Emerging Market Debt –
Renewed Interest

Fixed Income **Spotlight**

By **Kevin Loo**, Product Manager **April 2014**

Led by Hard Currency Sovereigns, Emerging Market Debt (EMD) rebounded sharply year to date. EM Local Rates and EM Corporates also produced strong returns as concerns over the wider asset class subsided. Importantly, outflows have stopped and inflows have started as investors return after being underweight. EM current account deficits have shown signs of improvement, while some 'lukewarm' global economic data and increasing concerns over global deflationary risks kept Developed Market (DM) central banks feeding the liquidity drip. For now, carry looks to be a compelling strategy as EM fixed income looks cheap relative to most other bond classes.

EM FIXED INCOME RALLIES DESPITE TENSIONS

The first quarter of 2014 saw a strong outperformance of EM fixed income with returning sector inflows. This demonstrates that investors are often rewarded by investing in unloved areas, at what usually seems like the darkest time (***see piece "Darkest Before Dawn", Jan-2014***). The strong rebound in EM fixed income has been driven by valuations and likely has room to continue even in the face of soft EM fundamental growth momentum and lingering US/Fed and China risks. EM had benefited from a combination of easing of political tensions, range bound US Treasury yields, an European Central Bank (ECB) concerned with deflation, expectations that the Bank of Japan (BoJ) may ease further and the onset of "mini-stimulus" in China. Ultimately lower volatility in core bond markets is reigniting the appetite for carry trades. EMD is a prime candidate to benefit as yields remain significantly higher relative to other asset classes with higher rating quality.

Barring EM local rates, since the start of the year EMD yields have compressed. Credit spreads of hard currency EM sovereign bonds were particularly volatile, backing up 69bps, only to rally significantly as spreads fell by 79bps, closing the quarter at 323bps. In our view, EM hard currency sovereign spreads are about at fair value. Yet, compared with Global High Yield (B), EM hard currency sovereigns (BBB+) provide a yield pick-up around 40 basis points (bps). Elsewhere in EMD, EM Local Rates (BBB-) provide circa. 120bps yield spread pick-up with EM corporates (BBB) giving a yield spread of circa. 10bps. On balance, these are attractive versus developed market opportunities. The outlook for EMD has improved compared to the end of last year but is still under the shadow of soft economic fundamentals. EM domestic growth remains tepid with global growth failing to show signs of sustained breakout. In light of significant relative yield valuation opportunities, EMD carry trades will be a powerful force supporting reallocation back to the sector. Recent inflows have seen investors be selective, firstly adding risk into EM hard currency sovereigns and EM corporates. Some investors have sought a tactical higher reward / risk opportunity, wagering that EM local rates (yield of 7%) and FX will outperform external debt over the longer term.

Figure 1: YTD EM Debt outperforms

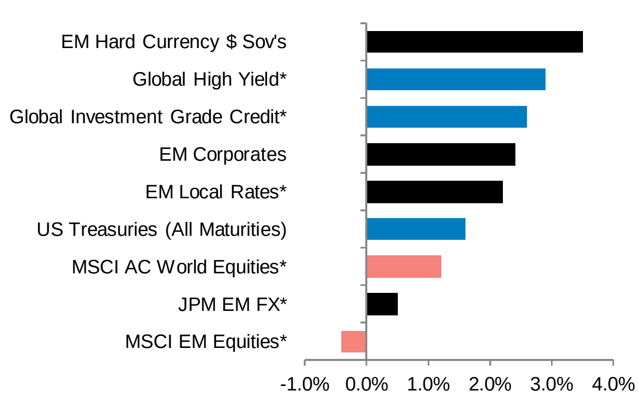
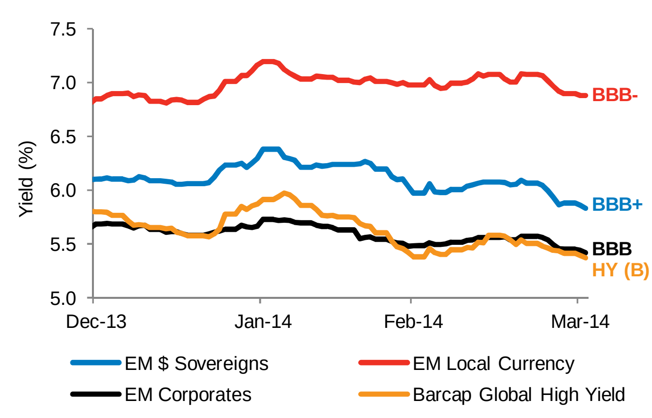


Figure 2: EM has higher rating and yield pick-up over HY



Source: Fidelity Worldwide Investment, Bloomberg, uses JP Morgan EM and Barclays Capital Global bond indices (March 31st, 2014). Past performance is no guide to future performance.

LEAVING THE WORST BEHIND: EM CONTINUES TO ADJUST

The broader backdrop for EMD still contains potential pitfalls. The US Fed is heavily data dependant; softening China growth will likely add to future volatility. Importantly, these economic developments are overlaid with elevated political risks in many countries as important elections approach and parts of the population voice dissatisfaction with existing regimes. Therefore, expect relative value to offer fruitful opportunities to be exploited.

EM growth is likely to stay sub-par but economies will continue to adjust as a consequence of weaker currencies. South Africa, Turkey, Brazil, Indonesia and India have increased policy rates and accepted higher interest rate regimes. This will dampened domestic demand and albeit with different speeds, will lead to improvements in external imbalances as exports recover. One disappointment has been the pace of export improvements. Part explanation could be US weather effects, so upcoming global data releases will be key to informing investors of this impact.

Figure 3: Delayed DM Final Demand to Support EM Growth

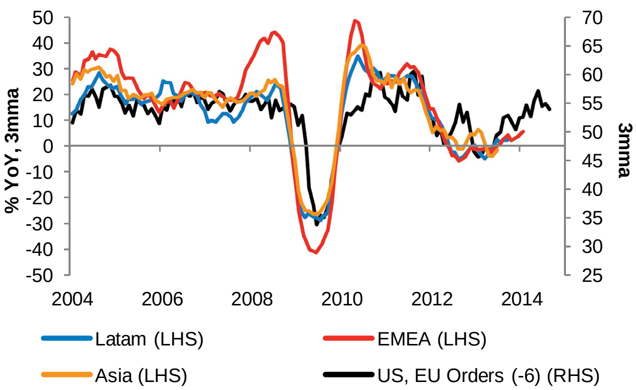
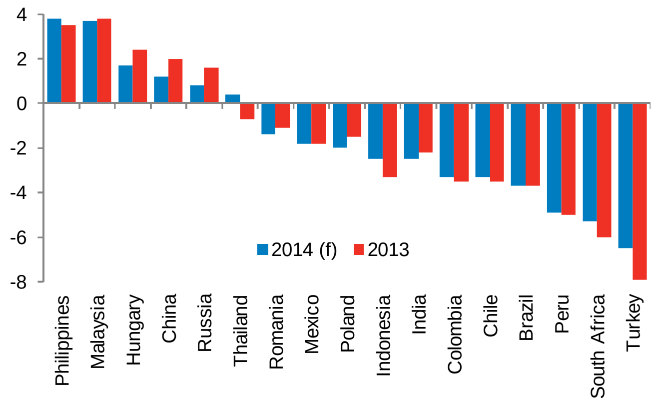


Figure 4: Turnaround Stories in Select Current Accounts



Source: Fidelity Worldwide Investment, Bloomberg, uses JP Morgan EM and Barclays Capital Global bond indices (March 31st, 2014). Past performance is no guide to future performance.

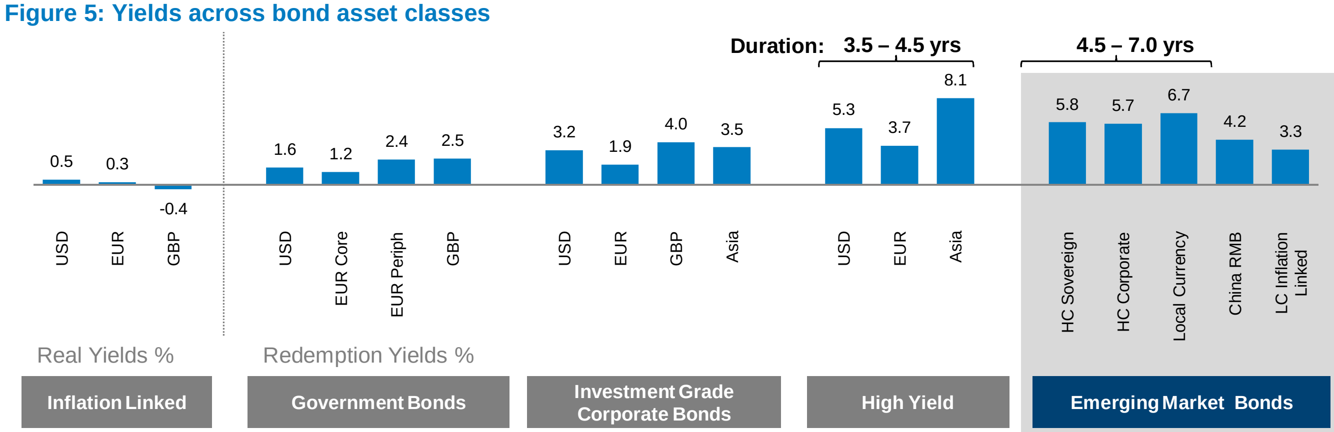
EM LOCAL RATES OFFER HIGH RISK PREMIA

The key theme in EM local rates (and by extension hard currency dollar sovereigns) is increased of country differentiation. Compared to a fall of 1.54% in Q4 2013, the JPM GBI-EM Global Diversified local index returned 1.90% in Q1 2014. , But quarterly performance does not highlight the wide dispersion. Russia (-9.01%) and Philippines (-3.40%) local rates underperformed. Vulnerable countries particularly with large current account deficits including Indonesia (13.29%), Turkey (3.18%), South Africa (0.49%), and Brazil (7.68%) outperformed in stark contrast to the prior 10 months.

Risk premia has been emerged in many markets. While far from calling a broad-based recovery in EM assets, in our mind many of these risks are sufficiently compensated for by the higher local yields on offer. Indeed, cheaper valuations, lighter positioning, higher EM policy rates and ongoing external adjustments strongly argue for EM local currency bonds.

Within a depressed global growth environment and with a relatively stable EM FX environment, investors will be hard pressed to ignore the powerful, albeit fragile, pull of higher carry EM fixed income assets.

Figure 5: Yields across bond asset classes



Source: FIL Limited (1 April 2014). JPM and BofA ML indices, shows yield to worst for high yield indices. *Inflation linked bonds show real yields.

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