Portfolio Manager Perspectives
BlueBay Emerging Market Debt Update
Weekly Update

October 31, 2018

Animal Spirits – Emerging Markets Update

There was no respite for global equity markets this week as volatility continued to spike and any signs of weaker US earnings sent share prices sharply lower. In Europe, a series of underwhelming data prints, combined with fighting talk from the Italians, ensured that there was no respite for the region's equities.

Meanwhile, investors began to refocus on Chinese growth concerns amid ongoing trade tensions and higher global equity volatility. With China being the key delta for global growth, the international focus on the country is likely to persist but it is unlikely the root cause of the US equity market sell-off. It seems more plausible that hawkish Fed speak, combined with heavy positioning and fears over peak earnings in the US, are the main culprits despite what has been a solid third-quarter earnings season for US corporates.

The recent weakness in oil is perhaps another sign of the impact of higher real rates in the US beginning to weigh on a well-owned position, which in turn is perpetuating the weaker growth narrative that equity investors fear.

In EM News:

- Jair Bolsonaro claimed a resounding victory in the Brazilian presidential elections on Sunday as the country pivots to the right. He now carries the high hopes of investors as they look to the ex-Army captain to pass the much-needed pension reform the country requires in order to stabilise its fiscal deficit. Performance has been positive in Brazilian markets as Bolsonaro's election has roused animal spirits across the international and local investor bases. Indeed, Bolsonaro may continue to receive the benefit of the doubt for now… at least until the new Congress returns in February.
- South Africa delivered a weak budget with a higher headline deficit number, which is now seen peaking at 4.2% in 2021, while government debt to GDP is also forecast to keep rising until 2025. Moody's stated that this was credit negative, but took no further action.
- The Chinese yuan continued its steady rise towards the '7' handle against the US dollar, hitting new lows for the year as the government emerged with statements of support for its embattled stock market, claiming that it had instructed various entities to start buying stocks. While not the ideal way to make your equity market go up, it is a brave investor who bets against the Chinese government.
- Turkish assets continued to trade well even as President Erdogan pushed Saudi Arabia to release more details around the Khashoggi murder in Istanbul. Positioning in Turkey appears to be underweight among the investor base as Turkish assets remain resilient despite the broader macro volatility.

Weekly market snapshot as of 10/26/2018

	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	-0.01%	-0.35%	-0.35%	-2.00%	15	18	18	52	312	5.93%
Hard currency corp - IG	0.14%	-0.34%	-0.34%	-1.41%	12	14	14	29	207	4.91%
Hard currency corp - HY	-0.20%	-0.36%	-0.36%	-2.74%	20	23	23	86	462	7.52%
Hard currency sov	-0.15%	-1.68%	-1.68%	-4.67%	15	30	30	80	365	6.74%
Local currency corp	-0.88%	-1.60%	-1.60%	-3.36%	-	3	3	(34)	133	6.97%
Local currency sov	-0.83%	-1.09%	-1.09%	-9.15%	n/a	n/a	n/a	n/a	n/a	6.70%
Local currency sov - rates	0.13%	0.07%	0.07%	0.31%	n/a	n/a	n/a	n/a	n/a	n/a
Local currency sov - FX	-0.97%	-1.17%	-1.17%	-9.43%	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	
Turkey	0.82%	Financial	0.20%	Turkey	1.26%	Turkey	1.79%
Dominican Rep.	0.71%	Diversified	0.17%	Brazil	0.61%	Argentina	1.39%
China	0.51%	Transport	0.16%	Philippines	0.12%	Brazil	0.68%
Zambia	-2.92%	Infrastructure	-0.36%	Mexico	-1.74%	Peru	-0.47%
Venezuela	-3.11%	Metals & mining	-0.39%	Chile	-1.77%	Colombia	-0.47%
Belize	-4.44%	Real estate	-0.54%	Colombia	-3.56%	Mexico	-0.49%

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

- Ukraine returned to the bond market with a 5-year and 10-year issuance which was well received, trading around half a point higher initially before market jitters began to shake out some of the loose hands. With yields near 10%, we believe bonds should be well supported into the end of the year.
- Argentina officially secured its revised IMF programme on Friday as the country continues to make solid progress in stabilising its markets and recovering from a bout of volatility over the summer.

In EM corporates news:

- Mexican assets suffered ahead of a referendum on the future of the new airport, which is part-way under construction. We now know that the vote went against continuing construction and AMLO has decided to cancel the project. This creates obvious questions around AMLO's attitude to foreign investors, given there are approximately USD6 billion in outstanding bonds which were issued to fund construction of the new project, and which were supposed to be repaid through passenger revenues from the new airport. Many see this as an unnecessary provocation of the investor base and one which may have dire consequences given the huge amount of debt that Mexico's state-owned petroleum company has out in the market. If investors begin to question AMLO's policies towards the firm then we will all be in for a wild ride.
- Venezuela's state-owned oil & gas company paid the amortisation and coupon payments which were due on its secured 2020 bonds. Normally a company paying its bonds is not that newsworthy, but for Venezuelan bond investors payments have been hard to come by of late. The company's 2020 is the only bond in the entire capital stack that it is paying; reason being it stands to lose its most prized asset, a US subsidiary refinery, if it fails to honour this bond. The payment should mean bonds are now over-collateralised and, perversely, the company is now even more incentivised to keep paying given the overcollateralisation. However, the question remains the ability to pay, particularly with oil production continuing to decline in tandem with under-investment in the oil industry.
- Turkish banks began to report third-quarter earnings which are being closely watched given the stresses in the Turkish financial markets this year. For now, the private banks are showing resilience with NPLs up in the order of 1% but FX liquidity healthy and loan books shrinking, helping with capital ratios. While there is no doubt NPLs will continue to rise, investors may take some comfort that the banks are showing more resilience than expected at the same time as Turkish markets have begun to stabilise.

Outlook:

With US equities finally coming off the highs and experiencing a correction, it is easy to look at the long list of headwinds markets face and draw negative conclusions. Concerns over Italy, a slowing China, renewed trade rhetoric and higher real rates are all reasons for investor caution. And yet with year-end fast approaching, performance sub-par for most investors and still-high cash balances, there remains the distinct possibility that equity markets will gradually recover into year-end and that broader risk markets will follow. On balance, US earnings have remained upbeat and while economic activity has certainly weakened in Europe and China, there is hope that the European slowdown is transitory and that targeted Chinese stimulus can stabilise growth there.

In emerging markets, the passing of the Brazilian elections represents another hurdle cleared this year. While Mexico's AMLO has done his best to inject another bout of volatility into EM assets, it is likely that the Mexican market will settle over the coming days given the current strength of the sovereign balance sheet. A meeting mooted between Presidents Trump & Xi at the upcoming G20 meetings also provides some hope for a truce in the trade wars. While we don't hold out much hope on that front, we can see US mid-terms as a possible catalyst for EM into year-end. Investors will have to choose whether or not cheap valuations, positive technicals and still-resilient fundamentals are enough to warrant chasing risk into year-end, or whether the weaker macro backdrop will keep animal spirits at bay.

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