Profiting from the panic in emerging markets

Rashaad Tayob

Manager of the Nedgroup Investments Flexible Income Fund

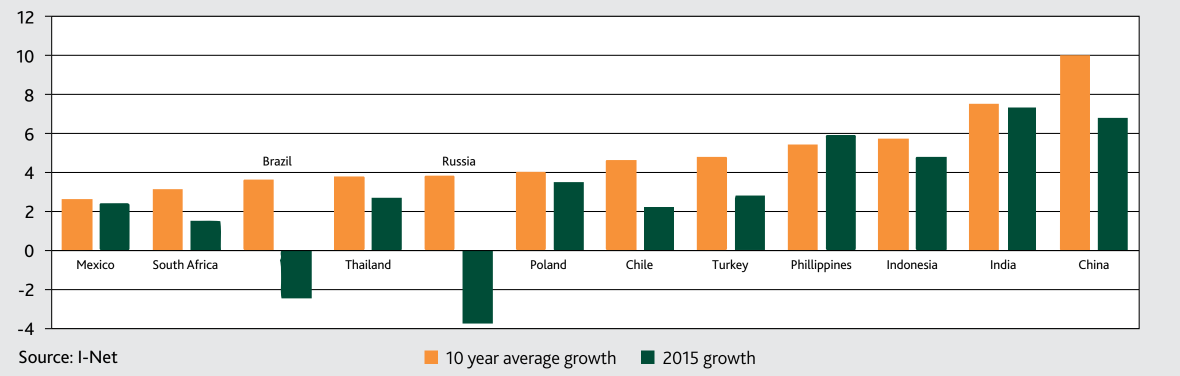
Panic has enveloped emerging markets as investors have lost faith in the growth story. Emerging market fundamentals have deteriorated across the board. Growth has slowed while debt levels have increased rapidly. This toxic combination has left investors nursing large losses and has forced them to question the rationale for emerging market investments.

Emerging markets have the potential to be an attractive investment destination. They have the potential to grow much faster than first world countries as they start at a much lower base of development. However, this potential growth has to be converted into actual growth through intelligent stewardship of the economy. In recent years emerging market countries, including South Africa, have failed to produce an economic and political environment conducive to growth.

Globally, there continues to be large amounts of capital chasing opportunities for growth, especially since growth and returns in developed markets is quite muted. If emerging markets can rebalance their economies and deliver structural reforms which are positive for growth, then they will continue to attract the massive investment flows which have been the norm for the last two decades. However, investors have been badly burned in recent years and the capitulation will intensify if the mismanagement of emerging market economies continues.

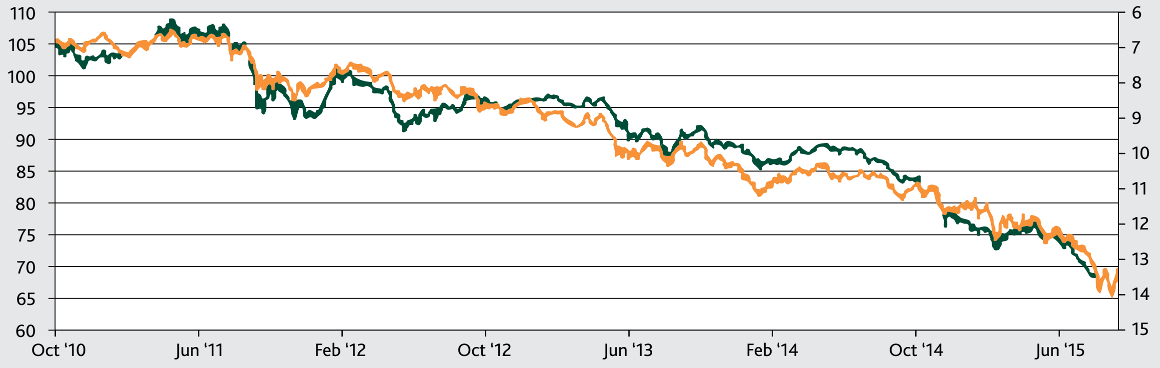
The chart below shows the growth performance of a range of emerging markets versus the 10-year average. Growth rates have slowed across the emerging market universe and with it the relative attractiveness of emerging market investments. South Africa, Brazil, Russia and Turkey stand out as countries suffering a severe slowdown relative to recent history.

Emerging market growth is slowing



Source: I-Net

Emerging market currency losses



Source: I-Net

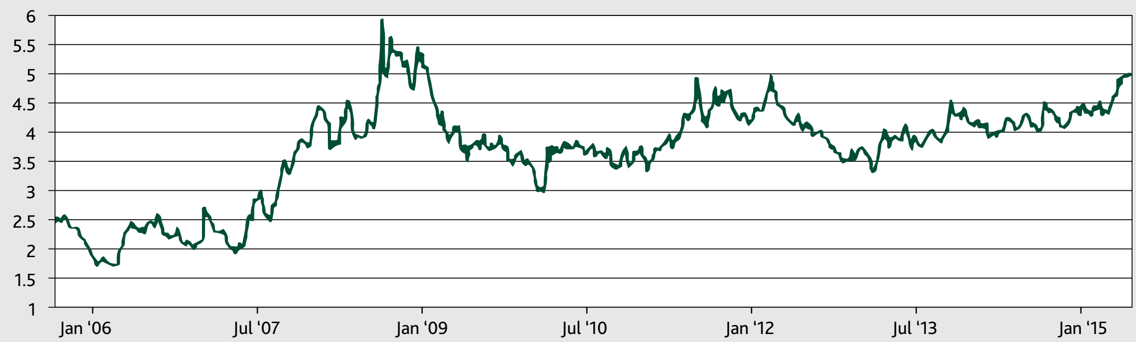
Fears of an interest rate hiking cycle in the United States precipitated a massive outflow from emerging markets in the third quarter of 2015. Investors withdrew $40 billion for the three-month period with $21 billion from debt markets and $19bn from equities. This high level of withdrawals has not been seen since the financial crisis in 2008. The International Institute of Finance recently reported that net capital flows to emerging markets in 2015 will be **negative** for the first time since **1988**. This is a dramatic reversal of a long-term trend and it is not surprising that emerging market currencies came under severe pressure. *The chart above* shows the performance of the rand and the JP Morgan Emerging Market Currency Index. For the last five years investors have suffered consistent losses on their emerging market currency positions. This has been a severe detractor to investor returns as the gains in equities and bonds have generally not been sufficient to offset the currency depreciation.

Bond yields have also risen as global investors have not been willing to chase yields pickup aggressively as they continue to lose capital through currency depreciation. Emerging market bond yields relative to DM has risen towards the panic levels of the financial crisis of 2008. If investors continued to experience capital loss on the currency movements, then their required yield to hold emerging market currencies will continue to increase.

While emerging market fundamentals remain poor, the negative sentiment has at times become extreme. However, these market moves have the potential to create opportunities. In the Nedgroup Investments Flexible Income Fund we have utilised the negative patches of emerging market sentiment to add performance to the fund in a number of ways:

- **Offshore currency exposure**
  The fund has benefited from having an offshore currency exposure as the rand has experienced a consistent depreciation in recent years. We have tactically increased the currency exposure towards 7% when the rand experiences a strong recovery and reduced exposure below 4% when the rand is oversold. The currency exposure has also proved to be an excellent hedge during risk-off environments. While the rand is cheap on a valuation basis, there does not appear to be any catalyst for a sustained recovery. Growth remains muted, real interest rates are low and the current account deficit remains wide. While these conditions remain, we are likely to maintain an offshore currency exposure and manage it tactically as the market moves.

Emerging markets bond index yield minus US Treasury yield



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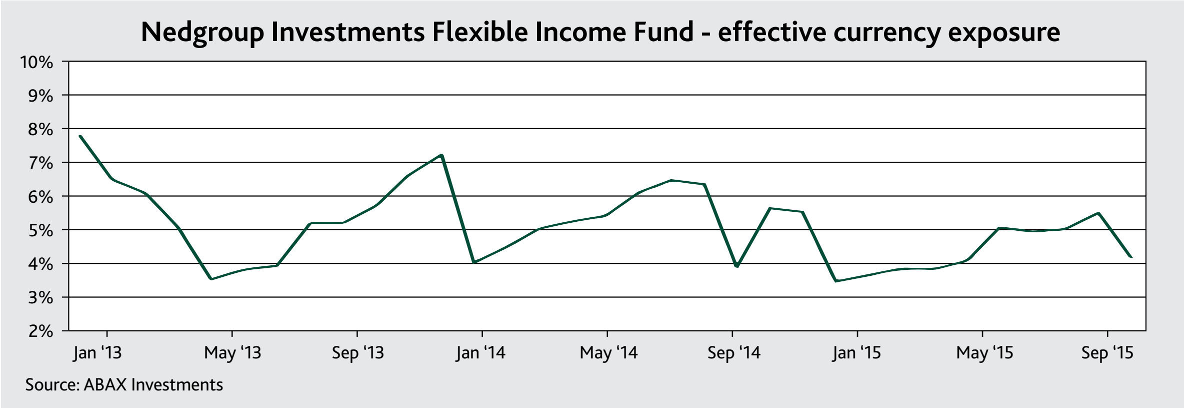

- **Low bond exposure**
  Since the Fed taper in 2013, the South African bond market has been volatile. Muted economic growth and rising debt levels have resulted in credit rating downgrades and a reassessment of South Africa's risk. Yields at the long end have repriced upwards and long bonds have suffered losses. In recent years, we have maintained a low level of bond and interest rate exposure. The fund has therefore not suffered any drawdowns during the bond market sell-offs that materialised in recent years. We remain cautiously positioned in the bond space as fundamentals continue to deteriorate.

- **Offshore yield pickup**
  During the emerging market panic episodes, offshore emerging market debt can sell-off quite significantly. For example the five-year credit spread for South Africa increased from 1,5% at the end of 2014 to over 3% at the end of September 2015. A five-year credit spread this high, is unwarranted given the fundamentals and is more reflective of flows, and extreme negative sentiment. The elevated country credit spread has a knock-on impact on South African-related state-owned enterprises and corporate issues.

  We have added exposure to South Africa Credit, as well as corporates such as Naspers, Old Mutual, Impala, FirstRand, Eskom and Transnet. By investing in offshore bonds we have achieved yield pickups twice as large as what the domestic market offers. We have limited risk by investing in shorter term bonds with a weighted average term of 2,5 years. The ability to actively manage offshore bond exposure has enabled us to add significant value to the fund through yield pickup and capital gains.

The deterioration in the growth outlook for emerging markets has disappointed investors. Key markets like Brazil, Russia, Turkey and South Africa have experienced a significant deterioration in political and economic fundamentals. However, periods of extreme negative sentiment have created opportunities to add value at low risk. We will continue to manage the Nedgroup Investment Flexible Income Fund cautiously in this environment and take advantage of opportunities to add value as it appears.