Fixed Income Weekly

FOR PROFESSIONAL INVESTORS

Don't buy the index: EM debt is more alpha-rich than at any time in the past four years

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October 23, 2017

Key takeaways

- The index yield (JPMorgan Government Bond Index Emerging Markets) is currently at its lowest since the 'taper tantrum'
- Rich valuations in other asset classes have attracted flows into EM fixed income and, according to JPMorgan, cumulative inflows into the asset class totaled USD 77.1 billion by September and are forecast to exceed USD 110 billion by the end of the year
- Global growth is expected to remain supportive with Latin America forecasting the largest year-on-year increase in GDP growth in 2018

Full commentary

Despite heightened geopolitical uncertainty and a 50 basis points increase in the US fed funds rate this year, emerging market local currency bond yields have declined by 80 basis points and outperformed the benchmark 10-year US Treasury bond by 60 basis points. In fact, the index yield (JPMorgan Government Bond Index- Emerging Markets (GBI-EM)) is currently at its lowest since the 'taper tantrum'. How did we get here and will it continue? Several factors have contributed to this year's outperformance:

1. Favorable index composition

The key theme in EM local currency bonds this year has been dispersion. This is a story of two different EMs currently unfolding: declining inflation in high-yielding countries coexists with rising or bottoming inflation in low-yielding countries. Declining inflation has allowed central banks to cut interest rates from very high levels. These countries account for just over 50% of the GBI-EM Index, while countries where policy rates have risen account for 22%. So in the index, the high-yielding rate cutters dominate. In addition, policy rate increases in Mexico, Argentina and Turkey (with a combined 18.7% weight) were perceived in the financial markets as having increased central bank credibility, resulting in a rally in the medium to longer-term segments of the local yield curves for most of the year. Regionally, the decline in yields has been driven by Latin America and emerging Europe (see Figure 1).

2. Supportive global factors

The global macroeconomic environment has been supportive of EM bonds. Global growth has been revised up during the year (although the most recent revisions were downward) and leading indicators point to continued strong momentum. Meanwhile, inflation has been surprising on the downside. In addition, trade volumes and prices have risen this year, which, historically, have a multiplier effect on EM growth and a positive impact on their currencies through the terms of trade. Furthermore, rich valuations in other asset classes have attracted flows into EM fixed income. According to JPMorgan, cumulative inflows into the asset class totaled USD 77.1 billion by September and were forecast to exceed USD 110 billion by the end of the year. That level would surpass the record of USD 103 billion in 2012. Flows have been driven by both traditional EM debt investors as well as crossover investors (see Figure 2).

Outlook for 2018

Unlike 2017, we foresee a less clear-cut macroeconomic theme for 2018. Alpha generation and country-level dispersion will likely prove much stronger themes. Most of the EM countries cutting interest rates are at the tail end of their monetary cycles, but further policy easing is still expected in Russia, Brazil and, potentially, Colombia. South Africa has only just begun cutting rates. Mexico and Turkey are the only countries which will likely have sharply declining inflation next year, but the extent of monetary easing there can be expected to depend on geopolitics and inflation. In addition, some countries could be raising policy rates next year, such as the Czech Republic and Romania, but these are small index components and monetary policy tightening there is already expected.

In our view, the bottom-line is that the strong tailwinds that drove EM yields markedly lower this year are likely to be less pronounced in the near term, although on the whole, yields can continue to grind lower. We expect EM yields to become more sensitive to idiosyncratic factors. Investors are also more likely to maximize interest income if capital appreciation opportunities are no longer as obvious.

Last week's market developments

Monday, October 16

- No data to report

Tuesday, October 17

- UK Consumer Price Index decreased to 0.3% m.o.m. for September
- UK PPI manufactured products output decreased to 0.2% m.o.m. n.s.a. for September
- Eurozone Consumer Price Index increased to 0.4% m.o.m. for September
- US industrial production growth increased to 0.3% m.o.m. for September

Wednesday, October 18

- UK ILO unemployment rate remained at 4.3% s.a. for August
- US housing starts decreased to 1,127,000 for September

Thursday, October 19

- Japan All Industry Activity Index remained at 0.1% m.o.m. s.a. for August
- US Philadelphia Fed Business Outlook Index increased to 27.9 for October
- US Conference Board Leading Index decreased to -0.2% m.o.m. for September

Friday, October 20

- US existing home sales increased to 5.39 million for September s.a.a.r.

Source: Bloomberg, data as of October 23, 2017

Global factors

The growth environment should remain supportive, with Latin America forecast to see the largest year-on-year increase in GDP growth in 2018. The EM inflation outlook is also benign with inflation remaining within the target range for most countries at the end of next year. This may look like a continuation of the environment we saw in 2017, but there are two key differences that investors should take into account in 2018.

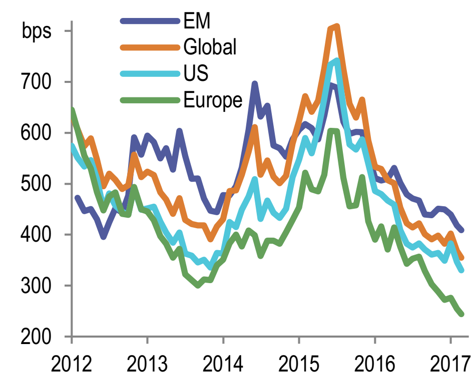
The first concerns the efforts by the G4 central bank to shrink their balance sheets, which can be expected to take effect towards the middle of the year. Historical data suggests that much of the flows in and out of EM bonds can be explained by global liquidity conditions in general and central bank balance sheet changes in particular. The second is global inflation, and particularly US inflation. This has been a key pillar of the benign environment despite the various interest-rate rises by the US Federal Reserve. Any sign that a strong US labor market and increased wage growth are spilling over into higher underlying inflation would lead to a reassessment of the framework that markets have become accustomed to over the past several years.

Charts of the Week

Figure 1. GBI-EM constituent statistics & Figure 2. Global high yield index spreads

GBI-EM	Weights (%)	Index Yield (%)	Index Duration (yrs)	Current Policy Rate (%)	Monetary Policy Cycle 2017
Indonesia	9.6	6.82	6.31	4.25	-50
Malaysia	5.8	3.88	4.82	3.00	0
Philippines	0.3	4.84	6.98	3.00	0
Thailand	7.7	2.23	5.92	1.50	0
Czech	3.7	0.86	5.38	0.25	+20
Hungary*	4.6	1.53	4.29	0.90	0
Poland	8.8	2.79	4.29	1.50	0
Romania	3.1	3.05	3.6	1.75	0
Russia	7.4	7.52	4.81	8.50	-150
Turkey**	7.6	10.94	3.48	11.96	+368
South Africa	8.1	9.3	7.17	6.75	-25
Argentina	1.1	14.91	3.7	26.25	+150
Brazil	10	8.62	3	8.25	-550
Chile	2	4.54	6.89	2.50	-100
Colombia	7.2	6.31	4.92	5.25	-225
Mexico	10	7.02	5.45	7.00	+125
Peru	2.7	5.37	7.85	3.50	-75
Uruguay	0.3	7.86	5.13	9.25	0
% cutting or easing					51.6
% hiking or tightening					22.4

Sources: Data as at 12 October 2017. Sources: J.P. Morgan, BNP Paribas Asset Management.



Sources: Data as at 23 Oct 2017 Sources: Bank of America Merrill Lynch, J.P. Morgan, Barclays, BNP Paribas Asset Management.

Central Bank Watch

	Last move	Date of move	Current policy rate	Implied 3-Month Rate on December 2017 Interest Rate Futures Contract	Next meeting
Fed	+25 basis points	June 14, 2017	1.00% - 1.25%	1.27%	November 1
ECB	-5 basis points	March 10, 2016	0.00%	-0.18%	October 26
BoJ	-20 basis points	February 16, 2016	-0.10% - 0.00%	0.07%	October 31
BoE	-25 basis points	August 4, 2016	0.25%	0.53%	November 2

Source: Bloomberg; data as of October 23, 2017

This week's market developments

Monday, October 23
- No data to report

Tuesday, October 24
- France Manufacturing PMI Index is expected to decrease to 56 s.a. for October
- Germany Manufacturing PMI Index is expected to decrease to 60 s.a. for October
- Eurozone Manufacturing PMI Index is expected to decrease to 57.8 s.a. for October
- US Manufacturing PMI Index is expected to increase to 53.5 s.a. for October

Wednesday, October 25
- Pan Germany Business Climate Index is expected to decrease to 115.1 for October
- UK GDP is expected to remain at 0.3% q.o.q. for September
- US Durable Goods New Orders Index is expected to decrease to 1.0% m.o.m. for September

Thursday, October 26
- US wholesalers inventories are expected to decrease to 0.4% m.o.m. for September
- US initial jobless claims are expected to increase to 235k s.a. for October
- US Conference Board Leading Index is expected to decrease to 0.1% m.o.m. for September

Friday, October 27
- US GDP is expected to decrease to 2.5% s.a.a.r. for September
- University of Michigan Consumer Sentiment Index is expected to decrease to 100.7 m.o.m. for October

Source: Bloomberg, data as of October 23, 2017

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