Weekly Manager Views – 30 April 2014

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Long Only and Absolute Return Fixed Income

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- Back in February, our view was that emerging markets were best approached using a combination of straight bonds and forward-starting swaps. We are pleased to say this strategy has worked well over recent months, and fund performance has been further supported by falling yields.
- We tempered our positioning by part-hedging the underlying credit and currency, so the net positive performance was dented by tightening spreads and currency appreciation. For example, the Brazilian real has led the FX pack over the past two months or so (since 19 February), returning close to 9.0%, followed by the Colombian peso, Turkish lira and South African rand. In contrast, the worst performers have been the Chinese renminbi, Chilean peso and Japanese yen – and when including developed markets, the US dollar can be added to the underperformers list. Fortunately we have managed to avoid having any significant exposure to these.
- Alongside the currency, Brazilian bonds have proved particularly strong performers. The seven-year bond is up around 4% since 19 February, benefiting the performance of our strategies.
- Looking at global markets, futures contracts on US five and 10-year Treasuries have recently underperformed UK Gilts and, notably, German Bunds, which have risen in value as European inflation data continues to disappoint to a greater extent over US growth data. European monetary growth aggregates continue to hover at around 1–2%. The rate of change of credit lending is critical to future growth. We believe any further form of quantitative stimulus in Europe needs to focus on breaking down the barriers that restrict lending to small and medium-sized enterprises in the majority of countries where the cost of debt remains extremely high and its availability scarce.
- Overall, emerging market hard currency bonds, while expensive relative to their chequered history, currently seem a relatively promising option compared to, say, US and EU corporate debt. This view seems to be gathering traction as flows back into emerging market funds are predominantly into hard currency bond funds, on account of their perceived limited drawdown potential.
- In terms of volatility in global currency markets, current levels are around the lowest they have been since the global financial crisis. In this kind of environment, we are buying options on the basis that realised or implied volatility – or both – will pick up. We have been buying puts and calls to cover ourselves against different market moves, and now hold both types of options on FX pairs including US dollar versus Swedish krona, New Zealand dollar, euro and Australian dollar. Regarding sterling, our view is more directional, as data continues to surprise to the upside, and we hold sterling calls / euro puts.
- Looking at the interest rate markets, again volatility levels are very low and we have been buying straddles on 10-year swaps, as well as five and 10-year futures, in anticipation of movements in yields.
- The current uniformity in the credit markets is creating opportunities for pairs trades with limited or no cost. While our pairs trades have yet to pay off, if there is a break-out in the relative price of credit then we have positions in place that may benefit.

Emerging Markets Fixed Income and FX

Michael Biggs
Investment Manager, GAM

- We remain quite bullish on the macro position for developed markets; conversely we are more cautious about the outlook for China. Based on this view, we identified three investment themes: we wanted to buy exporters and the current account adjustment stories, while being cautious about commodity producers.
- The first theme, the emerging market export rebound, has not performed as well as we had hoped in the first quarter of 2014. Although developed market imports have stayed reasonably strong, there has been some softness in demand from the US and weaker growth from China. We are playing this theme via holdings in Mexico, Poland and, to a lesser extent, Korea. Nevertheless we remain comfortable with this as a theme and expect returns to increase as the US recovery rebounds in the second quarter which should lead to a pick-up in emerging market export numbers.
- The second theme we are playing is current account balance improvements. A rebound in demand from developed markets, weakening emerging market demand and the real effective exchange rate (REER) depreciation should cause a current account adjustment. Trade balances significantly improved through the back end of last year. They have since remained stable, current accounts have improved and the deficit countries have outperformed. This is a theme that has worked well and we feel this trend could be reinforced further in the second quarter when developed market growth rebounds.
- The other theme is that we are cautious on commodity producers and are hence positioned short. This trade has worked very well

for us throughout the first quarter via shorts in the South African rand, Chilean peso, Russian ruble and Peruvian nuevo sol, but is now reaching an end and we are looking to reduce our positioning.

- Another factor we have identified is that emerging market bond yields have increased to attractive levels. Nominal bond yields on the JP Morgan Government Bond index – Emerging Markets (GBI-EM) have increased to around 7%, while real rates are at around 2.5%, which is in line with the historical average. This is at a time where real yields in developed markets are depressed, so the real rate differential is high. With yields at these levels, we need very little on the FX side in order to achieve high single-digit returns.
- At the same time inflation pressures have been modest, with some surprises on the downside, which makes the asset class look attractive relative to its alternatives. We will aim to take advantage of these yields by extending duration on the portfolio. We also feel that if emerging market equities perform well, emerging market bonds will also do well with potentially more upside. Emerging market local currency bonds also look attractive against their hard currency counterparts. The risk premium you get for taking the FX risk on local currency over hard currency has generally fluctuated between 2% and 3% over the past eight years, and it is currently at the upper end of this range.

Source: GAM