

# Emerging market debt – caution required in 2011

January 2011

**E**merging market debt had a good 2010. However, the headline return masked several sell-offs. These were periods of risk aversion driven by developed market problems. When looking at 2011, investors should consider how several factors could impact their exposure.

## Reconciling long-term exposure and short-term risk

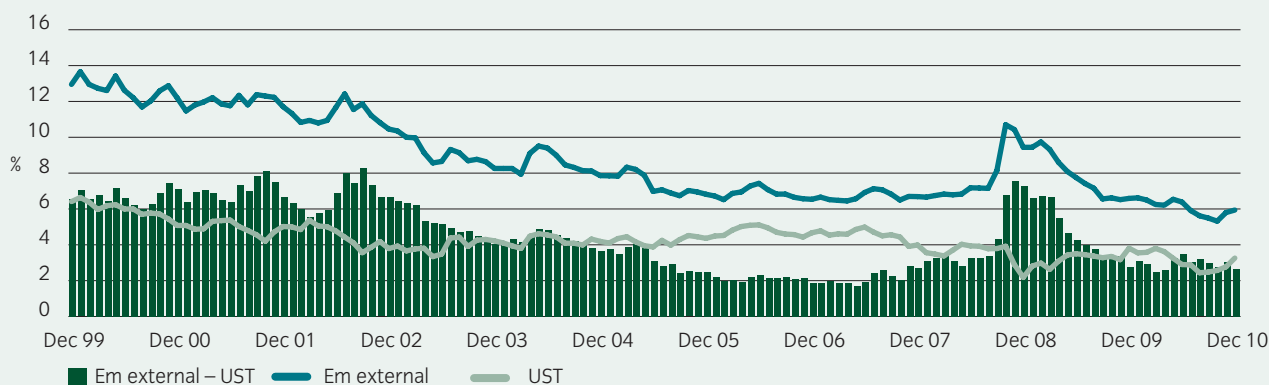
Emerging markets, and emerging market debt (EMD) in particular, is perhaps one of the most favoured sectors for many investors at present. Long-term secular trends point towards a buoyant future for the asset class, and strong performance in 2009 and 2010 cemented this impression.

Recently, we wrote about possible concerns for long-only local market concerns and this theme is now seeing wider coverage. However, there are a number of factors that could affect EMD in 2011. These represent both a risk and opportunity for investors in EMD, but those in traditional long-only portfolios may be exposed to the former while missing out on the latter.

## Rising global yields

The impact of rising US treasury yields could be seen easily in the poor returns for external sovereign debt in December. Spreads narrowed, but not sufficiently to offset the 50bps increase in ten-year US treasury yields, and hence overall returns were negative. Any future sell-off in the US is likely to see the same result, if only because the cushion offered by EMD spreads is not substantial. This can be seen in chart 1: as any positive cycle progresses, the spread decreases and hence there is less capacity to absorb these falls.

Chart 1: Yields on US treasuries, EMD and the spread



Source: Bloomberg, as at end December 2010.

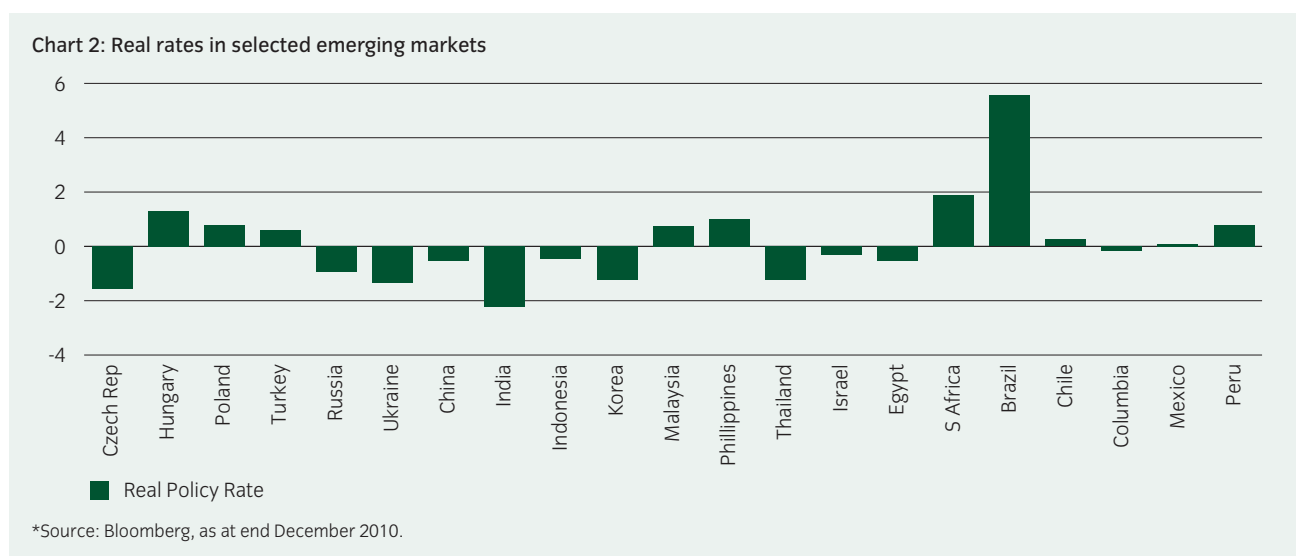
US treasury yields have recently risen, but despite this, remain very close to historic lows. In addition, US and global growth prospects continue to improve, albeit modestly.

As a result, further increases in developed market sovereign yields seem inevitable. Higher yields on developed country bonds not only affect EMD through pushing all yields higher, but also diminish demand for EMD: when yields generally are rising, investors do not have the same need to ‘chase yield’ and hence may be happy to take the yield on purportedly safer bonds.

## Inflation

While it can be argued that inflation is not a major problem, few would disagree that inflation is real – as a glance at recent headlines on rising food and commodity prices will testify. Rising inflationary pressures will exert further pressure upwards on developed market yields. Furthermore, expansionary US Federal Reserve policy means that inflation risks remain, particularly for those emerging markets with undervalued exchange rates.

Higher inflation is already a fact of life in a number of emerging markets. This can be best seen in Asia, where real rates are already negative in China, India, Korea and Thailand. Chart 2 shows that this is not limited to Asia, with the likes of Egypt and the Czech Republic also having negative real rates. This is clearly not a sustainable position and yields will have to rise to move to more normal conditions. Korea and Thailand increased interest rates in early January 2011 and further increases can be expected.



## Fundamentals

Strong emerging market fundamentals have been a foundation of the growth in popularity of the asset class, as fiscal positions and debt profiles have been improving, while political risk has generally been lower. While still broadly true, we are seeing signs of change. The recent turmoil in the Ivory Coast was perhaps an extreme example, where the incumbent President refused to step down after losing an election, pushing bond prices down to around 40 cents in the dollar. Venezuela, Belarus and Hungary also face political challenges, and although we do not expect political risk contagion across the asset class, there is undoubtedly greater risk here than during 2009 and 2010.

Political risk is not the only fundamental factor facing potential hurdles. There is scope for monetary policy errors as well: India and China may be too slow to hike rates; Hungary may be too slow to cut rates; and Turkey has taken an experimental approach by cutting rates and simultaneously increasing reserve requirements. Again, this is not to suggest that we are predicting widespread policy errors, but at the same time it is undeniable that central banks face a more difficult environment, and that therefore the scope for such errors must increase.

Finally, the increase in the popularity of EMD has allowed poorer quality names to come to market and issue paper. In October last year Mexico issued its latest 100-year sovereign bonds, while numerous hitherto unknown corporate names have successfully sold bonds.

## Technicals

Emerging market inflows have been supported by very low levels of global interest rates. As rates are increased, this support will weaken, dampening the trend. There is also still significant deleveraging taking place in developed markets.

## Contagion

Although emerging market contagion is a significantly decreased phenomenon compared to the 1980s and 1990s, the events in peripheral eurozone debt markets showed that this cannot yet be completely discounted as risk premia increased across many markets. Eurozone sovereign debt and bank solvency problems have not yet been solved, and thus further concerns (and concomitant risk premia increases) can therefore be expected in 2011.

## Conclusion

We still believe that the basic investment case for EMD remains strong over the medium and long term. However, the factors mentioned here mean that the risk / reward trade-off is more evenly balanced – or skewed to the downside in some parts of the market – than at any time in the last two years. Thus we expect to see greater price volatility and periods of weakness.

This backdrop is not an easy one, and we believe that taking a traditional, long-only approach in these circumstances may not be appropriate. We believe that an absolute return approach, with the ability to take both long and short positions, is required. This flexibility means that an investor can benefit from both positive and negative market conditions. For example, in the Absolute Insight Emerging Market Debt Fund, we already have around 40% of the Fund's gross exposure in external debt CDS. In addition we have a swap position in India that will make money if yields rise. These hedges should allow a smoother journey through the year. Long-only investors could expect a rockier ride.

Please note the value of investments and any income will fluctuate and is not guaranteed (this may be partly due to exchange rate fluctuations). Investors may not get back the full amount invested.

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