

Staying upbeat

Emerging markets' credit rally continues post-Brexit

By Todd Schubert

EMERGING Market (EM) bonds experienced their best six-month return since 2012 during the first half of 2016. The JPM CEMBI Broad rose 8.6 per cent, driven by an 11.4 per cent increase in EM high yield and a 6.8 per cent rise in EM high grade. These spectacular results occurred as the stars aligned for EM bonds in the guise of dovish Federal Reserve monetary policies, rising commodity prices, growing confidence in the Chinese government's ability to deal with its economic challenges and the successful impeachment of Brazilian President Dilma Rousseff.

Returns in the first half of the year were driven by Latin America as well as metals and mining, and oil and gas companies. Brazil rebounded with a vengeance, rising 18.0 per cent year-to-date (YTD) after a dreadful 2015 which saw the country downgraded to high yield. Solid performance from Latin America was fairly broad-based, with Argentina up 12.4 per cent and both Mexico and Colombia up 9.7 per cent. Outside Latin America, Russia maintained its strong form from 2015, rising 11.5 per cent. China, Asia's largest country within the JPM CEMBI, notched a 5.9 per cent return while South Korea, the second-largest Asian country within EM bonds, rose only 4.1 per cent.

Metals and mining followed Brazil's rebound with an 18.6 per cent YTD return followed by oil and gas at 12.0 per cent. Both telecom at 5.8 per cent and banks at 6.8 per cent lagged the JPM CEMBI index returns.

Upside capped by headwinds

Our positive view on EM credit is underpinned by supportive top-down and bottom-up fundamentals as well as reasonably solid technical factors. Year-to-date issuance of US\$131.5 billion is running around 19 per cent behind 2015. For the full year 2016, JP Morgan lowered its forecast to US\$220 billion, versus US\$238 billion in 2015 and a record US\$372 billion in 2014.

Valuations for both high yield and high grade are somewhat challenging, but we believe that the impact from Brexit should be modest and short-lived. Concerns surrounding global growth should elicit accommodative monetary policy. EM derives minimal revenues from Europe which should be positive for fixed income. However, the negative sentiment and volatility may limit the asset class' performance, particularly over the coming weeks.

Ultimately, we believe that the second half of 2016 will be more about "income" and "carry" than capital appreciation, and idiosyncratic bets rather than beta (market

moves). In such an environment, we maintain our preference for high yield.

We had maintained an overweight Latin America/underweight Asia call since the beginning of the year, and this strategy worked well during the first half of the year. However, after the solid performance the past six months, valuations are not nearly as compelling in Latin America, and in risk-off scenarios Asia tends to be less volatile than the other regions. As a result, we are moving to a more neutral Asia/CEEMEA/Latin America allocation, with perhaps a slight positive bias towards Latin America.

Nuanced top-down geographic strategy

We would focus on specific country, sector and individual credit bets as the primary driver of performance over the remainder of the year.

Although Asian bonds offer less compelling valuations compared to Latin America and CEEMEA (Central & Eastern Europe, Middle East and Africa), this is balanced by the stable and/or improving macroeconomic fundamentals and lower political risks in Asia. Therefore, on a volatility and/or risk-adjusted basis, we still like Asian bonds for the more stable returns.

Within Asia, we are overweight high yield (ex-China property as we see them fully valued) as the lack of issuance has created a positive technical backdrop for both remaining issues as well as new deals. We prefer the Indonesian high yield space, due to the benign macro environment, which is supported by the potential for further monetary easing and fiscal improvement from the tax amnesty programme. We would balance this with an underweight in Asian investment grade (particularly South Korea and Malaysia) where valuations are challenging.

Within CEEMEA, we are overweight Russia where economic conditions appear to have bottomed; balance sheets are among the strongest in EM and technicals are strong. Russia's credit complex has experienced a negative net supply of about US\$40 billion since December 2013 and Russian corporates accounted for only 6 per cent of global issuance year-to-date. We would balance our overweight in Russia with an underweight in the Middle East where lower oil prices have resulted in dramatic changes in the prevailing economic paradigm.

In Latin America, we view Argentina as one of the few regional countries with a positive credit trajectory and we expect new issuances coming from corporates in the second half of 2016 following the strong supply from the sovereign and provinces during the first half of the year. We also see some upside in select Brazilian credits, even after this year's rally and maintain a modest overweight bias to Brazil.

The mass downgrade of both Russian and Brazilian corporates altered the dynamic of the "BB" cohort considerably. With the rally in Brazil and to a lesser extent Russia thus far this year, "BB" names now look much more challenged on a valuation basis. This fact notwithstanding, we would still overweight "BB" as we believe that a "flight to quality" trade within high yield as a result of Brexit and other macroeconomic and political concerns could persist over the near term.

We see value in selective EU bank contingent convertibles (CoCos) and Tier 2 bonds based on investors' hunt for yield. Post-Brexit, we have noticed a decoupling between the price action of EU bank shares and EU bank CoCos, that is, the stocks of some of the EU banks have dropped on average 17 per cent versus CoCos, which have dropped on average 3.2 per cent.

The reason for the decoupling is as follows: By creating a low growth, low interest rate environment, Brexit makes it extremely hard for banks to make money. However, this is an equity story, so it makes sense for stock prices to fall a lot. Investors' hunt for yield is powerful and has been reinforced post-Brexit as confidence in the lower-for-longer interest rate environment has risen. **W**

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