Global Asset Management

BlueBay Asset Management

EM Local Currency Investing
Investor risk appetite brings new players to an expanding opportunity set

Executive Summary

Emerging market debt has seen record inflows across 2016 and 2017 as income-seeking investors seek out higher returns in reaction to the bleak yield landscape across much of the developed market (DM) universe.

Local-currency denominated assets did particularly well in this context, with the JPMorgan GBI-EM Global Diversified index returning over 20% from February 2016 to October 2017. This relatively new asset class is rapidly expanding from a base of some 17 markets, presenting, in our view, a number of interesting developments for investors from both a return and diversification perspective.

Holding restrictions around China's local bond market were eased in 2016 with the launch of the China Interbank Bond Market scheme (CIBM). BlueBay is at the forefront of CIBM developments, being one of only four investment institutions worldwide to be granted a license to access the market to-date. At an excess of US$ 7 trillion in size, and with foreign investors currently holding only 2% of this, the opportunity set appears abundant to us.

Argentina has also expanded its debt offering, having implemented a programme of striking political and economic transformation. Now readily accessible to the international investment community, Argentina's attractive yields make it one of the gems of the EM debt universe.

Egypt is another market that has gone through significant reform, following the military coup in 2014. Aided by IMF support and efforts to de-peg the Egyptian pound, our rigorous on-the-ground due diligence has highlighted select pockets of opportunity.

We believe tactical trade potential is also present in Nigeria, when approached using strict due diligence processes to counter economic and corporate governance challenges.

The local currency corporate debt market is an area of increasing interest with the EM universe. For mainstream EM countries, which have an established local currency sovereign market and seasoned local-currency benchmark curve, we have seen a rising number of corporates seeking to take advantage of an investor base willing to increase their tactical allocation to this sub-sector.

In our view, the local currency market rally witnessed over the last 20 months has been firmly rooted in fundamentals, and further aided by broader risk-on sentiments towards emerging markets. We believe there are a number of factors that put EM local currency debt on a firmer footing today, potentially paving the way for a multi-year recovery:

- Higher growth and lower inflation
- Improved current account deficits
- Real and nominal yields
- Cheap currencies

The three core risk considerations are:

1. G3 balance sheet reduction
2. China leverage build up
3. Busy election calendar and increased geopolitical risk

We believe that the positive structural case for EM local currency debt should outweigh occasional sell-offs and corrections within the asset class. Our bias would be to add on weakness to take advantage of the positive structural story.

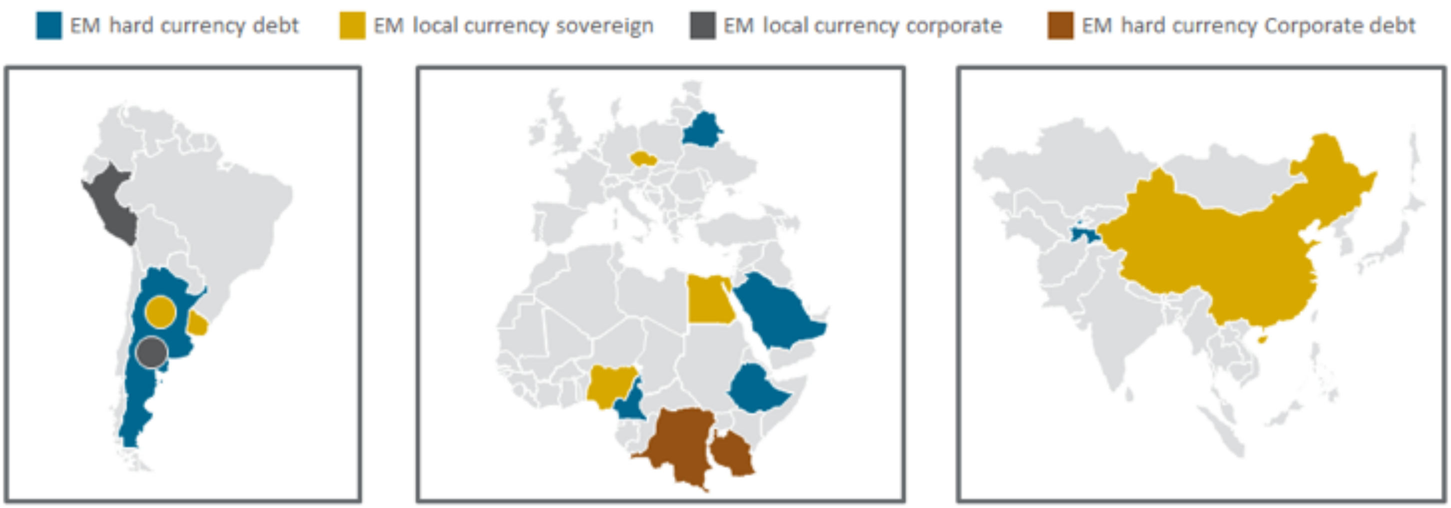
The emerging market (EM) journey is well known for being peppered with twists and turns. After disappointing performance through 2013–2015, this year and the last have provided a relatively smooth section of road with stronger performance. We have witnessed record-breaking inflows in EM debt this year as income-seeking investors sought out higher EM returns in reaction to the bleak yield landscape across much of the developed market (DM) universe. Local-currency denominated assets did particularly well in this context, with the JPMorgan GBI-EM Global Diversified index returning over 20% from February 2016 to October 2017.

This strong performance wasn't necessarily down to technical factors alone though, as EM countries are set to contribute in excess of 50% of global GDP by 2025 and are playing a very prominent role in the global political landscape, with China, India, Russia and Brazil increasingly taking a more assertive stance. The EM asset class is now well on its way to transition from niche investment zone to asset allocation essential.

As the more established branch of the investment universe, the hard currency side of the market has become the familiar EM portfolio constituent, offering investors exposure to the region's growth dynamics without the volatility accruing from local EM currency volatility. This section of the market has proved to be more mature and the investment universe is very diverse, with 65+ countries and a number of idiosyncratic drivers.

Local currency EM debt, on the other hand, is a relatively new asset class, but one with plenty of interesting developments underway to catch investors' attention. The relatively concentrated original universe of some 17 liquid countries is expanding. In 2017, we have seen a number of new entrants to this market, which, alongside its return potential, significantly increases diversification within the asset class.

Exhibit 1
New EM debt markets opening up across the world



Source: BlueBay Asset Management, as at September 2017

Many of the new entrants are interesting from a portfolio management perspective. In our view, some of them present idiosyncratic economic drivers, such as Uruguay, while others, such as Nigeria and Egypt, offer very attractive yields. The following table shows some of the more attractive current opportunities. But perhaps the most exciting potential development is in China, where the opening up of the local currency markets – rather than the development of it – could prove to have a seismic impact on regional assets.

Exhibit 2
What are you getting paid for taking new EM local market risk?

Countries	5 Year Local Debt Yield	Liquidity	Comments
China	3.6%	High	Liquid alternative to low yielding, less liquid, Asian markets
Egypt	15%	Poor	IMF program ensures reform agenda is maintained
Nigeria	15%	Medium	Government keen to implement capital account convertibility
Argentina	16%	Good	Reform agenda is maintained
Uruguay	8%	Medium	Good yield for BBB rated issuer
Peru (Corporate)	6%	Poor	Strong Quasi sovereign credit
Czech Republic	0.1%	Good	Good Rating but low yield

Bloomberg, Bluebay Asset Management, as at 18 September 2017

China local currency bond market: Potentially a seismic change

Since the liberalisation drive over three decades ago, China has grown to be the world's second-largest economy by nominal GDP, effectively doubling in size over last 10 years. Yet international investors have been subject to stringent access restrictions limiting them to the offshore debt market – totalling about US$400 billion in size. The breadth of the huge onshore market – at a staggering US$7 trillion for the sovereign and corporate debt universe combined – has been limited to domestic participants only, placing the tantalising opportunity set out of reach of the bulk of the global investor base. But this is finally changing with the introduction of the CIBM and Bond Connect programmes. At BlueBay, we favour the CIBM route for our commingled vehicles.

Exhibit 3

Source: HSBC, September 2017

Investors will remember the narrative back in 2013 around possible access to onshore China being provided by the Qualified Foreign Institutional Investor (QFII) quota system (and RQFII, its renminbi counterpart), and the possibility of London becoming the access hub to the mainland Chinese opportunity set. Unfortunately the QFII system was seriously hamstrung on the basis of restrictive quota sizes and investment lock-up periods.

The China Interbank Bond Market scheme (CIBM) is fast becoming everything QFII promised to be but never delivered. Opened in 2016, it marks a milestone in the country's ongoing journey to open up its onshore markets by providing financial institutions with access to the world's third-largest bond market; all without the shackles of quota limits and long lock-ups. China's local currency market is now well and truly open for international investors who have CIBM access.

BlueBay is at the forefront of CIBM developments, being one of only four investment institutions worldwide to be granted a license to access the market to-date. At an excess of US$ 7 trillion in size, and with foreign investors currently holding only 2% of this, the opportunity set appears abundant to us.

CIBM – the better route

- Bluebay has opened relevant accounts to enable us trading through CIBM, using HSBC as a local clearer
- Unlike QFII, **no quota involved**, no lock-ups, no limitation on repatriation
- Enormous **opportunity set**, better diversification
- CIBM allows foreign investors to access a wider-range of securities compared to Bond Connect

The appeal of local currency Chinese bonds is their liquidity profile – it's high, offsetting their comparatively low yield profile. Historically, international investors have been forced to hold other low-yielding Asian securities, such as Thai and Malaysian bonds, as a proxy trade for accessing the Asian growth story. This led to significantly tighter Asian yields, with comparatively poor liquidity. From a portfolio management perspective, being able to physically access Chinese local currency fixed income may eliminate the need to hold other low-yielding Asian bonds as proxy. Consequently, the CIBM has the potential to redraw the yield-landscape across the whole of Asia.

The next logical step would be China's inclusion in the JPMorgan GBI-EM Global series of indices. We will be closely watching the space to tailor our allocations accordingly.

Accelerated route to local currency: an Argentine perspective

Most EM countries in the early stages of development begin by issuing US dollar-denominated debt, allowing them to develop a US dollar benchmark and build the institutional framework through dollar funding. Once a dedicated local investor base is established – often in the form of pension and insurance companies – sovereign issuers begin offering local currency denominated debt as their preferred route of funding. The whole process usually takes well over a decade as markets develop and the political landscape undergoes change.

Argentina has fast-forwarded through this process, issuing hard currency sovereign debt in 2016 and compressing its journey through to local currency corporate issues into just a year. Facilitated by striking political transformation, investors can now benefit from the market's attractive yield profile, e.g. 5-year bonds offers around 16.5%. Argentine local currency debt was included in JPMorgan GBI-EM Global Diversified index in 2017, a highly favourable outcome for a country that only started issuing local currency debt relatively recently.

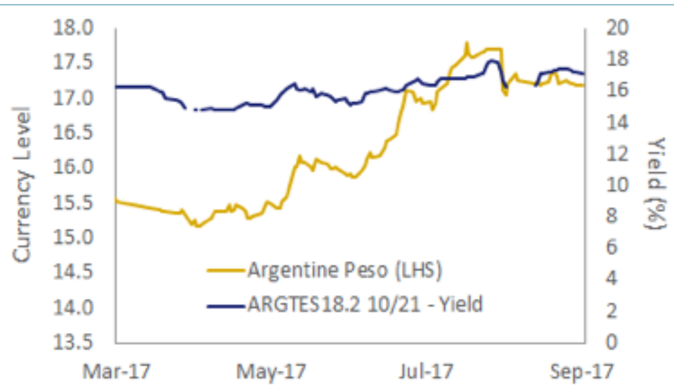
Exhibit 4
Argentina's local currency timeline

Source: Bloomberg, as at September 2017

How and why has Argentina achieved this?

- First, the Argentine government has a strong pro-reform stance. Since taking office in late 2015, Mauricio Macri and his team have lifted currency controls; settled a decade-long lawsuit that blocked the country from international capital markets; launched EM's largest-ever bond (at US$16.5 billion); reduced export tariffs; started to accurately compile and release accurate national statistics; and hiked heavily subsidised utility tariffs as part of a hands-on, no-nonsense change programme. Argentina has clearly signalled to the world that it is an open and business-minded economy with reform measures designed to tempt investors in.
- Second, the team under Macri is exceptionally sophisticated and market-friendly. Technocratic in nature, they have a strong background in financial markets with a deep understanding of how things really work. For example, Minister of Public Finances Luis Caputo has served as chief of Latin American trading at both JP Morgan and Deustche Bank.
- This sophisticated team combined with orthodox central bank policies have also pursued a modest interest rate path, cutting slowly in an effort to keep inflation in check, resulting in what we view as a very controlled weakening of the currency.

Exhibit 5
Argentina 2021 Yield and Currency history



Source: Bloomberg, as at September 2017

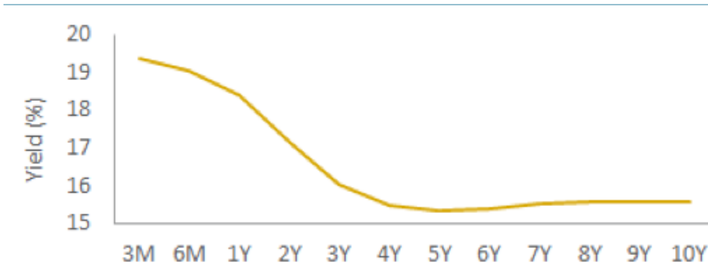
Re-designed to appeal, Argentina has taken huge strides forward in presenting itself to the global finance community. Its heavy recent issuance of debt and history of default (five times in the past 100 years) make it a market to monitor. But its accessibility combined with attractive yields makes it one of the gems of the EM debt universe.

Tapping Egyptian yield pockets

Some 12,000 km across the Atlantic Ocean is Egypt, with its own interesting proposition. The 'Arab Spring' that began in Tunisia in December 2010 quickly spread across North Africa, toppling governments and causing uprisings in Libya, Egypt, Yemen, Syria and Bahrain. After a military coup in 2014, Egypt's rocky past is slowly being restored through a commitment to structural reform by new President Abdel Fattah El Sisi with dedicated support from the International Monetary Fund (IMF).

The granting of a US$12 billion three-year loan by the IMF in 2016 provided Egypt with essential cushioning as it stabilised following the uprising and set it up to move toward fundamental economic transformation. Market reaction to the agreement was positive, with international flows returning as both domestic and international investor sentiment improved.

Exhibit 6
Egypt Yield Curve

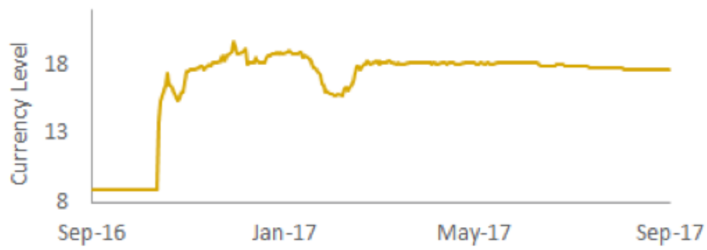


Source: Bloomberg, as at September 2017

IMF support provides the economic backbone to Egypt but is not a cure-all solution for the country's troubles. Inflation is expected to fall to 18% levels from 30% by the end of 2018 and carry is attractive at the front end of the curve, but this is a well-owned trade. On-the-ground due diligent is critical in Egypt.

Our interest in the Egyptian market is fuelled by two primary drivers: the IMF working as an anchor to the economic development of the country and through insight gained from our on-the-ground research trip. The IMF's involvement was also crucial in setting a path towards de-pegging the Egyptian pound, which relieved the pressure on the much-needed foreign reserves.

Exhibit 7
Egyptian pound devaluation



Source: Bloomberg, as at September 2017

Learning from past mistakes – Nigeria

Nigeria is another relatively young market where strict due diligence is essential to balance out economic and corporate governance challenges. But as a country committed to learning from past mistakes, it is displaying what to us are some very interesting pockets of value across the debt spectrum.

Nigeria had been included in the local currency debt index in 2011, marking an important milestone in its drive to reform the economy and bring in foreign funding. Its future became troubled in 2015, however, as oil prices – its main export – began to fall and production was hit by a military uprising in the main production region (Niger Delta). The central bank restricted the full convertibility of the currency, creating a significant divergence between official and unofficial rates and ultimately exclusion from the JPMorgan local currency debt index. The yield of the local currency bonds jumped from 8% to 20% in a span of few weeks and economic conditions where further hit by 20% inflation levels. In reality, the measures taken by the government to paint a picture of stability proved to be counter-productive.

With much anticipation by the international community, Nigeria has implemented significant measures to turn its fortunes around. President Muhammadu Buhari has been away from office on a leave of medical absence, and the efforts of the replacement team have resulted in the currency converging with unofficial rates, yields tracking downward and the overall country story improving, aided by a strengthening oil price and rebel co-operation.

Nigeria is many reform measures behind established EM players such as China, but like in Egypt, an on-the-ground presence combined with stringent security analysis may result in accretive tactical trades.

EM local currency corporate debt market

Aside from geographic specifics, another area of increasing interest is the slow-but-sure development of EM local currency corporate market. For mainstream EM countries, which have an established local currency sovereign market and seasoned local-currency benchmark curve, we have seen an increasing number of corporates seeking to take advantage of an investor base willing to increase their tactical allocation to this sub-sector.

Strong quasi-sovereign credits opened up the Peruvian sol-denominated local currency corporate market to offshore investors. At the same time, more established issuers remain active across the EM landscape. We have also seen the reopening of the offshore Turkish lira corporate market, as well as an increase in rand-denominated AT1 (coco) bonds from South African banks. In India, too, the so-called Indian rupee-denominated 'masala bond market' has seen continued issuance. Last but not least, on the back of successful issuances from the sovereign, Argentina has seen a number of fixed-rate issuances from names in the energy and banking sectors. A number of issuers have also benefited from the structure of Argentine peso-denominated floating rate notes.

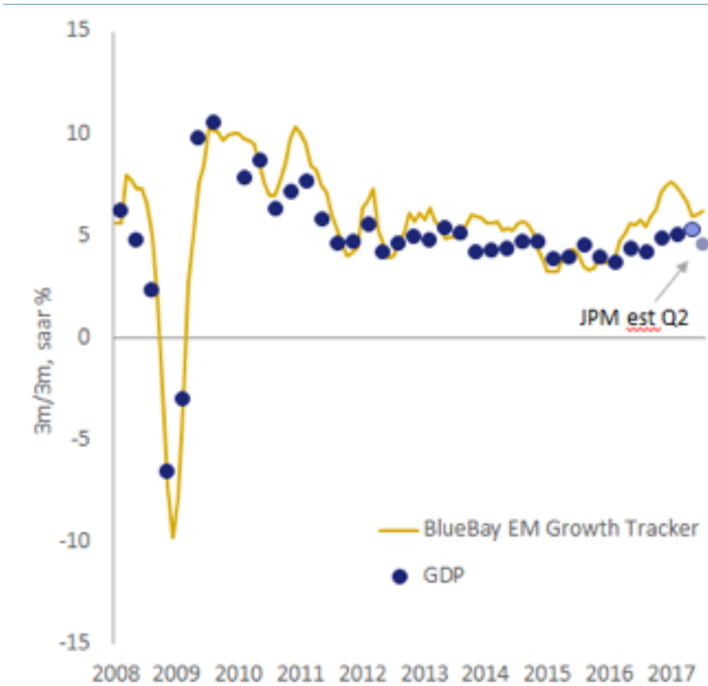
The structural case for EM local currency debt market

In our view, the local currency market rally witnessed over the last 20 months has been firmly rooted in fundamentals, and further aided by broader risk-on sentiments towards emerging markets. This focus on fundamentals is especially important against a backdrop of potential tightening in the monetary conditions across the G3 countries. Monetary tightening in the US was an early trigger for the so-called 'taper tantrum' and the 'fragile five', although the underperformance of many EMs was also caused by vulnerable fundamentals, whereas the backdrop now is more robust

Today, the picture is much improved for EM countries. We feel there are a number of factors that put EM local currency debt on a firmer footing today, potentially paving the way for a multi-year recovery.

1. Higher growth and lower inflation: EM local currency debt remains a growth-sensitive asset class. We believe its prospects are positive given the synchronised growth recovery in DM and EM we have witnessed recently. At the same time, global inflation continues to be relatively subdued. This powerful combination creates a benign environment for EM local currency debt to rally.

Exhibit 8
Strong Growth Momentum in EM



Source: Macrobond, Bloomberg and Bluebay Asset management

In sharp contrast to initial expectations of muted global trade growth, the reality has been a meaningful acceleration. Global trade growth now stands close to a seven-year high. Despite the noisy protectionist rhetoric from a number of DM politicians and policy makers, this recovery in global trade growth is a clear sign that EM growth has become increasingly prominent and domestic-demand driven over the last decade.

Exhibit 9
Global trade growth

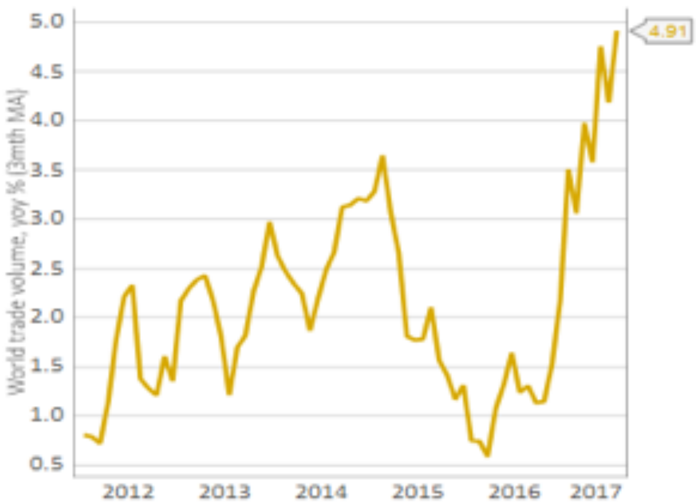
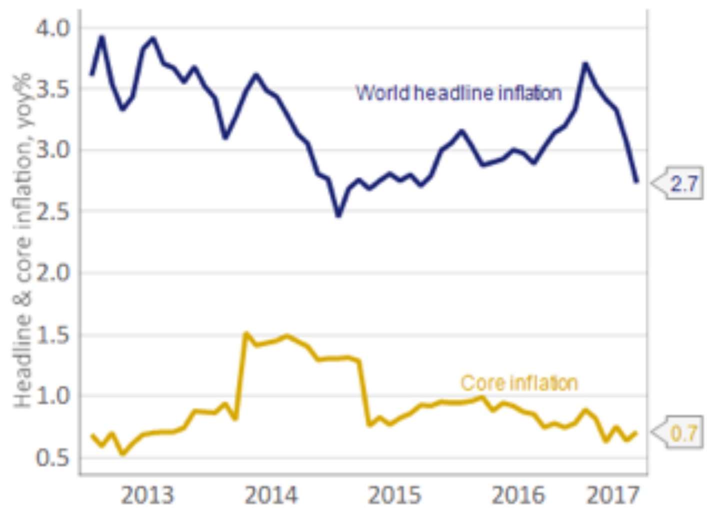


Exhibit 10
World headline and G3 'core' inflation, yoy%



Note: G3 core inflation is the average of US, Euro area and US consumer price inflation excluding food & energy
Source: IMF; Macrobond; BlueBay calculations; latest monthly data for August 2017

2. Improved current account deficits: As mentioned previously, we have witnessed a meaningful improvement to the current account deficits of EM economies. On a GDP-weighted aggregate basis, the current account deficit has halved over the last five years, from -2% to -1%. In addition, a number of export-orientated EM economies remain in current account surplus territory. This implies that these economies are better able to withstand the shock of a global monetary policy tightening.

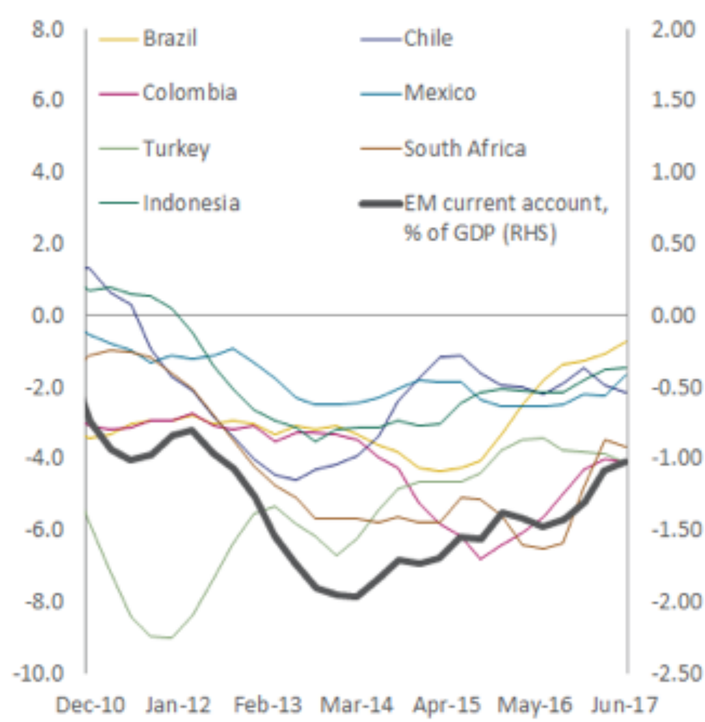
The notable exception to this picture is Turkey, where we have seen a degree of deterioration in its current account deficit over the last six months and a poor mix of funding for the deficit (nearly 70% accrues from fast-money foreign investors).

If a global monetary tightening does occur, idiosyncratic stories such as Turkey remain vulnerable.

3. Real yields and nominal yields: The real yields for the local currency debt of EM countries is about 250bps over that of the real yields of the G3 countries. For a foreign investor, we believe the real-yield differential is very appealing and we believe will be a structural factor in the continued re-allocation of capital from DM to EM until this spread narrows meaningfully.

At the same time, the nominal yields paint an even more attractive picture for us. In the G10, the vast majority of government bond yields are negative territory, with US Treasuries being one of the highest-yielding securities within G10 rates. From the perspective of US and European investors alike, it presents a compelling case to increase allocations to mainstream EM countries such as Brazil, Mexico, South African and India.

Exhibit 11
Current Accoun deficits improve materially



Source: Macrobond, Bloomberg and Bluebay Asset management
As at 31 August 2017, * EM average: Argentina, Brazil, Chile, Colombia, Mexico, Peru, Hungary, Poland, Romania, Russia, Turkey, South Africa, Indonesia, Malaysia, Philippines

Exhibit 12
Developed Markets: Yields by country

Negative yields | Yields between nil and 1% | Yields between 1% and 2% | Yields between 2% and 5% | Yields greater than 5%

	1Y	2Y	3Y	4Y	5Y	6Y	7Y	8Y	9Y	10Y	15Y	20Y	30Y
Germany	-0.67	-0.68	-0.53	-0.36	-0.18	-0.06	0.08	0.23	0.40	0.54	0.75	1.03	1.30
Austria	-0.46	-0.53	-0.39	-0.27	-0.18	-0.08	0.06	0.26	0.41	0.70	1.13		1.60
Netherlands	-0.64	-0.64	-0.51	-0.36	-0.24	-0.01	0.17	0.34	0.51	0.66			1.36
Slovakia	-0.27	-0.38	-0.45	-0.45	-0.22	-0.10	-0.05			0.93	1.46	1.81	
Finland	0.06	-0.63	-0.38	-0.41	-0.15	-0.08	0.13	0.22	0.46	0.54	1.00		1.45
France	-0.55	-0.44	-0.43	-0.27	-0.08	0.07	0.24	0.46	0.64	0.80	1.16	1.47	1.85
Belgium	-0.55	-0.49	-0.41	-0.27	-0.09	0.07	0.28	0.49	0.65	0.82	1.19	1.29	1.84
Ireland	-0.44	-0.45	-0.33	-0.29	0.00	0.18	0.39	0.60	0.55	0.84	1.29		1.92
Italy	-0.35	-0.20	0.18	0.42	0.78	1.07	1.46	1.71	1.90	2.09	2.67	2.80	3.23
Spain	-0.39	-0.32	-0.17	0.00	0.27	0.46	0.81	1.07	1.31	1.50	1.92		2.82
Portugal	-0.25	0.12	0.27	0.61	1.21	1.71	1.99	2.42	2.64	2.88	3.33		3.85
Greece		3.43	7.77							5.40	6.37	6.39	
Switzerland	-0.83	-0.76	-0.64	-0.55	-0.43	-0.36	-0.22	-0.12	-0.03	0.05	0.30	0.39	0.50
Sweden		-0.67		-0.30	0.04		0.31	0.54		0.74	1.35	1.66	
Australia	1.63	1.79	1.97	2.12	2.17	2.27	2.41	2.50	2.59	2.68	2.98	3.22	
Japan	-0.12	-0.11	-0.09	-0.06	-0.06	-0.04	0.00	0.02	0.05	0.08	0.30	0.59	0.88
UK	0.30	0.27	0.32	0.38	0.59	0.72	0.85	0.98		1.23	1.59	1.75	1.86
USA	1.21	1.35	1.51		1.84		2.11			2.29			2.90

Exhibit 13
Emerging Markets: Yields by country

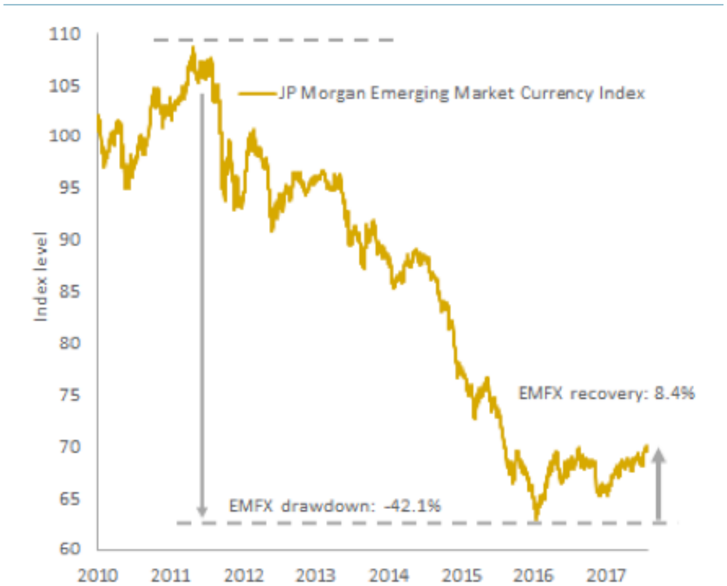
Negative yields | Yields between nil and 1% | Yields between 1% and 2% | Yields between 2% and 5% | Yields greater than 5%

	1Y	2Y	3Y	4Y	5Y	6Y	7Y	8Y	9Y	10Y	15Y	20Y	30Y
Brazil	7.96	8.25	8.72	9.05	9.69		9.88			9.99			
Chile	2.57	2.80		3.28	3.48		3.55			4.27			
China	3.51	3.60	3.69	3.82	3.87		3.95			4.09	4.30	4.42	4.56
Colombia		5.56	5.88	6.02	6.25			6.45		6.82	7.04		
Hungary	0.10		0.84		1.83					3.10	3.67		
India	6.30	6.33	6.46		6.56	6.69	6.78	6.85	6.69	6.47		7.51	7.10
Indonesia	6.00	6.56	6.74	6.84	6.78	6.94	6.98	7.12	7.15	6.95	7.39	7.63	7.93
Malaysia	3.20	3.31	3.40	3.60	3.69	3.82	3.91	3.95	3.99	3.99	4.41	4.56	
Mexico	7.17	6.78	6.75	6.75	6.76	6.80	6.83	7.00	6.85	6.88	7.03	7.15	7.23
Peru	3.75				4.60					5.51	5.82	6.04	
Philippines	3.04	3.65	3.90	4.26	4.72		4.80			5.01		5.17	
Poland	1.62	1.84	2.19	2.48	2.71		3.06			3.36			
Romania	0.75	1.29	1.71	2.28	2.54		3.29			3.86	4.16		
Russia	7.99	8.00	7.99		7.95					7.86	7.93	8.01	
South Africa		7.15	7.38		7.54		7.96			8.63	9.26	9.61	
Thailand	1.43	1.42	1.50		1.87		2.02			2.43	2.83	3.02	3.32
Turkey	11.82	11.55	11.06	10.89	10.87					10.61			

Source: BlueBay Asset Management, Bloomberg, as at 17 August 2017

4. Currencies remain cheap: Despite the strong performance of this segment of the market and the recently rally in currencies, the reality is that on a nominal basis, EM currencies remain nearly 30% cheaper than their most expensive levels. This large valuation gap should act as an additional structural driver for the reallocation of capital towards EM.

Exhibit 14
Despite rally, cheap nominal valuations in EM currencies



Source: Bloomberg, JPMorgan, Bluebay Asset Management, as at 31 August 2017

EM local currency debt has a favourable structural case on a forward-looking basis. Unlike the hard currency debt segment, this is a more concentrated and less mature sub-sector, and is ripe for further issuers to take advantage of. With a positive macro backdrop and solid performance, we have seen a number of issuers accessing the market. This trend, if sustained, will grow the local currency debt universe and introduce further differentiation

Risks: No discussion on EM debt would be complete without acknowledging the risks. Although from a macro perspective we think the balance of factors have tended to favour EM risk-on in 2017, we are mindful of a number of developing factors that could potentially lead to an asset class corrections, notably impacting local currency debt. In particular, we would acknowledge three risk factors that have the potential to weaken the attractiveness of EM debt and at the very least, could introduce significant volatility.

1. G3 balance sheet reduction: The abundant money supply in the world today driven by quantitative easing for nearly 10-years seems to be coming to an end. Tighter monetary policy and reduced liquidity could expose fundamental vulnerability in selected EM economies.

2. China: While China has outpaced expectations in terms of growth and has offered the global economy a sense of stability in 2017, we acknowledge that leverage build up remains a concern. Although there are some mitigating factors, are cautiously monitoring the debt build up in china.

3. Busy election calendar and increased geopolitical risk:

a. A number of mainstream EM countries are heading to the polls in 2018, including Russia, Mexico and Brazil. The outcomes of these elections will determine the pace of reforms in some of these countries and could increase volatility in EM assets.

b. Today's world today has a number of geopolitical flash points – including the Middle-Eastern situation with Saudi Arabia / Qatar / Iran tensions, North Korea versus US rhetoric and a number of war zones. Each of these scenarios currently looks contained, but as investors we remain mindful of future risks.

On acknowledged these risks, we believe that the positive structural case for EM local currency debt should outweigh occasional sell-offs and corrections within the asset class. Our bias would be to add on weakness to take advantage of the positive structural story.

Global Asset Management

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