Global Asset Management

BlueBay Asset Management

Portfolio Manager Perspectives
BlueBay Emerging Market Debt Update
Weekly Update

February 23, 2018

Higher CPI but EM Bites Back

The big data release last week was the CPI number on Wednesday. It came in significantly higher than expectations, although seasonal adjustments and one-off factors created some noise. On the same day, retail sales were released and they were a large miss, reminding us that we are heading into Q1 US data releases, which have been weaker than expectations for the last few years. The initial reaction to the CPI number was a 1% sell-off in equity, but this quickly reversed and risky assets gained, building on their momentum from earlier in the week. While the performance of risk assets was a surprise to many, we believe the moves in the US dollar and US real rates likely held the answers as the dollar trended weaker and rates softened on the week. On the technical side, CTA and risk parity data shows that there has already been significant de-risking among this community.

Emerging market (EM) assets bounced, with currencies and equities notably contributing to returns. EM credit markets also retraced about a third of the month to-date, widening as the bounce in oil and commodities proved supportive for the higher beta component of the market. It was notable though, in our view, that high-yield credits with weak stories failed to bounce – a sign that differentiation is here to stay. Rather than blindly buying the dip, the theme has become one of selective purchasing.

In Emerging Markets News:

- In Brazil, one of the more popular and market-friendly candidates, Luciano Huck, confirmed he will not run for president. The government also delayed the crucial vote on pension reform, which was noted as a negative development by the major ratings agencies.
- In Mexico, electoral polls showed Lopez Obrador's lead increasing to 33%. There is now a blackout period before the official campaign season begins at the end of March.
- South African assets outperformed as Cyril Ramaphosa was sworn in as president
- China released data showing it had increased its holdings of US Treasuries over the prior year, debunking the theory that Chinese demand for American debt was waning.
- Egypt cut interest rates for the first time since floating the currency, signalling the start of a much anticipated easing cycle.
- Nigeria and Egypt came to the market with multi-tranche deals in the midst of market volatility, coming with healthy new issue premiums; bonds appreciated on the break, up 3-4 points in the long end.
- Kenya began a roadshow ahead of an international bond issuance.

In EM Corporates News:

- The US released the results of the Section 232 investigation into aluminium and steel imports, recommending tougher tariffs/quotas than initially expected. While we are yet to see which measures will actually be implemented, the news was interpreted positively for a Brazilian steelmaker, given its large US operations.
- An embattled Chinese conglomerate that faces an acute liquidity crunch, has begun executing on various asset sales, including its stake in a German bank, providing some much needed stability to its bond curve.
- The vote to approve the privatisation of a Brazilian quasi-sovereign utility was set for early April.
- A Brazilian industrial conglomerate sought new loans in a bid to raise liquidity to satisfy an impending bond maturity in April. Meanwhile, the S&P cut the rating for the issuer to CCC from CCC+.
- A Turkish bank came to market with a USD400 million issuance at a healthy new issue concession and outright yields of 6.8%.

Outlook:

For EM, we have seen the trajectory for real rates in the US to be a crucial determinant of performance in the past. We believe this time is likely to be no different. So far, the main move higher in nominal rates has been driven by higher break-evens, which has allowed for a weaker dollar and stronger commodities – both of which we consider to be providing crucial supports for EM.

The more recent high-frequency data for EM also continues to support the narrative of improving growth, and with many parts of EM in a different stage of their monetary policy cycle as compared to developed markets. In our view there are reasons to believe that EM is well placed to navigate the road ahead this year. For now, a still accommodative ECB and BoJ should keep core rates in check, but we have seen that the market is prepared to challenge this view and as ever the data will be key.

Performance for the week to 16 February 2018:

	Contributors/detractors	+/-
EM Corporates	A long position in a Russian real estate name bounced back after being offered down in the street aggressively last week. Mexican quasi-sovereign oil exposures also contributed as a tender offer was finalised.	+
EM Sovereign	The key contributors were longer-duration exposures in Nigeria, Ecuador and Egypt as risk sentiment bounced back and we took advantage of the tactical opportunity.	+
EMFX.	Hedges in the Russian ruble impacted performance, while longs in the South African rand were the main contributors.	+
Macro Hedges	Shorts across the US rates curve were the leading contributors as positive CPI number pushed rates higher.	+
Local Rates	Received positions across South African sovereigns and quasi-sovereigns were the top contributors. A tactical long in Dominican Republic local bonds also added.	+

It is worth remembering that first-quarter US data has shown seasonal weakness over the last few years, with US 5-year rates having moved more than 100bps in less than six months. It is certainly feasible in our opinion that the rates bears at least pause for breath for now. The pain trade from here would actually be a growth disappointment that would challenge many investors' portfolio positioning. This is why we have gradually scaled back our shorts in the US rates over the last month or so. Increased rhetoric around trade is another factor to consider as the US may act upon the recommendations of the section 232 report, which would likely draw some retaliation from the Chinese in our view.

For credit specifically, the flow dynamic will be important with the market digesting large ETF outflows, but for now cash balances are being deployed by institutional funds. Despite the positive fundamental backdrop, we continue to expect bouts of volatility in the coming months and so we will be trying to stay nimble to capitalise on these opportunities. In the short term, with Chinese New Year welcoming in the year of the dog, the market should be back to full service and we will see whether higher yields do indeed bring buyers.

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