



Global Emerging Markets – Local Currency Debt

Monthly commentary

April, 2011

Market review

Performance for emerging market local currency sovereign debt was again very strong in April, with the GBI EM Global Diversified benchmark rising 4.73% in US dollars. With the exception of Peru, all benchmark countries posted positive returns for the month.

The Peruvian elections are now at the second round stage and given the uncertainty of the outcome, political risks are high. Investors are concerned that Ollanta Humala, the Nationalist candidate, will be elected President and introduce populist reform to the cost of foreign investment. Both the currency and bond market have reacted nervously registering losses over the course of the month. Although we are closely monitoring the incoming survey results, we feel that once sentiment subsides it is more important to understand the actual impact each candidate will have on the economy and financial markets if elected. We vividly recall that former Brazilian president Lula was elected on an extreme populist mandate in 2003. However, once elected his government chose to reform the country in a market friendly manner that helped to transform the economy of Brazil into the international powerhouse it is today.

Market outlook

There is a trend for central bank willingness to tolerate greater appreciation of their currencies to mitigate the impact of imported inflation. This theme is likely to continue to play out in many countries over the coming months. Emerging market central bankers have fought hard over the past decade to establish credibility and will be reluctant to relinquish this easily. FX reserves are high in many countries and cannot be accumulated indefinitely – doing so comes at a cost. We believe therefore that a combination of interest rate hikes and currency appreciation offers the best option available to fight inflation expectations rising.

In direct contrast to the US Federal Reserve, the ECB rhetoric continues to be hawkish and the market is now pricing in aggressive hikes in the refinance rate. The Eastern European currencies with the closest financial and trade linkages to the eurozone have once again been very strong this month, with the Hungarian forint, Polish zloty and Czech Koruna all registering gains against the dollar. However, although bond yields in both core and peripheral Europe have been rising this year, the currency market has been largely sanguine over the growing political discord between the providers and recipients of financial aid. We believe that the scale of the debt crises makes some form of sovereign restructure in Greece inevitable. This is largely now just a question of when and how and the route between points A and B are likely to be bumpy given the sensitivity of both the economic and political outcomes and the threat of contagion to other vulnerable European states.



Strategy

Over the course of this year our yield advantage relative to the benchmark has narrowed significantly. This is a result of two key decisions on the portfolio. Firstly, we believe that near term, some of the high yielding currencies have benefited disproportionately from the liquidity environment created by the US Fed's loose monetary policy. These include the Brazilian real, South African rand and Hungarian forint. The structural medium term story of further currency strength in these markets is still very much in place, but we are looking to more aggressively position the strategy in those countries that we feel will allow greater flexibility of their currency to fight imported inflation. The key beneficiaries here will be the Asian countries most closely linked to the Chinese economy

The second reason for our declining yield advantage has been our relative short duration position in markets where long dated bond yields have risen aggressively. Turkey is a prime example of this phenomena and it is clear that investors are beginning to look more closely at monetary policy at the country level and are selling those markets whose central banks appear to be falling behind the curve. Newly installed central bank governor, Erdem Basci, has been accredited with the architecture of the unorthodox monetary policy implemented by Turkey over the past year, so it is unlikely to be reversed in the near term. This leaves Turkey vulnerable to an inflation shock and we continue to like the breakevens available on Turkish linkers here.