Portfolio Manager Perspectives
BlueBay Emerging Market Debt Update
Weekly Update

August 8, 2019

Sentiment turns on a dime

The Fed underwhelms and trade tensions resurface; EM investors patiently wait for interesting entry points to open up.

Summary

As we moved into August, President Trump injected a large dose of volatility into markets with his surprise announcement of a 10% tariff on an additional USD300 billion of Chinese goods, commencing at the start of September. Global equity markets duly tanked and core rates rallied even more, with 30-year German Bunds finally breaching the zero bound.

Prior to this, the week had already been eventful enough as the Federal Reserve (Fed) meeting on Wednesday night delivered a 25bps interest rate cut (its first in over 10 years) with a more hawkish tone in the press conference. Chairman Powell referred to the cut as a "mid-cycle adjustment", inferring that the Fed may be 'one and done'. This seemed totally counter-productive, but with risk markets selling off during the press conference, Powell attempted to walk this back, specifically stating that he had not said 'one and done' and citing that trade concerns would be a key part of the Fed's decision-making process when considering whether to cut again. President Trump, therefore, just made Chairman Powell's job a whole lot easier come September.

Performance-wise, EM fixed income followed a predictable pattern, with local markets the big underperformers due to FX, while hard currency held-up better given the rally in core rates. Investment grade meaningfully outperformed higher-yielding credits, where growth concerns typically weigh more heavily.

Market Review

- The US imposed sanctions on Russia, prohibiting US financial institutions from participating in the issuance of new Russian sovereign debt. The sanctions, which came as a surprise to the market, are due to take effect from late August and are in retaliation for the 2018 nerve-agent attack in the UK.
- In China, the leadership announced its priorities for 2H19, with trade concerns featuring along with a commitment to continue with the incremental easing measures they have pursued for the past 12 months.
- The Turkish central bank lowered its inflation forecast for 2019, setting the stage for new Governor Murat Uysal to continue easing the policy rate into year-end.
- Brazil's central bank cut interest rates by 50bps, leaving the policy rate at 6% and signalling that there may be further easing to come.

Market Outlook

Market sentiment has once again turned on a dime. The Fed has underwhelmed, trade concerns have resurfaced and most risk assets are fully valued. China has allowed the CNY to break the psychologically important 7.00 barrier versus the US dollar and the US has labelled China a currency manipulator. Add this to the fact that we are in August – a traditionally illiquid and volatile month – and you have a nasty cocktail for risk, which is likely, in our view, to leave investors with a sore head at best.

In EM fixed income, one of the key positives for the asset class over the last few months has been its high relatively carry, which has drawn investors in as volatility has remained subdued. With the trade-off between global growth concerns and central bank accommodation still playing out, investors have been happy to earn the extra carry the asset class offers.

In our view, August illiquidity coupled with heightened headline risk does not bode well, but looking a little farther ahead, there may be a silver lining. After all, President Trump is entering an election year in 2020 and he makes no secret of the fact that he uses the S&P as a gauge of his own performance as president. He is also frank about the fact that he thinks the Fed made a mistake in raising interest rates so aggressively last year. It seems to us that his strategy here is for some short-term pain to create longer-term gain.

In the end, if Trump's actions force a further two Fed cuts and other central banks commit to their own easing programmes, it is likely to at least provide some backstop to growth expectations. If a trade deal with China ultimately follows – given this remains in the best interests of both countries – then the medium-term set-up for EM should remain a healthy one, in our view, especially as valuations are in the process of resetting. For now though, a degree of patience is warranted as potentially interesting entry points open up in August.

Index Review – Weekly Market Snapshot as of 08/02/2019

	Total return			Spread / yield change (bps)				
	Weekly	MTD	YTD	Weekly	MTD	YTD	Spread (bps)	Yield (%)
Hard Currency Sovereign	-0.05%	-0.05%	12.61%	10	17	-79	336	5.34
Hard Currency Corporate	0.34%	0.11%	10.36%	15	14	-40	318	4.96
Local Currency Corporate	-1.43%	-1.46%	6.96%	1	-4	22	179	6.84
Local Currency Sovereign	-1.50%	-1.59%	7.98%	-2	-1	-97		5.49

Source: Bloomberg, JPMorgan

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