign balance sheet. The bonds involved did not actually move much in price after the event, but we believe the Azeris may come to regret this move in future when financing conditions are more stringent.

In general, we have been encouraged by the overall markets' resilience to the Brazil shock and still see conditions as supportive for EM over the summer months. Global growth remains firm with no apparent inflationary threat. Central banks remain extremely accommodative, and in EM appear set to ease further. We continue to believe a long biased, 'high carry' portfolio is appropriate for the summer months.

David Dowsett
Partner, Co-Head of Emerging Markets
BlueBay Asset Management