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First State Investments

Emerging Markets Bond

Monthly Review and Outlook

August 2016

Key highlights:

- US monetary policy remained the key focus for global bond markets in August.
- We remained selectively overweight in high yield credits which we would expect to outperform.
- The market environment remains supportive of risk assets and the search for yield, and technical conditions remain solid.

Market review

With the Federal Reserve's annual symposium at Jackson Hole taking place during the month, US monetary policy remained the key focus for global bond markets in August. While the Fed chairwoman's speech was focused on longer-term monetary policy options, the hawkish comments from Fed official William Dudley earlier in the month led to higher expectations of a September rate hike. Overall though, G7 monetary policy remains accommodating.

The search for yield within the context of a constructive market environment – mediocre global growth, low inflation, accommodating G7 central banks and negative yields in many developed country bonds – continued unabated through August. Emerging markets (EM) debt returned 1.8% (US dollar terms) with the yield on EM debt coming down by 19 basis points (bps) to 4.98% and the spread by 30 bps to 338 bps. US 10-year yields were 11 bps higher over the month at 1.57%.

Oil and commodity-related credits, especially in Africa, outperformed. Among them were Zambia (12%), where an IMF agreement is expected after the elections, Iraq (8.1%), Cameroon (5.9%) and Ghana (5.6%).

Weaker performers included South Africa (-0.8%) where municipal elections saw the African National Congress (ANC) suffer its worst performance since coming to power in 1994 at the end of Apartheid. Shortly after the elections, Finance Minister Gordhan, who is considered to be the main pillar of fiscal orthodoxy and good governance, was summoned by a unit of the police in relation to a probe into activities of the tax authorities (where Gordhan previously worked). The market interpreted this potentially politically motivated corruption investigation as a sign of escalating tensions between the Finance Minister and President Zuma, which could be the prelude for a change at the finance ministry. In Chile (-0.4%), the CEO of quasi-sovereign copper producer Codelco gave a downbeat assessment of the company's outlook. Codelco is a key source of revenue for the Chilean government.

Portfolio positioning

We remained selectively overweight in high yield credits which we would expect to outperform. We took some profits in the overweight position in Argentina. We believe that the scope for continued outperformance of the credit in the short-term has decreased as the fiscal consolidation will be much slower than the market seems to price in. Unfavourable Supreme Court rulings about pensions and subsidies have made fiscal tightening more challenging for the government.

We maintained our core overweight to Indonesia where President Joko Widodo has made a strong appointment in Sri Mulyani as finance minister, who returns to the post after several years at the World Bank, and is now expected to deliver on reform execution.

We added some exposure to Turkey, following the sharp sell-off in the wake of the attempted coup on the view that the credit was oversold. Investors are concerned that the rating of Turkey might get downgraded, but a rating's downgrade is in our view at least partly priced at current spread levels.

Performance

In USD terms, the First State Emerging Markets Bond Fund returned 2.19% in August.

Outlook

The market environment remains supportive of risk assets and the search for yield, and technical conditions remain solid. Risks to the positive outlook are potential political noise due to the tight US presidential election race, which remains characterised as much by inflammatory rhetoric and controversy as political debate. Key political events are upcoming in Europe as well. There are, however, some positive EM developments taking place: EM growth, particularly relative to developed market growth, is starting to pick up, commodity prices appear to have stabilised and current accounts in some countries are improving. Longer-term we would expect to see these factors become the more dominant drivers of returns.