Carl Shepherd, from Newton Investment Management’s Global Dynamic Bond team, explains why they are favoring short-dated, hard-currency emerging market debt (EMD) over local-currency issues despite the higher yields on offer from the latter.

Amid the hoo-ha surrounding Donald Trump’s election in November, emerging market bonds sold off markedly, but in recent weeks their overall yields have been moving lower and spreads (yield premiums) over high-quality government bonds have been tightening. Negative price action has been seen in the underlying U.S. Treasury market instead.

In an absolute-return sense, and with a view to keeping an eye on downside protection, we believe much of the emerging market bond asset class is better left watched for the time being.

At the moment, we favor hard currency (not local currency), shorter-dated bonds. We do hold some lower-rated names but these relate to issuers that do not have onerous debt obligations falling due over the next couple of years, most of which could sit tight for a while if the markets were to become turbulent.

There is nothing particularly profound in this, given that generally everyone wants short-dated U.S. dollar-denominated issuance. In a rising U.S. rate environment, investors are loath to take on U.S. interest-rate exposure with long-duration U.S. dollar-denominated debt. However, it’s an approach we believe offers scope to pick off some of the recent issuers which, while having poorer creditworthiness, have already covered all of (or the bulk of) their issuance requirements for 2017 in the first few weeks of the year.

Taking into account debt profiles, foreign exchange reserves and other measures such as import coverage, we think that these bonds should be fine to weather a storm. If these measures remain robust, short-duration bonds may pull to their par redemption value as they approach maturity, even if sentiment turns negative, and the scope for negative performance should be limited.

TRADE WINDS

Donald Trump has stated that he believes the U.S. dollar is too strong and is hurting U.S. exporters. However, the bulk of the policies he has espoused so far would be conducive to further U.S. dollar strengthening, especially versus emerging market currencies. Trade tariffs on imports, and the “onshoring” of industry (e.g., car manufacturing), are likely to result in a stronger dollar, higher inflation and higher U.S. base interest rates.

These conditions have traditionally presented a difficult backdrop to emerging market government debt markets. Back in 2014 and 2015, together with concerns over the viability of the Chinese economic model, they were a significant headwind to the asset class. Some of these fears have dissipated, owing to improvement in global trade, a reduction...
in some very large fiscal and current-account deficits, and an adherence to more conformist policymaking in the majority of major emerging market debt-issuing economies.

While we believe investors have overlooked some of these concerns in relation to hard-currency emerging market government debt, the above factors have tempered our appetite somewhat to embrace local-currency-denominated debt in a period of U.S. dollar strength, despite the higher yields on offer.

LOOKING AHEAD

In common with volatility gauges on other markets (including oil, for example), the VIX index, a measure of U.S. equity-market volatility (see below), has failed to reflect the possibility of greater instability in 2017, having remained around the lows of the last three years.

President Trump has suffered a few recent rebuffs in pushing through aggressive policy decisions. It remains to be seen whether future policy will tend towards greater toeing of the line or whether Trump redoubles his efforts. Based on previous reactions, our expectation would be towards the latter.

Between Trump's election victory and his inauguration, market participants were speculating as to whether the approach of campaign-trail Trump would be reflected in the approach of President Trump. Everything we have seen now leads us to believe that the answer to that question is “yes.” This is now a “known unknown,” and yet it has had a muted reaction in financial markets.

In the context of limiting downside risk, we need to be mindful that potential volatility in risk assets and the U.S. Treasury market, coupled with uncertainty about the pace and scale of U.S. interest-rate increases, rising global inflation and the likelihood of a stronger dollar, should reasonably be causing emerging market government bond spreads to widen, not tighten. That leads us to be cautious and to keep our powder dry for what we think will be better buying opportunities.

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RISKS

All investments contain risk and may lose value. Equities are subject to market, market sector, market liquidity, issuer, and investment style risks to varying degrees. Small and midsize company stocks tend to be more volatile and less liquid than larger company stocks as these companies are less established and have more volatile earnings histories. Investing in foreign denominated and/or domiciled securities involves special risks, including changes in currency exchange rates, political, economic, and social instability, limited company information, differing auditing and legal standards, and less market liquidity. These risks generally are greater with emerging market countries. Bonds are subject generally to interest-rate, credit, liquidity and market risks, among other factors, to varying degrees. Investments in foreign currencies are subject to the risk that those currencies will decline in value relative to the U.S. dollar or, in the case of hedged positions, that the U.S. dollar will decline relative to the currency being hedged. Each of these risks could increase the fund’s volatility.

INDEX DEFINITIONS

JPMorgan Emerging Market Bond Index (EMBI): A benchmark index for measuring the total return performance of international government bonds issued by emerging market countries that are considered sovereign (issued in something other than local currency) and that meet specific liquidity and structural requirements. U.S. 5-year Treasury yield: Average yield of a range of Treasury securities all adjusted to the equivalent of a ten-year maturity. VIX - CBOE Volatility Index: VIX is the ticker symbol for the Chicago Board Options Exchange (CBOE) Volatility Index, which shows the market’s expectation of 30-day volatility. It is constructed using the implied volatilities of a wide range of S&P 500 index options.

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