

Fixed income

Q&A



ANSWERS

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What are the attractions and pitfalls of investing in emerging market debt (EMD)?

We see many attractions to investing in EMD. Improved credit dynamics relative to developed markets is one key consideration.

The peripheral European debt crisis has highlighted how much the credit quality of emerging market (EM) countries has improved in recent years in terms of debt-to-GDP ratios, fiscal deficits, international reserve cushions and current account surpluses. Even though correlations between asset classes have risen, EM bonds provide portfolio diversification when held within a broader portfolio.

In addition to the positive fundamental credit story, EMD is also supported by favourable technical drivers. Many EM countries have low budget deficits and low financing requirements. Looking ahead to 2012, these countries need to raise on average only 7.7% of GDP, which should underpin the asset class. Developed countries, by comparison, have gross financial needs of more than 27% of GDP in the same year.

We believe that relative to the developed markets, the outlook for EM countries will improve further, due to favourable demographics and improving credit quality. We would therefore expect further credit rating upgrades for EM countries, while developed countries are likely to see further rating downgrades.

As with any investment, there are risks in investing in EMD. Default risk is one; investors holding sovereign debt of Argentina or Ecuador, for example, suffered losses when these nations defaulted some years ago. However, emerging nations are today in a much more comfortable position to service their debt obligations than their developed market peers. Volatility, as a result of broader sovereign debt issues and macroeconomic concerns in developed markets, is another risk.

Why does your fund invest primarily in hard-currency debt rather than local?

There are advantages to both local and hard-currency debt. The performance of local debt and hard-currency debt is driven by different factors and the fund is primarily focused on the latter. Whereas the development of domestic markets and inflation dynamics are key drivers of local debt performance, credit trends dominate external debt.

The hard-currency (US dollar) market is a popular source of funding for economically emerging countries. Africa, for example, began to access this market relatively recently. Consequently, we have access to a more diverse range of issuers than that available in local-currency markets. That said, the fund

can opportunistically invest in bonds denominated in local currency but we view the risk/reward of hard-currency bonds as more attractive than that of local-currency bonds. We therefore have only small positions in local currency.

Do you worry about a potential bubble in EMD?

EMD funds have seen considerable inflows, both into hard and local-currency markets. However, we believe this is a long-term trend as allocations to EMD among institutional investors are still low. Investors are faced with low yields in the US and the stronger eurozone countries and increasing risks in the European peripheral markets. In this environment, EM offers favourable fundamentals and an attractive yield.

The structural issues of competitiveness and low growth in some European countries are undermining investor sentiment and are likely to cause bouts of volatility across all financial markets. EMD is not immune to this but we believe the asset class offers good, long-term value at current levels.

How will the inflation outlook for global EM affect your portfolio?

Some EM countries face a risk of over-heating and inflation has been rising in some countries. Many have raised interest rates to combat inflation. As commodity prices have come down there are now signs inflation may have peaked in many countries, and growth, rather than inflation, has become the bigger concern. Brazil, for example, had raised interest rates several times in the first half of 2011 because of inflation concerns but started to cut rates in August, as global growth slowed.

In terms of our portfolio, we look at many factors when analysing country risk; monetary policy and inflation are only two factors we look at in our comprehensive analysis. We aim to invest in bonds of countries where we anticipate improving creditworthiness has not yet been priced in.

Which sectors and regions offer the best EMD opportunities?

We see interesting opportunities in the Middle East and are overweight Turkey, Russia and Brazil. We are overweight the more liquid credits and underweight the less liquid ones.

What duration profile does the fund have at launch?

The fund's duration will fluctuate in the range between +1.5 to -1.5 years of the benchmark's average duration. Our benchmark is the JPM Emerging Markets Bond Index Global Diversified Index. We tend to own 10-year bonds, as these are very liquid.