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Spotlight on emerging markets

The role of economic cycles in EM credit, rates and FX

M&G INVESTMENTS

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Economic cycles in emerging market (EM) countries create a hugely varied landscape, which provides a diversified investment universe. Against this backdrop, **Claudia Calich**, emerging markets bond fund manager, believes a flexible mandate is crucial to take advantage of the full opportunity set of bonds and currencies.

The value of investments will fluctuate, which will cause prices to fall as well as rise and you may not get back the original amount you invested.

Four distinct EM economic cycles

Widely different economic conditions invariably prevail in individual countries. When investing in EM bonds, we believe that correctly assessing the implications of these various economic cycles is a key factor in determining how to build (or avoid) exposures to a country's assets. Given these considerations, we believe a highly flexible mandate is crucial to be able to exploit fully the range of opportunities to add value in the EM sovereign and corporate debt markets, and currency markets.

Figure 1 overleaf shows four distinct economic cycles that are typically found when analysing developing nations. The relevant positioning strategies that we would favour against each backdrop are also summarised.

Avoiding fundamental downturns

Some countries may be in 'crisis', such as Venezuela at the current time, while others may be 'stabilising' after a problematic period. In the former phase, the country's currency is likely to come under massive pressure as the economy goes into crisis.

As a result, inflation overshoots and the central bank is forced to hike interest rates to counter rising prices and capital outflows. In an environment of rising country risk, credit curve steepening leads to bond prices falling. Taking short positions in a country's bond or foreign exchange (FX) market can be a useful strategy if either its economic outlook is particularly unfavourable, or if valuations, particularly on the FX side, look significantly overstretched.

Picking the turning point

For stabilising countries, there will be firm evidence that the economy is bottoming out. However, at this stage inflation is still elevated and/or rising, with local real yields lacking attraction. In our active approach, we assess these environments very closely, with the intention of picking the turning point to add investment opportunities. On a selective basis, sovereign and corporate bond allocations can offer upside potential in these instances, while long exposure to the local currency may also be appealing.

In our current outlook, Ecuador provides a case in point in this category. Oil production is very important for its economy and, therefore, it has benefited from the recent rise in oil prices. GDP growth was -1.5% in 2016, but is forecast to have been modestly positive in 2017, to exhibit a typical 'bottoming out' trend. The fund holds US dollar-denominated debt in Ecuador that yields 8%, which we consider an attractive spread for this B rated country.

Real yield appeal

Encouragingly, many emerging market economies progress from the stabilising backdrop to an 'improving' stage. During these times, an economy displays healthy recovery signals, such as an appreciating currency and declining inflation expectations.

In turn, lower inflation can add compelling real yields to the investment case for the country. Monetary policy is also likely to help bond investors' sentiment, given that as inflation peaks the central bank can support the economy by lowering interest rates.

We believe Egypt is in such an improving economic cycle. Relevantly, tourists are returning to the country, helping to accelerate its growth outlook, with GDP growth forecast at more than 4% in the current year and in 2019. Furthermore, high inflation – triggered by the break from a currency peg – should have peaked and we expect disinflation and real yields to be supportive. In the fund, this backdrop underlines our overweight

allocation to the country, which includes local currency exposure. Changes in currency exchange rates will affect the value of your investments. As a general theme, we would also favour a long duration stance when allocating to emerging economies in these cycles.

Boom times: risk and opportunities

If an economy progresses to a boom cycle, EM bond investors can weigh up some key risks and opportunities. In these cycles, inflation rises above the central bank's target, a consequence of the economy overheating. In addition, the country's currency valuation is likely to be high, and there is the prospect of interest rate rises to counter inflation and balance the economy. This background typically warrants staying short in terms of positioning on the local rate curve.

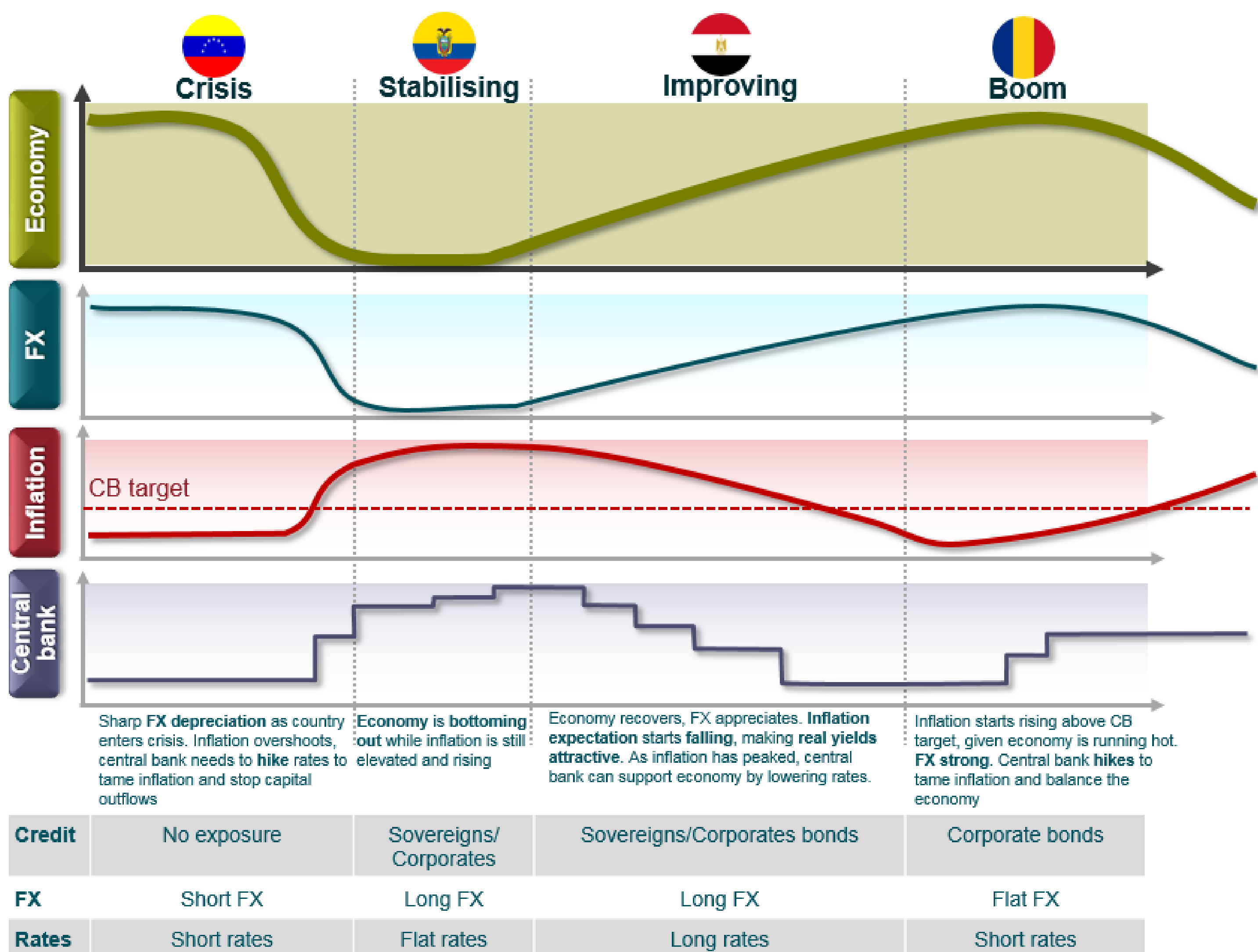
Romania currently appears in boom territory, producing a hefty 7% growth in GDP in 2017. Such an increase suggests the economy is growing above potential, with rate tightening by the National Bank of Romania already taking place in the first quarter of 2018. Having previously favoured Romania as one of the fund's larger exposures in emerging Europe, we have recently reduced our allocation to the country against this backdrop.

The positive side in a boom scenario is that default risk is low, helping to drive spreads tighter. In the fund, we are happy to seek additional value by investing in corporates that benefit from the robust economic environment while paying a spread pick-up. A corporation with output geared to the local economy can provide such potential. In a related example, within this approach the fund holds hard currency bonds from Via Trans Radio Chilena (VTR), a Chilean telecom company.

Overall we take a flexible approach, which allows us to hold those bonds and currencies that we believe offer the best relative value. In contrast, countries or industries where we feel the outlook is unfavourable are avoided.

Actively managing duration, credit risk, and currency positioning drives long-term performance as we seek to generate competitive returns in different economic and market conditions.

Figure 1: The importance of having a flexible EM mandate



	Crisis	Stabilising	Improving	Boom
Credit	No exposure	Sovereigns/ Corporates	Sovereigns/Corporates bonds	Corporate bonds
FX	Short FX	Long FX	Long FX	Flat FX
Rates	Short rates	Flat rates	Long rates	Short rates

Source: M&G, 2018. Country examples given above: Crisis – Venezuela; stabilising – Ecuador; improving – Egypt; boom – Romania.

Please note, past performance is not a guide to future performance.

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