First State Investments

Emerging Markets Bond

Monthly Review and Outlook

November 2016

Key highlights:

- Emerging Market assets were also negatively affected by concerns that Trump could implement some of the protectionist policies promised in the campaign.
- We were underweight duration at the start of the month, particularly in the long-end. We sold some more long-dated bonds before the US election.
- We expect high volatility and uncertainty, we are cautiously positioned, but look to add risk if risk premia widen further.

Market review

The unexpected victory of Donald Trump in the US presidential election triggered a steep sell-off in US Treasuries as the market started to price expectations the president-elect will pursue the reflationary policy agenda outlined during the campaign. While the timing and size of the fiscal stimulus which is expected to include tax cuts and infrastructure spending is unknown, markets priced in a higher growth scenario. EM assets were also negatively affected by concerns that Trump could implement some of the protectionist policies promised in the campaign.

Emerging market (EM) debt was impacted by the US Treasuries sell-off, losing 4.1% (in US dollar terms). US 10-year yields rose 54 basis points (bps) to finish the month at 2.37%, while EM spreads widened by 21 bps to 361bps to yield 5.91%. Long-dated EM bonds were worst affected: bonds with maturities of more than 10-years fell 7.4%. EM high yield (-3.8%) held up better than IG (-4.3%).

Underperforming credits included Argentina (-7.4%). Argentina is among the credits needing to issue large amounts next year given the slow fiscal consolidation. Other underperformers included Uruguay, which is sensitive to US Treasury yields and has substantial long-dated issuance. Mexico fell (-6.9%) being one of the most exposed credits to greater US protectionism. Turkey's underperformance (-5.8%) likely reflected its reliance on external financing given its large current account deficit.

After the OPEC agreement on production cuts, most oil credits performed well. Outperformers were mostly idiosyncratic such as Venezuela (-0.6%), despite a late interest payment on some PDVSA bonds. Several African credits outperformed, and Iraq (-0.6%) and Egypt (-1.6%) held up well. Russia (-1.2%) may have also benefited from expectations of better relations with the US.

Portfolio positioning

We were underweight duration at the start of the month, particularly in the long-end. We sold some more long-dated bonds before the US election, but also opportunistically added some exposure in long-end bonds as spreads widened. We also reduced some exposure to higher-yielding credits. We reduced Ukraine exposure given uncertainty as to whether the US will continue to give support to the country with Trump as president. We also reduced some exposure to African credits, which have been among the better performers in the recent sell-off.

Performance

In USD terms, the First State Emerging Markets Bond Fund declined by 3.9% in November.

Outlook

We expect market volatility to remain high until the US president-elect's agenda and cabinet is more defined. Investors are scrutinizing the appointments to senior cabinet posts and policy outlines can cause large swings in sentiment. Whatever policies do materialise, it's hard to envision a scenario that would be very positive for EM economies, with the exception possibly of commodity exporters. Countries with significant trade links with the US or which receive large remittances as well as those with high external financing needs could be potentially negatively affected by the new US policies. President-elect Trump's cabinet appointments thus far have included some individuals known for 'hard-line' views, but how US relationships with Asia, Russia or the Middle East will change is difficult to anticipate. Given that we expect high volatility and uncertainty, we are cautiously positioned, but look to add risk if risk premia widen further.