Global Asset Management

BlueBay Asset Management

Portfolio Manager Perspectives
BlueBay Emerging Market Debt Update
Weekly Update

January 10, 2018

A weak US dollar and optimism over global growth created the perfect storm for a melt up in EM risk in the first week of 2018. Fear of missing out (FOMO) seems to be the order of the day as this bullish tone has EM equity up 3.7% and local markets up close to 2% on the week, with Latin America leading the way. Commodity performance added further fuel to the rally, but the positive sentiment has not only been confined to EM, with Japanese, US and European equity all up sharply to start the year. With many investors only getting back into the office on Monday, there is a palpable sense of sticker shock at the levels of risk assets. FOMO has become the catchphrase of the week...

Credit market performance has been tempered by a renewed impetus for higher US rates and by issuers meeting the strong demand dynamics with a wall of supply. In EM specifically, we have seen a sharp compression of high yield over investment grade – a classic compression move that typically occurs as growth expectations improve and core rates move higher.

In emerging markets news:

- South African assets rallied on rumours that the ANC will consider removing Jacob Zuma ahead of the scheduled end of his term in 2019 – perhaps as soon as this week
- Argentina sold US$9 billion of bonds at a reasonable concession to secondary markets, but the adjustment of the 2018 inflation target from 8-12% to 15% and the adjustment of the 2019 target from 3.5%-6.6% to 10% created a sharp sell-off in the Argentine peso and also weighed on Argentine US$ assets
- Market expectations for Chinese growth improved, given the more supportive global backdrop and its implications for Chinese exports. Chinese PMIs also surprised to the upside last week
- The Emerging Markets Traders Association (EMTA) met to discuss trading conventions on Venezuelan debt and concluded that bonds should trade flat of accrued interest, after repeated non-receipt of coupons and limited communication from the Venezuelan authorities

In EM corporates news:

- Stressed mining credits outperformed as the strong start for commodities, coupled with positive bottom-up catalysts, led to an extremely strong start to the year for a Brazilian steelmaker and a Brazilian miner's bonds
- A defaulted Brazilian telecom company saw its bonds move sharply higher as it moved closer to court ratification of the revised restructuring plan
- A Chinese conglomerate continued to suffer from liquidity issues as headlines surfaced that the company had missed payments to several Chinese lenders in recent weeks; the company's 12-month US$ risk trades at close to 13%, so this is a critical juncture

Performance to 5 January 2018:

EMARF	Contributors/detractors	+/-
EM Corporates	Drivers include longs in quasi-sovereign oil names, along with a high yield compression theme in Chinese real estate. High yield mining was also a notably positive contributor as commodities rallied	+
EM Sovereign	Positive drivers were longs in Argentine sovereign and provincial debt, along with Mongolia (helped by the commodity rally) and a spread trade at the long end of the Indonesian sovereign curve. CDS hedges in the Middle East and Latin America detracted from performance	+
EMFX.	Positive performance from long Brazilian real was offset by short positions in Turkish lira and Colombian peso	+
Macro Hedges	Shorts across the US Treasury curve contributed	+
Local Rates	Received positions in Brazil and outright long bond exposures in Russia contributed to performance, while Argentine local bonds detracted on revised inflation targets	+

Outlook:

The first week of the year was marked with a renewed global growth trade that lifted almost all risk assets, but there is an uneasy equilibrium as the other key components to the goldilocks environment were low inflation and stable core rates.

The outlook for core rates is uncertain but it is clear that we are now at a critical juncture with US rates at or near key support levels and upward pressure increasing on the still-accommodative European and Japanese rates markets.

For EM, a key support continues to be stable-to-improving investor sentiment around China, where growth expectations are also stable to improving, with investor concerns around deleveraging (post the party plenum late 2017) receding. Higher commodity prices are linked to this, and are again providing a net support to EM assets.

The EM political calendar will heat up later in 2018, but for now the themes that have supported EM in the first week of the year seem set to continue. We would see EM local assets and higher yielding hard currency as the natural beneficiaries of this environment.