Global Asset Management

BlueBay Asset Management

# Portfolio Manager Perspectives
# BlueBay Emerging Market Debt Update
## Weekly Update

October 3, 2018

## Crunch Time in Brazil

Emerging market (EM) local currency bonds had another good week, capping off a positive month of returns despite the continuing headwinds from a Fed tightening cycle and ongoing trade tensions between the US and China. Oil prices also continued to march higher with Brent oil up 4% on the week, at levels north of USD80 – this remains a crucial differentiator to country performance with oil exporters making windfall gains. Meanwhile, in developed markets, Italian risks have once again flared up with the Italians delivering a budget objective of -2.4% for next year, setting themselves upon a collision course with the EU and roiling peripheral debt markets in the process. In the US, the Federal Reserve hiked rates and remains on course to deliver one further hike this year, with the dot-plot forecasting a further three hikes next year and one final hike in 2020.

**In EM News:**

- Argentina delivered on its promises of a new and improved IMF package, with the programme revised up by USD7.1bn and a front-loading of drawdowns. The President of the Central Bank Luis Caputo, resigned amid the new programme in apparent protest at the new FX framework that sets a non-intervention band for the FX between ARS34-44, while also committing to maintaining a stable level for the monetary base in a bid to turn inflation dynamics once and for all. The programme was well received by markets, with the USD bond curve bull steepening, although ARS predictably sold off and seems likely to test one end of the band – which one is unfortunately anyone's guess right now.
- In Brazil, elections are scheduled for 7 October in a race that is now predicted to go to a second round run-off between Bolsonaro on the right and Haddad on the left. Second-round simulations are too close to call, but with both candidates showing rejection rates of around 40%, this is certainly looking like another polarising election, to add to the many we have seen globally over the last couple of years. With Brazilian assets more priced for a Bolsonaro win than a Haddad win, following their recent rally the skew of risks seems to be on the downside here, although light positioning may mitigate any move wider.
- The Chinese yuan weakened amid ongoing trade tensions with the US; the path for the currency should remain one of gradual depreciation to reflect increased Chinese stimulus as they seek to mitigate the impact of US tariffs.
- It was confirmed that Saudi Arabia, Qatar, United Arab Emirates, Bahrain and Kuwait would all be joining the JP Morgan emerging market bond indices at the start of 2019 - this provided a boost to GCC spreads, which were also helped by higher oil prices.

*Weekly market snapshot as of 09/28/2018*

| | Total return 1 week | Total return MTD | Total return QTD | Total return YTD | Spread change 1 week | Spread change MTD | Spread change QTD | Spread change YTD | Current spread | Current YTM |
|---|---|---|---|---|---|---|---|---|---|---|
| **Hard currency corp** | 0.50% | 0.94% | 1.44% | -1.66% | (5) | (26) | (21) | 34 | 294 | 5.75% |
| Hard currency corp - IG | 0.33% | -0.09% | 1.09% | -1.07% | (1) | (9) | (15) | 15 | 192 | 4.77% |
| Hard currency corp - HY | 0.72% | 2.33% | 1.92% | -2.40% | (9) | (51) | (20) | 63 | 439 | 7.30% |
| **Hard currency sov** | 0.73% | 1.51% | 2.30% | -3.04% | (8) | (35) | (34) | 50 | 335 | 6.41% |
| **Local currency corp** | 0.52% | 1.06% | -0.83% | -1.80% | 4 | 6 | 8 | (37) | 134 | 6.96% |
| **Local currency sov** | 0.98% | 2.59% | -1.82% | -8.15% | n/a | n/a | n/a | n/a | n/a | 6.62% |
| Local currency sov - rates | 0.52% | 0.95% | 0.24% | 0.24% | n/a | n/a | n/a | n/a | n/a | n/a |
| Local currency sov - FX | 0.47% | 1.64% | -2.05% | -8.36% | n/a | n/a | n/a | n/a | n/a | n/a |

***Movers and shakers on the week***

| Sovereign credit | | Corporate credit | | EM FX | | Local rates | |
|---|---|---|---|---|---|---|---|
| Venezuela | 11.11% | Metals & Mining | 0.80% | Turkey | 4.55% | Turkey | 3.79% |
| Kenya | 3.42% | Transport | 0.77% | Brazil | 2.21% | Indonesia | 1.01% |
| Cameroon | 2.65% | Financial | 0.62% | Russia | 1.55% | Mexico | 0.79% |
| Slovakia | -0.29% | Industrial | 0.27% | Hungary | -1.25% | Peru | -0.26% |
| Argentina | -1.94% | Real Estate | 0.23% | Romania | -1.28% | Argentina | -0.68% |
| Costa Rica | -3.91% | Infrastructure | 0.09% | Argentina | -7.22% | Philippines | -0.90% |

Source: Bloomberg, JPMorgan. Past results are not indicative of future results.

**In EM corporates news:**

- One of Turkey's largest banks managed to successfully roll its syndicated loan facility, achieving a rollover rate of >100%, which set market concerns to rest for now. Turkish assets and the lira in particular benefited from improved sentiment as a result.
- In India, an infrastructure lender remained the subject of much speculation, with a restructuring plan approved by its shareholders. The main components of the plan included asset sales, a recap by shareholders and a near-term debt raise, while there were also strong signals that the government may look to take control of the company. Other infrastructure lenders remained under pressure amid the uncertainty.
- A Brazilian miner signed an agreement which would allow the company to begin construction of a new tailings facility, which is a prerequisite to restarting operations. Bonds rallied on the news.

**Outlook:**

October looks set to be a volatile month. While the usual concerns remain, with trade wars and US inflation the key themes, the near-term outlook is set to be dominated by Italy and Brazil. Both countries seem equally reluctant to address fiscal issues at this point in time, and both seem set to test the resolve of their core investor bases. Whether or not the markets will force either or both into fiscal prudence remains to be seen, but with credit spreads in the high 200s for both countries there is meaningful room for spreads to move in both directions.

In Brazil, we will get first-round election results this coming Sunday with expectations that a second round will be needed to decide between Bolsonaro and Haddad. If this is the case, the second round will likely prove a very close run race, based on current polling with Haddad representing a return to the left for Brazil. A lack of fiscal reform would see debt-to-GDP approaching 100%, while successful fiscal reforms could see debt-to-GDP stabilising closer to 80%, highlighting the binary outcomes facing Brazil.

For the asset class more generally some key supports of late have come from flow dynamics, which have turned positive across the bulk of EM assets, including EM equities where there is a yawning valuation gap between the US equity market and EM. Whether or not optically cheap valuations will be enough for sustained EM outperformance in the midst of a Fed tightening cycle is questionable, and we prefer to think of the world right now as one where there is no one overarching theme. As long as the Fed remains gradualist in its approach, then we believe differentiation will be the name of the game and EM should remain a rich opportunity set for those that are willing to separate the wheat from the chaff.