



## Global Emerging Markets – Local Currency Debt

### Quarterly commentary

September, 2011

#### Market review

The third quarter proved volatile for all risk assets, as investors struggled with assessing the impact of several as of yet unresolved developed market solvency issues. In August it was partisan politics in the US threatening to prevent the debt ceiling from being raised, through to September where consensus is growing in Europe that a restructuring in Greece (and perhaps elsewhere) is inevitable. These issues have spilled over into fears of another banking system crisis led by Europe's undercapitalised banks and the sharp slowdown in global growth that such a crisis could precipitate. This latter scenario proved costly for emerging markets local currency debt as the asset class suffered its worst quarter since its inception in 2003; down 8.55% in USD terms. Rexiter outperformed by 80 basis points over this period. Interestingly however, lower growth expectations were reflected in bond prices with curves rallying across many of the benchmark countries, and the losses stemming entirely from FX. Only two countries in the benchmark posted positive total returns for the quarter: Indonesia where collapsing rates and a high yield more than offset a modest (-2.44%) currency loss, and Peru where the currency barely moved at all (-85bps).

#### Market outlook

Going forward, our assessment of the asset class has not been significantly impacted by recent events. We still see emerging market debt very favourably compared to developed markets on both a long term fundamental and a shorter term technical basis. Generally speaking, the countries we invest in have low debt levels and small fiscal deficits meaning policy makers can engage in fiscal expansion to counter the downtrend in global growth expectations. Also, with local rates across the asset class at historically wide levels relative to developed markets, there is significant room for monetary easing as commodity prices and global inflation expectations fall. Probably the biggest change we see to our forward looking forecasts is that we expect a greater portion of the strategy's total return to come from capital gains as rates are cut.

FX valuations also look attractive as the recent sell off has pushed a number of currencies below our estimation of fair value. We believe that the currencies of several of the fundamentally stronger countries will trend back to their pre-August level by year end making the fourth quarter a good entry point for investors in the asset class. The rising likelihood of another round of quantitative easing in the US and perhaps even in Europe supports this outlook. That said we believe there is no easy solution to the problems faced by developed markets and this uncertainty will continue to weigh on countries in Emerging Europe such as Hungary.

#### Strategy

Going into the fourth quarter, the strategy is positioned to take advantage of what we believe will be a relative quick bounce back into positive territory for some of the fundamentally stronger countries we invest in. We have unwound several short currency positions and further reduced our Emerging Europe exposure where underperformance is likelier to persist. The strategy has finished the quarter with some spare capacity in the forward currency overlay which we will look to re-deploy over the next couple of months.



In terms of duration, the strategy remains short relative to the benchmark overall but with several significant overweights at the country level. The impact that lower global growth assumptions has on each country's inflation outlook varies considerably, depending on factors such as recent currency performance, commodity pricing impact on inflation and domestic growth factors. In particular, we favour the long end of Brazil and South Africa where falling commodity prices will offset currency weakness and where the domestic economies are slowing sharply. Also, high real rates in both countries also give policy makers additional room to shift policy rates further down.

We don't think there will be any easy solutions to the solvency issues facing the European banking sector and select sovereigns and that this will weigh on risk assets as we work our way through. However, much of Latin America and Asia are well positioned to weather the storm and have capacity to cut rates and increase spending to counter external weakness.