



Global Emerging Markets – Local Currency Debt

Monthly commentary

July, 2011

Market review

Local currency emerging market debt continues to be in demand internationally with flows strong and impressive performance. Asia led the way in July with strong returns across all four benchmark countries. Foreign exchange appreciation continues to be the dominant driver of these returns.

As the flawed G7 currencies continue to compete for the title of least attractive, we expect Asian currencies to inevitably continue to “benefit” from upwards pressure. This positive environment could receive a further boost if inflation in the region trends upwards. FX reserves are at elevated levels and the cost of accumulation high. It would not surprise us to see greater tolerance for currency strength in the coming months and years.

In EMEA, returns continue to be much more variable. The macro story in this region continues to be less compelling than in Asia or Latin America and we expect relatively higher volatility in both rates and FX to continue. It is increasingly important to be mindful of political factors as their impact on asset prices have become both sudden and dramatic.

With copper prices continuing to rise, Chile and Peru were the star turns in the Latin American region. Although the Brazilian real strengthened again in July we remain concerned that the currency is now critically over-valued on a fundamental basis.

Market outlook

It is clear that the risks of an economic downturn in the developed economies have risen over the past month. This has been subsequently acknowledged by both the ECB, who look to be more cautious in its tightening strategy and by Ben Bernanke, who has explicitly promised to keep US rates on hold for at least two years. To communicate with such certainty such a prolonged period of low rates has little precedent. What is less clear is what this all means for financial markets. On the one hand we seem set for a prolonged period of high liquidity. The 10 year US Treasury bond yield fell temporarily below 2% in August and seems likely to stay low. With real yields negative this should encourage investors to seek out stronger returns elsewhere, boosting demand for higher yielding assets. However, failure to engineer an economic recovery with zero interest rates for such a prolonged period will see confidence diminished further and send asset prices tumbling globally.

Both the short and medium term prospects for emerging market asset prices are likely to be driven as much by events in the developed world as they are by domestic factors. The difference now compared to what the history books will tell you is that many emerging economies are potentially going to be viewed as safe havens for concerned investors rather than the first place to sell. This is already beginning to play out in emerging market local currency bond yields. In 2008 at the height of the financial crises, the benchmark yield on local currency emerging market debt spiked up over 9.5%. Compare and contrast that to today. In spite of continued wrangling over the US debt ceiling and a less than satisfactory response by the European Commission to European peripheral debt sustainability, emerging market sovereign yields continue to track lower (6.58% as at 8th August). Although it is perhaps a little too early to herald a new dawn for the asset class, emerging markets have been stress tested over the past five years and the upshot of this is greater awareness internationally of the relative macro strength of many of these markets. This should provide emerging market investors with greater comfort over the coming months and years.



Strategy

Whilst it is impossible to ignore what is happening in both the US and core Europe, and its effect on global asset prices, it is dangerous to try and make a judgement call on how the end game plays out in either. Therefore, we continue to look for relative value between the currencies and bonds of emerging market economies and shy away from making the big judgement calls on global macro that we feel are best left to asset allocators.

As such, we continue to make full use of our 30% currency overlay strategy on the portfolio and this contributed 28bp to performance in July. We were successful in generating alpha with our long exposures to the Zambian kwacha, South Africa rand, Russian rouble, Malaysia ringgit and Philippines peso. With the exception of the rand, which we now feel is overvalued and took profits on in July, these economies are all strong and we expect currency valuations to more accurately reflect this over the coming months. We remain short the Brazilian real which we feel is strongly overvalued and at risk of a sharp correction, and the Czech koruna and Lithuanian lita which remain vulnerable to developments in Western Europe.

In bond space, although the portfolio is now reasonably close to the benchmark duration, at country level we have strong conviction positions in the markets we feel are currently mis-pricing inflation and sustainability dynamics. We remain short duration Hungary, where fundamentals remain weak and FX risks high, and long duration South Africa where real rates do not reflect the downturn in the economy and prospects for further interest rate cuts by the central bank.