Global Asset Management

BlueBay Asset Management

Portfolio Manager Perspectives
BlueBay Emerging Market Debt Update
Weekly Update

February 15, 2018

EM Resilient but not Immune to Macro Volatility – EM Credit Market Update

Volatility in equities continues to be the dominant theme in markets with analysts pointing to the recent average hourly earnings figure as the catalyst, but many also pointing to technical reasons behind the sell-off. The focus now turns to the US CPI number, which experts claim will be noisy in any case with seasonal factors at play along with other 'one off' adjustments, meaning the number may not actually tell us very much at all, but the market will likely lurch violently one way or the other on the relative strength (or not) of the number. Looking at the bigger picture, the recent passage of a USD300 billion boost to federal spending certainly provides a strong fiscal impetus which, when combined with low unemployment, is making the case for higher inflation more likely. However, there are also many structural reasons why inflation has been more contained than in the past, and these have likely not gone away overnight. Either way, it certainly feels that for now we are back to trading the 'bad news is good news' theme in markets, and vice versa, with the correlations increasing between rates and equity. We believe differentiation among equity gainers and detractors has also been lacking in this most recent sell-off, indicating technicals are weighing more heavily than fundamentals. Whether the equity weakness is sustained for long enough to have a meaningful effect on global growth is still up for debate, but in our view it is leading to a tightening in financial conditions that needs to be monitored closely.

Credit markets have begun to widen in response to the volatility in macro markets, but it has been relatively orderly for now, supported by the upbeat fundamentals that had previously driven spreads near to the post-crisis tights. Many investors have cash on the sidelines and are waiting to deploy into market weakness. Now that the weakness has come, there has been a decided lack of buying on the dips. The jury is still out as to why this may be the case – concerns over a paradigm shift in global markets possibly, or fear of outflows. We certainly need more data to declare a paradigm shift, and institutional flows are typically quite sticky, so there is hope in markets that spreads can gradually recover their lost ground. EM credit decompressed over the week with the previously in vogue high yield duration paper underperforming in particular.

Importantly, commodities began to show signs of weakness and the dollar showed signs of strength this week. Fundamentals should mean commodities are well supported but the stronger dollar theme typically plays into weaker commodity prices and we see this as another key theme currently impacting markets.

In emerging markets news:

- Brazil's central bank cut rates by 25bps and signalled that the rate-cutting cycle was done for now
- The Russian central bank also cut rates by 25bps, while Mexico hiked by 25bps on inflationary concerns
- South African assets were volatile on speculation that Jacob Zuma's tenure as President would come earlier than planned, paving the way for much needed reforms
- The Argentine peso traded weaker and broke through the psychologically important 20 level before the central bank intervened
- The Dominican Republic raised USD1.8 billion in a dual tranche bond offering consisting of a 30-year dollar bond and a local currency bond, which yielded 8.9% and performed well on the break

In EM corporates news:

- The bonds of a Venezuelan oil and gas giant finally began to trade flat of accrued interest as continued non-payment of coupons dispels the selective default theory. When Venezuela began to trade flat it brought in a new type of buyer and prices rallied; we may see similar in the corporate as more hedge funds get involved
- EM corporate issuance slowed dramatically with only USD6 billion of deals pricing compared to USD12 billion the week prior

Performance to 9 February 2018:

	Contributors/detractors	+/-
EM Corporates	Long positions in Argentine utilities impacted performance as sovereign-induced weakness spread to the corporate space. Oil exposures were also detractors, particularly in the long end, where price action was impacted by lower oil prices and a bear steepening in Treasuries. A Russian real estate name also suffered as locally circulating rumours made for choppy price action, which we feel is not justified. The main contributor was a Brazilian telecom name where we made progress on formalising our claims.	-
EM Sovereign	The main detractor was a long position in Argentine sovereign paper, which suffered due to a combination of the country's sensitivity to a harsher external environment combined with the relative liquidity of the actual bond issues as investors sold recent new issues and looked to raise cash. We rotated exposure into the belly of the curve given the significant flattening in the 10s 30s curve. In contrast, shorts in Colombia, where oil weakness led to a sharp repricing of spreads, provided a positive contribution.	-
EMFX.	Longs in South Africa and Brazil impacted performance while shorts in Mexico contributed positively.	-
Macro Hedges	Equity index puts contributed to performance while shorts in rates detracted from performance. We are maintaining rates shorts given the uncertain inflationary environment.	+
Local Rates	Russian rates and Argentine local assets were the key detractors, the former on oil concerns and the latter on the market's continuing reassessment of the correct trading level for ARS in light of the new inflation targets.	-
Total		-

Outlook:

While the most recent bout of volatility has been unnerving given the lack of a robust fundamental catalyst, it is likely indicative of the world we are heading into. Stronger fiscal stimulus into an ageing cycle has obvious risks but no one truly knows how strong the structural disinflationary forces are and it will be the interplay between these two that ultimately determines the market's direction. The answers to both of these questions do not come from one single number, of course, but from an accumulation of data over time, and so it is fair to assume that we will have further periods of volatility as the year plays out as the market overreacts in both directions and extrapolates trends too far into the future. In our view, the key lesson from the current volatility is that, while technicals will move prices in the short term, it is ultimately fundamentals that prevail. This is particularly the case in credit markets, where a sell side running light balance sheets and an ever growing buy side will always exacerbate price swings in times like these, but where a strong fundamental anchor remains the key to generating returns over the longer run.

For EM credit markets, we believe fundamentals generally do remain healthy with many EM economies benefiting from the improving global growth backdrop and in many cases EM assets offering comparatively attractive valuations. The short-term trend of lower issuance is likely to continue as Chinese New Year approaches and as many companies hit blackout periods ahead of year-end results releases. We therefore see technicals as likely to stabilise as the early year supply glut clears, while corporate results should remain robust and be a supportive factor for the asset class for now.

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