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First State Investments

Emerging Markets Bond

Monthly Review and Outlook

April 2016

Key highlights:

- Risk assets made further gains amid continued strength in oil prices, which briefly reached their highest levels since November, the Federal Reserve reconfirming its dovish stance and better data from China.
- We added moderately to risk and bought small positions in some African credits before the IMF spring meetings in anticipation of potential announcements of IMF program progress.
- The rally in EM debt has been supported by stabilizing commodity prices, a more dovish US Fed and waning concerns about Chinese growth.
- We continue to focus on idiosyncratic EM credits where we see positive fundamentals which are not fully priced yet.

Market review

April proceeded in a similar vein to the preceding month. Risk assets made further gains amid continued strength in oil prices, which briefly reached their highest levels since November, the Federal Reserve reconfirming its dovish stance and better data from China. The more supportive external environment led to a 1.8% (US dollar terms) return for emerging markets (EM) debt as the yield narrowed by 15 basis points (bps) to 5.71% and the spread narrowed 20bps to 389bps. US 10-year yields were 6bps higher at 1.83%.

The oil price was supported by signs that the substantial supply glut may be starting to ease with production beginning to come down in the US and a several day strike by Kuwaiti oil field workers. These factors more than outweighed any concern at the failure of OPEC to agree a production freeze at its meeting in Doha mid-month. High beta oil credits continued to outperform, notably Venezuela (9.7%), Angola (6.6%), Gabon (5.8%) and Ecuador (5.8%). Venezuela remains in a parlous state; amid a drought that is threatening the capital's main source of electricity government workers have been told to take five-day weekends. At the same time, the opposition has started a recall referendum which could eventually lead to the departure of President Maduro.

Argentina completed the largest ever single-day bond issue by an emerging economy during the month, and its first issue in 15 years. It raised $16.5bn across four separate maturity tranches, above the original target of $15bn.

In Brazil, the Lower House voted with a two-thirds majority to impeach President Rousseff. A Senate special committee will now decide whether to approve or reject the vote, likely the former. If this proves the case, the process will move to a Senate vote requiring a simple majority to ratify the decision. Rousseff would then have to step down and Vice President Temer would take over. The Senate would have 180 days to make the impeachment official, if not Rousseff will be able to resume the presidency. Brazilian bonds continued to rise over the month with gains of 1.9% and it remains one of the strongest performing credits year to date.

In EMEA, a new government was established in Ukraine, which is a first step to regaining access to IMF funding, but the challenge remains passing additional reform bills through the Rada.

Malaysia was among the weakest credits (-0.4%) as 1MDB, the state-run strategic development company, missed an interest payment despite having the necessary funds. 1MDB said it was withholding the payment because of a dispute with the Abu Dhabi wealth fund International Petroleum Investment Company (IPIC), which is a guarantor of the bond and also failed to make the payment, though it later agreed to do so. The market impact was fairly muted as investors perceived 1MDB's liability to be manageable and unlikely to damage Malaysia's financial health.

Portfolio positioning

Overall we are neutrally positioned in terms of risk exposure. The market has rallied strongly on supportive global factors and a lot of positive news now seems to be priced. Given negative yields on many developed country bonds, however, select fixed income markets with positive yields remain in demand. We participated in the 10 and 30-year tranches of the new issue from Argentina where we see scope for spreads to narrow over time. We added moderately to risk and bought small positions in some African credits before the IMF spring meetings in anticipation of potential announcements of IMF program progress.

Performance

In USD terms, the First State Emerging Markets Bond Fund returned +1.5% in April.

Outlook

The rally in EM debt has been supported by stabilizing commodity prices, a more dovish US Fed and waning concerns about Chinese growth. In the short term, we expect a continuation of this supportive external environment for EM debt, as global growth remains mediocre, with a US interest rate rise unlikely for the second quarter. Similarly, China stimulus measures have stabilized growth, although at the expense of slower structural reform. We continue to focus on idiosyncratic EM credits where we see positive fundamentals which are not fully priced yet. From a technical perspective, issuance needs in most countries are low, so that the technical market situation is supportive.