



Global Emerging Markets – Local Currency Debt

Monthly commentary

November, 2010

Market review

November took back much of the gains experienced in emerging market debt on the back of Federal Reserve Board continued policy of “quantitative easing” of the past few months, with the JP Morgan GBI-EM Global Diversified falling 4.65% in US dollars. Year-to-date the index continues a positive return of 12.16%.

Concerns over European sovereign debt levels resurfaced over the month, which led investors to run to safety. Notably, Ireland needed a EUR85bn bailout to save their banking sector. We saw the cost of borrowing rise for most of peripheral Europe, which obviously spilled over to emerging Europe and to other emerging markets. Almost all of the emerging fixed income markets in which we invest suffered losses. As could be expected, it was Central Europe that suffered most of the losses, with Hungary losing nearly 14% in US dollar terms. The forint fell over 10% with concerns that Hungary will not be able to fund itself. In general terms however, approximately half of the losses over the month were due to the appreciation of the US dollar against emerging market currencies.

Market outlook

Investors in US Treasuries seemed to ignore the Federal Reserve’s announcement of \$600 billion asset purchases and long dated yields moved higher in November. Inflation and employment data are going to be closely watched by investors in the next year. The market will remain volatile while it comes to term with the duration of the economic recovery. The Fed monetary stimulus needs to go somewhere and investors will continue to look to the emerging markets for a better source of return. This will have the positive effect of appreciating emerging currencies and supporting emerging market bond prices. With that, however, we struggle with the prospects for Europe and hence emerging Europe. The bailout of Irish banks in November was only six months since the Greek troubles in May – and both Spain and Portugal appear to be getting closer to needing assistance.

These trends, a looming sovereign debt crisis, deleveraging in the G3 and ultra loose policies, should strongly support flows into emerging market debt. Inflation and growth are higher in the emerging world, but monetary policy is being contaminated by the advanced economies’ central banks. This excess liquidity supports yield convergence despite strong growth and inflation. The main collateral damage of these trends is likely to be inflation in the emerging world. The degree of inflation will vary from country to country and be dependent on their output gaps and monetary policy.

Strategy

There were no large changes to the strategy over the month. The increase in volatility and price movement led the team to concentrate on the driving forces behind these moves. Certainly the deterioration of the debt situation in Europe has concentrated the mind. We believe the two notch downgrade in Hungary was appropriate, given their considerable growth problems, fiscal measures and refinancing of their bloated debt levels. Being underweight the country, currency, duration and, for that matter, underweight Central Europe, still seems very appropriate.

We will be reviewing our overall strategy and scenarios for 2011 in December following Rexiter’s global scenario meetings and asset allocation meetings. We are currently short duration in many of our markets where we believe inflation will be a concern going into the new year and where the demand for longer duration interest rate sensitive bonds are overpriced.