



Global Emerging Markets – Local Currency Debt

Monthly commentary

May, 2011

Market review

Returns for emerging market local currency sovereign bonds turned negative in May with the GBI EM Global Diversified benchmark losing 1.20% in US dollar unhedged terms. The losses can mainly be attributed to the problems surrounding debt sustainability in Europe and the contagion effects this had for emerging European countries. We have been underweight the region for some time which significantly helped performance this month.

The sovereign debt crisis in peripheral Europe gained more traction over the month, which weighed down on risky asset classes, especially those markets with trade links to the Eurozone. The near-term uncertainty surrounding the Greek bond maturity, due in August, and how they will repay investors is the centre of debate for European authorities and market participants. With this uncertainty, the Euro lost over 3% of value to the US Dollar, reversing most of April's gains. Adding to general risk aversion, the ongoing economic problems the other side of the Atlantic also continue. Low rates of employment and other weak data from the US convinced the market that interest rates there will be held 'lower-for-longer'. However, meanwhile in emerging markets, the general debate is quite different: the discussion continues to be how central banks cool much relatively higher rates of growth than in developed markets. The concern for central banks continues to be the dilemma of how to cool this growth and moderate inflation without increasing rates and thereby attracting excessive international capital. At the margin, however, inflation in emerging markets seems to appear to be slowing and, in many markets, prices are reaching peak rates of growth.

Market outlook

The outlook remains little changed from last month, however the increasingly lower confidence on the sustainability of certain peripheral European markets gives us increased conviction in our long held view that some form of restructure in Greece will happen. Increasingly more market participants are now discussing 'how' the restructure will occur, not 'if'. Amongst other concerns for Europe, is whether Credit Default Swaps (CDS) will trigger in the event of a restructure and who will be left with losses. Looking into the future, any restructure or default will be carefully finessed but no matter whether CDS are activated or not, we are also concerned with how the holders of other troubled peripheral European markets will stand following such a restructure. Either way it will be a troubling time for Europe. The only way we can see a soft solution, would be a concerted outright bailout package, which we feel would be near impossible to get as it would require harmonised political agreement across the whole of the union. Any restructure will almost certainly be therefore Euro negative. Our conclusion is thus that the markets and currencies that have close links to the Eurozone will surely suffer.

Thematically for emerging markets, headline inflation looks as though it may be peaking or has peaked in many markets, particularly in Asia. Food security and base effects are taking some steam out of the growth. The pace of interest rate rises, at the very margin, is likely to slow and will be supportive of bond valuations. That said, emerging markets remain vulnerable to events in the developed world. Moderate growth with mild inflation should remain highly supportive of emerging market valuations and currencies.



Strategy

We believe that emerging markets will continue to benefit from the liquidity provided by the ultra-loose monetary policy in the US. Emerging currencies have performed particularly well and we continue to expect this to last. However, we still prefer inflation importing countries that have the latitude to appreciate their currency as a policy tool. Asia offers the best opportunity in this respect but at the margin with expectations of lower inflation we need to pare back our expectations for currency strength. We believe this will be only moderately slower but not slow.