



## From Egypt to Libya...

### How the MENA crisis affects local currency emerging market debt and Rexiter's approach to managing the risk

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**It will come as no surprise that the singularly most common question we have been asked over the past six weeks is the effect of the Middle East and North Africa (MENA) crisis on local currency emerging market debt prices. The good news for local currency emerging market debt investors is that Egypt aside, which has a less than 0.5% representation in our benchmark, the current participants in this crisis are outside of the investable universe. Further, we anticipate that it is extremely unlikely that political unrest will spread to countries within our universe.**

The key causes of unrest; a lack of democratically elected politicians, widespread poverty and high levels of youth unemployment, are far less commonplace in the emerging markets that we invest in than they are in the MENA region. However, it would be foolhardy to think that these emerging countries and their financial markets and economies can be completely insulated from the effects of the crises if they extend more fully into Saudi Arabia and beyond.

To date however, local currency emerging market debt investors have suffered very little as a result of events in MENA. JP Morgan's global bond index – emerging markets global diversified (GBI-EMGD) benchmark is down just over 0.6% in local currency terms and the EUR/USD cross has demonstrated more volatility than the majority of emerging market currencies.

We believe that the resilience of local currency emerging market debt in the face of heightened global geopolitical risk is down to two main factors. First, emerging markets have been rigorously stress tested following the Lehman crisis and have passed this test with flying colours. The financial crisis has increased investor awareness of the huge positive strides that emerging markets have made over the past decade. Generally, they have stronger balance sheets and better growth potential than their developed counterparts. This endorsement from the market ensures that large outflows to 'safe havens' are less likely now than they have ever been. Secondly, as local currency yield curves have evolved, both domestic and international investors alike can choose to switch their money between the equity and bond market of a particular country rather than flee the country outright.

Our perception is that active fundamental emerging market fund managers like Rexiter, have two potential methods available to them in positioning their portfolios to reflect the outcome of this crisis. The first is to try to directly call how long the conflict will last, how widely it will spread and its impact on global oil prices. For example, those with a pessimistic view on the crisis might structure their portfolios to reflect the potential for US\$200/bbl oil. These portfolios would most likely be very short duration and aggressively overweight oil producing countries. Performance will stand or fall primarily on getting this single call correct. This is a difficult call to make on either a day-to-day or long term basis and we do not believe that as active emerging market managers this is a sensible way to manage a portfolio.



The second method is to recognise and invest in relative value opportunities across the emerging market debt asset class, which is where our skill set lies. Therefore, we believe that our portfolio should not be structured either explicitly or implicitly to reflect a strong view on the outcome of the MENA crisis. We understand that the direction and magnitude of oil price movements as a result of events across the region will have varying effects on the economies and asset prices of emerging markets. On a country by country basis we focus our analysis on the potential inflationary effects, balance of payments position and fiscal flexibility of each. We anticipate the response of central banks and governments, and how this response will manifest itself in bond and currency prices. Our analyses of these factors have uncovered opportunities to arbitrage inappropriate market responses to what has already happened to the oil price rather than anticipating what we feel is going to happen to the oil price. We can then stress test our portfolio to ensure we are not implicitly exposed to either a benign or negative outcome to the conflict. This approach focuses on eliminating the systemic risk, but taking idiosyncratic risk born out of fundamental analysis.

We also believe the crisis has the potential for positive developments in both bond prices and exchange rates. Although there will be exceptions, emerging market central bankers are unlikely to allow rising energy costs to manifest themselves in escalating inflationary expectations. They have worked hard to establish their credibility and independence and will loathe relinquishing that. If they respond prudently to rising energy costs, central banks can establish greater credibility. This will provide the market with a re-assurance that real rates can be structurally lower therefore reducing long term borrowing costs.

Capital controls, which have become very popular over the past year across emerging markets to stem 'hot money' inflows, are more likely to be relaxed as stronger currency appreciation will be tolerated more readily to act as a buffer to imported inflation. Russia has already widened its currency trading band and implied that a stronger rouble would be used in conjunction with monetary tightening to combat rising inflationary expectations.

The conflict in the MENA region means the world is more of an uncertain place both to live and to invest. However, an emerging market debt manager with strong fundamental analyses and an in depth knowledge of their markets can use this volatility to provide strong absolute and relative returns on behalf of investors.