



Global Emerging Markets – Local Currency Debt

Quarterly commentary

March, 2011

Market review

After starting 2011 with weak performance in January, emerging markets debt bounced back, finishing the quarter up over 3% in US dollar terms. Strong growth, high commodity prices and easy monetary policy in the US and Eurozone have led to strong investor demand for emerging markets assets. The quarter has been notable for some very big global events such as the ongoing political conflict in the Middle East and North Africa, as well as the Japanese earthquake and subsequent tsunami. While these have had only an indirect effect on local currency emerging markets debt, mainly through the spike in the oil price, they have contributed to a rise in market volatility.

Central and Eastern Europe have been the main beneficiaries of the trend after lagging significantly behind Asia and Latin America in 2010. The market seems to be more sanguine about debt sustainability in the peripheral EU countries in spite of a sharp uptick in CDS spreads for countries like Greece and Portugal in the last few weeks. We are not convinced that Europe will be able to manage these issues so easily and are concerned that the export led growth model in countries like Hungary, will suffer through 2011. We remain quite bullish on growth in Asia and Latin America but highlight currency intervention risk from governments and central banks as overhanging our rosy outlook.

Market outlook

Inflows continue to be strong into emerging markets, as loose developed market monetary policy pushes capital into higher yielding local currency bonds. This has been creating problems for central banks facing rising inflationary pressures as they are having to choose between price stability or export competitiveness and growth. Policy rate hikes attract even more capital which pushes the FX rate higher making exports more expensive. Brazil stands out as being the most aggressive in implementing so-called 'macro prudential' and other measures to contain flows, which have been largely ineffective. The real is now at its all time strongest level in real terms.

While we are cognizant of intervention risks across the range of EM countries, we still believe there is considerable value in certain currencies and yield curves. Rates relative to domestic markets are actually higher now than they were pre-financial crisis and are set to widen further as emerging central banks cautiously normalise monetary policy. Additionally, policy makers in Asia have been allowing currencies to appreciate to help contain inflation in tradable goods.

Global growth should begin to slow down as the ECB and China both tighten monetary and fiscal policy to combat inflation and, in the case of China, to slow credit expansion. The effect of higher rates on weak Mediterranean sovereign credits is likely to exacerbate an already negative outlook and CDS spreads are now pricing in a high probability of a debt restructuring for Greece, Portugal and Ireland. This should have a knock on effect on growth prospects for Eastern European exports, with Hungary looking particularly vulnerable. In general however, prospects for the emerging markets still looks quite bright relative to the G7 and capital flows should continue to be supportive.



Strategy

As we round out the first quarter, the portfolio is positioned to take advantage of the strong investor interest in some of the higher beta emerging market names, while at the same time maintaining an overall short duration exposure relative to the benchmark. Many of our markets are growing at or above potential, and with commodity prices strong and central banks constrained by politics, we believe that there is a high probability of inflation expectations rising sharply.

Although we feel in certain countries valuations look stretched, there are pockets of value to be found in each region. In Asia, we see more scope for currency appreciation as the authorities relax controls to combat inflationary pressures without having to hike rates sharply. Latin America holds a higher intervention risk that should keep further appreciation muted this year but rates look attractive where rising inflation expectations have been priced into yield curves. Mexico is an exception to this general outlook however, as the peso has lagged its regional peers and should continue to gain from the slow recovery in the US.

Outside of the benchmark group of countries, we are maintaining our exposures in Argentina and Africa. In the case of the former, we are confident that strong growth and export performance should provide enough liquidity to finance the government in the near term, even in the absence of access to foreign markets. Also, we expect debt negotiations with the Paris Club to be successful, eliminating a potential barrier for future issuance.