



## Global Emerging Markets – Local Currency Debt

### Quarterly commentary

December, 2011

#### Market review

The benchmark returned a small positive in US dollars in the final quarter of 2011 with risk assets bouncing back from large falls in value in September. Rexiter's local currency emerging market debt portfolio has performed strongly over the last three months generating positive alpha in each. Both country and security selection contributed positively to these strong relative returns with Eastern Europe and Latin America the top performing regions.

Two of our high conviction positions this year generated almost 1% of alpha in the final quarter as political risks in Hungary and unorthodox monetary policy in Turkey started to take their toll on asset prices. We currently hold a 0% weight to Hungarian bonds as policy error has begun to compound structural economic problems in this country. Investors have become increasingly concerned about both the communication and implementation of government policy in Hungary under Prime Minister Orban's leadership. The recent change to the Central Bank law has effectively reduced this institution's independence and decreased the probability that Hungary will secure much needed funding from the IMF. We believe that unless this situation reverses in the coming months that bond yields will increase as investors demand a higher risk premium to own Hungarian assets.

Our recent visit to Ankara highlighted just how uncomfortable both local banks and investors are with the central bank's unorthodox monetary policy. Whilst the focus of the central bank seems to have shifted from generating growth to containing inflation and reducing the current account deficit, the funding uncertainty banks face is likely to send the Turkish economy into recession in 2012. We remain concerned that a deterioration in the European situation will render Turkey vulnerable to further lira weakness – this will feed through into inflation and could ultimately begin to increase expectations that prices are no longer anchored. Given the risks here we continue to hold inflation linked bonds and t-bills.

#### Market outlook

Until Europe stumbles upon a palatable solution to the structural debt and growth problems that encompass the region we feel that market volatility will continue to be elevated into 2012 across all asset classes. It is our sense that European politicians are happy to sit on their hands for as long as they possibly can however there are plenty of potential trigger events over the next twelve months that could either force decisive action or see the euro zone collapse. Whilst it is difficult to make a judgement call on how events will ultimately play out in Europe we are confident that things will deteriorate further before they get better and under almost any one of our scenarios the euro weakens significantly more against both the dollar and a basket of emerging market currencies.

Although the global economy remains fragile there are many positive stories across emerging markets that we feel investors can capture through an overweight exposure to this asset class. The benchmark yield remains high relative to developed market countries. This carry should continue to attract overseas investment particularly as bond market yields have remained generally stable across emerging economies. This stability in borrowing costs is testament to the huge strides in both fiscal and monetary discipline that many emerging market economies have taken over the past decade. Whilst this is very positive for both lenders and borrowers we feel that this story is not over and that a convergence of both ratings and rates is likely to continue given the stronger balance sheets that emerging economies generally enjoy.



In Asia we expect economies to remain strong and that a wider acceptance and tolerance of currency appreciation is likely to be a theme over the next twelve months. In EMEA however political risks are elevated over the next twelve months. The upcoming Russian elections are not as clear cut as those of recent years, there are questions marks over the health of PM Erdogan in Turkey and policy uncertainty in Hungary remains high.

### Strategy

Our strategy continues to be one of relative value investing. As detailed above we remain negative on the situation in developed Europe and have sizeable underweight and short positions in Eastern European assets that we feel do not reflect these risks. There is little room for either fiscal or monetary easing in many of these countries rendering them vulnerable to a sharp slowdown in economic activity. To compound the problem, inflation is elevated in many instances with weak exchange rates, high energy costs and increases to administered prices putting pressure on household spending. Although there are exceptions, we remain unconstructive on this region.

In Latin America we feel the Mexican peso remains under-valued and that the recent improvement in US economic data that should act as a boost to the Mexican economy has not yet been reflected in asset prices in this country. We therefore retain our large overweight exposure to the peso. Although we feel at current levels the Brazilian real better reflects economic fundamentals in this market, positioning remains elevated and we continue to hedge back half of our overweight currency exposure.

The Philippines and Malaysia are our preferred Asian bonds markets as we feel both offer the potential for lower rates given our growth and inflation outlook for these countries. The market is not yet pricing in these potential cuts and at current valuations we find these markets relatively attractive.

Although fundamental analysis continues to be the cornerstone of our investment approach we remain mindful of the excessive volatility that investors need to assess when structuring an emerging market debt and currency portfolio. As a result we will continue in 2012 to implement tactical positions where valuations become stretched either through excessive fear or greed.