Emerging Markets Debt

Beyond the cover story

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HSBC Global Asset Management

EMD: Beyond the cover story

Introduction

Over the past two years, we have maintained a relatively cautious long-term outlook on Emerging Markets (EM). That view was based on our observation of weakening fundamentals in many EM countries that had relied on the commodity boom and quantitative easing in the US to fund macroeconomic imbalances. We highlighted China's ongoing economic rebalancing and a potential shift in monetary policy in developed markets (DM) as the key headwinds for the emerging world.

Recently, however, we have begun to observe a stabilization in economic fundamentals in a number of countries, global monetary policy support that has mitigated external threats, and finally, attractive relative valuations in EM versus the developed markets. As a result, we have been selectively adding risk in our portfolios, with a focus on relative value opportunities and on optimizing total carry.

Total Carry refers to the expected return on a portfolio over a given horizon provided market conditions remain unchanged.

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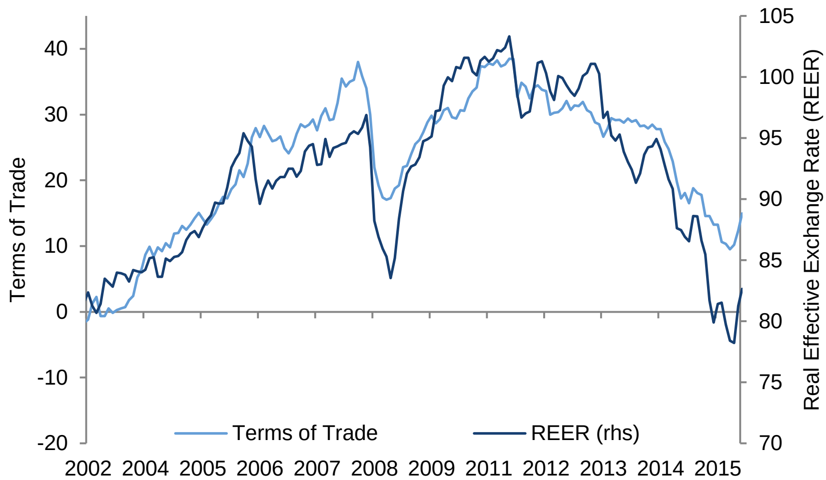
Stabilization in fundamentals

Emerging market currencies have experienced significant depreciation over the past three years in response to lower commodity prices and expectations of higher interest rates in the US. However, we believe certain EM currencies offer attractive investment opportunities given improved valuations and high levels of carry. The depreciation in EM currencies also translates into an improving external position as trade balances and current accounts are stabilizing and, in some cases, improving. Admittedly, much of this is due to import contraction, however, we are beginning to see an uptick in export volumes.

Figure 1: EM currencies depreciated over the past 3 years in response to deteriorating terms of trade

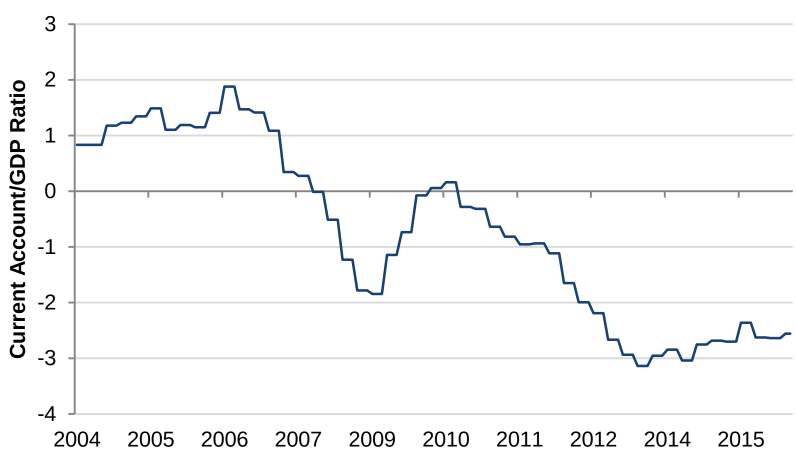


Source: Bloomberg, data as of April 30, 2016.

Terms of Trade is the ratio of an index of a country's export prices to an index of its import prices.

Real Effective Exchange Rate (REER) is the weighted average of a country's currency relative to an index or basket of other major currencies, adjusted for the effects of inflation.

Figure 2: Current account balances are improving in response to weaker currencies



Source: Bloomberg, data as of April 30, 2016.

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External challenges mitigated by supportive monetary policy

Emerging markets continue to face challenges through multiple channels. Monetary tightening in the US, deceleration in global growth, a slowdown in China and the looming threats of Brexit have not disappeared. However, in our view these risks have been well telegraphed now and should be evaluated in the context of DM central banks standing ready to intervene at the first signs of trouble.

In particular, we believe that the normalization of US monetary policy should have a manageable effect on EM countries. First, we think that future increases in US rates will be largely dependent on US economic and financial conditions and global factors, to the extent that these impact the US economy, as members of the Federal Reserve have repeatedly communicated. Second, we think the terminal policy rate, in 2019 and beyond, will be much lower than the level of rates seen in prior economic recoveries.

Looking at global trade, which has a direct bearing on the fortunes of EM economies, we have indeed observed a marked deceleration over the past couple of years. However, even on this front there has been stabilization and a small uptick as evidenced by the Baltic Dry index.

Figure 3: Global trade shows signs of stabilization

Source: Bloomberg as of June 7, 2016.

The deceleration in China undoubtedly represents a setback for the emerging world, as historically its growth has been propelled by China's commodity-consuming economy. China accounts for 45% - 50% of total world demand for industrial metals, for example, while two-thirds of EM countries still derive most of their exports from commodities. Today, China is faced with multiple challenges of

1) rebalancing its economy away from investment-driven activities towards consumption,
2) stabilizing growth,
3) liberalizing financial markets and
4) containing the rapid expansion of credit that has fueled growth in the past.

Despite the alarming headlines, we believe that with its centralized banking system, a closed capital account, and low leverage at the central government level, China should be able to "muddle through" in the next few years, avoiding a full-blown credit crisis while rewiring its economy to maintain low- to mid-single digit growth. Although we remain cautious with respect to the Chinese renminbi, we do not foresee a large one-off valuation such as the one seen in the summer of 2015 as stability on a trade-weighted basis is the optimal solution for a government in the process of engineering a shift towards a more domestically driven economy.

Finally, the UK's vote to leave the European Union represents a near-term negative catalyst for risk assets, including emerging markets. There has already been a significant impact on EM assets in the financial markets and we will likely continue to see volatility in the near-term. We view this as an opportunity, however. In addition, we think global monetary policy will likely remain supportive: the FOMC has already telegraphed a cautious approach to US rate hikes and the UK's "Leave" vote could possibly provide grounds for coordinated global monetary policy support.

In terms of economic and trade channels, the longer-term direct impact of Brexit on EM is probably limited. However, the potential unraveling of the European Union poses a secular risk to global growth beyond EM—a risk that is difficult to quantify today.

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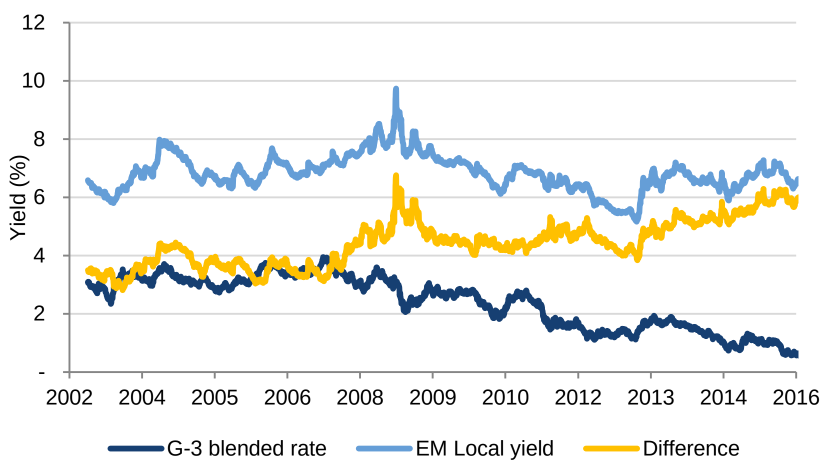
Attractive relative valuations

Looking at valuations in EM, hard currency spreads and local rates levels do not appear cheap on an absolute basis or on a historical basis. However, in a world of negative or near zero interest rates in developed markets, EM valuations look compelling on a relative basis. For example, the average yield on the GBI-EM Global Diversified index, which is comprised of local currency denominated sovereign bonds from 15 EM countries, is currently 6.5%. This compares to a yield of 1.55% in the US, -0.01% in Germany, and -0.2% in Japan sovereign bonds with similar durations. If we compare the EM index yield to a blend of the G3 government yields over the past decade, we see that a yield of 6.5% might have seemed less compelling when DM yields were close to 4%; but it now looks a lot more attractive versus a G3 yield of 0.5%. Clearly, fluctuations in EM rates will be higher than their DM counterparts, however we believe that long-term investors are well compensated for this volatility.

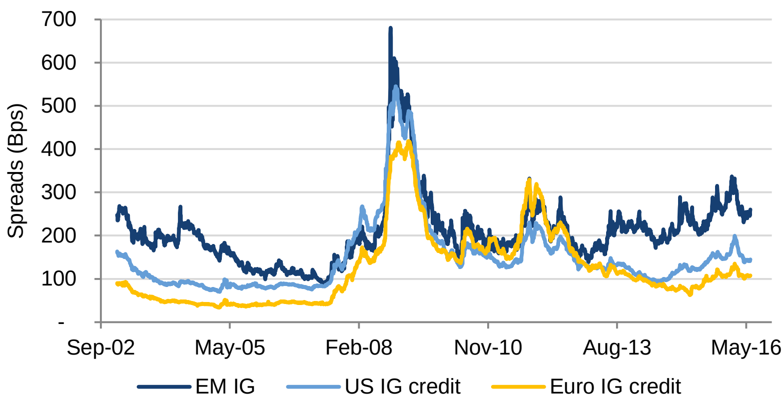
Figure 4: EM vs. DM historical yields



Source: Bloomberg as of June 8, 2016.

Many investors view emerging markets hard currency bonds as an alternative source of credit to US and Euro corporate and municipal issues. EM issuers appear moderately attractive with investment grade EM sovereigns offering one of the widest historical credit premiums versus similarly rated US and Euro credit bonds. (Figure 5)

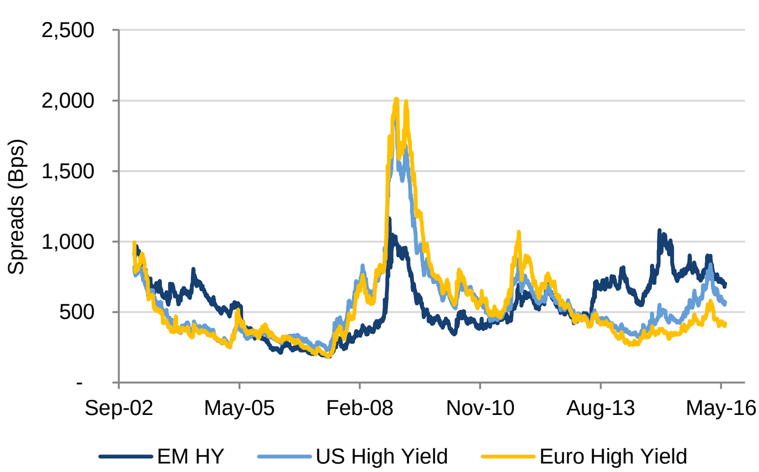
Figure 5: Investment grade credit



Source: JP Morgan, Barclays, as of June 8, 2016.

EM high yield also offers a relative premium to US and Euro high yield; however, this differential has declined over the past year as US high yield spreads in particular have widened. In our EMD portfolios, we continue to focus on higher quality countries with large reserves, floating exchange rate regimes and responsible fiscal and monetary policies as these countries are better positioned to face external challenges. Lower rated countries often have managed currency regimes, lower liquidity buffers and weaker macroeconomic policies and are especially vulnerable to reversals in investor sentiment. In some of these high yield countries however, valuations justify adding exposure after a thorough assessment of their willingness and ability to pay and of liquidity considerations.

Figure 6: High yield credit



Source: JP Morgan, Barclays, as of June 8, 2016.

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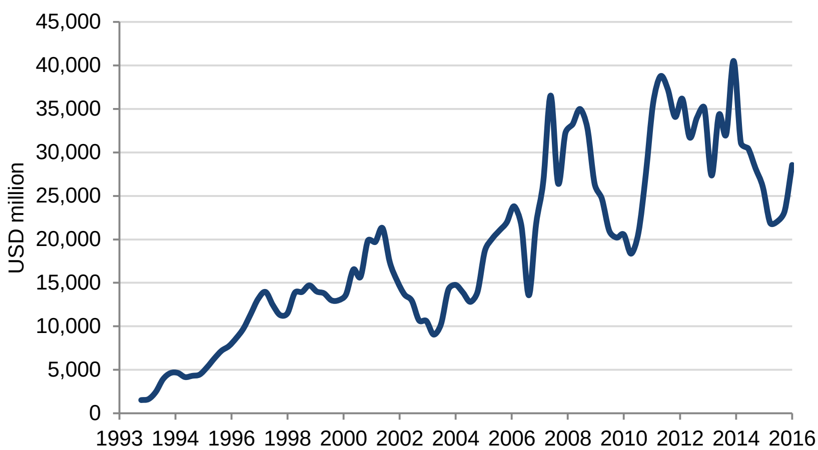
Capital flows return to EM

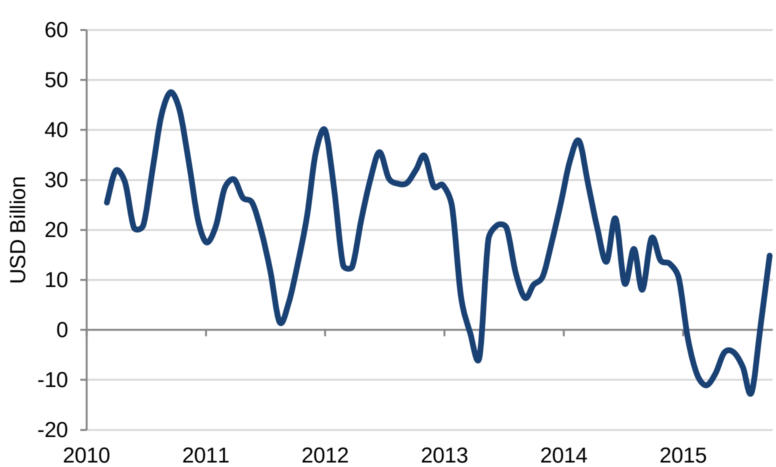
As a result of stabilization in EM fundamentals, a more benign external environment, and attractive relative valuations, we have observed a pick-up in foreign direct investment and portfolio inflows into emerging markets debt (Figure 7 and 8). As long as US monetary policy continues to be well communicated and, in the absence of a sudden shock, we believe the EMD asset class will continue to be supported. While portfolio flows are notoriously fickle, especially in EM, we believe FDI by its nature is far more stable and supports the medium- to long-term prospects of emerging market economies.

Figure 7: Foreign direct investment (FDI) in EM



Source: EIU as of December 31, 2015.

Figure 8: Portfolio flows in EM



Source: Institute of International Finance as of April 30, 2016.

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Conclusion

We believe emerging markets will continue to face periodic turbulence. While our outlook has turned more constructive, we are not predicting the return of the golden era in the 2000s. A sharp deceleration of the Chinese economy, a revision in expectations of Fed tightening and geopolitical events continue to cast shadows. However, we are observing improving fundamentals and attractive relative valuations in EM versus DM - both against a backdrop of accommodative global monetary policy. We are therefore adding risk in our portfolios - albeit selectively - with a focus on relative attractiveness among countries, companies and currencies and on optimizing total carry, or yield, among all available sectors of EM debt - hard currency investment grade and high yield, sovereigns and corporates, and currencies and local bonds.

Authors

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Mr. Upadhyay, as Head of the Global Emerging Markets Debt team, is responsible for the Global Emerging Markets Debt portfolios. He joined the team in September 2015 from PIMCO where he was an emerging markets and global credit portfolio manager for nine years. During his time at PIMCO, Mr. Upadhyay spent time as an Associate to PIMCO's Global Bond portfolio management team with exposure to rates and currency products before managing emerging markets debt portfolios and diversified income portfolios (hybrids of EMD and credit). Prior to joining the firm, Mr. Upadhyay held positions at Citibank and ABN AMRO Bank and has been working in the financial industry since 2000. Mr. Upadhyay has a Bachelor of Science from the Hindu College, Delhi University (India) and a MBA from the Indian Institute of Management, Indore, India.

Ms. Yangol is a portfolio manager on the Global Emerging Markets Debt team, focusing on EMD local markets and global macro and country research. Prior to this role, Ms. Yangol was a senior product specialist for the Global EMD capabilities at HSBC, delivering insights on our macro views and EMD portfolio strategy based on detailed portfolio analytics and macroeconomic research. Olga joined HSBC EMD team in January 2014 from PIMCO, where she was responsible for advising institutional clients on emerging markets, asset allocation and hedge fund investments. Prior to this, Olga was an executive director at CIBC World Markets, where she specialized in interest rate, foreign exchange and equity derivatives structuring and designed investment and hedging strategies for asset managers and corporate clients. She holds an MBA from MIT Sloan School of Management and she received her undergraduate degree in Information Systems and Finance from McGill University. Olga is a CFA Charterholder, and holds Financial Risk Manager and Chartered Alternative Investment Analyst designations. She is fluent in Russian and French.

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