MARKET FLASH

LA FRANÇAISE – 14 May 2018

INCREASED VOLATILITY IN EMERGING DEBT

Since the second half of April, the emerging debt market has seen a period of increased volatility. The main trigger of this emerging bond correction, over and above US 10-year interest rates which rose from 2.8% to 3%, is without doubt the US dollar's appreciation. There are certainly many reasons behind the dollar's rebound but for the most part, it reflects a de-synchronisation of US growth from the rest of the world. In fact, growth expectations in Europe and the emerging countries have been knocked back by slightly weaker indicators. We know that the consequences of a strong dollar for emerging markets is that currencies depreciate, mainly those of countries managing fragile balances, such as Argentina and Turkey.

This is precisely what happened in Argentina, whose currency has depreciated by 8% since 24 April. The central bank decided to intervene on the foreign exchange market and then raised interest rates by 300 basis points. The reverse may have been wiser. The markets remained in doubt and the correction accelerated. The central bank had to intervene by selling USD5 billion of reserves and raised interest rates by a total of 12.5 points to 40% to achieve some stability. In the end, Argentina turned to the IMF for backing on 8 May to help reassure the markets. Similarly, Turkey saw its currency depreciate and the central bank decided to raise its interest rates by 75 basis points, but this was not enough to claw back the losses. As is often the case during stress periods, emerging country central banks are very quickly tested and their credibility put on the line.

Aversion is most evident in hard currency bonds, i.e. denominated in US dollar and euro. This market has, in fact, seen a lot of positive flows since 2017. The average risk premium (JPMorgan EM Global Diversified index) increased from 295 in mid-April to 338 basis points on 8 May 2018, returning to the levels seen in early 2017.

The sharp acceleration in the downward movement, coming amid a positive macroeconomic environment of higher growth and low inflation, suggests to us that this correction is a technical and temporary one. Moreover, we have seen no reallocation to safe havens. Also, the local bond market held up fairly well during the volatility peak. This market reacts more to domestic, inflationary and growth issues and its behaviour since the start of the year confirms our view that the correction stems more from technical than fundamental factors. The fundamentals of the emerging economies remain very good overall and, what's more, we have no fears of a potential slowdown in China which could jeopardise these economies. The IMF continues to project average growth in emerging countries of 4.9% in 2018 and 5.1% in 2019. These countries are still at the beginning of the recovery cycle, and the capital outflows observed during these phases are generally temporary. Consequently, the fundamentals should outweigh any technical aspects.

Argentina has sought financial aid from the IMF. In our view, it is highly likely to obtain this aid given the reforms initiated by the Macri government. The crisis gripping Argentina is one of confidence in an environment with a fairly high overweighting of investors in the country. The government responded quickly, and the measures adopted, including a hike in interest rates and an accelerated tax adjustment of 0.5% to 2.7% for the current year, reflect an orthodox approach that will give it the necessary credibility with the IMF. The crisis has spread to other major countries, including Russia, Brazil and Turkey, with a sharp acceleration of correlations that are specific to technical corrections, without any idiosyncratic distinction.

Our conviction concerning emerging market debt in Q3 2018 remains positive. The bear market we have just seen has led to a reconstitution of risk premiums, which are now back at January 2017 levels. Beyond the fundamentals, the sudden rise in correlations is typical of a rather technical sell-off. However, any further strengthening of the dollar would probably need to be watched closely and would warrant protection against, at least in the short-term.

Fund management maintains its current positioning. A “stand-by agreement” is expected to be obtained in Argentina, the terms of which we should know before long, which should benefit the entire emerging debt market. At present, we feel that risk premiums are largely undervalued given the favourable economic and financial conditions that emerging countries are enjoying. For our directional strategies, we are therefore focusing on maintaining our positions in hard currency bonds and we may invest as opportunities arise in those that offer a more attractive risk/return ratio. We are also sticking with our relative value strategies around the flattening of credit spread curves in Latin America, and our positions based on the convergence of risk premiums between state-owned companies and the corresponding sovereign risk. Lastly, on the forex market, we exhibit a slightly negative bias on currencies that would suffer from fresh trade tensions between China and the US.