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First State Investments

Emerging Markets Bond

Monthly Review and Outlook

May 2016

Key highlights:

- The minutes of the Federal Reserve April policy meeting dealt the market a surprise when they were released in May by indicating that a rate hike is likely before Q4 if current growth and inflation trends persist.
- We participated in some new issues in May and tendered the Slovenia bonds which the issuer was buying back at attractive levels. We expect market liquidity to be thin over the summer months.
- In the absence of negative surprises from China or on the inflation front in the US, we expect this favourable environment for emerging market hard currency bonds to remain in place.

Market review

The minutes of the Federal Reserve April policy meeting dealt the market a surprise when they were released in May by indicating that a rate hike is likely before Q4 if current growth and inflation trends persist. This more hawkish tone led to some risk assets selling off. The oil price continued to rise with Brent crude breaking through the $50 level for the first time in six months; supply disruptions in Nigeria and Canada and news of a decline in US crude inventories gave support.

Emerging markets (EM) debt remained relatively resilient with a modest decline of 0.2% (US dollar terms). The yield on EM debt was up 10 basis points (bps) to 5.81% and the spread widened 8bps to 397bps with US 10-year Treasury yields virtually unchanged at 1.85%. High yield (+0.25%) outperformed investment grade (-0.55%) over the month. Ecuador gained 4.0% against a backdrop of optimism around the prospect of support from the IMF, while Iraq (+3.5%) agreed a loan accord with the IMF.

Argentina (+2.7%) made further gains. Following its successful bond issue last month, the country's return to global capital markets took another positive step as credit-default swaps (a hedge against the possibility of a default) were quoted for the first time since September 2014.

Political events remained to the fore notably in Brazil (-0.8%), Turkey (-1.7%) and South Africa (-1.2%). In Brazil, Vice-President Michel Temer's first few days as acting president were not without challenge as Planning Minister Romero Juca became implicated in the Lava Jato scandal and was forced to resign. Markets appeared to welcome the appointment of former Banco Central do Brasil (BCB) Governor Meirelles as Minister of Finance and the proposal to appoint Goldfajn at the helm of the BCB. A comprehensive programme of fiscal reform was announced though it will require amendments to the constitution.

In Turkey, Prime Minister Davutoglu was unexpectedly replaced by Binali Yildirim, a close ally of President Erdogan, thus further consolidating power in the hands of the president. The cabinet reshuffle was not as radical as some had feared though there were notable changes with Deputy PM Mehmet Simsek given reduced responsibilities.

The crisis in Venezuela continued to escalate with political tension and the risks of widespread civil unrest and hyperinflation rising. The opposition continued its attempts to bring a recall vote to oust President Maduro. The finance minister confirmed that further funds will be forthcoming from China later this year.

There were unsettling developments in South Africa, where amid rising factionalism in the ruling ANC party a newspaper report suggested that Finance Minister Gordhan, who has a reputation for blocking presidential interference in state-owned enterprises, was facing arrest though this did not happen.

Portfolio positioning

Overall, we are neutrally positioned in terms of duration. We participated in some new issues in May and tendered the Slovenia bonds which the issuer was buying back at attractive levels. We expect market liquidity to be thin over the summer months.

Performance

In USD terms, the First State Emerging Markets Bond Fund returned 0.0% in May.[1]

Outlook

The global environment and particularly the stance of Central Banks continue to be important drivers of all markets. Given moderate global growth and low global interest rates, demand for bonds with higher risk premia remains high. In the absence of negative surprises from China or on the inflation front in the US, we expect this favourable environment for emerging market hard currency bonds to remain in place.