First State Investments

Emerging Markets Bond

Monthly Review and Outlook

October 2016

Key highlights:

- US Treasuries sold-off as economic data in the US improved, strengthening expectations of a US rate hike in December.
- We reduced duration risk in October, taking profit particularly in some long-dated bonds which had performed very well.
- Trump is also expected to undertake fiscal stimulus, through tax cuts, and infrastructure spending, likely leading to higher US rates, Treasury yields have moved higher following the election.

Market review

US Treasuries sold-off as economic data in the US improved, strengthening expectations of a US rate hike in December. Investors also re-assessed the likelihood of further policy action in the EU and Japan. In the US election campaign, the likelihood of a Hillary Clinton victory increased mid-month before falling back, keeping uncertainty elevated. In emerging market (EM), October saw significant issuance and Saudi Arabia's inaugural sovereign bond issue raised $17.5bn, surpassing Argentina's $16.5bn issue in April.

EM debt (in US dollar terms) was down on the month (-1.24%) as US 10-year yields rose 23 basis points (bps) to 1.84%. EM spreads widened marginally to 340bps with the yield increasing to 5.24%. Long-dated investment grade (IG) EM bonds sold-off as the US Treasury curve steepened, while high yield (-0.9%) held up better than IG (-1.5%).

The worst performing bonds were those of Mozambique (-28.1%), as the government announced a potential restructuring as debt had risen to unsustainable levels. Venezuelan bonds also fell (-8%) amid the national oil company PDVSA offering a voluntary swap to holders of short-dated bonds in a bid to preserve cash. The investor participation rate fall some way short of the 50% targeted amount. Colombia declined (-3.4%) in the wake of the referendum result rejecting the peace agreement in September, which may delay fiscal reform and possibly result in less comprehensive reforms.

Positive performers comprised mainly a mix of high yield credits including Ecuador (+4.4%), which reversed the decline seen in the wake of its $1bn 2022 bond issue in late-September, Ghana (+3.1%), Pakistan (+2.5%) and Ukraine (+1.7%).

Portfolio positioning

We reduced duration risk in October, taking profit particularly in some long-dated bonds which had performed very well. Given event risks in November and December (US election, OPEC meeting, potential US interest rate hike), we wanted to reduce portfolio risk. We also reduced higher-risk African credits where we believed that a lot of potential positives were already priced in. We added some shorter-dated bonds in Bahrain and Russia.

Performance

In USD terms, the First State Emerging Markets Bond Fund declined by 1.1% in October.

Outlook

The election of Donald Trump as president in the US introduces significant uncertainty over the future course of the global economy, geopolitics and financial markets. While the precise implications of a Trump presidency are as yet difficult to fully predict, in view of the president elect's rhetoric during the campaign there is a risk of significant disruption to the current global environment, especially if the US introduces protectionist policies as expected, which would be negative for EM. We now see greater risks to EM countries where a high share of exports go to the US and where remittances from the US are high. Trump is also expected to undertake fiscal stimulus, through tax cuts, and infrastructure spending, likely leading to higher US rates, Treasury yields have moved higher following the election, impacting countries with high external financing needs.