# Emerging market debt, 2018: The good, the bad and the ugly

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With 11 years' investment experience, Trevor is a portfolio manager in the Fixed Income team where he jointly manages the emerging market government bond and currency portions of the Global Dynamic and Global Bond funds. He also has previous experience of managing short-dated government bond and money market funds. Trevor joined Newton in 2006, and is a member of the bond/FX strategy, themes and cash focus groups.

**Carl Shepherd**
*Portfolio manager,*
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Carl is a portfolio manager in the Fixed Income team. He focuses predominantly on emerging market government bonds, and manages the emerging market bond portion of the Global Dynamic and Global Bond funds. He also manages some gilt funds and has previous experience of managing short-dated government bond, and money market funds. In addition to his work as a portfolio manager, Carl is a member of the cash focus, weekly credit, bond/FX and emerging markets strategy groups.

Prior to joining Newton in 2002, Carl worked as a performance specialist in the defined contributions pensions team at Legal & General.

In this 2018 preview of a buoyant asset class, Newton[1] Global Dynamic Bond portfolio managers Carl Shepherd and Trevor Holder identify their favourite investment destinations in the world of emerging market fixed income and those they're avoiding.

## PART ONE: THE GOOD

### Carl Shepherd: Peru

***With solid debt coverage ratios and improving fundamentals in its all-important copper sector, Peru tops the list of Carl Shepherd's underappreciated EMs.***

"If I were to highlight one country with demonstrably strong but generally overlooked fundamentals, I'd definitely point to Peru." So says Newton fixed income manager Carl Shepherd when asked to highlight his "unloved" EM debt market of choice.

Part of the rationale, he says, is the improvement in terms of trade for the country and its increasingly competitive mining industry. Not only have copper prices been on the up (see Figure 1) but, due to increased investment over the past decade, Peru has been steadily increasing its share of global copper production, mainly at the expense of its southerly neighbour Chile.

FIGURE 1: COPPER'S PRICE RISE


Source: Bloomberg, 16 January 2018.

[1] **Investment Managers are appointed by BNY Mellon Investment Management EMEA Limited (BNYMIM EMEA) or affiliated fund operating companies to undertake portfolio management activities in relation to contracts for products and services entered into by clients with BNYMIM EMEA or the BNY Mellon funds.**

Meanwhile, debt to GDP is around 23%, equivalent to around US$86bn, Shepherd says. Since current FX reserves stand at around US$63bn, this means debt coverage ratios are strong.

He adds: "Peru does still have issues with dollarisation of the economy, hence the large FX reserves the government holds but this is a hangover from previous financial crises where it's a constitutional right to have a US dollar bank account. Even so, local currency issuance has become more prevalent, and now constitutes 63% of outstanding debt. A local currency euroclearable bond came to the market last year – and the government aims to make all of the local bonds in issuance euroclearable over the next 18 months, which should boost liquidity."

Despite the wider positives, Peru's 2026 local currency government bond currently yields 4.7%, he points out, noting that with the year-on-year consumer price index (CPI) standing at 1.36%, this provides a real yield of 3.34%. "That's great value for an issuer with such low indebtedness and a solid 'single-A' investment rating."

### Trevor Holder: Indonesia

***For Trevor Holder, Indonesia ranks highly as one to watch in 2018. Despite a stable economy, low inflation and an investment grade credit rating, yields on local currency bonds remain unjustifiably elevated in his view.***

Indonesia is an example of a country that's not unappreciated by the market, "but which is underappreciated nonetheless", according to Holder.

For one thing, he says, macroeconomic stability has improved considerably under the reformist government of President Joko Widodo supported by globally respected Minister of Finance (and former World Bank director) Sri Mulyani Indrawati, and the prudent leadership of Governor Agus Martowardojo at the Bank of Indonesia.

Debt to GDP remains below 30%, and the fiscal deficit is below 3% of GDP (as per constitutional law), Holder notes. Meanwhile, cuts to energy price subsidies have limited the government's exposure to the oil price recovery and increased the scope for public infrastructure investment.

Although much-needed infrastructure spending is still constrained by the 3% fiscal deficit limit, targeted investments to tackle severe congestion in Jakarta are beginning to bear fruit, he says, as evidenced by the recent unveiling of a fully operational 36km rail link from Soekarno-Hatta International Airport to the capital, and further network extensions scheduled for 2019.

Elsewhere, balance of payments pressures have reduced significantly in recent years, with the current account deficit declining to 1.3% of GDP last year, says Holder. This, coupled with reduced restrictions on foreign direct investment, limits Indonesia's vulnerability to US monetary tightening and to associated bouts of global 'risk' aversion, he adds.

Furthermore, government and central bank policies have helped tackle Indonesia's persistent inflation problem. "Indeed, the Bank of Indonesia has maintained positive real interest rates since 2015, squeezing domestic demand and imports, while supporting the value of the Rupiah and the attractiveness of the local currency bond market to foreigner investors," he says. "The government's rollout of a live pricing app for local farmers also improves the authorities' ability to manage food stocks and food inflation, with food CPI falling to historic lows of less than 1.5% year on year. Core inflation has now fallen below 3% year on year, while GDP growth remains steady and sustainable at around 5% year on year."

FIGURE 2: INDONESIA CPI YOY

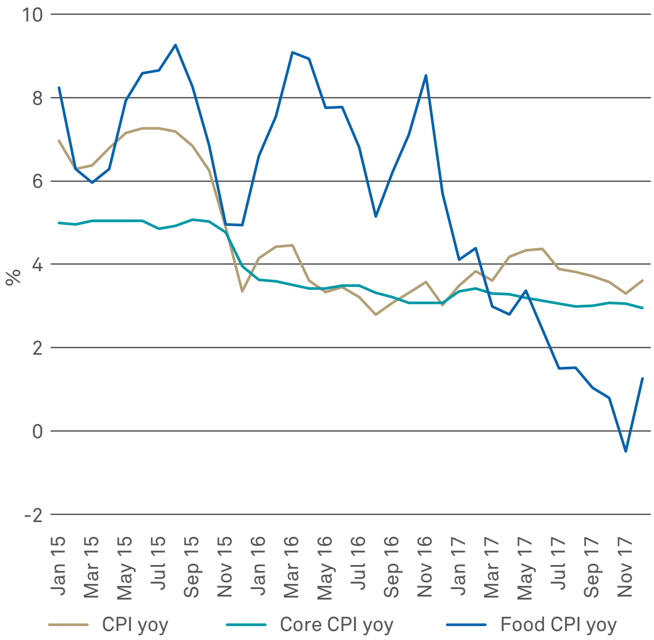
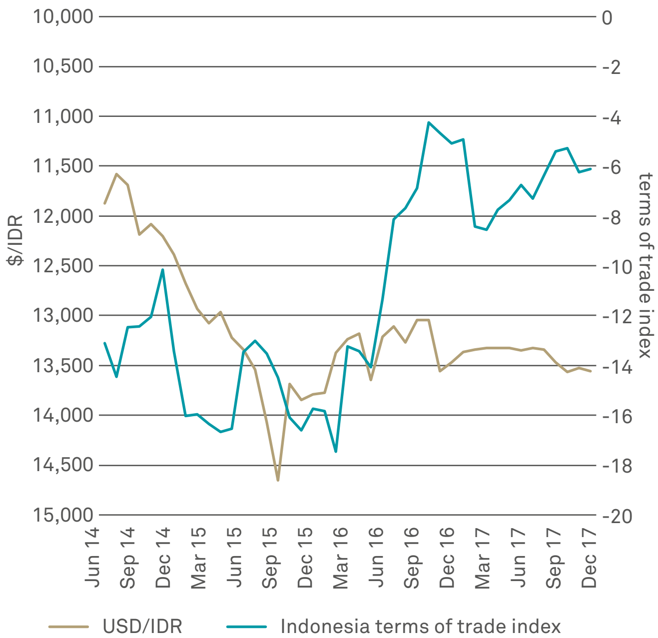



FIGURE 3: US$/IDR VS. INDONESIA TERMS OF TRADE




Source: Bloomberg, 16 January 2018.

In recognition of this more becalmed macroeconomic backdrop, ratings agency Standard & Poor's finally granted Indonesia investment grade status in 2017 (five years after Moody's and Fitch felt compelled to do so). The credit outlook remains 'favourable', says Holder, with Moody's positive outlook suggesting a further ratings increase is in prospect.

Despite this stable macro and inflation backdrop, real yields on Indonesia's local currency bonds are elevated and the yield curve remains at historically steep levels. Nominal yields on 20-year issuance stand at 7% (versus base rates of 4.25%), providing a +3.4% premium to year-on-year inflation. Says Holder: "These yields look extremely attractive in the context of those offered by investment grade-rated peers, suggesting considerable scope for curve flattening and capital appreciation."

The prospect of Indonesia's inclusion in the Bloomberg Barclays Global Aggregate Index later this year "would offer further support to the bond market and capital account backdrop", he adds, particularly with presidential elections off the radar until 2019 (and 'Jokowi' in any case currently enjoying a comfortable c.30% lead in the polls). Here the contrast is with some other high-yielding EM issuers such as Mexico and Brazil where elections are scheduled for 2018.

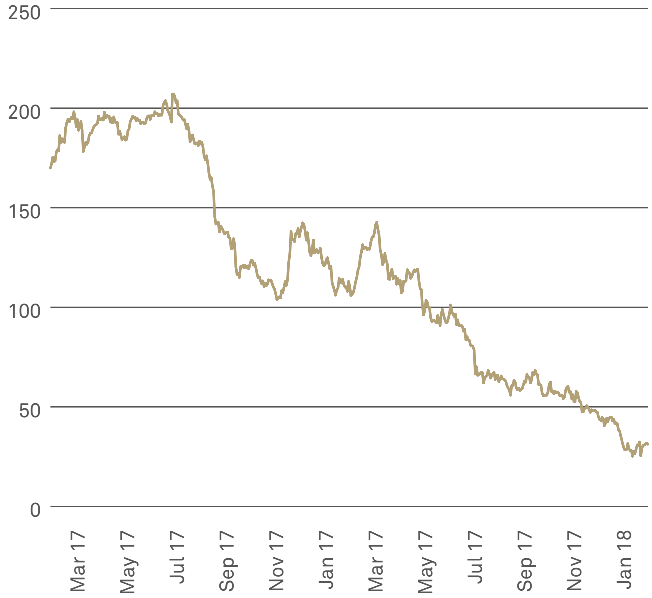
For Holder, there is one additional argument in favour of Indonesian debt. "With the central bank having steadily accumulated FX reserves (now US$130bn, equivalent to 14% of GDP) and having resisted currency appreciation amid a sharp bounce in Indonesia's terms of trade over the last 24 months, we feel the strong global growth and favourable commodity price environment (palm oil, coal, and petroleum gas are the country's main exports) suggests the downside for the rupiah should be relatively limited. This enables us to own the long end of the Indonesian local curve on an unhedged basis."

## PART 2: THE BAD

***While not "bad" per se, Bulgarian government bonds certainly seem overpriced, says Shepherd.***

On the flipside of the coin, Shepherd highlights short-dated Bulgarian debt, which, he says, is trading at unrealistic levels. Yields on Bulgarian EUR-denominated 2022 bonds, for example, have fallen to zero and even into negative territory. Shepherd notes that while the Bulgarian government does have a low level of debt, it also continually falls foul of EU transparency standards. This doesn't mean a default is likely any time soon (the bonds are rated investment grade, after all) but he does expect transparency issues to prevent the economy from realising its true potential and from maintaining its rate of convergence with the rest of Europe. He concludes: "I don't really feel it's an issuer I should be paying for the privilege of lending to."

FIGURE 4: BULGARIAN 2022 €-DENOMINATED DEBT: SPREAD OVER BUND 2 2022 BONDS




Source: Bloomberg, 15 January 2018.

## PART 3: THE UGLY

### Argentina

***Yields on both Ukrainian and Argentinian debt illustrate the current disconnect between investor appetite and an appreciation of risk, according to Shepherd.***

EM issuance had a banner year in 2017, with a record US$670bn raised for the 12 months to December[2]. But for Shepherd, both current pricing and levels of oversubscription for new issues suggest there may be trouble ahead.

A case in point, he says, is Argentina's 100-year bond issue in June, which was 3.5 times oversubscribed – a remarkable achievement given the country's record on defaults. "For me this demonstrates a simple fact: that several areas of the hard currency markets have now become completely dislocated from the reality of the issuer's ability to pay."

The yield on US$-denominated 2021 Argentinian bonds is similarly telling, says Shepherd. Here the mid-point spread over US Treasuries is only just above 200 basis points despite the bond's maturity occurring well into the second term of Argentina's President, Mauricio Macri. "Our view is that Macri would have to win the next election to justify these spreads and in the context of Argentinian politics, nothing can be called a certainty," says Shepherd. "Coupled with domestic inflation of around 28% and the kind of weak fundamentals you'd expect from a single B issuer, we think this makes current spreads on Argentinian debt unrealistic within the context of their ability to service the debt."

[2] Reuters: 'Emerging market dealmaking fees set record US$200m', 20 December, 2017

FIGURE 5: ARGENTINIAN 2021 US$-DENOMINATED DEBT: SPREAD OVER US T2 2021 BILLS

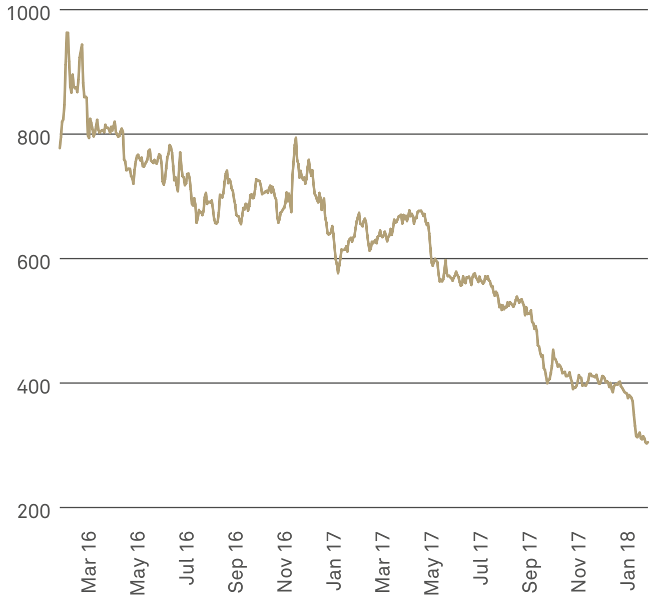

Source: Bloomberg, 16 January 2018. For illustrative purposes only.

## Ukraine

Ukrainian debt is another area the Newton bond team is avoiding. Here, Shepherd notes how current spreads over Treasuries on US dollar-denominated Ukrainian government bonds are in the 300-400bps range. Much of the current demand, he says, is from investors wary of Venezuelan debt where recovery rates are now "nigh on impossible to work out". Since the Ukraine is one of the next traditionally high yielders (along with Argentina), the result is an influx of money and spreads that have become "unjustifiably compressed", in Shepherd's view.

He adds: "These inflows are despite the Ukraine being in danger of losing funding from the IMF, the EU and the US due to scant progress on curbing corruption and the chokehold oligarchs retain on domestic politics and the economy."

FIGURE 6: UKRAINE 2022 US$-DENOMINATED DEBT: SPREAD OVER US T2 2022 BILLS




Source: Bloomberg, 16 January 2018.