



Global Emerging Markets – Local Currency Debt

Quarterly commentary

June, 2011

Market review

Emerging markets local currency debt had a strong start to the second quarter, rising nearly 5% in USD terms in April with all countries in our benchmark except for Peru posting positive returns. However, these gains could not be sustained with investors increasingly worried about the outlook for developed markets and what impact a negative credit event in the US or Europe would have on commodity prices, demand for emerging market exports and the availability of investment capital. JP Morgan's GBI EM Global Diversified index finished the quarter up 4% after a volatile, but directionless May and June.

Behind the headline figure however, things were a bit more interesting. Our regional overweight to Latin America worked well with the region outperforming Central and Eastern Europe and Asia by approximately 5% in USD terms. Colombia led the pack, rising more than 10% on the back of strong investment flows and oil receipts. At the opposite end of the spectrum is Turkey who, along with Thailand, posted the only negative returns for the quarter. Investors remain cautious as Turkey's rapid GDP growth through the first half has been largely financed externally with the current account deficit approaching 10% of GDP. This leaves Turkey particularly vulnerable to any interruption in capital flows.

Market outlook

All eyes are focused on the US and Europe. In the former, we have the unresolved issue of the debt ceiling, as well as the possibility of a third round of so-called quantitative easing should the economy continue to falter. This would put further appreciation pressure on emerging market currencies after the lull in inflows we've experienced over Q2. Whereas in Europe, a resolution to the Greek debt crisis has yet to be found and asset prices are reflecting a high degree of contagion throughout the union.

We think that while, in the short term, these events will increase volatility in local emerging market asset prices, if one takes a longer view, they make the case for investing in emerging market sovereign bonds even stronger. With the exception of Central and Eastern Europe, emerging markets are well positioned to weather an extended period of developed market weakness and is increasingly being viewed as a 'safe haven' asset class. Buying on market weakness in select high conviction, fundamentally sound countries could be a very successful strategy under this scenario.

We also still remain wary about the prospect of further capital controls being introduced to combat appreciation pressure stemming from another possible round of quantitative easing in the US. In particular, we see further controls targeting FX derivatives in Brazil as being likely, such as an increase in the IOF tax on capital inflows used for funding margin accounts. While these controls are unlikely to change the direction of the real, they could lead to a rise in volatility as their effects are digested by the market.



Strategy

Although it is taking longer than anticipated to bear fruit, our strategy continues to favour a significant regional short position in Central and Eastern Europe, in favour of long positions in Latin America and Asia. Any restructuring of euro denominated sovereign bonds would have a substantial negative impact on credit markets and the ability of countries like Hungary to finance their large current account deficits. We think inflows into emerging market local currency bonds will continue to be positive, but that the rapid gains in currencies seen in 2010 and early 2011 are unlikely to be repeated for the rest of this year. Instead, our focus is on avoiding those markets we see as most vulnerable to sudden shifts global risk appetite and credit conditions.

In Asia, we believe policy makers will continue to tolerate a moderate pace of currency appreciation in order to ease inflationary pressures and keep policy rates lower. We believe that most of the Latin American issuers have somewhat less flexibility in this regard with the Brazilian real standing out as being overvalued. The region has more direct exposure to the global macro trade through commodity pricing which would suffer considerably under some of the more pessimistic scenarios for Europe and the US.