Investment Strategy Note

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Emerging market bonds: better to remain selective

- **We remain selectively overweight on emerging market bonds**
- **So far our selective overweight favoured non-commodity exporting economies since – as a general rule – they are less vulnerable to the stronger US dollar and higher US yields**
- **Russia stands out as an exception to this rule given its strong debt position, adequate reserve coverage and better fiscal prospects in the light of higher oil prices**
- **As for the overall asset class, recent spread tightening has been excessive, but hard currency paper can remain resilient as long as US dollar strength remains constrained**

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An increasingly challenging environment, Russia stands out

The Trump presidency is full of questions marks, specifically when it comes to the country's future trade relations with the rest of the world. Yet for all the uncertainties, high reflation expectations have already determined a significant pick-up in yields and the US dollar.

Weaker emerging currencies combined with anti-China and anti-Mexico rhetoric inevitably lead to a correction of bond prices in the immediate aftermath of the Trump election. This correction reversed quickly, however, with spreads tightening again to pre-election levels.

Such tightening stands in contrast with macro-fundamentals and – at least at the level of the general asset class - some pull-back seems inevitable as a consolidation of higher US yields will highlight the reduced attraction of emerging debt. At the same time the stronger greenback will raise the refinancing costs of emerging market governments and companies.

We remain selectively overweight on emerging markets as we still see pockets of opportunities – economies with relatively sound fundamentals - within the EM bond space. When screening for outliers in a generally difficult environment, ***Russia stands out with relatively low debt levels and a decent external position.*** With its heavy reliance on oil revenues, the country stands to benefit from stable oil prices.

Below you find a short list of Russian US dollar bonds. These bonds have not been selected based on any micro or company (issuer) analysis, but solely screened on the basis of quantitative criteria, such as maturity (4-6 years), minimum issue size of 1 billion, and S&P rating not inferior to the sovereign (BB+).

ISIN number	Bloomberg ticker	Coupon	Maturity
XS0830192711	SIBNEF	4.375%	9/22
XS0805570354	GAZPRU	4.95%	7/22
XS0767472458	Russia	4.5%	4/22

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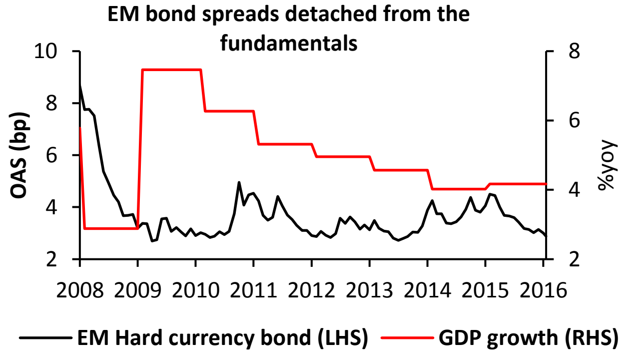
Emerging market bonds remain very resilient

Following an initial knee-jerk reaction after the Trump election, emerging market hard currency sovereign and corporate bonds have been remarkably resilient in the face of the recent correction in emerging currencies.

Trump is no Taper Tantrum		
	May-Sep 2013	Since Nov 8 2016
10 year US Treasuries	-1.4%	-0.6%
Emerging Currencies*	-5.0%	-0.7%
Emerging Bonds**	-8.0%	-1.0%

*MSCI Emerging Market Currency Index
** Bloomberg Barclays Hard Currency Bond Index
Source: Bloomberg

In the context of a lower growth scenario, the risk of increasing global protectionism, and a more hawkish Fed (which will significantly reduce emerging markets' central banks capacity to enact monetary stimulus), such resilience seems optimistic.

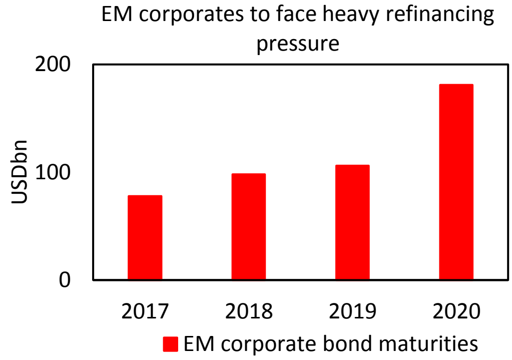


Source: Bloomberg

Heavy refinancing risk won't make it easier

According to Bank of International settlements data, dollar denominated credit to EM non-bank borrowers almost doubled to USD3.3trn from the beginning of US quantitative easing programme in end 2008 till June 2016. Over USD400bln worth of debt is scheduled to mature over the next four years.

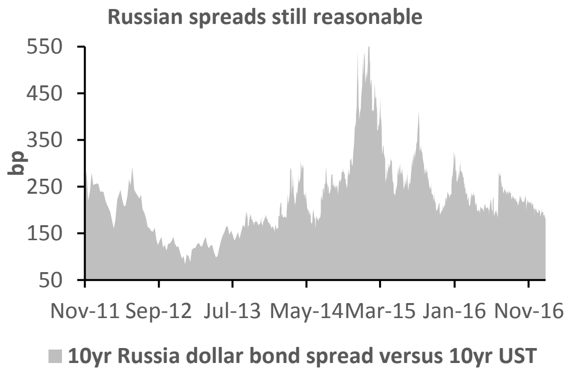
It is clear that the general asset class is likely to face some pullback.



Source: Bloomberg

Attractive valuations in Russia bonds

Whilst Russian bonds staged an excellent performance 2016, their valuation is not out of touch with fundamentals. Growth seem to have bottomed, whilst inflation has peaked allowing the central bank to cut rates in spite of the strong US dollar. This should keep spreads stable or allow for further reduction.



Source: Bloomberg

Decent external position and higher oil price provide major guarantees

Where Russia really stands out is in its solid public finances with a public debt as low as 9% of GDP and a manageable external debt at 40% of GDP. At more than three times the size of short-term external debt and 3-month imports combined, the reserve adequacy is also quite healthy and among the highest in emerging markets. Stable oil should help in bringing the fiscal deficit from close to 4% to less than 2% of GDP.

Thus, whilst the overall emerging bond space seems rather well priced, Russia's bond yields seem sustainable for the coming years.

Sources

All information in this report has been obtained from the following sources except where indicated otherwise:

1. *Bloomberg*
2. *Wall Street Journal*
3. *RTTNews*
4. *Reuters*
5. *Gulfbase*
6. *Zawya*

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